SENATE COMMITTEE ON APPROPRIATIONS
Senator Sabrina Cervantes, Chair
2025 - 2026 Regular Session

AB 1383 (McKinnor) - Public employees' retirement benefits

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Urgency: No
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Policy Vote: L., P.E. & R. 5 - 0
Mandate: No
Consultant: Robert Ingenito

Bill Summary: AB 1383 would modify the Public Employees' Pension Reform Act of 2013 to increase (1) pensionable compensation, (2) defined benefit retirement formulas, and (3) contribution cost sharing, as specified.

Fiscal Impact:

- The current California Public Employees Retirement System (CalPERS) actuarial analysis estimates that the bill would increase pension costs for *state, school, and local agency* plans by approximately $4.8 billion in the present value of future benefits (PVB) and increase annual normal cost contributions by approximately $233 million. The estimated impact varies depending on which provisions of the bill are implemented, as follows:
  - Increasing the pensionable compensation limit for all PEPRA members: This provision would increase annual normal cost contributions by approximately $241 million in the first year and increase the PVB by approximately $4.2 billion. The higher costs would apply to all affected employee groups with members whose benefits are impacted by the increased compensation limit.
  - Increase the benefit age factor for PEPRA safety members: This provision would increase annual normal cost contributions by approximately $38 million in the first year and increase the PVB by approximately $560 million. These costs could be partially offset by an unknown amount if earlier retirement reduces workplace injuries or disability-related costs among safety members.
  - Allowing PEPRA and new safety members to receive a 3 percent at age 55 retirement formula: This provision would increase annual normal cost contributions by approximately $353 million in the first year and increase the PVB by approximately $3.4 billion. However, these costs would only occur if an employer and employees negotiate adoption of the enhanced formula through a memorandum of understanding.
- Under current law, PEPRA member and employer contributions generally share the normal cost of benefits equally. Therefore, for the first two scenarios—which would take effect without collective bargaining—the employer share of the

estimated increase in normal cost contributions is approximately $141 million annually across state, school, and local employers (General Fund, special funds, and local funds). Additionally, these estimates reflect costs for current PEPRA members only; employer costs would increase over time as additional employees are hired under the bill's expanded benefit provisions.

- CalPERS would incur approximately $1.2 million in one-time administrative costs for information technology updates, revised publications and training materials, increased member call volume, and program support (Public Employees' Retirement Fund).

Background: ***Pension System Prior to 1999.*** Before 1999, California's public retirement systems, including CalPERS, provided defined benefit pensions based on a formula incorporating three primary factors: (1) years of credited service, (2) age at retirement, and (3) final compensation. Rather than depending on investment returns or employee contributions, retirees received a guaranteed lifetime benefit determined by statute and, if applicable, collective bargaining agreements. Retirement formulas varied by employee classification, with public safety employees generally receiving more generous benefits than miscellaneous employees because of the physical demands and earlier retirement expectations associated with those occupations.

Prior to 1999, the retirement formulas available to state employees were generally more modest than those adopted in subsequent years. For example, many state miscellaneous employees were covered by a formula that provided approximately 2 percent of final compensation for each year of service at age 60 ("2 percent at 60"), while safety employees typically received formulas such as 3 percent at age 50. Final compensation for many members was based on the highest average compensation earned over a three-year period, which moderated pension costs by reducing the effect of end-of-career salary increases.

Senate Bill 400 (1999). Enacted during a period of exceptional investment returns and strong funding levels, SB 400 (Ortiz, 1999) significantly enhanced retirement benefits for many CalPERS members. The legislation was premised on the expectation that robust investment earnings would finance much of the increased cost without requiring substantial additional employer contributions. Among its most significant provisions, SB 400:

- Increased retirement formulas for many state miscellaneous employees from 2 percent at age 60 to 2 percent at age 55, with benefit factors increasing to 2.5 percent at age 63.

- Applied the enhanced benefit formulas retroactively to both past and future service, substantially increasing the pensions of current employees.

- Changed the calculation of final compensation for many state and school members from the highest consecutive three-year average salary to the highest consecutive 12-month salary, resulting in larger pension benefits.

- Authorized numerous state and local employers to adopt enhanced retirement formulas for additional employee groups, particularly public safety employees.

Impact of SB 400. SB 400 substantially increased long-term pension liabilities for CalPERS and participating public employers. Although the legislation was enacted when CalPERS was more than fully funded and investment markets were producing historically high returns, subsequent market downturns—particularly the dot-com collapse and the 2008 financial crisis—revealed that investment earnings alone were insufficient to finance the enhanced benefits. Employer contribution rates increased significantly over time as unfunded liabilities grew, placing additional pressure on state and local government budgets. While investment losses and other actuarial factors also contributed to the growth in pension liabilities, SB 400's retroactive benefit enhancements are widely regarded as one of the principal factors increasing the long-term cost of California's public pension systems.

Assembly Bill 340 (2012) – Public Employees' Pension Reform Act. In response to growing pension liabilities and escalating employer costs, the Legislature enacted AB 340 (Furutani, 2012), establishing the California Public Employees' Pension Reform Act of 2013 (PEPRA). The reforms took effect on January 1, 2013, and primarily apply to individuals who first entered California public retirement systems on or after that date ("new members"). Existing employees (referred to as “classic” members) generally retained the retirement benefits they had already earned. PEPRA implemented numerous reforms designed to reduce future pension costs, including:

- Establishing lower retirement formulas for new employees, such as 2 percent at age 62 for many miscellaneous state employees and 2.7 percent at age 57 for many public safety employees.

- Increasing normal retirement ages for many employee groups.

- Requiring new members to pay at least 50 percent of the normal cost of their pension benefits, subject to collective bargaining.

- Imposing limits on pensionable compensation that may be used to calculate retirement benefits.

- Narrowing the definition of pensionable compensation by excluding certain forms of pay from retirement calculations.

- Restricting pension-spiking practices and placing new limits on post-retirement employment.

Impact of AB 340 (PEPRA). PEPRA fundamentally altered the trajectory of California's public pension systems by reducing the cost of retirement benefits for future employees while preserving the vested benefits of existing workers. Because the reforms generally applied only to employees hired on or after January 1, 2013, the fiscal savings accumulated gradually as the workforce turned over. Over time, the proportion of employees covered by the lower-cost PEPRA benefit formulas has steadily increased, reducing normal pension costs and slowing the growth of future pension liabilities.

PEPRA fundamentally changed the trajectory of California's public pension systems by reducing the cost of retirement benefits for employees hired on or after January 1, 2013, while preserving the vested benefits of existing employees. Because the reforms apply only to new members, their fiscal effects have accumulated gradually as the workforce has turned over. As a result, an increasing share of employees is now covered by lower-cost benefit formulas, reducing normal pension costs and slowing the growth of future pension liabilities.

These reductions, however, do not represent actual budgetary savings or cash available for other state priorities. Instead, they reflect avoided costs—estimates of how much higher employer pension contributions would have been absent PEPRA. Employer pension contributions have generally continued to increase as governments fund benefits earned by current employees and pay down substantial unfunded liabilities associated with benefits earned before PEPRA's enactment. Thus, while PEPRA has improved the long-term sustainability of California's public retirement systems by lowering the cost of future benefits, it has not eliminated existing pension debt or reduced annual pension expenditures in absolute terms.

Thus, PEPRA did not eliminate existing unfunded liabilities associated with benefits previously earned by employees and retirees, which continue to require significant employer contributions. As a result, while PEPRA improved the long-term sustainability of California's public retirement systems, governments remain responsible for amortizing pension obligations that accrued before the reforms took effect.

Proposed Law: This bill, among other things, would do the following:

- Freeze existing PEPRA safety formulas and make them applicable only for service from 2013 to 2026, increase safety retirement plans as of January 1, 2027 for all public employers, and make the new formulas bargainable, as specified.

- Require employers to move, beginning January 1, 2027, from their existing PEPRA safety formula to one of three new, more generous retirement formulas that would give employees at age 55 what their PEPRA formula gives at age 57 unless the parties bargain for a higher or lower formula, as specified. However, the bill would prohibit employers from using impasse procedures to impose a lower plan.

- Establish a bargainable fourth formula that would provide 3 percent at 55 rather than PEPRA’s current maximum formula that provides 2.7 percent at 57.

- Reset, through a two-step modification, PEPRA’s limits on compensation that a retirement system is permitted to include in the calculation of a member’s retirement.
    - First, the bill would increase the 2013 adjusted base on which a retirement system determines the pensionable compensation caps by mandating the system use the 2027 Social Security 430 (b) base instead, for all

retirement system members, non-safety as well as safety. According to CalPERS, this amount for 2026 would be $184,500.

- Second, it would increase for members not covered by Social Security (e.g., safety members) the pensionable compensation cap from 120 percent to 135 percent of the new 2027 Social Security 430(b) base. According to CalPERS, this amount for 2026 would be $249,075.

- After imposing one of the formulas closest to the employer's PEPRA formula, authorize a public employer and a recognized employee organization to negotiate for a different formula for a prospective increase to the retirement benefit formulas for safety members and new safety members.

- Require that benefit formula increases adopted pursuant to this bill, be established in accordance with PEPRA's prohibition against retroactive benefit increases.

Related Legislation:

- AB 1054 (Gipson) would establish a Deferred Retirement Option Program (DROP) to allow participating State Bargaining Unit (BU) 5 peace officers (CAHP) and State BU 8 firefighters (CalFire Local 2881) to elect a deferred retirement date, continue working 1-5 years, freeze their defined benefit (DB) pension benefit accrual, divert their employee contributions and potentially the employer contributions to their DROP account, earn the higher of a guaranteed 5 percent interest or CalPERS' investment return rate on their DROP savings, and upon reaching the deferred retirement date, receive their pension and a one-time lump-sum payment of their program account balance upon termination of employment and subsequent retirement from CalPERS. The bill is currently pending in this Committee.

- SB 292 (Pan, 2015) specified that the requirement for employees subject to PEPRA to pay 50 percent of the actuarial normal cost of their pension benefits does not apply in specific cities and one county in which voter-approved tax levies were enacted prior to 1978 for the purpose of paying pension costs. The Governor vetoed the bill.

- SB 13 (Beall, Chapter 528, Statutes of 2013) made technical corrections to PEPRA in order to clarify the Legislature's intent in enacting PEPRA and to assist affected employers and retirement systems in implementation of PEPRA.

- AB 340 (Furutani, Chapter 296, Statutes of 2012) established PEPRA, which made major revisions to the public retirement systems' laws and applied to all public employers and public pension plans on and after January 1, 2013.

- SB 400 (Ortiz, Chapter 555, Statutes of 1999), among other things, provided enhanced retirement formulas for State Peace Officer/Firefighter members who retire on or after January 1, 2000. The enhanced formula provided a retirement benefit factor of 3 percent at and after age 55 and allowed members to retire, on a discounted basis, as early as age 50 and also provided enhanced pension formulas for state patrol members who retire on or after January 1, 2000. The enhanced formula provided a retirement benefit factor of 3 percent at age 50 and was also available as a contract option for local contracting agencies.

Staff Comments: Pensionable compensation refers to employee pay that is factored into the calculation of the pension benefits an employee will receive upon retirement. PEPRA excludes certain types of pay that do not count toward pensionable compensation, such as transportation reimbursements and unused vacation time, and caps pensionable compensation at a certain amount. The CalPERS pensionable compensation limit for PEPRA members for the 2025 calendar year is $155,081 for social security participants and $186,096 for non-social security participants. In contrast, the limit for classic members is $350,000. As noted above, this bill would increase the pensionable compensation limit for PEPRA members. The comparable limits for 2026, according to CalPERS, would be $184,000 for social security participants and $249,075 for non-social security participants. Increasing the compensation cap ultimately increases the future retirement benefit for PEPRA members who earn in excess of the existing cap. This proposed change accounts for the vast majority of the bill’s fiscal impact.

CalPERS reported a preliminary 14.8 percent net investment return for fiscal year 2025-26, exceeding both its 6.8 percent assumed rate of return and the prior year's 11.6 percent return. Portfolio growth in 2025-26 increased the value of the Public Employees' Retirement Fund to $637.1 billion and improved its funded status from 79 percent to 85 percent.

Staff notes that a pension system's funded status compares the money it has set aside today with the estimated cost of paying all pension benefits that current and former employees have already earned. An 85 percent funded pension system means that, based on current actuarial assumptions, the pension fund has approximately 85 cents for every $1.00 it expects to owe in future benefits. The remaining 15 cents—known as the unfunded liability—must be paid over time through future employer contributions and investment earnings. For CalPERS, even at an 85 percent funded ratio, that remaining gap represents well over $100 billion in pension obligations.

An increase from 79 percent to 85 percent is a significant improvement because it means the pension system is financially healthier than it was a year earlier. Strong investment returns increased the value of the fund's assets, reducing the amount of pension debt that state and local employers must pay down over time. As the funded ratio improves, employer contribution rates may face less upward pressure than they otherwise would.

However, an improved funded status does not mean the pension system has excess money available to increase benefits. The additional investment gains are being used primarily to reduce an existing funding shortfall, not to create a surplus. Increasing pension benefits would increase the system's future liabilities, offsetting some of the recent progress and requiring higher employer contributions over time. In other words, moving from 79 percent to 85 percent is comparable to paying down a mortgage: owing less than before is positive, but it does not mean the homeowner can immediately afford to take on a larger loan. Until the pension system is fully funded and able to sustain higher benefit obligations over the long term, expanding benefits (even only prospectively, as this bill proposed to do) would increase future costs for participating employers and taxpayers.

Finally, as noted above, for PEPRA members current law generally requires employees to pay at least 50 percent of the normal cost of their pension benefit. This bill could increase the normal cost for employee groups that include members whose benefits are affected by the current PEPRA compensation limits, including some non-safety groups. Because PEPRA member contribution rates are generally established at one-half of the normal cost, an increase in the group's overall normal cost would likely result in higher contribution rates for all members of the group unless the employer elects to pay a greater share of the normal cost, which the bill would authorize.

As a result, employees who receive no benefit increase under the bill could nevertheless be required to contribute more toward their pension. For example, lower-paid employees whose salaries are below the pensionable compensation cap and therefore unaffected by the bill could face higher contribution rates to help fund enhanced benefits for higher-paid employees whose compensation exceeds the cap.

Finally, **staff notes** that any pension actuarial analysis is inherently dependent on numerous assumptions regarding investment returns, salary growth, workforce demographics, and other economic and actuarial factors. CalPERS' most recent analysis of this bill is based on data from the June 30, 2024 actuarial valuations. Since that valuation date, economic conditions and market expectations have changed significantly, including increased volatility resulting from changing trade policies, tariffs, geopolitical conflicts, and broader economic uncertainty. As a result, updated actuarial valuations incorporating more recent investment performance and economic data could produce materially different estimates of the bill's impact on pension costs and liabilities.

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