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CALIFORNIA CROWD-OUT

How Rising Retirement Benefit Costs Threaten Municipal Services

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Executive Summary

In recent years, California municipalities have seen retirement benefit costs grow at a rate above that of taxes, fees, and charges. "Crowd-out" is the term given to this condition by some public officials forced to deal with the resulting fiscal strain. Balanced budget requirements mandate that when costs grow more rapidly than revenues, something must give. All too often, this has meant reductions in core government services, most of which—police, fire, libraries, parks, and street and sidewalk maintenance—are delivered at the local level in California.

Retirement benefit costs have caused California localities to underfund basic infrastructure maintenance needs, even in affluent areas such as Sonoma County. Teachers in Los Angeles are threatening to strike over stalemated contract negotiations, as the school district has found itself unable to satisfy union demands for increased personnel and salaries, as well as its long-term benefit commitments.

This paper takes a broad look at California crowd-out, documenting the phenomenon across the local government sector. It will compare rates of growth between revenues and retirement costs and examine workforce levels, salary trends, infrastructure spending, and other service indicators. Major findings include:

Cause

- Crowd-out is a structural problem that asserts itself mainly during economic downturns and recoveries. In each of the last three recessions since the early 1990s, California local governments have seen annual pension contributions grow at a rate above tax revenues.
- A survey of cost trends in own-source revenues and retirement benefits across 25 municipalities, including San Diego, San Jose, and San Francisco, found that all experienced crowd-out over the last decade.
- Examples of crowd-out may be found in every variety of California municipality: city, county, transit agency, school district, high income, low income, and throughout all regions.
- The portions of local pension costs that have risen most rapidly have been those associated with systems' unfunded liabilities.
- Active employee health care benefit costs have also grown rapidly over the last decade, though in more recent years, the pressure has weakened. A survey of 14 localities' active employee health care spending found that the median increase during FY05–09 was 40 percent, but only 20 percent during FY09–14.
- Crowd-out will continue because of pressure to increase payments on retiree health care and mandated pension expense increases by CalPERS and CalSTRS, the state retirement systems in which many local governments participate.

Effect

- Census Bureau data show that, between 2004 and 2012, growth in pension costs for California local governments outpaced spending on core services, such as police and fire, and quality-of-life services, such as parks and libraries.
- Crowd-out's most tangible effect has been on personnel. In December 2014, local government staffing levels in California remained eight percent below where they were in December 2007. Private-sector job levels in California, by contrast, were 2.4 percent higher.

- Job cuts have not been across the board. Local staffing data suggest that reductions in public-safety personnel have been less steep in recent years than for non-public-safety personnel. Bureau of Labor Statistics data show that local government education jobs have been reduced more than noneducation jobs.
- In California over the last 15 years, local government salaries have increased 5 percentage points more slowly than private-sector salaries, and 3.4 points over the last five years.
- Whether governments should increase their workforces must be evaluated on a case-by-case basis. But by restricting municipalities' staffing possibilities, crowd-out also restricts municipalities' policy possibilities.
- Crowd-out has had a more significant effect on the ability to perform basic maintenance than on major capital investments. Were localities to devote what they currently spend on pension debt service to basic maintenance instead, some could reduce all or most of their infrastructure backlog within a few years.

California's fiscal position has improved since 2010. No longer does it have the lowest credit rating among American states; its unemployment rate is down; and it has not faced a multibillion-dollar budget deficit since the FY12 budget cycle. But local services are not improving at a rate proportionate to economic growth. When the next recession hits, more municipal bankruptcies will come. For the moment, the greatest threat is mediocrity, not insolvency.

Recommendations

1. Local governments should focus on scaling back retiree health care benefit commitments instead of, or as part of, funding arrangements.
2. Pension reform will require state action, likely through a ballot initiative. The success of pension reform at the state level will, however, depend on local leadership.

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CALIFORNIA CROWD-OUT
HOW RISING RETIREMENT BENEFIT COSTS THREATEN MUNICIPAL SERVICES

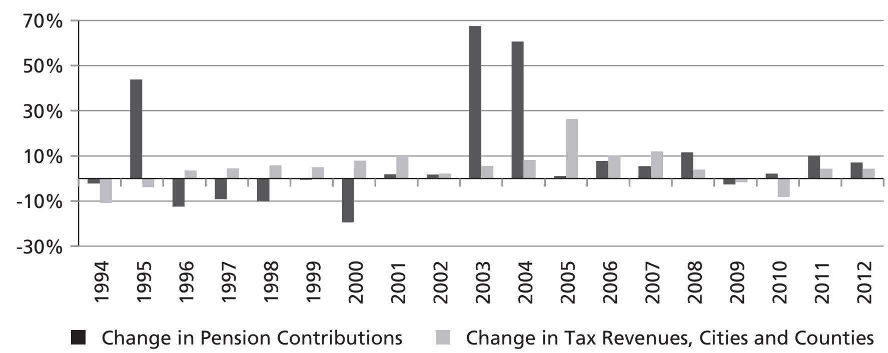
Stephen D. Eide

INTRODUCTION

Crowd-out may be measured and analyzed in a few ways.[1] **Figure 1** expresses the problem in the most basic fashion. There have been three recessions since the early 1990s. In each case, California cities and counties' tax revenue growth rate dropped below the growth rate of local government pension contributions.

A public pension benefit is a fixed payment, guaranteed by the government employer, that is financed by a mix of employee and employer contributions and investment return. When the value of a pension system's investments drops during recessions, the employer must increase contributions to stay current on its plan to ensure that it will have sufficient assets during the next 20–30 years to fund workers' retire-

Figure 1. Annual Change in Pension Contributions and Tax Revenues for California Cities and Counties, 1994–2012



Source: Census Bureau and State Comptroller ments. Since revenues also drop during recessions, pension systems require employers to spend more on retirement benefits when they can least afford it. Crowd-out is thus a feature, not a bug, of public pension systems.

Figure 2 relies on data derived from governments' annual financial reports. It compares the rate of growth in major own-source revenues with pension costs over the last decade and pension and retiree health care costs since 2009. In nearly every instance, retirement benefit costs have grown more rapidly than taxes, fees, and charges.

Note the variety of the 25 localities in Figure 2: 20 cities, three counties, and two transit agencies. Pension-driven crowd-out is found throughout northern and southern California, coastal and inland, and among low- and high-income municipalities.

The FY09 figures have been broken out to relate localities' postrecession crowd-out experience and to include costs associated with retiree health care (other post-employment benefits, or OPEB). The Government Accounting Standards Board began requiring governments to report information on their OPEB liabilities only in 2007. Figures used to

Figure 2. Change in Retirement Costs vs. Change in Revenues, FY05–14 (%)

	Change in Pension Costs, FY05–14	Change in Taxes, Fees, and Charges, FY05–14	Changes in Pension and OPEB costs, FY09–14	Change in Taxes, Fees, and Charges, FY09–14	FY05–FY14*	FY09–FY14*
Alameda—Contra Costa Transit District	97.4	40.7	34.2	20.2	56.7	14.0
Anaheim (city)	101.9	56.0	13.9	26.0	45.9	-12.1
Bakersfield (city)	71.7	33.6	30.9	10.6	38.1	20.3
Escondido (city)	124.3	-18.1	16.2	-21.0	142.4	37.2
Fontana (city)	256.6	-23.7	74.7	-49.5	280.3	124.2
Garden Grove (city)	47.5	-0.4	29.6	-10.6	47.9	40.2
Glendale (city)	192.2	11.7	25.3	-12.5	180.5	37.8
Irvine (city)	128.8	31.2	45.4	13.1	97.6	32.3
Modesto (city)	80.7	-20.8	26.6	-15.5	101.5	42.1
Monterey (county)	87.6	1.9	26.6	-10.9	85.7	37.5
Moreno Valley (city)	247.5	5.1	-21.5	-8.4	242.4	-13.1
Newport Beach (city)	56.1	47.2	12.3	18.6	8.9	-6.3
Orange County Transportation Authority	132.5	8.5	26.5	24.8	124.0	1.7
Oxnard (city)	96.1	17.7	30.2	-5.9	78.4	36.1
Palo Alto (city)	54.9	69.9	72.8	41.2	-15.0	31.6
Roseville (city)	86.9	10.3	30.5	9.0	76.6	21.5
San Diego (city)	54.0	33.4	46.0	-1.7	20.6	47.7
San Francisco (city and county)	537.5	72.2	184.8	34.8	465.3	150.0
San Jose (city)	141.2	10.1	93.2	-9.5	131.1	102.7
San Mateo (county)	90.7	114.3	46.2	36.3	-23.6	9.9
Santa Ana (city)	91.3	-5.7	1.5	-17.8	97.0	19.3
Santa Barbara (city)	77.1	14.0	19.6	-16.6	63.1	36.2
Santa Barbara (county)	145.9	26.3	56.4	0.1	119.6	56.3
Sunnyvale (city)	111.2	68.8	52.9	39.8	42.4	13.1
Vallejo (city)	46.7	-0.1	93.0	4.3	46.8	88.7

*Rate of growth of retirement benefits minus rate of growth of taxes, fees, and charges.
Source: CAFRs, author's calculations

calculate cost growth were those of localities' actual cash contributions, not those which system actuaries recommended that they contribute. California municipalities generally do make their full annual required contribution (ARC) for pension costs but do not make their full ARC for OPEB costs.

There are three reasons to believe that California municipalities' crowd-out problem could get worse in the near-term. First, governments will have to confront their unfunded retiree health care liabilities.[2] In the state and local sector, it is standard for employers to continue to provide health coverage between the time when workers retire and when Medicare begins (age 65). Some governments also supplement Medicare through reimbursing Medicare Part B monthly premiums and/or providing Medigap insurance for costs that Medicare does not cover.

As discussed later, governments should be considering scaling back OPEB programs. But if governments intend to maintain OPEB commitments, the only fiscally responsible way to manage them is through paying their full ARC. Paying more up front allows investment return to take some of the cost burden off taxpayers and workers. But transitioning from paying 20 percent of ARC to 100 percent will intensify crowd-out.

The second reason is that California's two major pension systems, CalPERS and CalSTRS, in which many localities participate, will require significant contribution increases in coming years. AB 1469, enacted last summer by the state government, mandated that CalSTRS members will see their annual employer share grow from 8.25 percent of salary to 19.1 percent between 2014 and 2020.[3] Costs for teacher pensions will effectively double between 2014 and 2018. Rising teacher pension costs are already beginning to strain collective negotiations, as districts are unable to meet union wage increase demands because so much of their future revenue is already committed for pensions.[4]

CalPERS members are already projecting cost increases as a result of revised lifetime-expectancy assumptions, the adoption of a more conservative rate of return on investments, and other changes.[5] When retirees live longer and investment return is assumed to pay for less of the ultimate benefit, employers have to contribute more to ensure that benefit commitments are met.[6] **Figure 3** shows the official actuarial projections for near-term pension increases for the largest five CalPERS member cities.

Long Beach, for example, is already contributing $27 for each $100 in salary it pays to uniformed

Figure 3. Projected Change in Employer Contribution Rates, Largest CalPERS City Members, FY16–21

City	Participants	Employer Contribution Rate as Share of Payroll, FY16	Employer Contribution Rate as Share of Payroll, FY21	Change
Long Beach Misc	6,068	18.4%	26.2%	42.5%
Long Beach Safety		27.2%	40.2%	48.1%
Sacramento Misc	5,337	15.7%	18.2%	16.2%
Sacramento Safety		34.0%	44.0%	29.4%
Oakland Misc	4,774	32.9%	41.4%	25.7%
Oakland Safety		37.7%	46.0%	22.1%
Santa Monica Misc	3,005	19.6%	23.6%	20.7%
Santa Monica Police		42.8%	52.1%	21.7%
Santa Monica Fire		32.4%	40.7%	25.5%
Anaheim Misc	2,999	26.4%	33.9%	28.6%
Anaheim Police		35.5%	46.4%	30.8%
Anaheim Fire		38.1%	45.5%	19.4%

Source: CAFRs, author's calculations

employees; by 2021, it will be contributing $40. These cost increases assume that investment returns will yield 7.5 percent annually and come on top of the 3 percent annual growth in payroll that all these cities assume.

The third reason that crowd-out will increase is because of restrictions on raising local taxes. As a legal matter, general and special tax increases require voter approval—majority and two-thirds supermajority, respectively. Many localities have succeeded in recent years in approving new taxes. Between 2001 and March 2014, 1,591 tax-increase measures were put before local voters in California; 923 (58 percent) passed.[7] It is unclear how much more capacity cities and counties will have for additional tax increases.

In 348 California cities, the sales- and use-tax rate is already at least 9 percent, while the current statewide average is 8.44 percent (7.50 is the base rate, but districts may vote to raise it further).[8] In 2014, California's combined state and local average sales-tax rate was the eighth-highest in the nation.[9] In addition to legal and political constraints, future tax-increase proposals will be complicated by the state government's plans to make recent income-tax increases permanent and to broaden the sales-tax base.[10] According to the Tax Foundation's most recent survey, California already boasts the fourth-highest tax burden among American states.[11] Diminished local revenue flexibility, plus high and rising pension costs, mean that crowd-out will be even harder to ignore in the future.

I. CROWD-OUT: PENSIONS

Crowd-out is rooted in overly generous benefits. Pensions are high in California partly because half of all government workers do not qualify for Social Security and partly because salaries are high. Under the defined-benefit model, benefits are structured to provide a certain percentage of an employee's final salary throughout his retirement. The "100,000 club"[12] of six-figure pensioners in California is certain to grow in coming years, as government workers continue to retire with six-figure salaries.[13] In 2013, 13,882 employees of Los Angeles city government and the Department of Power made over six figures. California is one of only eight states whose average public pension benefit payment exceeds $30,000.[14] This distinction is related to the state's ranking as the second-highest in the nation for average local worker salary (**Figure 4**). Bureau of Economic Analysis data show that per-capita spending on state and local government is also higher in California than in most other states (**Figure 5**).[15]

Salaries are high in California largely because of the strength of public-employee unions: 61.5 percent of government workers in the state are represented by unions, sixth-highest in the nation.[16] Union influence has also caused pension benefits to rise by securing, with the lobbying assistance of state pension agencies,

Figure 4. Top Ten Average Salaries, Local Government Employees, 2013

New Jersey	$72,114
California	**$58,699**
Rhode Island	$56,711
Hawaii	$56,362
New York	$55,022
Massachusetts	$54,793
Connecticut	$53,625
Maryland	$52,584
Alaska	$52,294
Nevada	$52,270

Source: BEA

Figure 5. Top Ten per Capita Spending on State and Local Employee Wages, 2013

Alaska	$4,800
Wyoming	$4,604
New Jersey	$3,668
New York	$3,603
Connecticut	$3,457
North Dakota	$3,318
Washington	$3,301
California	**$3,217**
Nebraska	$3,198
Vermont	$3,179

Source: BEA

more generous benefit formulas. Many public-safety workers are eligible for "3 percent at 50": after reaching age 50, they can retire and draw a pension equivalent to their final average salary, times years of service, times 3 percent. For a 50-year-old firefighter making $100,000 who has been working 25 years, this means a pension of $75,000.

Three percent at 50 became widespread following the state legislature's passage of SB 400 in 1999.[17] Though it technically applied only to members of the state highway patrol, SB 400's 3 percent at 50 provision stimulated competition among other state and local agencies to adopt the new formula and is commonly cited for the statewide growth in pension liabilities since the collapse of the dotcom bubble. CalPERS has estimated that SB 400 accounts for 27 percent of the increase in state pension contributions between FY98 and FY10.[18] In 2012, the state passed the Public Employees' Pension Reform Act, which scaled back benefit formulas (though the most important changes applied only to new hires).[19]

Crowd-out is not exclusively a function of generous pensions. Equally important is how governments have managed the costs associated with the underlying benefits.

Governments' annual pension bills have two components: the "normal" cost and the payment on the unfunded actuarial accrued liability (UAAL). The normal cost is for benefits earned in that particular year. Each year, the employer and the employee contribute a certain percentage of salary to be invested over time and to fund, ultimately, the retirement benefit earned in that year. But when pension systems become underfunded (i.e., when total liabilities exceed assets on hand) the employer/taxpayer must make additional contributions to address the unfunded liability. The part of the pension bill that has grown most rapidly (i.e., is most responsible for crowd-out) is the payment on the UAAL (**Figure 6**).

In other words, when a government's pension bill rises 50 percent in five years, the proximate cause is probably not that benefits have become 50 percent

Figure 6. Change in Normal Cost vs. UAAL Cost, FY06–FY13, Select California Municipalities

	FY06 Normal Cost, $	FY06 UAAL Cost, $	FY13 Normal Cost, $	FY13 UAAL Cost, $	Change in Normal Cost, %	Change in UAAL Cost, %
San Jose	75,031,925	9,708,409	103,375,078	104,892,491	37.8	980.4
Anaheim	19,189,553	9,573,862	27,514,597	23,914,337	43.4	149.8
Bakersfield	9,981,140	7,599,071	13,425,544	10,214,361	34.5	34.4
Berkeley	13,786,483	9,332,868	19,236,739	14,950,580	39.5	60.2
Escondido	6,228,668	3,451,246	8,454,286	8,395,248	35.7	143.3
Long Beach	38,251,639	2,664,261	50,057,662	19,743,878	30.9	641.1
Newport Beach	6,041,014	4,007,052	8,732,023	10,363,920	44.5	158.6
Oakland	44,774,113	32,725,322	52,512,585	51,137,744	17.3	56.3
Palo Alto	10,114,781	3,131,266	11,563,325	12,108,408	14.3	286.7
Sacramento	25,290,501	12,073,339	34,614,878	23,400,565	36.9	93.8
Bay Area Rapid Transit Authority	19,550,164	4,853,377	22,034,834	14,343,777	12.7	195.5
Santa Barbara	8,702,669	7,224,266	10,956,736	11,272,715	25.9	56.0
Santa Rosa	9,881,884	4,848,697	14,232,917	8,057,207	44.0	66.2
Los Angeles Unified School District (safety employees)	3,832,517	4,237,997	5,477,020	3,137,595	42.9	-26.0
Median					**36.3**	**118.5**

Source: Actuarial Valuations

Figure 7. Median Annual Change in Employer Health Insurance Premium Costs, 2004–13	
	Median Annual Change
Private Business	3.8%
State and Local Government	5.9%
Source: Centers for Medicare and Medicaid Services	

more generous but that the pension debt—the gap between assets and liabilities—has expanded.

II. CROWD-OUT: ACTIVE EMPLOYEE HEALTH BENEFITS

Government budgets have also been strained by workers' health care costs. Employers across all industries and sectors have, of course, struggled to manage health care costs in recent years. But state and local premium costs are higher than in most other industries.[20] **Figure 7** shows that state and local employers nationwide have seen premium costs grow more rapidly than those for corporate employers.

But the crowd-out problem associated with growing active employee health care benefit costs has been more muted in recent years. Thanks to layoffs—which do not decrease pension liabilities but do affect benefit costs for active workers—and a global slowdown in health care costs, costs grew more slowly over the second half of the past decade than in the first half (**Figure 8**).

III. CROWD-OUT: RETIREE HEALTH BENEFITS

In the public sector, rising health benefit costs for active employees are not the only problem. As mentioned, California localities commonly continue to offer health insurance throughout workers' retirement years. OPEB is less expensive than pensions. Even generous health care plans for individuals fall short of California's $30,000-plus average pension payout. And the federal government's Medicare program assumes most costs after retirees reach 65. But OPEB expenditures are more difficult to justify when measured against the standard of what governments need to offer to attract and maintain a qualified workforce.

Private-sector employers commonly offer some form of cash retirement benefits, even if not a defined-benefit pension. Of large American employers (200-plus employees) that offer health benefits to current employees, only 25 percent offer retiree

Figure 8. Growth in Costs for Active Employee Health Benefits, FY05–FY14

	FY05, $	FY09, $	FY14, $	FY05–FY09, %	FY09–FY14, %
San Jose	41,889,381	56,800,422	50,391,133	35.6	-11.3
Orange County	108,867,720	127,999,561	172,626,821	17.6	34.9
Santa Barbara City	7,555,397	10,636,064	12,024,342	40.8	13.1
Santa Rosa	9,016,615	12,537,708	15,431,889	39.1	23.1
Bakersfield	9,082,194	13,405,920	13,460,547	47.6	0.4
Sonoma County	29,913,807	37,288,002	18,549,231	24.7	-50.3
Berkeley	9,090,231	13,671,021	16,002,185	50.4	17.1
Bay Area Rapid Transit Authority	24,451,493	37,383,253	52,963,112	52.9	41.7
Fresno	21,456,864	28,494,429	29,027,956	32.8	1.9
Newport Beach	5,714,966	9,861,525	12,059,116	72.6	22.3
San Diego County	68,696,062	91,535,835	111,788,854	33.2	22.1
Irvine	4,521,141	6,880,657	9,508,424	52.2	38.2
Escondido	5,580,000	7,800,000	8,200,000	39.8	5.1
San Francisco Unified	40,131,950	52,266,760	64,089,203	30.2	22.6
Median				**39.4**	**19.6**

Source: Local governments

coverage, while 83 percent of state and local governments do, according to the Kaiser Foundation's 2014 Health Benefits Survey.[21] In California, only 9.7 percent of private-sector establishments that offer health insurance also provide insurance to pre–Medicare eligibility retirees.[22]

For the many governments that do not pre-fund OPEB, OPEB-related crowd-out is driven purely by annual increases in health insurance premiums. Eventually, cities that remain committed to offering OPEB to workers will have to set up investment trusts to relieve workers and taxpayers of some of the burden of paying for the benefit. But investment gains also mean occasional investment losses. Investment-funded retiree health care benefits are doubly volatile, for costs depend on the long-term cost of health care and on the health of world financial markets.

The transition from pay-as-you-go to pre-funding will require major increases in up-front costs—and thus, crowd-out (**Figure 9**). The Bay Area Rapid Transit Authority (BART) recently began fully funding OPEB payments. The result: a 120 percent cost increase between FY07, the last year of "pay as you go" (i.e., funding only the given year's retirees' benefits), and FY10, the first year of full pre-funding (**Figure 10**). Clearly, pre-funding is a burden, but the longer governments wait to phase it in, the more years of investment return they will have squandered.

IV. CROWD-OUT: SERVICES

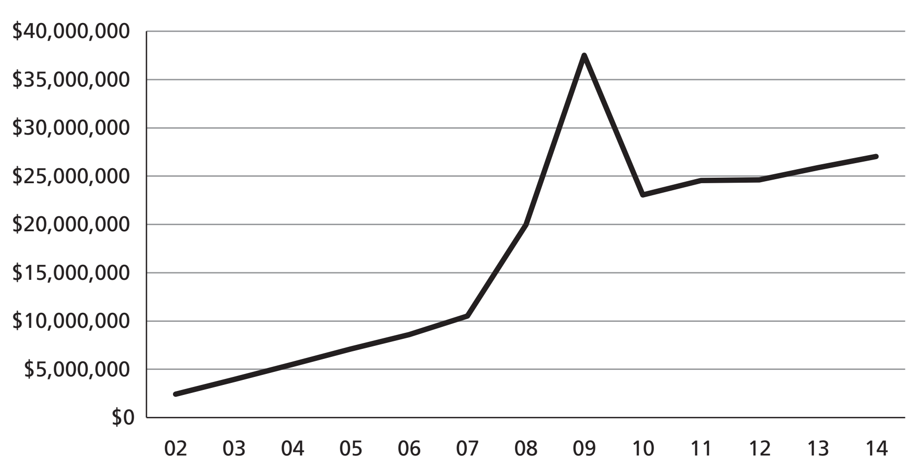
In California, crowd-out's effect on services has varied, depending on the type of locality (cities, counties, school districts, and transit agencies perform different functions), their relative affluence, and local preferences. Since 2000, Los Angeles has seen its pension costs rise from 2 percent to 18 percent of its

Figure 9. Cost of Pre-Funding OPEB

City	Funded Ratio	Actual Annual Contribution	Required Annual Contribution	Difference	
San Francisco	0.4%	$166,628,000	$353,251,000	$186,623,000	52.8%
Oakland	0.0%	$20,633,000	$40,476,000	$19,843,000	49.0%
Sacramento	0.0%	$17,473,000	$39,930,000	$22,457,000	56.2%
Long Beach	0.0%	$4,709,000	$14,437,000	$9,728,000	67.4%
Inglewood	0.0%	$4,485,081	$17,342,000	$12,856,919	74.1%

Source: CAFRs

Figure 10. BART OPEB Contributions, FY02–FY14



Source: BART

Figure 11. Trends in Revenues and Spending on Services and Pensions for California Local Governments, FY08–FY12

	2004, $	2008, $	2012, $	2004–12, %	2008–12, %
Total Local Own-Source Revenues	124,931,257	147,127,555	152,961,586	22.4	4.0
Local Government Library Spending	1,178,941	1,453,001	1,366,148	15.9	-6.0
Net Local Spending on Parks and Recreation	2,727,420	4,204,312	3,633,765	33.2	-13.6
Local Spending on Police	10,318,580	13,466,325	13,353,115	29.4	-0.8
Local Spending on Fire Protection	4,873,319	6,883,909	6,772,039	39.0	-1.6
Local Pension Spending	8,650,956	11,085,758	12,984,585	50.1	17.1

Source: Census Bureau and Tax Policy Center

general fund budget, though the city has remained determined to expand the size of its police force.[23] In 2013, community demands prompted San Jose to lay off police officers to keep libraries open. Elevated retirement costs pose the most serious threat to budgets when coupled with *declining* revenues, a situation that led to bankruptcy in the cases of Stockton, San Bernardino, and Vallejo. But crowd-out afflicts high-income communities, too. Indeed, the problem is most evident in communities where revenues are growing but services continue to lag.

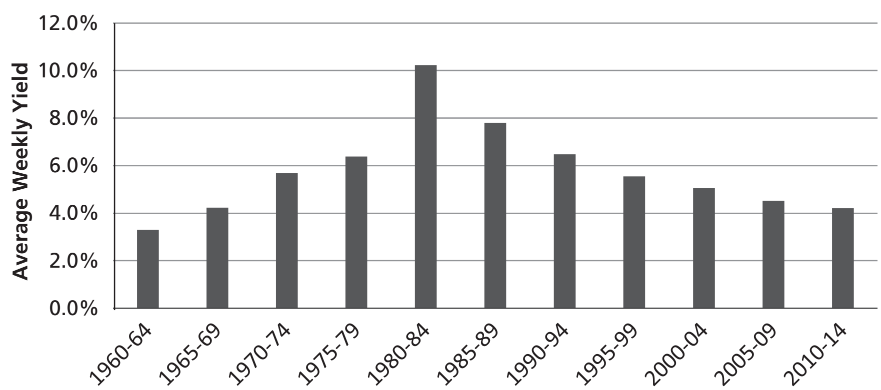
Figure 11 expresses crowd-out's effect on services in the most basic way: trends in pension contributions compared with locally funded services. In California, local governments provide nearly all the funding for police, fire protection, local parks, and library services. During 2004–12, pension contributions grew more rapidly than expenditures on these four services.

Crowd-out's most common effect—a smaller workforce—is not always a bad thing. Some downsizing could be "right-sizing."[24] The question of localities' spending priorities should be evaluated case by case. But crowd-out is not an evaluative process. The essence of crowd-out is fiscal inflexibility.

V. CROWD-OUT: INFRASTRUCTURE

Some have argued that crowd-out may be restricting capital investment in the public sector.[25] According to the Federal Reserve, the total amount of outstanding credit market debt for state and local governments has declined each year since 2010.[26] Throughout this period of decline, the average yield

Figure 12. Four–Year Weekly Yield Averages, Bond Buyer's 20 GO Bond Index, 1960–2014



Source: The Bond Buyer

Figure 13. Pension Debt Service as a Share of Basic Street Maintenance Backlog, Select California Cities			
	Estimated Backlog, $	**FY14 Pension Debt Service (UAAL Payment), $**	**FY14 Pension Debt Service Payment as Share of Backlog, %**
Sunnyvale	19,000,000	12,476,944	65.7
Sacramento	90,000,000	24,314,176	27.0
San Jose	504,000,000	125,807,415	25.0
San Diego	478,000,000	232,600,000	48.7
Fremont	133,000,000	14,996,367	11.3

Source: San Jose Office of the City Auditor and Actuarial Valuations

for the Bond Buyer's 20-Bond General Obligation Municipal Index was 4.2 percent, the lowest since the 1960s (**Figure 12**).

When some governments have issued debt in recent years, excessive retirement benefit debt has raised their cost of borrowing. Major ratings agencies now give pension and OPEB measures more weight in evaluating issuers' credit quality. Pennsylvania, Illinois, and New Jersey are the three American states now faced with the most serious doubts about their credit quality. In each case, the leading cause is pension debt.

Various factors influence public officials' decisions to pursue bond issuances to finance major new capital costs, the most important of which is whether they believe that voters will approve the issuances. In California, local agencies generally need two-thirds voter approval to issue general obligation bonds.[27] Officials' interpretations of local polling data is just as likely as pension cost pressure to influence their decisions on whether to pursue approval for major new borrowing endeavors.

Crowd-out's impact on infrastructure investment is more likely felt on routine maintenance, which governments generally finance out of operating revenues, not specific bond issuances. Consider Sonoma County. Despite considerable affluence, Sonoma's "Pavement Condition Index" is among the lowest of all California counties[28]—and lowest among the Bay Area's eight counties.[29]

In June 2015, Sonoma voters will be asked to approve an additional 0.25 percent in sales tax for use in road maintenance.[30] The tax would generate $8.7 million annually, which, coupled with the $12 million the county receives from the gas tax, would be enough to stave off further deterioration, according to the county Department of Public Works. To restore Sonoma's roadwork to "Good" or "Very Good" condition, it is estimated that $954 million, or nearly $50 million annually, would be needed over the next two decades.[31] Sonoma County has already invested $80 million in "roads, bridges, drainage, and safety features" in the past three years.

Over the past decade, as Sonoma's infrastructure struggles deepened, the county's total yearly pension costs grew from $48 million to $88.1 million.[32] In FY14, Sonoma spent exactly three times what the proposed tax increase will raise, $26.1 million, just on retiree health. Pre-Medicare county retirees are eligible for up to $6,000 in premium contributions; Sonoma's OPEB plan is 7 percent funded.[33] Were Sonoma's retirement benefit costs under control, the numbers strongly suggest ample revenues for maintenance at existing tax rates.

Figure 13 compares six California cities' maintenance backlog with annual UAAL costs (i.e., the debt service portion of their pension bill). Were these cities to devote all of what they now spend on pension debt towards streets and sidewalks instead, they could address all or most of their backlog within a few years.

The same exercise could be performed for basic maintenance elsewhere in the state. One recent report claimed that state parks faced a "$1.3 billion maintenance backlog";[34] Los Angeles needs $1.35 billion to replace its at-risk water mains by

Figure 14. Major California Transit Agencies' Retirement Debt Relative to Bonded Debt Issued for Capital Purposes

Agency	Bonded Debt for Capital Purposes, $	Pension Debt, $	OPEB Debt, $	Pension and OPEB Debt, $	Retirement Debt as Share of Bonded Debt, %
L.A. County (LAC-MTA)	3,530,585,000	443,859,000	854,317,000	1,298,176,000	36.8
San Francisco Bay Area (BART)	1,153,045,000	207,224,000	222,688,000	429,912,000	37.3
Santa Clara (VTA)	1,193,791,000	191,670,000	62,500,000	254,170,000	21.3

Source: CAFRs

Figure 15. Change in Public- and Private-Sector Jobs, 2007–14, California and Nationwide

	Change, December 2007–December 2014	
	%	#
California, State Government	2.9	14,100
California, Local Government	-8.1	-145,900
California, Local Government (Education)	-9.4	-92,700
California, Local Government (Noneducation)	-6.6	-53,200
California, Private Nonfarm	2.4	309,600
Nation, State Government	-1.2	-60,000
Nation, Local Government	-2.7	-390,000
Nation, Local Government (Education)	-3.2	-258,000
Nation, Local Government (Noneducation)	-2.1	-132,200
Nation, Private Nonfarm	2.3	2,716,000

Source: BLS

2025;[35] Governor Jerry Brown estimates the state government's deferred maintenance needs total $66 billion.[36] In FY15, California's UAAL cost for its main CalPERS plan for employees is $2.4 billion.[37]

California transit agencies, less legally restricted in their ability to issue debt, also face struggles with retirement costs. Of the four agencies listed in **Figure 14**, pension and OPEB commitments increase their total bonded debt load 21–45 percent.

VI. CROWD-OUT: PERSONNEL

Local governments' main expense is personnel. Nowhere has the slow pace of the public sector's recovery been more manifest than in workforce levels. Both in California and nationwide, private-sector employment has been much more resilient than government employment (**Figure 15**).

Government staffing cuts were not uniform across the board. In general, nonpublic safety experienced deeper cuts than public safety (**Figure 16**). Job losses in education services were steeper than in noneducation services (**Figure 17**), though it is not clear how many of these losses were teachers. (Local K–12 agencies also employ substantial support staff.)[38]

The ultimate impact of public personnel reductions on services must be assessed case by case. In some instances, numbers may be down due to outsourcing (often a way of delivering service more efficiently). Rising pension costs have pushed down police numbers but have not produced a statewide crime wave. Indeed, in recent debates, it has typically been police unions, opponents of pension reform, that exaggerate the crime threat.[39] Vallejo, San Bernardino, and Stockton all probably need to hire more police officers, but other local governments may be able to get by with fewer.

Policy decisions should shape staffing decisions, but staffing realities can also influence policy, as the history of policing in California attests. What became known as the "reform model" of policing developed, in part, out of California cities' preference for small police departments and their massive geographic footprints.[40] To patrol effectively,

Figure 16. Workforce Decline in Select California Cities, Public-Safety vs. Nonpublic-Safety Positions

	FY09 Public Safety	FY09 Other	FY14 Public Safety	FY14 Other	Public Safety Change	Nonpublic Safety Change
Anaheim	899	1,272	811	1,045	-9.8%	-17.8%
Bakersfield	671	604	736	586	9.7%	-3.0%
Escondido	377	728	383	707	1.6%	-2.9%
Fontana	291	302	218	262	-25.1%	-13.2%
Garden Grove	446	496	377	487	-15.5%	-1.8%
Glendale	614	1,328	551	1,037	-10.3%	-21.9%
Irvine	355	744	368	572	3.7%	-23.1%
Modesto	531	737	455	684	-14.3%	-7.3%
Moreno Valley	393	648	286	398	-27.2%	-38.6%
Newport Beach	397	435	366	370	-7.8%	-14.9%
Oxnard	495	711	521	705	5.3%	-0.8%
Palo Alto	291	785	274	745	-5.8%	-5.1%
Roseville	353	1,046	327	958	-7.3%	-8.4%
San Diego	3,978	6,821	3,772	6,639	-5.2%	-2.7%
San Francisco	6,563	21,239	6,207	21,460	-5.4%	1.0%
San Jose	2,781	5,710	2,286	3,977	-17.8%	-30.4%
Santa Ana	934	999	596	842	-36.2%	-15.7%
Santa Barbara	327	762	316	700	-3.4%	-8.1%
Sunnyvale	340	657	319	589	-6.2%	-10.4%
Vallejo	250	278	236	287	-5.6%	3.2%
Median					**-6.7%**	**-8.3%**

Source: CAFRs

Figure 17. Education vs. Noneducation Job Losses, California Local Governments, FY09–14

	Dec–09	Dec–14	# Change	% Change
Local Government Education	945,400	895,500	-49,900	-5.3
Local Government Noneducation	787,000	752,600	-34,400	-4.4

Source: BLS

departments relied heavily on automobiles and central dispatch systems. Throughout the 1960s and 1970s, the reform model proved ineffective in keeping crime down and was later replaced in many cities by community policing. But as leading policing theorist George Kelling has noted, "Community policing is very labor intensive."[41] California cities still have far fewer cops per capita than their East Coast counterparts (**Figure 18**). This may restrict their possibilities for policing models, now and in the future. Fiscal inflexibility leads to administrative and policy inflexibility.

Crowd-out may also be pushing salaries down. Though, as noted, California local government salaries are still relatively high compared with other states, they have not been growing as rapidly as private-sector salaries (**Figure 19**).

Nationwide, Bureau of Economic Analysis data show that, as a share of total compensation, state and local wages and salaries have declined from 80 percent to below 70 percent over the past quarter-century (**Figure 20**). Over the long term, health insurance costs have been the main driver of this "compensation crowd-out" effect, though in more recent years, pension costs have grown more rapidly than health care costs (**Figure 21**).

In early March 2015, five of seven members of the Board of the Los Angeles Unified School District (LAUSD) voted to send out "Reduction in Force" layoff notices to 2,400 employees, including some teachers.[42] According to the board, this move was necessitated by "multiple big-picture funding challenges, including declining enrollment, *increasing retirement pension costs, rising health benefit costs for current employees and retirees*, as well as the underfunding of Special Education"[43] (emphasis added).

LAUSD is currently locked in a contract dispute with the United Teachers Los Angeles (UTLA), which has threatened to strike over demands for an 8.5 percent raise and 5,000 more represented employees.[44] In January 2015, Superintendent Ramon Cortines estimated that labor and management were approximately $833 million apart over two years.[45] Over the past two years, LAUSD spent $617 mil-

Figure 18. Police Staffing Levels, 2012

City	Total per 1,000	Uniformed per 1,000
San Francisco	3.2	2.6
Los Angeles	3.4	2.6
San Jose	1.5	1.1
San Diego	1.9	1.4
Fresno	1.8	1.5
New York City	5.9	4.2
Chicago	4.7	4.4
Philadelphia	4.8	4.2
Washington, D.C.	6.9	6.1
Boston	4.3	3.4

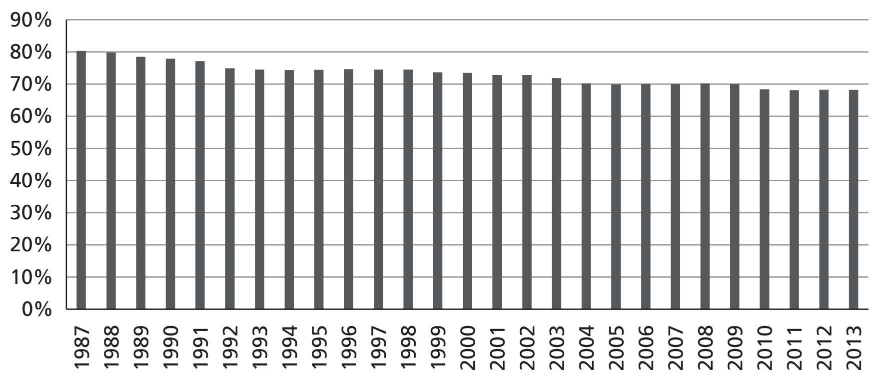
Source: FBI

Figure 19. Change in Average Salary, Private Nonfarm and State and Local Employees in California, 1998–2013

	1998	2009	2013	1998–2013	2009–2013
Private Nonfarm	$27,180	$37,662	$41,649	53.2%	10.6%
State and Local Government	$38,496	$53,405	$58,096	50.9%	8.8%
Local Government	$38,164	$52,901	$56,711	48.6%	7.2%

Source: BEA

Figure 20. Wages and Salaries as Share of Total Employee Compensation, State and Local Governments, 1987–2013



Source: BEA

Figure 21. Change in State and Local Government Spending on Salaries and Benefits, 1993–2013 ($, Millions)

	1993	2003	2013	1993–2013	2003–2013
Wages and Salaries	$415,300	$678,500	$887,500	113.7%	30.8%
Pension Contributions	$34,992	$46,212	$108,700	210.6%	135.2%
Health Insurance Premiums	$36,100	$84,200	$156,000	332.1%	85.3%

Source: BEA, Census Bureau, and Centers for Medicaid and Medicare Services

lion on retiree health care alone—a sum that would more than cover the demand for higher pay or more employees.[46] LAUSD may need to downsize as a result of a lower local birthrate and increased competition from charter schools. But the high costs associated with its retirement benefit debt ensure that this process will be more painful than otherwise.

VII. CROWD-OUT: LIBRARY SERVICES

In 2005, Salinas, California, made national headlines by seriously considering closing its public libraries.[47] The city faced a fiscal emergency that had arisen because of various factors, including "increasing retirement costs and increasing employee health insurance costs."[48] Salinas resolved the crisis through the passage of Measure V, a local initiative that created a 0.5 percent Temporary Transactions and Use Tax. The funds were used for a variety of municipal purposes; but libraries, whose fate was central to the campaign to pass Measure V, are now exclusively dependent on this revenue stream.[49]

At present, Measure V's main purpose seems to be to help Salinas backfill its pension obligations. In FY15, Salinas's costs for unfunded retirement obligations is $7.5 million. Measure V brought in $11 million, $4.3 million of which was for libraries. In other words, Salinas's libraries would not need revenues from Measure V were the city not also burdened by servicing its retirement debt commitments.

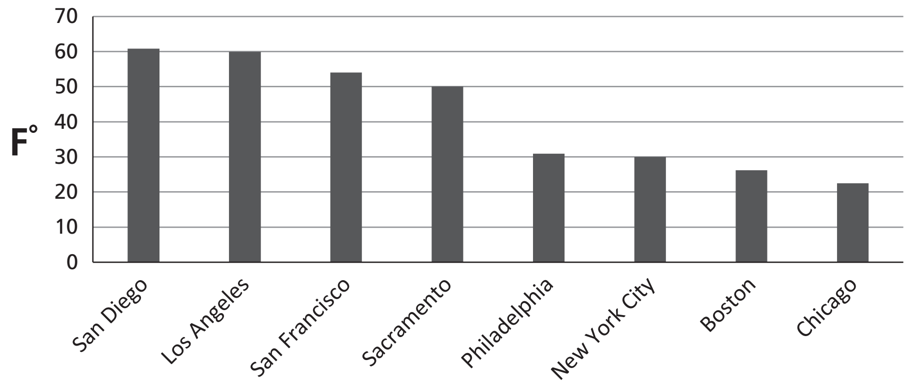
Measures of library services are a useful proxy for quality-of-life services delivered at the municipal level. According to census data, public libraries in California are 98.5 percent funded by local governments. The aforementioned figures on public-safety personnel staffing levels suggest that noncore quality of life services, such as libraries and parks, have borne a disproportionate share of the crowd-out burden. But the precise impact is difficult to assess in a broad, quantitative way because, beyond noting staffing reductions, decline is hard to measure for quality-of-life services. One exception, which stands out statistically, is reduced library hours, which are easily quantifiable and an obvious service reduction (arguably more so than personnel cuts). The public may or may not notice a 20 percent reduction in general government staff but will notice a 20 percent reduction in library hours. The California State Library maintains a database with metrics on more than 180 local library systems. A comparison between figures on library reductions and Census Bureau fiscal data suggests that revenue reductions alone cannot account for the recent reduction in library services (**Figure 22**).

Figure 22. Change in Library Hours vs. Change in Local Revenues in California, 2008–09 to 2011–12

	FY09	FY12	Change
General Revenue, California Local Governments	$242,345,475	$224,652,031	-7.3%
Own-Source Local Revenue, California Local Governments	$125,104,840	$152,961,586	22.3%
Average Hours Open per Outlet	13,057	11,675	-10.6%
Total Hours Open, All Outlets	2,350,254	2,113,207	-10.1%

Source: California State Library's Public Library Statistics Portal and Census Bureau; revenue figures adjusted for inflation

Figure 23. Average Daily Temperature, January 2015



Source: National Oceanic and Atmospheric Administration

Library hours have been reduced more steeply than revenues have declined for two reasons: (1) governments' desire to prioritize public safety services; and (2) rising costs, including for retirement benefits. That rising costs—and not merely declining revenues—have been behind service reductions was also a conclusion of a recent report on the recession's impact on California public libraries.[50]

VIII. REASONS FOR OPTIMISM

California localities are at a crossroads. In recent years, the tendency has been to group California with other blue states, such as New York, because it votes consistently, by a wide margin, for Democratic presidential candidates, as well as because of California's high taxes and extensive regulations. But a closer look at measures of local health reveals that California may be better understood as a hybrid blue and red state. At least within the blue state cohort, California localities retain significant advantages, beginning with climate (**Figure 23**)—for American cities, climate continues to be an important correlate of prosperity.[51]

Statewide, questions have been raised about the health of California's population trends, particularly with respect to domestic outmigration:[52] 2010 saw the first congressional reapportionment in California history where the state failed to add a new seat in the House of Representatives. But local demographic data, when compared with other blue-leaning states, offer reason for optimism.

Figure 24 compares the ten poorest large cities (population: 150,000-plus) in California with those in the Northeast and industrial Midwest. Not only do these ten California cities have higher median household incomes; they have not experienced major depopulation, as measured by reduced density, in recent decades. Even bankrupt San Bernardino and Stockton have experienced positive population growth in recent years. Indeed, examining **Figure 25**, one would never guess that it was San Bernardino and Stockton, not Akron and Cincinnati, that recently went bankrupt.

CONCLUSION

Government services were crucial to California's rise. As blessed as California has been with respect to climate, terrain, natural beauty, and a dynamic private sector, it could not have become the most populous American state and the world's eighth-largest economy[53] without the contributions of sound public services, such as higher education, public safety, and water and transit infrastructure. During the boom years following World War II, the effectiveness of California's public sector stood in sharp contrast to that of the East and the Midwest, then struggling with depopulation, industrial decline, and other problems with which governments seemed unable to cope.

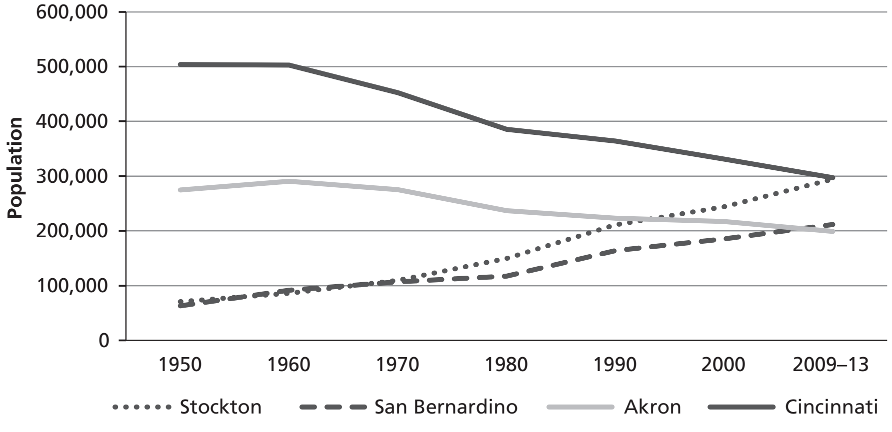
Healthy government budgets will be necessary to adequately meet California's many challenges; that will require addressing crowd-out. The challenges to retirement benefit reform are legal and political and

Figure 24. Urban Decline in Major Low Income California Cities vs. Major Low Income Northeastern and Industrial Midwestern Cities, 1960–2013

City	2009–13 Pop.	2009–13 Median Household Income	Pop. Per Sq. Mile, 1960	Pop. Per Sq. Mile, 1980	Pop. Per Sq. Mile, 2013	Change, Pop. Per Sq. Mile, 1960–present	Change, Pop. Per Sq. Mile, 1980–Present
Akron, OH	199,038	$33,909	5,478.3	4,089.3	3,208.6	-41.4%	-21.5%
Buffalo, NY	260,568	$30,942	12,994.1	8,520.7	6,452.3	-50.3%	-24.3%
Cincinnati, OH	297,150	$34,116	6,526.6	4,941.8	3,812.5	-41.6%	-22.9%
Cleveland, OH	394,335	$26,217	11,527.0	7,263.6	5,074.8	-56.0%	-30.1%
Detroit, MI	706,663	$26,325	12,102.5	8,848.1	5,093.1	-57.9%	-42.4%
Milwaukee, WI	596,459	$35,467	8,236.9	6,627.2	6,206.3	-24.7%	-6.4%
Newark, NJ	277,357	$33,960	16,884.2	13,718.7	11,464.3	-32.1%	-16.4%
Rochester, NY	210,624	$30,875	8,611.1	7,110.0	5,888.1	-31.6%	-17.2%
Springfield, MA	153,428	$34,311	5,452.0	4,760.0	4,814.9	-11.7%	1.2%
Toledo, OH	285,459	$33,317	6,489.9	4,221.8	3,536.4	-45.5%	-16.2%
Median						**-41.5%**	**-19.4%**
San Bernardino	211,528	$38,385	3,677.0	2,217.0	3,439.0	-6.5%	55.1%
Fresno	500,819	$42,015	4,960.0	3,306.0	4,423.0	-10.8%	33.8%
Stockton	294,406	$46,831	3,753.0	3,744.0	4,774.0	27.2%	27.5%
Modesto	202,629	$47,060	3,659.0	4,264.0	4,545.0	24.2%	6.6%
Salinas	152,340	$49,264	3,217.0	5,365.0	6,452.0	100.5%	20.3%
Pomona	150,006	$49,474	3,731.0	4,032.0	6,536.0	75.2%	62.1%
Los Angeles	3,827,261	$49,497	5,448.0	6,380.0	8,166.0	49.9%	28.0%
Sacramento	471,477	$49,753	4,259.0	2,872.0	4,815.0	13.0%	67.6%
Lancaster	157,368	$50,193	N/A	1,298.0	1,669.0	N/A	28.6%
Oakland	397,011	$52,583	7,068.0	6,284.0	7,103.0	0.5%	13.0%
Median						**24.2%**	**28.3%**

Source: Census Bureau

Figure 25. Population Trends in Poor Cities in California and Ohio



Source: Census Bureau

require action at both the state and local levels.

1. Local governments should focus on scaling back retiree health care benefit commitments instead of, or as part of, funding arrangements.

Noting that state government's OPEB costs have risen from 0.6 percent of the state's general fund budget to 1.6 percent between FY01 and FY14, Governor Brown has recommended establishing pre-funding arrangement financing, by contributions from employees and state government.[54] California local governments, which comprise a far larger share of the state's total public-sector workforce than the state, should not feel bound to model their approaches to OPEB reform on the Brown proposal. If state and local governments remain committed to offering health care benefits to retired workers, pre-funding is critical. That commitment should, however, be reassessed.

Prior to establishing pre-funding arrangements, local governments should perform a labor-market analysis, encompassing private- and public-sector employers, to determine the true value of such benefits to current and future workers. Would governments have been less competitive in the labor market had they devoted the billions spent last year on OPEB on raises instead? Throughout the California municipal landscape, OPEB is less standardized than pension benefits. Examples abound of localities offering very modest or no OPEB, such as Newport Beach, Riverside, and Escondido. These governments' labor-market experiences have been insufficiently analyzed throughout the debate over OPEB reform.

2. Pension reform will require state action, likely through a ballot initiative. The success of pension reform at the state level will, however, depend on local leadership.

Former San Jose mayor Chuck Reed and former San Diego city councilman Carl de Maio, both of whom led successful local pension reform initiatives in 2012, have announced plans for a state-level pension reform initiative for 2016.[55] Though details have not yet been made public, the alleviation of local governments' pension burdens is expected to be a central aim. Local officials' support will be crucial to the success of the Reed–de Maio initiative.

Most of the more publicly visible government services are municipal services: public safety, education, parks, libraries, and streets and sidewalks. Municipal officials therefore have a unique vantage point on the reasons that the public has not seen service levels improve in recent years proportionate to improvements in the economy. They need to explain to voters, as Reed and de Maio did in San Jose and San Diego, the connection between escalating pension costs and reduced library hours, underfunded parks, and cracked sidewalks and potholes. It has often been said, in recent years, that crisis breeds opportunity; but with respect to crowd-out, the nature of the problem—and thus the case for reform—may be clearer in good times than in bad. By the time the economy goes back into recession, and California cities must once again turn to federal bankruptcy court to stabilize their finances, it will be too late.

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