The 2019-20 Budget:

Structuring the Budget: Reserves, Debt and Liabilities

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Executive Summary

After many consecutive years of economic growth, California's budget continues to be on strong footing. The $21 billion surplus available in the Governor's January budget proposal reflects the strong fiscal position of the state. This gives the Legislature a unique opportunity to address a variety of statewide issues and further prepare the state for a recession or other crisis.

Governor's Proposals Put the State on Better Fiscal Footing. The Governor's plan to improve the budget's fiscal position largely is based on a roughly $11 billion plan to pay down retirement liabilities and budgetary borrowing. In addition, the Governor builds more reserves, devotes most of his new spending proposals to one-time commitments, and adds roughly $3 billion in ongoing spending to the budget. We think the Governor's focus on paying down debt is commendable and that the budget's overall structure puts the budget on better footing. That said, we have several suggestions for improving the Governor's plan—alternatives that would likely save the state more money and would put the state in an even better fiscal position.

Building More Reserves Than Proposed by the Governor Would Be Prudent. If the Legislature concurs with the Governor's approach to make roughly $3 billion in new ongoing commitments, but wants to minimize potential reductions to ongoing programs in a recession, we suggest the Legislature consider building more reserves than the Governor proposes. We offer a variety of options for achieving this goal, including building more cash reserves or prepaying retirement liabilities. Because we also agree with the Governor's approach to use a significant portion of discretionary resources to pay down debt, increasing reserves above the level proposed by the Governor could require reducing one-time programmatic proposals.

Options to Improve the Debt Repayment Plan. We have a variety of suggestions for the Legislature to consider that could improve the Governor's debt repayment package and are likely to save the state more money. These options fall into two areas: (1) paying down retirement liabilities and (2) modifying the Governor's proposals to address budgetary borrowing.

Paying Down Retirement Liabilities to Maximize State Savings. The Governor proposes using more than $6 billion General Fund to make supplemental payments to reduce the unfunded liability associated with state employee pensions (CalPERS) and teachers (CalSTRS). Of this total, about $4.1 billion would address the state's share of these systems' liabilities. On these proposals, we suggest the Legislature:

- ***Consider Goal of Supplemental Payments.*** Our understanding is that a supplemental payment to the state's CalSTRS unfunded liability likely would yield a lower savings rate over the next few decades than a payment of the same magnitude to CalPERS. This raises a trade-off for the Legislature. If it would prefer to maximize state savings, then funding CalPERS rather than CalSTRS would be preferable. If, instead, its goal is to address the unfunded liability at both systems, then the Governor's approach is reasonable.
- ***Maximize General Fund Savings When Using General Fund Resources***. The Governor's plan to make a supplemental payment to CalPERS relies exclusively on General Fund money, but achieves savings for both the General Fund and other funds. We offer two options that would maximize the General Fund benefit: (1) devote the entire supplemental

payment to one CalPERS plan which is nearly entirely paid for by the General Fund (Peace Officers and Fire Fighters) or (2) distribute the payment to all state plans and require other funds that benefit from the General Fund payment to repay the General Fund. Under the second option, the benefit to other funds likely would exceed the cost of repaying the General Fund.

Modifying the Governor's Proposals to Address Budgetary Borrowing. The Governor also uses $4.5 billion to address budgetary borrowing, including to repay all outstanding special fund loans, undo two budgetary deferrals, and repay all outstanding settle up owed to schools and community colleges. On these proposals, we have two recommendations. First, we recommend the Legislature reject the Governor's proposal to undo two payment deferrals and consider instead using those resources ($1.7 billion) to build more reserves. Second, we recommend the Legislature pay down high-interest liabilities, like retirement liabilities, instead of using $2.1 billion to repay outstanding special fund loans. For example, the Legislature could maintain the state's current plan to repay these loans over the next few years and use the funds to pay additional amounts toward CalPERS. This would save the state hundreds of millions of dollars relative to the Governor's current plan.

INTRODUCTION

After many consecutive years of economic growth, California's budget continues to be on strong footing. The nearly $21 billion surplus available in the Governor's January budget proposal reflects the strong fiscal position of the state. By historical standards, this surplus is very significant.

The Governor introduces a wide range of policy proposals to achieve a variety of objectives. First, the Governor proposes allocating roughly $11 billion to pay down state debts and liabilities. The Governor also proposes the state continue recent efforts to build more reserves and devotes most of his new spending proposals to one-time commitments. Together, these actions are intended to continue the state's recent progress in preparing for an economic downturn or other crisis.

This report considers the overall structure of the Governor's budget to evaluate how well it prepares the state to address a future budget problem. We begin with background to explain the state budget structure, budget problems, and options for addressing budget problems. We also provide background on the state's existing reserves and debts and liabilities. We then present some key considerations as the Legislature considers its overall budget structure. Finally, we present and assess each of the Governor's major budget reserve and debt and liability proposals and offer some alternatives for legislative consideration.

THE STATE BUDGET STRUCTURE

This section provides background information on the budget's structure.

Each Year, the Legislature Must Pass a Balanced Budget. The State Constitution requires the Legislature to pass a balanced budget each year. Specifically, Article IV prohibits the Legislature from enacting a budget bill that would appropriate more in General Fund expenditures than are available in resources. The General Fund is the state's main operating account, but the state also has hundreds of other separate funds (including, for example, special funds). Each of these individual funds receives revenues (often from fees or bonds), makes expenditures (including for employee salaries and retirement benefits), and has its own reserve level.

Major Features of the General Fund Budget. To ensure the General Fund is balanced, anticipated expenditures must not exceed resources available. There are two main components of available resources:

- ***Revenues.*** Revenues from taxes and fees are the major sources of available resources. The three largest sources of state revenues are the personal income tax (PIT), sales tax, and corporation tax. While some revenue sources, like the sales tax, grow relatively steadily from one year to the next, the PIT is quite volatile—in most years growing by billions of dollars and in some years shrinking by billions of dollars. The PIT makes up over 70 percent of General Fund revenues.
- ***Reserves.*** Budget reserves are monies set aside for future use, like a household's savings account. In a year the state makes a reserve deposit, it reduces revenues available. In a year the state makes a withdrawal from a reserve account, it increases available revenues.

There are three major components of anticipated expenditures:

- ***Constitutional Spending for Schools and Community Colleges.*** Proposition 98 (1988) establishes a constitutional minimum spending requirement for schools and community colleges. The requirement changes each year based upon various factors, including General Fund revenue, per capita personal income, and student attendance. The state meets the requirement through a combination of state General Fund revenue and local property tax revenue. In most years, spending on schools and community colleges comprises about 40 percent of the General Fund budget making it the single largest General Fund expenditure.

- ***Spending on Debt and Liabilities.*** The annual state budget commits billions of dollars each year to repaying state debts and liabilities. As described later, the state's largest liabilities are related to pensions and other retirement benefits. The Legislature has very little discretion over some debt repayments (such as bond debt service and contributions to state employee pension benefits), but considerably more flexibility about how and when to repay other debts.
- ***Other Spending.*** The annual state budget also appropriates billions of dollars to other programs and purposes. After K-14 education, the largest area of state expenditures is health and human services programs (representing about one-third of the General Fund). The Legislature can allocate spending on a one-time basis (that is, for only one year), a temporary basis (for a set period of years), or an ongoing basis (indefinitely). Once made, ongoing expenditures will continue unless the Legislature takes action to end them.

State's Budget Position and Cash Position Differ. The state budget process aligns General Fund revenues with expenditures on an annual basis. This budgetary position is different than the General Fund's *cash position*—a daily or point-in-time estimate of whether the fund has sufficient cash on hand to make expenditures. Although state expenditures are distributed fairly evenly throughout the fiscal year, the state receives most revenues in a few key months (most notably, April, June, and January). As a result, even though the budget is balanced on an annual basis, in a single week or month the General Fund can expend more revenues than it receives, creating a cash deficit. These cyclical cash fluctuations are normal.

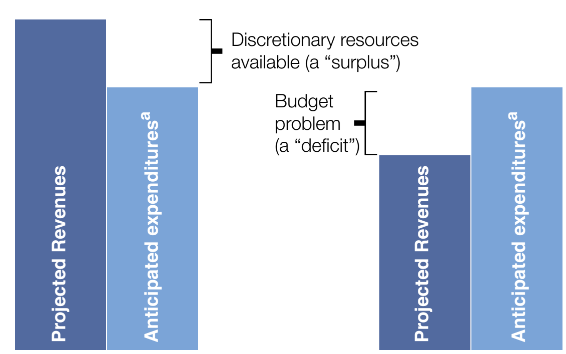
BUDGET PROBLEMS

In some years, state revenues exceed spending under current law resulting in additional resources available to allocate (a "surplus"). In other years, revenues are insufficient to cover current law expenditures and the state faces a budget problem (a "deficit"). Figure 1 illustrates these different situations. The surplus (or deficit) in any given year differs from the budget's operating surplus (or operating deficit), which is the ongoing amount by which revenue growth is expected to exceed spending growth (or, in the case of an operating deficit, the amount by which spending growth exceeds revenue growth).

In this section, we discuss two main drivers of budget problems—recessions and unexpected crises. We then discuss the tools the state can use to prepare for a budget problem and actions the state must take to address a budget problem if its level of preparation is insufficient to cover the entirety of the budget problem.

Figure 1

Budget Can Face a Surplus or Budget Problem



[a] The cost of currently authorized programs before policy changes.

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Sources of Budget Problems

Large Budget Problems Emerge During Recessions. In a recession, revenues decline due to reduced economic activity. Despite this economic slowdown, absent policy changes, much of the state's expenditure base grows relatively constantly. This creates a budget problem in the tens of billions of dollars over the period of multiple years. (During the Great Recession, the federal government provided significant assistance to the state through increased federal spending. In a more moderate recession, such assistance may not be available.)

In a Recession, School Spending Requirement Can Reduce the Size of Budget Problem. Typically, when revenues decline year over year, required constitutional spending on schools and community colleges also goes down. The state has historically responded to these reductions in the minimum requirement by also lowering spending, as Figure 2 shows. By the guarantee dropping and the state lowering spending, schools are sharing in the budget problem and the size of the state's budget problem is reduced accordingly. (As shown in the figure, the state opted not to reduce school spending down to the minimum requirement in 2001-02.)

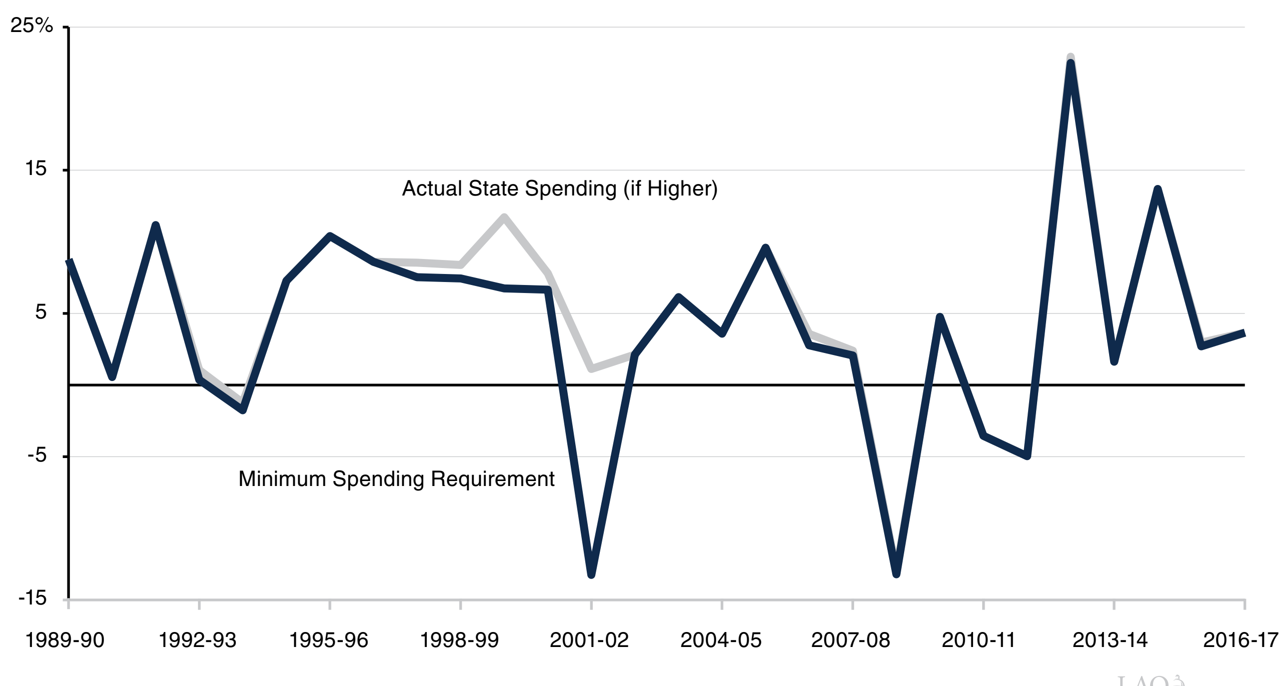
Unexpected Crises Can Significantly Increase Expenditures, Creating a Budget Problem. Although historically much less costly than recessions, unexpected expenses related to natural disasters and other crises can significantly increase the demand on available resources and also cause a budget problem. (In the case of major disasters, the federal government reimburses the state for the majority of certain related expenditures, but these reimbursements do not cover the full cost of the disaster.) Some examples of past events that have caused significant unanticipated costs for the state include:

- ***Loma Prieta Earthquake.*** In 1989, an earthquake in Northern California resulted in severe damage to infrastructure in cities across the region, including the partial

Figure 2

School and Community College Spending Drops in a Recession

Percent Change Over Prior Year



collapse of the San Francisco-Oakland Bay Bridge. In response to the earthquake, the state increased the sales tax by a quarter cent to raise $800 million ($1.6 billion in today's dollars) for disaster relief.

- ***Energy Crisis in Early 2000s.*** When the state's two largest utilities faced serious financial problems in the early 2000s, the state Department of Water Resources began purchasing electricity on behalf of the utilities' customers. The state used proceeds from the sale of long-term electricity bonds to finance $11.2 billion in these costs. (Electricity ratepayers, rather than the General Fund, repaid these bonds financed by a surcharge on electricity bills.) In addition, in response to the crisis, the state spent $1 billion (roughly $1.5 billion in today's dollars) on various conservation and rebate programs in the 2001-02 budget.
- ***2018 California Wildfires.*** In November 2018, the Camp, Woolsey, and Hill fires collectively resulted in the most destructive fire season in state history in terms of loss of life and property damage. While the state costs associated with these events are still evolving, initial estimates suggest these fires will result in additional state General Fund costs of over $900 million for disaster response and debris removal (after federal reimbursements). The Governor also has proposed the state spend some additional funds to assist local governments with their associated costs.

Reserves Are the Main Tool to Prepare for a Budget Problem

Budget reserves are monies set aside for future use, like a household's savings account that is dedicated to emergencies. Reserves help insulate the budget from temporary shortfalls, delaying or mitigating the need for the Legislature to make difficult choices, including spending reductions and tax increases.

Setting Aside Reserves Has Two Major Benefits. Making reserve deposits has two key features that help improve the budget's bottom line. First, making a deposit, rather than increasing ongoing spending, lowers the rate of growth of the state's spending base, shrinking the size of any future budget problem. Second, making a deposit increases the resources available to address a future budget problem.

Illustration of How Reserves Work. Figure 3 shows a hypothetical example of how reserves work. The left side of the figure shows spending from year to year without budget reserves, while the right side shows a budget with reserves. Without reserves, the state must significantly drop spending from year to year during a recession (when revenues decline). With reserves, the state sets aside money during an expansion (lowering spending in those years), but then can use those funds in a recession to reduce the need for budget cuts.

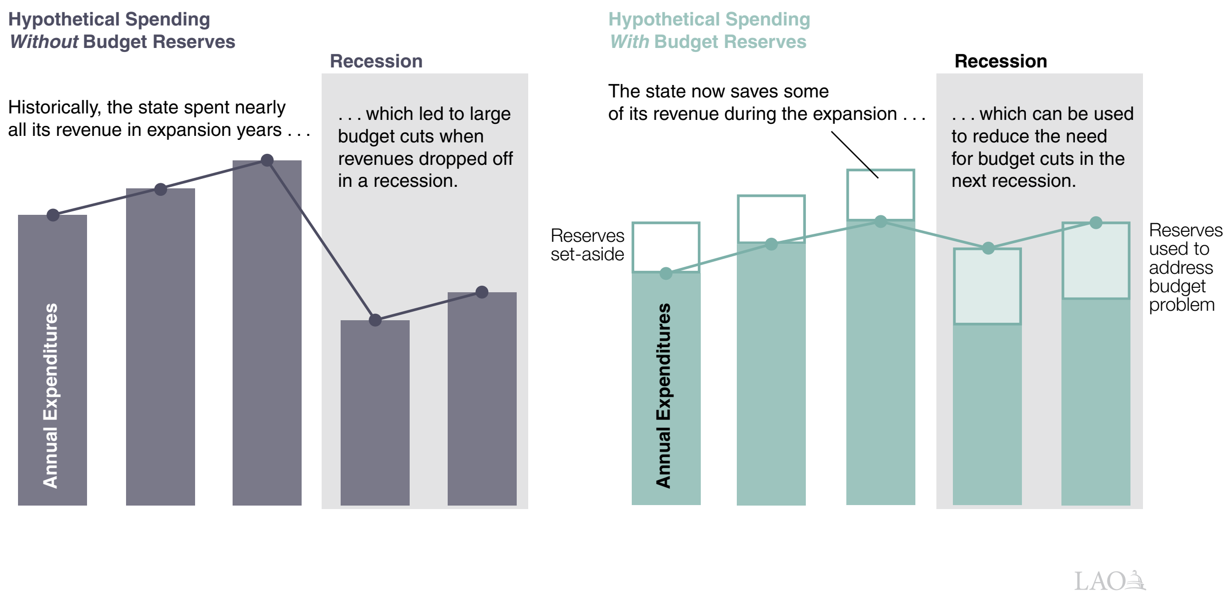
State Has Other Tools to Prepare for a Budget Problem

In addition to reserves, there are other tools the Legislature can use before a recession that help (1) address and/or (2) minimize the size of a future budget problem. Some of these tools have both of these reserve benefits, while others have only one of the two benefits. Specifically, the Legislature can:

- ***Prepay Debt.*** The Legislature can *prepay* future debts, most notably retirement liabilities. For example, in some cases, the state can transfer funds to a pension system early so that, at a later date, the state can reduce its annual required contribution to that system. In this case, the pension system holds this deposit in trust, and the state can use the deposit later in lieu of a future required payment. Prepaying debts has both benefits of reserves.
- ***Pay Down Debt.*** A different tool available to the Legislature is *paying down* future debts, including retirement liabilities (called supplemental payments). In this case, the state transfers additional funds to a pension system to reduce costs over the long-term, saving money on an ongoing basis. Paying down debts has one benefit of reserves

Figure 3

Illustration of How Reserves Work



(it addresses future spending obligations, thereby reducing the size of a future budget problem), but not the other benefit of reserves (holding money available to spend on programs in the future).

- ***Spend on a One-Time Basis.*** One-time programmatic spending also benefits the budget in the event of a budget problem. One-time spending has one of the benefits of reserves (it reduces the size of a future budget problem) but not the other benefit of reserves (holding money available to spend on programs in the future).

Some Tools Have Additional Benefits. Prepaying and paying down debt can have an additional benefit that setting aside funds for reserves does not. Specifically, if the state transfers these funds to a pension system, the system's board can invest the funds, likely earning a higher rate of return than the funds would earn invested as state reserves. In the case of prepaying debt, this benefit is only temporary during the years the pension systems hold onto the funds (before the state applies the funds toward a future payment obligation).

When a Budget Problem Persists, State Must Take Other Actions

If reserves and other tools are insufficient to cover the entire budget problem, the Legislature finds other solutions to address the remaining problem. There are three broad categories of these actions: spending reductions, revenue increases, and cost shifts. For example, to address budget problems in the past, the state has increased taxes; reduced programmatic spending; and shifted costs to local governments, school districts, and future years.

STATE BUDGET RESERVES

This section describes the state's General Fund reserves.

Budget Stabilization Account (BSA). The BSA is the state's general purpose constitutional reserve and it is governed by the rules of Proposition 2 (2014). A set of complicated constitutional formulas requires deposits into the BSA each year until deposits reach 10 percent of the fund's balance. In addition to required deposits, the state has twice made additional, optional deposits into the account. The constitution limits the Legislature's access to funds deposited into the BSA.

Special Fund for Economic Uncertainties (SFEU). The state's other primary general purpose reserve account is the SFEU. Unlike the BSA, which has restrictions on withdrawals, the Legislature has wide discretion to use the funds in the SFEU. Under statutory language that recently expired, the administration also has had authorization to use funds allocated in the SFEU to respond to disasters. Specifically, the administration could transfer funds from the SFEU to a disaster-specific subaccount and then expend those funds for response and recovery activities.

Safety Net Reserve. The 2018-19 budget created the Safety Net Reserve to set aside funds for future costs of two programs—California Work Opportunity and Responsibility to Kids and Medi-Cal—in the event of a recession. Absent policy changes, these programs typically experience increased expenditures during a recession when unemployment increases and their caseloads rise.

School Stabilization Account. In addition to creating new rules for depositing funds into the BSA, Proposition 2 established a specific statewide school reserve account (the Public School System Stabilization Account). This school account is governed by a separate set of formulas. To date, these formulas have not required any deposits. Therefore schools do not have any dedicated state-level reserves available for a recession. As described in the nearby box, however, individual school districts have built up reserves at the local level.

Budget Deficit Savings Account (BDSA). The 2018-19 budget package also created the BDSA as an additional savings account. This account has similar restrictions on withdrawals as the BSA, although these rules are statutory.

STATE DEBTS AND LIABILITIES

This section describes California's major outstanding debts and liabilities and discusses how the state has been addressing them.

Three Primary Types of Debts and Liabilities. California's debts and liabilities fit into three broad categories:

- ***Retirement Liabilities.*** As discussed below, California has unfunded liabilities associated with pension benefits for judges and state employees, retiree health benefits, and the state's share of pension benefits for the state's teachers and school administrators.
- ***Bond Debt.*** These liabilities include the principal and interest amount of outstanding general obligation and lease revenue bonds issued by the state to finance capital infrastructure.
- ***Budgetary Borrowing.*** For the purposes of this report, these are the debts the state has incurred in the past to address its budget problems. These include loans from other state funds to the General Fund and outstanding obligations to other entities, like cities, counties, and school and community college districts.

Retirement Liabilities

Public employees earn retirement benefits (typically pension and Other Post-Employment Benefits [OPEB, most commonly retiree health benefits]) over the course of their careers and then receive the benefits in retirement. The value of the benefits earned by employees constitutes a liability to the employer. In some cases, a substantial share of the liabilities accrued to date has been prefunded through employer and/or employee contributions that have been invested over the course of employees' careers. These investments earn an annual rate of return. In other cases, retirement benefits are paid on a pay-as-you-go basis where employers instead pay the cost of the benefits as they are received by retired employees. To the extent that insufficient assets have been set aside to prefund benefits that have been earned to date—or investment returns have been lower than expected—an unfunded liability exists. In this section, we discuss four major state retirement liabilities.

State Employees' Pensions. Depending on their job, state employees earn pension benefits under one of five state pension plans (Miscellaneous, Industrial, Safety, Peace Officer/Firefighter, and Highway Patrol) administered by the California Public Employees' Retirement System (CalPERS). The state and employees make regular contributions toward these benefits. The state's contributions to CalPERS are made from the General Fund and other funds. As Figure 4 (see next page) shows, the General Fund's share of the state's contribution to each pension plan varies.

Overview of Local School Reserves

School and Community College Districts Have Local Reserves. While the state has not set aside any reserves specifically for schools, school and community college districts have the option to build their local reserves. District reserves can be restricted or unrestricted. Restricted reserves can legally be spent only for specific programs (such as special education), whereas unrestricted reserves can be spent for any purpose. Local reserves can help districts respond to drops in state funding, address unexpected costs, manage cash flow, and save for large purchases.

Some State Policies Promote, Others Discourage, Local Reserves. To promote fiscal stability, the state requires school districts to maintain a minimum level of unrestricted reserves. For an average district, these minimums equal 3 percent of annual expenditures. However, if a district wants to maintain reserves that are more than twice the minimum, it must adopt an annual statement justifying any reserves exceeding that threshold. State law also caps district reserves at 10 percent of expenditures once the balance of the state school reserve reaches a specified threshold. (These caps have never been operative because the state has made no deposits into the state school reserve. Additionally, small school districts are exempt from the cap.) The state does not have any specific policies regarding minimum or maximum reserve levels for community colleges.

School and Community College Reserves Have Been Growing Throughout Economic Expansion. The most recently available data show that school districts' unrestricted reserves totaled $11.7 billion (18 percent of expenditures) in 2016-17, up from $7.6 billion (15 percent) in 2013-14. (Most school districts adopt annual statements justifying their reserve levels.) For community colleges, unrestricted reserves totaled $1.6 billion (21 percent) in 2016-17, up from $1.1 billion (18 percent) in 2013-14. During this period of growing reserves, both school and community college districts were experiencing significant overall funding increases. (Despite these statewide trends, available data show that about 30 school districts and one community college hold reserves of less than 6 percent.)

Figure 4

State CalPERS Plans

(Dollars in Billions)

Plan	State 2019-20 Contribution[a]	General Fund Share of Contribution	Other Funds' Share of Contribution	Total Unfunded Liability	Funded Ratio
Miscellaneous	$3.7	48%	52%	$34.8	68%
Industrial	0.2	70	30	1.0	76
Safety	0.5	45	55	2.9	76
Peace Officer/Firefighter	1.8	98	2	15.2	66
Highway Patrol	0.5	—	100	4.9	60

[a] Includes both normal cost and payments toward the plans' unfunded liabilities.

For example, whereas nearly all of the state's contributions to the Peace Officer/Firefighter plan come from the General Fund, no General Fund dollars go towards the Highway Patrol plan. In total, the unfunded liability associated with the state's CalPERS pension benefits is about $59 billion.

Retired State Employees' Health and Dental Benefits. Eligible state employees receive health benefits in retirement from the state. Although the state adopted a plan in 2015-16 to begin prefunding these benefits for current employees, the state pays for current retirees' health benefits on a pay-as-you-go basis. The state has an unfunded liability associated with the benefit of about $91 billion.

Teachers' Pensions. California teachers earn pension benefits administered by the California State Teachers' Retirement System (CalSTRS). Although the state is not the employer for teachers, it contributes money to the pension system and determines the system's funding policy and benefit levels. (The University of California also administers its own pension and retiree health benefit systems; however, the Legislature does not play a direct role in establishing these benefit-related levels or funding policies.) In 2014, the state adopted a plan to fully fund CalSTRS by 2046. Under the funding plan, the state, school districts (the employers), and teachers make regular contributions to CalSTRS. Further, through a complex calculation, the state and school districts share responsibility to pay down the $104 billion CalSTRS unfunded liability. The state's share of the unfunded liability is about $35 billion. The state's contributions to CalSTRS are paid from the General Fund. School districts use their own general purpose funds to pay these costs.

Judges' Pensions. Supreme and Appellate Court justices and Superior Court judges who were appointed or elected before November 9, 1994 earn pension benefits under Judges Retirement System I (JRSI). Pensions under JRSI are paid by the state on a pay-as-you-go basis. The total unfunded liability of JRSI—assuming the state continues to pay for this benefit on a pay-as-you-go basis—is estimated to be $3.3 billion.

Bond Debt

State Has Two Main Types of Bond Debt. California issues bonds to finance most of its infrastructure spending. Two main types of bonds issued by the state are general obligation bonds and lease revenue bonds. General obligation bonds must be approved by voters. Lease revenue bonds are issued for state facilities and are repaid by the state departments that use those facilities. The state repays bonds with interest to investors who purchase them. The state currently has about $84 billion in outstanding General Fund-supported bond debt and repays a portion of this debt each year.

Budgetary Borrowing

State Has $9.3 Billion in Outstanding Budgetary Borrowing Remaining. Before accounting for the Governor's debt repayment proposals in the January budget, we estimate the state has $9.3 billion in outstanding budgetary borrowing (generally reflecting the most recent estimate available). As shown in Figure 5, the state has made significant progress in addressing these debts in recent years—significantly reduced from an estimated $31 billion in 2014. The remaining budgetary borrowing amounts fall into four categories:

- ***Deferrals.*** To address budgetary shortfalls, at various points, the state made adjustments to expenditure accounting to push costs into different fiscal years, providing a temporary budgetary benefit. The state made three such major changes that are still outstanding: (1) the state converted the Medi-Cal program from an accrual basis to cash, (2) the state deferred employee payroll by dating June payroll checks July 1st, and (3) the state deferred the fourth quarter General Fund payment to CalPERS due in June to July.
- ***Outstanding Mandates.*** Proposition 4 (1979) requires the state to reimburse local governments—including cities, counties, special districts, schools, and community colleges—for new programs or services that the state requires them to provide. The state deferred its reimbursement of these costs as it addressed significant budget shortfalls in the early 2000s. The state has been repaying past due mandates, but still owes about $1.5 billion in outstanding mandates.
- ***Special Fund Loans.*** As one of many actions it took in the 2000s to address its budget problems, the state loaned amounts to the General Fund from other state accounts, particularly special funds. The General Fund is required to repay special funds when needed to ensure the special fund can meet the objectives for which it was created. Courts have given the Legislature latitude in making determinations about when to repay special funds under this standard.
- ***Settle Up.*** Settle up includes past due amounts to schools and community colleges from years in which the estimated constitutional spending requirement turned out to be larger than the amount that was initially included in the budget. Settle up existing as of July 1, 2014 is eligible to be paid from Proposition 2.

Addressing Debt and Liabilities

Different Debts Carry Different Effective Interest Rates. Liabilities tend to grow in cost over time, reflecting an interest or "carrying" cost. Different types of liabilities grow at very different

Figure 5

State Has Made Significant Progress in Addressing Budgetary Borrowing

(In Billions)

Outstanding Budgetary Borrowing	2014	2019
Deferrals of State Spending		
Medi-Cal[a]	$2.0	$2.0
State payroll[b]	1.0	1.0
CalPERS quarterly payment	0.4	0.7
Subtotals	($3.5)	($3.7)
Outstanding Mandates		
Schools and community colleges	$11.5	$0.7
Cities, counties, and special districts	1.9	0.7
Subtotals	($13.4)	($1.5)
Special Fund Loans	$6.7	$2.1
Settle Up	1.5	0.7
Budgetary Borrowing Fully Repaid	**2014**	**2019**
Economic recovery bonds	$4.6	—
Transportation Investment Fund borrowing	0.3	—
Quality Education Investment Act obligation	0.4	—
Subtotals	($5.2)	(—)
Totals	**$30.2**	**$7.9**

[a] Our most recent estimate available to undo Medi-Cal related deferrals is from 2016-17, consequently the cost today is likely higher than this amount.

[b] Includes only General Fund payment proposed for 2019-20.

Note: Figure shows most recent estimate available of outstanding budgetary borrowing before Governor's proposals for 2019-20. Excludes amounts that arise from typical government operations—such as the value of state worker balances.

rates. Left unaddressed, retirement liabilities tend to grow—over the long run—at a rate similar to their assumption for investment returns—currently 7 percent for both CalPERS and CalSTRS. On the other hand, most budgetary liabilities are either fixed or grow at comparatively low interest rates (for example, 1 percent or 2 percent). With respect to bond debt, the state can "refund" many outstanding bonds for a lower interest rate when the prevailing rates in the market decline (similar to the way a household would refinance a mortgage). Because interest rates have been low for many years, much of the state's outstanding bond debt carries a relatively low interest rate. Budgetary borrowing often carries the lowest interest rates of these three types. As such, among the three major types of state liabilities, retirement liabilities carry the highest interest costs.

State Budget Pays Down Billions of Dollars in Debt Each Year. The annual budget pays down several billion dollars of liabilities each year. These include costs to pay down pension unfunded liabilities, debt service on bonds, and budgetary borrowing. For example, as shown in Figure 6, the *2018-19 Budget Act* allocated about $17 billion to pay down state debts and liabilities, including nearly $4 billion to CalPERS to pay down the unfunded liability for state employee pensions and over $5 billion for debt service on general obligation bonds. That said, the state also generates new debts and liabilities each year, for example, when voters authorize new bond sales or financial market losses increase the value of the state's unfunded liabilities.

Proposition 2 Requires Annual Payments Toward Certain Eligible Debts. Proposition 2 requires the state to set aside certain amounts of General Fund spending each year to pay down specific eligible debts. (As with the reserve requirement, these amounts are determined by a set of formulas.) Only some of the debts listed in this section are eligible for repayment under Proposition 2. Specifically, Proposition 2 can be used to pay down a subset of budgetary

Figure 6

General Fund Paid Down $17 Billion in Debts and Liabilities in 2018-19

(In Billions)

Retirement Liabilities[a]	
State employee pensions	$3.6
Teachers' pensions	3.1
Judges' pensions[b]	0.3
Retiree health and dental	2.2
Bond Debt Service	
General obligation	$5.3
Lease revenue	0.7
Budgetary Borrowing	
Special fund loans	$0.8
Mandates	0.5
Other	0.1
Total	**$16.6**

[a] Excludes normal cost except for teachers' pensions.
[b] Pay-as-you-go benefit payments to current retirees.

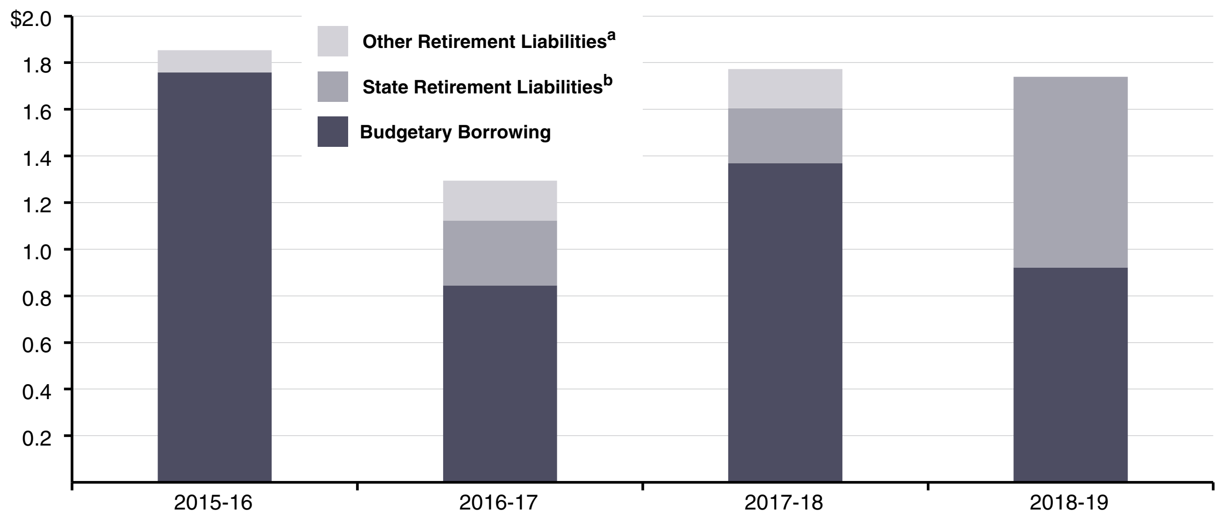
borrowing—most notably, special fund loans—and to pay down state retirement liabilities (that is, payments above what is required under law). Bond debt and some types of budgetary borrowing—like deferrals—are not eligible for repayment under Proposition 2. (Some of the amounts listed in Figure 6 are attributed to annual Proposition 2 debt payments.)

State Has Focused Proposition 2 Payments on Budgetary Liabilities. Figure 7 shows how the state has allocated required debt payments under Proposition 2 since its passage at the end of 2014. Specifically, the state has primarily focused these requirements on repaying budgetary borrowing. Since the 2015-16 budget, the state has repaid $3.7 billion in special fund loans using Proposition 2 (this represents over half of the cumulative required payments since 2015-16). In the most recent fiscal year, the state used a greater proportion of Proposition 2 funding to focus on retirement liabilities.

Figure 7

The State Has Focused Required Debt Payments on Budgetary Borrowing

(In Billions)



[a] University of California Retirement Plan.
[b] In 2018-19 this is primarily to repay the CalPERS borrowing plan.

KEY CONSIDERATIONS IN STRUCTURING THE BUDGET

As discussed earlier, in some years the state faces a budget problem (a deficit) and in other years it has additional discretionary resources available (a surplus). In years a surplus exists, the Legislature must determine how to allocate the resources among reserves and one-time and ongoing commitments. (A budget commitment can either be a spending increase—either for programs or to repay debts—or revenue reduction.) This section provides considerations for the Legislature as it determines the distribution of resources across these three structural components. Figure 8 summarizes these considerations.

Figure 8

Key Considerations in Structuring the Budget

Determining a Target Level of Reserves
- What is the size of the recession for which the Legislature would like to prepare?
- What are the current levels of one-time and ongoing commitments in the budget?
- How willing is the Legislature to take other actions during a recession?
- Would the Legislature like to mitigate reductions to both school and nonschool programs?

Allocating One-Time Spending Between Debt Repayments and Program Commitments
- Would the Legislature prefer to address the state's immediate needs or save money to address more future needs?
- Would the Legislature prefer to address state debts or debts of other entities first?

Setting the Level of Ongoing Commitments
- How quickly are revenues expected to grow under various economic conditions?
- How quickly are existing spending commitments expected to grow under various economic conditions?

Determining a Target Level of Reserves

We often recommend that the Legislature first consider its target level of reserves. There is no single "right" level of reserves. Rather, an appropriate level of reserves in any year's budget depends on a number of factors:

- ***The Size and Length of Future Recession.*** The first consideration in determining a target for total reserves is the size of the next recession—and associated budget problem—for which the Legislature would like to prepare. No one can predict when the next recession will occur or how long or deep it will be. Nonetheless, in determining a reserve target, the Legislature must first assess what it expects economic trends to be in the future and the extent to which it is optimistic or cautious about the economic outlook. In general, a larger reserve increases the likelihood that the state can weather a more severe recession without the Legislature needing to take corrective action (such as increasing revenues, reducing spending, or shifting costs).
- ***Current Level of Ongoing and One-Time Commitments in the Budget.*** The next factor to consider when determining a target level of reserves is the budget's current level of one-time and ongoing commitments, including how ongoing commitments are expected to grow. For example, with more one-time spending, the Legislature needs less reserves because one-time spending does not carry through to the next fiscal year—reducing the size of a potential budget problem. In general, the state needs more reserves if (1) a higher proportion of the state's budgetary spending is ongoing or (2) the state expects significant growth in ongoing spending.
- ***Willingness to Take Other Actions During a Recession.*** We noted earlier that the Legislature has three possible responses to address a budget problem if reserves are insufficient to cover the shortfall. Namely, the Legislature can increase revenues, reduce spending, or shift costs. If the Legislature is more willing to take these actions, less reserves are needed. On the other hand, if the Legislature would prefer to cover most or all of a future budget problem with reserves, then more reserves would be needed.
- ***Whether to Mitigate Reductions to Both School and Nonschool Programs.*** As discussed earlier, the state historically has reduced funding for schools and community colleges when state revenues have declined, corresponding with declines in the constitutionally required funding level. If the Legislature instead wishes to use state reserves to mitigate reductions to school spending levels, additional reserves would be required to cover larger deficits.

Allocating One-Time Commitments Between Debt and Programs

After determining an appropriate level of reserves, we recommend that the Legislature determine how it wishes to allocate one-time commitments between debt repayment or programmatic purposes. As we discuss in this section, there are a number of factors to consider when determining the appropriate balance between these two types.

Balancing Immediate Needs Against Future Needs of the State. Paying down additional debt in the budget reduces the amount of money available today for programmatic purposes. That said, paying down more debt today means the budget has more funds available in the future for any purpose including programs. Because most debts carry an interest cost, spending $1 today to pay down debt saves the budget more than $1 over time. The Legislature may nevertheless have a preference to address some programmatic needs immediately. As such, choosing between paying down debt and one-time programmatic spending is often a balance between the state's current needs and expected future needs.

Weighing State Debts Against Debts of Other Entities (Including Schools). As it determines the amount to pay toward debt, the Legislature can choose to pay state-level liabilities or the liabilities of other nonstate entities, like schools and community colleges. Similarly, the Legislature can choose to allocate General Fund resources to repay only debts incurred by the General Fund or it can use these monies to benefit a broader array of state funds.

Setting the Level of Ongoing Commitments

The third major consideration in the structure of the budget is its level of ongoing commitments. The level of ongoing spending that can be supported by available revenues over a multiyear period is equal to the difference between:

- ***Anticipated Growth of Revenues.*** The budget's capacity for new ongoing spending depends on assumptions about how revenues will grow. For example, the health of the job market, performance of the financial markets, and growth rate of wages will have important implications for how quickly or slowly PIT grows. If the Legislature expects revenues to keep growing at a healthy pace, more resources would be available on an ongoing basis. If revenue growth is expected to weaken, then less new funding is available on an ongoing basis.
- ***Growth of Currently Authorized Spending.*** The next important consideration is the growth rate of existing programmatic commitments. Some programs within the budget grow relatively quickly (for example, several health and human services programs), but others grow more slowly. Programmatic growth also can depend on a variety of factors, like demographic trends and economic conditions. If the Legislature expects existing programs to grow faster than revenues, then no funding is available for new ongoing spending absent other policy changes. If existing programs are growing more slowly, the budget likely has more capacity for new ongoing commitments.

If revenues are expected to grow faster than currently authorized spending, an operating surplus exists and the budget likely has the capacity to take on additional commitments. If, however, anticipated resources are not adequate to cover spending commitments, then the budget might not have capacity for new ongoing spending.

Both Factors Depend on Future Economic Conditions. Both revenue and spending growth depend, to a large degree, on how the economy will perform over the next few years. In the most basic sense, the economy can take one of two paths: either keep growing or enter a recession. Within these two paths, however, there are many different sets of economic conditions that have significant budgetary implications. For example, the level of and growth in employment, wages, the financial market, housing prices, consumer confidence, and many other economic factors can all play a role in how revenues will grow and the budget's multiyear condition.

STRUCTURING THE 2019-20 BUDGET

This section considers the Governor's overall budget structure, reserve proposals, and debt and liability reduction proposals to evaluate how well they prepare the state to address a future budget problem. (Other forthcoming LAO publications will address the Governor's many one-time and ongoing spending and revenue proposals.) Overall, we find the Governor's proposed budget puts the state on better fiscal footing by devoting a significant portion of available resources to paying down debt and focusing spending proposals on one-time purposes. In this section, we also offer some alternatives for the Legislature to consider—alternatives that are likely to save the state more money or better prepare the budget for a future recession. Figure 9 (see next page) provides a summary of our options and recommendations outlined in this section.

Figure 9

Summary of LAO Options and Recommendations on Governor's Reserves and Debt and Liability Proposals

Building Reserves

Building more reserves than proposed by the Governor would be prudent.

Options for building more reserves:

- Build more cash reserves.
- Prepay CalPERS pension costs.

Paying Down Retirement Liabilities

Consider goal of supplemental payments. If Legislature wishes to maximize savings, concentrate payments on CalPERS.

Maximize state General Fund savings when using General Fund resources.

Options that maximize General Fund savings:

- Devote entire supplemental payment to POFF plan.
- Require other funds to repay General Fund for their shares of the supplemental payment.

Addressing Budgetary Borrowing

Recommend rejecting proposal to undo deferrals.

Recommend rejecting special fund repayment proposal and instead use $2.1 billion to pay high-interest liabilities, like pensions.

POFF = Peace Officers and Firefighters.

OVERALL BUDGET STRUCTURE

Our Office and the Governor's Budget Estimated Large Surplus for 2019-20 . . . Our November *Fiscal Outlook* estimated the General Fund would have $14.8 billion in available discretionary resources to allocate in the 2019-20 budget process. Based on the administration's January proposals, we estimated the Governor's available surplus was $20.6 billion. (The difference between these two estimates is largely due to lower than expected Medi-Cal spending under the Governor's budget.) By historical standards, these surplus estimates are extraordinary.

. . . But There Are Some Early Signs Revenues Could Be Weaker Than These Estimates. Revenues in January are roughly $2 billion below estimates for the month under the Governor's budget. This shortfall is almost entirely due to lower than expected estimated payments, which could in part reflect the decline in the financial market at the end of 2018. (There are other factors—including recent changes to federal tax policy—that could explain part of this shortfall.) Final payments in April could make up some of this shortfall, however, there are signs the pace of economic growth is slowing. Home sales in the last quarter of 2018 were 12 percent lower than the same period in 2017. Similarly, housing construction slowed at the end of 2018 with fewer permits issued in the last few months of the year than those same months the prior year. Unemployment claims also ticked up at the end of 2018, however, job growth remained strong through December.

Governor's 2019-20 Budget Structure. The Governor's budget structure for 2019-20 includes four major components:

- ***Increases Reserves by $2.1 Billion.*** Under the Governor's proposed budget and revenue estimates, 2019-20 would end with $18 billion in reserves—about $2.1 billion higher than the level enacted in 2018-19. This would represent about 12.6 percent of General Fund revenues and transfers, somewhat higher than the enacted 2018-19 level of nearly 12 percent.
- ***Pays Down $10.8 Billion in Debts and Liabilities.*** Including constitutionally required debt payments, the Governor proposes repaying $10.8 billion in debts and liabilities in 2019-20. (This total includes required Proposition 2 debt payments.) These planned repayments include $4.1 billion for the state's CalPERS and CalSTRS unfunded liabilities, as well as $2.3 billion on behalf of districts for their share of the CalSTRS unfunded liability. The Governor also proposes repaying $4.4 billion in budgetary borrowing.
- ***Provides $5.1 Billion in Discretionary One-Time Spending.*** After satisfying constitutional requirements and funding current law policies, we estimate the Governor allocated $5.1 billion in available discretionary resources on a one-time or temporary basis for a variety of programmatic expansions.
- ***Provides $2.7 Billion in Discretionary Ongoing Spending.*** The Governor's

discretionary spending proposals also include $2.7 billion in ongoing spending. Because some of these ongoing proposals are phased in over a multiyear period, we estimate the cost at full implementation of all of these ongoing proposals is $3.5 billion.

RESERVES

This section considers the Governor's proposed reserve level for the 2019-20 budget. First, we describe the major components of the Governor's overall level of proposed reserves for the end of 2019-20. Then, we discuss some considerations for the Legislature as it looks ahead to the May Revision and June budget act—in particular, noting some reasons to believe the overall level of reserves could end up lower. Then, we describe some reasons why the Legislature might prefer a higher level of reserves than currently proposed by the Governor. We conclude with some options for legislative consideration that would help build more reserves—and reserve-like benefits—than currently proposed.

Governor's Reserve Proposals

Proposes Total Reserves of $18 Billion. The Governor proposes a total reserve level of $18 billion for the end of 2019-20. As shown in Figure 10, this total reserve would include three components: $15.3 billion in the BSA, $1.8 billion in the SFEU, and $900 million in the Safety Net Reserve. (Due to an accounting error, the SFEU balance is actually about $500 million lower than the administration estimated in mid-January.) Under the Governor's budget assumptions, there would be no balance in either the schools' reserve or the BDSA at the end of 2019-20. We describe the details of these reserve proposals below.

- ***Governor Takes a New Interpretation of Proposition 2.*** Under the rules of Proposition 2, when the BSA reaches a threshold of 10 percent of General Fund taxes, additional funds required under the formulas must be spent on infrastructure. The 2018-19 budget package made an optional deposit into the BSA so that it would reach this constitutional threshold at the end of the year. The Governor takes a new interpretation of these rules, under which optional deposits do not count toward the threshold. Under this new interpretation, the state is required to make a $1.8 billion deposit into the BSA and has no infrastructure spending requirement.
- ***Governor Increases Discretionary Reserves by $546 Million.*** In addition to the required BSA deposit, the Governor increases discretionary reserves (relative to the *2018-19 Budget Act*) by $546 million. This plan lowers the balance of the SFEU from just under $2 billion (enacted in 2018-19) to $1.8 billion (proposed for the end of 2019-20). However, the administration proposes depositing an additional $700 million into the Safety Net Reserve, which we describe in detail in the box on page 18.

Governor Sets Aside Funds for Disasters Within General Purpose Reserves. The Governor further proposes using funding for unexpected costs related to disasters within the state's discretionary reserve, the SFEU. In the past, statutory language has designated a fund for disasters as a subaccount within the SFEU. This statutory language, which expired at the end of 2018, also gave the administration the authority to transfer funds between these accounts as needed to respond to disasters. The administration proposes reauthorizing this language as part of an early action package in the current year.

Figure 10

Total Reserves in Governor's Budget Proposed for the End of 2019-20

(In Millions)

Budget Stabilization Account	$15,302
Special Fund for Economic Uncertainties	1,808
Safety Net Reserve	900
School Stabilization Account	—
Budget Deficit Savings Account	—
Total	**$18,010**

Required BSA Deposit Might Be Lower in May

BSA Deposit Will Be Lower if . . . Under the administration's estimates and assumptions, the state is required to deposit $1.8 billion into the BSA this year. This required deposit could fall, however, under two circumstances (explained below). If this BSA deposit is lower, total reserves would also be lower (absent other policy choices).

. . . Revenues Are Lower. As mentioned earlier, there are some reasons to believe that revenues could be weaker at the time of May Revision relative to the Governor's January estimates. Lower revenues, particularly those from capital gains, in 2019-20 would mean the required BSA deposit will be lower. For example, if capital gains revenues are lower by roughly $1 billion in 2019-20, the required BSA deposit in that year would fall by a few hundred millions of dollars.

. . . Legislature Maintains Previous Interpretation of Proposition 2. The 2018-19 budget package anticipated the BSA would reach its constitutional threshold of 10 percent of General Fund taxes, triggering required spending on infrastructure. Budget trailer language appropriated these future, anticipated spending requirements to three purposes: (1) state infrastructure, (2) rail infrastructure, and (3) multifamily housing. The Governor's interpretation of Proposition 2 eliminates this required infrastructure spending and instead funds additional reserves. If the Legislature maintains its previous interpretation of Proposition 2, infrastructure spending would be higher and the BSA reserve balance would be lower.

Depending on Legislative Priorities, More Reserves Likely Needed

Reserve Targets Assuming No Other Actions. Our past budget publications have estimated ranges of reserves that would be needed for the state to weather various types of recessions with minimal reductions to ongoing programs. Based on

Safety Net Reserve

Governor Proposes to Deposit $700 Million Into Newly Created Safety Net Reserve. In addition to creating the Safety Net Reserve, the 2018-19 budget plan deposited $200 million into a California Work Opportunity and Responsibility to Kids (CalWORKs) subaccount within the reserve. The Governor's 2019-20 budget proposes depositing $700 million more into the reserve and changing its rules so that funds could be used for either CalWORKs or Medi-Cal.

Underlying CalWORKs Costs Increased During Great Recession, Prompting Programmatic Reductions. We estimate that during the Great Recession, baseline costs for the CalWORKs program increased by about $1.6 billion annually by 2010-11 (compared to pre-recession levels). In response to these growing costs and lower revenues, the state enacted several programmatic reductions—including, among other actions, a 12 percent monthly grant reduction—that reduced expenditures in the program by nearly $1 billion per year. This past experience may prove helpful in assisting the Legislature as it evaluates the Governor's proposed Safety Net Reserve deposit. Although a recession as severe as the Great Recession is unlikely, CalWORKs costs (as well as costs for other safety net programs) would nevertheless increase significantly during an economic downturn.

Consider Desired Level of Protection for These Programs. In crafting the 2019-20 budget, the Legislature will want to consider its target level of reserves overall and for the Safety Net Reserve specifically. One key consideration will be whether the Legislature intends to avoid any, or only some, program reductions in CalWORKs, Medi-Cal, and other safety net programs in the event of a budget problem. If the Legislature would like to minimize changes to eligibility or benefits during the next recession, more reserves would be needed.

the experience of recent recessions, we estimate the state would need about $20 billion in reserves to cover a budget problem associated with a mild recession and $40 billion to cover a moderate recession. In last year's *Fiscal Outlook* publication, we estimated $25 billion would be sufficient to cover the budget problem associated with Moody's Analytics "moderate" recession scenario. This scenario is not based on a recent historical example, but rather a model of one possible recession scenario that Moody's believes could materialize in the coming years.

Our Recent Economic Scenarios Suggested $3 Billion Could Be Available for Ongoing Commitments. The budget's target level of reserves should depend, in part, on the amount of ongoing spending currently authorized by the budget. Our *Fiscal Outlook* report from November included the results from two scenarios: economic growth and recession. In both scenarios about $3 billion in ongoing spending was feasible over the multiyear period. Under the economic growth scenario, this was the amount that nearly depleted the budget's operating surplus in the last year of our analysis. In the recession scenario, the budget could cover these commitments before depleting available reserves in the last year of the outlook. (The two scenarios produced in our *Fiscal Outlook* are among the many different paths the economy and state budget could take in coming years. While our growth scenario reflected the consensus among professional economists at the time, it should not be viewed as predictive of what will occur.)

Building More Reserves Now Would Reduce the Need for Programmatic Cuts in the Future. Importantly, our recession scenario from November found $3 billion in ongoing commitments were supportable in a recession scenario, assuming the state entered the recession with $25 billion in reserves—more than the $18 billion now proposed by the Governor. If the Legislature would like to make around $3 billion in new ongoing commitments and wants to minimize reductions to ongoing programs in a recession, building more reserves than proposed by the Governor would be prudent.

If the Legislature Intends to Use General Purpose Reserves for Schools, State's Reserve Needs Are Higher. The above estimate of reserves needed is based on an assumption that the state would fund schools and community colleges at their minimum level. More explicitly, this means that in a recession scenario, General Fund spending on K-14 education would decline even as the state maintains other programmatic spending using reserves. As such, if the Legislature wanted to mitigate reductions to schools and community colleges by using statewide reserves, more reserves would be needed.

If the Legislature Intends to Use General Purpose Reserves for Disasters, State's Reserve Needs Are Higher. When discussing the overall level of state reserves, our office typically considers the amount needed in the event of a recession. In recent years, however, reserves also have been needed to address costs associated with disasters, particularly wildfires. (While a significant portion of these costs are reimbursed by the federal government, some costs are not reimbursed. For example, the administration estimates the state will incur around $1 billion in costs, after reimbursements, for the 2018 wildfires.) The administration proposes to continue to use the SFEU to address disasters in 2019-20. Were a major disaster to occur simultaneously with a recession, reserves would be needed to address *both* the disaster and the budget problem. Given the severity and frequency of recent disasters, more reserves may be necessary to prepare for this possibility.

LAO Options

Build More Reserves. If the Legislature concurs with our assessment that more reserves may be needed, it has other options for building more reserves beyond those proposed by the Governor. For example, to build cash reserves, the Legislature could make a deposit into one of the state's several reserve accounts.

Prepay CalPERS Retirement Contribution . . . Alternatively, to achieve the same benefits of reserves, the state could prepay CalPERS retirement liabilities using a "Section 115 Trust." CalPERS expects it will offer governmental employers a Section 115 trust option by July 1, 2019 under the California Employers' Pension Prefunding Trust (CEPPT) Fund. The state could use CEPPT to set money aside that could be used to make future payments to CalPERS, offsetting a future requirement.

. . . Though Prepaying CalPERS Involves Trade-Off. The option to prepay a retirement liability has a potential additional benefit that building cash reserves does not have. Over time, CalPERS could earn a higher rate of return on the money held in the CEPPT than the state would earn by holding it in reserves (which are invested in low-risk assets that earn a low return). With higher returns comes more risk, however. In the event of a recession, funds available in the CEPPT could decline thereby lowering the amount available for pension payments at that time. (Once financial markets recover, so too would the amount available in the CEPPT.) Consequently, if the Legislature wishes to use such an option, we would recommend it carefully consider the role this transfer would play in the context of the state's overall reserve level and level of risk it wished to take on for assets held in the CEPPT.

DEBTS AND LIABILITIES

This section addresses the Governor's proposals to pay down various debts and liabilities. Figure 11 summarizes all of the debt and liability proposals in the Governor's budget. They fall into two categories: paying down retirement liabilities with supplemental payments and addressing budgetary borrowing. In the remainder of this section, we describe each of these proposals in detail and provide our comments and some alternatives for legislative consideration.

Governor's Proposal to Pay Down Retirement Liabilities

Additional State Payments to Pension Systems' Unfunded Liabilities. The administration proposes that the state make supplemental payments totaling more than $6 billion to reduce CalPERS' and CalSTRS' unfunded liabilities. Specifically, the Governor proposes:

- ***$3 Billion Supplemental Payment to State Employee CalPERS Liabilities.*** The administration proposes making a $3 billion supplemental payment to CalPERS in July of 2019, attributed to expenditures in 2018-19. The administration proposes that the $3 billion payment be distributed across the pension plans in a way that is proportionate to each plan's share of the state's General Fund contribution to CalPERS. (The payment by plan is shown in Figure 12 see page 22.)
- ***$2.3 Billion Supplemental Payment Towards Districts' Share of CalSTRS Unfunded Liability.*** To reduce school districts' share of the CalSTRS unfunded liability, the Governor proposes the state pay CalSTRS an additional $2.3 billion General Fund. This proposal means the state would pay a larger share of the unfunded liability than assigned to it under the 2014 CalSTRS funding plan. (As discussed in the nearby box, the administration also proposes transferring $700 million to CalSTRS to provide school districts with rate relief in 2019-20 and 2020-21; however, this would not reduce the CalSTRS unfunded liability.)
- ***$1.1 Billion Supplemental Payment Toward State's Share of CalSTRS Unfunded Liability.*** The Governor also proposes that the state pay $1.1 billion General Fund toward

Figure 11

Debt and Liability Proposals in the 2019-20 Governor's Budget

(In Millions)

Debt Repayment	Amount
Retirement Liabilities	
CalPERS	$3,000
CalSTRS (districts)	2,300
CalSTRS (state)[a]	1,117
Budgetary Borrowing	
Special fund loans	$2,051
June-to-July payroll deferral	973
CalPERS 4th quarter deferral	707
Settle up	687
Total	**$10,835**

[a] Counts toward state's Proposition 2 debt payment requirement.

the state's share of the CalSTRS unfunded liability. This money would be counted toward Proposition 2 debt repayments. In addition, the Governor proposes that future Proposition 2 debt repayment obligations be used to pay down the state's CalSTRS unfunded liability further. (The administration estimates an additional $1.8 billion would be paid to CalSTRS over the next three years with these payments.)

Potential Savings From Supplemental Payments

Two Different Models for Examining Savings. There are two different ways to estimate the possible savings associated with each of these payments. The first estimate is an *actuarial model*, which is based on one scenario where precise actuarial assumptions (including investment returns) materialize over the next 30 years. For illustrative purposes, such a model would assume a pension system achieves *exactly* a 7 percent rate of return in every year for decades and produces one estimate of savings. Because this does not reflect real world experience with the financial market and investment returns, the second method—called a *stochastic analysis*—examines a range of possible outcomes based on many scenarios. As a result, a stochastic model yields many estimates of savings. We look to the median estimate from this analysis for what savings could be.

District Rate Relief

Budget Provides $700 Million for District Rate Relief. Separate from his proposals to pay down the California State Teachers' Retirement System (CalSTRS) unfunded liability, the Governor proposes providing roughly $700 million over the next two years (roughly $350 million per year) to provide school and community college districts immediate budget relief. Specifically, the payments would reduce districts' CalSTRS rates in 2019-20 and 2020-21—freeing up resources for other parts of districts' operating budgets. Under current law, district rates are scheduled to grow from 16.3 percent of pay in 2018-19 to 18.1 percent in 2019-20 and 19.1 percent in 2020-21. The administration estimates that under its proposal, district rates over the next two years instead would grow to 17.1 percent of pay and 18.1 percent, respectively. The state would make the $700 million payment from General Fund revenues outside of the Proposition 98 minimum requirement.

Administration Proposes District Rate Relief When School Funding Is at Historically High Level and Growing. Most districts identify rising pension costs as one of their most significant fiscal challenges. School funding, however, has grown by nearly $22 billion (37 percent) over the past six years, significantly outpacing growth in pension costs. Adjusted for inflation, school and community college funding per student is at its highest level since the passage of Proposition 98. Under the Governor's 2019-20 budget, school and community college funding continues to grow, increasing a projected 3.6 percent. Though districts view rising pension costs as difficult to manage today, these difficulties will be much more pronounced if the state were to enter a recession and Proposition 98 funding were to drop.

Consider Setting Aside Funding for Future Rate Relief. Rather than providing districts with budget relief over the next two years, the state could modify the Governor's proposal to provide rate relief during the next economic downturn. Under this alternative, the state would set aside funds for school district retirement costs, but not immediately adjust district contribution rates. Later, during a downturn, the Legislature could choose when to apply the additional funds and reduce district rates. Such an approach is beneficial because it mitigates the need for pension rate increases at a time when districts would have less funding and be facing even more difficult budget choices.

CalPERS Contribution Generates General Fund and Special Fund Benefit. Figure 12 shows the results of the CalPERS stochastic model by plan. Under the median scenario, CalPERS estimates the state's $3 billion supplemental payment to CalPERS would save, in total and on net, $6.3 billion. This is considerably higher than the expected savings under the actuarial model ($4.2 billion). Although the General Fund would pay the entire amount of the supplemental payment, it would not realize this entire benefit. Assuming the General Fund share of these savings is roughly in line with the fund's share of payroll costs by plan, the General Fund savings associated with this payment would be roughly $4.4 billion and other funds would accrue the remainder ($1.9 billion). (The actual shares of savings could deviate from these rough estimates somewhat.)

CalSTRS Has Limited Authority to Set Rates . . . The 2014 CalSTRS funding plan established a long-term plan to fully fund the CalSTRS pension system by 2046. Under this plan, the CalSTRS board has limited authority to increase contribution rates—limiting the increase in contribution rates in any given year and the total contribution rates—for the state and school districts until 2046 (at which point contribution rates return to the much lower rates in place before the funding plan). Because of the limitations on the board's rate-setting authority, CalSTRS has less flexibility than CalPERS to increase contribution rates in response to investment losses. This contributes to the state savings ratio from the proposed payments to CalSTRS being lower than a payment to CalPERS over the next few decades.

Figure 12

Anticipated Savings by CalPERS Plan Under Stochastic Model

(In Billions)

Plan	Total Contribution	Net Savings
Miscellaneous	$1.4	$2.9
Industrial	0.1	0.2
Safety	0.2	0.4
Peace Officer/Firefighter	1.4	2.7
Highway Patrol	—	—
Total	**$3.0**	**$6.3**

. . . Meaning the State Might Not Achieve Savings From Contribution to CalSTRS Before 2046. CalSTRS' limited rate setting authority dampens the expected savings to the state compared to what the administration initially asserted. Using *actuarial* assumptions about investment returns, CalSTRS estimates that the proposed $1.1 billion payment to the state's share of the unfunded liability would result in $2 billion net savings through 2046. While we do not have stochastic analysis for this particular payment, we understand there is a roughly 15 percent and 20 percent probability it would show that the state will achieve no savings before 2046. In these scenarios without savings by 2046, CalSTRS actuaries indicate that savings would materialize after 2046. In addition, the average savings ratio under the stochastic analysis is lower than the actuarial estimate.

Consider Options With Greatest Budgetary Benefit

The Governor proposes using General Fund resources to make supplemental payments to CalPERS and CalSTRS. As we discuss below, we think that using these funds differently than proposed by the Governor could have greater budgetary benefits for the state. (We also suggest the Legislature consider the timing of the transfers to CalPERS and CalSTRS, as discussed in the box on pages 24 and 25.)

Consider Goal of Supplemental Payments. The state's supplemental payments to CalSTRS might not result in savings for the state before 2046. Before the Legislature approves the Governor's proposed state supplemental payments to CalSTRS, we suggest it consider the primary objective of the supplemental payments. One objective could be to make steps toward addressing the liability without regard to the level of savings to the state. Another objective could be to maximize state savings within the next few decades. Maximizing state savings creates greater flexibility for the state to address budgetary problems in the future. The proposed state contribution to CalSTRS would make progress toward addressing the system's unfunded liability, but might not achieve as much state savings as other options. The Legislature might want to consider maximizing state savings as the highest priority when considering how to make supplemental payments to retirement benefits. One option for maximizing state savings would be to concentrate pension supplemental payments on behalf of the state to CalPERS. We discuss ways to maximize the General Fund benefit of those payments below.

Maximize General Fund Saving. The Governor proposes using General Fund money to make the supplemental payments to CalPERS—generating both General Fund and special fund benefit. We suggest that the Legislature consider prioritizing General Fund savings when using General Fund resources. Overall, we estimate (based on the CalPERS stochastic model) that under the Governor's proposal the General Fund would only receive $4.4 billion of the $6.3 billion in net savings from a supplemental payment to CalPERS. If the Legislature would prefer to maximize General Fund savings on this General Fund payment, we suggest it consider:

- ***Making Contributions to the Peace Officers and Firefighters (POFF) Plan.*** Nearly all (about 98 percent) of the state's contributions to POFF are from the General Fund. The POFF plan currently has an unfunded liability of $15 billion and a funded ratio of 66 percent. The state could make a supplemental payment to the POFF plan that substantially reduces that plan's unfunded liability and produces savings that almost entirely benefits the General Fund. Although there is substantial General Fund benefit from this approach, making such a large contribution to one pension plan could raise questions about what the state is doing for other pension plans.
- ***Requiring Other Funds to Repay General Fund.*** Alternatively, the state could make supplemental payments to all five CalPERS pension plans—apportioned based on each plan's unfunded liability—but require other funds that benefit from the supplemental payment repay the General Fund. Other funds would still receive a net benefit because they would only need to use a portion of the savings they receive in contribution reductions to pay back the General Fund. In addition to distributing the cost of the supplemental payment across the state's funds, this approach also has the benefit of distributing the benefit across all of the state's five pension plans.

Governor's Proposals to Address Budgetary Borrowing

Repays $2.1 Billion in Special Fund Loans. In addition to the proposals related to retirement liabilities, the Governor proposes fully repaying all remaining special fund loans in 2019-20. The largest of these loan repayments is $768 million to repay "weight fee loans," which are loans to the General Fund from a fund receiving transportation weight fee revenues that—upon repayment—are used for transportation bond debt service. The Governor's plan also includes $236 million to repay a loan from the Transportation Congestion Relief Fund and $200 million to repay a loan from the Greenhouse Gas Reduction Fund. (For a variety of reasons, borrowing from some of these funds may not be available in the future.)

Governor Undoes Two Budgetary Deferrals. The Governor proposes undoing two budgetary payment deferrals with the understanding the state could take these actions again in the future. (This could function similar to a reserve because the state would spend money now and could take action again in the future to achieve savings.) Specifically the Governor proposes reversing the:

- ***June-July Payroll Deferral.*** The 2009-10 budget package included an ongoing one-month deferral of June state payroll to early July, providing savings for the state. This accounting action did not affect when paychecks were issued to state employees. Because payroll costs grow over time, the deferral continues to provide ongoing savings for the state General Fund. For example, in 2016-17, the associated General Fund benefit was $65 million (savings vary from year to year depending on how payroll costs are growing). Undoing this deferral would eliminate this annual benefit. The administration estimates the cost to undo this action will be $973 million for the General Fund. (The state never recognized the deferral in other funds' budgetary statements and, as a result, undoing it would only have budgetary implications for the General Fund.)

- ***Fourth Quarter CalPERS Payment Deferral.*** The state routinely defers its fourth-quarter contributions to CalPERS to the subsequent fiscal year. Because pension costs grow over time, this deferral provides ongoing savings for the General Fund. For example, in 2016-17, this General Fund benefit was $56 million (savings vary from year to year depending on how pension costs are growing). Undoing the deferral would eliminate these savings. The administration estimates the cost to undo this action is $707 million General Fund (other funds' fourth quarter CalPERS payments are not deferred).

Governor Repays $687 Million in Settle Up. The Governor proposes the state repay $687 million in settle up obligations to schools and community colleges. While most of this obligation is eligible for Proposition 2 debt requirements, the Governor does not propose attributing any of it to Proposition 2.

Provide Flexibility by Changing Timing of Debt Repayments

State's Cash Position Varies Throughout the Fiscal Year. Cash flows in the General Fund can swing widely throughout the year. In particular, the state usually faces seasonal cash deficits during the early months of the state fiscal year. Cash surpluses are more common during the second half of the fiscal year. This is because state tax collections are concentrated in the second half of the fiscal year, especially in April (the annual income tax payment deadline), January, and June.

Resources Available Based on Projections. The current estimate of the surplus available to allocate for the upcoming fiscal year is largely based on projections of revenues for the next 16 months. (Some of this surplus is attributable to actual revenues received through the end of 2018.) These estimates are inherently uncertain. Actual revenues over the next year could be lower or higher than current projections by billions of dollars.

Governor Proposes Debt Repayments Early in Fiscal Year, Limiting Flexibility. As the figure shows, the Governor proposes making some key debt repayments in the first month of the 2019-20 fiscal year (although the payments would be attributed to 2018-19). Notably, the Governor proposes transferring $7.1 to California Public Employees' Retirement System (CalPERS) and California State Teachers' Retirement System (CalSTRS) in July 2019. When an employer—including the state—makes a contribution to a pension fund, the employer has no legal right to withdraw the funds at a future date. This means that, once transferred in July 2019, the state would no longer be able to revisit these transfers, even if revenues in 2019-20 end up being significantly below expectations. In this case, the Legislature would only have the option to make adjustments to other parts of the budget (such as by lowering programmatic expenditures).

Recommend Making Transfers to CalPERS and CalSTRS Later in the Fiscal Year. To maintain legislative and budgetary flexibility, we recommend the Legislature schedule any transfers to CalPERS and CalSTRS for later in the fiscal year. While we do not have a reason to believe revenues will fall significantly short of the administration's projections, there is

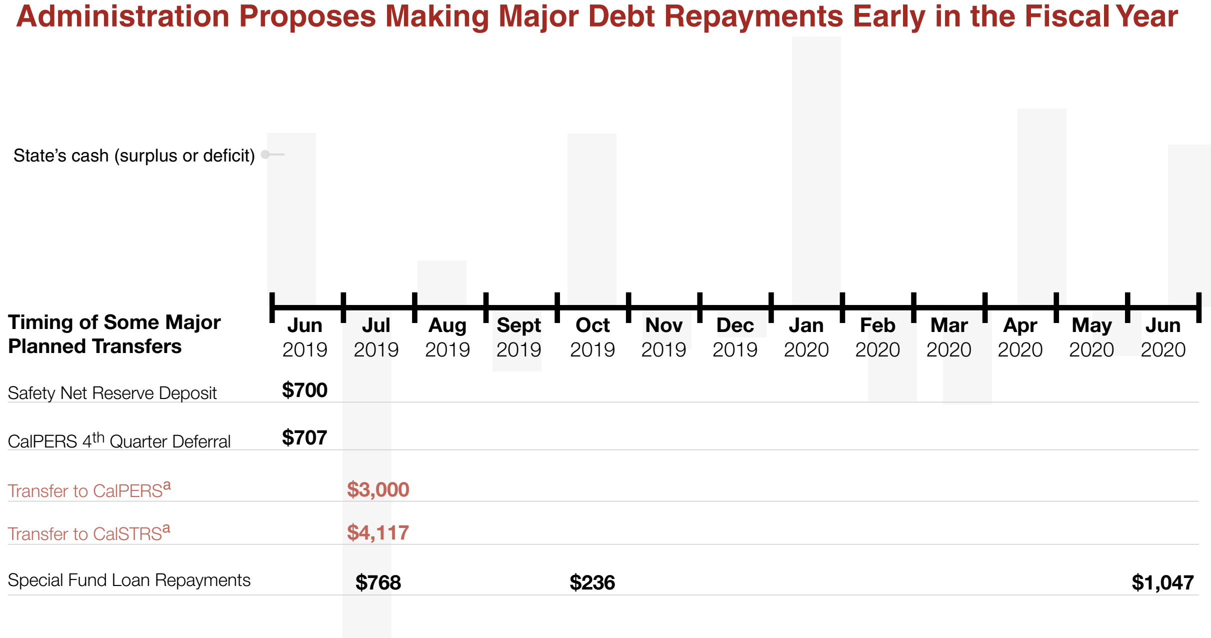
Governor Restructures Multiyear Proposition 2 Debt Repayment Plan. The prior administration had a multiyear plan to repay all remaining special fund loans using Proposition 2 debt payment requirements (in the case of one of these loans, this multiyear plan also is reflected in statute). The new administration proposes repaying all remaining special fund loans this year and does not attribute them to Proposition 2. Using the additional capacity freed up with this action, the administration plans to make additional payments to CalSTRS for the state's share of the system's unfunded liability. In particular, over the next few years, under the administration's estimates and proposals, the state would transfer to CalSTRS $802 million in 2020-21, $615 million in 2021-22, and $345 million in 2022-23. The actual amounts of these payments will vary substantially based on economic and financial market conditions.

Recommend Rejecting Proposal to Undo Deferrals

The Governor proposes undoing two deferrals with the aim of achieving a reserve-like benefit. In both cases, the deferral provides annual budgetary savings. Both of these deferrals involve administrative work to implement. Given these limitations—and the stated intent to reuse these tools in the future—we recommend the Legislature reject the Governor's proposal to undo these deferrals. Instead, the Legislature could use these resources to build additional reserves.

always inherent uncertainty in revenue projections. By scheduling these transfers to occur later in the fiscal year, the Legislature would have the opportunity to observe cash trends in key revenue months and, if needed, make a midyear adjustment to repayments and other planned expenditures. That said, transferring these funds later in the fiscal year does reduce the associated savings somewhat because it forgoes the rate of return the pension systems can earn on the funds in the interim.

Administration Proposes Making Major Debt Repayments Early in the Fiscal Year



[a] Once transfer is made, state cannot retrieve the funds.

Recommend Prioritizing High-Interest Liabilities

Governor's Multiyear Plan Prioritizes Lower-Interest Debts. The Governor's plan to restructure the multiyear Proposition 2 debt repayment schedule uses money today to prioritize low-interest debt (special fund loans) and uses future revenues to pay high-interest debt (the CalSTRS unfunded liability). Moreover, Proposition 2 debt payment requirements are somewhat uncertain and can be higher or lower by several hundreds of millions of dollars each year. If the state enters a recession or the stock market is lower than anticipated, Proposition 2 payments to CalSTRS will be much lower than currently anticipated.

Governor Repays Some Special Fund Loans With Significant Balances. Every state fund faces a unique situation. Some funds have significant reserve balances, while others face structural deficits. The repayments of all remaining outstanding special fund loans would generally repay loans to funds that have significant balances. Figure 13 shows the Governor's proposed special fund repayments for 2019-20, the amount of reserves that each fund is projected to hold *before* these repayments (at the beginning of 2019-20), and the amount that reserve levels represent as a percent of expenditures. As the figure shows, several of these funds currently have significant reserve balances, in several cases exceeding 100 percent of their annual expenditures.

Recommend the Legislature Prioritize Retirement Liabilities Over Budgetary Borrowing. If the Legislature instead prioritizes higher-interest debts over lower-interest debts, the state would save more money over the long term. For example, rather than repaying special fund loans, the Legislature could use $2.1 billion to pay down additional CalPERS liabilities today, saving the state at least hundreds of millions of dollars over the long term. As such, we recommend the Legislature maintain its former multiyear plan for Proposition 2 to repay budgetary borrowing over the next few years and instead dedicate those freed up funds toward retirement liabilities.

Figure 13

Governor Proposes Repaying Some Special Funds With Significant Reserve Balances

(Dollars in Thousands)

Fund	Proposed 2019-20 Repayments	Beginning Reserve 2019-20	Reserves as Percent of Expenditures
Greenhouse Gas Reduction Fund	$200,000	$1,327,411	55%
Vehicle Inspection Repair Fund	90,000	99,669	68
Immediate and Critical Needs Account	90,000	222,483	98
Occupancy Compliance Monitoring Account	57,000	26,533	469
Tax Credit Allocation Fee Account	35,000	43,237	1,071
Gambling Control Fund	29,000	62,263	365
Fingerprint Fees Account	24,000	56,160	58
State Board of Barbering and Cosmetology Fund	21,000	19,304	86
State Corporations Fund	18,500	87,730	139
Hospital Building Fund	15,000	146,826	209
Real Estate Fund	10,900	32,793	57
Firearms Safety and Enforcement Special Fund	4,900	12,408	110
Psychology Fund	3,700	5,197	92
Drinking Water Operator Certification Special Account	1,600	3,688	196
Osteopathic Medical Board of California Contingent Fund	1,500	2,373	74
Physician Assistant Fund	1,500	1,918	87
Acupuncture Fund	1,000	2,971	82

Note: Excludes nongovernmental cost funds and the oil spill response trust fund.

CONCLUSION

The Governor's Budget Puts Forward a Variety of Policy Proposals. The Governor's budget includes a variety of policy proposals, seeking to achieve a range of policy outcomes. By doing so in January, the Legislature can engage in a robust conversation about key choices that will influence the state's budget structure into future years.

Governor's Proposals Put the Budget on Better Footing. The Governor proposes using a significant portion of discretionary resources to pay down state debts and liabilities. Further, he proposes the state build additional reserves and focuses new spending commitments on one-time purposes. These proposals put the budget on better footing to withstand a future budget problem as a result of a recession or another crisis. As the Governor has put it, these proposals improve the budget's resilience.

Building More Reserves Than Proposed by the Governor Would Be Prudent. If the Legislature makes roughly $3 billion in new ongoing commitments, but wants to minimize potential reductions to ongoing programs in a recession, building more reserves now would be prudent. We offer a variety of options for achieving this goal, including building more cash reserves or prepaying retirement liabilities. Because we also agree with the Governor's approach to use a significant portion of discretionary resources to pay down debt, increasing reserves above the level proposed by the Governor would require reducing proposed one-time programmatic spending.

Governor's Debt Repayment Efforts Are Commendable, but Improvements Could Be Made. We think the Governor's approach to devote a significant portion of available discretionary resources to paying down debt is commendable. That said, we have several suggestions for improving the Governor's plan—alternatives that are likely to save the state more money and would put the state in an even better fiscal position. These suggestions fall into two areas:

- ***Paying Down Retirement Liabilities.*** With respect to the Governor's proposals on retirement liabilities, we suggest the Legislature (1) consider focusing state contributions on CalPERS, rather than CalSTRS, unfunded liability and (2) maximize General Fund savings when using General Fund resources.
- ***Addressing Budgetary Borrowing.*** We have two recommendations regarding the Governor's plan to address budgetary borrowing. First, we recommend the Legislature reject the Governor's proposal to undo two payment deferrals and consider instead using these resources to build more cash reserves. Second, we recommend the Legislature pay down high-interest liabilities, like retirement liabilities, instead of using $2.1 billion to repay outstanding special fund loans.

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This report was prepared by Ann Hollingshead and Nick Schroeder, and reviewed by Carolyn Chu. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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