



Pension Reform in California

As February 2005 drew to a close, Governor Arnold Schwarzenegger of California faced increasingly vociferous attacks from powerful interest groups over his proposed public employee pension reform. For two months, critics have repeatedly struck at the heart of Governor Schwarzenegger's proposal—the conversion of the state's public employee pension plans from defined benefit plans to defined contribution plans. Labor unions have been particularly vocal, using tactics ranging from phone banks and mailers to mass protests and emotionally-charged television commercials featuring the widows of firefighters killed in the line of duty.

The debate over pension reform began in earnest in January 2005. During his State of the State address on January 6th, Governor Schwarzenegger announced four ambitious new initiatives to address California's fiscal problems. These initiatives included new spending limits, merit pay for teachers, redistricting and pension reform. Governor Schwarzenegger's proposed pension overhaul drew heavily on two bills introduced in the California Legislature in December 2004 by Dr. Keith Richman, a Republican Assemblyman representing California's 38th district. Under the plan, all new public employees hired after July 1, 2007, would only be permitted to participate in retirement accounts similar to 401(k) plans, rather than the guaranteed annual pension payments to which retired and current public employees are now entitled.

Since early January, pension reform has made little progress within California's Democrat-controlled Legislature. Amidst this growing stalemate among lawmakers and the continuing attacks of opponents, Governor Schwarzenegger is now reassessing his pension reform strategy. As he does so, it is imperative that he keep in mind the trade-offs involved and the perspectives of key stakeholders, including the labor unions, the managers of CalPERS and CalSTRS (California's two biggest public employee pensions), state legislators and the media.

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Background on California

The State of California is comparable to a large country in many respects. With a population of 35.9 million in 2003, California alone accounts for over 12 percent of the US population. California's population is spread across a total land area of roughly 156,000 square miles (just larger than the entire United Kingdom), with population concentrations in what are some of the nation's biggest metropolitan areas, including Los Angeles and San Francisco. The population of California is relatively diverse—the largest racial groups are White (46.7 percent), Hispanic or Latino (32.4 percent), Asian or Pacific Islander (11.1 percent) and Black (6.4 percent). Politically, California is generally regarded as a liberal state. Of all registered voters as of February 2004, 43.2 percent were registered Democrat and 35.6 percent were registered Republican.

Like its population, California's economy is large and diverse. Its gross state product (GSP) was just over \$1.4 trillion in 2003, making it the seventh-largest economy in the world. It is by far the largest state economy in the US, accounting for over 13 percent of the total gross domestic product of the entire nation. California's economy includes large real estate (14.6 percent of total GSP), manufacturing (11.1 percent) and retail trade (7.6 percent) industries, but the state is perhaps best-known for its high-technology sector. Home to Silicon Valley and pioneering firms like Hewlett-Packard, Intel and Google, California led the world in the high-technology boom of the 1990s. Driven in part by this boom, economic growth was quite strong during the late-1990s, averaging 7.0 percent annual growth between 1995 and 2000. However, when the Internet bubble burst and the nationwide economic recession began, California's economic growth slowed to only 2.0 percent in 2001 and 3.4 percent in 2002, rebounding slightly to 5.7 percent in 2003.

This slowdown in the economy coincided with a growing fiscal crisis within California's state government. Between 1995 and 2001, the State of California's general government revenues and expenditures both grew quickly, averaging annual growth of 9.1 percent and 8.6 percent, respectively. In 2002, however, revenues declined by \$7.4 billion, or 6.0 percent, due largely to drops in personal income and corporate tax collections. Meanwhile, expenditures grew by an additional \$11.9 billion, or 9.9 percent, resulting in a deficit of \$15.4 billion. The situation only worsened in 2003, when the deficit ballooned to just under \$20.0 billion (see Appendix A.)

Under the leadership of Governor Gray Davis, the state government borrowed an additional \$18 billion in internal loans and government bonds specifically to fund the deficits in 2002 and 2003, on top of the billions of dollars borrowed for other purposes. This was the largest deficit borrowing package in state history, and, in combination with the state's other financial and economic troubles, it undermined the state's creditworthiness.

Faced with economic malaise, budget shortfalls and deficit borrowing, Californians became increasingly frustrated with Governor Davis. Davis had just been re-elected to a second term in November 2002, but in February 2003, campaigns were launched to collect signatures to

qualify a ballot initiative to recall him. The recall was qualified with 1.6 million signatures on July 23, 2003, setting off a race for governor among 135 officially-certified candidates, including actors Arnold Schwarzenegger and Gary Coleman, political commentator Arianna Huffington, Lieutenant Governor Cruz Bustamante and State Senator Tom McClintock.

Following a spirited campaign, Schwarzenegger was elected California's next governor on October 7, 2003. The election results seemed to offer a clear mandate for innovative change: Davis was recalled by a healthy margin of 55 percent to 45 percent, and Schwarzenegger, a Republican, won a decisive victory with 49 percent of the vote versus 32 percent for his closest competitor, winning 3.7 million votes out of the 7.4 million cast. Thus, Governor Schwarzenegger claimed with confidence in his inaugural address that his election "was about changing the entire political climate of our state" and that he would not "do things the way they've always been done."

Schwarzenegger found himself in a challenging fiscal environment when he took office on November 17, 2003. He had campaigned as a reformer, pledging to address the state's fiscal crisis through unconventional measures. Since then, his results have been mixed. He has managed to narrow the budget deficit to \$9.4 billion from nearly \$20.0 billion, largely by growing revenues while keeping expenditures flat. But he has also incurred an additional \$15.0 billion of deficit borrowing, and he has had trouble keeping a number of his campaign promises, particularly his pledges to keep education spending levels intact and to root out waste and fraud in government spending. It is within this context that Governor Schwarzenegger proposed his drastic pension plan overhaul and must now consider his next steps.

California's Public Employee Pension Plans

Pension plans are established by corporations, unions, government agencies or other organizations to provide benefits (usually in the form of cash payments or non-cash assistance such as health insurance) to employees after their retirement from active service. In the State of California, there are approximately 2.2 million active state and local government employees, the vast majority of whom are enrolled in a public employee pension plan. The two largest public employee pension plans in California are state plans—the Public Employees' Retirement Fund (managed by CalPERS) and the State Teachers' Retirement Plan (managed by CalSTRS). These plans are two of the biggest in the world, with combined total assets accounting for over 10 percent of the nearly \$3 trillion in assets managed on behalf of all state and local governments throughout the US (See Appendix B for financial highlights on CalPERS and CalSTRS). Some local government entities in California operate their own retirement plans, such as the San Diego City Employees' Retirement System, but hundreds of cities, towns, school districts, water districts and other public agencies contract with CalPERS or CalSTRS to manager their retirement plans.

The California Public Employees' Retirement System (CalPERS). Founded in January 1932, CalPERS manages total assets of \$199.5 billion and net assets of \$168.4 billion. It operates 14

different pension funds, including five defined benefit plans, four defined contribution plans, a health care fund and a long-term care fund, covering employees ranging from state judges and legislators to police officers and firefighters. The biggest of these funds (accounting for 99 percent of CalPERS' total net assets) is the Public Employees' Retirement Fund (known as PERF), which offers retirement benefits, disability benefits, death benefits and survivor benefits.

As of June 30, 2004, there were 1.4 million members of PERF, with about 800,000 active members, 200,000 inactive members, and over 400,000 benefit recipients. PERF provides coverage to three major categories of employees: (1) state members (32.6 percent of total membership), (2) school members (35.0 percent), and (3) public agency members (32.3 percent). State members include direct current or former employees of the state government, such as members of the California Highway Patrol. School members include non-teaching public school current or former employees, such as administrators and security guards. Public agency members include current or former employees of public agencies that contract with CalPERS to manage their retirement benefits, including municipalities, such as City of San Francisco, and authorities, such as Metropolitan Water District of Southern California.

The California State Teachers' Retirement System (CalSTRS). While not big as CalPERS, CalSTRS is also an extremely large pension plan operator. CalSTRS controls total assets of \$136.5 billion and net assets of \$116.2 billion across six major programs. The biggest of these is the Defined Benefit Program (the DB Program) within the State Teachers' Retirement Plan (STRP), which accounts for over 99 percent of CalSTRS' total net assets. As of June 30, 2004, there were about 750,000 members of the DB Program, of whom 59 percent were active members, 15 percent were inactive members, and 26 percent were benefit recipients. All members of the DB Program are California public school employees, kindergarten through community college. Many are teachers, but membership is also open to supervisors, as well as to others who are involved in the preparation of instruction materials.

Characteristics of Defined Benefit Plans. Both PERF (CalPERS) and the DB Program (CalSTRS) are defined benefit plans. In defined benefit plans, retired members receive guaranteed stable periodic benefit payments, year after year, until the member dies or chooses to leave the plan. Members must pay a certain amount into the plan from their payroll during each year of active service, and employers must also contribute a certain amount into the plan each year. These payments are pooled into investment funds that are professionally managed by the plan sponsors to ensure that the plan has sufficient assets to pay current and future benefits. The amount of the periodic benefit payment due to each member is determined using formulas that generally incorporate elements of a member's work history, including years of service, age at retirement and compensation at retirement. Defined benefit plans are common among industrial corporations like General Motors, which has a number of multi-billion dollar defined benefit plans covering most of its 324,000 employees.

For members of CalPERS' PERF, benefit formulas vary based on job classification and other factors. For example, some members are eligible at age 55 and guaranteed 2.0 percent of final compensation for each year of service, while others are eligible at age 60 and guaranteed 1.25 percent of final compensation for each year of service. The average member who retired during 2002-2003 with 25-30 years of credited service and average final compensation of \$61,872 received an average benefit of \$39,132. The definition of "final compensation" is itself variable, as it includes only the last 12 months of service for some employees and the last three consecutive years of service for others. Active employees must contribute into the plan between five percent and eight percent of their salary each year, while employers must contribute in an amount that is actuarially determined each year based on funding needs.

For members of the CalSTRS' DB Program, benefit formulas are more standardized, since the DB Program's membership base is more homogeneous than PERF's membership base. Most members are eligible at age 60 with five years of credited service, and they receive a benefit equivalent to two percent of final compensation for each year of credited service. The average member who retired during 2003-2004 had 27.1 years of credited service, average final compensation of \$70,692 and received an average benefit of \$43,272. Final compensation is defined as the highest three consecutive years of compensation for members with less than 25 years of service and the highest 12-month period for members with more than 25 years of service. After retirement, benefits increase two percent per year to protect against inflation. Required contribution rates for active plan members are eight percent of salary, while required contribution rates for employers are 8.25 percent of their total payroll costs. The State of California itself is not a participating employer in CalSTRS, rather it participates in CalPERS. However, the state has a legislative mandate to contribute to the CalSTRS DP plan, equal to 2.017 percent of total members' compensation, as well as a variable contribution requirement to protect members' purchasing power.

The Deteriorating Financial Condition of CalPERS and CalSTRS

The pension fund industry as a whole has experienced increasing financial difficulties in the early 2000s. A recent survey of 24 of the biggest public employee pension funds conducted by Gabriel, Roeder, Smith & Company ("GRS") found that plan funding levels have generally deteriorated over the past few years.¹ Due largely to the stock market declines from 2000 through 2002, the aggregate funded ratio for the 24 plans declined from 108 percent in 2000 to 90 percent in 2003, and the aggregate ratio of underfunded actuarial accrued liability to covered payroll shifted dramatically from an overfunding of 37 percent to underfunding of 48 percent (see Appendix C for a more detailed discussion of pension plan regulations, accounting techniques and financial analysis.)

¹ Study can be obtained from: <http://www.grsnet.com/>.

Mirroring these industry trends, the financial condition of PERF has also deteriorated. PERF's funded ratio declined from 120 percent in 1998 to 88 percent in 2003, which translates into an underfunded actuarial accrued liability (UAAL) of \$22.3 billion. Over the same time period, the ratio of UAAL to covered payroll changed from an overfunding of 89 percent to underfunding of 64 percent. This deterioration owes largely to the poor financial markets of 2000-2002. Between 1998 and 2004, total contributions increased by \$2.8 billion, almost in line with the \$3.2 billion increase in total benefits. Asset growth failed to keep pace with liability growth, however, because of poor investment performance in 2001 and 2002, when investment income was -\$12.3 billion (-9.6 percent return on investment) and -\$9.7 billion (-8.1 percent return on investment), respectively. As a result, the actuarial value of assets actually *declined* by \$3.8 billion from \$162.4 billion to \$158.6 billion between 2000 and 2003, while at the same time the actuarial accrued liability *increased* by \$45.0 billion from \$135.9 billion to \$180.9 billion.

By most measures, the DB Program is in a more precarious financial situation than PERF. The DB Program's funded ratio declined from 104 percent in 1998 to 82 percent in 2003, which translates into an UAAL of \$23.1 billion. Over the same time period, the ratio of UAAL to covered payroll— changed from overfunding of 19 percent to underfunding of 97 percent. As at PERF, the deterioration at the DB Program owes in part to the poor financial markets of 2000-2002. The DB Program experienced investment losses of \$10.2 billion in 2001 (-9.1 percent return on investment) and \$6.3 billion in 2002 (-6.0 percent return on investment). Meanwhile, the actuarial accrued liability has exploded, growing from \$74.2 billion in 1998 to \$131.8 billion in 2003. Asset values have not been able to keep pace with this rapid increase in liabilities, leaving the DB Program underfunded by a significant amount.

An Alternative—Defined Contribution Plans

The deteriorating financial condition of CalPERS and CalSTRS, in combination with the state government's other fiscal problems, are what prompted Governor Schwarzenegger to propose a conversion to defined contribution plans for new employees. In defined contribution plans, retired members receive variable benefits that are determined based on contributions into their personal pension accounts, plus accrued investment earnings. Generally, both members and employers contribute to the account on a regular basis throughout the period of active service, and the contributions are invested in stocks, bonds, mutual funds or other securities, at the member's discretion. Unlike a defined benefit plan, employers who offer defined contribution plans have no responsibility for managing the investment assets. So, two members with the same work history who retired in January 2000 would receive different benefit payments if one invested heavily in technology stocks and the other invested mainly in government bonds.

Defined contribution plans are controversial because they shift the burden of risk from employers who offer the plans to the employee members of the plans. In defined benefit plans,

employers bear the risk because they manage the investment accounts and are obligated to make guaranteed benefit payments every year, even if the stock market collapses. In defined contribution plans, the employer and members provide the initial contributions. From that point forward, the members bear the risk because the benefit they receive is determined solely by their investment choices and the ups-and-downs of securities markets. Members do not have the security of guaranteed monthly payments, and may outlive their pension assets.

Related to this difference in risk, there is also a difference in the volatility of the annual cash contributions that are required of employers each year. Under the current system, the State of California's required contributions are very volatile from year to year—if the securities markets perform poorly, the State must pay extra to make up for investment portfolio losses. For example, the State's required contributions into CalPERS have fluctuated widely recently, from \$1.2 billion in 1998, to \$0.2 billion in 2001, to \$2.1 billion in 2004. This phenomenon is not unique to California: According to the GRS study, the required employer contributions for 24 of the biggest public employee pension funds increased by roughly 44 percent between 2000 and 2003 to make up for investment losses.

Finally, defined benefit and defined contribution plans differ in terms of the level of flexibility afforded the employee. Generally, employees can choose their level of contribution to a defined contribution plan (often anywhere from zero percent of their salary to 15 percent or more), while their level of contribution to a defined benefit plan is more strictly mandated. This gives employees in a defined contribution plan greater financial flexibility before retirement, but if they contribute at a low level during their employment, their assets upon retirement are more likely to be insufficient. This issue is exacerbated by the common practice of "employer matching," which sets the level of employer contribution equal to the level of employee contribution. Often, employees can also borrow against their assets in a defined contribution plan but not against their assets in a defined benefit plan, another option that is appealing in the short run but may threaten long-term retirement security. If not managed correctly, these borrowings may be heavily taxed, further burdening the employee.

Key Trade-offs and Issues

As Governor Schwarzenegger contemplates his options related to pension reform, he must consider a number of relevant trade-offs and issues.

Budgetary Issues. As described above, the choice of pension system—defined benefit or defined contribution—has a significant impact on the volatility of required employer contributions. If CalPERS and CalSTRS were to switch to defined contribution plans, the State of California would be responsible for a steady, predictable payment into members' personal pension accounts each year, as opposed to a widely fluctuating amount. This increased degree of certainty

makes defined contribution plans a very appealing alternative for Governor Schwarzenegger, given California's uncertain and troubled fiscal situation.

It is also important to consider the magnitude of California's annual required contributions in relation to the overall state budget. Between 1997 and 2004, California's total annual pension contributions to CalPERS and CalSTRS averaged \$1.8 billion, equating to approximately 1.6 percent of total government expenditures. Over the same time period, these contributions averaged 3.9 percent of the total payroll costs of employees enrolled in CalPERS and CalSTRS. Opponents of pension reform argue that defined contribution plans are just as costly to administer as defined benefit plans, meaning that pension reform will have little impact on the overall state budget.

Intergenerational Equity. Pension reform also involves issues of intergenerational equity. In a defined benefit plan, current employees contribute to the plan each year under the assumption that when they retire in the future, the plan will have sufficient assets to pay them the yearly retirement benefit to which they are entitled. If a plan encounters financial difficulties, however, it may erode its asset base and be forced to use current contributions to pay for current retiree benefits, leaving insufficient assets to pay for future retiree benefits and leading to bankruptcy. This situation would entail a redistribution of wealth to current retirees from future retirees (i.e. current employees), who would find themselves paying into the plan but receiving no benefits in the future.

As a result, there is heated debate about the long-term sustainability of CalPERS and CalSTRS as they are currently structured. Proponents of Governor Schwarzenegger's proposal argue that CalPERS and CalSTRS cannot survive forever as defined benefit plans. He argued that they would eventually become financially insolvent, and before they do so, current retirees will benefit at the expense of current employees. Contributing to this problem is the possibility that members may try to artificially inflate their "final compensation" during their last year of service by taking on new short-term duties or working extensive overtime, an issue that is not inherent in defined contribution plans. Opponents of pension reform, on the other hand, argue that CalSTRS and CalPERS have survived for decades and can continue to do so as defined benefit plans. Both sides can cite detailed statistical analyses and independent studies that support their positions, making the issue especially contentious.

Social Security. There is a complex relationship between California's public employee pension plans and the Federal Social Security system. Members of CalSTRS do not contribute to Social Security at all, so the retirement benefits that they receive through their school employment are provided entirely by CalSTRS. Furthermore, under federal law, CalSTRS members who are eligible for Social Security through other sources, such as another job or a spouse's job, often face a reduction in the Social Security benefit due to the retirement benefits paid by CalSTRS. CalPERS. The enforcement of this law accomplished by "coordination" with Social Security, meaning that

members who receive a Social Security benefit receive a reduced retirement benefit from CalPERS. Under a defined contribution plan, there is no reduction in the benefits paid by Social Security or the DC plan.

Political Consequences. Finally, there are significant political consequences at stake. Elected as a reformer and “political outsider,” Governor Schwarzenegger made a number of bold campaign promises (of which pension reform was *not* one). As of February 2005, he had kept one major pledge—to repeal California’s \$4 billion increase in the car tax—but he has recently been criticized for failing to meet other ambitious goals, particularly related to education. Meanwhile, Governor Schwarzenegger’s approval ratings have begun to show some signs of strain. According to the Public Policy Institute of California, his overall approval ratings as of late January 2005 remained relatively high at 60 percent (down from 65 percent one year earlier). However, his support among Democrats and Independents has declined markedly, eroding the bipartisan base of support that he enjoyed during his first year in office. Even if he chooses not to run again when he is up for re-election in 2006, Governor Schwarzenegger is under pressure to maintain his political support as he seeks to implement his reform agenda.

The Major Stakeholders

Outside of the Governor’s office, several factions are heavily invested in the debate over pension reform and hold strong opinions about the matter.

Labor Unions. The harshest critics of Governor Schwarzenegger’s proposed pension plan reforms have been the California labor unions, particularly the California Labor Federation (2.1 million members from the manufacturing, service, retail, construction and public sectors), the California Teachers Association (335,000 members) and the California Professional Firefighters union (30,000 members). These unions organized intense grass-roots activism against pension overhaul, including protests at Governor Schwarzenegger’s public appearances, phone banks, mailers and door-to-door visits. Calling Governor Schwarzenegger’s proposals a “war on working people,” labor unions highlighted the higher risk that defined contribution plans pose for union members because such plans make retirement benefits entirely dependent upon investment markets. They have also expressed concern about the possible loss of survivor and/or disability benefits, which are generally not included as part of defined contribution plans.

Officials at CalPERS and CalSTRS. Officials at CalPERS and CalSTRS have also been outspoken in their opposition to Governor Schwarzenegger’s pension proposals. Shortly after Governor Schwarzenegger’s announcement, the governing bodies of both CalPERS and CalSTRS announced their official opposition to defined contribution plans. They mounted public information campaigns and produced research studies in support of their stance. Like the labor unions, CalPERS and CalSTRS have stressed the increased risk to members and the possible loss of survivor and/or disability benefits. They have also concluded that defined contribution plans are

more costly to administer than are defined benefit plans and that defined benefit plans are powerful incentives that help California attract and retain highly-skilled public sector employees. Therefore, they argue that a shift to defined contribution plans would cause a deterioration in the level of public service in the state.

California State Legislature. Democrats hold majorities in both houses of the California State Legislature, and they have been in disagreement with Governor Schwarzenegger over much of his reform agenda, including education, budget reform, economic development and voter redistricting. Given their close ties to the labor unions, Democratic legislators oppose Governor Schwarzenegger's pension proposals, led by Assembly Speaker Fabian Nuñez (D-Los Angeles) and Senate President Pro Tem Don Perata (D-Oakland). For the most part, Governor Schwarzenegger has relied on the support of Republicans, particularly the sponsor of the December 2004 pension reform bill, Assemblyman Keith Richman (representing the Northwest San Fernando Valley, Simi Valley and Santa Clarita). Richman, a medical doctor who was first elected to the Legislature in 2000, is a founder of "The Bipartisan Group," a group of legislators dedicated to constructive nonpartisan cooperation. Along with pension reform, his other areas of focus include energy policy, HMO reform, workers' compensation reform and expanding access to healthcare. Despite Dr. Richman's efforts and Governor Schwarzenegger's aggressive support of pension reform since his January 2005 State of the State address, however, pension reform has made little headway in the Legislature to date.

Local Government Officials. Pension reform at the state level would impact hundreds of local government entities, both those that contract with CalPERS or CalSTRS for their retirement plans and those that do not. Governor Schwarzenegger's proposal would apply to *all* non-federal public employees in California hired after July 1, 2007, meaning that even future employees of entities that operate independent plans, like San Diego County, would be affected. Many of these independent plans are facing the same sort of financial distress as CalPERS and CalSTRS, such as Los Angeles County (\$3.9 billion UAAL, only 87 percent funded), San Diego County (\$1.4 billion UAAL, 76 percent funded) and Orange County (\$978 million UAAL, 83 percent funded).

Like Governor Schwarzenegger, local government officials must consider issues like the risk of long-term financial insolvency, budgetary concerns (as participating employers, their annual plan contributions will change depending upon the structure of the pension plan), political consequences and intergenerational equity. Upon weighing these risks, many of the larger entities decided not to support Governor Schwarzenegger's proposal. The San Diego County retirement board, for example, voted to oppose it, arguing that it unfairly punishes all public pension systems instead of only the problem few.

Conclusion

With pension reform opponents gaining traction among the general public and continuing to hound Governor Schwarzenegger, he must soon decide how he will move forward with pension reform. How should he respond to his critics? Should he maintain a conciliatory or more combative stance? Should he appeal directly to voters through a ballot initiative or continue to work through the State Legislature?

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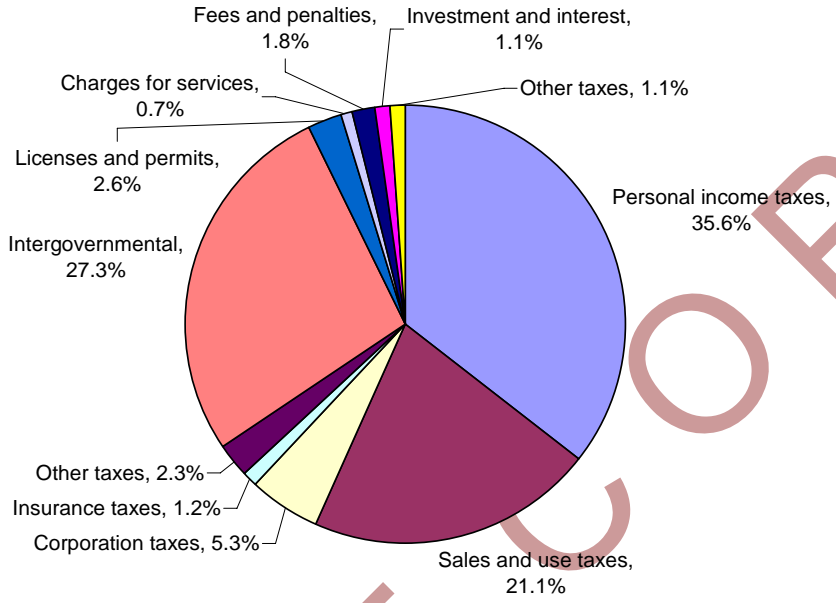
Appendix A

California's General Government Revenues and Expenditures

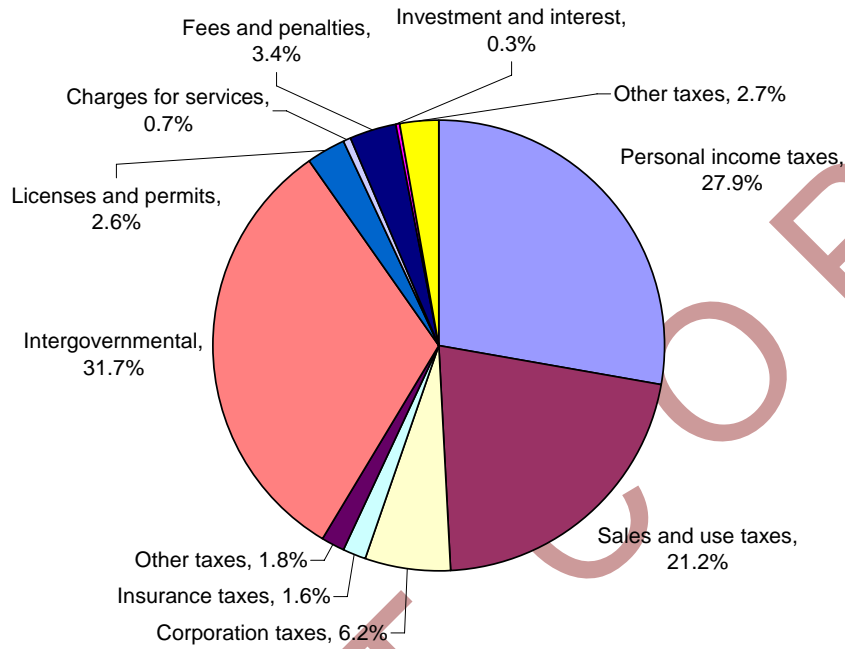
Revenues. California's biggest sources of revenue are personal income taxes, sales and use taxes, and intergovernmental revenues (predominantly federal grants), which together account for roughly 80 percent of total revenues. The revenue mix has changed over the past few years. Personal income taxes have declined from 35.6 percent of revenue in FY2001 to 27.9 percent of revenue in FY2004, while intergovernmental revenues, corporation taxes, and fees and penalties have increased as a percentage of total revenue.

State of California General Government Revenues					
(\$ in millions)					
	<u>6/30/2000</u>	<u>6/30/2001</u>	<u>6/30/2002</u>	<u>6/30/2003</u>	<u>6/30/2004</u>
Revenues by Source					
Personal income taxes	\$39,516	\$44,630	\$32,875	\$32,661	\$37,723
Sales and use taxes	\$25,398	\$26,385	\$25,907	\$26,946	\$28,686
Corporation taxes	\$6,570	\$6,580	\$4,553	\$6,861	\$8,379
Insurance taxes	\$1,301	\$1,502	\$1,599	\$1,886	\$2,119
Other taxes	\$2,806	\$2,926	\$3,038	\$2,746	\$2,422
Intergovernmental	\$31,543	\$34,137	\$36,828	\$41,934	\$42,919
Licenses and permits	\$3,246	\$3,277	\$2,904	\$2,996	\$3,470
Charges for services	\$848	\$832	\$854	\$907	\$919
Fees and penalties	\$1,999	\$2,240	\$5,024	\$4,185	\$4,663
Investment and interest	\$939	\$1,366	\$1,180	\$614	\$378
<u>Other taxes</u>	<u>\$1,202</u>	<u>\$1,344</u>	<u>\$2,959</u>	<u>\$3,044</u>	<u>\$3,599</u>
Total revenues	\$115,368	\$125,219	\$117,720	\$124,781	\$135,276
% Growth					
Personal income taxes	28.0%	12.9%	-26.3%	-0.6%	15.5%
Sales and use taxes	11.0%	3.9%	-1.8%	4.0%	6.5%
Corporation taxes	21.2%	0.2%	-30.8%	50.7%	22.1%
Insurance taxes	2.2%	15.4%	6.4%	18.0%	12.4%
Other taxes	6.8%	4.3%	3.8%	-9.6%	-11.8%
Intergovernmental	6.3%	8.2%	7.9%	13.9%	2.3%
Licenses and permits	-2.7%	0.9%	-11.4%	3.2%	15.8%
Charges for services	4.4%	-1.9%	2.6%	6.3%	1.3%
Fees and penalties	7.6%	12.1%	124.3%	-16.7%	11.4%
Investment and interest	35.5%	45.5%	-13.6%	-47.9%	-38.5%
<u>Other taxes</u>	<u>184.1%</u>	<u>11.8%</u>	<u>120.1%</u>	<u>2.9%</u>	<u>18.2%</u>
Total Growth	15.5%	8.5%	-6.0%	6.0%	8.4%

**General Government Revenues by Source
FY2001**



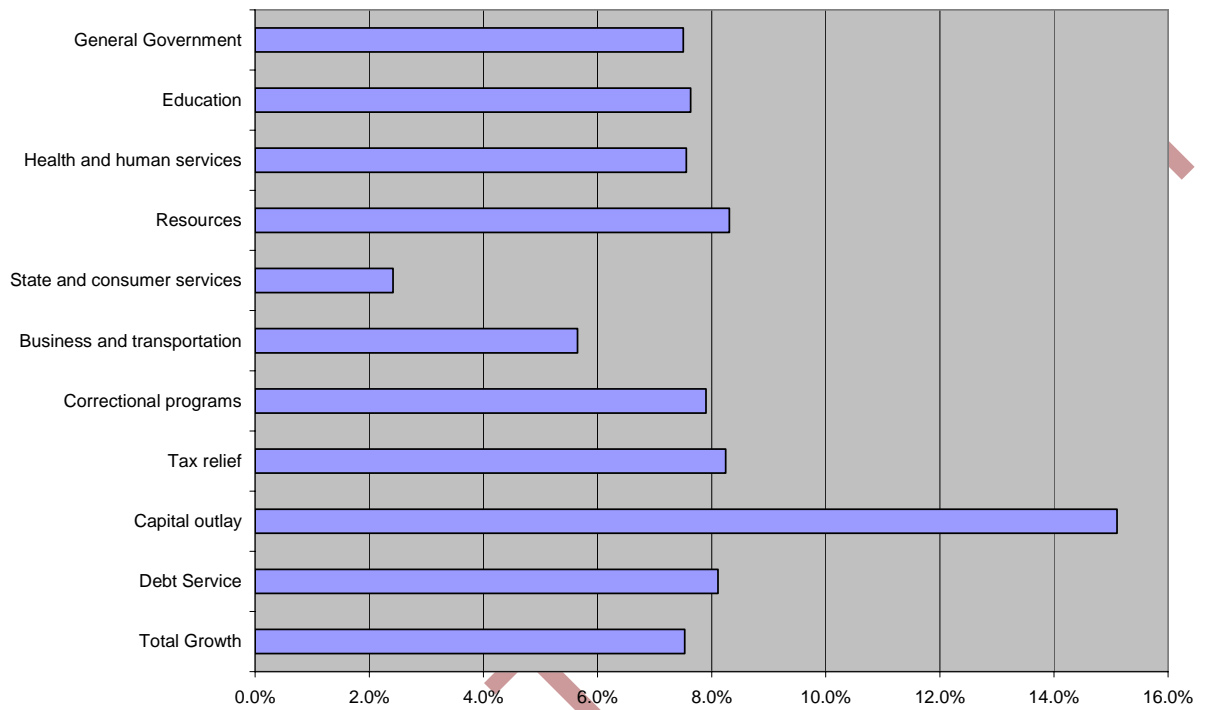
**General Government Revenues by Source
FY2004**



Expenditures. Education and health and human services are California’s biggest expenditures, accounting for roughly 75 percent of total expenditures. Following Governor Schwarzenegger’s election in 2003, total expenditure growth slowed to a virtual halt in 2004, from an average of 11.0 percent between 2000 and 2003. Capital outlays have grown the fastest recently, starting from a very low base. Of the state’s larger annual expense items, resource expenditures have been the fastest growing, but education, health and human services, and others have grown nearly as fast.

State of California General Government Expenditures					
<i>(\$ in millions)</i>					
	<u>6/30/2000</u>	<u>6/30/2001</u>	<u>6/30/2002</u>	<u>6/30/2003</u>	<u>6/30/2004</u>
<u>Expenditures</u>					
General Government	\$6,012	\$6,062	\$7,768	\$8,043	\$8,028
Education	\$36,905	\$40,854	\$45,324	\$50,744	\$49,527
Health and human services	\$44,703	\$49,361	\$53,143	\$58,996	\$59,820
Resources	\$2,678	\$3,516	\$3,722	\$3,368	\$3,686
State and consumer services	\$850	\$942	\$1,091	\$941	\$935
Business and transportation	\$7,320	\$8,288	\$8,493	\$8,917	\$9,119
Correctional programs	\$4,601	\$5,125	\$5,593	\$5,841	\$6,237
Tax relief	\$2,173	\$3,686	\$3,672	\$3,897	\$2,984
Capital outlay	\$710	\$905	\$1,654	\$1,667	\$1,246
<u>Debt Service</u>	<u>\$2,248</u>	<u>\$2,417</u>	<u>\$2,641</u>	<u>\$2,350</u>	<u>\$3,071</u>
Total Expenditures	\$108,201	\$121,156	\$133,101	\$144,765	\$144,654
<u>% Growth</u>					
General Government	14.4%	0.8%	28.1%	3.6%	-0.2%
Education	18.9%	10.7%	10.9%	12.0%	-2.4%
Health and human services	8.5%	10.4%	7.7%	11.0%	1.4%
Resources	13.9%	31.3%	5.8%	-9.5%	9.4%
State and consumer services	6.7%	10.8%	15.8%	-13.8%	-0.6%
Business and transportation	8.4%	13.2%	2.5%	5.0%	2.3%
Correctional programs	5.0%	11.4%	9.1%	4.4%	6.8%
Tax relief	262.8%	69.6%	-0.4%	6.1%	-23.4%
Capital outlay	-24.5%	27.5%	82.8%	0.8%	-25.3%
<u>Debt Service</u>	<u>3.6%</u>	<u>7.5%</u>	<u>9.3%</u>	<u>-11.0%</u>	<u>30.7%</u>
Total Growth	13.3%	12.0%	9.9%	8.8%	-0.1%

**General Government Expenditures by Source
Compounded Annual Growth Rate, 2000-2004**



Appendix B

CalPERS and CalSTRS Financial Information

CalPERS Financial Information					
	<u>6/30/2000</u>	<u>6/30/2001</u>	<u>6/30/2002</u>	<u>6/30/2003</u>	<u>6/30/2004</u>
Membership Data					
Active Members	715,105	752,080	795,785	809,646	803,973
Inactive Members	148,676	164,552	186,392	204,714	198,094
<u>Benefit Recipients</u>	<u>355,690</u>	<u>369,278</u>	<u>381,746</u>	<u>396,151</u>	<u>413,272</u>
Total Members	1,219,471	1,285,910	1,363,923	1,410,511	1,415,339
Actuarial Data					
Actuarial Value of Assets	\$162,439	\$166,860	\$156,067	\$158,596	N/A
<u>Actuarial Value of Liabilities</u>	<u>\$135,970</u>	<u>\$149,155</u>	<u>\$163,961</u>	<u>\$180,922</u>	N/A
Unfunded / (Funded)	(\$26,469)	(\$17,705)	\$7,894	\$22,326	N/A
<i>Funded Ratio</i>	119%	112%	95%	88%	N/A
Covered Payroll	\$28,098	\$30,802	\$32,873	\$34,784	N/A
<i>UAAL as % of Payroll</i>	-94%	-57%	24%	64%	N/A
Financial Data					
<u>Additions to Plan Assets</u>					
Contributions	\$2,113,905	\$2,087,875	\$2,955,707	\$3,812,969	\$6,527,793
Net Investment Income	\$16,579,088	(\$12,255,822)	(\$9,704,479)	\$5,474,084	\$24,265,850
<u>Other (expense) Income</u>	<u>\$3,570</u>	<u>\$7,481</u>	<u>\$4,686</u>	<u>\$8,648</u>	<u>\$6,723</u>
Total additions	\$18,696,562	(\$10,160,466)	(\$6,744,086)	\$9,295,701	\$30,800,366
<u>Deductions from Plan Assets</u>					
Benefits	\$5,176,074	\$5,792,949	\$6,431,019	\$6,991,914	\$7,639,085
Purchasing Power	\$0	\$0	\$0	\$0	\$0
Refunds	\$140,644	\$128,865	\$103,386	\$114,025	\$151,526
<u>Administrative Expenses</u>	<u>\$175,051</u>	<u>\$183,866</u>	<u>\$208,688</u>	<u>\$214,274</u>	<u>\$188,361</u>
Total deductions	\$5,491,769	\$6,105,680	\$6,743,092	\$7,320,213	\$7,978,973
Net increase (decrease)	\$13,204,794	(\$16,266,147)	(\$13,487,178)	\$1,975,488	\$22,821,393

CalSTRS Financial Information					
	<u>6/30/2000</u>	<u>6/30/2001</u>	<u>6/30/2002</u>	<u>6/30/2003</u>	<u>6/30/2004</u>
Membership Data					
Active Members	N/A	N/A	442,208	448,478	444,680
Inactive Members	N/A	N/A	96,159	104,617	116,128
<u>Benefit Recipients</u>	<u>165,282</u>	<u>170,972</u>	<u>177,069</u>	<u>181,868</u>	<u>193,245</u>
Total Members	661,392	686,859	715,436	734,963	754,053
Actuarial Data					
Actuarial Value of Assets	\$102,225	\$107,654	N/A	\$108,667	N/A
<u>Actuarial Value of Liabilities</u>	<u>\$93,124</u>	<u>\$109,881</u>	<u>N/A</u>	<u>\$131,777</u>	<u>N/A</u>
Unfunded / (Funded)	(\$9,101)	\$2,227	N/A	\$23,110	N/A
<i>Funded Ratio</i>	<i>110%</i>	<i>98%</i>	<i>N/A</i>	<i>82%</i>	<i>N/A</i>
Covered Payroll	\$18,224	\$20,585	N/A	\$23,862	N/A
<i>UAAL as % of Payroll</i>	<i>-50%</i>	<i>11%</i>	<i>N/A</i>	<i>97%</i>	<i>N/A</i>
Financial Data					
<u>Additions to Plan Assets</u>					
Contributions	\$4,076,295	\$4,693,113	\$4,547,052	\$5,116,831	\$4,852,601
Net Investment Income	\$12,693,700	(\$10,237,078)	(\$6,303,251)	\$3,689,361	\$16,617,075
<u>Other (expense) Income</u>	<u>\$166</u>	<u>\$414</u>	<u>(\$5,462)</u>	<u>(\$71)</u>	<u>(\$2,001)</u>
Total additions	\$16,770,161	(\$5,543,551)	(\$1,761,661)	\$8,806,121	\$21,467,675
<u>Deductions from Plan Assets</u>					
Benefits	\$3,435,518	\$3,764,894	\$4,266,191	\$4,740,359	\$5,349,421
Purchasing Power	\$190,478	\$189,388	\$256,976	\$233,815	\$223,501
Refunds	\$82,247	\$79,765	\$76,579	\$82,991	\$88,896
<u>Administrative Expenses</u>	<u>\$50,775</u>	<u>\$55,334</u>	<u>\$64,534</u>	<u>\$73,608</u>	<u>\$95,947</u>
Total deductions	\$3,759,018	\$4,089,381	\$4,664,280	\$5,130,773	\$5,757,765
Net increase (decrease)	\$13,011,143	(\$9,632,932)	(\$6,425,941)	\$3,675,348	\$15,709,910

Appendix C

Pension Plan Finances

Public Pension Fund Financial Reporting. The financial condition of defined benefit pension plans, including CalPERS and CalSTRS, can be analyzed using each plan's Comprehensive Annual Financial Report (CAFR). This report includes information on the plan's cash inflows (such as investment income and member/employer contributions into the plan), cash outflows (such as benefits paid and refunds), assets, liabilities and investment allocations. Every pension plan's CAFR also includes important actuarial information. The "actuarial" values of pension plan assets and liabilities incorporate various assumptions about the future. Actuarial values are meant to be more representative of the plan's actual financial position than are the asset and liability values as reported according to standard accounting principles. Since actuarial values are so important, the underlying actuarial assumptions must also be disclosed in the CAFR, including the four most important assumptions: 1) investment rate of return, 2) projected salary increases, 3) consumer price inflation, and 4) post-retirement benefit increases. Actuarial values are used to calculate key measures of a plan's financial health, such as the funded/underfunded amount, the funded ratio and covered payroll.

Financial Statement Data. Key data points in a pension plan's financial statements include:

- **Contributions**—The amount paid into the plan during the period, to be invested by the plan sponsors and used to pay future benefits. Contributions can come from members, employers and outside parties. These payments increase the plan's assets.
- **Investment Income**—The return generated on the plan assets through investing activities, such as capital gains, interest and dividends. These amounts also increase the plan's assets.
- **Benefits**—The total amount paid by the plan sponsor to members during the period, as determined by the benefit formula. These payments are a deduction from the plan's assets.
- **Member Refunds**—The amount paid to members who have chosen to voluntarily leave the plan. They receive a refund of their contributions, but give up all claims to future benefits. These payments are also a deduction from the plan's assets.
- **Investment Allocations**—The plan's professional investment managers usually allocate investment funds into one of six main asset categories: Domestic Stocks,

Domestic Bonds, Foreign Stocks and Bonds, Alternative Assets, Real Estate and Cash. A fund's investment allocation is the major determinant of investment returns and volatility. In comparison to bonds, stocks are generally expected to generate higher volatility and higher returns over time.

- Actuarial Value of Assets and Actuarial Accrued Liability—The “actuarial” asset and liability values represent a plan's financial position according to various assumptions about the future. For example, required benefit payments 20 years from now will depend on the salary levels, ages and years of service of members who retire between now and then, as well as on the projected lifespans of current retirees. Similarly, asset levels 20 years from now will depend on the fund's investment performance over the next 20 years. Based on detailed statistical analyses, actuaries estimate these and other variables and determine the present value of the assets and liabilities based on their assumptions.
- Underfunded or Funded Amount—The difference between the actuarial value of assets and the actuarial accrued liability. This is a key measure of the health of a pension plan. A “funded” plan has more actuarial assets than liabilities, while an “underfunded” plan has fewer actuarial assets than liabilities, indicating the potential for future funding problems.
- Funded Ratio—The ratio of the actuarial value of assets to the actuarial accrued liability, which is also a key measure of plan health. A funded ratio of 100 percent means that the fund has just enough assets to cover its liabilities, a funded ratio of more than 100 percent means that the fund has more assets than liabilities, and a funded ratio of less than 100 percent means that the fund has fewer assets than liabilities.
- Covered Payroll—The underfunded or funded amount is also expressed as a percentage of the total annual payroll of all active employees of the organization, known as covered payroll. This ratio is interpreted as a measure of the severity of the underfunding problem, if one exists. If a pension plan's ratio of underfunding to covered payroll increases from 10 percent one year to 80 percent the next, for example, the situation is said to have deteriorated markedly.

Actuarial Assumptions. Hundreds of actuarial assumptions must be made, relating to everything from the average retirement age of a teacher in the year 2025 to the probability that a police officer will be disabled in the line of duty before his or her assumed retirement date. There are four

actuarial assumptions that are particularly significant and are included in every pension plan's financial statements.

- Investment Rate of Return—The assumed rate of return on invested funds, as determined by the investment allocation, portfolio management strategies, individual security selections, and general macroeconomic trends. Not surprisingly, this is extremely difficult to predict with much accuracy. However, it has a tremendous impact on the underfunded/funded amount. Compounded over many years, a small increase in the assumed rate of return can translate into billions of dollars of additional assets in the future.
- Projected Salary Increases—Since benefit payments are calculated based in part on salary at the time of retirement, projected salary increases must be estimated so that future salary levels can be estimated. A higher level of projected salary increases translates into a higher amount of benefit payments and therefore a higher actuarial accrued liability.
- Consumer Price Inflation—An estimate of the average increase in the cost of standard consumer goods and services across society over time. This assumption feeds into the estimate of projected salary increases, as well as other economic assumptions.
- Post-Retirement Benefit Increases—In many defined benefit plans, benefits increase periodically after retirement in order to protect retirees from a slow loss in purchasing power due to inflation. If post-retirement benefits are assumed to increase quickly, the actuarial accrued liability will be higher.