PRI CAPITAL *ideas*
Volume 2, No. 9

AUGUST 2016

Reforming California's Pension System

KERRY JACKSON

California governments owe their current and future retirees maybe as much as $600 billion. But the governments aren't going to pay. Taxpayers will be handed the bill, and in some cities, each household is on the hook for more than $50,000. In at least one municipality, the household share of the liability exceeds that city's median household income.

Not every city is in as much trouble as Irwindale, though, where each household's share of the combined pension debt is $134,907, according to Stanford University's pension tracker, and the median household income is only about $62,000 a year. But few in California should rest easy – the unfunded pension problem threatens almost every wallet in the state.

Through the decades, California governments have promised their workers they would retire with lavish pensions through defined-benefit plans guaranteeing set incomes. To say this arrangement is generous understates the facts. The California Public Policy Center looked at the data and found that in 2012, two "public servants" were collecting more than $500,000 a year in pensions while 443 were raking in more than $200,000 a year. Mark Bucher, the center's CEO, said two years ago that more than 30,000 across the state belong to the "$100,000 pension club."

But the system doesn't work well for the rest of us, who have to fund the retirees' benefits with our tax dollars and will also suffer through the economic crunch that paying off these liabilities will inevitably cause.

The root of the problem – outside of elected officials eagerly using other people's money to meet the demands of public employee unions, which return the favor in the form of votes and other political support – is the cold fact that governments have not set aside enough funds to pay the platinum retirements they agreed to provide. For example, "California contributed $11.3 billion toward its state-run pension systems in 2013, $4.9 billion below" the level necessary to meet its obligations, Pacific Research Institute fellow Wayne Winegarden wrote in California's Pension Crowd-out, published earlier this year.

Covering the debt burden exclusively through tax increases would require the largest tax increase in California's history – an annual $28.3 billion net tax increase over the next 30 years, A lack of funding from governments isn't the only problem. Pension systems can help finance themselves through investments. Last month, the California Public Employees' Retirement System, better known as CalPERS, the largest public pension fund in the country, reported that its investment returns for the fiscal year that ended June 30 were a mere 0.61 percent. Compare this to the S&P 500 index, which posted returns of 5.61 percent over the last 12 months. The end of CalPERS fiscal year is also the 20th in a row that the system, which represents 1.6 million government workers, retirees and their families, has failed to meet its expected 7.5 percent rate of return.

CalPERS' poor returns, which still won't hit the expected mark for another decade, says its investment consultant, aren't due to bad luck. They've been caused by the "socially responsible" – meaning politically correct, pleasing to the political left – investments CalPERS has made. Of course those choosing the reckless investments won't be held responsible. They'll be bailed out by the taxpayers.

Some estimate California's public pension hole is about $170 billion, which is 125 percent of the total state tax revenues. But Winegarden says the figure could be as high as $600 billion when risk is accounted for. Whatever the case, the economic costs of building up such unfunded liabilities are likely to be high.
"Covering the debt burden exclusively through tax increases would require the largest tax increase in California's history – an annual $28.3 billion net tax increase over the next 30 years," Winegarden wrote in his report.

That would be, by any definition, a disaster, as it will shrink California's economy by 21 percent over the next 30 years, says Winegarden.

How do we avoid this? Winegarden suggests repealing the "California Rule," which essentially says that, once hired, a public employee's pension benefits can never be rendered less generous. He believes repeal will likely require a constitutional amendment, but the effort would be worth it.

Winegarden also proposes freezing defined-benefit programs for current workers, and offering them the choice between "receiving a payment equal to the present value of their benefits" or staying "in a reformed defined-benefit program that would include, among other adjustments, appropriate policies to accommodate market risk."

The third leg of his solution is to offer new and current employees retirement plans funded by set, or defined, contributions. This is how pensions are amassed in the private sector, so it's not too much to ask public employees earn their retirements the same way.

Sacramento won't enter this new world easily. But if it doesn't go there, the old world is going to start crumbling fast.