WWW.EDCHOICE.ORG

The Foundation for Educational Choice

POLICY BRIEF

OCTOBER 2010

Trouble Brewing in San Francisco

BY STUART BUCK

The city of San Francisco will face enormous budgetary pressures from the growing deficits in public pensions, both at a state and local level. In this policy brief, I estimate that San Francisco faces an aggregate $22.4 billion liability for pensions and retiree health benefits that are underfunded – including $14.1 billion for the city pension system and retiree health benefits, and an estimated $8.3 billion share of unfunded liabilities for California state retiree benefits. These estimates are made by correcting the state and local pension plans' figures, which use a too-optimistic assumption that their investments will grow by about 8% per year for the indefinite future.

San Francisco faces an aggregate $22.4 billion liability for pensions and retiree health benefits that are underfunded.

Unless state and city pensions are brought under control, these skyrocketing costs could easily force San Francisco to limit or forego many other important public expenditures, such as road repair, schools, and healthcare.

BACKGROUND

The San Francisco Employees' Retirement System (or SFERS) covers more than 53,000 current employees and retirees. Currently, police and fire employees can retire at 55 with a pension equal to 3% of their final year's salary times their years of service (e.g, a 30-year employee would get 90% of his final salary for the rest of his life). Other employees can retire at 60 with 2.3% of their final year's salary times their years of service.

As in other cities, San Francisco pensions have come under scrutiny for the large payouts that a privileged few retirees are receiving. For example, the former police chief retired in 2003 with a yearly pension of $242,000.[1] There are currently 2,384 retirees in San Francisco whose yearly pension is over $75,000. Most of these generous pensions are because of Proposition H, which was passed in 2002, granting police and fire employees the right to retire with a 3% multiplier. Voters were told at the time that "no cash would be required since the City's Retirement System currently has a large surplus," and that the city would not even need to contribute money to the retirement system at all "for at least the next ten years."[2]

While SFERS currently claims that its pension is overfunded by some $582,566, its true financial situation is destined to get worse in the future. For instance, as of June 30, 2009, SFERS' actual assets were $11.886 billion, a drop from $15.8 billion the year before. In June 2010, a San Francisco Civil Grand Jury (one of the civil grand juries that are impaneled in each California county to investigate the behavior of local government) released a report titled "Pension Tsunami: The Billion Dollar Bubble."[3] This report found that San Francisco's pension and healthcare costs will rise from $413 million this year to nearly $1 billion in the next five years. These "unsustainable" programs would then amount to 1/3 of the city's budget.

As for the funding status of SFERS, the "Pension Tsunami" report found that the pension would be 91% funded next year, dropping to 68% funded in 2014-15. Health benefits for San Francisco retirees

While San Francisco spent $17 million on retiree health benefits, that number is projected to be $140 million in 2011, and to rise after that.

are paid directly out of the city budget. While San Francisco spent $17 million on retiree health benefits, that number is projected to be $140 million in 2011, and to rise after that. An actuarial consultant found in 2008 that the unfunded liability for health benefits was $4 billion.

The "Pension Tsunami" report concludes that "unless serious pension reform is undertaken, our children and grandchildren, who were too young to vote at the time, may be saddled with the costs of benefits of former public employees," who were awarded increased benefits on the erroneous assumption that "it would cost nothing" because the stock market would rise forever.

Moody's Investors Service currently has a "negative" outlook on San Francisco, meaning that "we think it greater than a 50-50 chance that within the next two years, we will lower the city's rating." "Unless something significant changes — the economy, voters approve [new taxes] or the city negotiates greater concessions from labor — which seems unlikely, the rating is likely to be reduced."[4]

FINDINGS

Unfortunately, San Francisco's financial situation is even worse than reported. The current estimates of pension liabilities have been made on the assumption that San Francisco will earn 7.75% on its investments in perpetuity. If we use a more conservative assumption that San Francisco's investments will earn about 5.19%—which is the corporate bond rate that private pension plans currently use – SFERS actually has an unfunded liability of about $6.1 billion.

On top of that, if we look at the actual market value of SFERS investments rather than the "actuarial" value (which doesn't yet fully take into account all of the market losses in 2008 and 2009), the unfunded liability rises again to some $10.1 billion. That figure may change from month to month as the value of SFERS investments changes, but it is still much higher than anything that SFERS currently admits.

We should also take into account San Francisco's share of the unfunded pension and healthcare liabilities incurred by the California state government, as those unfunded liabilities will also affect San Francisco taxpayers. In a separate report, I estimate that California's unfunded liabilities are around $378.4 billion. San Francisco's population in July 2008 was 808,576, while California's population was 36,961,664 in July 2009, according to the U.S. Census Bureau. San Francisco's pro rata share of the state's unfunded liabilities is therefore roughly $8 billion.

Adding it all up, San Francisco is facing a $10.1 billion liability for its pension system, $4 billion for its retiree healthcare benefits, and $8.3 billion for its share of California state pension and healthcare benefits. **The total is $22.4 billion, which amounts to about $27,728 per person in San Francisco, including children.**

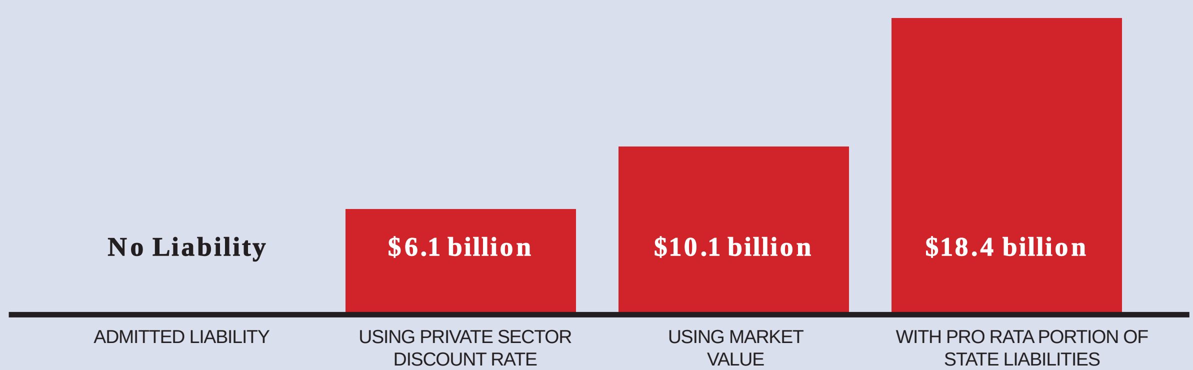
As a subset of the above figures, San Francisco teachers make up exactly 1% of the membership of the California teachers' pension plan, which is underfunded in the amount of about $101.5 billion. San Francisco teachers are therefore likely responsible for an estimated $1 billion in underfunding.

CONCLUSION

The prospects for reform are growing. In June 2010, San Francisco voters passed a proposition that "significantly reduces pension liabilities going forward because it requires increased pension-fund contributions for new city employees, and seeks to reduce pension 'spiking' by basing pension payouts on a worker's average compensation over the last two years of employment, rather than the final year, when a big push in overtime can lead to greatly enhanced pension benefits."[5] Then in July, "proponents turned in more than 75,000 voter signatures to put a measure on the November ballot to require San Francisco city employees to pay more toward their retirement funds."[6] On the other hand, as a local CBS station reported in mid-August, "San

Adding it all up, San Francisco is facing a $10.1 billion liability for its pension system, $4 billion for its retiree healthcare benefits, and $8.3 billion for its share of California state pension and healthcare benefits.

SAN FRANCISCO'S UNFUNDED PUBLIC PENSION OBLIGATIONS



Francisco's biggest labor unions have filed suit to get [the November proposition] off the ballot. They say it's unconstitutional, and that the petitions voters signed to place it on the ballot were misleading."[7]

On a statewide level, the *Los Angeles Times* recently reported that "Gov. Arnold Schwarzenegger recently reached tentative deals with six state workers' unions to reduce benefits and hike employee retirement fund contributions for new hires. He has also vowed to veto any budget for the current year — now almost three weeks overdue — that does not roll back retirement benefits to 1999 levels and require workers to contribute an additional 5% of pay toward retirement."[8] On the other hand, a pension reform bill "intended to curb pension spiking has become so watered down that it would now do little to prevent California public employees from boosting their end-of-career paychecks, critics say, prompting reform advocates and bill sponsor state Controller John Chiang to withdraw support."[9]

Absent significant reform at both the city and state level, San Francisco's staggering pension and retiree health benefit liabilities will constrain the city's ability to engage in any other public spending in the foreseeable future. As David Crane, a Schwarzenegger appointee to the California teachers' pension system, has said, "All of the consequences of rising pension costs fall on the budgets for programs such as higher education, health and human services, parks and recreation, and environmental protection that are junior in priority and therefore have their funding reduced whenever more money is needed to pay for pension costs."[10]

---

[1] "Future of SF Pension Questioned Ahead of Vote," CBS5, 16 Aug. 2010, available at http://cbs5.com/politics/san.francisco.pension.2.1863451.html.

[2] Pension Tsunami report, p. 19, available at http://www.sfsuperiorcourt.org/Modules/ShowDocument.aspx?documentid=2660.

[3] The city's response to the Pension Tsunami report is here: http://media.baycitizen.org/uploaded/documents/2010/8/consolidated-response-grand-jury-report/CGJ%20Consolidated%20Response.pdf.

[4] Elizabeth Lesly Stevens, *The Bay Citizen*, Newsom: I'm Already Reforming Pensions, My Way," 25 Aug. 2010, available at http://www.baycitizen.org/budget-crisis/story/newsom-already-reforming-pensions-my-way/.

[5] Elizabeth Lesly Stevens, *The Bay Citizen*, Newsom: I'm Already Reforming Pensions, My Way," 25 Aug. 2010, available at http://www.baycitizen.org/budget-crisis/story/newsom-already-reforming-pensions-my-way/. That voter proposition can be found here: http://media.baycitizen.org/uploaded/documents/2010/7/prop-d-text/PROP%20D%20text.pdf

[6] Tony Perry and Marc Lifsher, "Municipalities take aim at public pensions," *Los Angeles Times*, 18 July 2010, available at http://www.latimes.com/news/local/la-me-pensions-20100719,0,898989.story?track=rss.

[7] "Future of SF Pension Questioned Ahead of Vote," CBS5, 16 Aug. 2010, available at http://cbs5.com/politics/san.francisco.pension.2.1863451.html.

[8] Tony Perry and Marc Lifsher, "Municipalities take aim at public pensions," *Los Angeles Times*, 18 July 2010, available at http://www.latimes.com/news/local/la-me-pensions-20100719,0,898989.story?track=rss.

[9] Catherine Saillant, "California pension reform effort loses support," *Los Angeles Times*, 18 Aug. 2010, available at http://articles.latimes.com/2010/aug/18/local/la-me-0818-pension-reform-20100818.

[10] Quoted in Steven Greenhut, "Progressives for Pension Reform?," *City Journal*, 9 Sept. 2010, available at http://www.city-journal.org/2010/eon0909sg.html.

ABOUT THE AUTHOR

Stuart Buck is currently a Distinguished Doctoral Fellow in the Department of Education Reform at the University of Arkansas. He attended Harvard Law School, graduating with honors in 2000, and serving as an editor of the Harvard Law Review. After law school, Buck clerked for Judge David A. Nelson of the United States Court of Appeals for the Sixth Circuit in 2000-01, and then for Judge Stephen F. Williams of the United States Court of Appeals for the D.C. Circuit in 2001-02.

ABOUT THE FOUNDATION FOR EDUCATIONAL CHOICE

The Foundation for Educational Choice The Foundation for Educational Choice is a 501(c)(3) nonprofit and nonpartisan organization, solely dedicated to advancing Milton and Rose Friedman's vision of school choice for all children. First established as the Milton and Rose D. Friedman Foundation in 1996, the foundation continues to promote school choice as the most effective and equitable way to improve the quality of K-12 education in America. The foundation is dedicated to research, education, and outreach on the vital issues and implications related to choice and competition in K-12 education.