COUNCIL AGENDA: 05-24-11
ITEM: 3.5

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: City Council

FROM: Mayor Chuck Reed
Vice Mayor Madison Nguyen
Councilmember Rose Herrera
Councilmember Sam Liccardo

SUBJECT: **Fiscal Reforms**

DATE: May 13, 2011

APPROVED: Chuck Reed Madison Nguyen

DATE: 5/13/11

INTRODUCTION

The dramatic impacts of the budget shortfall on our community demonstrate why we have to gain control over skyrocketing retirement costs. If we act now, we can preserve the retirement benefit levels our employees and retirees have earned and accrued, and we can restore jobs and vital services.

If we fail to act, jobs and services will be decimated in a fiscal disaster and retirement benefits will be cut.

This proposal is not the only solution. It is one combination of ideas that we believe will solve the problem. We are open to other solutions, and our proposal directs staff to engage with employee groups – many of whom have said they are eager to work in partnership to solve this crisis – and to discuss alternatives that also solve the problem.

RECOMMENDATION

A. Declare a Fiscal and Public Safety Emergency

Declare a fiscal and public safety emergency and direct staff to return to the Council on June 21 with a formal declaration that describes the necessity of making fiscal reforms to avert a fiscal disaster, prevent substantial degradation of public safety and other vital city services, and maintain the integrity of our retirement system so that earned and accrued benefits can be paid to current and future retirees.

B. Amend the Charter in order to Limit Retirement Benefits and to Require Voter Approval of Increases in Retirement Benefits

Approve the City Manager's Fiscal Reform Plan and direct staff to return to the Council on June 21 with proposed changes to the Charter to implement the Manager's recommendations, subject to the following additions and limitations, all to be placed into the Charter in order to set maximum limits on benefits and other compensation that may not be exceeded without voter approval:

1. **Place Limits on Retirement Benefits for New Employees**
   Without voter approval of enhancements or increases, new employee retirement benefits shall be limited to a hybrid plan that may consist of a combination of social security, defined benefits or defined contributions but the maximum City contribution in total shall not be less than 6.2% nor greater than 9% of base salary or 50% of the costs of the benefits, whichever is less.

   Health Benefits: Medical care or health insurance for retired employees may only be provided to employees who have 20 years of service or more or to employees who receive a service disability retirement. Employees will pay a minimum of 50% of the cost of retiree healthcare.

   Retirement Provisions: If a defined benefit plan is included it must be based on actuarial assumptions that are risk-free for the City and the employees and the age of eligibility for payment of accrued service retirement benefits shall be 65, except for sworn police officers and fire fighters, whose service retirement age shall be 60. Earlier retirement may be permitted with reduced payments that do not exceed the actuarial value of full retirement.

2. **Place Limits on Retirement Benefits for Existing Employees**
   Without voter approval of enhancements or increases, retirement benefits for existing employees shall be limited as follows:

   Slow Down the Accrual Rate: Benefits earned and accrued benefits to date shall not be reduced but additional pension benefits shall accrue at a maximum rate of 1.5% per year of service.

   Increase the Age of Eligibility: The age of eligibility for service retirement for existing employees shall increase by six months annually on July 1 until the retirement age reaches the age of 60 for police officers and fire fighters and 65 for all other employees. Earlier retirement may be permitted with reduced payments that do not exceed the actuarial value of full retirement.

   Increase Years of Service for Medical Benefits: The years of service required to qualify for health insurance benefits after termination of service shall increase by six months annually on July 1 until it reaches 20 years, except for employees who receive as service disability retirement. Employees will continue to pay a minimum of 50% of the cost of retiree healthcare.

3. **Place Limits on Benefits for Existing and Future Retirees**
   Without voter approval of enhancements or increases, retirement benefits for existing retirees shall be limited as follows:

   Slow the Rate of Increase: Increases in pension payments to retirees shall be limited to the increase in the Bay Area CPI and shall not exceed 1% per year.

Restrict Bonuses: Bonuses or other supplemental payments may be made only to long term service retirees or disability retirees whose household income falls below the poverty level (extremely low income) and shall not be funded from plan assets.

4. **Place Additional Limitations on Growth in Retirement Benefits if the Fiscal and Public Safety Emergency Gets Worse**
   At any time the city pension or retiree health care plans have unfunded liabilities for pension or retiree healthcare greater than those existing on June 30, 2010, the following limitations shall be in effect for existing employees who have not opted into the benefits program for new employees, except upon prior approval of the voters:

   a. Retirement benefits shall not continue to accrue beyond the minimum benefits specified in the Charter, Article XV.
   b. Calculation of benefit payments shall be based on a 3-year average as specified in the Charter, Article XV.
   c. The age of eligibility for payment of service retirement benefits shall not be less than the retirement age specified in the Charter, Article XV.
   d. Benefits shall not be increased after retirement.
   e. Employees' share of the costs to amortize any unfunded liabilities greater than those existing on June 30, 2010, shall be 50%, unless they have opted into the benefits program for new employees.

   At any time the city pension or retiree healthcare plans have unfunded liabilities for pension or retiree healthcare greater than those existing on June 30, 2010, bonuses, increases, or supplemental pension payments to retirees shall not be allowed, except upon prior approval of the voters.

   These temporary provisions shall remain in effect until the unfunded liabilities have remained below the level of June 30, 2010 for three consecutive years.

5. **Implementation Provisions**
   a. All pension and retiree healthcare plans must be actuarially sound and unfunded liabilities shall be determined annually through an independent audit using standards set by the Government Accounting Standards Board.

   b. All of the above Charter amendments shall be severable but if any of the above provisions are or become illegal, invalid or unenforceable as to existing employees, then the existing employees' share of the costs to amortize any unfunded liabilities shall be 50%, unless they have opted into the benefits program for new employees.

   c. If any of the above provisions are or become illegal, invalid or unenforceable as to retirees, then all benefit enhancements or increases granted to retirees since the date of their retirement shall be eliminated.

   d. Existing and new employees will continue to pay a minimum of 50% of the cost of retiree healthcare.

e. The City Council shall retain its power to amend or change any retirement plans under Charter sections 1500 and 1503 and no ordinances, agreements, policies or practices may eliminate that power without approval by the voters.

C. AMEND THE CHARTER IN ORDER TO REQUIRE VOTER APPROVAL OF INCREASES IN OTHER BENEFITS UNTIL THE EMERGENCY HAS PASSED AND ESSENTIAL SERVICES HAVE BEEN RESTORED

1. Preserve and Restore Essential Services

The following services are essential to the safety and quality of life for San Jose residents: police protection, fire protection, street maintenance, libraries, and community centers. Any time these essential services are not provided at or above the levels of January 1, 2011, or any time the libraries, community centers, fire stations or police substation built or under construction on January 1, 2011 are not operational, or any time the pension plans have unfunded liabilities, the Mayor, the City Council, the City Manager, the other Officers of the City, the Board of Arbitrators, and other arbitrators are prohibited from making or approving any contract, memorandum, agreement, award, grant, decision, resolution or ordinance to allow or require the City to do any of the following, except upon prior approval by the voters:

a. Create or increase an unfunded liability for pensions, healthcare or other post employment benefits.

b. Pay for unused sick leave or unused vacation time, except as required by state or federal law.

c. Increase compensation for members of bargaining units after contracts expire.

d. Give automatic step increases or other raises for time in the job that are not based on performance.

e. Use hours not worked in determining eligibility for overtime or for retirement benefits.

f. Pay overtime to executive, professional, or administrative employees or to other employees who are exempt from overtime requirements under the Fair Labor Standards Act or who are otherwise exempt from the Act.

g. Pay workers compensation benefits for disability on top of disability retirement benefits without an offset to eliminate duplication of payments for the same cause of disability.

h. Pay workers compensation benefits beyond what state or federal law require.

i. Allow existing or former employees to make decisions to grant workers compensation or disability benefits for existing or former employees.

j. Calculate retirement benefits on any compensation other than actual base salary paid or years (2080 hours) actually worked for the City of San Jose, except as required by state law.

k. Make layoff or rehiring decisions without considering individual employee performance.

l. Pay for more than 50% of the increase in the cost of healthcare benefits.

D. Outreach to Employees

Direct staff to meet and consult with bargaining units on these potential ballot measures. The outreach plan should include a process to engage immediately with those unions willing to acknowledge the retirement cost crisis and which desire to engage constructively with alternative solutions.

E. Prepare Ballot Measure Language

Direct staff to return to Council on August 2 with ballot measure language to submit to the Registrar of Voters for a possible election in November to change the Charter to implement the above recommendations, as may have been modified through the meet and consult process, providing that provisions that are in conflict with express terms of negotiated contracts in effect at the time of voter approval shall be implemented on the expiration dates of those contracts.

F. Survey Voters on Potential Tax Measures

Direct staff to prepare to survey voters to determine if implementation of these fiscal reforms increases the level of support for a potential tax increase.

BACKGROUND

Over the past decade, vital city services have been reduced repeatedly because costs per employee have grown dramatically. San Jose's unfunded liabilities for retirement benefits have grown by billions of dollars and have driven up San Jose's annual retirement costs by more than $190 million since 2000 ($63 million in 2000 to $255 million in 2011).

Last year we reduced our work force by 800 positions, down to 4200 general fund workers. Our police and fire departments today have about 2400 employees. Now we are facing another huge budget shortfall and are likely to have to cut another 600 positions, including police officers and fire fighters, dropping our general fund staffing down to 3600 positions.

If left unchecked, by 2016 retirement costs will increase, even using optimistic assumptions, to $400 million per year. That increase in costs will require additional staffing reductions that will drive our general fund staffing down to 3000 employees.

Unfortunately, even greater increases in retirement costs are likely if actuarial assumptions - such as life expectancy, retirement ages or rates of investment return - are modified by the retirement boards to reflect modern conditions. As discussed at our study session on February 14,[1] our retirement costs could jump to $650 million per year by 2016 as assumptions are updated.

Costs could also go up dramatically as new federal accounting standards are adopted. For example, the Governmental Accounting Standards Board (GASB) is currently considering accounting rules that would lower the permissible discount rate (*Pension Accounting and Financial Reporting by Employers*[2]). That change could result in an increase in annual costs to

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[1] View the Council meeting online at http://sanjose.granicus.com/MediaPlayer.php?view_id=22&clip_id=4824. The discussion regarding future retirement costs is at 2 hours, 9 minutes into the meeting.

[2] The full report, *Preliminary Views of the Governmental Accounting Standards Board on major issues related to Pension Accounting and Financial Reporting by Employers*, is online at: *http://gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176156938122.*

amortized unfunded liabilities "by 150 to 200 percent above current levels." (*New Proposals for Pension Books: GASB's potential accounting rules may clobber employers' budgets*, by Girard Millar, Governing, May 20, 2010[3]).

Additional huge cost increases to pay for unfunded liabilities would result in enormous reductions in staffing, destroying our ability to protect the public and preserve the quality of life for the people of San Jose. If we fail to act, and retirement costs grow to $650 million by 2016, the ranks of general fund employees will shrink down to about 1600 workers. Even though it is not the worst case scenario, dropping to 1600 general fund workers would have a devastating impact on our city and leave us unable to provide vital services.

Neither we nor our retirees can afford to take the risk these costs will continue to escalate, pushing the City or the pension funds into insolvency, and putting the reduction of retirement benefits in the hands of a bankruptcy judge.

We must take bold and decisive action to make the changes necessary to save our city from a fiscal and service delivery disaster.

The Charter allows the Council to make changes to retirement benefits and we must exercise that power:

> *"...the Council may at any time, or from time to time, amend or otherwise change any retirement plan or plans or adopt or establish a new or different plan or plans for all or any officers or employees."* SECTION 1500

To make those changes, outlined in the recommendations above, a new section should be added to the Charter as ARTICLE XIX PENSION REFORM, FISCAL STABILITY AND PROTECTION OF ESSENTIAL SERVICES, to help stop spiraling cost increases, avert fiscal disaster, protect the integrity of the retirement system, and put San Jose on the path to rebuild the police force, fully staff fire stations, maintain streets, and keep libraries and community centers open.

These proposed fiscal reforms would not deprive employees of benefits that have been earned and accrued, but they are reasonable and necessary to enable the city to pay for benefits that have been earned and accrued without destroying the city's ability to protect public safety and provide basic services for the people of San Jose. Our inherent power to make reasonable changes to the pension system, without taking away earned and accrued benefits, in order to maintain the integrity of the system has long been recognized by the California courts.

Some of these fiscal reforms may impact expectations of increases in future benefits that are viewed by some of our employees as vested and, therefore, unchangeable. Yet, these fiscal reforms are appropriate, reasonable, temporary and necessary to resolve this grave fiscal crisis. Thus, they are within the constitutional range of power of the City to protect the vital interests of our community, even if vested contract rights may be affected.

The fiscal emergency that we are dealing with requires action. Our power to act "to protect the lives, health, morals, comfort and general welfare of the public" is recognized under the United States and California Constitutions, even if contract rights are impaired (see *Declarations of*

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[3] Read the article at: http://www.governing.com/columns/public-money/new-gasb-proposals-pension-bookkeeping.html

Fiscal Emergency: a Resurging Option for Public Entities Attempting to Deal with the Current Economic Climate, California Public Law Journal, Vol. 34, No. 1, Winter 2011[4]).

Some people believe that the pension crisis is imaginary, that we have only to wait until the market goes back up and we'll be fine. That's simply wishful thinking. The $155 million payment to the retirement funds the City made this year was not imaginary. The $250 million payment the city must make next fiscal year is not imaginary. The hundreds of jobs that were eliminated this year were not imaginary. The hundreds of employees who will lose their jobs in the next fiscal year are not imaginary.

Such erroneous characterizations of our fiscal crisis demonstrate why it is necessary to take these measures to the voters to allow them to prevent a disaster.

Of course, if market gains result in the issue resolving itself by June, as some assert, some of the temporary measures may not be necessary for very long.

Placing these fiscal reforms on the ballot will allow the people of San Jose to decide these critical matters that will have a dramatic impact on their quality of life.

[4] Online at www.calbar.ca.gov/publiclaw.