



California State Teachers'
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March 8, 2011

Mr. Daniel W. Hancock
Chair, Little Hoover Commission
925 L Street, Suite 805
Sacramento, CA 95814

Dear Mr. Hancock:

We have had an opportunity to review the report issued by the Little Hoover Commission entitled *Public Pensions for Retirement Security*, and our conclusion is that implementing the recommendations made in the report – even if it were possible to do – would likely weaken, rather than strengthen, retirement security for California's public educators. In fact, in some circumstances, the Commission's recommendations could increase the total cost of providing retirement benefits.

The report makes many of the same misdiagnoses others have made of the cause of the financial problems faced by public pensions. These misdiagnoses lead to impractical recommendations, which may reduce the liabilities incurred by public pension plans, but do so at the expense of the retirement security of school educators and at increased cost to school employers. A fuller and more accurate understanding of the causes can point to remedies which not only reduce liabilities, but do so without jeopardizing the security of public employee pensions.

California is at a critical crossroads in its debate about pensions. Given the importance of this issue to literally millions of Californians, it is time to move past the political rhetoric and focus on solutions that are truly responsive to the problems. Not only are there substantive legal weaknesses in the report, but it fails to convey the underlying drivers of this financial dilemma. The report opens with the assumption that underfunding is due primarily to "overly generous benefit promises, wishful thinking and an unwillingness to plan prudently," a premise that fails to reflect any recognition of the financial market's collapse and its underlying causes. I respectfully refer the Commission to the recently released report of the Financial Crisis Inquiry Commission that thoughtfully documents the market's downfall.

The credibility of the report also suffers from broad generalizations that do not hold up when applied to specific plans. The CalSTRS benefit structure, on a comparative basis, is not "overly generous", but rather provides a moderate benefit that replaces approximately 60 percent of pre-retirement income for educators – educators who receive no Social Security benefits for their decades of service.

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Although there are a number of misleading statements, I want to highlight our concerns surrounding two significant recommendations:

Reducing future accruals of benefits for current employees

The most controversial and, in our view, ultimately the most meaningless recommendation is that the Legislature should explicitly authorize the reduction of future unaccrued retirement benefits for current public employees. In support of that recommendation, the report acknowledges on one hand that those promised benefits are protected by “decades of case decisions that treat pensions as contracts,” then on the other hand, asserts that the case law is “sufficiently murky as to demand further exploration” and that “legal interpretations are likely to continue evolving in order to reflect changing economic conditions.” However, the report cites no case in California in which a court has held that pension benefits payable to existing employees, even for future service, could be reduced without being accompanied by comparable new advantages.

The report also refers to federal law allowing private employers to freeze accrued pension benefits, suggesting that a similar approach could be applied to current public employees. Again, the report simply ignores layers of jurisprudence applying the U.S. and the California Constitutions protections against impairment of contract obligations to pension promises made to public employees. Private companies are not subject to the same constitutional prohibition.

California judicial decisions consistently demonstrate that public employee pensions “are a government obligation of great importance” (Carman v. Alvord (1982) 31 Cal.3d 318, 325, fn. 4) and serve as an inducement “to enter and continue in public service.” (Phillipson v. Board of Administration (1970) 3 Cal.3d. 32, 49.) The public employee’s pension “constitutes an element of compensation” and the right to the pension is contractual and “accrues upon acceptance of employment.” (Betts v. Board of Administration (1978) 21 Cal.3d 859, 863.) Once the inducement is accepted, the pension promises become “obligations which are protected by the contracts clause of the Constitution.” (Kern v. City of Long Beach (1947) 29 Cal.2d 848, 853.) Therefore, the state “may not deny or impair the contingent liability any more than it can refuse to make the salary payments which are immediately due.” (Miller v. State of California (1977) 18 Cal.3d 808, 815 [citing Kern v. City of Long Beach, *supra*, at p. 855]; see also United Firefighters of Los Angeles City v. City of Los Angeles (1989) 210 Cal.App.3d 1095 [law that capped annual cost of living increases was an unlawful impairment for employees who worked before the cap was established].)

Moreover, a public employee has a vested right “to earn a pension on terms substantially equivalent to those then offered by the employer.” (Carman, *supra*, at p. 325.) In other words, “the employee has a vested right not merely to preservation of benefits already earned pro

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rata, but also, by continuing to work until retirement eligibility, to earn the benefits or their substantial equivalent, promised during . . . prior service.” (Pasadena Police Officers Assn v. City of Pasadena (1983) 147 Cal.App.3d 695, 703.) Improvement to pension benefits during the tenure of employment also become “vested rights of the employees when conferred.” (Betts v. Board of Administration, *supra*, 21 Cal.3d 859, 867 [quoting Abbott v. City of San Diego (1958) 165 Cal.App.2d 511, 518].) It is indisputable, therefore, that a public employee has a vested right to prospectively accrue the pension benefits promised at the time of employment, as well as any subsequent improvement.

Any legislation hastily enacted based on this report’s recommendations will be subject to rigorous judicial review. Declaiming the current system’s ability to meet its future liabilities does not constitute legally sufficient grounds to impair the vested rights of current employees. In limited legal situations, the state may argue that such a change is necessary and reasonable. However, courts give little deference to a “legislative assessment of reasonableness and necessity,” because “the State’s self-interest is at stake... [and a] governmental entity can always find a use for extra money, especially when taxes do not have to be raised.” (Valdes v. Cory (1983) 139 Cal.App.3d 773, 790 [quoting United States Trust Co. v. New Jersey (1977) 431 U.S. 1, 26]; see Board of Administration v. Wilson (1997) 52 Cal.App.4th 1109 [“fiscal emergency” did not justify failing to pay required contributions to CalPERS].) Instead, the courts look to any legislative enactment impairing pension rights to determine whether (1) it serves to protect the “basic interests of society;” (2) there is an “emergency justification for the enactment”; (3) the enactment is “appropriate for the emergency;” and finally (4) any such enactment is “designed as a temporary measure [emphasis added], during which time the vested contract rights are not lost but merely deferred for a brief period, interest running during the temporary deferment.” (Valdes, *supra*, at p. 790; see also Sonoma County Organization of Public Employees v. County of Sonoma (1979) 23 Cal.3d 296 [substantial budget shortfalls in the immediate aftermath of Proposition 13 was not a valid reason to limit cost-of-living increases promised to public employees].) The only thing that would be temporary about freezing benefit accruals related to future service performed by current employees is the period of time such an action would be allowed by the courts.

The report also fails to point out that those six decades of California case law have dealt with proposed modifications of vested pension rights. California courts have looked to such adjustments and explained that vested pension rights may be amended on a limited basis to the disadvantage of current employees, but only if that change is accompanied by “comparable new advantages” to the employees affected by the change. (International Assn. of Firefighters v. City of San Diego (1983) 34 Cal.3d 292, 300-301.) “However, there is a strict limitation on the conditions which may modify the pension system in effect during employment.” (Betts v. Board of Administration, *supra*, 21 Cal.3d 859, 864.) The adjustment must have a “material relation to the theory of a pension system and its successful operation.” While the courts have recognized that “changes made to effect economies and save the employer money do ‘bear some material relation to the theory of a pension system and its successful operation,’” such a reason by itself is not “sufficient justification for change.”

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(Claypool v. Wilson (1992) 4 Cal.App.4th 646, 666.) The type of adjustment suggested by the report's recommendation would be scrutinized first to see what has been taken from and provided to the affected employees. "The comparative analysis of disadvantages and compensating advantages must focus on the particular employee whose own vested pension rights are involved." (Betts v. Board of Administration, *supra*, 21 Cal.3d 859, 864.) "[T]he offsetting improvement must also 'relate generally to the benefit that has been diminished.'" (*Id.* at pp. 864-865 [quoting Frank v. Board of Administration (1976) 56 Cal.App.3d 236, 244].)

The implementation of the Commission's recommendations would require a complete reversal of decades of judicial rulings. Making such a broad recommendation without consideration of the detailed legal framework surrounding public employee pensions is naïve at best, and renders the recommendation superficial and meaningless. In fact, the recommendation is merely an invitation to litigation that will prove protracted, costly and likely ultimately fruitless for the state.

Integrating retirement benefits with Social Security

The report also recommends that public employers explore options for coordinating pension benefits with Social Security. In case Social Security should ever be mandatory for public employees, such as California teachers who are currently not participating in the program, we agree that it is prudent to give some thought as to how their pension would be coordinated with Social Security, and measuring the likely effects on California educators, their employers and the state. However, to suggest that "integrating Social Security may become more advantageous as employee and employer contribution rates continue to increase at levels higher than Social Security taxes" ignores reality. In other words, to repeat a phrase used in the report, the math doesn't work.

CalSTRS has analyzed the implications of mandatory Social Security on our members and employers. We found that, if CalSTRS benefits were reduced to offset the benefit a member would earn from Social Security, the total cost of this coordinated benefit structure would be \$1.8 billion more each year to the member and employer. This is because, for a given level of contribution, CalSTRS pays a higher benefit than does Social Security. If the objective were to maintain total contributions and payroll taxes of a coordinated plan to the amount of contributions paid to CalSTRS, the average total benefit, including Social Security, paid to a CalSTRS member would be 33 percent lower than the benefit currently paid by CalSTRS alone. By shifting a portion of the retirement benefit to Social Security, either the retirement security of CalSTRS members would be undermined, or they and their employers would face substantial increases in the costs of funding that retirement.

The Teachers' Retirement Board agrees that improvements need to be made in the financial integrity of benefit programs offered by CalSTRS, and it has evaluated dozens of financial options over the last several years to address the situation. We welcome the opportunity to

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work with stakeholders and legislators to address the funding situation in a manner that respects the budget situation facing the state and schools, while maintaining the financial security of educators in retirement – something which you acknowledged was appropriate at the beginning of your report. Such discussions about solutions, however, can only be successful if the facts are clear to everyone with respect to the specific retirement system being discussed, and when people are not distracted by impractical recommendations.

Sincerely,



Jack Ehnes
Chief Executive Officer

Cc: The Honorable Edmund G. Brown, Jr.
Teachers' Retirement Board
Ana Matosantos, Department of Finance