

Governor Schwarzenegger's Proposed Change to the Retirement System: Real Reform or Another Broken Promise?

Governor Schwarzenegger is gathering signatures for a possible special election later this year so he can take his case of government reform to the people. The estimated cost of the election is \$70 million. Currently there are 53 initiatives circulating and 18 awaiting review for the special election. The projected cost to Alameda County is \$3 Million, which the county would have to absorb. Mr. Schwarzenegger claims that his proposals to change the public retirement system, take redistricting out of the hands of the legislature, change the payment formula for teachers and give him greater control over the budget is the way to address excessive spending and address issues the legislature refuses to tackle. In this column over the next few months I will give my analysis/rebuttal to the Governor's proposals. In this issue I will look at the proposed changes to the retirement system.

The current retirement system for the public employees is called a Defined Benefit Plan. In this system an employee receives a pension based on years of service, salary at the time of retirement, and age at the time of retirement. The benefit is an annuity that the retired person receives until death. Under this program public safety employees have a formula which provides them a higher rate of pay at the time of retirement due to the life threatening risks associated with their jobs. The plan has three basic funding streams, the employer's contribution, the employee's contribution (which is capped), and the return on investments made by the manager of the program.

As Chair of the Alameda County Retirement Association (ACERA) my colleagues and I look at the retirement revenues constantly to see if there is enough money to cover the cost of current retirees, and projected new retirees. If there is not enough money to cover these costs, it is the employer (in this case the State or local government) is required to make up the difference; this is referred to as an unfunded liability. Critics of the current system say that the volatility and uncertainty of the State contributions to the retirement fund as a result of the unfunded liability is crippling to the entire budget process. The formula and essentially the benefits are locked in, at the time someone becomes a public employee and therefore critics add the State (your tax dollars) is absorbing all of risks related to unfunded liabilities.

The Governor is proposing a Defined Contribution plan to replace the current system. As currently proposed, the State and the employee would put a percentage of the employee's salary into a retirement account. When the employee retires, whatever is in the accounts (contributions from the employer, employee, and the investment returns) goes to the employee. In addition, under this plan the employee can control their own investments.

It is easy to see how the public might gravitate toward the Defined Contribution Plan which will take the State off the hook for covering the cost of the unfunded liability. In addition, there is the freedom to invest your money how you want; which has a **feeling** of American individuality.

If the Governor's proposal sounds too good to be true, it is! Let's look at the things the Governor is not telling us. Some estimate the cost of changing the retirement system is estimated to be \$500 Billion dollars. This is the cost of meeting the unfunded mandate due to new State employees not paying into the Defined Benefit Plan. To put it into perspective the Legislative Analyst Office (LAO) projects the FY 05/06 shortfall is about \$8.6 Billion dollars. In addition, the LAO says "Once fully phased in for all public sector employees after several decades, these savings in annual retirement costs could potentially be in the hundreds of millions of dollars or over \$1 Billion annually." The proposed cost savings over time is relatively small and we would not see any savings for years to come. Furthermore, staff for ACERA informed the ACERA Board that the County's contribution to employee's retirement may increase by 3.5%, under the Governor's proposal. It should be noted that ACERA has not done a full analysis of the cost to Alameda County.

Proponents of the change also say that the private companies do not offer Defined Benefit Plans. A 2002 Watson Wyatt survey stated, 1/2 of the Fortune 100 companies offer a Defined Benefit Plan as their primary retirement package.

So what is the benefit of the Defined Contribution Plan? Essentially the risk of the unfunded liability is removed from the State, and the employee now has the responsibility of insuring that his or her retirement package is adequate. I can understand how some may see that as fair. In looking at that issue it is important to consider a few things. Those who have access to the best financial investment information will have the best performing portfolios, I doubt that will be the rank and file public employees. Furthermore, the returns on individual investment accounts are not projected to be as strong as the investment returns in the Defined Benefit Plan.

My final point is a philosophical one. Many public sector employees have the ability to make more money in the private sector. One of the attractions of a public sector job is the set retirement package, which will provide you with adequate funds to cover the cost of your retirement; that is the promise of public sector employment. The Defined Contribution Plan breaks that promise.