Government Finance and Operations Policy Committee
117th Annual CSAC Annual Meeting
Tuesday, November 29, 2011 — 2:30 p.m. - 4:30 p.m.
Imperial Ballroom B, Hilton Union Square, 333 O'Farrell Street
City and County of San Francisco, California

Supervisor Bruce Gibson, San Luis Obispo County, Chair
Supervisor John Moorlach, Orange County, Vice Chair

2:30 p.m. I. **Welcome and Introductions**
Supervisor Bruce Gibson, San Luis Obispo County, Chair
Supervisor John Moorlach, Orange County, Vice Chair
Supervisor Mike McGowan, Yolo County, CSAC 1st Vice President

2:35 p.m. II. **GASB Proposed Rules for Pension Accounting**
Alan Milligan, Chief Actuary, CalPERS

3:00 p.m. III. **Pension Reform Update**
Eraina Ortega, CSAC Legislative Representative

3:30 p.m. IV. **Pension Benefits: Vesting**
Eraina Ortega, CSAC Legislative Representative
Faith Conley, CSAC Senior Legislative Analyst

3:35 p.m. V. **LAO's Fiscal Outlook**
Marianne O'Malley, Managing Principal Analyst, State and Local Finance, Legislative Analyst's Office
Brian Brown, Local Government Issues, Legislative Analyst's Office

4:00 p.m. VI. **Realignment 2011: The Constitutional Amendment Explained**
Jean Kinney Hurst, CSAC Legislative Representative

4:20 p.m. VII. **Election Funding**
John Arntz, Director of Elections, San Francisco County (Invited)

4:30 p.m. VIII. **Closing Comments and Adjournment**
Supervisor Bruce Gibson, San Luis Obispo County, Chair
Supervisor John Moorlach, Orange County, Vice Chair

ATTACHMENTS

Attachment One .... Pension Reform Update
Governor Brown's 12-Point Pension Plan
Texts of Pension Reform Initiatives

Attachment Two .... Pension Benefits: Vesting
Little Hoover Commission Report: Public Pensions for Retirement Security, Executive Summary
CalPERS Report: Vested Rights of CalPERS Members
LAO Report: An Initial Response to the Governor's Proposal, Excerpt

Attachment Three .... LAO's Fiscal Outlook
The 2012-13 Budget: California's Fiscal Outlook

Attachment Four .... 2011 Realignment: The Constitutional Amendment Explained
Summary of Initiative
Text of Initiative

Attachment Five .... California's Historic Election Divestment

Attachment One

Pension Reform Update

November 14, 2011

1100 K Street
Suite 101
Sacramento
California
95814

Telephone
916.327.7500
Facsimile
916.441.5507

To: Supervisor Bruce Gibson, San Luis Obispo County, Chair
Supervisor John Moorlach, Orange County, Vice-Chair
Members, Government Finance and Operations Policy Committee

From: Eraina Ortega, Legislative Representative
Faith Conley, Senior Legislative Analyst

Re: Pension Reform Update

Recommendation: This is an informational item.

Background. At the end of the legislative session in 2011, the Legislature, in lieu of passing legislation addressing individual pension issues, convened a conference committee to consider a comprehensive pension reform package. The conference committee met at the end of October and heard testimony from employer and employee representatives about the status of pension reform negotiations. The committee is scheduled to meet again on December 1 to consider a proposal for pension reform released by Governor Brown on October 27. A final hearing of the conference committee is expected in January to finalize recommendations for legislation that could move forward in 2012. Additionally, throughout 2011 several initiatives were filed with the Attorney General. The majority of the initiatives do not appear to have the financial backing to qualify for the ballot, however it remains to be seen if the two that were most recently filed, the Government Employee Pension Reform Act of 2012 Version 1 and Version 2 will garner the support needed. The Governor's proposal and the initiatives are discussed in detail below.

Governor's Twelve Point Pension Reform Plan

On October 27, Governor Brown issued a summary of his 12-Point Pension Reform Plan. To date, neither draft legislation nor additional detail to fully explain how the proposal will be implemented has been made available. The plan includes the following:

- **Equal Sharing of Pension Costs.** All new and current employees must transition to a contribution level of at least 50 percent of the normal cost of their pension benefits.
- **Mandatory "Hybrid" Plan for New Employees.** Brown is proposing a mandatory hybrid plan, a single retirement structure designed to achieve 75 percent wage replacement upon retirement. For those local agencies participating in Social Security, the make-up of the plan would be: a one-third defined benefit component, a one-third defined contribution (to be managed professionally) component and one-third Social Security. For those local agencies not participating in Social Security, the components of the hybrid plan would be: two-thirds defined benefit and one-third defined contribution.
- **Increase in Retirement Ages.** Retirement ages for new miscellaneous public employees will be set at the Social Security retirement age (67); the Administration has not settled on a set retirement age for safety employees yet, but maintains that it will be "commensurate with the ability of those employees to perform their jobs in a way that protects public safety."

- **Definition of Final Compensation.** Final compensation for new employees will be defined as the highest average annual compensation over a three-year period and as the normal rate of base pay, excluding special bonuses, sick leave, unused vacation and unplanned overtime.
- **Employment of Retired Annuitants.** The Governor's proposal would limit all public retirees to 960 hours or 120 days of work per year for a public employer and prohibits all retired employees who serve on public boards and commissions from earning retirement benefits for that service.
- **Forfeit of Pension Benefits in Felony Convictions.** Public officials and employees, if convicted of a felony related to abuse of their official duties, in seeking an elected office or in connection with obtaining salary or pension benefits, would forfeit pension and related benefits.
- **Ban Retroactive Pension Increases.** Applying pension benefit enhancements to work already performed by current employees and retirees would be prohibited.
- **Prohibit Pension Holidays.** Employers would be prohibited from suspending employer and/or employee contributions necessary to fund the annual pension costs of the pension fund.
- **Prohibit Purchase of Service Credit.** Employees would no longer be able to purchase additional retirement service credit (also known as "airtime") for time not actually worked.
- **Restructure California Public Employees' Retirement Board of Administration.** The Governor proposes adding two independent public members with financial expertise to the CalPERS' Board and replacing the State Personnel Board representative with the Director of the California Department of Finance.
- **Retiree Health for State Employees.** Increases the vesting period for state employees to earn retiree health benefits.

Proposed Pension-Related Initiatives

Several initiatives have been proposed for the November 2012 ballot to address public pension reform; below is a summary of those proposals.

- **Raise Public Retirement Ages Act**
  Taking effect immediately upon approval of the voters, this proposal will raise the retirement age of all members of the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) to 65 years for miscellaneous employees and 58 years for public safety members.

- **End Public Sector Bargaining Act**
  This proposal would delete the authority for state, county, government officers and agents or governing bodies to recognize any labor union or other employee association as an employee bargaining agent. Such parties would be unable to enter into collective bargaining agreements or memorandums of understanding with such unions with respect to employee matters.

- **Tax Public Pensions Above $100,000 Act**
  This proposal would impose a 15 percent state income tax on any CalPERS- or CalSTRS-provided public pension amounting to between $100,000-149,000

annually. A 25-percent state income tax would be imposed on those public pensions over $150,000.

- **Costa-Matteoli Pension Solvency Act**
  The following proposal applies to all public pension systems in California and provides that:

  - Only a member's base pay can be used as the annual final compensation for the purpose of calculating retirement benefits (cannot include bonuses, overtime, vacation, sick leave, medical benefits or uniform allowances); if a court or regulatory agency mandates the inclusion of such, the public agency cannot fund that benefit until the pension's trust fund becomes solvent.
  - If a public retirement system is less than 97-percent funded, a "Diet-COLA" must be imposed, equal to 50-percent of any cost-of-living-adjustment (COLA).
  - No benefits may be retroactive.
  - To calculate a member's retirement benefit, the public retirement system must use their annual base salary earned that year times the plan's accrual rate.
  - There can be no public retirement system trust fund pooling.
  - The minimum retirement age must be 59.5 years.
  - The State Controller has broad authority to audit the state's public pension systems.
  - Any public pension above $60,000 will incur a progressive income tax.
  - For the purpose of calculating pension benefits for new employees, public retirement systems must employ a $100,000 base pay cap with COLAs. All public agencies must pay the full amount of required annual obligations to a pension fund trust at all times.

- **Fair and Proportional Retirement for Public Officials Act of 2012**
  This proposal would require that retirement benefits for "politicians", defined as elected public officials and/or appointed government officials who vote to determine government business or who set government policy and/or determine funding expenditures, must be governed by the most restrictive rules that apply to the least compensated employees in the government agency; additionally, "politicians" would be unable to collect retirement benefits or other post-employment benefits other than that which is based on their proportional years of service with the government agency with which they last worked and only the average of the last three years of base pay with that agency may be used.

  The Act would retroactively apply to "politicians" who had set their own compensation or benefits or acting as a group or board or by another politician or government administrator. If a "politician" were to act in contrast to the Act's provisions, it provides that he or she would forfeit any unpaid salary, benefits or retirement income. Also, any "politician" must verbally accept the Act's provisions as a condition of taking office.

- **Government Employee Pension Reform Act of 2012, Version #1**
  This proposal will require **future government agency employees** (hired after July 1, 2013) to contribute an amount at least equal to the amount contributed by an employer to a public retirement plan and does not permit the employer to cover any part of the employee contribution. For miscellaneous employees, the employer would be prohibited from contributing in aggregate any more than six percent of the employee's base wage; for public safety employees, this figure is nine percent. The employer, if employees are not covered by Social Security, must provide to the employees a replacement benefit that matches the Social Security benefit they would receive, the cost of which would be shared equally by the employer and the employee. All death and disability benefits provided by the employer must be provided outside of the retirement plan.

  The proposal also includes provisions which would apply to current employees (those hired prior to July 1, 2013) who are part of a government agency retirement plan.

  - To prevent pension "spiking," employees' retirement benefits would be calculated using the average of their highest three years base wage.
  - Retroactive increases in retirement plan contributions or benefits are prohibited.
  - Retirement benefits would not be provided to employees convicted of a felony arising out of their service as a government employee.
  - The purchase of service credit would be prohibited.

  Additionally, if the retirement plan doesn't meet the minimum funding level (80 percent as provided in the proposal), the fund would be determined at risk and an appropriate amount to fund the plan at or above the minimum level must be provided or it must be declared that such an appropriation cannot be done without impairing the governmental agency's ability to provide essential services. If it is determined that funds cannot be appropriated in such a manner, the employer must limit **for current employees** any contributions to the normal cost of the retirement plan to six percent for miscellaneous employees and nine percent for public safety employees. Any additional funding needed to fund the plan at or above 80 percent would be covered by the employees and any retirement benefit costs savings must be used to reduce the plan's unfunded liability.

  The proposal also requires that every board of a government agency retirement system must have at least a majority of members who have demonstrated financial, legal, accounting, healthcare, actuarial or benefits consulting expertise and that they not be current members of the system or have family members who are. The Director of the Department of Finance would be a voting member of any state or local government pension fund with $5 billion or more in total liabilities and the Legislature would establish the criteria and process for the eligibility and selection of board members.

  Government Employee Pension Reform Act of 2012, Version #2
  This proposal permits the Legislature to, by a two-thirds vote, enact a hybrid retirement system for all government employees hired after July 1, 2013 that is

designed to provide replacement income upon full retirement.

The proposal defines "full career in government service" as 30 years for public safety employees at 58 years of age and 35 years at the age of 67 for miscellaneous employees. When combined with anticipated defined contribution plan benefits and any benefit payments through Social Security, the defined benefit portion of the employee's retirement may not exceed 75 percent of their base wage and is limited to 25 percent of the employee's pensionable pay after a full career in government service (50 percent if the employee is not in Social Security). Further, the defined benefit part of the hybrid plan cannot exceed $100,000 per year and must be calculated based on the average of their highest three years base wage; the employer and employee is also required to equally share the cost of the defined benefit portion of the retirement benefit.

Retirement plan trustees would be required to adopt accounting standards and actuarial assumptions ensuring that the cost of the defined benefit portion of the retirement benefit is fully paid in the year it's earned. The employer would select the defined contribution plan administration and offer retirees (upon retirement) the option to convert the defined contribution benefits into annuities. The proposal would allow employees to retire five years before their full retirement age with a full actuarial deduction for earlier retirement applied to the employee's pension benefits.

Version #2 includes the following from Version #1: minimum funding requirements, three-year averaging provision to prevent spiking, prohibition of service credit purchases and retroactive increases in retirement plan contributions or benefits (or benefit formulas), the forfeiture of retirement benefits in the case of a felony conviction and requirements for an independent and expert pension board.

Policy Considerations. Staff believes it is premature for CSAC to take action on the pension reform proposals at this time. In the case of the initiatives, CSAC does not typically take positions on initiatives until the measures have qualified for the ballot, in the case of the Governor's proposal, there is simply not enough detail available yet to provide a complete analysis and recommendation to the committee. Based on the information we have, there are two critical issues that committee members may wish to consider in anticipation of future discussion and action on the Governor's proposal and/or the Government Employee Pension Reform Act of 2012. It is these issues that present the most direct challenge to CSAC's platform and principles for pension reform.

- **Local control vs. statewide implementation of reforms.** CSAC's first principle for pension reform is "Protect local control and flexibility". CSAC has held that a statewide mandated retirement system is neither appropriate nor practical, given the diversity of California's communities. The Legislative Analyst, in its response to the Governor's pension proposal, raised the question of whether some diminution in local control over retirement benefits is merited given the long-term nature of pension costs and the potential for competition among local and state employers to recruit and retain employees. This will be a key question for CSAC as well.

- **Defined benefit vs. mandatory hybrid model.** CSAC has supported providing local agencies the option to implement defined contribution retirement plans within both CalPERS and 1937 Act systems, as stand-alone benefits or hybrid systems. While the Governor's proposal is lacking sufficient detail to consider the merits of this particular hybrid plan, the threshold question of whether counties would support a shift from defined benefit pension plans to a hybrid model is the more fundamental question.

Action Requested. This item is for information only.

Staff Contact. Please contact Eraina Ortega (eortega@counties.org or 916/650-8180) or Faith Conley (fconley@counties.org or 916/650-8117) for additional information.

Materials.
Governor Brown's Twelve Point Pension Reform Plan
Initiative Text: *Raise Public Retirement Ages Act*
Initiative Text: *End Public Sector Bargaining Act*
Initiative Text: *Tax Public Pensions Above $100,000 Per Year Act*
Initiative Text: *Costa-Matteoli Pension Solvency Act*
Initiative Text: *Fair and Proportional Retirement for Public Officials Act of 2012*
Initiative Text: *Government Employee Pension Reform Act of 2012, Versions 1 and 2*

Raise Public Retirement Ages Act

Section 1. Title

This measure shall be known and may be cited as the Raise Public Retirement Ages Act.

Section 2. Findings and Declaration of Purpose

The People of the State of California find and declare that the purpose of local and state government is to provide cost-effective and quality public services and benefits to residents at a reasonable cost. The current system of public sector pensions is inimical to appropriate taxation and government spending and regulatory policies. Therefore, the People of the State of California hereby enact the Raise Public Retirement Ages Act.

Section 3. Raise Public Retirement Ages Act

Section 12 of Article 7 of the California Constitution is added to read:

Article 7, Section 12. Retirement Ages of Public Sector Employees

No new memorandum of understanding or other contract or agreement between any public agency and public sector employees utilizing the California Public Employees' Retirement System and California State Teachers' Retirement System may allow retirement of employees with full retirement benefits at an age younger than 65, with the exception of sworn public safety officers, who may receive full retirement benefits starting at age 58.

Section 4. Severability

The provisions of this Act are severable. If any provision of this Act or its application is held invalid, that finding shall not affect other provisions or application that can be given effect without the invalid provision or application.

Section 5. Effective Date

This Act shall become effective upon its approval by the voters.

End Public Sector Bargaining Act

Section 1. Title

This measure shall be known and may be cited as the End Public Sector Bargaining Act.

Section 2. Findings and Declaration of Purpose

The People of the State of California find and declare that the purpose of local and state government is to provide cost-effective and quality public services and benefits to residents at a reasonable cost. The current system of public sector collective bargaining is inimical to appropriate taxation and government spending and regulatory policies. Therefore, the People of the State of California hereby enact the End Public Sector Bargaining Act.

Section 3. End Public Sector Bargaining Act

Section 6 of Article 14 of the California Constitution is added to read:

Article 14, Section 6. Prohibition of Public Sector Collective Bargaining

No state, county, municipal, or like government officer, agent, or governing body is vested with or possesses any authority to recognize any labor union or other employee association as a bargaining agent of any public officers or employees, or to bargain collectively or to enter into any collective bargaining contract, memorandum of understanding or other agreements with any such union or association or its agents with respect to any matter relating to public officers or employees or their employment or service.

Section 4. Severability

The provisions of this Act are severable. If any provision of this Act or its application is held invalid, that finding shall not affect other provisions or application that can be given effect without the invalid provision or application.

Section 5. Effective Date

This Act shall become effective upon its approval by the voters.

Tax Public Pensions Above $100,000 Per Year Act

Section 1. Title

This measure shall be known and may be cited as the Tax Public Pensions Above $100,000 Per Year Act.

Section 2. Findings and Declaration of Purpose

The People of the State of California find and declare that the purpose of local and state government is to provide cost-effective and quality public services and benefits to residents at a reasonable cost. The current system of public sector pensions is inimical to appropriate taxation and government spending and regulatory policies. Therefore, the People of the State of California hereby enact the Tax Public Pensions Above $100,000 Per Year Act.

Section 3. Tax Public Pensions Above $100,000 Per Year Act

Section 36 of Article 13 of the California Constitution is added to read:

Article 13, Section 36. Income Tax on Public Sector Pensions Above $100,000 Per Year

A state income tax of 15 percent above the standard state income tax rate is hereby instituted on all public sector pensions paid by the California Public Employees' Retirement System and the California State Teachers' Retirement System on annual pension income from these sources, exclusive of health benefits and health insurance, between $100,000 and $149,999; and of 25 percent above the standard state income tax rate on all public sector pensions paid by the California Public Employees' Retirement System and California State Teachers' Retirement System on annual pension income from these sources, exclusive of health benefits and health insurance, above $150,000.

Section 4. Severability

The provisions of this Act are severable. If any provision of this Act or its application is held invalid, that finding shall not affect other provisions or application that can be given effect without the invalid provision or application.

Section 5. Effective Date

This Act shall become effective upon its approval by the voters.

PENSION SOLVENCY ACT

Section 1. THIS INITATIVE MAY BE KNOWN AND CITED AS THE COSTA-MATTEOLI PENSION SOLVENCY ACT AND/OR THE PENSION SOLVENCY ACT

[FINDINGS AND DECLARATIONS]

Section 2. The People Of The State Of California Do Find And Declare:

WHEREAS, California public retirement systems are severely underfunded and otherwise insolvent and unsustainable to provide members their pensions; and

WHEREAS, the California Governor and State Legislature are refusing to be diligent and are refusing to enact and implement any effective and efficacious policy and/or legislation that will make public retirement system(s) trust fund(s) solvent and sustainable; and

WHEREAS, approximately eighty percent (80%) of all current California public pension payments are paid out to twenty percent (20%) of recipients, and over 80% of current California public pensions are less than $50,000; and

WHEREAS, final annual compensations of over $100,000 are becoming commonplace; and

WHEREAS, a few public employees have manipulated and other public employees are manipulating their pensions to receive a final annual compensation above $200,000; and

WHEREAS, the few people receiving exorbitant pensions should bare their fair share of returning the public retirement systems back to solvency and to sustainability; and

WHEREAS, medical costs are increasing faster than the average cost of living increases; and

WHEREAS, the people of California concur with the 2011 El Dorado County Grand Jury findings pertaining to public pensions paid to firemen; and

WHEREAS, the California Governor and the California State Legislature have not been diligent, for the past nine (9) years, in stopping corruption in the management and operations of Cal PERS and of some municipalities, Districts, and Boards thus causing public retirement trust funds to become insolvent and un-sustainable; and

WHEREAS, some public agency elected officials and administrators may have, over the past nine (9) years, fraudulently enacted and implemented policies and procedures that allow themselves, family, friends, and fellow coworkers, past, present, and/or future, to receive exorbitant pensions thus causing trust funds to become insolvent and un-sustainable; and

WHEREAS, California taxpayers who do not have pensions themselves are being forced to pay for these exorbitant pensions to keep the public retirement pension trust funds solvent and sustainable; and

PENSION SOLVENCY ACT

WHEREAS, California taxpayers are prohibited and otherwise discriminated against having equal opportunity to partake in and enjoy the benefits of a properly managed, solvent, and sustainable California governmental Defined Benefit Program that is currently only provided to a limited group of California citizens; and

WHEREAS, the California State Constitution allows the people of the State of California to use the initiative process; and

WHEREAS, the California Declaration of Rights states, "All political power is inherent in the people", and that, "They have the right to alter or reform it whenever the public may require it"; and

WHEREAS, the traditional American philosophy of constitutional limited government - limited for liberty - is being placed in serious jeopardy by a dysfunctional Executive Branch and a dysfunctional Legislative Branch of government who are using uncontrollable taxing authorities to build powerful bureaucracies that are not accountable to the people.

[PURPOSE OF INITIATIVE]

Section 3. The People Enact This Initiative For The Following Purposes.

A. To insure that California public retirement systems remain solvent and sustainable for current recipients and future generations.

B. To require public agencies to provide solvent and sustainable public retirement systems within taxpayer's means.

C. To provide a mechanism to reduce some health care costs; yet, also mitigate restrictions on receiving retirement health care benefits brought about by the Pension Solvency Act.

D. To require public agencies to pay their obligations to public retirement trust funds at all times in order to ensure trust funds remain solvent and sustainable.

E. To not generate and provide exorbitant public pensions that will, in part, cause city or county governments or special Districts (such as Fire Districts) to become bankrupt.

F. To provide California taxpayers the opportunity to receive a non-discriminatory retirement program in that: while California taxpayers pay for public employee defined benefit program pensions, and in so doing keep public trust funds solvent and sustainable, the California taxpayer, both employer and employee, shall also have equal opportunity to participate in and enjoy the benefits of a solvent and sustainable California governmental defined benefit pension program.

G. To stop public agencies from fraudulently and illegally, in the past, present, and future, providing exorbitant pensions that result in public retirement trust funds to become insolvent and unsustainable.

H. To eliminate fraudulent and other illegal practices, procedures, and programs which cause public trust funds to become insolvent and unsustainable.

I. To aid public retirement trust funds regain solvency and sustainability by recovering funds lost to fraud and other crimes.

J. To insure that the reserve powers of the people will remain dominate over the out of control authority of the California Governor and California State Legislature.

K. To insure a free and open society where governmental entities and agencies get their authority from the consent of the governed.

[TEXT]

Section 4. The California Pension Solvency Act

A. Non-Modification.
The Pension Solvency Act, total or in part, shall not be altered, rewritten, or modified any way whatsoever by contract, memorandum of understand, or any other agreement.

B. Mandatory Inclusion.
1. The Pension Solvency Act shall become effective upon its approval by the voters.
2. Upon voter approval of the Pension Solvency Act, all California public agency pension plans shall be administered in accordance with the provisions of the Pension Solvency Act.
3. The public agency's public retirement trust fund(s) shall remain in the Pension Solvency Act for a minimum of two (2) years.

C. Definitions
1. "Base pay" means an employee's amount of compensation, excluding extra lump sum compensation. An employee's base pay is expressed as an annual salary.
2. "Annual Final Compensation" means the annual pension salary.
3. "Member" means any active employee, inactive employee, or an employee retired from any public agency and includes any beneficiary (example: deceased member's wife who receives a final compensation) or legal representative of said member.
4. "Public agency" means the state or a county, city, city and county, district, school district, authority, university, or any public or municipal corporation, political subdivision, or other public agency of the state, or any department, division, bureau, board, commission, agency, or instrumentality of these entities.
5. "Public retirement system" means all state and local public retirement systems, including, but not limited to, the Public Employees' Retirement System (Cal PERS), the State Teachers' Retirement System, the Judges' Retirement System II, the Legislators' Retirement System, the University of California Retirement System, and county and district retirement systems created pursuant to the County Employees Retirement Law of 1937.

6. "Solvent" means the ability to pay all that a public agency's retirement system owes.
7. "Sustainable" means to continue to be able to pay all that a public agency's retirement trust fund owes.

D. Pension Spiking While Under The Pension Solvency Act.
   1. Only a retired member's 'base pay' shall be used as the 'Annual Final Compensation' and be used to determine his or her 'Adjusted Annual Final Compensation' pursuant to Appendices A, B, and C.
   2. No other compensation such as bonuses, accrued overtime, accrued vacation, accrued sick leave, medical benefits, or uniform allowance shall be added onto a retired member's 'base pay' to establish the 'Annual Final Compensation' used to calculate the 'Adjusted Annual Final Compensation'.
   3. If for any reason a public agency is mandated by a court or regulatory agency to calculate benefits using other than 'base pay' adjusted pursuant to D.2. above, then said mandated public agency shall not fund that benefit until their public retirement system trust fund has become 'solvent' pursuant to 'M' below and the trust fund has opted out of the Pension Solvency Act pursuant to 'O' below. Furthermore, payments to pay said benefit(s) shall not be retroactive.

E. Diet Cost of Living Allowance (Diet-COLA)
   1. For each year a public retirement system is less than ninety-seven percent (97%) funded, a Diet-COLA shall be imposed equal to fifty percent (50%) of any COLA.
   2. The full one hundred percent (100%) COLA shall be used in the calculation that determines if the public retirement system trust fund is one hundred percent (100%) funded.

F. Methods of Computations.
   1. Upon voter approval of the Pension Solvency Act, public retirement systems in California shall calculate benefits earned that year using the base salary earned that year times the plans accrual rate and notify each employee of the estimated projected benefits that he/she have earned at retirement age.
   2. Each year thereafter, each public retirement system shall calculate benefits earned that year by each active member and notify each active member of the estimated projected final compensation that he/she will receive at retirement age.
   3. No retroactive benefits shall be calculated or otherwise accrued.

G. Solvency Funding Adjustment.
   1. Upon voter approval of the Pension Solvency Act, every public retirement system trust fund's Annual Final Compensation shall be subject to the First Year Solvency Funding Adjustment Index, as presented in Appendix A.
   2. The First, Third, and Fifth Year Pension Funding Adjustment Indices' 'Annual Final Compensation' shall be adjusted annually pursuant to a Cal PERS COLA.
   3. The 'Accrued Adjustment' shall be automatically withheld from each retired member's 'Annual Final Compensation' whether the receiver is a resident of California or not.

4. All withheld adjustments shall remain in the public retirement trust fund from which they originated.
5. All Solvency Funding Adjustment Index Tables shall be applied on a fiscal year basis.

H. Pension System Separateness.
1. Each California public agency that is contracted with a public retirement system shall have their trust fund be considered funded or unfunded separate and distinct from any and/or all other California public retirement system(s) trust fund.
2. Comingling or pooling of any public retirement system trust fund, in total or in part, is prohibited.
3. Upon a public agency entering into the Pension Solvency Act, said public agency's public retirement system trust fund shall be extracted in total from any comingled or pooled fund and returned to said separate trust fund.
4. Upon a public agency entering into the Pension Solvency Act, all separate retirement trust funds within a public agency:
   a. Shall cease being comingled and/or pooled,
   b. Shall be extracted in total from any comingled or pooled fund, and
   c. Shall be returned to each separate fund and be managed independently.
5. The definition and determination of what constitutes a public retirement system trust fund shall be that definition and determination upon passage of the Pension Solvency Act and shall not be redefined or modified in any way or manner whatsoever.

I. Mortality Rate For Active Members
1. Accruals for active members shall be indexed in accordance with most recent mortality rate.
2. The most recent mortality rate shall be calculated and considered current on a fiscal year basis, no more and no less.
3. The most recent mortality rate shall be calculated on 1 June of each year, and said calculated most recent mortality rate shall be applicable throughout the following fiscal year.

J. Retirement Age For Active Members And Inactive Members
While the Pension Solvency Act covers a California public agency's public retirement system, the minimum retirement age, from the date of implementation of the Pension Solvency Act through to the end of implementation, shall be fifty-nine and a half (59-1/2) years of age.

K. Medical Coverage Cost Reduction And Mitigation
1. Cal PERS medical providers may contract medical services to other medical providers throughout the United States and United States Territories to provide medical coverage to Cal PERS active and retired members and their plan dependents when said members are not in California.
2. Cal PERS medical providers may contract medical services to private foreign medical providers and other US or foreign government medical providers throughout the

world to provide medical coverage to Cal PERS active and retired members and their plan dependents when said members are not in California.

3. Example to K.1. and K.2: A Cal PERS medical provider may contract with the United States Arm Forces to provide medical coverage to Cal PERS active and retired members and their dependents while traveling or living outside California or outside the United States.
4. During the implementation of the Pension Solvency Act, any active member, who ceases employment and does not retire from the public agency's public retirement system, and any inactive member shall be eligible to retire with medical benefits upon retirement, even after the agency's public retirement trust fund has been taken out of the Pension Solvency Act.

L. Fiscal Savings And Limitations From Pension Solvency Act

Savings generated by the Pension Solvency Act shall remain in the public agency's public retirement system trust fund from which it was generated. No pension funds, including savings from the Pension Solvency Act, may be taken from any trust fund for any purpose other than the purpose of said trust fund.

M. Solvency Determination

1. A trust fund shall be considered 'solvent' when said trust fund is fully funded at one hundred percent (100%) and can remain solvent for three (3) years.
2. The trust fund's administrator shall conduct an annual solvency audit on all its public agency public retirement system trust funds when said trust funds are not included in the Pension Solvency Act.
3. The trust fund's administer shall conduct annual solvency audits whenever the trust fund's funding level falls below one hundred percent (100%) and is unsustainable for a three (3) year period.
4. Immediately upon the trust fund's administrator's determination that a trust fund is insolvent (less than one hundred percent (100%) funded and unsustainable for the following three (3) years), then the California State Comptroller shall audit said trust fund to confirm insolvency. Upon insolvency confirmation by the California State Comptroller, the trust fund administrator shall notify all members of the trust fund that their trust fund is insolvent and will be placed under the Pension Solvency Act.
5. If a trust fund administrator refuses to allow the California State Comptroller to audit a trust fund, then the California State Comptroller shall confiscate all subject trust fund records, including emails of trust fund board members, administrators, and investors, conduct its confirmation audit for solvency and sustainability, and refer all discrepancies and perceived crimes to the California Attorney General's office for investigation and prosecution.
6. All trust fund board members, administrators, and investors and their subordinates and legal staff shall not delete or destroy any correspondence whatsoever, including emails; nor shall they direct any rank and file employee to do so.
7. A trust fund shall not receive more than one audit by the trust fund Administrator in any one fiscal year and shall not receive more than one confirmation audit by the State Comptroller's Office in any one fiscal year. The trust fund Administrator's

audit shall not be considered final until after the State Comptroller's confirmation audit is final.

8. The trust fund's administrator shall be paid out of the trust fund for all work pursuant to solvency determination of said public agency's public retirement system trust fund.
9. The trust fund's administrator shall not contract out any and all tasks or services pursuant to the solvency determination of a public agency's public retirement system trust fund.
10. The trust fund's administrator shall pay the State Comptroller fifty percent (50%) of the cost for the State Comptroller's confirmation audit.

N. Mandatory Re-Inclusion

1. Whenever the California State Comptroller confirms or determines independently that a public agency's public retirement system trust fund is not 'solvent', then said trust fund shall be immediately re-included into and be covered by the Pension Solvency Act. This confirmation or determination may occur any time during a fiscal year.
2. The public agency's public retirement system trust fund shall remain re-included in the Pension Solvency Act pursuant to 'O' below.
3. After re-inclusion, members of the public agency's public retirement trust fund may choose, pursuant to 'O' below, to remain under the Pension Solvency Act when their trust fund becomes 'solvent'.

O. Opting Out Of The Pension Solvency Act

1. Once the pension trust fund Administrator determines a trust fund to be 'solvent', the California State Comptroller shall confirm the determination that the pension trust fund is 'solvent'. The pension system may then be taken out of the Pension Solvency Act pursuant to O.2. through O.8. below.
2. Active, inactive, and retired members of said trust fund shall vote to opt out of the Pension Solvency Act.
3. The trust fund administrator shall give active, inactive, and retired members in said trust fund a vote to remain in the Pension Solvency Act or opt out of the Pension Solvency Act.
4. Fifty percent (50%) plus one will determine the vote.
5. Such vote shall be offered on a two-year cycle.
6. Only the trust fund administrator shall administer the vote. The administration of the vote shall not be contracted out.
7. Only members of the trust fund (or member beneficiary (example: wife of a deceased member) or a member's legal guardian) shall have the right to vote with a one member-one vote limitation.
8. The trust fund shall pay the trust fund administrator for the cost of the vote.

P. Re-Indexing

1. Widows, widowers, and orphans shall be exempt from Re-Indexing.
2. During the time when a public agency's public retirement system trust fund is covered by the Pension Solvency Act and said trust fund's liability continues to increase, then the First Year Solvency Funding Adjustment Index shall be re-indexed

to withhold additional funds to bring said fund into solvency pursuant to the Third Fiscal Year Solvency Funding Adjustment Index, as presented in Appendix B.

3. During the time when the public agency's public retirement system trust fund is covered by the Third Fiscal Year Solvency Funding Adjustment Index and said trust fund's liability continues to increase, then the Third Year Solvency Funding Adjustment Index shall be re-indexed to withhold additional funds to bring said fund into solvency pursuant to the Fifth Year Solvency Funding Adjustment Index, as presented in Appendix C.
4. For the Fifth Fiscal Year Solvency Funding Adjustment Index the base salary shall include all current public salary as well as all public pensions, including, but not limited to, Federal pension; Social Security Pension; Military Pension; any State's Pension; any US Territory pension; any California, other State, and/or US Territory local pension. These incomes shall be added to the Annual Retirement Income in the Fifth Fiscal Year Solvency Funding Adjustment Index.
5. Upon a public retirement system trust fund becoming 'solvent', the First Year Solvency Funding Adjustment Index shall be put back into effect and remain in effect until the fund is opted out of the Pension Solvency Act pursuant to 'O' above or is re-indexed.
6. If a public retirement trust fund remains under the First Year Solvency Funding Adjustment Index and the pension fund again becomes insolvent (unsustainable for three (3) years at one hundred percent (100%) funded), then the agency's public retirement system trust fund shall be re-indexed to withhold additional funds pursuant to P.2. and then to P.3. above if necessary.

Q. Public Agency's Mandatory Payment Of Annual Obligations

1. All public agencies shall at all times (except pursuant to Q.2. below) pay the full amount of their required annual obligations into their public pension trust fund(s), even when a trust fund is not in the Pension Solvency Act and even when a trust fund, that is in the Pension Solvency Act, is greater than one hundred percent (100%) solvent and sustainable for three (3) years. Annual obligations shall be based on the 'Annual Final Compensation' when the trust fund is not subject to the Pension Solvency Act, even if the trust fund is in the Pension Solvency Act.
2. If trust fund members choose to have their trust fund remain in the Pension Solvency Act and their trust fund becomes one hundred and five percent (105%) funded, then the public agency at its discretion may readjust downward their annual obligation payment into the trust fund to no less than an amount that will retain the trust fund at one hundred percent (100%) funded and sustainable for three (3) years.

R. Excluding California Supreme Court Judges' Conflict of Interest

Judges of the California State Supreme Court who hear matters pertaining to the Pension Solvency Act, shall have their personal pensions be exempt from the Pension Solvency Act.

S. Investigation of Fraud and Abuse Causing Insolvency And Un-Sustainability

1. Within 30 days of voter passage of the Pension Solvency Act, the California State Attorney General shall request the Federal Prosecutor, in San Francisco's Federal

Prosecutor's office, to investigate all Cal PERS Board of Directors, Cal PERS executives, and Cal PERS top level management & investors (who have held such positions for the past nine (9) years) for, but not limited to, fraud, conspiracy to commit fraud, extortion, fraud under color of official right, extortion under color of official right, bribery, mail fraud, banking fraud, wire fraud, interstate transportation of stolen property, injury to second and third-party victims, Racketeer Influenced and Corrupt Organizations (RICO) Act violations, conspiracy to violate RICO, and cover-up of such crimes that may have occurred over the previous nine (9) years prior to passage of the Pension Solvency Act.

2. Within 30 days of voter passage of the Pension Solvency Act, The California State Attorney General shall request the Federal Prosecutor, in San Francisco's Federal Prosecutor's office, to investigate any retired public employee who receives more than two hundred fifty thousand dollars ($250,000) Annual Final Compensation and, if said employee was an employee of a District or Board (example: a Fire District), to investigate the employee, the District's or Board's elected officials, and upper management for, but not limited to, fraud, conspiracy to commit fraud, extortion, extortion under color of official right, fraud under color of official right, bribery, mail fraud, banking fraud, wire fraud, interstate transportation of stolen property, injury to second and third-party victims, Racketeer Influenced and Corrupt Organizations (RICO) Act violations, conspiracy to violate RICO, and cover-up of such crimes that may have occurred over the previous nine (9) years prior to passage of the Pension Solvency Act.
3. Upon conviction of any crime in violation of S.1 and S.2 above prosecuted by the Federal Prosecutor, the Cal PERS Director, Cal PERS executive, Cal PERS top level manager or investor, any retiree making over two hundred fifty thousand dollars ($250,000) Annual Final Compensation, and/or District's or Board's elected official and upper level manager (and/or all beneficiaries) shall forfeit all Cal PERS or subject trust fund retirement and/or retirement contributions as the court dictates, pay back all forfeit monies to Cal PERS or subject trust fund, and be liable to Cal PERS or said trust fund's Administrator (essentially taxpayers) for the amount of one million ($1,000,000) dollars in penalties to be paid into the subject trust fund.

T. Current And Future California Public Agency Employees And Appointees

1. Upon voter passage of the Pension Solvency Act, all new and all reinstated public agency employees and any politically appointed individual shall have an annual 'base pay' cap of $100,000 that is applicable to withholding for and to calculation of 'Annual Final Compensation'. For purposes of calculating pensions, a 'base pay' ceiling of no higher than $100,000 shall be used.
2. The $100,000 'base pay' cap shall be subject to annual COLAs.
3. Upon voter approval of the Pension Solvency Act, all new public agency employee contracts shall have no other compensation such as bonuses, accrued overtime, accrued vacation, accrued sick leave, medical benefits, or uniform allowance added onto 'base pay'. Said other compensation shall not be used when calculating 'Annual Final Compensation'.
4. Any public agency employee contract, found by a Superior Court to be in violation of the Pension Solvency Act, shall be considered un-severable and in total null and void;

and, the respective bargaining unit shall reenter collective bargaining to obtain a new contract.

U. Equal Opportunity Requirement Of The Pension Solvency Act

1. The California State Legislature shall create the California Separate Private Employees Retirement System (Cal SPERS) that mirrors the California Public Employees Retirement System (Cal PERS) with the following requirements.
   a. Cal PERS shall be the Administrator of all Cal SPERS trust funds.
   b. Cal SPERS shall be a separate subsidiary of Cal PERS.
   c. Cal SPERS shall be a defined benefit program.
   d. Cal SPERS trust funds shall remain separate from all public pension trust funds and comply with item H. above.
   e. All Cal SPERS trust funds shall accrue pursuant to two percent (2%) at sixty-three (63).
   f. Cal SPERS 'annual final compensation to salaried members' shall mean the highest average annual compensation earned by the salaried member during the consecutive 60-month (5 year) period immediately preceding his or her retirement or last separation from state service if earlier, or during any other period of 60 consecutive months during his or her public retirement system membership that the member designates on the application for retirement.
   g. Cal SPERS 'annual final compensation to non-salaried members' shall be factored on the average of all yearly payments into Cal SPERS.
   h. Base Pay Limitations to Cal SPERS participation.
      1) The Cal SPERS 'employee contribution for salaried members' shall be calculated on the salaried member's annual taxable 'base pay' limited to one hundred thousand dollars ($100,000).
      2) The Cal SPERS 'employee contribution for non-salaried members' and for business owners shall be calculated on the non-salaried member's personal annual taxable income limited to one hundred fifty thousand dollars ($150,000).
      3) Both base pay limits in 1) and 2) directly above shall be adjusted pursuant to the Cal PERS COLAs calculation process; however, said adjustment shall be made once every ten (10) years, no more or no less. Adjustments shall not be retroactive.
   i. A buy-in of up to five (5) years of U. S. Military Credit shall be available to Cal SPERS vested members.
   j. All conditions to be vested in Cal PERS shall apply to becoming vested in Cal SPERS.
   k. Cal SPERS minimum retirement age shall be fifty-nine and a half (59-½) years of age.
   m. Cal SPERS COLAs for 'Annual Final Compensation' shall be the same as Cal PERS COLAs.
   n. Only members (and member beneficiaries) who have paid into Cal SPERS may draw a Cal SPERS benefit.
   o. Cal PERS health care options shall be available, at the Private Agency's/ employer's option, to Cal SPERS members and their dependents.

p. An employee is eligible to join Cal SPERS if he/she works 20 hours or greater per week.
q. An employee and his/her dependents are eligible to join a Cal SPERS medical program if the employee works 20 hours or greater per week.
r. Only United States citizens and individuals legally residing and legally working in the United States may be eligible to be a Cal SPERS member. A California Drivers license or any other state drivers license by itself does not constitute standing to join Cal SPERS.
s. The Pension Solvency Act provides California businesses and non-profit entities the option, at their choice, to provide a defined benefit annuity retirement program to their employees, managers, administrators, and owners under Cal SPERS.
t. No pension funds, including savings from the Pension Solvency Act, may be taken from any Cal SPERS trust fund for any purpose other than the trust fund purposes.
u. Cal SPERS shall not establish nor manage 401(k) and/or 457 benefit programs.
v. Cal SPERS shall not contract out 401(k) and/or 457 benefit programs.
w. Cal SPERS may provide Deferred Compensation programs.
x. Any Cal SPERS Employer may provide 401(k) and 457 benefit programs separate from Cal SPERS to their employees.
y. Cal PERS shall establish Cal SPERS upon voter passage of the Pension Solvency Act, and Cal SPERS shall be fully implemented and fully functional no later than 365 days after voter approval of the Pension Solvency Act.

2. Upon approval of the Pension Solvency Act, all public agency defined benefit pension programs shall remain defined benefit pension programs, including the California Public Employees Retirement System (Cal PERS).
3. The California Pubic Employees Retirement System (Cal PERS) shall cease providing and managing 401(k) and 457 benefit programs for all Cal PERS active, inactive, and retired members.
   a. Implementation shall be a three-year phase-out period where existing Cal PERS members' 401(k) and 457 accounts shall be transferred to private investment programs.
   b. The first year of the three-year phase-out period shall consist of Cal PERS establishing the phase out procedures.
   c. The second two years of the three-year phase-out period shall consist of Cal PERS active, inactive, and retired members choosing a private investment program or more than one private investment program and transferring their 401(k) and 457 accounts.
   d. After the three-year phase out period, Cal PERS shall not reestablish 401(k) or 457 benefit programs.
   e. Cal PERS may continue to provide private investment training programs for active, inactive, and retired members.
   f. The California Public Employees Retirement System (Cal PERS) may continue to provide Deferred Compensation Programs.
   g. This paragraph (paragraph V.3.) shall take effect and be implemented by Cal PERS no later than the 365th day following voter approval of the Pension Solvency Act.

Section 5. Conflicting Interpretations - Penalties

A. In the event that another measure ("competing measure") appears on the same ballot as this Act that seeks to adopt or impose provisions or requirements that differ in any regard to, or supplement, the provisions or requirements contained in this Act, the voters hereby expressly declare their intent that if both the competing measure and this Act receive a majority of votes cast, and if this Act receives a greater number of votes than the competing measure, this Act shall prevail in its entirety over the competing measure without regard to whether specific provisions of each measure directly conflict with each other.

B. In the event that both the competing measure and this Act receive a majority of votes cast, and the competing measure receives a greater number of votes than this Act, this Act shall be deemed complementary to the competing measure. To this end, and to the maximum extent permitted by law, the provisions of this Act shall be fully adopted except to the extent that specific provisions contained in each measure are deemed to be in direct conflict with each other on a "provision-by-provision" basis.

C. This initiative is intended to be comprehensive. It is the intent of the People that in the event that this initiative and another initiative relating to the same subject appear on the same statewide election ballot, the provisions of the other initiative or initiatives are deemed to be in conflict with this initiative. In the event this initiative shall receive the greater number of affirmative votes, the provisions of this initiative shall prevail in their entirety, and all provisions of the other initiative or initiatives shall be null and void.

D. If this initiative is approved by voters but superseded by law or by any other conflicting ballot initiative approved by the voters at the same election, and the conflicting law or ballot initiative is later held invalid, this initiative shall be self-executing and given full force of law.

Section 6. Severability

If any provision of the Pension Solvency Act or the application of any such provision to any person or circumstance shall be held invalid, the remainder of the Pension Solvency Act, to the extent it can be given effect or the application of such provision to persons or circumstances other than those as to which it is held invalid, shall not be affected thereby, and to this end the provisions of the Pension Solvency Act are severable.

Coauthor
Edward J. "Ted" Costa, CEO
People's Advocate, Inc.
3407 Arden Way
Sacramento, CA 95825
(916) 482-6175

Coauthor
Robert J. Matteoli

APPENDIX A: FIRST YEAR SOLVENCY FUNDING ADJUSTMENT INDEX

FIRST YEAR SOLVENCY FUNDING ADJUSTMENT INDEX				
Annual Final Compensation	% Adjustment per Increment	Monetary Adjustment per Increment	Accrued Adjustment	Adjusted Annual Final Compensation
	95% Continuous	$4,750		
$150,000				$107,250
	90%	$4,500	$42,750	
$145,000				$106,750
	85%	$4,250	$38,250	
$140,000				$106,000
	80%	$4,000	$34,000	
$135,000				$105,000
	75%	$3,750	$30,000	
$130,000				$103,750
	70%	$3,500	$26,250	
$125,000				$102,250
	65%	$3,250	$22,750	
$120,000				$100,500
	60%	$3,000	$19,500	
$115,000				$98,500
	55%	$2,750	$16,500	
$110,000				$96,250
	50%	$2,500	$13,750	
$105,000				$93,750
	45%	$2,250	$11,250	
$100,000				$91,000
	40%	$2,000	$ 9,000	
$95,000				$88,000
	35%	$1,750	$ 7,000	
$90,000				$84, 750
	30%	$1,500	$ 5,250	
$85,000				$81,250
	25%	$1,250	$ 3,750	
$80,000				$77,500
	20%	$1,000	$ 2,500	
$75,000				$73,500
	15%	$ 750	$ 1,500	
$70,000				$69,250
	10%	$ 500	$ 750	
$65,000				$64,750
	5%	$ 250	$ 250	
$60,000				

APPENCIX B: THIRD YEAR SOLVENCY FUNDING ADJUSTMENT INDEX

THIRD YEAR SOLVENCY FUNDING ADJUSTMENT INDEX				
Annual Final Compensation	% Adjustment per Increment	Monetary Adjustment per Increment	Accrued Adjustment	Adjusted Annual Final Compensation
	95% Continuous	$4,750		
$145,000				$102,250
	90%	$4,500	$42,750	
$140,000				$101,750
	85%	$4,250	$38,250	
$135,000				$101,000
	80%	$4,000	$34,000	
$130,000				$100,000
	75%	$3,750	$30,000	
$125,000				$98,750
	70%	$3,500	$26,250	
$120,000				$97,250
	65%	$3,250	$22,750	
$115,000				$95,500
	60%	$3,000	$19,500	
$110,000				$93,500
	55%	$2,750	$16,500	
$105,000				$91,250
	50%	$2,500	$13,750	
$100,000				$88,750
	45%	$2,250	$11,250	
$95,000				$86,000
	40%	$2,000	$ 9,000	
$90,000				$83,000
	35%	$1,750	$ 7,000	
$85,000				$79, 750
	30%	$1,500	$ 5,250	
$80,000				$76,250
	25%	$1,250	$ 3,750	
$75,000				$72,500
	20%	$1,000	$ 2,500	
$70,000				$68,500
	15%	$ 750	$ 1,500	
$65,000				$64,250
	10%	$ 500	$ 750	
$60,000				$59,750
	5%	$ 250	$ 250	
$55,000				

APPENDIX C: FIFTH YEAR SOLVENCY FUNDING ADJUSTMENT INDEX

FIFTH YEAR SOLVENCY FUNDING ADJUSTMENT INDEX				
Annual Final Compensation	% Adjustment per Increment	Monetary Adjustment per Increment	Accrued Adjustment	Adjusted Annual Final Compensation
	95% Continuous	$4,750		
$140,000				$97,250
	90%	$4,500	$42,750	
$135,000				$96,750
	85%	$4,250	$38,250	
$130,000				$96,000
	80%	$4,000	$34,000	
$125,000				$95,000
	75%	$3,750	$30,000	
$120,000				$93,750
	70%	$3,500	$26,250	
$115,000				$92,250
	65%	$3,250	$22,750	
$110,000				$90,500
	60%	$3,000	$19,500	
$105,000				$88,500
	55%	$2,750	$16,500	
$100,000				$86,250
	50%	$2,500	$13,750	
$95,000				$83,750
	45%	$2,250	$11,250	
$90,000				$81,000
	40%	$2,000	$ 9,000	
$85,000				$78,000
	35%	$1,750	$ 7,000	
$80,000				$74, 750
	30%	$1,500	$ 5,250	
$75,000				$71,250
	25%	$1,250	$ 3,750	
$70,000				$67,500
	20%	$1,000	$ 2,500	
$65,000				$63,500
	15%	$ 750	$ 1,500	
$60,000				$59,250
	10%	$ 500	$ 750	
$55,000				$54,750
	5%	$ 250	$ 250	
$50,000				

Fair and Proportional Retirement for Public Officials Act of 2012
INITIATIVE MEASURE

SECTION 1. Fair and Proportional Retirement for Public Officials Act of 2012
The same retirement rules shall apply to politicians as the most restrictive rules which apply to any subordinate employee in the same organization in which the politician serves or served.

If retired politicians previously set their own retirement income and benefits rules, without a majority affirmative vote of the resident governed citizens, adjustments are made retroactively.

SECTION 2. Findings and Declarations
Politicians have voted themselves lavish salaries, luxurious benefits and plush retirement benefits at the expense of the tax payers. This is unconscionable, and must be changed.

SECTION 3. Statement of Purpose
The sole purpose of this Act is to make politicians subject to the same retirement policies they impose on others, and to preclude politicians from enacting retirement policies disproportionately beneficial to themselves.

SECTION 4. Fair and Proportional Retirement for Public Officials Act of 2012
A. The same retirement rules shall apply to politicians as the most restrictive rules which apply to union members, or non-union hourly workers or non-management employees at a lower level in the same organization in which the politician serves or served.
B. If retired politicians previously set their own retirement income and benefits rules, without a majority affirmative vote of the resident governed citizens, adjustments are made retroactively.

C. Definitions:
1. **Politician(s):** elected public official(s) and/or appointed government administrator(s), who vote to determine government business, or who set government policy, and/or who determine the expenditure of tax-funds or fee-funds, or who influence similar government business.
2. **Retirement compensation** consists of factors such as (but not limited to): retirement base pay.
3. **Retirement benefit** is any additional value officially provided to the retired politician above retirement compensation. For example, but not limited to: health care, and/or any "memberships" (by that or any other name), and/or any tax funds or fee funds obligated (by that or any other term) for the benefit of the retired politician.
4. See addendum "DEFINITIONS – Initiative Acts of 2012" for additional definitions

D. Proportional to years of service:
1. Politicians may draw no **retirement compensation and/or post-employment benefits** other than that which is consistent with, and based only on, their **proportional years of service** with the government organization in which they LAST served (with the exception of military retirement pay - which may also be drawn, if earned), and subject to the other constraints in this Act.

E. Same rules:
1. Retirement **compensation** and retirement **benefits for politicians** are hereby mandated to be **governed by, and** shall be none other than, **the most restrictive rules**, or constraints, and subject to all conditions which apply to the least compensated worker category subordinate to the politician.

F. Multiple employee worker categories:
1. **Worker category** means any worker group (or class of workers) at a subordinate level in the same organization in which the politician serves or served. Examples include, but are not limited to, union employees, non-union hourly workers, and other non-management employees.

2. If **more than one worker category** (by that or any other name), exists at a subordinate level in the same organization in which the politician serves or served, then the same rules, constraints, calculations and conditions of the group having **the lowest retirement compensation and benefits** shall be used to calculate the retirement compensation and benefits of the politician.
3. If any subordinate worker group is excluded from retirement compensation or benefits, the politician shall have NO retirement compensation or benefits (by those or any other names). If there are no worker groups subordinate to the politician, the politician shall receive NO retirement compensation or benefits (by those or any other names).
4. Example scenario
a. **For example**, but not limited to, a **scenario** as follows::
1) Given that there exists a **first** worker **category** at a subordinate level in the same organization in which the politician serves or served where "vested retirement benefits" are paid for 5 years, or more, service (with or without a minimum retirement age), and this category worker receives **2%** of their base salary per year of service, and:
2) Given that there exists a **second** worker **category** at a subordinate level in the same organization in which the politician serves or served where "vested retirement benefits" are paid for 5 years, or more, service (with or without a minimum retirement age), and that category worker receives **3%** of their base salary per year of service.
3) Given that retired workers in both the first and second worker categories receive $100 per month as a health care retirement benefit . . .:
4) Then:
a> If the politician serves four (4) years, then the politician shall receive NO retirement **compensation or benefits**. (Less than 5 years service, thus no vesting for retirement).
b> If the politician serves eight (8) years, then the politician shall receive eight(8) years service, multiplied by their base salary (defined elsewhere in this Act) multiplied by the **lowest percentage** per year of any subordinate worker category (in this example: 2%). The retired politician shall receive $100 as a health care benefit.
c> If the politician served eight (8) years for a different level of government and is drawing retirement compensation and benefits from that level of government (e.g.: the state), and then serves 10 years for their current level of government (e.g.: the county), then the politician shall provide proof that they have irrevocably forfeited the retirement compensation and retirement benefits from their 8 years service from the first level of government (e.g.: the state) if they desire to receive retirement compensation based on their 10 years service at the second government level (e.g.: the county). The politician's retirement compensation shall be their 10 years service multiplied by their base salary (defined elsewhere in this Act) multiplied by the **lowest percentage** per year of any subordinate worker category (in this example: 2%). The retired politician shall/can draw from only one retirement source (other than a military retirement).
5) Retirement benefits (for example, but not limited to: health care allowance) payable to the retired politician or for the retired politician shall be, and shall be none other than, the **least** amount paid to any retired worker group in the same organization as the politician serves or served. In this example scenario, the retired politician shall receive $100 per month as a health care benefit.

G. Average 3 year base salary **used**
1. **Base salary is** the salary advertised for the position and which is approved by a simple majority affirmative vote of the resident governed citizens. In no case may/can the "salary" be artificially increased by the inclusion of other defined benefits (for example, but not limited to: health/medical care allotments (by that or any other name), or by vehicle allotments, or by expense account allotments, or by "cashed-in" vacation time, or by any other amount or factor other than salary.
2. For calculation purposes, the "base salary" used for retirement compensation and post-employment benefits shall be based on the average of the last three (3) years BASE salary the politician received. In no case, may any other factors be used except the average of the last three (3) years BASE salary.

H. Retroactive
1. If the politician's compensation and/or benefits was set and/or established and/or determined by 1) them self or 2) themselves acting as a group or board <by that or any other name> or 3) another politician(s) or 4) any government administrator(s) (by that or any other name), and not established by

simple majority affirmative vote of the resident governed citizens, then **all** compensation and **all** benefits payable to **all** retired politicians shall be immediately and automatically **rescinded** by authority of this Act, and shall be immediately and automatically **revised** to an amount calculated to be the lowest payment, calculated by the **most restrictive rules,** pertaining to retirement compensation and benefits for any union member, or non-union hourly worker, or non-management employee or any other employee group at a lower level in the same organization in which the politician served.

a. This **revision** shall be **applied retroactively** to all retired politicians drawing retirement compensation / benefits from:

1) the level of government at which this Act is established AND/OR

2) any level of government below the level at which this Act is established. (For example, but not limited to, if the Act is established at the state level, it automatically applies at the county and city / municipality level).

I. Offending Politician(s)

1. Any **politician(s)** who act(s) in contrast to the provisions of this Act is, hereby, deemed n offending politician.

J. Forfeitures for offending politicians

1. An **offending politician** shall

a. forfeit all right to any and all unpaid **salary**, and

b. forfeit all right to any/all form of future **compensation** associated with the **elected** or **appointed** position for the duration of the term of office, and.

c. forfeit all other **benefits** which would normally arise from acceptable service in the position, and.

d. forfeit all right to all future **benefits** (by whatever name), and

e. forfeit **any and all retirement** income/compensation (by whatever name). For clarification, the offending politician shall receive **no** retirement income and **no** additional benefits above that which the politician previously set aside from the politician's previously paid salary. If these previously set aside personal funds are held on "account" with the tax-supported organization or any other approved holding organization, the politician may withdraw the amount currently in their account (using standard accounting procedures and subject to tax withholding).

1) By accepting any political office (or the return to any political office or to a different political office - whether at the same or different level of government) the politician is deemed to have specifically and voluntarily accepted, and voluntarily agrees to be subject to, all provisions of this Act Particularly and specifically is the voluntary acceptance of this provision to relinquish ALL retirement income and ALL benefits from ALL government sources, regardless of when or through what office or service those benefits were acquired, if they are determined to be an offending politician. .

2) Forfeitures by the offending politician shall be timely seized by the law enforcement agency at the level of government at which this Act is enacted.

3) However, the **ELECTED** offending politician shall **NOT be removed** from office. As such, no circumvention of this Act may be accomplished by any subordinate; and the governed citizens are not burdened by excessively frequent elections. The office shall remain filled, but **all** costs associated with the elected **politician** (present and future) and the incumbent's ability to vote on any measure shall be removed. EXCEPTION: The only exception is when sufficient number(s) of offending politicians are removed from income and voting status such that the total number of remaining voting members in that governing body (e.g.: the County Board of Supervisors, or the State Senate) falls below the necessary quorum. In such case, all offending politicians in that governing body (e.g.: the County Board of Supervisors, or the State Senate) shall be immediately and automatically removed from office. The law enforcement agency at the same level of government as this Act, shall ensure compliance with this provision. The election official for that governing body shall ensure that a special election is rapidly held to replace all of those offending politicians in **that** governing **body**.

4) In **addition** to the other forfeitures herein described **for** offending politicians, an offending politician who is a **manager** shall be immediately **removed** from their office and **expelled** from the tax-supported organization from which they received their salary, before expulsion. A **new** manager shall be appointed, and that new manager **shall** serve under the same constraints specified by this Act. Additionally, the offending politician / manager, shall be **ineligible** to **campaign** for, **or** be elected to, or be appointed to, or be in any way a consultant for, advisor for, personal assistant to, employee of, or contractor (by that or

any other name) for any tax supported office or any tax supported organizational position at the level of government commensurate with the scope of this Act and the **level of government** at which the offending politician / manager served.

K. CONDITION OF ACCEPTANCE OF PUBLIC OFFICE:

1. As a condition of the acceptance of public office each politician must willingly and verbally accept all provisions stipulated in this act. If any politician serves in political office without such verbal acceptance, their service is deemed to automatically imply consent to, and voluntary acceptance of, all provisions stipulated in this Act.

L. MODIFICATION OF THIS ACT:

1. UNDER NO CIRCUMSTANCES WILL / SHALL / CAN ANY ELEMENT OF THIS ACT BE CHANGED WITHOUT A SIMPLE MAJORITY AFFIRMATIVE VOTE OF THE RESIDENT GOVERNED CITIZENS at the scope of government represented by this Act. Resident governed citizens will vote directly on ANY / EACH / and ALL proposed changes.
2. **Under no circumstances** shall any incumbent politician individually or collectively or by any combination of incumbent politicians attempt to modify, undermine, circumvent, or attempt to nullify this Act, or any provision of it, in any way.
a. Any politician advocating the change of any part of this Act by any means **EXCEPT** a simple majority affirmative vote of the resident governed citizens shall immediately be deemed an **"offending politician"** and shall be subject to the forfeitures stated in this Act.

M. PREEMINENCE

1. This Act is hereby granted, and mandated, precedence over all other conflicting laws, and/or policies and/or procedures and/or directives (by whatever name) of prior date, **at, or below**, the same level of government as this Act..
2. All other conflicting **laws**, and/or **policies** and/or **procedures** and/or **directives** (by whatever name) of prior date, **at and/or below**, the same level of government as this Act, are hereby mandated to be modified, as necessary, to align with the provisions of this Act, or to be voided.

N. CONFLICTING MEASURES

1. This Act shall take effect notwithstanding approval by the voters of another measure relating to any similar matter, not directly in conflict with this measure, by a greater number of affirmative votes.
2. If this Act is superseded by law or by any other conflicting ballot measure approved by the voters at the same election, and the conflicting measure is later held invalid, this measure shall be given the full force of law.

O. COMMENCEMENT

1. This Act shall become effective upon the date on which it received a simple majority affirmative vote.

P. DURABILITY

1. This Act shall have legal standing and durability / duration until changed or eliminated by a simple majority of affirmative votes cast by the resident governed citizens.

Q. SEVERABILITY

1. The provisions of this Act are severable. If any provision of this Act or its application is held invalid, the invalid provision shall not affect other provisions or applications that can be given effect without the invalid provision or application.

R. INCLUSIONS

1. The addendum titled: **DEFINITIONS – Initiative Acts of 2012** is included in, and made an integral part of, this Act by reference.

DEFINITIONS – Initiative Acts of 2012
ADDENDUM TO INITIATIVES

TERMS and DEFINITIONS:
Herein, all terms indicating possession by the politician (For example, but not limited to the personal wealth of the politician) or the contributor shall be specifically extended to include any and all **Interests**, direct and/or indirect, past and/or indicated or promised for the future.

The definition of any word, defined herein, shall also apply, in full, to the various tenses (e.g.: past, present, and/or future) as appropriate to the context (e.g.: receive, received)
The definition of any word, defined herein, shall also apply, in full, to any form of that root word (e.g.: direct, directly, receive, receipt).

Herein, when an example is given for clarification, the item is not limited to the example(s) given.

Herein, "e.g.:" shall mean "for example", and, for further specification or clarification, "i.e.:" shall mean "that is".

Herein, the definition of a word which can be used as various parts of speech (e.g.: a noun or a verb) shall be considered applicable to any or all such parts of speech as logic and context dictate. An example is the word "benefit". Each part of speech shall be applicable whether the implication of the word is that the politician is receiving or is giving.

- **abdicate / abdication** – means the deferral of historical responsibilities and /or historical roles to another entity.
- **abdicate / abdication – means** the deferral of historical responsibilities and /or historical roles to another entity.
- **Acquire /** acquires is broadly defined to include:
  1) the act of constructively taking **physical possession** of anything of value,
  or
  2) the act of constructively receiving a **promise or commitment** or **provision** for **future** delivery or transfer or future benefit of anything of value.
- **Asset** - Any valuable, but non tangible, or non-liquid asset or asset not convertible into monetary form (e.g.: a contributed vacation) shall have the value assessed and that amount shall be the value of the asset. (This amount shall be seized from the offending politician's personal assets, or the assets of the offending politician's other, **direct** interests or indirect **interests**.
- appointed – means directed to serve, or authorized to serve, in an administrative or executive or management position whereby a **vote** or official approval of the appropriate **group** – usually comprised of an official Board or Council or other such panel of administrators – is required to officially install the incumbent into the appointed position.
- appointed government administrator – means any person serving in, or being considered for, any **appointed** position as an executive to serve as the head, director, chief, or any executive officer (e.g.: the County Administrative Officer) of any government entity and where such appointment requires an appropriate number of votes or approval indications, **not** from the governed, but rather from a board (e.g.: county Board of Supervisors) or council (e.g.: City Council) of a **government entity** or **quasi-government entity**.
- **"A benefit" / "of benefit" / beneficial** – means anything providing an advantage to the one benefited, whether:
  financial / economic, (e.g.: payoff, or something of value, or the elimination of unions, or the elimination of taxes for the contributor or the contributor's interest, or a favorable land acquisition, a mandate of action for which public funds will pay),
  or
  political, (e.g.: advantageous position or influence over another, or control or power over another)
  or
  social (e.g.: prohibition against eating meat, or a mandate to spay or neuter pets).

  "Benefit" specifically INCLUDES any government business which would **adversely** impact any individual, organization or group which **competes** with the **contributor**.

  For the one (or one's interest) benefited it also includes, but is not limited to any one, or any combination of, the following:
) any advantageous **provision**, (e.g.: sole source procurement)
) any action or influence toward a favorable outcome (e.g.: putting the contributor in better competitive position)
) any action or influence which will cause, or result in, a favorable outcome for the contributor, (e.g.: eliminating competitors)

  For the one (or one's interest) benefited it also includes, but is not limited to any one, or any combination, of the

following
directly or indirectly to:
1) the contributor or
2) the contributor's **interest**, or
3) the politician or
4) the politician's interest
in the **present** or in the **future**,
any bestowal or enabling of any of the following,
1) assistance,
2) subsidy,
3) compensation,
4) contract,
5) advantage,
6) profit,
7) gain
or any other such advantage which will accrue, or flow by any path, by any means, to the one benefited

The one benefited can be any one, or any combination, of the following:
1) individual,
2) group,
3) organization,
4) consortium,
5) association,
6) any other **entity**, (by any name, and whether or not officially organized) who/which is uniquely advantaged in any way, or who/which is advantaged as a group of less than 5% of the politician's constituents.

"Benefit" also includes any specific action or targeted outcome on behalf of the **contributor**, or for the benefit of the **contributor.**
"Benefit" includes the enhancement of the personal wealth of 1) the **contributor or 2) any one or any combinations of the contributor's interests** - including, but not limited to, the property of the **contributor**, or income sources of the **contributor.**

- board / council – means a group of individuals or organizational representatives who vote on proposals, and who make rules, procedures and policies by which a government organization operates.
- bunk container - truck trailers, cargo containers suitable for loading onto airborne, or sea-going cargo vessels or over-the-road trucks. Bulk containers shall be differentiated from "product containers".
- candidate – means anyone who has indicated or **announced**, formally or informally, their intention to serve in the appropriate **tax-supported public office** if and when they are later **elected** by the governed citizens. This includes any willing individual whose name appears on an official ballot for a tax-supported **public office**. However, this also includes **write-in candidates.**
- **channels** means American sources of material. If the material does not exist within the US, then the lowest cost of acquisition from sources external to the continental US.
- citizens of the United States – For the purposes of this Act: 1) An Individual born of parents one or both of whom, are/were United States Citizens OR one who has been legally naturalized and taken an oath of allegiance to the United States AND 2) one who is an adult having a mailing address and official residence in the United States or any of its **Insular Areas** (formerly protectorates), AND 3) an adult who is registered to vote in the district of their residence.
  - citizens of the United States – United States citizens having a mailing address and official residence in the US or any of its protectorates, and who are registered to vote. Herein, this term is specifically differentiated from the elected and/or appointed politicians.
- compensation received from the contributor shall mean, that which was received as the contribution, or the corresponding value of the contribution.
  In the case of a **self funded** offending politician, **compensation received from the contributor** shall be defined as the greater of
  1 the entire amount spent on the **offending** politician's campaign, **or**
  2. the estimated amount which the politician's **direct** interest or indirect interest would have gained from the offending vote or decision or influence. (as estimated by **a local,** reputable appraiser, accounting firm - not one of the investigative oversight organizations or the Distribution Agency)
  The greater of item 1 or 2 above shall be seized, and finalized from the offending politician's other, direct or indirect, assets.
  Constructive receipt
  Regardless of the source of funds or the timing of the receipt, or the individual accepting the contribution, a contribution shall be considered constructively received by the **politician** if any of the following are true:

1) If any contributor provides any value to the politician directly
2) If any contributor provides any value to creditors of the politician on behalf of the politician or the politician's direct interest or the politician's indirect interest (For example, but not limited to: allowing the politician or the politician's interest to use a credit card or have a tab or any other method of using any form of credit, which is to be paid by another entity, is deemed direct constructive receipt,).
3) If any contributor transmits (by any means), directly or indirectly, any value to entities or organizations with which, or to which, the politician has any direct interest or any indirect interest
Any valuable, but non tangible, or non-liquid asset or asset not convertible into monetary form (e.g.: a contributed vacation) shall have the value assessed and an equivalent amount shall be seized from the assets of the direct interest or indirect interest of the offending politician.

- **competitive** - competitive means amount at which a similar economic good could be acquired if manufactured or assembled, or mined or pumped or acquired via any process of harvesting or extraction (with or without additional processing) from a source within the continental US.
- **consumer** - consumer means the final retail user of the economic good
- **continental US labor** - means the use of American labor and calculating production cost using the hourly compensation of the average American manufacturing worker
- **contributing organization(s) / entity(ies)** – (whether singular or plural) means Any/all organization(s) (and/or entity(ies) which contribute to the politician or to, (or for) the politician's interest.
- **contribution** – means
any direct transfer or
any promise or commitment or provision of transfer
of anything
of value
greater than
the insignificant amount
from a contributor to a politician,
whether direct or indirect,
whether monetary or non-monetary,
whether current or future,
in any form,
shall be deemed a contribution constructively received by the politician.
- contribution oversight agency – see the GCIOO
- **contributor**
Contributor is broadly extended to include any entity who (or which), either directly or indirectly,
provides,
transfers,
gives,
anything of value to a politician

The term contributor is broadly extended to mean any combination of, or any single:
individual,
group,
organization,
consortium,
association,
or
any other entity,(by whatever title or name) whether or not officially organized, who gives, provides, or causes, directly or indirectly, the politician to receive, directly or indirectly, in the present or future, anything of value over the insignificant amount (basis 2011).
The term contributor is broadly extended to include the direct interest and/or the indirect interest of the politician.
The term contributor is broadly extended to include anyone who provided or who provides or who will provide any benefit of value to the politician.
The term contributor is broadly extended to include anyone who has any special interest (economic, social or political) in an outcome decided/influenced by the politician.
For the purposes of this Act, "contributor" includes any organization or entity which advertises (by that or any other name) in any mass media on behalf of, or for the benefit of, the politician - where the fee for the advertisement (by that or any other name) exceeds the insignificant amount.
Specifically excluded from the definition of "contributor" are individuals who personally donate their time to campaign for the politician/candidate.
- **control** – the ability to make decisions toward a desired goal or purpose, and the authority to issue orders supporting that goal, and/or the authority and power to mobilize forces to carry out actions in support of that goal or purpose. It also means the ability to direct the events of an entity, or to direct the actions of an entity

- cost of production - The mathematical product (multiplication) of the "labor rate" times the "number of man-hours required to "create or acquire" the economic good – assuming the use of the most current tools and equipment available within the borders of the United States..
- **creditor** – means any entity to whom the politician is indebted for any economic good or service the **politician** received. It also includes any entity to which the **politician** caused an entry to be charged to any account. A creditor includes anyone who and/or any organization which has provided to the politician an economic good or service, and for which they desire payment or reimbursement.
- demographic market means that population in the geographic area in which the economic good is to be sold (or through which the economic good is to be transferred)
- **direct** – means straight from the **contributor** to the **politician** or from the **politician** to the **contributor**
- **direct interest** – means any one or combination of the following:
  any entity which (prior to the politician assuming the duties of the office) provided funding to, or advocated, or actively supported the politician,
  any organization (or entity) whose role is to support the politician or the politician's interest – particularly if the organization (or entity) held contributed funds for use in supporting the politician or the politician's interest.
  any business, entity or organization holding anything of value over which the **politician** has or formerly had any **fiscal** control or directive influence,
  any entity for which the politician has (or had) even extended family ties, or
  any entity whose purpose is to affect social awareness or change to which the **politician** has or had ties, or
  any entity with which the **politician** has or had economic/business interest(s) or
  any entity with which the **politician** has other direct political-interest ties
  any entity with which the **politician** has other direct social-interest ties
  All politicians are hereby specifically deemed to have an "direct-interest" in and desire to benefit any direct or indirect interest with which they were associated before assuming the political office.
- direct, popular vote - the votes cast by all citizens of the United States (and the people of its insular areas (formerly known as "protectorates", for example Puerto Rico) who chose to exercise their right to vote in an honestly conducted election or the consideration of a ballot measure.
- **directly to the contributor** shall mean
  a direct path, without intermediary(ies), from the **politician or the politician's influence** to the **contributor**, or for the contributor's personal use and/or personal control.
  This includes a direct path from the politician to the **contributor**,
- distribution – a disbursement of liquid assets to the resident governed citizens, less usual and customary fees charged by the Escrow Agent, or other disbursements as specified within the Act
- Distribution Agency – The Distribution Agency is the very small organization independent from the WDO and independent from the government departments the WDO investigates. is responsible for enforcement against offending politicians It shall 1) be a check and balance of the WDO and 2), dispose of non-liquid, physical assets seized from offending politicians, and 3) distribute the converted, liquid assets directly to the resident governed citizens. This Agency is a very small, independent organization having managers elected by the citizens. It has minimal staff, and is sized as a very small fraction of the number of elected officials over which it has oversight.
- easily accessible public record – means
  1) rapidly posted to, and listed on, an appropriate, well publicized web page (and other electronic media as appropriate)
  2) rapidly available in printed form upon request by any governed citizen
  3) stated in a publication of general circulation (as appropriate, as required in the Act, or at the discretion of the WDO)
- economic good - any economically useful item - whether tangible or **intangible.**
  Tangible items include, but are not limited to, items; printed, written, manufactured or assembled, or mined or pumped or acquired via any process of harvesting or extraction (with or without additional processing).
  AND economic good includes
  Intangible items which include, but are not limited to, the dollar value of human services (for example but not limited to technical information services or technical help services – whether provided by phone or by internet.
  Intangible items also include but are not limited to items which are: electric or electronic, (but, specifically excluding the value of internet electronic traffic),
  Intangible items also include but are not limited to the value of intellectual goods or intellectual property, (for example but not limited to a computer program or part thereof, or a design, or part thereof)
  - Specifically EXCLUDED from this definition for the purposes of this Act are non-business internet transmissions.
  - Specifically, EXCLUDED from this definition for the purposes of this Act is money in certain forms as specified in the Act and only under the restrictions imposed by the Act.
  - Specifically EXCLUDED from this definition for the purposes of this Act are items for which there is

pictorial proof filed with the US Customs Service that the item(s) originated in the United States or were in use in the United States, were exported, and are being returned to the United States substantially unmodified.
- Specifically **EXCLUDED** from this definition for the purposes of this Act are humans possessing proper travel authority, and crossing the border as a matter of travel - whether for business or pleasure.

- EILOO - See Equity In Law Oversight Organization
- elected – means having received sufficient votes from the appropriate **constituents** to be chosen to serve in 1) a tax-supported public office or 2) in an **appointed** administrative position of a tax-supported government organization.
- elected candidate – **means** anyone who has been elected to the **tax-supported public office** or position sought by the candidate, but has not yet been inducted into the office.
- **Electronically / electronic form / electronic** – any digital (data) item or analog item (for example, but not limited to: a voice conversation).
- **entity** – means any individual or group or company or business or organization or cause or foundation or nation or political structure or association, or league (by that title or any other name), whether private or governmental or any combination of private and government, whether singular or plural, who stand individually or who associate themselves as a collective or cooperative group – officially or unofficially, for any specific purpose or purposes.
- **Escrow agent** – and independent agency determined by open source selection which holds the tax receipts until timely distribution can be accomplished.
- Equity in Law Oversight Organization (EILOO) - The investigative agency charged with oversight of elected and appointed politicians as it relates to self-serving legislation and/or policy; or to self-serving exemption from legislation and/or policy, It has the power, when acting with the Distribution Agency, to seize assets of offending politicians and their interests.
- **Excessive (Excess) contribution** – means a contribution of value greater than the **insignificant amount**
- **Finalize/finalization** – means
  the legal, financial and administrative steps necessary to
  convert legal title to real or personal property, and to
  convert physical assets into liquid assets (including publicizing and conducting public auctions). It requires, and authorizes those steps necessary to place the liquid assets in an escrow account - for timely distribution to the resident governed citizens in accordance with this Act.
- foreign – any entity having its loyalty (whether in whole or in part) to any entity or political cause or group other than the United States and/or its source of institutional authority from a location or entity other than within the furthest landmass boundaries of the United States (including its insular areas (formerly known as "protectorates", for example Puerto Rico). Includes, but not limited to, any economic good having origin in any location outside the United States.
  - foreign – any entity having its loyalty and source of institutional authority in a location other then within the furthest landmass boundaries of the United States (including its protectorates)
- GCIOO – see Government Contribution Investigation and Oversight Organization
- Gives – means any transfer from the contributor to the Candidate or Incumbent or Administrator, either directly or indirectly
- governed citizens – means_ resident citizens who have an active residence (not simply a P.O. Box) in the geographic area governed by the scope of this act, **whether or not registered** to vote.
- government administrator (also defined as **public administrator**) **manages** and/or **directs the staff** of any government or quasi-government organization existing or created at the level of this act (i.e.: federal agency if this act is a federal act, or state agency if this act is a state act, or county agency if this act is a county act or city agency if this act is a city act). A government administrator controls, or in any way **directs, the expenditures** of that **government entity** or **quasi-government entity**. A government administrator **approves** the creation of **procedures** and **policy** for that **agency**
- Government agency – means a government entity
- **government business** – means the direct and/or indirect **action** to initiate and/or establish (or modify), or effort to **influence** (to any degree), any, or all, of the following (including any other name carrying a similar connotation)
  1) It is also broadly defined. For example, but not limited to, any of the following:
  adjudication,
  allocation of government-controlled public funds and/or assets
  bill (a written law or legislation),
  contract (an agreement for payment in exchange for an economic good or service)
  code of standards/norms/acceptable level of performance or behavior
  decision
  declaration, directive, direction or mandate
  directive
  disbursement

distribution of government funds and/or assets
distribution of government-controlled public funds and/or assets
endorsement
expenditure
establishment of a fee
grant or denial of approval(s)
law,
measure, (a written law or legislation)
motion (a proposed written law or legislation)
position statement
policy
procedure,
pronouncement
proposed law,
proposition
recommendation,
resolution,
tax
treaty,
or any other matter allocated to the government for its action.

- government entity – means any chartered or registered or duly constituted and officially recognized person (e.g.: the governor), office (e.g.: Mayor's office), agency (e.g.: ______), commission (e.g.: ______), or organization or group (e.g.: Board of Supervisors), whose business is governance. A government entity has the official recognition, from the appropriate next-higher level of government, that the government entity is an agent of the government.
  The government entity also may include any official policy making group, or policy enforcing group, or decision-making board or council or any other such government unit.
- Government Contribution Investigation and Oversight Organization (GEIOO) – The investigative agency charged with oversight of elected and appointed politicians. It has the power, when acting with the Distribution Agency, to seize assets of offending politicians and their interests.
- government funds – means any amounts collected by the government via any form of tax, fee, levy, or any other such source of government income, It also includes any amount(s)disbursed via payment, grant, allocation, allowance (by those or any other such name(s). It also includes any form of value indicated by any stamp, credit, voucher, IOU or any other form of value (by any other name) issued by any tax-supported government entity..
- historic functions – functions traditionally relegated to elected American officials acting ethically on behalf of, and in the best interest of, the governed citizens (for example, but not limited to:
  creating laws, policies, and procedures,
  levying taxes,
  determining the proper use of public land,
  raising and maintaining an army and/or committing troops to battle,
  determining rules of commerce,
  determining judicial rules regarding civil law and criminal punishment,
  and similar matters of governance.)
- Import - import means to transfer, whether physically or electronically, into or through, any part of the United States (or any of its insular areas (formerly known as "protectorates", for example Puerto Rico) from any source or location outside the geographic area of the United States .
- import tax - a tax imposed directly, and only, on the entity seeking to import the economic good – under no circumstances shall any import tax be misconstrued as an additional sales tax (by whatever name) levied (by whatever name) on the intermediate recipient (e.g.: wholesaler/warehouser) or on the final consumer. This import tax shall be collected directly from the importer in US dollars
- imported item(s) is equivalent to, and exclusively defined as, newly imported, or modified items – The classification of newly imported item shall NOT apply to items which have pictorial proof, previously filed with the Customs Service before the item(s) was/were removed from US soil, showing that it/they are owned by a US citizen and are being returned in substantially the same condition and with the same functionality it/they had when it/they left the United States.
  For example, but not limited to:
) The personal household effects belonging to a US citizen returning from duty or service in a foreign country returning with items which were originally purchased, or in general use in, the United States. The personal household effects exemption shall be limited to one such exemption per head-of-household per year.
) Equipment used in the course of business (e.g.: unmodified musical or medical instruments.)
) Empty containers which were exported and are being returned to the US
) Items exported for repair (although import duty may be charged on the repaired portion of the item).

) Animals (domestic) temporarily exported for pasturage purposes and returned within eight months.
) Other re-imported items which are specifically specified as allowed after a direct, popular majority vote of the citizens of the United States.

- importer – importer means any corporation, agent, organization, consortium, fund, trust, individual, or any other entity (by whatever title or name) who attempts to import any "economic good".
- **incentive funds** – means
  ten (10) percent of the seized and/or finalized assets - **excluding** assets voluntarily relinquished by the politician under the Hold Harmless provision.
- Incumbent – means anyone currently serving in any **tax-supported public office**
- Indirect (Indirect) – means by any path from the source to the recipient – whether from the politician to the contributor or from the contributor to the politician (or to, or through, any of their respective interests).
  It also includes any **pass through** individual(s) or organization(s) between the contributor and the **politician or between the politician and the contributor.**
  It specifically includes any **contributor's direct business interests.**
  It also includes any path through any other
  social cause,
  specially formed group or organization (whether formally created or informally associated),
  foundation,
  company, or
  any other such entity
- Influence – **means**
  any action to use the position of the appointed government administrator, or the position of the elected incumbent to direct, or control or guide, or advocate the outcome of, any present or future matter
  any action to use the position of the appointed government administrator, or the position of the elected incumbent to influence of any present or future matter
- insignificant amount – means anything valued at less than or equal to the equivalent of the earnings of one person's normal work week at the prevailing minimum wage. Specifically, this is calculated as 5 days, times 8 hours per day, times the prevailing United States official minimum wage. (For example: 5 days x 8 hours per day x $8 per hour = $320.00 US currency). All value shall be appraised and converted, if necessary, so as to be measured in the currency of the United States (e.g.: dollars).
- Insular Area (formerly "protectorate") - means Puerto Rico, US Virgin Islands, American Samoa and any other area under the official protection of the United States.
- Interest – means - whether past, present or future, whether direct or indirect, whether any single or any combination of the following:
) any **person or group** or organization, or foundation, or entity with which one has/had a common concern, and for which one desires a **benefit** to accrue
) any **organization/committee/board/group** (by any other name) formed to fund or support the **candidacy** of the politician or to provide support of value to the politician (e.g.: election committee, or campaign fund, etc.)
) any **political** desire toward a specific outcome
) A **stake, share, or involvement** in an undertaking – especially, but not limited to, a **financial** one
) The selfish pursuit toward one's own **welfare** or advantage, (e.g.: self-interest)
) A legal matter of concern, or
) title to property, or
) legal right(s) in **property** (whether tangible or intangible)
) any matter concerning an immediate and/or extended **business**
) any matter concerning an immediate and/or extended **family/relative** (to the 3rd generation by blood-line, marriage, agreement or contract)
) any matter concerning an immediate or extended **friend or associate**.
) any matter concerning any entity (For example, but not limited to: a business) placed into any form of **trust or holding company** (by those or any other names) for the purposes of temporarily placing the entity outside the control of the politician or the politician's interest (for example, but not limited to: family, friend, associate, law firm, bank, etc.).
) A subject or goal about which one is concerned or enthusiastic - For example, but not limited to: a social **cause** or any non-profit or not-for-profit **entity** (e.g.: Humane Society, Green Peace, Center for Community Change, Advocates for Social Change, etc.) - including any coalition of such entities.
- Item – any economic good
- item containers – the container which contains one useable item. For example, but not limited to the box containing one pair of shoes, or one lamp, or one box of pencils.
- judicial decisions – decisions, rulings, determinations (by whatever title or name) issued by elected or appointed **officers of the** United States, or any other, United States judicial and/or United States legal system. Judicial

decisions by non-elected bodies (particularly foreign associations) and/or non-elected individuals are specifically ignored/voided/nullified for the purposes of this Act.

- **level of government** – means the legal scope (or span of legal influence) of government at which this act is enforceable (i.e.: the extent of the influence of the state, if this act is a state act; the extent of the influence of the county, if this act is a county act)
- **material** means the physical elements used in production
- **matter** – means any element of government business historically allocated to the entity of government (as of January 2011) at the level of the scope of this act (state if this act is a state act; the county if this act is a county act)
- medium of exchange – **means** anything of value which another entity will accept as payment for goods (whether tangible or intangible) exchanged or services rendered.
- Newly imported item(s)" is equivalent to, and exclusively defined as, newly manufactured, or newly acquired (mined, pumped, etc.) items, or newly repaired / modified items.
  EXCLUSIONS – The classification of newly imported item shall NOT apply to items which have pictorial proof, previously filed with the US Customs Service before the item(s) was/were removed from United States soil, showing that it/they are 1) owned by a US citizen and are 2) being returned in substantially the same condition and with the same functionality it/they had when it/they left the United States.
  For example, but not limited to:
) The personal household effects belonging to a US citizen returning from duty or service in a foreign country and returning with items which were originally purchased or in general use in the United States prior to the foreign duty or service. The personal household effects exemption shall be limited to one such exemption per head-of-household per year.
) Equipment originally purchased or in general use in the United States used in the course of business (e.g.: unmodified musical or medical instruments,)
) Empty containers which were exported and are being returned to the US – however, any and all contents shall be subject to inspection, evaluation and import taxation.
) Items originally purchased or in general use in the United States exported for repair (although import tax may be charged on the repaired portion of the item).
) Animals (domestic) temporarily exported for pasturage purposes and returned within eight months.
) Other items which are specified as allowed by a direct, popular majority vote of the citizens of the United States.
  Additionally, the classification of newly imported item shall NOT apply to money in the form of currency or gold or silver or precious metals, but ONLY under the condition that proof from the reputable third party is provided that the money has been transferred into an irrevocable trust (or escrow account) which is controlled by an independent third party, and from which those funds can only and exclusively be used for payment of an existing contract to acquire economic goods produced by another independent third party in the United States or its insular areas (formerly known as "protectorates", for example Puerto Rico); or can only and exclusively be used for payment of an existing contract to acquire economic services produced by another independent third party in the United States or its insular areas.
- **offending item** – an imported economic good for which documentation does not match the actual contents of a container; and/or an imported item and/or a foreign service which is in use within the boundaries of the United States for which no documentation can be produced to prove an import tax has been paid.
  - offending politician – any elected or appointed official who attempts to thwart, delay, nullify, or in any way circumvent this Act.
- offending politician – means any **politician** found to have received a contribution and who **attempts** to vote in violation of this Act, or influence **government business** (as broadly defined herein), whether successfully or unsuccessfully, in violation of this Act.
  AND, it also means any politician, judge, or official (whether elected or appointed) who attempts to thwart, delay, nullify, reduce, waive, (by those or any other names) or in any way circumvent this Act.
- offshore - off shore means outside the boundaries of 1) the continental US, and 2) the state of Alaska and 3) the state of Hawaii. Offshore is not related solely to oceanographic boundaries. (For example: Canada and all islands and countries south of the Southern continental US border are considered "offshore".)
- **on behalf of** – means that any entity has paid, directly or indirectly, for goods or services received by the **politician** directly or indirectly.
- **or** When used to separate a list of elements or conditions or constraints shall mean that any of the listed items, or any combination of the listed items apply. The phrase and/or, and the word or shall be synonymous, herein, (unless logical exclusivity prevails among elements of the list) and shall be interpreted to mean any single or any combination of the elements specified (including extension of the list of elements, if provided by that section).
- pass-through entity – means any entity(ies) which receives **value** from a contributor and transmits any part of it to any of the following, or any combination of the following:
) the **politician** or

) the **politician's interest** or
) the **politician's direct interest** or
) the **politician's indirect interest)** or
) any **other organization(s), person(s),** or **entity(ies)** with the eventual goal of benefiting the politician or the politician's interest.

- **physical possession** – means the actual possession of, or **present enjoyment** of, the value
- **politician** – means any governing official who is not specifically excluded and any of the following as applicable:
) candidate,
) elected candidate,
) incumbent who votes on proposed legislation or policies (by those or any other names),
) **appointed government administrator** who influences government policy or decisions,
) **any** contractor(s) compensated in any way by a politician or paid from tax (and/or fee) funds for their service in a government or quasi-governmental or advisory role and who are **not specifically excluded**, and/or who serve in, or for, any tax-supported public office, or who **influence** any government business
) Anyone who defines binding rules, policies, procedures, and/or taxes, on citizens;;
) Anyone who decides how land which is covered by government oversight is used
) Anyone who decides the amount or taxes/fees and/or how tax/fee revenue is expended.
- **politician's influence** – means the offices, agencies, organizations, accounts, laws, policies, procedures, staff, under the organizational control or pressure or deal-making (directly or indirectly) of the politician.
- populous – means those people (more inclusive than resident governed citizens) living in the area of influence of this act (the state if a state act, the county if a county act, etc.)
- produce / produced - produce / produced means the process of creating or acquiring any economic good (for example: including but not limited to, mining / pumping / manufacturing / growing / harvesting / etc). It also includes any service rendered.
- Product – means any economic good (for example: including **but not** limited to any item made, or provided, or acquired by, mining / pumping / manufacturing / growing / harvesting / etc – whether or not processed). It also includes any service rendered.
- product containers - smaller, more individualized containers (usually but not limited to cardboard (by that or any other name) boxes. Such product containers hold sufficient product to permit efficient warehousing and eventual distribution to a single retail company (but not limited to a single physical retail location). For example, but not limited to: a "case" of shoes having multiple pairs of shoes.
- promise or commitment or provision – **means** any assurance or indication that future value will follow. (For example: **a** promise of **a** later payment or a later employee position with the contributor (or an entity under the contributor's control or under the contributor's influence) or the **direct** or **indirect** indication of a later consultant position with the contributor (or an entity under the contributor's control or influence) or the indication the **politician** would be the sole source supplier to the contributor (or an entity under the contributor's control or influence) would be acquisition of a future value, and would be **constructive receipt** of the value.)
- **provides** – means causes, in any way or by any action or influence, to come to fruition - either directly or indirectly, presently or in the future.
- public office – means any officially recognized government position within an organization which exerts any influence over, or make any **decisions** regarding, **government business**,
- **purchaser** means the final or intermediate buyer of the economic good.
- **quasi-government entity** – means any combination of government entities, and/or any combination of government and private entities.
- ratify (by that or any other name) - to be approved and officially sanctioned. For the purposes of this Act, this means the direct, majority, popular vote of the majority of the citizens of the United States and the people of its insular areas (formerly known as "protectorates", for example Puerto Rico)
- receives (received / **receive**) – means **acquires**, in the **present** or via any expectation of **future** benefit - either directly or indirectly.
- resident American governed citizens –fully documented American citizens who have their active personal residence within, and spend more than one-half of their time within, the boundaries of the fifty (50) United States.
- resident governed **citizens** – means documented American citizens who have an active residence (not simply a P.O. Box) in the geographic area governed by the **scope of this Act**, AND who are **registered** to vote.
- **retail price** - retail price shall be the competitive final price to the consumer
- **retail sale** - retail sale shall mean distribution to the final retail US consumer.
- **scope** – means this act is enforceable at the government of a particular state within the United States if this legislation is enacted at the state level. If this legislation is enacted at the county level, the act is enforceable at the government of a particular county with any state within the United States, etc.)
  scope of this act also means the legal scope (or span of legal influence) of government at which this act is enforceable (i.e.: the extent of the influence of the state, if this act is a state act, the extent of the influence of the county, if this act is a county act)

- **shall be taxed** means that a tax shall be levied - including all necessary actions to collect the tax.
- **similar product** - similar product shall mean a product substantially of the same purpose, quality and functionality.
- **slash (the "/" character)** - means "and, or" as logic allows.
- Sovereignty – the right to decide individually or as a collective body those things which are meaningful to the individual or to the collective body – particularly regarding the actions which should be taken, and the relative costs of those actions.
- special escrow account - special escrow account means an account specifically established for the collection, holding and per-capita distribution of import taxes. No funds shall ever be borrowed from the special escrow account. Except to fund the watch-dog organization, the funds in the special escrow account may never be used ,in any way, for the general obligations of government. This account shall be auditable by the Federal Government Auditor, but shall remain out of the control of elected officials.
- special interest – (Politician's) – means any 1) **direct** interest or any **2) indirect** interest, or 3) **present** interest or **4)** indicated or promised **future** interest which might benefit the politician personally **or their interest.** All politicians are hereby specifically **deemed to have a** "special-interest" in and desire to **benefit** any direct or indirect interest with which they were associated **before** assuming the political office.
- **State law** – any law established by the direct, popular vote of the people of that State [or, as specifically applicable, that US insular area (formerly known as "protectorate", for example Puerto Rico)]
  - State law – any law established by the direct, popular vote of the people of that State (or, as specifically applicable, that US protectorate)
- **Supremacy** – any actual, or implication of, higher authority
  - Supremacy – any actual, or implication of, higher authority
- **tax** - tax shall mean the collection of a fee measured in US dollars
- **tax refund** - tax refund means a distribution from the dedicated escrow account established specifically for, and which contains the collections of the import tax.
- tax-supported public **office** – means any office or job or position within the organizational structure of a **government** entity **or quasi-government entity** in which, or by which, or through which, the incumbent of that public office is compensated from funds which source, in whole or in part, from government funds.
- the continental US - the continental US (continental United States) shall mean only the officially recognized states of the United States - specifically including the physically separated states of Hawaii and Alaska, and specifically ***excluding*** insular areas (formerly known as "protectorates", for example Puerto Rico).
- **The US** - shall include all states of the continental United States and including all insular areas (formerly known as "protectorates", for example Puerto Rico) of the United States.
- **Timely Distribution (Timely distributed) to the Resident Governed Citizens** – means that any and all assets forfeited directly, and/or **finalized** assets shall be distributed to the resident governed citizens on a per-household basis at the time when tax refunds are distributed. Under **NO circumstances** shall ANY forfeited, seized **or finalized assets be** placed **in** any **fund, or budget, or account (by whatever name) managed by any other politician(s).** All seized and finalized assets are **specifically reserved** for distribution to the resident governed citizens.
- **transfer** - - the transition through the US or any of its insular areas (formerly known as "protectorates", for example Puerto Rico) to a nation other than the US.
- **Treaty** (by that or any other title or name) – an agreement usually, but not restricted to agreements between nations, toward a common goal or purpose.
- **United States (also US)** – The individual states of the North American union which have associated themselves as the Untied States of America. Any reference to the United States shall equally apply to its insular areas (formerly known as "protectorates", for example Puerto Rico) unless specifically modified (for example but not limited to: the continental United States).
- **US Import Service** – the independent Service of the United States which defines, assesses and collects import tax; and which inspects imported containers. This Service performs services similar to the former US Customs Service.
- valid source – means
  a source of **value or benefit** having all of the following (which shall be verifiable during investigation within 30 days of investigation commencement) :
) a unique individual, with a given, family name
) a unique phone number
) a unique address
) having a verifiable, direct (first hand) live individual contributor (not a business or other such entity) with whom an interview reveals a genuine contribution of value - without expectation of any corresponding vote or influence upon government business.
- **Value** – means
  any useful **economic good** for which barter, or payment via any **medium of exchange,** or quid-pro-quo service would normally be required.

Value is ascribed to any item or act which increases physical and/or psychological pleasure (e.g.: an award or personal service) or which reduces displeasure.
Value also includes **Intangible** elements (for **example: any present control over** an entity and includes any promise or indication of future **control over an** entity).
However, **for the purposes of this act, value specifically means** an amount **In excess of the insignificant amount.**

- **verified American citizens** - means natural persons having verifiable birth records or naturalization documents showing official US citizenship. For distribution purposes, persons must be documented as of the end of the previous calendar year.
- vote – means
  1) Cast an indication of preference regarding an official motion or proposition requiring a decision, which is being considered by the leaders of the tax-supported organization. As determined by context, "vote" can also mean the indication of preference by the resident governed citizens.
  and/or
  2) Vote broadly also includes the exercise of the ability to have a **determining influence** regarding the definition of (or the implementation of) any executive order.
  and/or
  3) Vote broadly also includes the exercise of the ability to permit or authorize or direct or influence any government business.
- wholesale sale - wholesale sale shall mean distribution to the wholesale US consumer who will perform warehousing and/or additional manufacturing or additional processing toward a final economic good.

Version 1 Amendment 1

INITIATIVE MEASURE TO BE SUBMITTED DIRECTLY TO VOTERS

SECTION 1. STATEMENT OF FINDINGS

A. California government agencies recognize the value of providing adequate retirement benefits to their government employees. At the same time, government agencies have a responsibility to taxpayers to ensure such benefits are reasonable, adequately funded and do not drain funds needed for essential government services.

B. California's state and local pension systems present an immediate crisis. The California legislature's government reform agency, the Little Hoover Commission, issued a report in February, 2011 stating, *"California's pension plans are dangerously underfunded, the result of overly generous benefit promises, wishful thinking and an unwillingness to plan prudently."* The Commission also concluded the current governance structure of our pension funds *"lack oversight and accountability."* Taxpayers are left holding the bill for the excessive benefits promised by our politicians and our poorly managed pension funds. In fact, the problem is so serious, in October 2011, the City Managers' Department of the League of California Cities sent a letter to its board of directors indicating nothing short of an amendment to the state constitution was required to solve the government pension problem.

C. Under the federal law for private sector pension funds, a pension plan with assets less than 80 percent of its liabilities is deemed "at-risk" and the pension fund must take remedial financial measures. According to the Commission, all 10 of California's largest pension funds are presently at-risk, leaving generations of California taxpayers with over $240 billion in unfunded pension debt, or more than $20,000 for each California household.

D. In addition, the system is riddled with abuses. End-of-career "spiking" of a government employee's wage enables many to earn more in retirement than they ever earned while working and many retirees are receiving annual benefit increases that exceed the cost of living. Plans even allow pension payments to government employees who commit felonies in connection with their government employment. Pension board members and staff have been accused of conflicts of interest and failure to adequately perform their fiduciary duties to protect the fiscal integrity of their funds, especially by adopting unrealistic assumptions about future earnings and allowing large unfunded liabilities.

E. Raising taxes will not solve the problem. The level of taxation required to eliminate the hundreds of billions of unfunded pension liabilities would cripple our economy and thereby further reduce government revenues. Similarly, cutting government or reducing services to pay for the rising pension obligations is not possible without severely impacting critical government services like public safety, education and critical safety net services. As the Commission noted: *"Barring a miraculous market advance*

and sustained economic expansion, no government entity – especially at the local level – will be able to absorb the blow without severe cuts to services."

F. Lastly, we cannot correct the problem simply by establishing a second, less costly, pension system for new workers. The Commission was very clear on this point, *"The situation is dire, and the menu of proposed changes that include, increasing contributions and introducing a second tier of benefits for new employees will not be enough to reduce unfunded liabilities."* The problem *"cannot be solved without addressing the pension liabilities of current employees."*

G. Government employees, survivors and beneficiaries deserve the benefits reasonably expected to be received and to preserve the basic character of earned retirement benefits. Taxpayers agree with these goals but also deserve to have a government pension system that is free from windfalls and other disproportionate benefits which bear no relationship to the fundamental principles of a sound retirement system. California must adopt constitutional rules for pensions that adequately balance governmental employees' needs with the taxpayers' ability to fund those pension systems in a long-term, sustainable fashion without unduly stressing government's ability to provide essential government services.

SECTION 2. STATEMENT OF PURPOSE

The people hereby enact the "Government Employee Pension Reform Act of 2012" to:

A. Provide fiscally responsible and adequately funded pension benefits for all past, current, and future government employees and retirees;

B. Authorize the government's exercise of its inherent police powers to protect essential government services, and temporarily require government employees, including those hired prior to the effective date of these provisions, to contribute a larger share of their pension benefit costs and to meet other requirements while their pension funds are at risk; and

C. Require Pension Boards to possess the necessary expertise to manage government pension assets and liabilities, to be free from conflicts of interest and to exercise their fiduciary responsibilities based on generally accepted principles of sound accounting.

SECTION 3. GOVERNMENT EMPLOYEE PENSION REFORM ACT OF 2012.

Section 12 of Article VII of the California Constitution is added to read:

Sec. 12(a) The state and all other government agencies may provide reasonable and fiscally responsible pension or other retirement benefits for their government employees subject to the limitations provided herein.

(b) The following limitations shall apply to a retirement plan funded, in whole or in part, by a government agency and provided for the benefit of government employees hired on or after July 1, 2013:

(1) The retirement plan shall not have the potential to accumulate debt or unfunded liabilities owed by the government agency. Any defined benefit or annuity offered may not be underwritten by, or become the obligation of, a government agency or government pension fund.

(2) A government employee shall contribute an amount at least equal to the amount contributed by the government employer to any retirement plan. In no event may a government employer make any contribution to a plan which is the responsibility of a government employee.

(3) A government employer shall not contribute in the aggregate: (i) more than six percent (6 percent) of the base wage of a government employee, excluding public safety employees; nor (ii) more than nine percent (9 percent) of a public safety employee's base wage; to all of the retirement plans for which such government employee is eligible.

(4) Notwithstanding paragraphs (1) and (3), a government employer, whose government employees are not covered by federal Social Security, shall also provide a defined retirement replacement benefit that as precisely as possible matches the Social Security defined retirement benefit the government employee would otherwise receive. The amount of the defined retirement replacement benefit is to be measured by the benefit to the government employee, not the cost to the government employer. The cost of the defined retirement replacement benefit shall be shared equally by the government employer and the government employee as required by paragraph (2). In addition, any pension fund used to provide such defined retirement replacement benefit must be managed in a manner to minimize debt and long term cost. For public safety employees with at least thirty (30) years of service, notwithstanding the full retirement age under the Social Security Act, the full retirement replacement benefit shall be available at or after the age fifty-eight (58).

(5) All death and disability benefits must be provided outside the retirement system. Nothing in this provision shall prevent a governmental entity from providing such benefits.

(6) All government agencies shall retain exclusive authority to modify the terms of the retirement plan provided to its government employees at any time.

(7) On or before June 30, 2013, the legislative body of all government agencies providing pension or other retirement benefits shall enact laws providing for new retirement benefits for future government employees consistent with the provisions of this section.

(c) The following provisions shall apply to a retirement plan funded, in whole or in part, by a government agency and provided for the benefit of government employees whose employment commenced before July 1, 2013:

(1) No government employee who retires after June 30, 2016 shall receive pension benefits based upon a base wage greater than their highest annual average base wage over a period of three years.

(2) Within 120 days after the conclusion of a retirement plan's fiscal year, the responsible administrator shall obtain an independent review of the plan's assets and liabilities, including as a liability any outstanding balances of pension obligation bonds issued after July 1, 2011, using accounting standards and assumptions established by federal law for evaluating the funded status of private sector pension plans, including the Employee Retirement Income Security Act (ERISA). If, using market values, the plan's assets are less than eighty percent (80 percent) of the plan's liabilities (the "at-risk" funding level), the responsible administrator shall immediately notify the public and the government employer that the retirement plan does not meet the minimum funding level and is at-risk.

(3) If a government employer receives the notice pursuant to paragraph (c)(2) for any of its retirement plans indicating the retirement plan does not meet the minimum funding level and is at-risk, the government employer shall:

(i) Appropriate, or cause to be appropriated from a reserve account established pursuant to section 5 of Article XIIIB, an amount necessary to fund the plan above the at risk funding level; or

(ii) Make a finding and declare that the amount needed to fund their retirement plan above the at risk funding level required by paragraph (i) is not available without impairing the government employer's ability to provide essential government services. The failure of a government employer to make a sufficient appropriation required in subsection (i) or to make a finding and declaration under this subsection within 30 days of receiving the notice pursuant to paragraph (c)(2) shall be deemed to be a finding and declaration that funds are not available without impairing essential government services for the purposes of this section.

(4) If the government employer makes a finding and declaration pursuant to paragraph (c)(3)(ii), notwithstanding any other provision of law, including section 9 of Article I, or contract:

(i) The government agency shall immediately limit its contribution to the normal cost of the retirement plan to six percent (6 percent) of a government employee's base wage or nine percent (9 percent) in the case of public safety employees. Government employees not covered by Social Security benefits shall receive an additional government employer contribution to their normal cost obligation equal to the cost of the defined

retirement replacement benefit provided to its new government employees in subdivision (b)(4).

(ii) The government employee shall contribute the balance of the normal cost; provided however, in no event shall the obligation of the government employee under this section increase by more than 3 percent of the government employee's base wage per year. Furthermore, if the government employer and government employee's contributions so calculated leads to a contribution of less than 100 percent of the normal cost, the government employer shall make such additional contribution to ensure so that between the government employer and government employee 100 percent of the normal cost is contributed to the retirement plan.

(iii) To the extent the government employer's obligation to the normal cost is less than it was at the time of the finding, such savings shall be contributed to reduce the unfunded liability of such fund. The government employer also shall have the right to require the government employee to make additional contributions to the unfunded liability of the retirement plan as the government employer determines to be necessary and equitable, provided that the aggregate increase of the government employee's contribution to the normal cost and the unfunded liability in the aggregate does not exceed 3 percent of the government employee's base wage per year.

(iv) Once a finding and declaration in paragraph (c)(3)(ii) is made, the provisions of this paragraph shall remain in effect until such government employer's retirement plan exceeds the at risk funding level provided in paragraph (2) at which time the limitations of this paragraph shall cease.

(5) If the government employer makes a finding and declaration pursuant to paragraph (c)(3)(ii), the government employee shall have the right to withdraw from further participation in such plan and enter into the plan available to new government employees pursuant to Section 12 (b) above.

(d) All government agencies that provide pension or other retirement benefits for their government employees may also separately provide death and disability benefits for the benefit of their government employees, regardless of the date of hire. The cost of such death and disability benefits is not subject to the cost limitations established in this section.

(e) Nothing in this section shall limit the amount of a government employer's contribution to a government employee's health care benefit.

(f) No government agency shall provide a retroactive increase in retirement plan contributions or benefits or in the formula by which such benefits are calculated.

(g) Any increase, if any, in payments to government employee retirees granted after December 31, 2012, shall not exceed the annual percentage increase, if any, given to Social Security recipients in the most recent twelve month period. Except as provided in

the immediately preceding sentence, nothing in this section shall repeal, modify, change or impair the pension, retiree health, or other retirement benefits of persons who are receiving or are entitled to receive such benefits as a result of that person's retirement or separation from government agency employment prior to the enactment of this section.

(h) Nothing in this section shall provide for retirement benefits to Members of the Legislature pursuant to section 4.5 of Article IV.

(i) No pension benefit attributable to funds provided by a government agency shall be paid to a government retiree who has been convicted of a felony arising out of his or her service to such government agency.

(j) On and after the effective date of this section, a government employee shall not make contributions to receive additional retirement service credit for any time that does not qualify as government service or military service by the pension or retirement system.

(k) Every government employer and government employee shall make full normal cost contributions to a defined benefit plan unless the funded status of that plan as calculated in section (c)(2) is greater than one hundred twenty percent (120 percent).

(l) No additional retirement plans or deferred compensation benefits may be created or used to circumvent the intentions or limitations of these provisions.

(m) Pension and other retirement benefits only vest upon the performance of the work for which the benefit is earned and all pension and other retirement benefits are subject to prospective modification at the sole discretion of the government agency.

(n) As used in this section:

(1) "Base wage" means salary or hourly wage, excluding, but such exclusion is not limited to, overtime pay, bonus pay, severance pay, premium pay, per diems, allowances for transportation, housing, equipment and clothing and payments for accrued but unused vacation and sick days.

(2) "Government agency" includes, but is not limited to, the state, counties, cities, charter counties, charter cities, charter city and counties, school district, special districts, boards, and commissions.

(3) "Government employee" and "employee" mean a person who is or becomes an employee of a government agency, excluding judges subject to the provisions of section 20 of Article VI.

(4) "Government employer" means a government agency employing one or more government employees.

(5) "Normal cost" means the annual cost attributable, under the actuarial cost method selected by the pension plan, to current and future years as of a particular valuation date excluding any payment in respect of an unfunded actuarial liability.

(6) "Other retirement benefits" include, but are not limited to, a defined contribution plan providing government employer and government employee contributions to a plan or trust for the benefit of a government employee and benefits under the federal Social Security system.

(7) "Pension" or "pension benefits" means a plan or trust providing a pension benefit determined by a formula based on factors such as age, years of service, and compensation.

(8) "Public safety employee" means a government employee who is a state safety member as provided for by statute enacted by the Legislature.

(9) "Retirement plan" means an annuity, defined contribution plan, pension, deferred compensation, Social Security replacement plan or other retirement benefit. Health care benefits are not included in this definition and the limitations of this Act.

(10) "State" means the state of California and every political subdivision of the state, including, but not limited to, the Regents of the University of California, California State University, and agencies thereof.

SECTION 4. INDEPENDENT AND EXPERT PENSION BOARDS

Section 17.5 of Article XVI is added to read:

Sec. 17.5(a) Notwithstanding section 17(f), commencing July 1, 2013, every board of a government pension or retirement system shall be comprised of board members, at least a majority of whom: (1) have demonstrated expertise in the financial, legal, accounting, health care, actuarial, investment, life insurance or benefits consultant fields; and (2) are not members or beneficiaries of any California government pension plan or retirement system, or have immediate family members who are members or beneficiaries of such a plan or system.

(b) The Director of the Department of Finance shall serve as a voting member of any state or local government pension fund with total liabilities that exceed $5 billion.

(c) The Legislature shall establish the criteria and process for determining the eligibility and selection of board members pursuant to this section.

SECTION 5. GENERAL PROVISIONS

A. The provisions of this Act are severable. If any provision of this Act or its application is held invalid, that finding shall not affect other provisions or applications that can be given effect without the invalid provision or application.

B. This Act shall become effective immediately upon its approval by the voters pursuant to Section 10(a) of Article II. No government agency may enter into any employment contract or collective bargaining agreement providing for retirement benefits in excess of the limitations imposed by this Act. To the extent any current statute or constitutional provision adopted prior to the adoption of this Act is explicitly or implicitly inconsistent with the language or purposes of this Act, such statute or constitutional provision shall, upon the effective date of this Act, be rendered inapplicable, null and void.

C. Notwithstanding any other provision of law, if the State, government agency, or any of its officials fail to defend the constitutionality of this act, following its approval by the voters, the proponent, or in his or her absence, any citizen of this State shall have the authority to intervene in any court action challenging the constitutionality of this act for the purpose of defending its constitutionality, whether such action is in trial court, on appeal, and on discretionary review by the Supreme Court of California and/or the Supreme Court of the United States. The fees and costs of defending the action shall be a charge on funds appropriated to the Attorney General, which shall be satisfied promptly.

Version 2 Amendment 1

INITIATIVE MEASURE TO BE SUBMITTED DIRECTLY TO VOTERS

SECTION 1. STATEMENT OF FINDINGS

A. California government agencies recognize the value of providing adequate retirement benefits to their government employees. At the same time, government agencies have a responsibility to taxpayers to ensure such benefits are reasonable, adequately funded and do not drain funds needed for essential government services.

B. California's state and local pension systems present an immediate crisis. The California legislature's government reform agency, the Little Hoover Commission, issued a report in February, 2011 stating, *"California's pension plans are dangerously underfunded, the result of overly generous benefit promises, wishful thinking and an unwillingness to plan prudently."* The Commission also concluded the current governance structure of our pension funds *"lack oversight and accountability."* Taxpayers are left holding the bill for the excessive benefits promised by our politicians and our poorly managed pension funds. In fact, the problem is so serious, in October 2011, the City Managers' Department of the League of California Cities sent a letter to its board of directors indicating nothing short of an amendment to the state constitution was required to solve the government pension problem.

C. Under the federal law for private sector pension funds, a pension plan with assets less than 80 percent of its liabilities is deemed "at-risk" and the pension fund must take remedial financial measures. According to the Commission, all 10 of California's largest pension funds are presently at-risk, leaving generations of California taxpayers with over $240 billion in unfunded pension debt, or more than $20,000 for each California household.

D. In addition, the system is riddled with abuses. End-of-career "spiking" of a government employee's wage enables many to earn more in retirement than they ever earned while working and many retirees are receiving annual benefit increases that exceed the cost of living. Plans even allow pension payments to government employees who commit felonies in connection with their government employment. Pension board members and staff have been accused of conflicts of interest and failure to adequately perform their fiduciary duties to protect the fiscal integrity of their funds, especially by adopting unrealistic assumptions about future earnings and allowing large unfunded liabilities.

E. Raising taxes will not solve the problem. The level of taxation required to eliminate the hundreds of billions of unfunded pension liabilities would cripple our economy and thereby further reduce government revenues. Similarly, cutting government or reducing services to pay for the rising pension obligations is not possible without severely impacting critical government services like public safety, education and critical safety net services. As the Commission noted: *"Barring a miraculous market*

advance and sustained economic expansion, no government entity – especially at the local level – will be able to absorb the blow without severe cuts to services."

F. Lastly, we cannot correct the problem simply by establishing a second, less costly, pension system for new workers. The Commission was very clear on this point, *"The situation is dire, and the menu of proposed changes that include increasing contributions and introducing a second tier of benefits for new employees will not be enough to reduce unfunded liabilities."* The problem *"cannot be solved without addressing the pension liabilities of current employees."*

G. Government employees, survivors and beneficiaries deserve the benefits reasonably expected to be received and to preserve the basic character of earned retirement benefits. Taxpayers agree with these goals but also deserve to have a government pension system that is free from windfalls and other disproportionate benefits which bear no relationship to the fundamental principles of a sound retirement system. California must adopt constitutional rules for pensions that adequately balance governmental employees' needs with the taxpayers' ability to fund those pension systems in a long-term, sustainable fashion without unduly stressing government's ability to provide essential government services.

SECTION 2. STATEMENT OF PURPOSE

The people hereby enact the "Government Employee Pension Reform Act of 2012" to:

A. Provide fiscally responsible and adequately funded pension benefits for all past, current, and future government employees and retirees;

B. Authorize the government's exercise of its inherent police powers to protect essential government services, and temporarily require government employees, including those hired prior to the effective date of these provisions, to contribute a larger share of their pension benefit costs and to meet other requirements while their pension funds are at risk; and

C. Require Pension Boards to possess the necessary expertise to manage government pension assets and liabilities, to be free from conflicts of interest and to exercise their fiduciary responsibilities based on generally accepted principles of sound accounting.

SECTION 3. GOVERNMENT EMPLOYEE PENSION REFORM ACT OF 2012

Section 12 of Article VII of the California Constitution is added to read:

Sec. 12(a) The state and all other government agencies may provide reasonable and fiscally responsible pension or other retirement benefits for their government employees subject to the limitations provided herein.

(b) Subject to the exclusions identified below, government employees first hired on or after July 1, 2013 only shall be entitled to participate in retirement plans which comply with the following:

(1) The Legislature shall enact, by a two-thirds vote of each house, a hybrid retirement system for all government employees in accordance with this section.

(2) The hybrid retirement system shall be designed to provide, upon full retirement, replacement income as prescribed in this subparagraph:

(i) The service retirement formula applicable for the calculation of a defined pension benefit of any safety member classification shall provide a benefit upon retirement for a full career in government service at 58 years of age that, when combined with anticipated defined contribution plan benefits and any benefit payments under the federal Social Security Act, 75 percent of the member's base wage. For purposes of this clause, a "full career in government service" means 30 years of government service.

(ii) The service retirement formula applicable for the calculation of a defined pension benefit for any member in a non-safety classification shall provide a benefit upon retirement for a full career in government service at 67 years of age that, when combined with anticipated defined contribution plan benefits and any benefit payments under the federal Social Security Act, 75 percent of the member's base wage. For purposes of this clause, a "full career in government service" means 35 years of government service.

(iii) Any pension fund offering a defined benefit pension as part of a qualified hybrid plan shall:

(A) Calculate base wage based upon an average of their highest three years base wage.

(B) Limit the defined benefit to 25 percent of base wage after a full career in government service, except that government employees not participating in Social Security may receive up to 50 percent of base wage after a full career in government service.

(C) In no event provide for a pension benefit for the defined benefit portion that exceeds $100,000 per year, adjusted for inflation every 12 months beginning July 1, 2014.

(D) Provide that the government employer and government employee shall equally share all costs of the defined benefit, including any payments for unfunded liabilities.

(E) Allow government employees to retire five years before their full retirement age with a full actuarial deduction for the earlier retirement applied to their pension benefit.

(F) Provide that the fund trustees minimize unfunded liabilities and long term cost by adopting accounting standards and actuarial assumptions that ensure the cost of defined benefits are fully paid in the year they are earned and not deferred to future government budgets and future government employees. Any future unfunded obligations associated with these benefits shall be repaid in accordance with generally accepted accounting principles.

(iv) Each government employer shall select a defined contribution plan administrator that offers a range of appropriate, professionally managed investment options and minimizes operations and investment costs. Upon retirement, the government employer or its retirement plan shall offer retirees an option to convert defined contribution benefits into annuities underwritten by regulated financial institutions meeting prudent capital and financial standards established by the Legislature. A government employer or retirement plan may also offer a collective defined contribution plan so long as the public employer or taxpayers bear no investment or actuarial risk for additional contributions.

(3) All death and disability benefits must be provided outside the retirement system except for integrated defined contribution benefits. Nothing in this provision shall prevent a governmental entity from providing such benefits.

(c) The following provisions shall apply to a retirement plan funded, in whole or in part, by a government agency and provided for the benefit of government employees whose employment commenced before July 1, 2013:

(1) No government employee who retires after June 30, 2016 shall receive pension benefits based upon a base wage greater than their highest annual average base wage over a period of three years.

(2) Within 120 days after the conclusion of a retirement plan's fiscal year, the responsible administrator shall obtain an independent review of the plan's assets and liabilities, including as a liability any outstanding balances of pension obligation bonds issued after July 1, 2011, using accounting standards and assumptions established by federal law for evaluating the funded status of private sector pension plans, including the Employee Retirement Income Security Act (ERISA). If, using market values, the plan's assets are less than eighty percent (80 percent) of the plan's liabilities (the "at-risk" funding level), the responsible administrator shall immediately notify the public and the government employer that the retirement plan does not meet the minimum funding level and is at-risk.

(3) If a government employer receives the notice pursuant to paragraph (c)(2) for any of its retirement plans indicating the retirement plan does not meet the minimum funding level and is at-risk, the government employer shall:

(i) Appropriate, or cause to be appropriated from a reserve account established pursuant to section 5 of Article XIIIB, an amount necessary to fund the plan above the at risk funding level; or

(ii) Make a finding and declare that the amount needed to fund their retirement plan above the at-risk funding level required by paragraph (i) is not available without impairing the government employer's ability to provide essential government services. The failure of a government employer to make a sufficient appropriation required in subsection (i) or to make a finding and declaration under this subsection within 30 days of receiving the notice pursuant to paragraph (c)(2), shall be deemed to be a finding and declaration that funds are not available without impairing essential government services for the purposes of this section.

(4) If the government employer makes a finding and declaration pursuant to paragraph (c)(3)(ii), notwithstanding any other provision of law, including section 9 of Article I, or contract:

(i) The government agency shall immediately limit its contribution to the normal cost of the retirement plan to six percent (6 percent) of a government employee's base wage or nine percent (9 percent) in the case of public safety employees. Government employees not covered by Social Security benefits shall receive an additional government employer contribution to their normal cost obligation equal to 25 percent of the cost of the defined benefit provided to new government employees.

(ii) The government employee shall contribute the balance of the normal cost; provided however, in no event shall the obligation of the government employee under this section increase by more than 3 percent of the government employee's base wage per year. Furthermore, if the government employer and government employee's contributions so calculated leads to a contribution of less than 100 percent of the normal cost, the government employer shall make such additional contribution to ensure 100 percent of the normal cost is contributed to the retirement plan.

(iii) To the extent the government employer's obligation to the normal cost is less than it was at the time of the finding, such savings shall be contributed to reduce the unfunded liability of such fund. The government employer also shall have the right to require the government employee to make additional contributions to the unfunded liability of the retirement plan as the government employer determines to be necessary and equitable, provided that the aggregate increase of the government employee's contribution to the normal cost and the unfunded liability in the aggregate does not exceed 3 percent of the government employee's base wage per year.

(iv) Once a finding and declaration in paragraph (c)(3)(ii) is made, the provisions of this paragraph shall remain in effect until such government employer's retirement plan exceeds the at risk funding level provided in paragraph (2) at which time the limitations of this paragraph shall cease.

(5) If the government employer makes a finding and declaration pursuant to paragraph (c)(3)(ii), the government employee shall have the right to withdraw from further participation in such plan and enter into the plan available to new government employees pursuant to Section 12 (b) above.

(d) All government agencies that provide pension or other retirement benefits for their government employees may also separately provide death and disability benefits for the benefit of their government employees, regardless of the date of hire. The cost of such death and disability benefits is not subject to the cost limitations established in this section.

(e) Nothing in this section shall limit the amount of a government employer's contribution to a government employee's health care benefit.

(f) No government agency shall provide a retroactive increase in retirement plan contributions or benefits or in the formula by which such benefits are calculated.

(g) Any increase, if any, in payments to government employee retirees granted after December 31, 2012, shall not exceed the annual percentage increase, if any, given to Social Security recipients in the most recent twelve month period. Except as provided in the immediately preceding sentence, nothing in this section shall repeal, modify, change or impair the pension, retiree health, or other retirement benefits of persons who are receiving or are entitled to receive such benefits as a result of that person's retirement or separation from government agency employment prior to the enactment of this section.

(h) Nothing in this section shall provide for retirement benefits to Members of the Legislature pursuant to section 4.5 of Article IV.

(i) No pension benefit attributable to funds provided by a government agency shall be paid to a government retiree who has been convicted of a felony arising out of his or her service to such government agency.

(j) On and after the effective date of this section, a member shall not make contributions to receive additional retirement service credit for any time that does not qualify as government service or military service by the pension or retirement system.

(k) Every government employer and government employee shall make full normal cost contributions to a defined benefit plan unless the funded status as calculated in section (c)(2) is greater than one hundred twenty percent (120 percent).

(l) No additional retirement plans or deferred compensation benefits may be created or used to circumvent the intentions or limitations of these provisions.

(m) Pension and other retirement benefits only vest upon the performance of the work for which the pension and other retirement benefits are earned and all benefits are subject to prospective modification at the sole discretion of the government agency.

(n) As used in this section:

(1) "Base wage" means salary or hourly wage, excluding, but such exclusion is not limited to, overtime pay, bonus pay, severance pay, premium pay, per diems, allowances for transportation, housing, equipment and clothing and payments for accrued but unused vacation and sick days.

(2) "Defined benefit plan" includes any retirement benefit plan other than a defined contribution plan, specifically but not exclusively including a pension plan, a supplemental income replacement plan, or any other formulaic retirement benefit which retains or confers a post-retirement obligation upon the employer.

(3) "Government agency" includes, but is not limited to, the state, counties, cities, charter counties, charter cities, charter city and counties, school district, special districts, boards, and commissions.

(4) "Government employee" and "employee" mean a person who is or becomes an employee of a government agency, excluding judges subject to the provisions of section 20 of Article VI.

(5) "Government employer" means a government agency employing one or more government employees.

(6) "Normal cost" means the annual cost attributable, under the actuarial cost method selected by the pension plan, to current and future years as of a particular valuation date excluding any payment in respect of an unfunded actuarial liability.

(7) "Other retirement benefits" include, but are not limited to, a defined contribution plan providing government employer and government employee contributions to a plan or trust for the benefit of a government employee and benefits under the federal Social Security system.

(8) "Pension" or "pension benefits" means a plan or trust providing a pension benefit determined by a formula based on factors such as age, years of service, and compensation.

(9) "Public safety employee" means a government employee who is a state safety member as provided for by statute enacted by the Legislature.

(10) "Retirement plan" means an annuity, defined contribution plan, pension, deferred compensation, Social Security replacement plan or other retirement benefit. Health care benefits are not included in this definition and the limitations of this Act.

(11) "State" means the state of California and every political subdivision of the state, including, but not limited to, the Regents of the University of California, California State University, and agencies thereof.

SECTION 4. INDEPENDENT AND EXPERT PENSION BOARDS

Section 17.5 of Article XVI is added to read:

Sec. 17.5(a) Notwithstanding section 17(f), commencing July 1, 2013, every board of a government pension or retirement system shall be comprised of board members, at least a majority of whom: (1) have demonstrated expertise in the financial, legal, accounting, health care, actuarial, investment, life insurance or benefits consultant fields; and (2) are not members or beneficiaries of any California government pension plan or retirement system, or have immediate family members who are members or beneficiaries of such a plan or system.

(b) The Director of the Department of Finance shall serve as a voting member of any state or local government pension fund with total liabilities that exceed $5 billion.

(c) The Legislature shall establish the criteria and process for determining the eligibility and selection of board members pursuant to this section.

SECTION 5. GENERAL PROVISIONS

A. The provisions of this Act are severable. If any provision of this Act or its application is held invalid, that finding shall not affect other provisions or applications that can be given effect without the invalid provision or application.

B. This Act shall become effective immediately upon its approval by the voters pursuant to Section 10(a) of Article II. No government agency may enter into any employment contract or collective bargaining agreement providing for retirement benefits in excess of the limitations imposed by this Act. To the extent any current statute or constitutional provision adopted prior to the adoption of this Act is explicitly or implicitly inconsistent with the language or purposes of this Act, such statute or constitutional provision shall, upon the effective date of this Act, be rendered inapplicable, null and void.

C. Notwithstanding any other provision of law, if the State, government agency, or any of its officials fail to defend the constitutionality of this act, following its approval by the voters, the proponent, or in his or her absence, any citizen of this State shall have the authority to intervene in any court action challenging the constitutionality of this act for the purpose of defending its constitutionality, whether such action is in trial court, on

appeal, and on discretionary review by the Supreme Court of California and/or the Supreme Court of the United States. The fees and costs of defending the action shall be a charge on funds appropriated to the Attorney General, which shall be satisfied promptly.

Attachment Two

Pension Benefits: Vesting

1100 K Street
Suite 101
Sacramento
California
95814

Telephone
916.327.7500
Facsimile
916.441.5507

November 14, 2011

To: Supervisor Bruce Gibson, Chair, San Luis Obispo County
Supervisor John Moorlach, Vice Chair, Orange County
Members, Government Finance and Operations Policy Committee

From: Eraina Ortega, Legislative Representative, CSAC
Faith Conley, Senior Legislative Analyst, CSAC

Re: Vested Pension Rights for Current Public Employees – INFORMATIONAL ITEM

Recommendation: This is an informational item.

Background. During a public pension reform discussion at the September 2011 CSAC Board of Directors meeting, staff was asked to provide information regarding the vested rights current public employees have to retirement benefits. This memo provides information from reports recently released by the Little Hoover Commission, the California Public Employees' Retirement System (CalPERS), and the Legislative Analyst's Office. Staff recommends counties consult with their counsel regarding the specific application of these issues to their county circumstances.

Little Hoover Commission Pension Reform Report. In February 2011, the Little Hoover Commission issued "*Public Pensions for Retirement Security*," in which it suggests that the Legislature must give the state and local governments the authority to alter future, unaccrued pension benefits for current employees. While the Commission acknowledged that retirement benefits promised to current workers are protected by the State's Constitutional ban on contract impairment, the Commission points to California Supreme Court case (*Brown v. Board of Administration, 21 Cal 3d 859, 864 (1978)*) which sets a high bar for altering pension benefits if the change is reasonable and necessary to serve a public purpose and the reductions are offset by comparable new advantages. The commission believes that a financially distressed county, city or special district could attempt to reduce the pension benefits of current employees for future service. Any such attempt would immediately be challenged in court which could, under the commission's theory, lead to a new precedent for changing the pension benefits for current employees.

CalPERS Vested Rights Report. In response to various proposals aimed at reforming public retirement benefits provided to currently active employees, including the Little Hoover Commission Report discussed above, the California Public Employees' Retirement System (CalPERS) in July 2011 issued a review of the case law covering the pension rights of its members and the extent to which those rights are vested. CalPERS concluded that members obtain a vested right to promised benefits regardless of whether they have yet performed the work requirements necessary to qualify for those benefits and while those vested rights may be modified to maintain the integrity of the pension system, such modifications are under extremely limited circumstances and must "pass muster" under the Contract Clause of the California Constitution. The report also finds that, "The fundamental doctrine protecting California public employee pension rights is succinctly stated [Cal. Const. art. I, section 9]: 'A public employee's pension constitutes an element of compensation and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity.'"

LAO Provides Advisement on Current Employees. In its nonpartisan analysis of the Governor's 12-Point Pension Reform Plan, the Legislative Analyst's Office (LAO) offered its own comments regarding the vested rights to pension benefits for current public employees. The LAO refers to case law which holds that the vested right to earn a pension on terms substantially equivalent to those offered by the employer at the time of employment are obtained when the employer enters public service. This right includes the preservation of already-earned benefits and the earning of benefits promised during prior service by continuing to work until retirement eligibility. The LAO further states that for employers to have the flexibility to unilaterally make changes to the pensions of current and past employees, they need to have, "explicitly preserved their rights to make such changes either at the time of an employee's hiring or in subsequent, mutually-agreed amendments to the pension arrangement." Such changes must be offset by comparable advantages, which the LAO believes would negate any expected savings. Due to such challenges, **the LAO recommends the Legislature "focus primarily on changes to future workers' benefits,"** a more legally viable approach.

Action Requested. This item is for information only.

Staff Contact. Please contact Eraina Ortega (eortega@counties.org or 916/650-8180, or Faith Conley (fconley@counties.org or 916/650-8117) for additional information.

Materials.
Little Hoover Commission Report: *Public Pensions for Retirement Security*, Executive Summary
California Public Employees' Retirement System Report: *Vested Rights of CalPERS Members*
Legislative Analyst's Office Report: *An Initial Response to the Governor's Proposal,* Excerpt

PUBLIC PENSIONS FOR RETIREMENT SECURITY

LITTLE HOOVER COMMISSION

February 2011

Executive Summary

The 2008-09 stock market collapse and housing bust exposed the structural vulnerabilities of California's public pension systems and the risky political behaviors that have led to a growing retirement obligation for state and local governments, the scale of which taxpayers are just beginning to understand.

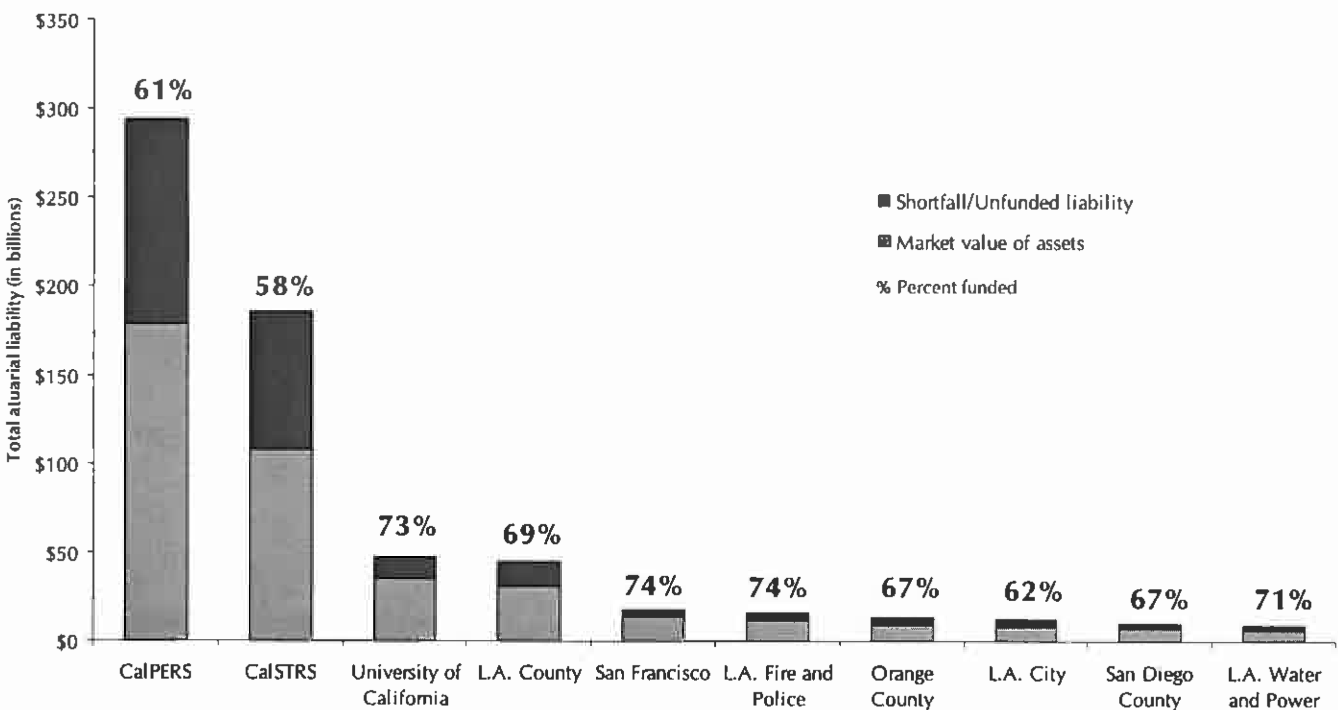
Treated like another speculative house during the boom, the state allowed public agencies and employees to pull equity in the form of increased retirement benefits from the pension funds whose value was inflated by optimistic market return estimates. The retirement promises that elected officials made to public employees over the last decade are not affordable, yet this is a mortgage that taxpayers cannot walk away from easily.

When the economy crashed, another lesson from the housing bubble became just as important. A public pension, like a house, is not a get-quick-rich investment. As a house is for shelter, a pension is for long-term financial security. Even the "teaser rates" reflecting aggressive investment assumptions are re-setting, revealing a higher cost to maintain a level of benefits that have become more generous than reasonable.

Boom and bust cycles are natural, if unpredictable, but political leaders agreed to changes in the pension system at the peak of a boom, and as a major demographic event began unfolding – the start of the retirements of the Baby Boomers.

Pension benefits promised to retirees are irrevocable, as are the promised benefits that current workers have accrued since their employment began. It also remains difficult to alter the theoretical, yet-to-be earned benefits for current workers. This situation, reinforced by decades of legal precedent, leaves little room for state and local governments to control mounting retirement costs, particularly when the only venue for change is the bargaining table.

Taxpayer groups, citizen grand juries and think tanks have sounded the alarm for reform, a call that is beginning to resonate in city councils,



The 10 largest public pension funds in California – encompassing 90 percent of all assets and members in the state's defined benefit systems – faced a combined shortfall of more than $240 billion in 2010. As a point-in-time measurement to gauge the financial health of these systems, this chart includes the percent of actuarial liabilities that are covered by the market value of assets in each fund. An 80 percent funded status is considered the low threshold for a stable system. Actuarial methodology used by each system to determine liabilities can vary, which can complicate comparisons between systems. This chart was assembled using the unaltered information as reported by the pension systems.

See end notes for sources.

county boards of supervisors, school boards and among trustees of specials districts now that they face the prospect of increasing required contributions into their pension funds by 40 to 80 percent of their payroll costs for decades to come. It is practically enough money to fund a second government, and it will – a retired government workforce.

Public employees might appear to have little incentive to push for reforms, yet they will pay a price for inaction: salary freezes, layoffs, increased payroll deductions and the threat of a city or county bankruptcy. Doing nothing to current pension obligations will cost public employees everything. A pension cannot grow without a job attached to it.

Public employees also share in the prospect of a very different California, as cities such as Los Angeles, San Diego, San Francisco and San Jose prepare to spend one third of their operating budgets on retirement costs in coming years. Pensions are at the center of what will be an intensifying fight for diminishing resources from which government can pay for schools, police officers, libraries and health services. With 86 percent of the retirees and beneficiaries of the California Public Employees' Retirement System remaining in the state, in what sort of communities do they want to live? Without reform, it will be communities with dwindling services and less police and fire protection.

The Little Hoover Commission began its study of California's public pension systems in April 2010 to understand the scale of the problem and develop recommendations to control growing pension costs in state and local governments. Over a six-month period, the Commission held a series of hearings at the State Capitol and conducted several other public meetings with stakeholders to address these issues. Through these hearings and additional research, the Commission found:

> ***Pension costs will crush government.*** Government budgets are being cut while pension costs continue to rise and squeeze other government priorities. As the Commission heard during its hearings, the tension between rising pension costs and lean government budgets is often presented today in a political context, with stakeholders debating the severity of the problem and how long it will last. In another five years, when pension contributions from government are expected to jump and remain at higher levels for decades in order to keep retirement systems solvent, there will be no debate about the magnitude of the problem. Even with the introduction of two-tiered pension plans, barring a miraculous market advance, few government entities – especially at the local level – will be able to absorb the blow without severe cuts to services.

The math doesn't work. Investment losses in 2008-09 certainly shocked the system, but several other factors have contributed to an unsustainable pension environment. Payroll growth – in terms of both compensation for public employees and the number of employees – has ballooned pension liabilities. The minimum retirement age has dropped to 55 – earlier for public safety employees – as people live longer, creating an upside-down scenario where governments potentially will send retirement checks to an employee for more years than they earned paychecks. At the same time, state and local governments have increased what used to be considered a good pension into pensions that are the most generous in the country. Banking on high fund returns and an aggressive investment strategy, employers and employees also have failed to contribute sufficiently – and on occasion, stopped paying into the system at all. Today, the state's largest pension systems are dangerously underfunded.

The system lacks discipline. The purpose of the public pension system has shifted away from providing retirement security to public employees. Today, the pension system is regarded as deferred compensation – the perceived tradeoff of earning a lower salary in the public sector in exchange for a good retirement package. The retirement systems invest aggressively to help workers accumulate wealth, which leaves taxpayers facing all the risk when returns fail to meet system needs. A lesson from history would suggest that, when the market eventually recovers, the pressure from employees will return to ramp up pension formulas and undo any reforms being made today. The ability or willingness of elected officials to hold the line on their own is in serious doubt.

The system lacks oversight and accountability. CalPERS, the largest pension plan in the country, covers state workers and many city, county and school district workers – roughly half of all public employees in California, 1.6 million altogether. Other public workers in universities, cities, counties, school districts and special districts receive retirement benefits through dozens of other independently run pension plans. The collective-bargaining environment also allows numerous employee unions within each government entity to negotiate separately for benefits, resulting in thousands of different retirement packages across the state. Since 2008, fewer than 30 of the 1,500 local public agencies in the CalPERS network have adopted a lower level of pension benefits for new hires. As pension portfolios shrunk and tax revenues plunged, nearly 200 public agencies in CalPERS

continued to increase retirement benefits for current workers. This lack of uniformity:

- Clouds transparency.
- Invites mischief and abuse, such as pension "spiking."
- Creates a compensation arms race among communities.
- Delegates complicated decisions to often inexperienced, local officials.

With needed reforms, defined-benefit pensions can remain a core component of public employee retirement plans.

The problem, however, cannot be solved without addressing the pension liabilities of current employees. The state and local governments need the authority to restructure future, unearned retirement benefits for their employees. The Legislature should pass legislation giving this explicit authority to state and local government agencies. While this legislation may entail the courts having to revisit prior court decisions, failure to seek this authority will prevent the Legislature from having the tools it needs to address the magnitude of the pension shortfall facing state and local governments.

The situation is dire, and the menu of proposed changes that include increasing contributions and introducing a second tier of benefits for new employees will not be enough to reduce unfunded liabilities to manageable levels, particularly for county and city pension plans. The only way to manage the growing size of California governments' growing liabilities is to address the cost of future, unearned benefits to current employees, which at current levels is unsustainable. Employers in the private sector have the ability and the authority to change future, un-accrued benefits for current employees. California public employers require the ability to do the same, to both protect the integrity of California's public pension systems as well as the broader public good.

Freezing earned pension benefits and re-setting pension formulas at a more realistic level going forward for current employees would allow governments to reduce their overall liabilities – particularly in public safety budgets. Police officers, firefighters and corrections officers have to be involved in the discussion because they, as a group, are younger, retire earlier and often comprise a larger share of personnel costs at both the state and local level. Public safety pensions cannot be exempted from the discussion because of political inconvenience.

Hybrid model. A new "hybrid" model for public employee retirement should be made available to state and local agencies to reinforce the

principles of retirement security and shared responsibility. The model, being tested in Orange County for miscellaneous workers, combines a lower defined-benefit pension with an employer-matched 401(k)-style plan. The 401(k) element is risk-managed to protect employee investments from market volatility in order to generate an adequate retirement income.

The idea is not new. The federal government adopted a similar approach more than 25 years ago for federal employees. Federal employees hired after 1987 have joined a three-tiered retirement plan that provides a defined-benefit formula up to 1.1 percent of final compensation for every year of service; a 401(k) plan with an employer match of up to 5 percent of salary (the first 1 percent is automatic); and, Social Security benefits (previously not provided) to augment the workers' retirement income. The newer defined-benefit pension plan requires lower contributions for employees and federal agencies – and it was 100 percent funded as of 2009. Employees hired after July 1, 2010 are automatically enrolled in the 401(k) element, with a 3 percent payroll deduction unless they change the contribution level.

Roughly half of all public employees in California do not participate in or receive Social Security benefits, so many public employees rely more heavily on state and local governments to provide larger retirement benefits. Serious consideration must be given to extending Social Security to non-covered, public-sector workers, toward the goal of building a three-part retirement strategy as has the federal government.

Uniformity. The state also must establish standards for more uniform and reasonable pensions. The public outrage over the "spiking" of benefits to provide a larger retirement income cannot continue to be ignored, nor can the increasing number of six-figure pensions for some managers and high-wage earners. The gaming and abuses of the pension system must end. To restore public confidence in the public pension system, the state must impose a cap in the $80,000 to $90,000 range on the salary used to determine pension benefits, or alternatively, a cap on pensionable income. Under such an arrangement, compensation above the cap would be factored into contributions toward an employee's 401(k)-style plan.

Transparency. The Legislature also must take steps to improve transparency of the state and local government costs of providing retirement benefits to current and future retirees. The debate over discount rates used to determine unfunded pension liabilities has laid bare the volatility of pension assets and raised important questions about the public's exposure to systemic pension obligation risk. A measure of liability is a way for the public to understand and start a fact-

based discussion about solutions to the problem. It is reasonable to try to come up with a "bottom line" on how much taxpayers owe, but it is an imperfect process. Numbers that have been used by think tanks and researchers to estimate the unfunded liabilities of California public pension plans can vary by hundreds of billions of dollars. Methodologies across studies are often inconsistent – using different asset bases, investment assumptions, the number of pension plans captured in the estimates, and the inclusion of retiree health benefits – leading to more confusion. There is no one "right" number that the state should mandate to determine actuarial liabilities. But an honest and public assessment of the risks and options about determining obligations can inform decision-makers when setting contribution rates and making investment strategies. Adding more independent, public members to retirement boards can help broaden perspectives to facilitate this conversation.

The Commission offers its recommendations in the spirit of Governor Brown's call in his State of the State address for pension reforms to be "fair to both taxpayers and workers alike." The Commission asks the Governor and the Legislature to take immediate and bold steps to put the state's pension plans on a path to sustainability and to add oversight to protect current employees, retirees and taxpayers. Delay will continue to create concern over California's ability to pay for its promises, distort local government budgets and further erode California governments' standing in the municipal bond market. The stakes are too high to continue making temporary changes at the margin.

Recommendations

Recommendation 1: To reduce growing pension liabilities of current public workers, state and local governments must pursue aggressive strategies on multiple fronts.

- The Legislature should give state and local governments the authority to alter the future, unaccrued retirement benefits for current public employees.
- State and local governments must slow down pension costs by controlling payroll growth and staffing levels.

Recommendation 2: To restore the financial health and security in California's public pension systems, California should move to a "hybrid" retirement model.

- The Legislature must create pension options for state and local governments that would retain the defined-benefit formula – but at a lower level – combined with an employer-matched 401(k)-style defined-contribution plan.

- ✓ The 401(k)-style component must be risk-managed to provide retirement security and minimize investment volatility.

Recommendation 3: To build a sustainable pension model that the public can support, the state must take immediate action to realign pension benefits and expectations.

- ❑ To provide more uniform direction to state and local agencies, the Legislature must:
  - ✓ Cap the salary that can be used to determine pension allowances, or cap the pension, at a level that is reasonable and fair. Once the employee exceeds the threshold, employees and employers could make additional retirement contributions into a risk-managed, 401(k)-type defined-contribution plan.
  - ✓ Set appropriate pension eligibility ages to discourage early retirement of productive and valuable employees.
  - ✓ Set a tight definition of final compensation, computed on base pay only, over a five-year average to prevent and discourage pension "spiking."
  - ✓ Set uniform standards for the maximum hours that retirees can return to work and continue to receive public-sector pensions.
  - ✓ Set uniform standards and definitions for disability benefits.
  - ✓ Restrict pension allowances to exclude service in an elected office.
  - ✓ Eliminate the purchase of "air time."
  - ✓ Strengthen standards for revoking or reducing pensions of public employees and elected officials convicted of certain crimes involving the public trust.
- ❑ To minimize risk to taxpayers, the responsibility for funding a sustainable pension system must be spread more equally among parties.
  - ✓ The Legislature must prohibit employees and employers from taking contribution "holidays," except under rare circumstances.
  - ✓ The Legislature must prohibit retroactive pension increases.
  - ✓ The Legislature must require employees and employers to annually adjust pension contributions based on an equal sharing of the normal costs of the plan.
  - ✓ State and local governments must explore options for coordinating pension benefits with Social Security.

Recommendation 4: To improve transparency and accountability, more information about pension costs must be provided regularly to the public.

- The Legislature must require government retirement boards to restructure their boards to add a majority or a substantial minority of independent, public members to ensure greater representation of taxpayer interests.
- All proposed pension increases must be submitted to voters in their respective jurisdictions.
  - ✓ The ballot measures must by accompanied by sound actuarial information, written in a clear and concise format.
- The Legislature must require all public pension systems to include in their annual financial reports:
  - ✓ The present value of liabilities of individual pension funds, using a sensitivity analysis of high, medium and low discount rates.
  - ✓ The government entity's pension contributions as a portion of the general operating budget and as a portion of personnel costs, trended from the past and projected into the future.
- The State Controller must expand the *Public Retirement Systems Annual Report* to include the above information. Administrative fees to pension systems should be considered as a funding source to support actuarial expertise and the timely production of the report.
- The Legislature must require pension fund administrators to improve procedures for detecting and alerting the public about unusually high salary increases of government officials that will push pension costs upward.

x

Vested Rights of CalPERS Members

Protecting the pension promises made to public employees

July 2011

CalPERS Profile

The California Public Employees' Retirement System (CalPERS) is the nation's largest public pension fund with assets of approximately $240 billion.

Headquartered in Sacramento, CalPERS provides retirement and health benefit services to more than 1.6 million members and 3,033 school and public employers. The System also operates eight Regional Offices located in Fresno, Glendale, Orange, Sacramento, San Diego, San Bernardino, San Jose, and Walnut Creek. Led by a 13-member Board of Administration, consisting of member-elected, appointed, and ex officio members, CalPERS membership consists of approximately 1.1 million active and inactive members and more than 500,000 retirees, beneficiaries, and survivors from State, school and public agencies.

Established by legislation in 1931, the System became operational in 1932 for the purpose of providing a secure retirement to State employees who dedicate their careers to public service. In 1939, new legislation allowed public agency and classified school employees to join the System for retirement benefits. CalPERS began administering health benefits for State employees in 1962, and five years later, public agencies joined the Health Program on a contract basis.

A defined benefit retirement plan, CalPERS provides benefits based on a member's years of service, age, and highest compensation. In addition, benefits are provided for disability and death.

Today CalPERS offers additional programs, including a deferred compensation retirement savings plan, member education services, and an employer trust for post-retirement benefits. Learn more at our website at **www.calpers.ca.gov.**

Contents

I. Introduction 3

II. Overview: Member Benefits And Contributions 4

III. Overview: Employer Funding Obligations 7

IV. California Contract Clause as Applied to Public Employees' Retirement Benefit Rights 8

V. Federal Contract Clause as Applied to Public Employees' Rights in California 12

VI. CalPERS Members' Rights 13

VII. The Role of CalPERS in Protecting Members' Vested Rights 16

VIII. Conclusion 17

I. Introduction

Recent economic crises affecting the world's governments and markets have brought fiscal pressures on state and local budgets in California. Budgetary constraints have focused attention on the cost of providing public services, and no cost has received more attention than the compensation and benefits earned by our public employees. Commissions, political leaders and private citizens all have weighed in on the subject, each proposing wide-ranging "reforms" aimed at reducing the retirement benefits earned by public servants. Proposals have included, for example: moving to less advantageous benefit formulas, imposing caps on pensionable compensation, changing the definition of pensionable compensation to exclude items that are currently included, lengthening the "final compensation" period on which benefits are calculated, restricting employees' rights to purchase additional service credit, lengthening eligibility periods, increasing employee contributions and eliminating employer paid member contributions. Many of these proposals seek to apply these "reforms" to currently active employees as well as those who may be hired in the future.

Understandably, this attention on the compensation and benefits of members of the California Public Employees' Retirement System ("CalPERS") has raised concerns as to the level of assurance the law provides that promised pensions will be available upon retirement.

CalPERS has prepared this paper for two purposes:

- To articulate the current state of California law regarding the nature of its members' pension rights and the extent to which such rights have become "vested" and may not be impaired; and
- To explain the role of CalPERS in ensuring that its members' vested rights are honored.

This paper is not intended to respond to any particular proposed legislation or initiative. Rather, it is intended to present CalPERS' institutional views in the broader context of its primary governing laws: the California Public Employees' Retirement Law (Gov't Code §§ 20000, et seq.) (the "PERL") and the California and United States Constitutions. The merits and enforceability of any new proposal must be analyzed on its own unique terms and conditions.

Finally, although some of the general principles and authorities discussed in this paper may be relevant to plans CalPERS administers other than the Public Employee Retirement Fund defined benefit plan, this paper is not intended to address any issues related to the CalPERS' health benefits plans, defined contribution plans, the Legislators' Retirement System or the Judges' Retirement Systems (I and II).

II. Overview: Member Benefits And Contributions

California law clearly establishes that public employee retirement benefits are a form of deferred compensation and part of the employment contract. Rights to this deferred compensation are earned when the employee provides service to the public employer.

By statute and contract, public employers, not CalPERS, decide how much of an employee's compensation will be paid currently and how much will be deferred and paid in the future. Simply put, employers grant the benefits owed to CalPERS' members. CalPERS in turn serves as the trustee of the trust created to fund these benefits, through the prudent administration and investment of the retirement fund.

The rights of all CalPERS members are established by statute. In the case of local agencies, members' rights are also governed by the contract between the agency and CalPERS. When contracting with CalPERS, local agencies may choose from a menu of options. Benefits for CalPERS members are often the product of collective bargaining.

This section provides a general overview of the core benefits earned by CalPERS members. It is not intended to be a comprehensive description of all benefits and rights of all CalPERS members.

A. Service Retirement Allowance

Each CalPERS member earns service credit towards a lifetime retirement allowance after employment, calculated under a formula which accounts for the member's years of credited service, the member's "final compensation" and the member's age at retirement. Each benefit formula is commonly referred to as a specified percentage of a member's "final compensation" for each year of service, based on a particular age at retirement. For example, under a "2% at 55" benefit formula, a member receives 2% of his or her "final compensation" per year of credited service, if that member retires at age 55. If the member retires earlier or later than age 55, the member receives a lower or higher percentage of "final compensation," according to a statutory table. For example, under the "State 2% at 55" table, a member retiring at age 50 receives 1.1% of "final compensation" per year of credited service. A member retiring at age 63 or older receives 2.5% of "final compensation" per year of credited service.

As noted, each formula applies a multiplier to a member's "final compensation." For some members, "final compensation" means the highest one-year average pensionable "compensation earnable" that they earn during their careers. For other members, the highest annualized three-year average "compensation earnable" that they earn during their careers is used. In general terms, "compensation earnable" includes the member's "payrate" (essentially base salary) and certain items of "special compensation," which are established as pensionable by law or regulation. "Compensation earnable" generally does not include items such as overtime pay and amounts that are not available to employees in the same group or class of public employment.

B. Disability Retirement Allowance

If a member has an injury or illness that prevents the member from performing the customary duties of his or her regular position, the member may be eligible for a disability retirement. If a member's disability is the result of a job-related illness or injury, and the member is a school, local or State safety, State peace officer/firefighter, State industrial, or State patrol member, the member may be entitled to an industrial disability retirement. Local miscellaneous members also may be eligible if their employer contracts with CalPERS to provide for an industrial disability retirement.

A member who is granted a disability retirement receives the greater of the service retirement allowance (if eligible) or an allowance based on a specified formula applicable to that member. A member who is granted an industrial disability retirement allowance receives the greater of his or her service retirement allowance (if eligible) or a specified percentage of the member's "final compensation" (usually 50%, but 60% for some members), plus an annuity purchased with his or her accumulated additional contributions.

> "California law clearly establishes that public employee retirement benefits are a form of deferred compensation and part of the employment contract."

C. Purchase of Service Credit

If they meet eligibility requirements, active members are entitled to purchase additional retirement service credit, which increases their retirement allowance. Additionally, where eligible, members can purchase service credit for prior public service, military service and certain other types of service. The member's cost to purchase additional service credit is set by statute and is based on actuarial assumptions and methodologies determined by the Board of Administration ("Board").

D. Death and Survivor Benefits

CalPERS provides benefits to the beneficiaries of active and retired members upon the member's death. Benefits and eligible recipients vary based on whether the member was still working at the time of death or was retired, and by the member's employer, occupation and the specific provisions in the contract between CalPERS and the employer. Additionally, a member may opt to have his or her retirement allowance reduced in order to increase the benefits that will become payable to the member's beneficiaries after the member's death.

E. Cost of Living Adjustments

A member's (or beneficiary's) initial allowance is subject to annual cost-of-living adjustments ("COLAs") that account for changes in the applicable cost of living index each year. Members and beneficiaries also may receive additional "Purchasing Power Protection" when annual COLAs have been substantially eroded by inflation over time.

F. Member Contribution Rates

Members generally contribute portions of their paychecks towards the cost of their future retirement benefits. These member contributions are established in various ways, including among other by statute, ordinance and memorandum of understanding, and they vary widely based on such things as the member's employer, occupation and bargaining unit, if any. In general, member contribution rates are established as a percentage of the member's monthly compensation. With respect to member contributions established by statute under the PERL: "The Legislature reserves the right to increase or otherwise adjust the rates of [member] contribution ... in amounts and in a manner it may from time to time find appropriate." Some member contribution rates also are expressly subject to collective bargaining.

Some employers may choose to pay a portion or all of the retirement contributions otherwise required of their employees. These payments typically are negotiated during collective bargaining and the law provides that the employer may "periodically increase, reduce, or eliminate" such payments.

G. Reciprocity

The "reciprocity" provisions of the PERL (and related provisions in the retirement laws governing other California public retirement system) provide for certain reciprocal retirement benefits for a person who works for two or more public employers during his or her career, with membership in two or more California public retirement systems.

The primary purpose of reciprocity is to "eliminate[] the adverse consequences a member might otherwise suffer when moving from one retirement system to another." Reciprocity provisions accomplish this in a number a ways, including, for example, allowing a member to use his or her highest compensation in any reciprocal system to determine the compensation used to calculate benefits from all such systems.

III. Overview: Employer Funding Obligations

The California Supreme Court long ago established that a promise of a pension made by a public employer to its employees is a promise the employer must keep. In other words, public employers in California are legally required to honor promises to current and former employees regardless of how much money they have set aside for that purpose.

In order to ensure that their promises are kept, the law requires California's public employers to pre-fund the benefits they owe by making contributions to CalPERS along with the contributions of their employees. By investing the combined contributions of members and employers, CalPERS is able to pay all of the benefits as they come due.

To successfully fund all promised benefits, the law requires the Board to maintain an actuarially sound retirement fund. As one court explained: "Actuarial soundness of [CalPERS] is necessarily implied in the total contractual commitment, because a contrary conclusion would lead to express impairment of employees' pension rights." Further, employees have a vested right to statutorily required employer contributions, even where those contributions are not linked to providing an "actuarially sound" retirement system.

"...a promise of a pension made by a public employer... is a promise the employer must keep. In other words, public employers in California are legally required to honor promises to current and former employees..."

The California Constitution provides that the Board "shall [] have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries" and "consistent with the exclusive fiduciary responsibilities vested in it, shall have the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system." The Board has authority to determine an actuarially sound rate of contributions that, together with investment earnings, will "assure the competency of the assets" of CalPERS such that all promised benefits are paid now and in the future. It is the Board's exclusive responsibility to determine the contributions that will be required of the participating employers and the participating employers then have a mandatory "ministerial" duty to pay the contributions that the Board determines are necessary. This obligation will be quickly enforced by the courts, by writ of mandate, if an employer fails to meet it.

As stated by the United States Supreme Court, a defined benefit plan "is one where the employee, upon retirement, is entitled to a fixed periodic payment. The asset pool [available to pay benefits] may be funded by employer or employee contributions, or a combination of both. But the employer typically bears the entire investment risk and … must cover any underfunding as the result of a shortfall that may occur from the plan's investments."

IV. California Contract Clause as Applied to Public Employees' Retirement Benefit Rights

A "vested" benefit is one that has matured into an irrevocable contractual right, which cannot be taken away or otherwise impaired without the member's consent, except in extremely limited circumstances. A "non-vested" benefit, on the other hand, is one that has been promised conditionally. It is generally alterable or completely revocable by the appropriate authority (usually the Legislature or the employer) without the member's consent. A public employee's right to the retirement benefits earned during employment is generally a vested right.

California has a strong public policy, enunciated through published legal decisions over the past half century, establishing that public employee retirement benefits are contractual obligations entitled to the protection of the "Contract Clause" of the State Constitution. That clause, found at Article I, section 9 of the California Constitution provides: "A ... law impairing the obligation of contracts may not be passed." (Article I, section 10 of the United States Constitution similarly prohibits a state from impairing the obligation of contracts.) This means that an employee's vested pension rights may not be impaired except under extremely limited circumstances.

The fundamental doctrine protecting California public employee pension rights is succinctly stated: "A public employee's pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity."

This doctrine has been applied and refined by dozens of California appellate cases since the 1940s. Several general rules have emerged through this jurisprudence:

RULE 1:

Employees Are Entitled To Benefits In Place During Their Employment

Public employees obtain a vested right to the provisions of the applicable retirement law that exist during the course of their public employment. Promised benefits may be increased during employment, but not decreased, absent the employees' consent.

These rules apply to all active CalPERS members, whether or not they have yet performed the requirements necessary to qualify for certain benefits that are part of the applicable retirement law. For example, even if a member has not yet satisfied the five year minimum service prerequisite to receiving most service and disability benefits, the member's right to qualify for those benefits upon completion of five years of service vests as soon as the member starts work.

The courts have established that this rule prevents not only a reduction in the benefits that have already been earned, but also a reduction in the benefits that a member is eligible to earn during **future** service. For example, a ballot proposition that purported to eliminate future benefit accruals for legislators was held unconstitutional because legislators were entitled to continue earning benefits under the law in place when they were first elected.

RULE 2:

Employees Are Entitled Only to Amounts Reasonably Expected from the Contract

Vested rights protection does not extend to unreasonable or unanticipated windfalls. In other words, the Contract Clause only protects the benefits that are reasonably expected from the contract, and does not protect "unforeseen advantages."

RULE 3:

Only Lawful Contracts with Mutual Consideration Are Protected by the Contract Clause

"The contract clause does not protect expectations that are based upon contracts that are invalid, unenforceable, or which arise without the giving of consideration. Nor does the contract clause protect expectations which are based upon legal theories other than contract, such as quasi-contract or estoppel."

For this reason, it is not an "impairment of contract" for CalPERS to correct an error by a member, the member's employer or CalPERS' staff that may have resulted in more favorable treatment to the member than the law allows. The PERL specifically authorizes CalPERS to correct such errors.

RULE 4:

Future Employees Have No Vested Rights to the Current Statutory Scheme

Employees to be hired in the future do not have vested rights to any particular retirement benefits because they have not yet entered into public employment. Thus, there is no constitutional impediment to unilaterally reducing (or even eliminating) retirement benefits for new hires of public employers, even if the public employers historically have provided such benefits to their employees as part of past employment contracts.

RULE 5:

Retired and Inactive Members Have Vested Rights to the Benefits Promised to Them When They Worked

Like active employees, retirees and inactive members have a vested right to the benefits that were in place when they were employed. However, retirees and inactive members generally do not have vested rights to beneficial changes created after their employment terminates. This is because a "member whose employment terminated before enactment of a statute offering additional benefits does not exchange services for the right to the benefits." An exception to the general rule that benefits granted after retirement are not vested arises when the retiree

or inactive member gives up another right acquired during employment in exchange for the right to receive post-employment improvements. In that case, the right to a post-employment improvement is generally a vested right.

RULE 6:

Active Employees' Vested Rights May Be Unilaterally Modified Only Under Extremely Limited Circumstances

Active public employees have a vested right to a substantial pension, but, under limited circumstances, the terms of their retirement rights may be modified before they retire. The California Supreme Court has explained: "[V]ested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. Nonetheless, such modifications must be reasonable, and to be sustained as such, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages. Further, it is advantage or disadvantage to the particular employees whose own contractual pension rights, already earned, are involved which are the criteria by which modifications to pension plans must be measured."

There are numerous California published decisions that discuss the circumstances under which modifications to the vested rights of active employees may be permitted. There are four primary steps for determining whether a modification is permissible:

(a) The first step in determining whether a modification is permissible is to determine if the unmodified right is in fact vested, meaning neither the employer nor the Legislature reserved the right to change the benefit. This is because the applicable retirement laws often contemplate changes. Indeed, the laws sometimes expressly reserve to the employer or the Legislature the right to modify or eliminate certain benefits. A member's vested right is only to the law as it is written at the time of employment, including all of its conditions.

(b) If a vested right exists, the next step is to determine whether that vested right has been changed in a way that is disadvantageous to the member.

(c) If it is determined that a vested right has been changed in a way that is disadvantageous to a member, the next step is to determine whether the change has a "material relation to the theory of a pension system and its successful operation." If it does not, then the modification is not permissible. Case law is clear 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," but, as discussed immediately below, this finding alone is not sufficient to justify a disadvantageous change to a member's vested rights.

(d) If the change bears a "material relation to the theory of a pension system and its successful operation," the final step is to determine whether the disadvantaged employees will receive a "comparable new advantage." When a court conducts this analysis, it looks specifically at what may be taken from and provided to the individually impacted employees. This member-by-member analysis, however, does not necessarily take into account each member's unique personal circumstances. Thus, a member does not get to pick and choose which advantages or disadvantages will apply to him, and then argue that his vested rights have been unconstitutionally impaired.

RULE 7:

The State's "Emergency" Powers Are Extremely Limited and Cannot Be Used to Reduce the Benefits that Have Been Promised

The courts have carved out one narrow exception to the constitutional prohibition against the impairment of contracts, although there is no case where a court has actually applied that exception in a way that has reduced the long term costs of public retirement benefits in California. Both the California and United States Supreme Courts have held that "a substantial impairment may be constitutional if it is "reasonable and necessary to serve an important public interest" during an emergency. The courts pay little heed, however, to the "legislative assessment of reasonable and necessary," 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." Thus, the courts apply a rigorous four-prong test when determining if this limited exception applies: (a) the legislative enactment must serve to protect "basic interests of society;" (b) there must be an "emergency justification for the enactment," (c) the enactment must be "appropriate for the emergency;" and (d) the enactment must be "designed as a temporary measure, during which time the vested contract rights are not lost but merely deferred for a brief period, interest running during the temporary deferment."

Thus, even if vested pension rights may be temporarily impaired in a true emergency situation, it is clear that the State's emergency powers do **not** enable it to solve its budgetary problems by eliminating or reducing the long term benefit promises it has made.

V. Federal Contract Clause as Applied to Public Employees' Rights in California

As stated above, it is clear that the "Contract Clause" of the California Constitution provides broad protections of the vested pension rights of California's public employees. Some current "reform" proposals suggest changing the State Constitution to reduce or eliminate public employee retirement benefits, in some instances even amending the Contract Clause itself. Presumably, proponents of these measures assume that by amending the State Constitution, they can avoid a constitutional challenge to their proposed impairment of vested retirement benefits. The assumption is misplaced, for two reasons:

First, if a proposed pension reform were to be enacted in the form of a constitutional amendment, it would still have to pass muster under the Contract Clause of the State Constitution. In other words, any new provision of the State Constitution would still be subject to the requirement that it not impair the obligation of contracts. Absent actually eliminating the entire Contract Clause, the fact that a pension reform measure may be adopted by way of a constitutional amendment would not assure its validity.

"Some current 'reform' proposals suggest changing the State Constitution to reduce or eliminate public employee retirement benefits...Presumably, proponents of these measures assume that by amending the State Constitution, they can avoid a constitutional challenge to their proposed impairment of vested retirement benefits. The assumption is misplaced..."

Second, even if a proposed amendment eliminated the State Constitution's Contract Clause in its entirety, *the Contract Clause in the United States Constitution would give rise to the same protection of vested pension rights* as the State Constitution. Most of the published California cases that have analyzed the constitutionality of modifying vested pension rights of public employees have not meaningfully distinguished between the Contract Clause in the California Constitution and the Contract Clause in the United States Constitution. In 1991, the California Supreme Court removed any doubt that the United States Constitution protects public employee pension rights in California to the same extent as the California Constitution, by explaining that prior case law had "never rejected the federal clause as a source of protection" and "in light of prior California decisions consistently extending federal contract clause protection to state public officers, it is simply 'too late' to retreat from the clear implication of those holdings."

Therefore, amending the California Constitution likely would not open the way to lawfully impairing vested pension rights. All of the rules discussed in Section IV above likely would still apply, no matter how the California Constitution may be amended, so long as the Contract Clause of the United States Constitution remains unchanged.

VI. CalPERS Members' Rights

Based on the legal analysis set forth above, CalPERS here articulates its understanding of the current state of vested rights law in California, as it applies to CalPERS members' benefits. Analyzing any particular member's vested rights, however, must be done on a case-by-case basis. Thus, nothing in this section is intended to express a view on any individual member's rights or any specific legislative or constitutional proposal. Further, the discussion in this section is not intended to be exhaustive, but rather to provide a general overview of our members' primary rights.

A. Vested Rights

In general, CalPERS members have vested rights to:

» Have their service retirement allowance determined based on the benefit formula that existed in the law when they provided service, if they satisfy all eligibility requirements.

» Have their retirement allowance based upon all service credit that they accrued by providing service or by purchasing service credit.

» Have their retirement allowance calculated using the definition of "final compensation" that existed in the law when they provided service.

» Have their "final compensation" determined according to the definition of "compensation earnable" that existed in the law when they provided service.

» Receive a disability allowance or an industrial disability allowance determined in accordance with the law that existed when they provided service, if the member satisfies all eligibility requirements.

» Purchase service credit under the terms that existed in the law when they provided service, if the member satisfies all eligibility requirements.

» Receive cost of living adjustments to their retirement allowance under the terms that existed in the law when they provided service. This includes "Purchasing Power Protection."

» Have their beneficiaries receive death and survivor benefits provided under the terms that existed in the law when the member provided service.

» Receive the benefits of reciprocity that existed in the law when they provided service, if they satisfy all eligibility requirements.

» Withdraw their contributions, plus accrued interest, upon separation from employment, when eligible for such a withdrawal.

» Have an actuarially sound retirement fund, which requires (a) that the CalPERS Board establish employer contribution rates sufficient to maintain the actuarial soundness of the system so that the competency of its assets is assured, and (b) that the employers timely pay those rates.

Because the above rights of CalPERS members are vested, they may only be modified if such modifications are "reasonable, and to be sustained as such, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages."

Finally, there remains a question as to whether vested rights may be consensually modified through collective bargaining without offending the Contracts Clause.

B. Non-Vested Rights

In general, CalPERS members do not have vested rights to:

» Benefit improvements that are granted to them after they have terminated employment (e.g., the "ad hoc" cost of living improvements granted to retirees based upon retirement date), unless such benefit improvements have been granted in exchange for a vested right that the retired members gave up voluntarily.

» Windfall benefits that arise out of circumstances that were never contemplated to be part of the employment contract.

» Payments in excess of those authorized by law, or arising from an error by the member, the member's employer or CalPERS.

» Perpetuation of the Board's discretionary actions affecting contributions and benefits. For example, the Board may change its actuarial assumptions and methodologies for calculating the cost for purchasing service credit, or for determining actuarial equivalency (for a variety of purposes). The Board has full authority to change actuarial assumptions and methodologies in the sound exercise of its discretion, and doing so does not impair any vested right, even if a change does not appear favorable to CalPERS members.

» Continuation of a benefit or contribution rate where the benefit or contribution rate is subject to change under the terms of the applicable statute, memorandum of understanding or employment contract.

» Continued employment with their employer or the continuation of the historical compensation practices of that employer, even if those practices impact the calculation of members' "compensation earnable" and "final compensation." For example, an employer may have historically paid certain premium amounts that qualify as pensionable "compensation earnable." While the member has a vested right to have such amounts included in "compensation earnable" when paid, the member does not have a vested right to continue to be paid those amounts.

Because the above rights are not "vested" under the Contract Clauses of the California and United States Constitutions, there is no constitutional impediment to the Legislature or a member's public employer (or the Board, in the case of its own discretionary acts) from unilaterally altering those rights. Unless and until such alterations are made, however, members of course have a right to receive all benefits provided to them under law. Further, other laws may limit the ability to make such alterations. For example, although specific employment practices may not be vested in perpetuity, the terms of a collective bargaining agreement must be honored during the period of that agreement's applicability.

VII. The Role of CalPERS in Protecting Members' Vested Rights

Under the State Constitution and the PERL, the Board (which is the 13-member governing body of CalPERS) has the exclusive and plenary authority and fiduciary duty to administer CalPERS in a manner that will assure prompt delivery of benefits and related services to the members and beneficiaries of the system. Board members are either elected by members of the system, appointed by State elected officials or sit ex officio.

One court explained the fiduciary duties of members of a public retirement board thusly: "[A] trustee's primary duty of loyalty is to the beneficiaries of the trust. The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary. The trustee must not be guided by the interest of any third person. This unwavering duty of complete loyalty to the beneficiary of the trust must be to the exclusion of the interest of all other parties. Under the rule against divided loyalties, a fiduciary cannot contend that although he had conflicting interests, he served his masters equally well or that his primary loyalty was not weakened by the pull of his secondary one."

The California Constitution provides: "A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty." The California Supreme Court has explained: "[P]ension plans create a trust relationship between pensioner beneficiaries and the trustees of pension funds who administer retirement benefits and the trustees must exercise their **fiduciary trust** in good faith and must deal fairly with the pensioners-beneficiaries."

The Board will act consistently with these principles. With respect to legislative and constitutional proposals that may impact its members' vested rights, the Board will exercise its best judgment and act appropriately under all existing circumstances. In doing so, the Board will observe certain general guidelines, including:

» CalPERS will make reasonable efforts to keep its members and beneficiaries apprised of changes or potential changes to the law that may impact their rights and responsibilities.

» CalPERS will ensure that funds spent in any process relating to potential changes in funding or benefit structures are appropriate expenditures of trust funds under Article XVI, section 17 of the California Constitution and other applicable law.

» CalPERS' actions will be carried out in a manner that implements the law. In the event CalPERS questions whether changes in the PERL or other applicable law may cause an unconstitutional impairment of its members' vested rights, CalPERS will exercise its best judgment, based on all existing circumstances, as to whether to initiate or participate in judicial challenges to such changes.

VIII. Conclusion

CalPERS is dedicated to administering the system in a manner that will ensure that the promises made to CalPERS' members and beneficiaries will be kept. CalPERS acknowledges the budgetary challenges that the State and other public agencies throughout California are presently facing, and will play an appropriate role in the addressing these challenges. In this process, it will be vitally important for all interested parties to heed the legal rules protecting the vested rights of CalPERS' members, which have developed over the course of many decades. Without due consideration of these rules, well-intentioned proposals may not achieve the purposes for which they are designed; indeed, they may lead only to additional litigation and administrative costs, which can only increase the long term cost of delivering the benefits that have been promised to CalPERS members. It is the hope of CalPERS that this paper will provide guidance to all parties as they address these challenges.

California Public Employees' Retirement System
400 Q Street
P.O. Box 942701
Sacramento, CA 94229-2701
(916) 795-3991
(916) 795-3507 fax
TTY: (916) 795-3240

Strict Legal Protections Limit Government's Flexibility

Our understanding of California's detailed case law on public pensions over the last century is as follows: in order to have the flexibility to unilaterally implement cost-saving reductions to the pensions of current and past employees, public employers need to have explicitly preserved their rights to make such changes either at the time of an employee's hiring or in subsequent, mutually-agreed amendments to the pension arrangement. Otherwise, reductions for these employees and retirees require that comparable, offsetting advantages be granted—advantages that tend to negate the pension savings.

"Comparable New Advantages" Generally Required When Disadvantaging Employees. The 1955 California Supreme Court case, *Allen v. Long Beach*, is an important landmark in California pension law. The court ruled that "changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages." One of the pension amendments invalidated in *Allen* increased each employee's pension contribution from 2 percent to 10 percent of salary. The Supreme Court, in fact, declared that this increased contribution requirement "obviously constitutes a substantial increase in the cost of pension protection to the employee without any corresponding increase in the amount of the benefit payments he will be entitled to receive upon his retirement."

In *Pasadena Police Officers Association v. City of Pasadena* (1983), a state appellate court said the precedent in *Allen* meant that "where the employee's contribution rate is a fixed element of the pension system, the rate may not be increased unless the employee receives comparable new advantages for the increased contribution." The appellate court added that while "an increase in an employee's contribution rate operates prospectively only and in effect reduces future salary...in *Allen* the Supreme Court struck down such a change on the grounds that it modified the system detrimentally to the employee without providing any comparable new advantages."

What About Changing Future Benefit Accruals? The logic in the *Allen* and *Pasadena Police Officers Association* cases, among others, makes it very difficult to assume that state or local governments could unilaterally change the rate at which current employees accrue pension benefits for their *future* service, as has been suggested by various recent proposals. (The Governor does not make such a proposal.)

In a 1982 case, *Carman v. Alvord*, the California Supreme Court noted that upon "entering public service an employee obtains a vested contractual right to earn a pension on terms substantially equivalent to those then offered by the employer." In the 1991 case concerning Proposition 140, the court considered that measure's termination of then-incumbent legislators' rights to earn future pension benefits through continued service. In that case, the court said the termination of the benefit accrual rights for these legislators was a contract impairment and was unconstitutional under the U.S. Constitution's contract clause because it infringed on their vested pension rights. (Proposition 140, it should be noted, did end pension benefits for legislators elected *after* its passage.) Furthermore, in the *Pasadena Police Officers Association* case, the appellate court noted that an employee "has a vested right not merely to preservation of benefits already earned...but also, by continuing to work until retirement eligibility, to earn the benefits, or their substantial equivalent, promised during his prior service."

Significant Challenges to Mandating That Current Workers Contribute More. While the case law described above is protective of current and past public employees' pension rights, it indicates that

governments may be able to unilaterally (that is, outside of negotiations) change elements of the pension arrangement if they have explicitly preserved the right to do so. For example, in *International Association of Firefighters, Local 145 v. City of San Diego* (1983), the California Supreme Court ruled that a city could increase employee contribution rates pursuant to city charter and ordinance provisions that allowed it to do so. Accordingly, some public employers that have carefully preserved such rights could unilaterally implement increases in current workers' pension contributions.

We suspect that many local governments may not be in a good position to defend their ability to implement such increases. While several sections of the state's CalPERS and 1937 Act laws purport to preserve the Legislature's ability to increase certain CalPERS contribution rates or make clear that state law itself does not limit local governments' ability to periodically increase, reduce, or eliminate their payments to offset required employee contributions, local governments—promising, as they do, a wide variety of retirement packages through dozens of retirement systems—may obligate themselves contractually.

Even in a 2009 decision upholding San Diego's ability to impose higher employee pension costs at a bargaining impasse, the Ninth Circuit federal appeals court distinguished between legislatively enacted reductions in employers' payment of a *share* of employees' required pension contributions (allowable, the court ruled) and legislatively imposed increases in the *total amount* of required employee pension contributions themselves (implying the latter may be unallowable under contract law). The Ninth Circuit stressed that looking into a state or local legislative body's *intent* was key to determining whether a retirement benefit provision was contractually protected. Accordingly, some local governments may have intended to include low employee contributions as a part of their pension contract, while others may not. This muddled, uncertain legal framework seems to us inconsistent with the Governor's claim that governments have broad legal ability to mandate current employee contribution increases. Furthermore, even if unilateral increases are permissible under contract law, they will directly or indirectly result in many governments having to pay more to employees in salaries or other forms of compensation in order to remain competitive in the labor market. For example, recent increases in most state employees' contributions negotiated with rank-and-file employees were accompanied by future salary increases of similar amounts.

Since increasing current employees' contributions is one of the only ways to substantially decrease employer pension costs in the short run, these substantial legal and practical hurdles mean that the Governor's plan may fail in its goal to deliver noticeable short-term cost savings to many public employers.

Key Lesson From Case Law: Governments Should Be Clear About Their Pension Rights. The case law makes clear to us that governments often have not been clear about what aspects of pension and retiree health benefits and contributions—if any—they can change unilaterally in the future and which they cannot. For this reason, we have recommended that the Legislature require local governments to explicitly disclose to employees—preferably, on the day that they are hired—which aspects of pension and retiree health benefits and contributions the public entity can change unilaterally (that is, without negotiation) and which it cannot. If it chose to do so, the Legislature could require that such disclosures reflect the results of collective bargaining and apply only to future employees. (Approval of such a requirement by voters may be necessary to avoid the state having to reimburse local governments for this disclosure mandate.)

Attachment Three

LAO's Fiscal Outlook

LAO

Mac Taylor
Legislative Analyst

November 2011

The 2012-13 Budget:

California's Fiscal Outlook

Table of Contents

Executive Summary 1

Chapter 1
The Budget Outlook 3

Chapter 2
Economy, Revenues, and Demographics 11

Chapter 3
Expenditure Projections 25

Executive Summary

This report provides our projections of current-law state General Fund revenues and expenditures for 2011–12 through 2016–17.

Economic Recovery Even Slower Than Expected

One year ago, we wrote that the U.S. economic recovery was progressing more slowly than previously expected. Once again, we have to make the same observation. While the economy has some bright spots, including export growth and strength in technology–related service sectors (which are important to California), weakness in the housing market continues to affect both the construction industry and the financial services sector. The end of the federal fiscal stimulus program and declining governmental employment also are limiting economic growth. In this forecast, we project continuation of this slow, arduous recovery, with California's unemployment rate remaining above 10 percent through mid–2014 and above 8 percent through the end of 2017.

LAO Revenue Forecast Would Translate Into $2 Billion of "Trigger Cuts"

Our updated assessment of California's economy and revenues indicate that General Fund revenues and transfers in 2011–12 will be $3.7 billion below the level assumed in the 2011–12 budget package passed in June. Under provisions of the 2011–12 budget package, this revenue shortfall would translate into $2 billion of trigger cuts to various state programs. (This includes all of the "Tier 1" trigger cuts and about three–fourths of the "Tier 2" trigger cuts.) The Director of Finance will determine the actual amount of trigger cuts to K–14 education and several other programs next month based on the *higher* of this 2011–12 revenue forecast and the forecast of the administration. Our expenditure forecast assumes that this amount of trigger cuts is implemented in 2011–12 and maintained throughout the forecast period.

Estimated 2012–13 Budget Problem of $13 Billion

$3 Billion Deficit at End of 2011–12. The net effect of (1) the lower projected revenues for 2011–12, (2) the trigger cuts, and (3) the expected inability of the state to achieve about $1.2 billion of other budget actions—as well as a few other minor changes—would leave the General Fund with a $3 billion deficit at the end of 2011–12.

$10 Billion Operating Shortfall for 2012–13. In 2012–13, the state will face increased costs due, in part, to the expiration of a number of temporary budget measures adopted in recent years. Most notably, under our forecast methodology (which does not incorporate any effects from a possible November 2012 ballot measure concerning taxes), General Fund Proposition 98 costs—as well as "settle-up" payments to schools—are projected to rise by $6 billion in 2012–13. Moreover, in 2012–13, the state must repay the $2 billion Proposition 1A property tax loan that was used to help balance the budget in 2009. We forecast that the General Fund's 2012–13 operating shortfall (the difference between annual General Fund revenues and expenditures) will be $9.8 billion.

$13 Billion Budget Problem to Solve in 2012. Accordingly, we project that the Legislature and the Governor will need to address a $12.8 billion budget problem between now and the time that the state adopts a 2012–13 budget plan.

Projected Out-Year Imbalances Gradually Decline

One year ago, the state faced ongoing budget imbalances of around $20 billion per year. Now, we forecast that the General Fund's operating shortfalls will be between $8 billion and $9 billion per year in 2013–14 and 2014–15 and then decline gradually to about $5 billion in 2016–17. By making very difficult budgetary decisions—including the trigger cuts—the Legislature and the Governor have strengthened the state's fiscal condition considerably.

Big Challenges to Face...Even With a Lower Deficit Forecast

Our forecast assumes no inflation increases for many state programs and assumes that the trigger cuts and most other recent program reductions remain in place in future years. Even under this modest budget scenario, the state faces an ongoing, multibillion dollar annual deficit, even as state revenues expand. Our forecast assumes that many billions of dollars of state budgetary and retirement obligations remain unpaid through at last 2017.

Conclusion

The Legislature now faces a much smaller budget problem than projected one year ago and the smallest projected out-year deficits since before the 2007–2009 recession. Unfortunately, there are few easy options left for balancing California's budget. Difficult program reductions already have been passed, and significant one-time budget actions may be more elusive than in prior years. Accordingly, the remaining work of eliminating the state's persistent, annual deficit will require more difficult cuts in expenditures and/or increases in revenues.

If, however, the Legislature and the Governor were to eliminate the state's ongoing annual budget deficit this year or over the course of the next few years, the focus of their efforts could finally shift away from short-term budget problems and turn to the serious long-term fiscal issues of the state's accumulated budgetary obligations and unfunded retirement liabilities.

Chapter 1

The Budget Outlook

This report provides our projections of the state's General Fund revenues and expenditures for 2011-12 through 2016-17. Our projections primarily reflect current-law spending requirements and state tax provisions, while relying on our independent assessment of the outlook for California's economy, demographics, revenues, and expenditures. This report aims to assist the Legislature with its fiscal planning as it begins to consider the 2012-13 budget. The basis of our estimates is described in the nearby box (see next page).

Chapter 41, Statutes of 2011 (AB 121, Committee on Budget), specifies that the Department of Finance (DOF) will compare the Legislative Analyst's Office's (LAO's) November 2011 revenue forecast with its December 2011 revenue forecast to determine the extent to which midyear expenditure reductions (referred to as the "trigger cuts") will be put in place. Figure 1 shows our estimate of the condition of the General Fund through the end of 2012-13 assuming no additional corrective budgetary actions. As we discuss in more detail below, our forecast assumes that most of the trigger cuts are implemented in 2011-12 and remain in effect through the rest of our forecast period.

The 2011-12 budget package assumed a year-end reserve of about $500 million. We now estimate that the General Fund will close the fiscal year with a $3 billion deficit. (Contributing to this deficit is an estimated $500 million drop in 2010-11 revenues compared with the level assumed in the budget package.) In 2012-13, expenditures are projected to exceed revenues by $10 billion. This would leave the state with a year-end deficit of about $13 billion, absent any

Figure 1

LAO Projections of General Fund Condition If No Corrective Actions Are Taken

(In Millions)

	2010-11	2011-12	2012-13
Prior-year fund balances	–$4,507	–$1,695	–$2,239
Revenues and transfers	94,292	84,764	86,038
Expenditures[a]	91,480	85,308	95,787
Ending fund balance	–$1,695	–$2,239	–$11,988
Encumbrances	770	770	770
Reserve[b]	–$2,465	–$3,009	–$12,758

Basis for Our Estimates

Our revenue and expenditure forecasts are based primarily on the requirements of current law, including constitutional provisions (such as the Proposition 98 minimum guarantee for school funding), statutory requirements, and current state tax policies. The estimates incorporate effects of projected changes in caseloads, federal requirements, and other factors affecting program costs. The estimates are *not* predictions of what the Legislature and the Governor will adopt as policies and funding levels in future budgets. Instead, our estimates are intended to be a reasonable baseline of what would happen if current–law policies continue to operate in the future.

Impact of Future Ballot Measures Not Considered. Because our forecast is based primarily on current law, our projections do not consider the future effects of ballot measures scheduled or proposed for future statewide elections. For example, we have not assumed passage of a November 2012 measure increasing General Fund revenues, as referenced in the budget package. As described in the "Proposition 98" section of Chapter 3, this results in the creation of additional Proposition 98 payment obligations during the forecast period.

No COLAs or Inflation Adjustments Assumed. Consistent with the state's policies in recent years, we generally have not assumed annual cost–of–living adjustments (COLAs) or price increases over the forecast period. There are, however some exceptions. For example, the state is required to maintain specific benefits in its health programs, which include inflationary increases. If, by contrast, our forecast included COLAs and price increases for all programs, General Fund costs would be higher by around $3 billion by 2016–17.

Assumption That State Prevails in Court Cases. Any multiyear state budget forecast involves various legal uncertainties. Our forecast generally assumes that the state prevails in active, budget–related court cases. The state faces an array of active cases, including ones related to redevelopment agencies, health and social services reductions, and the exclusion of sales tax revenues from Proposition 98 calculations. Our projections, however, do not reflect a transfer of $1 billion from Proposition 10 early childhood education programs to reduce General Fund spending, to be consistent with the treatment of these funds in the 2011–12 budget package.

Trigger Cuts Ongoing. Our projections include the impact of the trigger cuts beginning in 2011–12 and continuing through the forecast period.

Federal Tax and Spending Policies Uncertain. The activities of the congressional "super committee" charged with developing a deficit reduction plan—as well as various soon–to–expire temporary federal tax policies—mean that there is an unusually large element of uncertainty about future federal policies. As described in "Chapter 2," we therefore must make a number of assumptions about these matters. In general, our expenditure forecasts assume continuation of current federal policies. Future federal actions that are contrary to these assumptions could affect various elements of our forecast positively or negatively.

additional budgetary corrections. Accordingly, the Legislature and the Governor will have to address this magnitude of problem between now and the time a 2012–13 state budget plan is approved.

THE BUDGET FORECAST

Projected 2011–12 Year-End Deficit of $3 Billion

Provision for Midyear Expenditure Reductions in the Enacted Budget. The 2011–12 budget package assumed a total of $88.5 billion of General Fund revenues and transfers. The budget also contained trigger cuts that would take effect if revenues for 2011–12 were forecast to be less than the amount assumed in the budget package by $1 billion or more. There are two tiers of potential trigger cuts: first, if revenues are forecast to be $1 billion or more below the budget level, and second, if revenues are forecast to be $2 billion or more below. The second tier of cuts—all of which affect K–14 education—is prorated depending upon how much revenues are below the budget level. All the trigger cuts may be put in place if revenues are $4 billion or more below the level assumed in the budget.

Under Our Forecast, Most Trigger Cuts Assumed to Be Put in Place. We forecast that revenues will be $3.7 billion below the budget act amount in 2011–12. As such, under our forecast, a total of $2 billion of midyear expenditure reductions is assumed to be implemented by the Governor on January 1, 2012 (see Figure 2). This represents all of the "Tier 1" trigger cuts and three-fourths of the "Tier 2" trigger cuts. The assumed future effects of the trigger cuts are also shown in Figure 2. The ultimate magnitude of the trigger cuts will be determined by the administration after it compares our revenue forecast with its December forecast. The *higher* of the two forecasts

Figure 2

Trigger Reductions to General Fund Expenditures by Program Area

(In Millions)

	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17
Tier 1 Trigger Cuts						
Reduce University of California budget	$100	$100	$100	$100	$100	$100
Reduce California State University budget	100	100	100	100	100	100
Reduce funding developmental services	100	100	100	100	100	100
Reduce service hours in IHSS by 20 percent and anti-fraud efforts	110	210	210	210	210	210
Increase charges to counties for youthful offenders sent to CDCR facilities and reduce CDCR budget	99	166	159	154	152	151
Reduce community college apportionments[a]	30	—	—	—	—	—
Reduce child care funding	17	17	17	17	18	19
Eliminate state grants for local libraries	16	16	16	16	16	16
Eliminate vertical prosecution grants	15	15	15	15	15	15
Extend Medi-Cal provider cuts and copayments to all managed care plans	15	15	15	15	15	15
Reduce preschool funding[a]	6	—	—	—	—	—
Total Tier 1 Trigger Cuts	($608)	($739)	($732)	($727)	($726)	($726)
Tier 2 Trigger Cuts						
Proposition 98 reductions[a]	$1,436	—	—	—	—	—
Total Trigger Reductions	**$2,044**	**$739**	**$732**	**$727**	**$726**	**$726**

will be used to determine the level of reductions. (The administration may implement less than the maximum amount of trigger cuts. Our forecast, however, assumes the maximum amount of trigger cuts based on our forecasted revenue levels.)

As a result of our lower 2011-12 revenue forecast ($3.7 billon lower than the budget package) and the offsetting level of trigger cuts we assume ($2 billion), the *net* deterioration in the General Fund condition in the current year due to our lower revenue estimate is $1.7 billion.

Other Budget Actions at Risk. In our forecast, we assume that the state will be unable to achieve $1.2 billion in planned 2011-12 budget solutions. Some of the major issues are:

- ***Medi-Cal.*** Higher Medi-Cal costs of around $400 million seem likely due, in large part, to delayed federal approval for cost-cutting measures.

- ***Redevelopment.*** Our forecast assumes that the state will not be able to realize the full amount of the budgeted savings from this year's redevelopment agency legislation. We estimate that the state will only be able to achieve $1.4 billion in savings—$300 million less than was budgeted.

- ***Savings From State Operational Efficiencies.*** The budget package assumed that the administration would reduce General Fund departmental costs by $250 million through efficiencies in departmental operations and other cost-reduction measures. Our forecast assumes that much of this savings is unachievable.

$3 Billion General Fund Deficit Forecast for 2011-12. As shown in Figure 1, given these various issues, we forecast that 2011-12 will end with a General Fund deficit of $3 billion.

Continuing Budget Problem in 2012-13

Proposition 98 and Other Costs Contribute to Estimated $13 Billion Budget Problem. In 2012-13, the state will face increased costs due, in part, to the expiration of a number of temporary budget measures enacted in recent years. Most notably, under our forecast methodology (which does not incorporate any effects from a possible November 2012 ballot measure concerning taxes), General Fund Proposition 98 costs are projected to rise by $5.6 billion due to growth in the minimum guarantee, very weak property tax growth, and the loss of one-time funding for schools from the 2011 redevelopment legislation. In addition, the state will owe an additional $400 million in "settle-up" payments to schools. At the same time, in 2012-13 the state must repay the $2 billion Proposition 1A loan (which was used to help balance the budget in 2009). We also assume that the state repays $1 billion of loans to special funds. With the General Fund pressured by all of these factors, the state will be left with a 2012-13 operating shortfall (the difference between annual General Fund revenues and expenditures) of $9.8 billion. Accordingly—when combined with the projected "carry-in" deficit of $3 billion—the total budget problem that the state will need to address between now and the passage of the 2012-13 budget is estimated to be $12.8 billion, as shown Figure 1.

Projected Out-Year Imbalances Gradually Decline

Structural Deficit Significantly Reduced. In our report last November, we were projecting a structural deficit of $20 billion that persisted over the forecast period. As a result of ongoing spending reductions adopted in the 2011-12 budget package and improvement in the state's revenue situation since last November, we are forecasting significantly lower operating shortfalls. As shown in Figure 3, our forecast shows an annual budget problem of over $8 billion in 2013-14 and 2014-15, declining gradually to about $5 billion in 2016-17. While these numbers are markedly improved from

recent years, the state still faces daunting fiscal challenges.

LAO COMMENTS

Tough Decisions Have Reduced California's Chronic Deficits

The reduction in the ongoing deficit required difficult decisions by the Legislature and the Governor in developing the 2011-12 budget. Those included ongoing provider rate and service reductions in Medi-Cal, substantial grant reductions in income maintenance programs, a variety of cost-containment measures for community services for the developmentally disabled, and cuts to the budgets of the University of California (UC) and California State University (CSU), in addition to the trigger cuts.

In addition, the Legislature enacted two major pieces of legislation that changed the structure of California government: a measure related to redevelopment agencies (described in "Chapter 3") and measures that shifted various program responsibilities from the state to local agencies (described in the nearby box, see next page). Both of these measures had a significant positive impact on the state's General Fund budget in 2011-12, but—as currently structured—offer little direct state fiscal relief in future years. In addition, both of these measures are the subject of court challenges.

More Tough Decisions Ahead

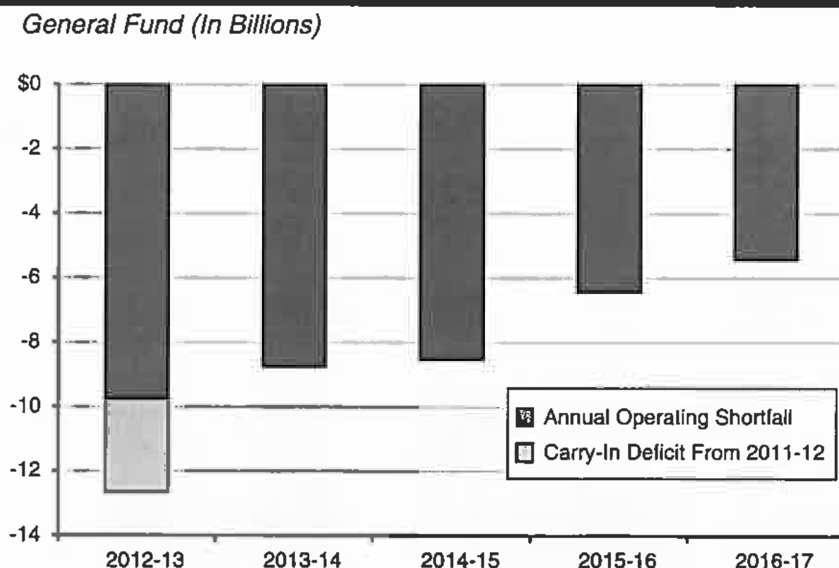
Funding the Proposition 98 Minimum Guarantee Will Be Difficult. Under our forecast, the 2012-13 Proposition 98 minimum guarantee is $4 billion higher than the revised 2011-12 spending level. With the loss of one-time funds related to the 2011 redevelopment legislation, General Fund Proposition 98 costs are projected to rise by $5.6 billion in 2012-13 under our forecast. Given the size of this projected increase, together with the other budget pressures facing the state, the Legislature will need to consider whether it can fund the minimum guarantee in 2012-13. If the Legislature determines it needs to suspend the guarantee, then it will need to decide how to reduce Proposition 98 spending. Over the last several years, the state has relied heavily on deferring school payments as a means of lowering Proposition 98 spending. Additional deferrals in 2012-13, however, could be unworkable for many districts given the magnitude of the existing deferrals (with 20 percent of Proposition 98 payments already made late).

State May Have to Reconsider Restoration of Prior-Year Cuts. In recent years, the state put into place a number of temporary reductions to

Figure 3

Operating Shortfalls Decline Gradually Over the Forecast Period

General Fund (In Billions)



health and social services spending that expire in the 2012–13 fiscal year. For example, in California Work Opportunity and Responsibility to Kids, there is over a $400 million restoration of prior-year cuts. Given the state's ongoing fiscal situation, the state may have to revisit these restorations in 2012–13.

Revenue Increases Also an Option. Given the potential consequences from the types of expenditure reductions discussed above, the Legislature will also want to consider revenue increases. For instance, the Governor has stated his desire to have certain increases in as yet unspecified taxes on the November 2012 ballot. We would recommend that the Legislature continue to review tax expenditure programs and reconsider various proposals from last year, such as modifications to enterprise zone programs and passage of a mandatory (rather than the current optional) single sales factor of corporate profit apportionment.

Big Challenges to Face... Even With This Lower Deficit Forecast

As noted above, our budget assumes no cost-of-living adjustments or price increases for many state programs. The impact of not adjusting for inflation means that the purchasing power of current state expenditures will be eroded by inflation over the forecast period, and the state will not be able to

Realignment

Background. As part of the 201112 budget plan, the Legislature enacted a major shift—or "realignment"—of state program responsibilities and revenues to local governments. In total, the realignment plan was intended to provide $6.3 billion to local governments (primarily counties) to fund various criminal justice, mental health, and social services programs in 2011–12, and increasing funding for these programs thereafter. The budget provides ongoing funding from three sources: (1) an ongoing shift of 1.0625 cents of the state sales tax rate, (2) an ongoing shift of vehicle license fee revenues that previously were allocated to the Department of Motor Vehicles and to cities and Orange County, and (3) a one-time shift of funds from the Mental Health Services Fund (established by Proposition 63 in November 2004).

Most of the state fiscal benefit from realignment in 2011–12 comes from Proposition 98 savings. Specifically, the budget assumes that, by depositing the sales tax revenue into a special fund for use by local governments for realignment, these funds are not available for the Legislature to spend for education purposes and thus are not counted as state revenue for purposes of calculating the Proposition 98 minimum funding guarantee. This action is estimated to reduce the Proposition 98 minimum funding guarantee by about $2 billion in 2011–12.

Realignment Revenues Could Outpace Program Costs. We project that the revenues dedicated to realignment in 2011–12 will total $6.3 billion, roughly equal to the administration's estimate of program costs for the realigned programs. Over the longer term, the relationship between realignment revenues and realigned program costs is not certain and will depend on many factors, including actual local costs to supervise the offenders transferred to their responsibility. Based on (1) the administration's estimates of costs to implement the realigned programs and (2) our estimates of growth in program caseload and program costs, we project that the growth in revenues dedicated to realignment could exceed local costs—potentially by hundreds of millions of dollars annually.

maintain the current level of services for many programs. Under this scenario, by 2016-17 many state employees will have received no *net* general salary increase (considering the net effect of both scheduled pay increases and recent pension contribution increases) for about a decade. Our forecast also assumes no restoration of recent budget reductions and trigger reductions. In other words, even with these modest funding assumptions, the state faces ongoing, multibillion dollar annual deficits, even as state revenues expand.

Forecast Does Not Account for Repayment of Most Budgetary Obligation. In recent years, the Legislature and Governor have used a number of different methods as part of balancing the budget. We estimate that the state will have accrued major budgetary obligations at the end of the forecast period, including: (1) $10 billion in interyear deferrals of payments to schools, (2) $10 billion of maintenance factor in Proposition 98, and (3) over $800 million in loans from special funds to the General Fund.

Solving the Ongoing Budget Deficit Would Not Address Massive Liabilities. Our forecast only includes current-law pension and retiree health payments by the state. It does not include added state payments to curb the massive (and growing) liabilities for retiree health benefits for state and CSU

The extent to which realignment revenue growth outpaces program costs, however, is subject to significant uncertainty. Actual program caseloads and other costs could be higher than we estimate, depending in part on how local governments implement realigned programs and their success in containing costs. Also, the realignment legislation established allocation formulas to distribute the revenues among the affected programs and across counties. These formulas, however, were established only for 2011-12. Therefore, there is uncertainty as to whether the allocations provided to specific programs or individual counties will be sufficient to keep up with program costs in the future.

Risks to Achieving State Savings Estimate. Budget trailer bill language adopted by the Legislature specifies that the exclusion of the sales tax revenues from the calculation of the Proposition 98 minimum guarantee is contingent upon voter approval of a ballot measure in November 2012 providing additional funding for school districts and community colleges. If no ballot measure is adopted satisfying these requirements, (1) the state must repay K-14 education for the loss of about $2 billion for the 2011-12 year over a five-year period, and (2) the sales tax revenues dedicated to 2011 realignment would be included in the Proposition 98 calculation in future years. In addition, the assumption that the realignment revenues are excluded from the minimum funding guarantee is subject to some dispute. We note, for example, that a lawsuit has been filed by some school districts and education associations challenging the legality of the exclusion.

Legislative Implications. As we describe in our publication, *2011 Realignment: Addressing Issues to Promote Its Long-Term Success*, there are several issues the Legislature should address before the end of the current fiscal year to increase the likelihood that realignment is implemented effectively and achieves the Legislature's objectives over the longer term. These include: establishing ongoing funding allocation formulas that are responsive to changes in program caseloads and costs over time, providing local governments with appropriate programmatic and financial flexibility to manage these new resources, and creating the right fiscal incentives to promote good program outcomes.

employees, teachers' pensions, and UC retirement benefits. Addressing the unfunded liabilities of just the teacher's retirement fund probably will require billions of dollars of additional payments annually over the coming decades.

Conclusion

The Legislature now faces a much smaller budget problem than projected one year ago, as well as the smallest projected out-year deficits since before the 2007–2009 recession. Unfortunately, there are few easy options left for balancing California's budget. Difficult program reductions already have been passed, and significant one-time budget actions may be more elusive than in prior years. Accordingly, the remaining work of eliminating the state's persistent, annual deficit will require more difficult cuts in expenditures and/or increases in revenues.

It is important to note that our forecast does not include funding to address some of the state's key long-term fiscal and policy problems. If, however, the Legislature and the Governor were to eliminate the structural deficit this year or over the course of the next few years, the focus of their efforts could finally shift away from short-term budget problems and turn to the serious long-term fiscal issues of the state's accumulated budgetary obligations and unfunded retirement liabilities.

Chapter 2

Economy, Revenues, And Demographics

THE ECONOMIC OUTLOOK

California and the nation are recovering from the longest and most severe economic downturn since the Great Depression. The 2007–2009 recession was precipitated by the implosion of overheated housing and financial markets in California and throughout the United States, the resulting balance sheet deterioration of financial firms and households, and the near collapse of world credit markets.

Unemployment in California—under 5 percent as recently as 2006—has remained above 11 percent for over two years now. Over one million jobs have disappeared from the state's economy since early 2008.

The latest evidence suggests that the state and national economies continue a slow, arduous recovery from this staggering economic drop-off. Our economic forecast is summarized in Figure 1 and described in more detail below. Our forecast is that California's unemployment rate will remain above 10 percent through mid-2014 and remain above 8 percent through at least the end of 2017.

Figure 1

The LAO's Economic Forecast

(November 2011)

	2010	2011	2012	2013	2014	2015	2016	2017
United States								
Percent change in:								
Real Gross Domestic Product	3.0%	1.8%	2.1%	2.8%	3.6%	3.4%	2.9%	2.6%
Personal Income	3.7	5.2	4.0	3.9	5.4	5.3	5.0	4.4
Wage and Salary Employment	–0.7	0.9	1.0	1.7	2.1	2.0	1.7	1.1
Consumer Price Index	1.6	3.1	1.5	1.9	2.1	1.9	1.7	1.6
Unemployment Rate (percent)	9.6	9.1	9.0	8.5	7.8	7.0	6.5	6.3
Housing Permits (thousands)	585	596	758	1,085	1,417	1,687	1,811	1,841
California								
Percent change in:								
Personal Income	4.0%	6.0%	4.1%	4.5%	5.6%	5.5%	5.0%	4.7%
Wage and Salary Employment	–1.4	1.2	1.3	2.1	2.2	1.9	1.6	1.4
Unemployment Rate (percent)	12.4	12.0	11.8	11.2	10.3	9.6	9.0	8.5
Housing Permits (thousands)	45	46	61	77	91	104	114	124

The United States Economy

Recovery Even Slower Than Previously Expected. In November 2010, we wrote that the U.S. recovery was progressing more slowly than previously expected. Once again, we have to make the same observation. Figure 2 compares several key variables of the May 2011 economic forecasts of the administration and of our office to our updated November 2011 economic forecast. In 2011 and 2012, we forecast that the U.S. economy will grow more slowly than previously expected. In 2011, the lower-than-expected real gross domestic product (GDP) growth results largely from major downward revisions in July in estimates of GDP growth for the first quarter of the year. At the time of our May forecast, federal data estimated that real GDP in that quarter had grown at a 1.8 percent annual rate. In July, this estimate was revised downward to 0.4 percent. Subsequent quarters have seen higher reported GDP growth, but the effects of this first quarter weakness drag down our annual estimate. Similarly, consensus estimates for real GDP growth in 2012 are lower than they were earlier in the year.

The employment outlook is somewhat weaker than we expected in May, and U.S. employment growth estimates included in our forecast are lower. There were some dismal job reports during the summer. The initial federal report of employment for August, for instance, said that there had been no net job growth for the nation during that month. Subsequently, however, this figure has been revised upward to 104,000.

What Parts of the Economy Are Doing Well? Over the last year, U.S. employment has grown most notably in the health services, leisure and hospitality, mining, trade, transportation/warehousing, and professional and technical services sectors. The latter sector (including technology and other services important to California's economy) has been among the strongest job producers—up 264,000 nationally over the past year. The manufacturing sector has gained 220,000 jobs over the last 12 months, buoyed, it appears, by healthy export growth, strong levels of equipment investment, and a revived domestic automobile market. Temporary help jobs are up 169,000 over the past year, including the past three months of 15,000 or greater growth—potentially a very good sign for the economy, as employers frequently convert many of these to permanent jobs.

Figure 2

Comparison of May and November Economic Forecasts

(Percent Change From Previous Year Unless Otherwise Indicated)

	2011			2012		
	Administration Forecast (May 2011)	LAO Forecast (May 2011)	LAO Forecast (November 2011)	Administration Forecast (May 2011)	LAO Forecast (May 2011)	LAO Forecast (November 2011)
United States						
Real gross domestic product	2.8%	2.8%	1.8%	2.9%	3.1%	2.1%
Employment	1.2	1.2	0.9	1.8	1.9	1.0
California						
Personal income[a]	4.4	5.4	6.0	4.5	3.8	4.1
Employment	1.3	1.6	1.2	1.9	2.0	1.3
Housing permits (thousands)	55	54	46	87	81	61

What Parts of the Economy Are Not Doing Well? The U.S. and California economies continue to be dragged down by the construction sector. The weakness in the housing market continues to affect other sectors too, including the financial activities sector, which has seen weak job growth over the past year. Consumers are still showing signs of significant stress, with consumption pulled down sharply by their need to reduce debt and their difficulty in obtaining credit. Moreover, while the Federal Reserve continues to rely on aggressive monetary policy—with a multiyear commitment to near-zero interest rates—the effects of the 2009 federal fiscal stimulus now are wearing off, with real federal government purchases of goods and services declining from 2010 levels. The end of the federal fiscal stimulus and budgetary woes also are affecting the nation's local and state governments, among which employment has declined recently. Federal government employment also has been declining over the past year.

Slow Recovery Expected Throughout Our Forecast Period. Following the deep 1981-82 recession, the U.S. economy bounced back quickly—with real GDP growth of 4.5 percent in 1983 and 7.2 percent in 1984. As shown in Figure 1, however, no such bounce back appears to be in store for the U.S. economy. We forecast a slow, steady recovery through 2017 with annual real GDP growth ranging between 2.1 percent and 3.6 percent. Unemployment is expected to gradually decline for the U.S., reaching about 6 percent by the end of 2017. Housing permit activity is expected to grow—welcome news for the construction and other related sectors—even though the 1.8 million housing permits we forecast for the nation in 2017 remains 15 percent below the peak levels of 2005.

The California Economy

Weaker Job Growth Than Previously Expected. As shown in Figure 2, we have downgraded our forecast for California employment growth since May. We now forecast 1.2 percent employment growth in the state in 2011 and 1.3 percent in 2012—both down from prior forecasts. Housing permits—a key indicator for the state's very weak construction sector—are now forecast to be even lower than in our May forecast. State and local employment contraction also is expected to contribute to the weak labor market in the state.

Personal Income Surprisingly Strong Despite Weak Job Growth. Despite the state's weak job growth, personal income growth in California in 2010 and 2011 has proven to be fairly strong. This forecast incorporates somewhat stronger personal income estimates for the state in 2010 and a higher forecast for 2011, as shown in Figure 2. For 2012, this forecast for personal income growth in the state is higher than it otherwise would be due to our assumption that the federal employee payroll tax cut is extended to 2012. We made no such assumption in May. (Assumptions about federal policy are discussed further below.)

Forecast Risks and Uncertainties

Federal Policy Is a Key Uncertainty in the Economic Forecast. Like other state revenue forecasters, we rely on national economic data provided to us by a major economic forecasting company. The data incorporate numerous assumptions about federal fiscal, monetary, regulatory, tax, and other policies. We use this information to inform many parts of our economic and revenue forecasts—utilizing our own judgment when appropriate.

For this forecast, however, there is considerable uncertainty about short-term and medium-term federal fiscal and tax policies. This uncertainty arises due to the activities of the congressional "supercommittee" charged with recommending substantial deficit-reduction measures in the coming weeks, the scheduled expiration of the 2011 employee payroll tax reduction and emergency unemployment insurance benefits, and the scheduled expiration of various tax cuts enacted under the prior federal administration (and extended under the current administration) at the end of 2012. Accordingly,

current national economic forecasts must make many assumptions about what federal policy will be a few months and a few years from now. Our economic and revenue forecasts generally incorporate the following assumptions:

- The employee payroll tax cut and emergency unemployment insurance benefits will be extended for 2012 and then phased out over several years.
- There will be no sequestration (automatic federal spending cuts beginning in 2013) resulting from the failure of Congress to enact deficit-reduction measures now being considered by the supercommittee. Instead, Congress and the President will enact a package of deficit-reduction measures to replace sequestration that will begin to take effect in 2014. These measures are assumed to stabilize, but not reduce, the federal debt-to-GDP ratio.
- The various federal tax cuts originally enacted during the prior federal administration will be extended an additional year to 2013. (This produces changes in state revenue estimates since, in prior forecasts, we assumed these tax cuts' expiration at the end of 2012 caused some taxpayers to accelerate recognition of capital gains from 2013 to 2012. Instead, in this forecast, we assume that acceleration occurs from 2014 to 2013.)

Clearly, many of these assumptions may not come to pass, but they do seem to reflect a consensus of economists about a reasonable approach for forecasting the U.S. economy in the coming years. Compared to these assumptions, *actual* federal actions in the coming months could either produce additional short-term benefit for the economy (for example, by extending payroll tax reductions for the next few years to employers, as well as employees) or result in an additional short-term drag (for example, if the payroll tax reduction is not extended or sharp decreases in federal domestic and defense spending take effect through the sequestration process).

No Estate Tax Receipts Assumed for the State. In 2001, as a part of the tax reductions enacted during the prior federal administration, the federal government adopted reductions over several years to its estate tax and eliminated a tax code provision known as the "credit for state death taxes." The state credit was eliminated entirely for estates of those dying after December 31, 2004. In 2010, Congress and the President agreed to extend the temporary 2001 estate tax legislation—including elimination of the state death tax credit—until the end of 2012. Under current federal law, therefore, the pre-2001 estate tax regime will resume at the beginning of 2013, including the state death tax credit. Nevertheless, most observers believe that, no matter what Congress does to the estate tax in 2012, there will no longer be a credit for state-level estate taxes. Our forecast assumes that this consensus is correct. Pursuant to Proposition 6 (1982), the state may only collect estate taxes equal to the state death tax credit in federal law. Accordingly, our forecast assumes that the state receives no estate taxes during this forecast period. We advise the Legislature to assume no such revenues during its 2012-13 budget process unless there is a clear indication from Congress that a state death tax credit will be adopted.

If our assumption proves to be incorrect and Congress allows the state death tax credit to resume, the amount of revenues the state would receive beginning in 2012-13 is highly uncertain. The level of revenues in this scenario would depend, for example, on how many and how large the estates are that are subject to taxation. This could total several hundred million additional dollars for the General Fund in 2012-13 and perhaps over $1 billion per year thereafter. (These additional revenues, if they were to be received, also would increase the state's Proposition 98 minimum guarantee by an amount equal to around one-half

of the revenue increase.)

Europe and the Financial Markets. Europe's woes—principally the feared default of Greece, Italy, Spain, and other nations on their national debt—have rattled investors in recent months. Recently, European leaders have taken actions intended to help stabilize the debt problems of heavily leveraged national governments there. Should the efforts of European leaders fail, some fear that the negative effects of national bond defaults could imperil European banks, thereby threatening credit markets and financial firms tied to those banks around the world. At the present time, we doubt that these issues will have a substantial effect on the U.S. economy. In California, for instance, European trade is a relatively small part of the state's imports and exports. Moreover, banks and other firms around the world now have had months to prepare themselves for European debt defaults.

A "Double-Dip" Recession? Probably Not. A double-dip recession in the U.S. now appears unlikely. Our forecast assumes that the economy grows slowly, but steadily, in the coming years. It is possible, however, that certain negative events in the coming months could precipitate one or more quarters of economic contraction not assumed in this forecast. For example, additional turmoil in the financial markets could cause such contraction. In addition, the effects of federal sequestration cuts or any major decline of consumer and business confidence due to failure of Congress and the President to agree on deficit reduction goals could affect the economy negatively.

Data Limitations. It takes time for the state's tax agencies to compile data from tax returns that is used by revenue forecasters. For our personal and corporate income tax forecasts, for example, we rely significantly on data compiled by the Franchise Tax Board (FTB) and presented on a routine biannual schedule to both our office and the administration—with the first set of data generally submitted each year in late April or May and the second set in late November or December. (The FTB also posts these "exhibit packages" on its website.)

The next FTB exhibit package likely will include some of the first solid data on 2010 California wages and salaries, capital gains, and other income tax information. By the time the administration completes its December revenue forecast, it may have the benefit of reviewing this or other FTB data that were not available for use in this forecast. Such FTB data could result in the administration's revenue forecasts being somewhat higher or lower than ours.

In addition, we note that since we prepared this economic forecast, federal job growth data has been revised upward for both August and September—by a total of 102,000 jobs over the two months. These upward adjustments (not reflected in our economic forecast) would have improved the 2011 employment levels assumed in our forecast—as well as state revenues—slightly.

THE REVENUE OUTLOOK

California's General Fund is supported by revenues from a variety of taxes, fees, licenses, interest earnings, loans, and transfers from other state funds. Over 90 percent of the total, however, currently is derived from the state's "big three" taxes—the personal income tax (PIT), the sales and use tax (SUT), and the corporate income and franchise tax (CT). A summary of our revenue projections is shown in Figure 3 (see next page). (Note that, beginning in 2011-12, this figure does not include SUT funds—estimated to total $5.1 billion in 2011-12—redirected from the General Fund to the Local Revenue Fund 2011 to pay for specified local programs.)

Figure 4 (see page 17) shows the differences between our forecasts of 2010-11 and 2011-12 revenues, as compared with those assumed in the 2011-12 budget package. For 2010-11, after including the most recent information available

to us on accruals and other adjustments, General Fund revenues were approximately $500 million below budget act expectations, spread across all of the Big Three revenue sources. For 2011–12, our forecasted revenues are $3.7 billion less than those assumed in the budget package.

Under current law, our estimate of 2011–12 revenues will be compared with the coming December estimate of the Department of Finance (DOF). The *higher* of the two estimates will be used to determine the amount of any "trigger" reductions (as discussed in "Chapter 1").

Personal Income Tax

At the end of 2010, temporary PIT rate increases and reductions in the dependent exemption credit expired. This is a major reason why PIT revenue is forecast to grow between 2010–11 and 2011–12 by only about 2 percent. (If, by contrast, there had been no such temporary PIT increases in 2010, the growth of the PIT would be about 7 percent between 2010–11 and 2011–12.) Our forecast assumes that PIT revenues grow by 5.2 percent per year between 2011–12 and 2016–17.

PIT Holding Up Well Despite Weak Economic, Financial Market News. Our PIT forecast for 2011–12 is higher than assumed in the budget act (excluding the $4 billion unallocated revenue assumption) despite the weaker outlook for the economy and financial markets. Income tax withholding and estimated payments have held up well since May, and overall revenue attributable to tax year 2010 appears to have been surprisingly high given the slow reported growth in personal income. We attribute this mainly to stronger growth in capital gains and some other categories of taxable income than we would typically expect based on the performance of asset markets and reported personal income growth. Specifically, some recent initial public offering (IPO) activity in the technology sector and extraordinary bonus income for some high-income earners may account for this unexpected strength.

Capital Gains Bounced Back From 2009 Low, but Slower Growth Forecast Ahead. Capital gains

Figure 3

LAO General Fund Revenue Forecast

(Dollars in Millions)

Revenue Source	2010–11	2011–12a	2012–13	2013–14	2014–15	2015–16	2016–17
Personal income tax	$49,779	$50,812	$53,134	$55,692	$57,682	$61,811	$65,625
Sales and use tax	26,983	18,531	19,980	21,573	23,220	24,483	25,856
Corporation tax	9,838	9,483	9,432	9,958	10,806	11,316	11,492
Subtotals, "Big Three"	($86,600)	($78,826)	($82,546)	($87,223)	($91,708)	($97,610)	($102,973)
Percent change	7.3%	–9.0%	4.7%	5.7%	5.1%	6.4%	5.5%
Insurance tax	$2,070	$1,895	$1,989	$2,210	$2,326	$2,434	$2,536
Vehicle license fee	1,330	80	5	—	—	—	—
Other revenues[b]	2,395	2,511	2,546	2,148	2,314	2,530	2,479
Net transfers and loans	1,897	1,451	–1,048	–1,126	–966	–235	–162
Total Revenues and Transfers	**$94,292**	**$84,764**	**$86,038**	**$90,455**	**$95,382**	**$102,339**	**$107,826**
Percent change	8.3%	–10.1%	1.5%	5.1%	5.4%	7.3%	5.4%

income consists of gains from sales of assets, such as stocks, bonds, and real estate. Taxable capital gains income is a very volatile part of PIT revenues—one that is virtually impossible to predict well, but can influence PIT receipts upward or downward by billions of dollars per fiscal year. Overall, as shown in Figure 5 (see next page), we are assuming that taxable capital income (as a percent of personal income) has bounced back from its 2009 low—buoyed by strong investment markets in 2010—but will grow at a slower rate going forward.

Since May, two factors have placed downward pressure on our capital gains forecast for 2011. First, our outlook for California real estate prices is even weaker now than it was in May. Second, this past summer's stock market slump caused stock prices—as measured by the Standard and Poor's 500 stock index—to be roughly 9 percent lower for the third quarter of 2011 than assumed in our May forecast. While we generally assume that stock prices will rise in the future, the effects of this summer slump result in our current assumptions of stock prices being lower throughout the forecast period than assumed in our May forecast.

Despite these dual downward pressures, our forecast assumes that capital gains income for California taxpayers will total $69 billion in 2011—down just 6 percent from our May forecast. This reduction is relatively small since we have incorporated in this forecast a positive adjustment to account for the healthy estimated PIT payments the state has received recently and current IPO activity in the technology sector.

While the factors described above have helped the recent rebound of capital gains, we do not forecast that California capital gains will rise to prerecession levels during the forecast period. As noted above and illustrated in Figure 5, capital gains generally are slightly lower over the forecast period than our May projections.

Capital gains forecasts—difficult as they are to forecast—can shift materially during the course of any fiscal year. Accordingly, it is possible that higher capital gains than we forecast could lead to PIT revenues being billions of dollars higher or lower than our forecast in 2011-12 or any future year.

Wages and Salaries—More Growth for

Figure 4

November 2011 LAO Revenue Estimates Compared With 2011-12 Budget Package

General Fund (In Millions)

	2010-11			2011-12		
Revenue Source	LAO November 2011 Forecast	Budget Package	Difference	LAO November 2011 Forecast	Budget Package	Difference
Personal income tax	$49,779	$50,027	–$248	$50,812	$50,408	$404
Sales and use tax	26,983	27,140	–157	18,531	19,009	–478
Corporation tax	9,838	9,963	–125	9,483	9,012	471
Subtotals, "Big Three"	($86,600)	($87,130)	(–$530)	($78,826)	($78,429)	($397)
Other revenues[a]	$5,795	$5,754	$41	$4,486	$8,561	–$4,075
Net transfers and loans	1,897	1,897	—	1,451	1,465	–14
Total Revenues and Transfers	**$94,292**	**$94,781**	**–$489**	**$84,764**	**$88,456**	**–$3,692**

High-Income Earners. In our report *The 2011-12 Budget: Overview of the May Revision*, we noted a significant PIT forecasting difference between our office and the administration related to high-income tax filers. Forecast differences for this group are important because of the higher marginal tax rates on their income. Specifically, prior to passage of the 2011-12 budget package, both our office and DOF had difficulty reconciling the very strong PIT results from last spring with the official economic data. Revenues were coming in much higher than the official labor and other economic data seemed to support. In the Governor's May Revision forecast, the administration assumed that higher PIT totals resulted in large part from huge growth in 2010 of salaries and wages for high-income wage and salary earners—those tax filers with over $200,000 of adjusted gross income (AGI). At the same time, the administration assumed that tax filers with less than $200,000 of AGI saw their wages and salaries fall by several percentage points. In our May forecast, we also assumed some higher growth for high-income wage earners—though not as much as the administration assumed—and small growth in wages for lower-income groups.

Since we lack hard data from PIT returns for 2010, we still must make a rough estimate of wage and salary growth for that income year. In this forecast, we assume higher 2010 wage and salary growth than we did in May for both higher-income and lower-income groups. Specifically, we assume that those with over $200,000 of AGI saw their wages and salaries grow by 7.5 percent in 2010, while those with under $200,000 of AGI saw their wages and salaries grow by 2.5 percent. In our forecast, higher-income earners' wage and salary growth outpaces that of lower-income earners throughout the forecast period.

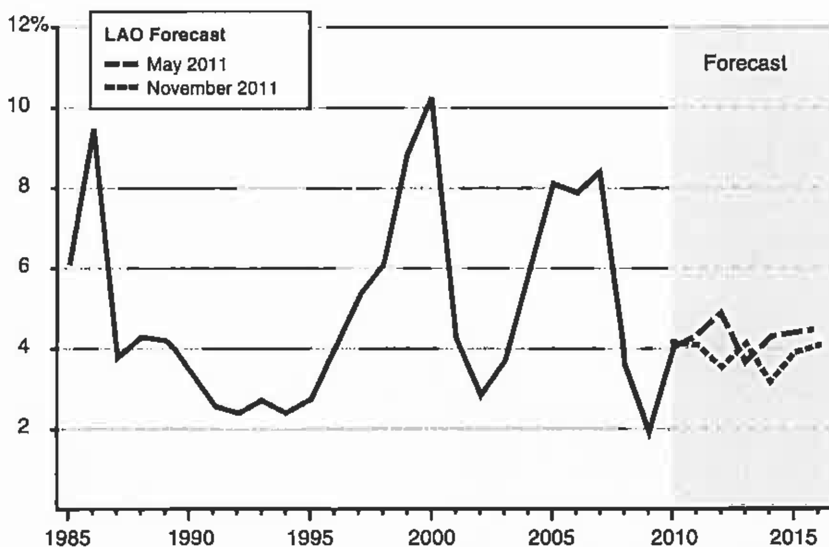
Sales and Use Taxes

We estimate that General Fund SUT revenues will total $18.5 billion in 2011-12, which is 2.5 percent, or $478 million, lower than the level assumed in the *2011-12 Budget Act*. A large part of the decline is due to the so-called "Amazon compromise" that delays taxation of certain online purchases to 2012-13.

Figure 5

Capital Gains Forecast Slightly Lower Than in May

Capital Gains as a Percent of Personal Income



In 2012-13, we estimate that SUT will grow strongly to $20 billion, a 7.8 percent increase from 2011-12. Over the first three years of the forecast period, SUT revenues are expected to grow at an average rate of 7.8 percent—somewhat faster than personal income—before dropping to more modest growth during the remainder of the forecast period.

Recent Policy Changes Reduce General Fund SUT Revenues. In 2011-12, General Fund SUT revenues are projected to fall significantly from 2010-11 levels, reflecting the net effect of: (1) the "fuel

tax swap" passed by the Legislature in 2010, under which the state no longer collects sales tax on gasoline, (2) the realignment of some state responsibilities to local government (which redirects $5.1 billion in state SUT receipts to cities and counties), (3) the expiration of the temporary 1 percent SUT rate increase adopted in 2009, and (4) projected growth in the SUT base of nearly 7 percent. Policy changes and underlying growth, taken together, reduce state General Fund SUT revenue from $27 billion in 2010–11 to an estimated $18.5 billion in 2011–12. Our forecast assumes that the 2011–12 SUT policies outlined above continue through the remainder of the forecast period.

Factors Affecting Forecast. The main determinant of SUT receipts is taxable sales. About two-thirds of taxable sales result from retail spending by consumers, including a significant portion on personal vehicles and large household purchases, both of which declined sharply during the recession. Other important categories of taxable sales are the purchase of building materials involved in new construction as well as business-to-business taxable transactions, where the purchasing business is the final consumer of the sold item.

Taxable Sales Fell Disproportionately During the Recession. From 2007 to 2009, taxable sales fell approximately 19 percent while personal income declined by just 2 percent. The reduction in taxable sales relative to income—illustrated in Figure 6—was the result of: (1) consumers and businesses curtailing costly purchases such as household appliances, new vehicles, and business machinery; (2) increased household savings rates; and (3) the long-term trend toward greater consumption of nontaxable goods (services and other products, such as those purchased online, for which the collection of SUT has been limited).

Taxable Sales Now Making Up Lost Ground. Since the start of the modest recovery, taxable sales have increased somewhat faster than personal income, signaling a correction to the decline in taxable sales discussed above. We expect this trend to continue through the first three years of our forecast, as illustrated in Figure 6 in the upward-sloping line beginning in 2011. We expect that consumers and businesses will gradually return to more normal levels of taxable spending relative to income during this period. Taxable sales in the final two years of the forecast grow approximately 5.5 percent annually as growth levels off over the remainder of the forecast period.

Figure 6

Taxable Sales Forecast to Rebound

Taxable Sales as a Percent of Personal Income

Uncertainties in the SUT Forecast Could Impact Actual Revenues. Taxable sales typically are influenced by (1) employment and income growth, (2) household savings rates, (3) the availability of consumer and business credit, and (4) overall confidence in the economy. These factors could differ substantially from our underlying assumptions in the following ways:

- ***Household Savings Rates, Incomes, and Employment Affect Spending Patterns.*** In recent months, national household savings rates have fallen to prerecession levels (savings tend to increase during recessions as consumers curb spending and pay down debt), likely indicating that savings built up over the past few years have supported recent growth in taxable sales. Should employment, income, or savings rates vary significantly relative to our expectations, actual taxable sales could differ substantially from our forecast.

- ***Consumer Credit Availability Influences Spending Decisions.*** The availability of consumer credit in the next few years (presently at historically low levels) is also significant, as credit generally allows consumers to finance large taxable purchases—such as vehicles, appliances, personal electronics, and home improvements.

- ***Consumer and Business Confidence May Affect Future Spending.*** National consumer confidence indicators are at their lowest levels since the end of the recession. Weak confidence about the economy, however, does not seem to have affected consumer spending—as evidenced by steady vehicle and retail sales in recent months. If current low consumer confidence about the economy drives Californians to spend less on taxable goods over the next several months, SUT receipts would grow more slowly than our forecast projects. In particular, we are concerned that possible congressional deadlock over the supercommittee's deficit reduction package could affect consumer behavior during the holiday spending season. Congressional deadlock could impair business confidence as well, which could lead businesses to postpone taxable investments—on machinery and other equipment, for instance.

Corporation Tax

Likely to Bottom Out in 2011-12 or 2012-13 Before Rebounding. Corporation tax revenues for 2010-11 are estimated to have totaled $9.8 billion, slightly higher than the previous fiscal year. We project CT receipts will be slightly lower in 2011-12 and 2012-13, but then grow steadily to $11.5 billion by the end of the forecast period.

Profits Forecast Stronger... Corporate profits—the main driver of our CT revenue forecast—now are projected to be higher than indicated in our last forecast in May 2011. Specifically, we now assume that before-tax national corporate profits will be $2 trillion in 2011, which is 15 percent higher than the value used in our previous forecast. The weak labor market, productivity growth, export expansion for certain U.S. products, and growing consumer demand all appear to be contributing to the strength in corporate profits.

...But Tax Credits Dampen Benefits of Profit Growth on CT Revenues. As profits increase, however, businesses will be more able to use new or previously earned state tax credits (such as research and development or enterprise zone credits) to reduce taxes owed.

Net Impact of Recent Policy Changes Now Reducing Revenues. In addition to tax credits, various major CT policy changes of recent years affect the revenue outlook. In 2009-10 and 2010-11, these policy changes had the net impact of increasing CT revenues. The expected net effect

of these recent changes to CT policies will be to lower revenues by around $700 million in 2011-12, compared to estimates of what revenues would have been had these policies not changed. This net negative effect is expected to grow, likely to over $1 billion annually for the remainder of our forecast period. This is shown in Figure 7. The recent major policy changes affecting the CT forecast are:

- *Changes in Multistate Business Taxation.* The elective single sales factor—the new option for businesses to annually choose which method is used to determine their California taxable income—and associated tax law changes are estimated to reduce CT revenues by around $1 billion per year.

- *Major Revenue Accelerations.* The Legislature has enacted several measures over the last few years that have accelerated revenue collections and delayed the use of tax deductions or credits. The actions include the suspension, for 2008 through 2011, of larger businesses' use of net operating loss deductions. This increased CT revenues. Since 2008, however, business losses have accumulated and will be deductible against income again starting in tax year 2012. Recently enacted—and modified—penalties on corporate taxpayers who are found to have significantly underpaid their taxes also serve to accelerate CT collections. This occurs as businesses try to avoid the penalties by paying upfront some of the tax they might have paid later following an audit.

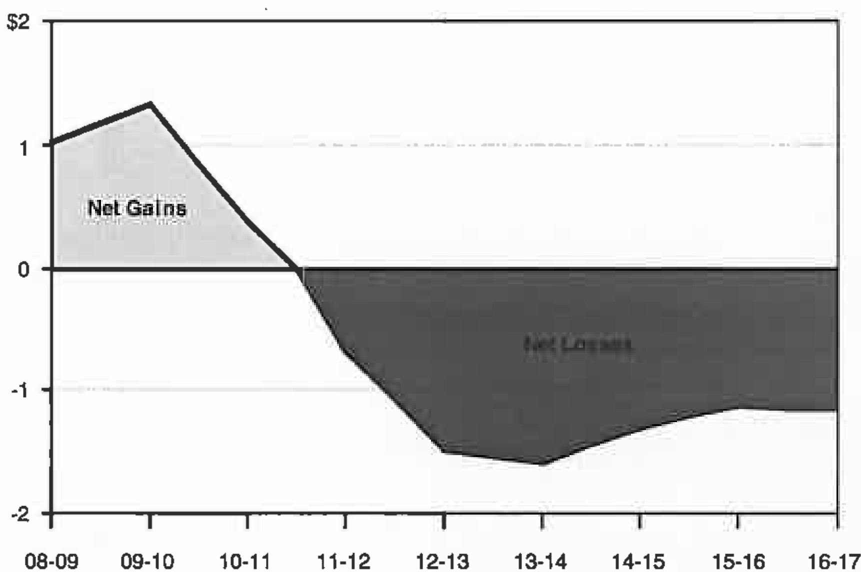
- *Expanded Credit Use.* Recent legislation also affected the use of tax credits. The single largest change is that credits are now easier to use due to a law that allows transfers of certain credits between companies that are treated as parts of a single business group for tax purposes.

Uncertainties in the CT Forecast. Forecasting CT revenues is very difficult. Several factors could result in our forecast being too high or too low by large margins in any given fiscal year. Besides the usual uncertainties in forecasting corporate profits, there are some particularly difficult issues now for CT forecasting.

Figure 7

Estimated Effects of Recent Policy Changes on CT Revenues

Changes From Revenues Otherwise Expected (General Fund, In Billions)



- ***Lags in Getting Certain Data.*** As there are long lags in getting certain data, developing our forecast requires us to estimate data associated with *prior* years. For example, the latest year for which we have firm data from FTB on California taxable profits is 2009. For CT revenues, this significantly impairs our ability to know how recent policy changes already have affected revenues. As described earlier, the administration may receive additional information on 2010 CT returns from FTB prior to releasing its December forecast.

- ***Recent Policy Changes Reduce the Reliability of Forecasts in the Near Term.*** Our forecast involves identifying patterns among economic variables and assuming these patterns will persist. In the past, for example, the ratio between California taxable profits and national profits has tended to return to a stable level after occasional increases or decreases. Due to recent CT policy changes in California, however, this ratio may be a much less useful guide for forecasting California profits. Accordingly, these policy changes—as well as the recent volatility of the economy during the recession and the current slow recovery—make it less likely that historical patterns will reemerge in the near term. This results in a need to incorporate a significant degree of judgment into our forecasts.

Demographics

Our forecasting process also involves examination of population and other demographic trends in the California economy. This is our first forecast to incorporate 2010 Census results. Future forecasts will incorporate them more, as we have time to examine additional Census data. Our demographic forecast for 2010 through 2017 is summarized in Figure 8.

Population Growth Slowed Considerably in the Late 2000s. Population estimates for years between Censuses typically are subject to some uncertainty, but it now appears that California's population growth slowed considerably in the second half of the 2000s. Growth seems to have been especially low in 2005 and 2006 at the height of the housing bubble, as high housing prices may have discouraged new people from moving to the state and encouraged some outmigration. It also appears that large numbers of undocumented immigrants may have left the state at the end of the decade in response to the lack of job opportunities.

Population Growth Forecast to Pick Up Slightly in Future Years. We expect population growth to return to around 1 percent a year by 2013. Combined domestic and foreign net migration appears to have been negative from 2005 to 2010, but we expect it to turn positive beginning in 2012 due to lower housing prices and slowly expanding job growth in the state. We project California's population will reach 40 million in 2017.

Most of the state's population growth will come from natural increase. The state still has a relatively young population, and births consistently outnumber deaths by about 300,000 per year. Birth rates have been falling and should remain fairly low even as the job market improves. Death rates, meanwhile, are falling sharply, and we expect this to continue. This means that California's population—like the nation's—will become proportionately older in the coming years, presenting federal, state, and local governments with new challenges in service delivery and the funding of health, social services, social insurance, and pension programs.

Figure 8

The LAO's Demographic Forecast

(In Thousands)

	Estimated		Forecast					
	2010	2011	2012	2013	2014	2015	2016	2017
Totals (July 1st)	37,345	37,619	37,964	38,373	38,793	39,217	39,626	40,051
Change	268	274	345	408	421	424	409	425
Percent change	0.72%	0.73%	0.92%	1.08%	1.10%	1.09%	1.04%	1.07%
Births	512	511	513	528	544	561	576	579
Deaths	242	242	244	246	247	250	253	255
Net domestic migration	–88	–169	–93	–49	–51	–57	–79	–69
Net foreign migration	86	174	169	180	182	176	170	170

Chapter 3

Expenditure Projections

In this chapter, we discuss our General Fund expenditure estimates for 2010-11 and 2011-12, as well as our projections for 2012-13 through 2016-17. Figure 1 (see next page) shows our forecast for major General Fund spending categories for all of these years. Below, we first discuss general budgetary trends and then discuss in more detail our expenditure projections for major program areas.

2011-12 Outlook

General Fund expenditures in 2011-12 are 6.7 percent below their 2010-11 levels, due for the most part to the shift of some $5.5 billion of expenditures from the General Fund to the Local Revenue Fund 2011 (as part of the realignment of state programs to local responsibility). In total, General Fund expenditures are forecast to be slightly (1 percent) lower than the budgeted amount due to the net effect of the trigger cuts and increased costs in some program areas.

Expenditure Growth During the Forecast Period

Sharp Growth in 2012-13. In 2012-13, our forecast shows General Fund spending climbing by 12 percent. A large component of this is the additional $5.6 billion in Proposition 98 expenditure combined with the $2 billion Proposition 1A property tax loan that the state must repay.

Lower Growth Projected After 2012-13. Our forecast shows overall General Fund spending growing by 3.6 percent in 2013-14, 4.7 percent in 2014-15 and in 2015-16, and 4.1 percent in 2016-17. As shown in Figure 1, this equates to an average annual growth rate of 5.8 percent between 2011-12 and 2016-17. The period is characterized by consistently high growth rates in two areas that represent over half of the General Fund budget in 2016-17: (1) Proposition 98 spending for K-14 education and (2) Medi-Cal. The remainder of the budget is projected to grow at a modest 3.5 percent annually over the forecast period. This modest growth is due in part to the stated legislative policy of having no automatic inflation adjustments for many programs (as discussed in "Chapter 1"). For instance, our forecast assumes no growth in the General Fund appropriations to the universities or the courts after 2012-13.

PROPOSITION 98

State budgeting for public education below the university level is governed largely by Proposition 98, passed by voters in 1988. The measure, modified by Proposition 111 in 1990, establishes a minimum funding requirement, commonly referred to as the "minimum guarantee." Both state General Fund and local property tax revenues apply toward meeting the minimum guarantee. Proposition 98 monies support K-12 education and the California Community Colleges (CCC), constituting about 70 percent of funding for these programs. These programs also receive support

from the federal government, other state sources, and various local sources. Proposition 98 monies also subsidize preschool for low-income families.

Calculating the Minimum Guarantee. The Proposition 98 minimum guarantee is determined by one of three tests set forth in the State Constitution. These tests are based on several inputs, including changes in K-12 average daily attendance (ADA), per capita personal income, and per capita General Fund revenue. Though the calculation of the minimum guarantee is formula-driven, a supermajority of the Legislature can vote to suspend the formulas and provide less funding than the formulas require. This happened in 2004-05 and 2010-11. As a result of a suspension or a "Test 3" year (when the Proposition 98 guarantee grows more slowly than per capita personal income), the state creates an out-year obligation referred to as a "maintenance factor." When growth in state General Fund revenues is healthier (as determined by a specific formula also

Figure 1

Projected General Fund Spending for Major Programs[a]

(Dollars in Millions)

	Estimates		Forecast					Average Annual Growth From 2011-12 to 2016-17
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	
Education								
K-14—Proposition 98	$35,691	$31,664	$37,240	$39,649	$41,810	$44,556	$46,451	8.0%
Other Proposition 98 obligations[b]	—	—	841	841	573	391	391	—
Child care	—	1,064	1,008	1,019	1,114	1,209	1,361	5.2
CSU	2,542	1,976	1,976	1,976	1,976	1,976	1,976	—
UC	2,711	2,072	2,071	2,070	2,069	2,068	2,067	—
Student Aid Commission	1,257	1,403	1,570	1,720	1,954	2,128	2,308	10.5
Health and Social Services								
Medi-Cal	12,437	15,140	15,611	16,734	18,245	19,567	21,036	6.8
CalWORKs	2,079	1,065	1,448	1,468	1,360	1,250	1,234	3.0
SSI/SSP	2,861	2,752	2,815	2,888	2,968	3,055	3,151	2.7
IHSS	1,436	1,530	1,281	1,328	1,377	1,438	1,504	-0.3
Developmental Services	2,437	2,526	2,733	2,843	2,966	3,095	3,231	5.0
Mental Health	1,794	1,252	1,273	1,319	1,345	1,351	1,357	1.6
Other major programs	3,136	1,890	2,088	1,985	1,990	1,886	1,874	-0.2
Corrections and Rehabilitation	9,217	7,749	8,311	8,139	8,222	8,344	8,569	2.0
Judiciary	1,657	1,214	1,213	1,228	1,227	1,227	1,227	0.2
Proposition 1A Loan Costs	91	91	1,986	—	—	—	—	
Infrastructure Debt Service[c]	5,344	5,345	5,216	6,317	6,809	7,114	7,295	6.4
Other Programs/Costs	6,790	6,576	7,107	7,683	7,906	8,106	8,220	4.6
Totals								**5.8%**
Percent Change		-6.7%	12.3%	3.6%	4.7%	4.7%	4.1%	

set forth in the Constitution), the state is required to make a maintenance factor payment, thereby accelerating growth in K–14 funding. Another type of Proposition 98 obligation is created when the finalized estimate of the minimum guarantee for a particular year ends up being higher than the Proposition 98 appropriation for that year. When this happens, the state needs to make a "settle-up payment" (or series of payments) to ensure the guarantee is met.

Current-Year Proposition 98 Adjustments

Figure 2 shows the major current-year Proposition 98 adjustments resulting from our forecast. Based upon updated 2011-12 information, the Proposition 98 calculations have changed in three ways, each of which is described below.

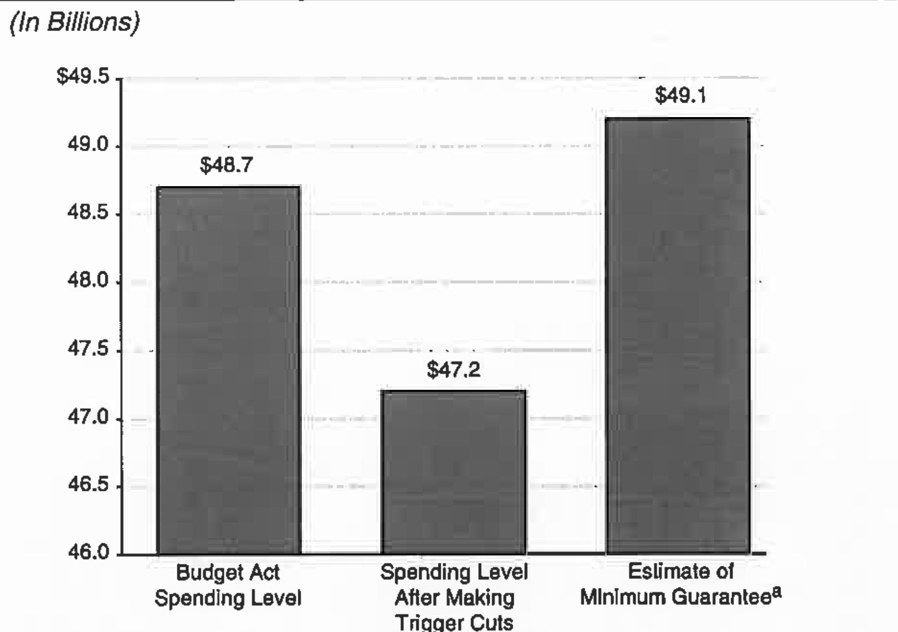
Unmet 2011-12 Revenue Projections Result in Proposition 98 Trigger Cuts of $1.5 Billion. The *2011-12 Budget Act* appropriated $48.7 billion in Proposition 98 funding. Under our revised current-year General Fund forecast, revenues are $3.7 billion below 2011-12 budget assumptions, which would trigger $1.5 billion in corresponding Proposition 98 cuts. As a result, revised 2011-12 Proposition 98 spending would be reduced to $47.2 billion. Specifically, all the Proposition 98 Tier I reductions would be enacted—resulting in a $30 million cut to CCC apportionments (accompanied by a fee increase beginning in summer 2012) as well as a $6 million cut to the State Preschool program (with an additional $17 million non-Proposition 98 General Fund being cut from other child care programs). Additionally, almost all of the Tier II reductions would be enacted—resulting in the elimination of the Home-to-School Transportation program (for half-year savings of $248 million), an additional $72 million cut to CCC apportionments, and a $1.1 billion reduction to K-12 revenue limits. Whereas budget legislation authorizes a revenue limit reduction of $1.5 billion, we estimate a somewhat smaller reduction given our estimates of General Fund revenues and the Proposition 98 minimum guarantee. The reductions would be effective beginning January 1, 2012, except for the revenue limit reduction, which would take effect February 1, 2012.

Assume Higher Base and Large Settle-Up Obligation Moving Forward. The 2011-12 budget package proposed that a ballot measure be approved to raise additional revenue for schools and community colleges. The budget package, however, also contained a provision specifying that

Figure 2

2011-12 Proposition 98 Estimates

(In Billions)



[a] Assumes no ballot measure. All sales tax revenues are included in Proposition 98 calculations. Difference between spending level and guarantee would become new settle-up obligation.

if no such ballot measure passed, the state would be required to provide an additional $2 billion in settle-up payments for K-14 education, reflecting the increase in the 2011-12 minimum guarantee if certain sales tax revenues had been included in the Proposition 98 calculations. To date, no such ballot measure has been adopted. Therefore, in calculating the minimum guarantee for 2012-13, our forecast assumes that all sales tax revenues are included in the Proposition 98 calculation, increasing the 2011-12 spending base by $2 billion. That is, even though the spending level with the trigger cuts would be $47.2 billion, we calculate the 2012-13 guarantee assuming a 2011-12 base of $49.1 billion. The budget package specifies that this settle-up obligation is to be paid in equal installments over a five-year period, beginning in 2012-13. We estimate annual payments of almost $400 million to satisfy this obligation.

Revisions in Redevelopment Savings Result in Higher General Fund Costs. The 2011-12 budget package also assumed the state would receive $1.7 billion in General Fund savings as a result of redevelopment agencies making "remittance payments" to school districts. As discussed in more detail later in this chapter, our forecast assumes the state will receive $300 million less than the initial estimate. As a result, the General Fund share of Proposition 98 costs for 2011-12 is up by about $300 million. (As specified in current law, we assume any increase in local redevelopment-related revenue for school districts would provide no General Fund benefit after 2011-12.)

Proposition 98 Forecast

Steady Increases in Proposition 98 Minimum Guarantee Throughout Period. The top part of Figure 3 shows our projections of the Proposition 98 minimum guarantee throughout the forecast

Figure 3

Proposition 98 Forecast

(Dollars in Millions)

	2012-13	2013-14	2014-15	2015-16	2016-17
Minimum Guarantee					
General Fund	$37,240	$39,649	$41,810	$44,556	$46,451
Local property tax	14,023	14,159	14,295	14,459	15,067[a]
Totals	**$51,263**	**$53,808**	**$56,105**	**$59,015**	**$61,518**
Percent change	4.3%	5.0%	4.3%	5.2%	4.2%
Proposition 98 "Test"	2	1	1	2	2
Key Factors					
K-12 average daily attendance	0.08%	-0.07%	-0.24%	-0.13%	0.01%
Per capita personal income (Test 2)	4.04	3.41	3.61	4.74	4.10
Per capita General Fund (Test 3)	4.28	5.29	4.81	5.85	4.74
Preschool through community colleges (P-14) cost-of-living adjustment	3.09	1.75	2.16	2.41	2.51
Year-to-Year Change in Guarantee	**$2,127**	**$2,545**	**$2,297**	**$2,910**	**$2,503**
Baseline Costs					
P-14 attendance	$82	$18	-$54	$1	$71
P-14 COLA	873	669	888	1,146	1,249
Backfill of one-time actions	2,283	—	—	—	—
Totals	**$3,238**	**$687**	**$834**	**$1,147**	**$1,320**
Funds Available/Shortfall (+/-)	-$1,111	$1,858	$1,463	$1,763	$1,183

[a] Our forecast assumes the state will have fully repaid the Economic Recovery Bonds by the end of fall 2016, with the "triple flip" ending in spring 2017 and related local property tax revenues thereafter flowing back to schools and community colleges.

period. For 2012-13, we project the minimum guarantee will be $51.3 billion, or 4.3 percent, higher than the revised prior-year level (of $49.1 billion). Thereafter, we project year-to-year increases in the minimum guarantee ranging from $2.3 billion to $2.9 billion, reflecting 4 percent to 5 percent annual increases. Although not reflected in the figure, the state's outstanding maintenance factor obligation would remain more than $10 billion throughout the forecast period. Also not shown in the figure, we assume the state continues to carry a $1.5 billion settle-up obligation from 2009-10 but makes no associated payments throughout the period. We also assume the state continues to make $450 million payments associated with the Quality Education Investment Act in 2012-13 and 2013-14 and then makes a smaller final payment to retire the obligation the following year.

Except for 2012-13, Year-to-Year Growth in Guarantee to Exceed Growth in Baseline Costs. The middle part of Figure 3 shows some of the key factors that underlie the forecast and/or drive education costs. As shown, K-12 ADA is projected to be virtually flat throughout the period. Projected growth in per capita General Fund ranges from 4 percent to 6 percent whereas growth in per capita personal income is slightly less, ranging from 3 percent to 5 percent. The cost-of-living adjustment (COLA) for preschool through community colleges (P-14) hovers around 2 percent throughout the period. The bottom part of Figure 3 compares our projection of the year-to-year change in the Proposition 98 minimum guarantee with the amount needed to fund annual increases in baseline costs. As shown in the figure, except for 2012-13, the minimum guarantee would grow by more than is needed for the state to fund changes in enrollment and inflation. Over the last four years of the period, the guarantee would grow by a total of $6.2 billion more than needed to cover baseline costs. Nonetheless, as discussed in more detail below, the state still would face notable budget challenges.

Major Proposition 98 Issues

We believe the Legislature should be mindful of several major issues as it begins to craft a Proposition 98 budget for the coming fiscal year.

Effect of Current-Year Trigger Cuts on School Districts Will Vary. Unsurprisingly, given the diversity among California's school and community college districts, the Proposition 98 trigger reductions will affect different types of districts differently. Understanding these impacts can help inform the Legislature's 2012-13 budget decisions.

- *Some Districts Already Have Planned for Reductions.* The districts that would be affected the least adversely by trigger cuts are those that built their 2011-12 budgets assuming some reduction in Proposition 98 per-pupil spending. These districts likely budgeted cautiously given the continued uncertainty regarding a tax package, concerns with the reliability of the $4 billion in additional revenue assumed late in budget negotiations, and the borrowing constraints they faced due to the new 2011-12 deferral of $2.1 billion. As a result of already making programmatic reductions, many of these districts are carrying relatively solid reserves. Thus, these districts likely will respond to trigger cuts by drawing down their reserves but make few, if any, midyear reductions.

- *Other Districts Significantly Affected.* In contrast, the districts likely to be the most affected by the trigger reductions are those that made few initial reductions in their 2011-12 programs. Instead, these districts were more optimistic in their budget assumptions—both assuming additional state revenue would materialize in 2011-12 and increasing their borrowing to sustain prior-year program levels. These districts will tend to be carrying less robust reserves.

As a result of all these local decisions, these districts will face much more difficult options in response to the trigger cuts. They, like the districts described above, likely will first draw down their reserves. If their reserve levels, however, reflect only the minimum levels required by state law, they would not be adequate to absorb the entire cut. School districts also will face challenges given that collective bargaining and impasse processes likely will make negotiating additional furlough days difficult, despite being authorized in state law. Given school districts also cannot impose teacher layoffs midyear, these districts could need to make significant reductions in classified staff and/or service programs that rely on temporary teachers. Under a worst-case scenario, these districts could run out of cash the last few months of the year, be unable to make payroll, and require an emergency state loan (for which the district pays all associated costs and loses local control for a period of up to 20 years).

Given Size of Budget Problem, Legislature Needs to Consider Whether It Can Fund the Minimum Guarantee in 2012-13. Based upon our forecast, the 2012-13 minimum guarantee would be more than $4 billion higher than the revised 2011-12 spending level (after making the trigger cuts). With a projected 2012-13 overall state budget shortfall of $13 billion, the state will need to consider whether it can provide that large of an augmentation to school districts and community colleges. If the Legislature determined that such a sizeable Proposition 98 augmentation would make balancing the overall state budget too difficult, it could consider suspending the Proposition 98 minimum guarantee and providing either no or less growth in Proposition 98 funding. Retaining the revised 2011-12 spending level or providing a smaller-than-$4 billion augmentation would affect districts differently. As discussed above, some districts would be either keeping programmatic support flat or making slight programmatic increases. In contrast, other districts would have to make programmatic reductions in 2012-13 under either of these scenarios.

Remainder of Forecast More Robust but Not Enough to Retire Existing Obligations. As shown toward the bottom of Figure 3, we project the minimum guarantee will increase by an average of $2.5 billion a year—or $10 billion cumulatively—from 2013-14 through 2016-17. Even this notable growth, however, does not appear sufficient to allow the state to retire all of its existing Proposition 98-related obligations. For example, even if the state dedicated this entire amount toward funding revenue limit COLAs and paying down the existing revenue limit deficit factor, it still would end the period with almost $1 billion in outstanding revenue limit obligations. Over the course of this period, the state would have foregone COLAs for all other Proposition 98 programs, and it would have continued to make more than $10 billion in late Proposition 98 payments each year. Moreover, by the end of the period, the state still is projected to be carrying a more than $10 billion maintenance factor obligation and a $1.5 billion settle-up obligation.

Maintenance Factor Issues Remain. In recent years, disagreements have emerged regarding how to run the Proposition 98 calculations in certain situations, with differences in interpretation leading to results that can differ by billions of dollars. The main disagreements relate to when maintenance factor is created and paid. For example, in 2011-12, depending upon one's interpretation of the State Constitution and associated statutory provisions, either no maintenance factor was created or $2.5 billion in maintenance factor was created. Moreover, the issue of how to pay maintenance factor can affect the long-term Proposition 98 funding level. Depending on one's interpretation of how to pay maintenance factor, differences of hundreds of millions to billions of dollars are at stake. To make matters even more complicated, different combinations of perspectives

on maintenance factor creation and payment can lead to even greater differences in results. Unless the Legislature (or voters) resolve these disagreements, calculating the Proposition 98 minimum guarantee will become increasingly problematic moving forward.

Child Care and Development (CCD)

Traditionally, CCD programs have been funded through a combination of state Proposition 98 General Fund and federal funds. The *2011-12 Budget Act* departed from this practice and instead used non-Proposition 98 General Fund for the state's share of all CCD programs except for State Preschool. Thus, we include State Preschool within our Proposition 98 forecast but run a separate forecast for the remaining CCD programs.

Current-Year Adjustments for CCD Programs. The *2011-12 Budget Act* provided $374 million in Proposition 98 General Fund monies for State Preschool and $1.1 billion in non-Proposition 98 General Fund for all other CCD programs. The trigger cuts would result in a $23 million reduction to these programs ($6 million in State Preschool and $17 million in reductions to all other CCD programs). We expect most programs will realize these savings by disenrolling some children who are currently being served. (Current law generally requires programs to disenroll children from families earning the highest incomes first.) More than offsetting the drop in non-Proposition 98 spending, we estimate 2011-12 General Fund child care costs have increased by $26 million due to higher-than-expected Stage 2 caseload.

Future CCD Costs Reflect Ripple Effects of Temporary CalWORKs Policy Changes. Moving forward, we project overall CCD costs (excluding State Preschool) will decline slightly in 2012-13, then grow to almost $1.4 billion by 2016-17. For California Work Opportunity and Responsibility to Kids (CalWORKs) child care, we project a decline and then slow growth in costs over the early years of the period, largely resulting from temporary CalWORKs policies that were in effect for 2009-10 through 2011-12. Specifically, participation in CalWORKs Stage 1 child care (funded through the Department of Social Services) has decreased by nearly 30 percent since 2008-09 due to temporary exemptions that allowed certain families to receive cash grants without meeting work participation requirements. We assume that this reduction in Stage 1 caseload will subsequently lead to reduced Stage 2 and Stage 3 caseload over the next several years, thereby curbing the state's child care costs. We project costs will increase more rapidly (average of 10 percent) in the latter three years of our forecast, when we expect normal child care usage patterns will resume and increases in overall CalWORKs caseload will have resulted in more child care enrollments. For non-CalWORKs CCD programs (General Child Care, Alternative Payment, and migrant programs), we assume costs increase gradually over the forecast period, with year-to-year changes growing from 1 percent in 2012-13 to 5 percent by 2016-17. This trend reflects declines and then slow growth in the population of children under age four, together with annual COLA rates of roughly 2 percent.

HIGHER EDUCATION

In addition to the community colleges (which are discussed above as part of the Proposition 98 forecast), the state's public higher education entities include the University of California (UC), the California State University (CSU), and the California Student Aid Commission (CSAC).

UC and CSU

Current-Year Trigger Cuts for Universities. Based on our revenue forecast, we have assumed $100 million in trigger cuts each for UC and CSU. Cuts of this magnitude amount to about 4.5 percent of the universities' General Fund support. However, given that the universities' core funding also includes a significant amount of tuition revenue, the programmatic reduction experienced

by the universities would be about 2 percent at UC and 3 percent at CSU. The universities have limited options for accommodating midyear reductions, as most decisions affecting workload for the remainder of the academic year (admissions and course scheduling for example) were made months earlier. Unless the universities find sources of replacement revenue (such as through a midyear tuition increase), they will have to accommodate the reductions with some combination of drawing down reserves, borrowing, and reducing per-student costs.

Overall University Costs Projected to Be Flat Throughout Forecast. Our forecast assumes the universities' annual General Fund operating costs will be roughly $4 billion over the course of the forecast period. This reflects our overall forecast approach of not providing automatic COLAs, as well as an absence of college-age population growth.

Enrollment Projected to Be Flat. Enrollment at the universities is affected by demographic changes in the student population as well as demand among eligible individuals. we project that demographic growth in the student population will slow and then become negative by the end of the forecast period. Though enrollment demand at the universities is difficult to project, as it depends on many different economic and social forces, we assume a modest increase in demand would generally be canceled out by the projected demographic declines. We therefore assume no increase in university enrollment during the forecast period.

UC Retirement Program Costs Not Included in Forecast. Because no statutory formula or plan has been adopted governing state support for the UC Retirement Program (UCRP), we did not include General Fund costs for UCRP in our forecast. Based on discussions with UC, however, we estimate that UC could request state General Fund contributions exceeding $400 million annually by the end of the forecast period. Beginning in the early 1990s, neither the state nor UC employees made contributions to UCRP. This was because UCRP investments were sufficient to cover retirement cost obligations. This is no longer the case, with UC recently reinstituting employee payroll contributions and UC employer contributions toward UCRP. These contributions, however, are insufficient to cover all of UC's projected retirement costs. Though UC recently has begun requesting increased state General Fund support to help close this gap, the state has yet to appropriate funds for this purpose.

California Student Aid Commission

Cal Grant Programs. Most of the state's direct General Fund support for student financial aid is provided through the CSAC's Cal Grant programs, which offer tuition coverage and subsistence grants to eligible students. These costs are affected both by the number of students participating in the programs and the universities' tuition charges. As discussed above, we do not anticipate significant changes in enrollment levels. However, recent trends in tuition increases, coupled with statements by the universities, suggest that UC and CSU tuition will continue to increase. As a result, we project that Cal Grant costs will increase from $1.4 billion in 2011-12 to $2.3 billion at the end of the forecast period. Our forecast also takes into account costs associated with passage of the California Dream Act of 2010. Among other provisions in the act, Chapter 604, Statutes of 2010 (AB 131, Cedillo), makes some nonresident students eligible to receive state financial aid beginning in 2013.

Key Issues

Given that state General Fund resources are likely to continue to be severely constrained for the next several years, the Legislature faces several key questions with regard to the higher education budget.

- ***How Much Should Students Pay?*** As noted above, the universities have signaled that they could continue to increase tuition significantly for at least the next several years. The Legislature may wish to provide direction to the universities with regard to

the share of education cost that non-needy students should be expected to pay.

- ***How Can Cal Grant Costs Be Managed?*** Because state law currently provides for a corresponding increase in Cal Grant payments when UC and CSU raise their tuition, state General Fund costs are driven in part by independent actions by the universities' governing boards. In some cases, the universities' decisions to increase tuition are made after passage of the state budget. The Legislature may wish to explore ways to better manage its own expectations for Cal Grant costs at the time of budget passage.

- ***How Should the Universities Reduce Operating Costs?*** Since the onset of the current recession, General Fund support for UC and CSU has declined by about a quarter. Much of this reduction has been backfilled with revenue from student tuition increases. Given the likelihood of continuing state budget constraints for the next several years, it may be necessary for the universities to further reduce their overall costs. The Legislature may wish to express expectations with regard to cost-saving opportunities related to factors such as faculty teaching and research expectations, student remediation rates, articulation of course sequences, student assessment and placement, and expansion of distance education and other alternative modes of instruction.

- ***How Should the State Address UCRP Costs?*** As noted above, UC's current efforts to restart UCRP contributions envision a corresponding increase in General Fund support, reaching several hundred million dollars per year by the end of the forecast period. Besides the magnitude of any augmentation, the Legislature also will have to consider how state support would be adjusted in future years, including potential increases or decreases in UCRP normal costs and unfunded liabilities.

HEALTH AND HUMAN SERVICES

Overview of Services Provided. California's major health programs provide health coverage and additional services for various groups of eligible persons—primarily poor families and children as well as seniors and persons with disabilities. The federal Medicaid program, known as Medi-Cal in California, is the largest state health program both in terms of the amount of funding and number of persons served. In addition, the state supports various public health programs, community services, state-operated facilities for the mentally ill and developmentally disabled, and health care insurance for children through the Healthy Families Program. Beyond these health programs, the state provides a variety of human services and benefits to its citizens. These include income maintenance for the aged, blind, or disabled; cash assistance and welfare-to-work services for low-income families with children; protection of children from abuse and neglect; and the provision of home-care workers who assist the aged and disabled in remaining in their own homes. Although various state departments oversee the management of these programs, the actual delivery of many services is carried out by county welfare and child support offices, and other local entities. Health programs are largely federally and state funded, while most human services programs have a mixture of federal, state, and county funding.

Overall Spending Trends. The 2011-12 budget provided $25.2 billion in General Fund spending for health and human services (HHS) programs. These costs would have been significantly higher, but the realignment package discussed earlier shifted $3.5 billion of state costs to counties. We

now estimate that these General Fund costs will be about $25.9 billion in 2011-12, primarily due to higher-than-anticipated costs in Medi-Cal and In-Home Supportive Services (IHSS). Based on current law requirements, we project that General Fund spending for HHS programs will increase to about $27.2 billion in 2012-13 and $28.6 billion in 2013-14. Over the final three years of the forecast, we project that spending will increase by about $1.6 billion each year, eventually reaching $33.4 billion. All of our estimates include annual savings of about $325 million pursuant to the trigger reductions for Medi-Cal programs operated by the Department of Developmental Services and IHSS.

Although the average annual increase in HHS spending is 5 percent during the forecast period, there is substantial variation in spending growth rates by program. General Fund spending for the state's largest HHS program, Medi-Cal, averages 6.8 percent per year during the forecast period. Conversely, the Supplemental Security Income/State Supplementary Program (SSI/SSP) and CalWORKs programs are both projected to have average annual growth of around 3 percent.

Anticipated Lower Caseload Growth Reduces Cost Pressures. The recent recession raised unemployment and reduced income, resulting in historically high numbers of Californians enrolling in state HHS programs. As a result, caseload growth for many HHS programs from 2008-09 through 2011-12 was well above historical trends. Our economic forecast assumes modest but sustained employment growth over the next five years. Accordingly, our caseload projections for many HHS programs reflect substantially lower growth rates compared to the experience of recent years. This in turn reduces cost pressures. Below, we discuss spending trends in the major HHS programs.

Impact of Federal Affordable Care Act (ACA). The ACA, also referred to as federal health care reform, is far-reaching legislation that will change how millions of Californians access health care coverage. Among many other provisions, the new federal law expands federal funding and eligibility for the Medi-Cal Program and mandates that individuals obtain private or public health coverage. Some key provisions will not take effect until 2014. The scope of ACA is so broad that it will be years before all of its provisions will be fully implemented and its overall ramifications fully understood. Our fiscal forecast includes some significant budgetary adjustments to account for the implementation of ACA. Some of these adjustments result in cost increases for the state while others result in savings.

Medi-Cal

Overall Spending Trends. We estimate that in the current year General Fund spending for Medi-Cal local assistance administered by the Department of Health Care Services will amount to $15.1 billion. This is about $450 million, or 3.1 percent, more than appropriated in the *2011-12 Budget Act.* We project that General Fund support will grow to $15.6 billion in 2012-13, a 3.2 percent increase from current-year expenditures. The largest factors contributing to this year-over-year spending growth are: (1) increases in caseload, utilization of services, and rising costs for those services; (2) costs for replacing one-time savings from a budget maneuver that accelerated provider payments and reduced expenditures in the 2011-12 budget; and (3) full-year savings in 2012-13 from various cost-containment measures implemented in part of 2011-12. After 2012-13, we project that General Fund spending will increase by about 8 percent each year, reaching a total of $21 billion by 2016-17.

Key Program Cost-Drivers. We assume that the cost per person for Medi-Cal health services will grow at an average annual rate of 5.4 percent over the entire forecast period. We also project that the number of individuals enrolled in Medi-Cal under current eligibility rules will grow at an average rate of only 0.8 percent per year. However, the overall Medi-Cal caseload will grow more than 6 percent

annually due to factors related to the ACA, most notably expanded eligibility beginning in January 2014. The impact of the ACA on our Medi-Cal spending forecast is discussed below.

Key Assumptions Related to Cost-Containment Measures. The 2011-12 budget assumed savings from a variety of cost-containment measures, such as copayments and utilization limits, for which the state is still awaiting federal approval. Our forecast assumes the implementation of these measures will be delayed several months, resulting in an erosion of 2011-12 budget savings. We assume, however, a full year of savings from the cost-containment measures in 2012-13. We also assume the state will implement provider rate reductions recently approved by the federal government, despite ongoing legal challenges.

ACA Impacts. Implementation of ACA will have a series of impacts on the Medi-Cal Program over the forecast period. For example, the federal government will initially cover the health service costs for individuals who become eligible for Medi-Cal in 2014 under the expanded eligibility categories required in the ACA. Our spending forecast captures a partial-year effect in 2017, when the state will pay for a small proportion of costs associated with the expanded eligibility categories. The state will also share costs for any increase in caseload in existing eligibility categories that results from persons enrolling in Medi-Cal in response to the individual coverage mandate created under ACA. We note that, due to ACA, our estimates related to caseload growth and other factors impacting program expenditures contain a significantly greater degree of uncertainty.

Mental Health

We estimate that General Fund spending for the Department of Mental Health (DMH) in 2011-12 will be about $1.3 billion and will grow very slowly, approaching $1.4 billion by 2016-17. General Fund spending would have remained virtually unchanged during the forecast but for an almost $80 million increase in DMH staff costs to provide treatment services for mentally ill inmates at a new prison facility in Stockton.

Current-Year Impacts. As shown earlier in Figure 1, General Fund spending for DMH programs decreased from almost $1.8 billion in 2010-11 to $1.3 billion in 2011-12. This net decrease of $540 million can be attributed to two main factors: (1) realignment-related state savings of $762 million from replacing General Fund expenditures for the Early and Periodic Screening, Diagnosis, and Treatment Program and Mental Health Managed Care with Proposition 63 funds; and (2) partially offsetting cost increases (including additional General Fund expenditures to replace expiring enhanced federal matching funds that were available in the prior year).

Developmental Services

We estimate that the General Fund spending for developmental services in 2011-12 will total $2.5 billion, assuming that the "revenue" trigger discussed earlier is pulled to achieve $100 million in ongoing savings. We project that General Fund support will grow to more than $2.7 billion in 2012-13, an increase of more than 8 percent from current-year expenditures. This year-over-year projected growth is largely due to increased caseload, utilization of services, and rising costs for community services provided by regional centers. It is also due to the expiration of temporary provider payment reductions that were implemented as a cost-cutting measure.

We project that General Fund support will grow to $3.2 billion by the end of the forecast period in 2016-17. This projected growth is largely due to increased caseload, utilization of services, and rising costs for community services. Our forecast assumes that regional center caseloads will grow at an annual average rate of 3 percent, and that costs overall will grow at an average annual rate of about 5 percent.

CalWORKs

Overall Spending Trends. For 2011-12, the state budget provided $1 billion from the General Fund for CalWORKs. This amount reflects the impact of the 2011 realignment legislation, which shifted about $1.1 billion in CalWORKs grant costs to the counties. We project that General Fund spending for CalWORKs will be about $1.1 billion in 2011-12 or approximately $75 million above the *2011-12 Budget Act* appropriation, due to higher-than-projected caseload. From this current-year base, we project spending will increase by about $400 million in 2012-13, stay fairly flat in 2013-14, and then decline in each of the next three years to around $1.2 billion in 2016-17. The increase in CalWORKs costs over the next two years is primarily the result of (1) the restoration of short-term reductions, (2) caseload growth, and (3) the state's fixed federal Temporary Assistance for Needy Families (TANF) block grant, which does not adjust for caseload changes. Long-term cost declines are primarily driven by projected declines in caseload levels.

Cost of Restoring Short-Term Policy Changes. For 2011-12, the Legislature achieved major ongoing CalWORKs savings through grant and eligibility reductions and additional short-term savings of over $400 million. The short-term savings included (1) extending certain exemptions from work participation requirements with a corresponding $375 million reduction in county block grants for employment services and child care and (2) suspending the case management portion of the Cal-Learn program for teen parents who remain in school, for a General Fund savings of $44 million. Our forecast reflects the complete restoration of these reductions beginning in 2012-13. (We note that the state General Fund bears 100 percent of these costs because the federal TANF block grant and county realignment funds do not adjust for caseload or policy changes.)

Caseload Levels Driven Mainly by Economic Conditions. Historically, changes in employment levels have significantly affected CalWORKs caseload growth. During the recent economic downturn, the growth rate of the CalWORKs caseload increased significantly. Conversely, during previous periods of employment growth, the CalWORKs caseload grew at a slower rate or declined. Our forecast of CalWORKs caseload reflects this empirical relationship between caseload and employment. The budget forecasts caseload growth of 1.2 percent in 2011-12. Based on recent caseload data, we estimate slightly higher caseload growth of 2.5 percent, resulting in additional costs of about $75 million. In 2012-13, as employment growth begins to increase, we project caseload will grow by only 0.6 percent. Beginning in 2013-14, we expect the caseload to gradually decline over the remainder of the forecast period.

SSI/SSP

State expenditures for SSI/SSP are estimated to be $2.8 billion in 2011-12 and 2012-13. Beginning in 2013-14, we project that General Fund support for SSI/SSP will increase by an average of $80 million per year, reaching $3.2 billion by 2016-17. The projected spending increases are primarily due to average annual caseload growth of about 2 percent with somewhat higher growth rates in the later years to reflect the aging of the population.

IHSS

For 2011-12, we estimate that General Fund spending for IHSS will exceed the budget act appropriation by roughly $300 million, resulting in total costs of about $1.5 billion. We then project that costs will decrease to around $1.3 billion in 2012-13. These amounts reflect implementation of revenue triggers mentioned earlier and a specific IHSS trigger discussed below which will result in combined savings of $110 million in 2011-12 and $350 million annually thereafter. Finally, we project only modest growth in program cost in the out-years.

Budget Solutions and Unrealized Savings. The 2011-12 budget reflects a package of solutions

including (1) receipt of additional federal funds due to a provider tax and implementation of the Community First Choice option under the federal ACA, (2) elimination of services for recipients whose need for services has not been certified by a medical professional, (3) a medication dispenser initiative, and (4) program integrity activities. Altogether, the budget assumed these initiatives would result in about $600 million in program savings in 2011–12. However, we estimate that this package will only save about $200 million in that year. Most of the unrealized savings in 2011–12 are related to delays in the implementation of the medication dispenser initiative and the Community First Choice option, along with overestimation of savings from other solutions.

Medication Dispenser Initiative and Budget Trigger. As part of the 2011–12 budget, the Legislature established a medication dispensing pilot program intended to improve medication compliance among Medicaid recipients, estimated to result in annual net cost avoidance of $140 million from reduced nursing home placement and hospital admissions. Budget legislation requires the Department of Finance (DOF) to report to the Legislature by April 10, 2012 on how much savings the pilot is likely to achieve. At that time, the Legislature will have until July 1, 2012 to enact alternative legislation to achieve a total of $140 million in ongoing savings from the medication pilot and/or new initiatives. If the DOF determines that these legislative actions are insufficient to achieve $140 million in savings, an across-the-board reduction in IHSS hours sufficient to meet this savings target will be implemented in 2012–13. Our forecast assumes that no savings from the medication dispensing pilot will be achieved in 2011–12, but that the full $140 million target will be achieved beginning in 2012–13.

Caseload Growth. Our forecast assumes that IHSS caseload will grow 3 percent per year throughout the forecast period. Our forecast is higher than the trend observed in 2009 and 2010, but below the rapid caseload growth that occurred prior to those years.

JUDICIARY AND CRIMINAL JUSTICE

The major state judiciary and criminal justice programs include support for two departments in the executive branch—the California Department of Corrections and Rehabilitation (CDCR) and the Department of Justice—as well as expenditures for the state court system.

CDCR

We estimate that General Fund spending for the support of CDCR operations in the current year will be about $7.7 billion, which is $1.5 billion, or 16 percent, less than the 2010–11 level of spending. This primarily reflects the estimated savings from (1) the realignment of certain lower-level offenders, parole violators, and parolees to counties beginning October 1, 2011 and (2) use of realignment revenues in the current year to reimburse CDCR for lower-level offenders in state prison who were sentenced prior to October 1. Our estimate of current-year spending is also lower because of assumed trigger reductions. Counties would be required to pay $125,000 per year to the state for each juvenile offender committed to the Division of Juvenile Facilities, resulting in an estimated savings of $79 million in the General Fund cost of operating state youth correctional facilities in 2011–12. In addition, there would be a $20 million unallocated reduction to CDCR's budget.

Our forecast projects that General Fund spending on corrections will increase to about $8.6 billion in 2016–17. As indicated above, the 2011–12 realignment package assumed that the Local Revenue Fund 2011 (realignment revenues) would reimburse CDCR about $1.2 billion for costs incurred in 2011–12 for lower-level offenders in state prison who were sentenced prior to October 1,

2011. Our forecast assumes that the General Fund will replace the $1.2 billion in 2012–13 and future years. In addition, as discussed in more detail below, our projections also reflect actions to reduce the state's inmate population as well as additional costs that CDCR will incur to staff and operate new prison facilities expected to be constructed during the forecast period.

Projected Savings From Reduced Inmate Population... Our forecast assumes that the realignment of certain criminal offenders from the state to the counties will reduce CDCR expenditures by $1.5 billion annually upon full implementation in 2014–15. Although this realignment of services would significantly reduce the state's inmate population, and go a long way towards complying with a federal court order to reduce prison overcrowding, it may fall short in meeting the requirements within the deadlines established by the court. (Please see nearby box for more detailed information about the federal court order.) Thus, our forecast assumes annual savings of over $100 million beginning in 2012–13 from additional inmate population reduction measures that would likely need to be adopted to comply with the court order. However, the actual savings achieved would largely depend on the specific actions taken to further reduce prison overcrowding.

...But Increased Costs to Operate Planned AB 900 Facilities. In 2007, the Legislature enacted Chapter 7, Statutes of 2007 (AB 900, Solorio), in order to relieve the significant overcrowding problems facing state prisons and improve rehabilitation. Specifically, AB 900 authorizes the construction of tens of thousands of additional prison beds. Our projections assume that about 15,300 additional beds will be constructed pursuant to AB 900 during the forecast period, resulting in an estimated $800 million in additional General Fund expenditures annually to staff and operate the new facilities. As the new facilities are built, the Legislature will need to make policy and budgetary decisions regarding the level of programming and staffing to be provided at these facilities, which will determine the actual increase in operational costs. Given the likely magnitude of these eventual costs, as well as the significant reduction in the state's inmate population resulting from the federal court ruling to reduce prison overcrowding, the Legislature may want to hold off from moving forward with some of the projects authorized under AB 900.

Judicial Branch

We estimate that General Fund spending for the support of the judicial branch in the current year will be about $1.2 billion, which is roughly $500 million lower than the amount appropriated in the *2011-12 Budget Act.* This estimate primarily

Federal Court Order to Reduce Prison Overcrowding

On May 23, 2011, the U.S. Supreme Court issued a ruling in a lawsuit against the state involving prison overcrowding. Specifically, the court upheld the ruling of a federal three-judge panel requiring the state to reduce overcrowding in its prisons to 137.5 percent of the system's overall "design capacity" within two years. Currently, the state prison system is operating at roughly 180 percent of design capacity—or about 32,000 inmates more than the limit established by the three-judge panel. The ruling, however, did not specify the particular measures that the state must implement to comply. On June 7, 2011 and July 21, 2011 the administration submitted reports to the three-judge panel describing specific measures that were recently taken, as well as those in the process of being implemented, to reduce overcrowding in California prisons. For more detailed information, see our recent publication, *A Status Report: Reducing Prison Overcrowding in California* (August 2011).

reflects the estimated General Fund savings from the realignment of court security to county sheriffs. Our forecast assumes that state spending on the judicial branch will remain roughly flat from 2011-12 through 2016-17.

OTHER PROGRAMS

Redevelopment

The 2011-12 budget package included two measures designed to generate (1) $1.7 billion in state education savings in the current year and (2) about $400 million in increased resources for school districts annually thereafter. Under these measures, each city or county with a redevelopment agency must choose whether to retain its redevelopment agency and make annual remittance payments to local school districts or allow its agency to be eliminated. Under either scenario, school districts receive additional local funding, either from remittance payments or property tax revenues redirected from the expired redevelopment agencies. In 2011-12, the remittance payments are intended to *offset* state funding obligations for schools. In 2012-13 and future years, the ongoing remittance payments (about $400 million annually) are intended to *supplement* the resources the state provides to schools.

Our forecast estimates that state education savings in the current year will be about $1.4 billion, about $300 million less than the amount assumed in the budget because:

- As permitted by law, DOF reduced the remittance payment obligations for certain local governments that experienced increases in their redevelopment debt obligations.
- Some cities and counties are expected to allow their redevelopment agencies to expire and that the amount of property taxes redirected from the expired agencies will be less than the local governments' remittance payments.
- Some of the remittance payments and property tax revenues will be allocated to school districts that do not receive state funding for apportionments (so-called "basic aid districts"). These funds, therefore, will not offset state school costs.

On November 10, 2011, the California Supreme Court heard a case challenging the constitutionality of the redevelopment bills. A decision is expected by January 15, 2012.

Employee Compensation

During 2010-11, the Legislature ratified new memoranda of understanding (MOUs) with each of the state's 21 collective bargaining units. These MOUs reduced state employee compensation costs through (1) the Personal Leave Program (PLP), which decreased most employees' pay by about 5 percent for the first 12 months of the new MOU's, and (2) increased employee pension contributions. The *2011-12 Budget Act* also directed the California Public Employees' Retirement System (CalPERS) to reduce employee health benefit costs by $80 million (General Fund).

Net Costs Beginning in 2012-13. Our forecast assumes that the state will achieve all of the MOU-related employee compensation savings anticipated in the *2011-12 Budget Act* ($135 million General Fund), but only $47 million of the anticipated savings in health benefits costs. Beginning 2012-13, our forecast assumes that employee compensation costs grow because:

- The temporary salary reductions associated with the PLP end in 2011-12.
- Employees at the top step of the salary range will receive pay increases as provided by the MOUs.

- Employee health care costs increase at an average annual rate of 7.6 percent.

By 2016–17, we forecast employee compensation costs (nonretirement) will be more than $550 million higher than in 2011–12, principally due to higher health care costs.

Public Employee Retirement Costs

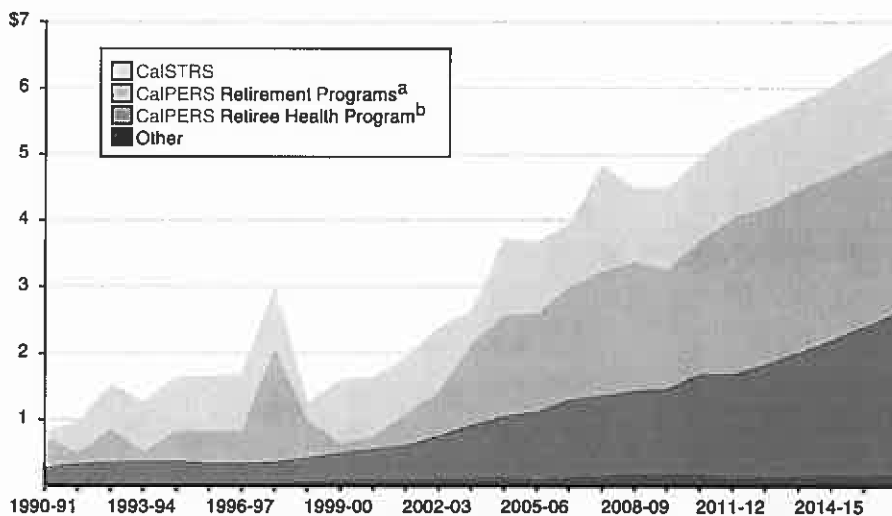
Our forecast reflects current-law increases in the state's annual payments to (1) pension programs for state and CSU employees, (2) teachers' pensions, (3) state and CSU retiree health benefit programs, and (4) pension programs for judges. (The teachers' pension program is administered by the California State Teachers' Retirement System [CalSTRS], and the other three programs are administered by CalPERS.) Figure 4 shows the recent history and forecasted trend for General Fund budgetary costs related to these retirement programs.

CalPERS Contributions Driven by Pay Raises, Investments, and Actuarial Methods. Our forecast assumes that the state's required contribution to CalPERS for state and CSU pensions rises from $3.6 billion (all funds) in 2011–12 to $3.8 billion in 2016–17. (Of the $3.6 billion to be contributed in 2011–12, about $2.1 billion is expected to be paid from the General Fund. This General Fund contribution grows to $2.2 billion in our forecast in 2016–17.) This assumes that CalPERS does not change its current actuarial rate-setting practices (including rate "smoothing") and that in 2012–13 and beyond, CalPERS investment returns hit the system's assumed investment target of 7.75 percent per year. Moreover, it assumes only the pay increases for state workers that are included in current MOUs—for most, a single 3 percent or 4 percent pay increase during the entire five-year forecast period. The forecast assumes that state workers continue to pay more in contributions to CalPERS throughout the forecast period, as agreed in collective bargaining agreements that were approved during the past year.

Figure 4

Current-Law State Retirement Costs to Keep Growing

General Fund (In Billions)



[a] Amount for 1997-98 includes an over $1 billion state payment related to a major court case involving CalPERS.

[b] Includes the budget item for these costs and LAO estimate of the General Fund share of the implicit subsidy for annuitant benefits that is paid along with employees' health premiums.

These various forecast assumptions limit the growth of the state's CalPERS contribution rates in our model. If, by contrast, pay raises were to rise faster than we assume, investment returns were to be significantly less, and/or actuarial methods of CalPERS were to change, the state's required payments to CalPERS could be hundreds of millions of dollars more than we forecast in 2016–17.

CalSTRS Contribution Driven by Rates Set in Statute and Teacher Salary Growth. The forecast assumes that the state's contributions to

CalSTRS grow from $1.3 billion in 2011–12 to $1.5 billion in 2016–17. State contributions in 2011–12 are based on a 2009–10 payroll level for K–12 and community college teaching and administrative personnel of $27.1 billion. The preliminary estimate for 2010–11 upon which the state's 2012–13 contributions will be based is $26.2 billion (down 3.2 percent from 2009–10). We assume that statewide payroll remains fairly flat through the forecast period.

Typically, the state pays about 4.5 percent of prior–year teacher payroll to CalSTRS, as required in contractual commitments that are outlined in the Education Code. The system also receives payments from school districts and teachers to cover pension program costs, which also are fixed in the Education Code. Pursuant to its contractual obligations, the state must contribute additional funds each year when certain unfunded liabilities emerge, as they did after the decline of world financial markets in 2008. In our forecast, these added contributions total $106 million in 2011–12 and grow to $394 million by 2016–17. (These added contributions are very small compared to the billions of dollars of additional funding per year that CalSTRS will require to remain solvent and eliminate its unfunded liabilities over the next few decades.)

Retiree Health Costs to Continue Increasing. The forecast assumes continued pay–as–you–go payments for the vast majority of state and CSU retiree health costs. These are forecast to grow from $1.5 billion in 2011–12 to $2.3 billion in 2016–17. This represents an average 9.4 percent annual growth rate during the forecast period. This growth is driven by two elements: (1) projected annual growth in state employee and retiree health plan premiums and (2) a rising population of state and CSU retirees.

Unfunded Liabilities Persist. The state's retirement programs are projected to have significant—and growing—unfunded liabilities through the forecast period. Because our forecast includes only current–law pension contribution requirements, it does not include funding sufficient to begin to reduce CalSTRS' unfunded liabilities (currently estimated to be around $4 billion per year beginning immediately to eliminate the liabilities over the next 30 years, assuming that CalSTRS achieves its investment targets over the long term). Moreover, because the state is not required under current law to contribute additional funds to UC to address its unfunded pension and retiree health liabilities, the forecast includes no General Fund resources to assist UC for these purposes. It also includes virtually no General Fund support to begin paying down large unfunded retiree health liabilities for current and past state and CSU employees. If the state does not take action concerning these liabilities soon, the extra costs needed to retire these unfunded liabilities over the next few decades will increase dramatically.

Debt Service on Infrastructure Bonds

The state uses General Fund revenues to pay debt–service costs for principal and interest payments on two types of bonds used primarily to fund infrastructure—voter–approved general obligation bonds and lease–revenue bonds approved by the Legislature. We estimate that General Fund costs for debt service on these bonds will be $5.2 billion in 2012–13, which is roughly equal to the state's General Fund debt–service costs every year since 2009–10. General Fund debt–service costs have not increased significantly over this period for a few reasons. Most notably, the Legislature and Governor enacted legislation to offset some General Fund debt–service costs with transportation funds. Additionally, the administration slowed the pace of bond sales over the last 18 months, including the cancellation of state bond sales during the first half of 2011.

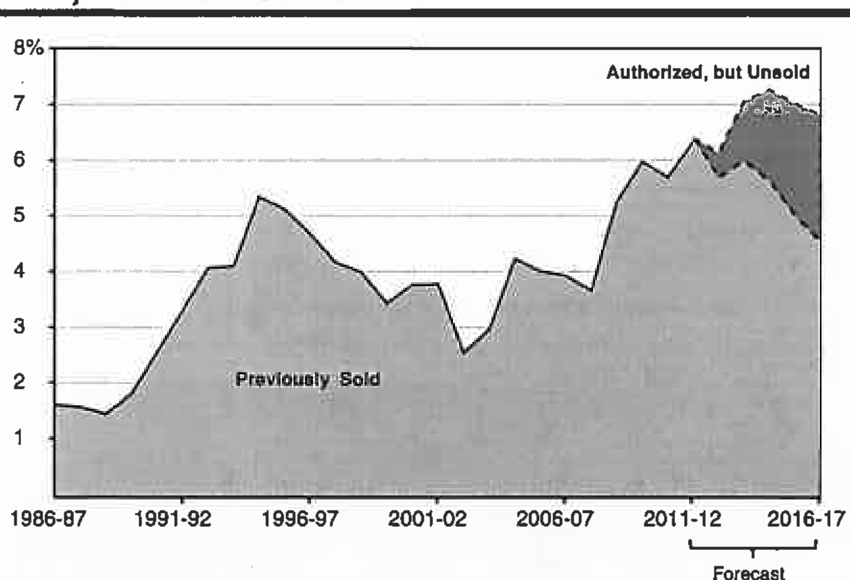
Over the forecast period, however, debt service is projected to grow 6.4 percent annually over the period, reaching $7.3 billion by 2016–17. Projections of debt–service costs depend primarily on the volume of past and future bond sales, their

interest rates, and their maturity structures. The exact timing of bond sales depends upon when various bond-related programs will be in need of funds and the accessibility of financial and credit markets. In general, our forecast assumes that the slower pace of bond sales continues for many programs because they currently have sufficient bond proceeds to cover their spending needs for the initial portion of the forecast. Nonetheless, over the entire forecast period, we assume that a total of about $36 billion of already authorized general obligation and lease-revenue bonds will be sold as currently approved projects move forward. A large share of this—about $24 billion—is from the nearly $54 billion in infrastructure bonds authorized by voters in 2006 and 2008. It also reflects the growing issuance of lease-revenue bonds for the prison system authorized by the Legislature in 2007. We also expect that transportation debt-service costs will exceed available transportation funds during the forecast period and the General Fund will resume paying a portion of these costs. Our forecast is based on the expected sale of bonds that have already been authorized, but does not include any proposed bonds (such as the water bond scheduled for the 2012 ballot).

Debt-Service Ratio (DSR) Expected to Rise. The DSR for general obligation and lease-revenue bonds—that is, the ratio of annual General Fund debt-service costs to annual General Fund revenues and transfers—is often used as one indicator of the state's debt burden. There is no one "right" level for the DSR. The higher it is and more rapidly it rises, however, the more closely bond raters, financial analysts, and investors tend to look at the state's debt practices and the more debt-service expenses limit the use of revenues for other programs. Figure 5 shows what California's DSR has been in the recent past and our DSR projections for the forecast period.

Figure 5

Projected Debt-Service Ratio[a]



[a] Ratio of annual General Fund debt-service payments to General Fund revenues and transfers.

The DSR we are projecting—over 7 percent at its peak—is higher than it has been in the past. In part, this reflects declines in General Fund revenues, as well as the continued sale of the large bonds approved since 2006. To the extent additional bonds are authorized and sold in future years beyond those already approved, the state's debt-service costs and DSR would be higher than projected in Figure 5.

State-Mandated Local Programs (Non-Education)

Over the last several years, the Legislature has taken various actions to reduce or defer costs for state mandates on local governments (cities, counties, and special districts). These actions include permanently repealing mandates, suspending statutory requirements to implement mandates, and deferring payments towards

retiring the state's backlog of mandate claims (over $1 billion). The 2011–12 budget shifted the responsibility and funding for providing certain mental health services to K–12 students from counties to schools (commonly referred to as "AB 3632" program). This action eliminates the need for ongoing mandate payments to counties for this program. Our forecast assumes that the Legislature continues to suspend all mandates it suspended in 2011–12. Our forecast also assumes that the state makes annual payments to retire the backlog of mandate claims, as specified in current law. Under these assumptions, state costs for mandates would increase from $48 million in 2011–12 to roughly $200 million annually throughout the forecast period.

Legislative Analyst's Office

Legislative Analyst

Mac Taylor 445-4656

Deputy Legislative Analyst

Daniel C. Carson 319-8303

Corrections, Transportation, and Environment

Deputy: Anthony Simbol 319-8350

Managing Principal Analysts:

Farra Bracht, Transportation 319-8355

Mark C. Newton, Environment 319-8323

Education

Deputy: Jennifer Kuhn 319-8332

Managing Principal Analyst:

Steve Boilard, Higher Education 319-8331

Health and Human Services

Deputy: Todd Bland 319-8353

Managing Principal Analyst:

Shawn Martin, Health 319-8362

State and Local Finance

Deputy: Jason Sisney 319-8361

Managing Principal Analyst:

Marianne O'Malley, General Government 319-8315

LAO Publications

The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

To request publications call (916) 445-4656. This report and others, as well as an E-mail subscription service, are available on the LAO's website at www.lao.ca.gov. The LAO is located at 925 L Street, Suite 1000, Sacramento, CA 95814.

Attachment Four

2011 Realignment: The Constitutional Amendment Explained

California State Association of Counties

November 16, 2011

1100 K Street
Suite 101
Sacramento
California
95814

Telephone
916.327-7500

Facsimile
916.441.5507

To: Supervisor Bruce Gibson, San Luis Obispo County, Chair
Supervisor John Moorlach, Orange County, Vice Chair
Members, Government Finance and Operations Policy Committee

From: Jean Kinney Hurst, Legislative Representative, Revenue and Taxation

Re: Realignment 2011: The Constitutional Amendment Explained — INFORMATIONAL ITEM

Recommendation: This item is for information only.

Background. The foundation of CSAC's support for realignment last year was a constitutional amendment that guarantees counties the promised revenue for as long as they are required to provide the programs. Due in part to the lack of two-thirds support for this and other elements of the state's budget, the Legislature did not pass such an amendment for the voters to consider. Despite this setback, CSAC continues to vigorously pursue constitutional protection. Getting the Legislature to pass an amendment early in 2012 would be the less expensive way to put the question to voters, but if they continue to prove unwilling or unable to do so, counties themselves must bring the question to voters via an initiative.

To prepare for this possibility, a coalition comprised of CSAC, the California State Sheriffs' Association, and the Chief Probation Officers of California have filed an initiative with the California Attorney General. Once the measure has received an official title, summary, and fiscal analysis, it will be eligible for signature gathering. To qualify for the November 2012 ballot, the campaign will have to submit well over a million signatures in early- to mid-April.

Policy Considerations. Continuing with Realignment 2011 without constitutional protection of the promised revenues is a risk that counties have very clearly said they are unwilling to take. The enclosed initiative was drafted to provide counties with the funding guarantee they need and the flexibility that will enable them to tailor the realigned programs to their needs.

The attached language will be presented to CSAC's Board of Directors on December 1 to aid their discussion of the measure and the best way to achieve constitutional protection.

Action Requested. This item is for information only.

Staff Contact. Please contact Jean Kinney Hurst (jhurst@counties.org 916/327-7500 x515) or Geoffrey Neill (gneill@counties.org or 916/327-7500 x567) for additional information.

Summary: Draft Realignment Constitutional Protections

Introduction. The measure's title and prefatory language frames the issue for voters and is intended to highlight the measure's purpose, obviously with an eye toward voter support. It is also very important should the measure see litigation.

Definitions. A significant drafting change relates to the definitions of the services realigned to counties. Rather than describe the new duties as a narrative, as in SCA 1X, the measure identifies realigned services by cross reference to specific statutes in the 2011 Realignment Legislation. We specifically defined Law Enforcement Subvention Programs to include booking fee replacement revenue, COPS funding, Juvenile Justice Crime Prevention Act funds, Juvenile Probation and Camp funds, CalEMA local assistance grants, and small and rural county sheriffs grants.

2011 Realignment Legislation is defined as the legislation that was enacted during the 2011 legislative session to assign new responsibilities to local agencies.

Revenues. Dedicates the existing 1.0625% of state sales and use tax revenues and the remaining 25.1% of Vehicle License Fees (VLF) to the Local Revenue Fund 2011 starting in fiscal year 2011-12 and continuing thereafter. These revenues are continuously appropriated to the Local Revenue Fund 2011 to fund the provision of realigned programs. Pending full implementation, the funds may also be used to reimburse state costs.

Counties must create a County Local Revenue Fund 2011 and use revenues deposited into the fund exclusively for realigned programs, as specified in statute.

The measure ensures that the legislature cannot redirect, shift, or otherwise interfere with the allocation of these revenues to the Local Revenue Fund 2011.

Mandates. Removes realigned programs from the SB 90 mandate process.

Future Program Changes. State legislation, regulations, executive orders, or administrative directives that are enacted after this year that have the effect of increasing costs shall only apply to the extent the state provides annual funding for the cost increase. The state is prohibited from requiring new programs or higher levels of service without funding.

Any legislation enacted between October 9, 2011 and the effective date of the amendment that has the effect of increasing costs or responsibilities for realigned programs shall be void unless the state provides annual and ongoing funding for the increased cost or responsibility. Local agencies are not required to provide programs or levels of service above the level for which funding has been provided.

The state is prohibited from submitting plans or waivers (or amendments to existing plans or waivers) to the federal government that increase costs to local agencies for realigned programs unless the state provides annual funding for the increase.

Increased costs that are associated with changes in federal statutes or regulations or court decisions will be shared with the state (state providing at least 50 percent of the nonfederal share of costs) for specified realigned health and human services programs.

The state may not use property taxes, 2011 realignment funds, or 1991 realignment funds to pay for these increased costs.

Funds deposited in the County Local Revenue Fund 2011 shall not be used to supplant other funding for realigned programs.

Except for the defined Law Enforcement Subvention programs, the Legislature may reduce or eliminate one or more of the realigned programs and reduce the appropriations of funds in the amount allocated for that program (or programs). The local agency is then no longer required to provide that service. If there is a dispute as to the amount of revenue reduced, a local agency may challenge the state in court. If the court finds that the state in fact reduced the appropriation in an amount greater than the amount actually spent, the court shall order the Controller to appropriate the correct amount to the counties.

Reductions to the defined Law Enforcement Subvention programs may only occur with a 4/5 vote of the Legislature.

Future Revenue Changes. The measure does not limit the Legislature's ability to impose a lawful fee or tax. The measure ensures that the Legislature can also reduce or eliminate fees or taxes.

However, if the dedicated revenue sources are reduced or eliminated, the state remains obligated to commit funding to the Local Revenue Fund 2011 in amount equal to or greater than the amount that would have been generated by those revenue sources for as long as local agencies are required to provide the realigned programs.

If the state fails to do so, the Controller is directed to transfer General Fund revenues on a monthly basis to the Local Revenue Fund 2011 and disburse them in accordance with 2011 Realignment Legislation. This obligation is a priority payment for the state behind general obligation debt and the state's responsibility to fund schools.

Subject to Audit. The measure authorizes the Controller to perform audits of expenditures from the Local Revenue Fund 2011 and any county Local Revenue Fund to ensure that those funds are used and accounted for in a manner constituent with this section, and to provide information about whether the cost of providing transferred services exceed the amount of revenues provided by the State.

1 This measure shall be known as "The Local Taxpayers, Public Safety and Local Services
2 Protection Act of 2012."

3 **SECTION 1. FINDINGS AND DECLARATIONS.**

4 The people of the State of California find and declare that:

5 (1) In the 2011 Legislative session, the State Legislature transferred from state
6 government to counties and other local governments the responsibility for providing a number of
7 public services, including law enforcement and public safety services, care for abused and
8 neglected seniors and children, mental health and substance abuse recovery programs, and
9 monitoring and detaining specified felony offenders, in a series of legislative enactments known
10 as "2011 Realignment."

11 (2) However, while the Legislature required local governments to provide these services,
12 the State did not provide a guaranteed source of ongoing funding to pay for the delivery of these
13 services beyond one year.

14 (3) Local governments are more accountable to the public and better able to deliver
15 services efficiently and effectively. However, transferring responsibility for services without also
16 guaranteeing State revenue to provide these services jeopardizes local government's ability to
17 provide law enforcement and public safety, mental health and substance abuse recovery, care for
18 abused and neglected children and seniors, and other services vital to Californians.

19 (4) Historically, the State Legislature has repeatedly raided and shifted funds dedicated
20 to local governments, and the State has also failed to adequately reimburse local governments for
21 the costs of providing services that the State mandates local governments provide.

22 (5) It is the intent of this ballot measure to require the State to transfer ongoing State
23 funding to counties and local governments to pay for the cost of providing services that were

1 transferred in 2011 by the State to local government. This measure dedicates *existing* state
2 revenues, and does not raise taxes.
3 (6) The ballot measure prohibits the State Legislature from raiding or otherwise
4 redirecting these existing revenues away from counties and local governments in the future
5 unless the transferred programs are reduced or eliminated.
6 (7) This ballot measure also prohibits the State from passing any new law or regulation
7 that imposes additional costs on local governments to provide services associated with 2011
8 Realignment, unless the State provides ongoing State funding to pay for these services.
9 (8) All revenues from this measure are subject to annual, independent audits by the State
10 Controller to ensure that they will be used only for local public safety responsibilities and other
11 local services that have been transferred to the counties and local governments by the State, and
12 to provide information about whether the cost of providing transferred services exceed the
13 amount of revenues provided by the State.
14 **SECTION 2. STATEMENT OF PURPOSE.**
15 The purpose of this measure is to require the State to provide ongoing, guaranteed funding to
16 counties and other local governments for the cost of providing services that were shifted in 2011
17 from the State to local government; to prohibit the State from reducing funding for 2011
18 Realignment in future years unless there also is a commensurate reduction in local government
19 program responsibilities; and to prohibit the State from passing any new law or regulation that
20 imposes additional costs on local governments to provide these services unless the State
21 provides a source of state funding to pay for the additional costs.
22 **SECTION 3.** Section 36 is added to Article XIII of the California Constitution, to read:
23 SEC. 36. (a) For purposes of this section:

1 (1) "Public Safety and Other Local Services" includes the programs and services
2 transferred to local agencies in the 2011 Realignment Legislation, including Law Enforcement
3 Subvention Programs.
4 (2) "2011 Realignment Legislation" means the following chaptered bills: Assembly Bills
5 94, 109 (as amended by Assembly Bill 117 of the 2011-2012 Regular Session of the Legislature
6 and Assembly Bill 17 of the 2011-2012 First Extraordinary Session of the Legislature), 111, and
7 118 (as amended by Assembly Bill 16 and Senate Bill 4 of the 2011-2012 First Extraordinary
8 Session of the Legislature) of the 2011-2012 Regular Session of the Legislature; Senate Bills 87
9 and 93 of the 2011-2012 Regular Session of the Legislature; and the programs set forth in Part
10 2.5 (commencing at section 5775) of Division 5 of the Welfare and Institutions Code and Article
11 5 (commencing at section 14680) of Chapter 8.8 of Part 3 of Division 9 of the Welfare and
12 Institutions Code, as those provisions existed on October 9, 2011.
13 (3) Law Enforcement Subvention Programs means the following provisions as they
14 existed on October 9, 2011:
15 (i) The criminal justice payments set forth in Article 12 (commencing at section 29550)
16 of Chapter 2 of Division 3 of Title 3 of the Government Code;
17 (ii) The supplemental local law enforcement services funding set forth in Chapter 6.7
18 (commencing at section 30061) of Division 3 of Title 3 of the Government Code;
19 (iii) Assistance for rural and small county law enforcement services set forth in Chapter
20 6.9 (commencing at section 30070) of Division 3 of Title 3 of the Government Code;
21 (iv) Criminal justice grants set forth in Chapter 3 (commencing at section 13820) of Title
22 6 of Part 4 of the Penal Code; and

1 (v) Juvenile probation funding set forth in Chapter 3.2 (commencing at 18220) of Part 6
2 of Division 9 of the Welfare and Institutions Code.
3 (b) In order to deliver local public safety, protective and preventative services for seniors
4 and children, and other public services that were shifted to local agencies from State government
5 as the result of the 2011 Realignment Legislation, this section creates a guaranteed source of
6 ongoing, dedicated state funding for local agencies, out of existing state funds, that cannot be
7 redirected, shifted or taken by the Legislature in the future unless there also is a commensurate
8 reduction in Public Safety and Other Local Services.
9 (c) Commencing in fiscal year 2011-2012 and continuing thereafter, the following
10 revenues shall be deposited into the Local Revenue Fund 2011, as established by Section 30025
11 of the Government Code:
12 (1) All revenues, less refunds, derived from the taxes described in Sections 6051.15 and
13 6201.15 of the Revenue and Taxation Code, as those sections read on July 1, 2011.
14 (2) All revenues (including penalties) less refunds, derived from the vehicle license fees
15 described in Section 11005 of the Revenue and Taxation Code, as that section read on July 1,
16 2011.
17 (d) (1) Funds deposited in the Local Revenue Fund 2011, less costs of administering the
18 fund, are hereby continuously appropriated to each County Local Revenue Fund 2011, as
19 allocated by the Controller as directed by statute, exclusively to fund Public Safety and Other
20 Local Services. Pending full implementation of the 2011 Realignment Legislation, funds may
21 also be used to reimburse the State for costs incurred in providing Public Safety and Other Local
22 Services on behalf of local agencies.

1 (2) The county treasurer, city and county treasurer, or other appropriate official shall
2 create a County Local Revenue Fund 2011 within the treasury of each county or city and county.
3 The money in each County Local Revenue Fund 2011, as created by the county treasurer, city
4 and county treasurer, or other appropriate official in accordance with Section 30025 of the
5 Government Code, shall be exclusively used to fund Public Safety and Other Local Services by
6 local agencies as specified by the 2011 Realignment Legislation.
7 (e) Notwithstanding Section 6 of Article XIII B, or any other constitutional provision, a
8 mandate of a new program or higher level service on a local agency imposed by the 2011
9 Realignment Legislation, or by any regulation adopted or any executive order or administrative
10 directive issued to implement that legislation, shall not constitute a mandate requiring the State
11 to provide a subvention of funds within the meaning of subdivision (b) of that section.
12 (f) (1) The Legislature shall be prohibited from enacting legislation after October 9, 2011,
13 that has an overall effect of increasing the costs or scope of responsibility borne by a local
14 agency for Public Safety and Other Local Services mandated, transferred or realigned to local
15 agencies by the 2011 Realignment Legislation unless the State provides annual, ongoing funding
16 for the increased cost or responsibility. Local agencies shall not be obligated to provide
17 programs or levels of service required by legislation, described in this paragraph, above the level
18 for which funding has actually been provided.
19 (2) Any legislation enacted after October 9, 2011 and prior to the effective date of this
20 paragraph that has an overall effect of increasing the costs or scope of responsibility borne by a
21 local agency for Public Safety and Other Local Services transferred or realigned by the 2011
22 Realignment Legislation shall be void unless the State provides annual, ongoing funding from
23 revenues appropriated by the State for such increased cost or responsibility. Local agencies shall

1 not be obligated to provide programs or levels of service required by legislation, described in this
2 paragraph, above the level for which funding has actually been provided.

3 (3) The State shall be prohibited from enacting regulations, executive orders, or
4 administrative directives, after October 9, 2011, that are not necessary to implement the 2011
5 Realignment Legislation, and that have an overall effect of increasing the costs already borne by
6 a local agency for Public Safety and Other Local Services mandated by the 2011 Realignment
7 Legislation, unless the State provides annual, ongoing funding from revenues appropriated by the
8 State for such increased cost or responsibility. Local agencies shall not be obligated to provide
9 programs or levels of service pursuant to new regulations, executive orders, or administrative
10 directives, described in this paragraph, above the level for which funding has been actually
11 provided.

12 (4) Any new program or higher level of service provided by local agencies, as described
13 in paragraphs (1), (2) and (3), in excess of the provided funding, shall not require a subvention of
14 funds by the State nor otherwise be subject to Section 6 of Article XIII B. This subdivision shall
15 not apply to legislation currently exempt from subvention under paragraph (2) of subdivision (a)
16 of Section 6 of Article XIII B.

17 (5) The State shall not submit to the federal government any plans or waivers, or
18 amendments to those plans or waivers, that have an overall effect of increasing the cost or
19 responsibility borne by a local agency for Public Safety and Other Local Services mandated,
20 transferred or realigned by the 2011 Realignment Legislation, except to the extent that the State
21 provides annual funding for the cost increase.

22 (6) The State shall not be required to provide a subvention of funds pursuant to this
23 subdivision for a mandate that is imposed by the State at the request of a local agency or to

1 comply with federal law. State funds required by this subdivision shall be from a source other
2 than ad valorem property taxes or the Social Services Subaccount of the Sales Tax Account of
3 the Local Revenue Fund, or the Local Revenue Fund 2011.

4 (7) Except as provided in paragraph (8) of this subdivision, nothing in this section
5 prohibits the Legislature from subsequently reducing or eliminating one or more of the Public
6 Safety and Other Local Services. Should the Legislature do so, it may reduce the appropriation
7 of the revenues described in subdivision (c) and allocated to the County Local Revenue Fund
8 2011 by the amount allocated by the State for one or more of the reduced or eliminated Public
9 Safety and Other Local Services during the prior fiscal year. Upon such reduction or
10 elimination, the local agency shall no longer be required under the 2011 Realignment Legislation
11 to provide such services. Any local agency may challenge the amount of the reduction in the
12 appropriation to the County Local Revenue Fund 2011 under this paragraph in a court of
13 competent jurisdiction. Upon a finding by the Court that the Legislature reduced the
14 appropriation in an amount greater than the amount allocated by the State for the reduced or
15 eliminated Public Safety Services during the prior fiscal year, the Controller shall impound and
16 allocate to counties the improperly reduced or unallocated funds from the continuous
17 appropriation provided for in subdivision (d).

18 (8) Notwithstanding paragraph (7) of this subdivision, the Legislature may only reduce,
19 eliminate, or reallocate the funding for, or otherwise make changes to, Law Enforcement
20 Subvention Programs by vote of four-fifths of the membership of both houses of the Legislature.

21 (g) (1) For Public Safety and Other Local Services described in paragraphs (3) to (5),
22 inclusive, of subdivision (i) of Section 30025 of the Government Code, as that section read on
23 July 1, 2011, if there are subsequent changes in the federal statutes or regulations that alter the

1 conditions under which federal matching funds as described in 2011 Realignment Legislation are
2 obtained that have the overall effect of increasing the costs incurred by a local agency, the State
3 shall provide annual funding of at least 50 percent of the nonfederal share of those costs as
4 determined by the State.

5 (2) When the State is a party to any complaint brought in a federal judicial or
6 administrative proceeding that involves one or more of the Public Safety and Other Local
7 Services described in paragraphs (3) to (5), inclusive, of subdivision (i) of Section 30025 of the
8 Government Code, as that section read on July 1, 2011, and there is a settlement or judicial or
9 administrative order that imposes a cost in the form of a monetary penalty or has the overall
10 effect of increasing the costs already borne by a local agency for Public Safety and Other Local
11 Services mandated, transferred or realigned by the 2011 Realignment Legislation, the State shall
12 provide annual funding of at least 50 percent of the nonfederal share of those costs as determined
13 by the State. Payment by the State is not required if the State determines that the settlement or
14 order relates to one or more local agencies failing to perform a ministerial duty, failing to
15 perform a legal obligation in good faith, or acting in a negligent or reckless manner.

16 (3) The State funds provided in this subdivision shall be from funding sources other than
17 ad valorem property taxes, the Social Services Subaccount of the Sales Tax Account of the Local
18 Revenue Fund, or the Local Revenue Fund 2011.

19 (h) (1) The funds deposited into a County Local Revenue Fund 2011 shall be spent in a
20 manner designed to maintain the State's eligibility for federal matching funds, and to ensure
21 compliance by the State with applicable federal standards governing the State's provision of
22 Public Safety and Other Local Services.

1 (2) The funds deposited into a County Local Revenue Fund 2011 shall not be used by
2 local agencies to supplant other funding for Public Safety and Other Local Services.
3 (3) This section shall not be construed to prevent the Legislature from subsequently
4 imposing, increasing, reducing, or repealing a fee or tax enacted in accordance with this
5 Constitution.
6 (i) If the Legislature reduces or repeals the revenue described in subdivision (c) and
7 adopts an alternative source of revenue to replace them, the alternative source of revenue is
8 hereby continuously appropriated, and shall be deposited into the Local Revenue Fund 2011 in
9 an amount equal to or greater than the aggregate amount that otherwise would have been
10 provided by the revenue described in subdivision (c) in the year the revenue was reduced or
11 repealed. If the Legislature reduces or repeals the revenue described in subdivision (c) and fails
12 to adopt an alternative source of revenue, the funds are hereby appropriated from the General
13 Fund to the Controller who shall transfer therefrom the amount described above in pro rata
14 monthly shares to the Local Revenue Fund 2011. Thereafter, the Controller shall disburse these
15 amounts to local agencies in the manner directed by statute. The State funds provided in this
16 subdivision shall be from funding sources other than ad valorem property tax, the Social Services
17 Subaccount of the Sales Tax Account of the Local Revenue Fund, or the Local Revenue Fund
18 2011. The State shall be obligated to provide the amount described above for so long as the local
19 agencies are required to perform the Public Safety and Other Local Services responsibilities
20 mandated, transferred or realigned by 2011 Realignment Legislation. The State obligations
21 under this subdivision have a lower priority claim to General Fund money than the first priority
22 for money to be set apart under Section 8 of Article XVI and the second priority to pay voter-
23 approved debts and liabilities described in Section 1 of Article XVI.

1 (j) The Controller, pursuant to his or her statutory authority, may perform audits of
2 expenditures from the Local Revenue Fund 2011 and any County Local Revenue Fund to ensure
3 that those funds are used and accounted for in a manner consistent with this section, and to
4 provide information about whether the cost of providing transferred services exceed the amount
5 of revenues provided by the State.

Attachment Five

California's Historic Election Divestment

November 16, 2011

1100 K Street
Suite 101
Sacramento
California
95814

telephone
916.327-7500

Facsimile
916.441.5507

To: Supervisor Bruce Gibson, San Luis Obispo County, Chair
Supervisor John Moorlach, Orange County, Vice Chair
Members, Government Finance and Operations Policy Committee

From: Jean Kinney Hurst, Legislative Representative, Revenue and Taxation
Geoffrey Neill, Senior Legislative Analyst, Revenue and Taxation

Re: California's Historic Election Divestment — INFORMATIONAL ITEM

Recommendation: This item is for information only.

Background. Over just the past couple years, the state of California has quietly accomplished, through a series of decisions, a historic divestment of election administration. This divestment takes place after more than a decade of significantly increased federal and state requirements on the conduct of elections. The loss of funding totals tens of millions per year statewide, and the increased requirements will make elections cost millions more.

Three years ago, the Legislature let lapse the decades-old statute that said the state was liable for the cost of special elections held to fill legislative and congressional vacancies. Since that time, counties have spent over $25 million to conduct these elections, which by nature are almost always unexpected and therefore unbudgeted.

In last year's budget, the Legislature disingenuously "suspended" the mandates to provide many voters with mail ballots upon request, making it optional for counties to abide by them. However, not only do these measures increase access to voters, they have become such an entrenched part of elections systems that many counties would incur greater cost by stopping the service than retaining it. Legislatively "suspended" mandates are never unsuspended, and some have been suspended continuously since for over twenty years. This action costs counties about $25 million per year.

The Legislature passed SB 6 to implement the provisions of Proposition 14, the direct primary. However, SB 6 contains many cumbersome requirements beyond what is necessary. For example, they require certain messages to be printed on the ballot itself, sometimes in extremely large font sizes; ballots are expensive, and the requirements will no doubt cause many counties to use an extra ballot card. The requirements make it functionally impossible for Los Angeles to continue conducting elections for its cities. SB 6 also requires counties to print endorsement letters from political parties — which are private organizations — at public expense.

Further, because under Proposition 14 all public office primaries except that of US President are now non-partisan, non-presidential general elections — those held in 2014, 2018, etc. — feature only one type of partisan contest: central committees. The

parties, as noted above, are private organizations, and having them as the only partisan office will increase election expenses significantly. But for them, each precinct would only have one ballot type. Besides which, central committee candidates, which about two-thirds of voters do not bother voting for, comprise about two-thirds of the candidates local election offices must service. Aside from eliminating the counties' responsibility to administer these elections, even modest proposals such as eliminating write-in spaces for central committees have met resistance in the Legislature.

Despite these growing cost pressures, the Legislature has not allowed counties to implement any of a number of cost-saving measures that maintain the integrity of elections. Among the ideas that local officials have floated:

- Expanding the number of voters per precinct, perhaps related to the number of vote-by-mail voters.
- Requiring the state to pay its pro rata share of election costs like other jurisdictions do.
- Increasing the minimum number of voters allowable
- Authorizing more unopposed offices not to appear on the ballot.
- Allowing local agencies to have more of their elections performed entirely by mail.
- Requiring school districts to pay their share of vote-by-mail costs, just like every other type of jurisdiction does.
- Eliminating the requirement to send sample ballot pages to vote-by-mail voters.

Policy Considerations. Counties have a long-standing duty to administer elections. The last decade has seen a significant increase in federal and state laws and regulations related to election administration, including regulation of voting machines, vote auditing procedures, and required mail balloting.

Counties pay for election operations out of their general funds, which also must pay for a host of other important functions, such as health services, public protection, and public safety. Significantly reduced state funding for elections means that either elections or those other core services paid for from county general funds must suffer significant reductions.

CSAC will continue to work with the Legislature, supervisors, and county election officials to reinstate state funding for elections and to implement sensible changes to the election process that do not affect their integrity.

Action Requested. This item is for information only.

Staff Contact. Please contact Jean Kinney Hurst (jhurst@counties.org 916/327-7500 x515) or Geoffrey Neill (gneill@counties.org or 916/327-7500 x567) for additional information.