# Mayor Chuck Reed
# City of San Jose
# Public Pension Costs: San Jose's Experience
# Testimony to the State of California Little Hoover Commission
# September 23, 2010

In June of this year, the City of San Jose closed a $118.5 million budget shortfall and created a balanced budget for the 2010-2011 fiscal year. This was our ninth straight year of budget deficits.

San Jose's situation is not unique. Cities throughout California faced these budget challenges, and they are not recent.

We can't solely blame the recession for our troubles – although it hasn't helped.
We can't solely blame the State of California – although the State has taken $500 million away from San Jose over the past decade.

The reality that we all must face is that employee costs – as the Santa Clara County Grand Jury reported in June of this year – are unsustainable. Cities are in the service business; as a result, for the majority of cities, employee costs are the largest part of our budget.

I want to be clear from the outset that I believe San Jose has the best employees in the state, if not the nation. The impact of rising pension costs has meant that San Jose can't hire more firefighters, police officers, librarians, gang intervention workers. As Mayor I think our growing City needs to be providing more services, especially in these difficult economic times. The majority of our non-public safety unions stepped forward in June and shared the pain, giving up ten percent of total compensation and helping fund retirement payments. I want to thank them again for these efforts. They helped save jobs of their friends and colleagues, and they helped save valuable services to our residents.

We had to ask for that level of concession because of the growth in pension and employee costs. Over the last decade, San Jose's general fund dollars have grown by 21%, while the average cost per employee has gone up by 87%. For public safety employees – firefighters and police officers – the increase is even more dramatic at 99%.

San Jose Police and Firefighters can retire at age 50 and the non-sworn employees can retire at 55. In some instances, pension payments are greater than the salary employees received when they were working, with an annual 3% increase, lifetime health and dental insurance provided without annual payments, and a lump sum payment of hundreds of thousands of dollars for unused sick leave.

Our Charter requires us to provide city employees with a defined benefit retirement plan, a minimum employer match of over 250%, a retirement age of 55, and city guaranteed benefits for life based on final compensation.

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We can no longer afford such generous and costly benefits and the Charter must be changed so we can gain control over skyrocketing retirement costs.

City payments for retirement benefits have tripled over the last 10 years even though our workforce has declined dramatically, and we have billions of dollars in unfunded liabilities that the taxpayers must pay.

The average cost to the City of San Jose for a police officer or firefighter is over $180,000 per year. Benefits, primarily retirement costs, are nearly 50% of salary.

Due to these cost increases, we have whittled away at services and jobs. We now have over 1,000 fewer employees delivering services to our residents and businesses. We have had to cut services to our residents and businesses year after year. These out-of-control costs are why we can't keep all of our libraries, community centers, and swimming pools open.

Many of these costs are the result of big pay and benefit increases awarded to our public safety unions by outside arbitrators. Sky-rocketing costs are also fueled by generous retirement benefits that are guaranteed in the City Charter.

On November 2, San Jose voters will decide on two ballot measures, V and W, on reforming the city's pension and binding arbitration systems. These two measures are critical first steps that will work to address these issues.

Measure V is a charter change to reform the arbitration process that currently governs negotiations with the police and fire unions. It would place some common-sense limits on outside arbitrators to keep them from spending money the City doesn't have.
Cities throughout the nation are facing the reality that pension costs are unsustainable.

Unfortunately, in cases like San Jose, these problems are structural. Pension benefits are guaranteed in the charter and can only be changed by the voters of San Jose.

Placing arbitration and pension reform on the November ballot is an important step on the path to restoring San José's fiscal health. These two measures are critical to save vital services like police and fire, libraries and community centers.

**Question 1. How have the pension increases implemented throughout California a decade ago affected your government?**

In 1999, the California legislature dramatically increased pension benefits for state employees. They thought the stock market would keep going up forever. It's the greatest financial blunder in the history of California – ten times worse than Enron.

The legislature's actions set off a tsunami of pension increases throughout the state. As contracts came up for negotiation, bargaining units sought to achieve the same benefits that employees were receiving in other jurisdictions or at the State of California. Keep in mind that these actions took place at the height of the dot-com boom. Employee unions insisted that salaries and retirement benefits had to increase to prevent the loss of talent to the private sector.

As a result, our annual costs for retirement benefits now exceed our revenues from property taxes. The chart below shows the impact of this growth both on our overall payroll costs and on the retirement costs. The two cannot be separated. The employee's highest salary determines his or her future retirement benefit.

**Salary and Benefit Costs - San Jose**

| | 2000-2001 | 2005-2006 | 2010-2011 (proposed) | Change |
|---|---|---|---|---|
| Base payroll | $416,010,420 | $508,874,448 | $523,748,973 | 25.9% |
| | | | | |
| Retirement benefits | 63,054,083 | 99,557,163 | 177,330,673 | 181.2% |
| Federated Retirement (civilian) | 39,409,193 | 49,556,197 | 82,738,474 | 109.9% |
| Police/Fire Retirement | 23,644,890 | 50,000,966 | 94,592,199 | 300.1% |
| | | | | |
| Health/Dental Benefits | 30,317,792 | 51,855,969 | 61,198,127 | 101.9% |
| Other Benefits | 6,608,312 | 11,875,017 | 14,476,464 | 119.1% |
| Total Benefits | | | | |
| Grand Total | 515,990,607 | 672,162,597 | 776,754,237 | 50.5% |
| | | | | |
| Average Total Cost Per FTE | 73,581 | 100,747 | 137,341 | 86.7% |
| | | | | |
| Total FTE | 7,013 | 6,672 | 5,656 | -19.35% |
| | | | | |

In addition to the legislature's actions, over the past 15 years, other actions taken by City Councils or dictated by outside arbitrators have caused employee compensation to grow much faster than revenues, resulting in cuts in service annually for the past nine years, including:

- Giving employees pay raises faster than revenues were growing.
- Giving raises and increasing benefits when revenues were falling.
- Giving raises and benefits retroactively at costs of tens of millions of dollars.
- Allowing police and fire employees to cash out unlimited amounts of sick leave when they retire.
- Providing healthcare for life to city retirees.
- Allowing pension payments to exceed 100% of the salary earned in the final year of employment.

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I'd like to say a few words about the role that binding arbitration plays in this situation. Arbitration is an additional challenge that more than 20 of California's charter cities face when trying to negotiate fiscally responsible solutions with our unions. In cities like San Jose, firefighter and police unions have the right to binding interest arbitration when contract negotiations fail. The public safety unions know they can hold out for the arbitrator, while the civilian unions don't want to make concessions because they fear the arbitrators will turn around and use their concessions to fund public safety raises and enhanced benefits.

They have reason to fear. Historically, arbitrators come into town, spend our money, and leave:

- In 1997, an outside arbitrator increased San Jose public safety pensions from 75% to 80% of highest salary.
- In 2007, an outside arbitrator increased San Jose firefighters' pension maximum from 85% to 90%.

Not only did the arbitrator award a 90% retirement benefit in 2007, the arbitrator decided that that retirement benefit should be retroactive to the day any firefighter working for city had started. That meant if you were a week away from retiring, your pension immediately increased by 5% to 10% for the rest of your life – even though those benefiting had never contributed anything to help pay for this enhanced benefit.

On a going forward basis, this benefit increase would have cost San Jose $5 million a year. By making it retroactive, the City of San Jose, and ultimately the taxpayers, were suddenly faced with a $30 million unfunded liability for the prior service cost. That was one arbitrator's decision. Of course we are still paying on that, and will be for a very long time.

The following charts show the impacts on our public safety retirement system. Many of these enhanced pensions were awarded retroactively.

Our civilian employees have received a maximum pension of 75% since 1975. All City employees – public safety and non-public safety – had a 75% maximum benefit for decades. There was no evidence that 75% of an employee's salary was an insufficient retirement benefit. However, for police and fire, the steady progression upwards in benefits started in the mid-1990s, to the current maximum 90%. Although we aren't in PERS, the pressure to match the PERS benefits for public safety employees was very strong.

**San Jose Fire Retirement Formulas**

| Effective Date | Sept 1970 | Feb 1996 | Feb 2000 | Jul 2007 |
|---|---|---|---|---|
| Max. Benefit | 75% | 80% | 85% | 90% |
| Formula | Yrs 0-30: 2.5% per yr | Yrs 0-20: 2.5% per yr Yrs 21-30: 3.0% per yr | Yrs 0-20: 2.5% per yr Yrs 21-25: 3.0% per yr Yrs 25-30: 4.0% per yr | Yrs 0-20: 2.5% per yr At 20 Yrs, 3% per year |

**San Jose Police Retirement Formulas**

| Effective Date | Sept 1970 | Feb 1996 | Feb 2000 | Jul 2006 |
|---|---|---|---|---|
| Max. Benefit | 75% | 80% | 85% | 90% |
| Formula | Yrs 0-30: 2.5% per yr | Yrs 0-20: 2.5% per yr Yrs 21-30: 3.0% per yr | Yrs 0-20: 2.5% per yr Yrs 21-25: 3.0% per yr Yrs 25-30: 4.0% per yr | Yrs 0-20: 2.5% per yr Yrs 21-30: 4.0% per yr |

**Question 2: What do communities need, going forward, and how can the state help lead that effort? Will adjusting pensions for new employees only be enough to address this shortfall?**

The most important thing the State of California can do is implement meaningful reform with its own employees and with PERS agencies. This will have a ripple effect throughout the state.

Many of the reforms talked about around the state are tinkering around the edges. San Jose is already far ahead of other cities in terms of employee participation in pension funding and dealing with unfunded liabilities for retiree healthcare, but we have to go farther to reach sustainability.

Second Tier

We need a second tier for new employees. This year as we were negotiating with our employee unions to close a $118.5 million shortfall, we consistently heard: Second tier doesn't really help us this year. It's all out in the future. Let's focus on what we need to do this year to balance the budget.

But that's not correct. If we were to say, for example, that the City should not pay more than 50% of the cost of benefits for new employees, that would help us next year, and the year after, and the year after for a very long time. We expect to replace approximately one-third of our workforce over the next five years due to retirements and aging of the Baby Boomers. If you do the math, the City is paying $253 million a year for benefits ($177 million for retirement), paying 90% of the cost for health insurance benefits, so if we were to reduce that to 50% for new employees, next year it's worth about $5 million, the following year about $10 million, and so on.

**Question 3: Please describe your experiences in San Jose and efforts to address pensions within the context of economic and budget issues.**

The current system is unsustainable and is a major factor in San Jose's structural budget deficit. In my first State of the City address in 2007, I said:

*"We cannot become a great city unless we eliminate our structural budget deficit. That is our greatest challenge. The budget deficit is public enemy number one, an enemy that will steal our hopes and kill our dreams of becoming a great city if we ignore it."*

Since then I have made solving our budget problems my number one priority. I want to share three areas where we have made progress:

1. Sunshine and transparency
2. Reforming oversight of our pension systems
3. Fiscal reform

Progress has been painfully slow because budget decisions and fiscal reforms require approval by a majority of the City Council. Unfortunately, when public employee unions pack the Council chambers with hundreds of advocates, the voices of the taxpayers who pay for the services and the residents who need the services get drowned out.

But the taxpayers and residents do get to vote, and I believe we are seeing a clear shift in public sentiment: Elected officials and candidates who are weak on fiscal responsibility will be severely penalized.

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Sunshine and transparency

Since taking office, I have worked to restore integrity, transparency and public trust in City Hall. The City Council has approved more than 90 ethical, fiscal, and open government reforms - more than 30 Reed Reforms, more than 40 sunshine reforms and more than a dozen biennial ethics review recommendations. A few key items include:

- Council members must disclose when they meet with lobbyists;
- The budget process has been opened to community input and participation;
- Agendas, staff reports and policy documents are now posted at least 10 days in advance of Council meetings, ensuring that the public has time to make their voice heard before major votes;
- Councilmembers must disclose e-mails and text messages received during Council meetings from lobbyists and special interests;
- San José became the first major city to designate electronic communications regarding city business that are sent/received through personal devices or accounts as public records; and
- The City Council eliminated Councilmember's' officeholder accounts (which used political donations to pay for items related to city business), thereby reducing potential conflicts of interest.

Increasing transparency and informing the public were critical groundwork to beginning to address issues like retirement board governance and fiscal reform. We needed to ensure that the special interest groups, the lobbyists, the influence peddlers and the fixers were not running City Hall.

Retirement System Reform and Oversight

San Jose's two retirement systems manage over $4 billion in assets, serving more than 10,000 employees, retirees and survivors. The City has $1.1 billion in unfunded liability for its pension system and $1.2 billion in unfunded liability for retiree healthcare benefits.

The retirement boards have exclusive control over how the retirement funds are invested and administered. The Boards' specific duties include: consideration of requests for retirement, administration and investment of the retirement funds, determining eligibility for membership in the pension plans, and determining employees' eligibility for retirement benefits.

When I joined the City Council, I discovered that there were clear conflicts of interest inherent in the make-up of the Boards responsible for overseeing the assets of these two systems. Two Councilmembers sit on each board. Seats are designated for employee and retiree representatives, and it has been possible for these special interests to control a majority of the board. There was a lack of will to manage the systems to the best interests of the people of San Jose, and as a result, the City/taxpayers were on the hook for any unfunded liabilities.

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In August 2008, the City Auditor concluded an investigation that found that retirement board members had traveled extensively on the Retirement Board's dime and had been wined and dined by investment professionals and pension fund managers. The City Council directed the City Manager to incorporate into the boards and commissions analysis, recommendations on restructuring the Federated City Employees' Retirement System and the Police and Fire Department Retirement Board to add independent Board Members with financial and investment expertise. The process was to include outreach to affected stakeholders. A consultant was hired, and they issued a report with recommendations on changing the composition of the retirement boards. These included adding independent Board Members with financial and investment expertise.

In the recent recession, San Jose's retirement funds lost over $1 billion. In addition, retirement costs continue to increase due to higher salaries that result in higher pension payments; earlier retirements; and increased longevity of our retirees. As a resulted, San Jose needed to dramatically increase pension contributions in 2010-2011, from $137 million to $177 million, with increased contributions in the years ahead.

In February 2010, the City Council approved a model for restructuring the retirement boards to serve the long-term interests of the City, taxpayers, employees and retirees, and be well-managed utilizing best practice and the highest standards of good governance. The amendments adopted expand the expertise of board members and ensure a majority of the board are independent members.

The Council also required that the Retirement Board hold its meetings at City Hall, in a publicly accessible location, and comply with state and local ordinances for open meetings, sunshine and transparency.

<u>Fiscal Reform</u>
On August 3, the City Council voted to place two important fiscal reforms before San Jose voters during the upcoming November 2 election.

The first, Measure V, is a charter change to reform the arbitration process that currently governs negotiations with the police and fire unions. This measure will require arbitrators to make the financial condition of the city and its ability to pay from on-going revenues without reducing City services the primary factors in their decisions.

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This measure would prohibit outside arbitrators from:

- increasing pay and benefits by more than the rate of growth in revenues.
- raising benefits retroactively.
- creating an unfunded liability that the city is obligated to pay.

The second initiative, Measure W, would allow the City to provide lower retirement benefits for new city employees. Currently, public safety employees can retire with up to 90% of their highest annual salary, while civilian employees can retire with up to 75%. Annual increases in benefits are guaranteed.

Our Charter requires us to provide city employees with a defined benefit retirement plan, an employer match of over 250%, a retirement age of 55, and city guaranteed benefits for life based on final compensation.

Many city employees can retire with pension payments that will quickly grow to be greater than the salary they made when they were working, with lifetime health and dental insurance, and a lump sum payment of hundreds of thousands of dollars for unused sick leave.

We can no longer afford such generous and costly benefits, but the people must decide to change the Charter so we can gain control over skyrocketing retirement costs.