LAO

The 2024-25 Budget:

Proposition 2 Debt Payment Proposals

GABRIEL PETEK | LEGISLATIVE ANALYST | MARCH 2024

SUMMARY

Governor's Proposed Application of the Proposition 2-Related Payment to CalPERS for 2023-24 Appears Unconstitutional. This report evaluates the Governor's Proposition 2 (2014)-related debt and liabilities payment proposals for 2023-24 and 2024-25. While we have no concerns with the Governor's proposed allocation of the 2024-25 payment, the Governor's proposed application of the existing 2023-24 California Public Employees' Retirement System (CalPERS) payment appears to be unconstitutional. That is because the payment would supplant, not supplement, what the state would otherwise provide to CalPERS in 2024-25.

This Report Offers Some Alternatives. Given that the Governor's proposal appears unconstitutional, we outline some alternatives for the Legislature. All of these options involve trade-offs. The first set of options would maximize savings in the budget window, but result in lower savings for future years. The second option results in more savings in the multiyear window, but lower savings for the long term. The final option includes essentially no short-term budgetary savings, but would improve the condition of the state's budget over the very long term.

Balancing Trade-Offs. Given this year's significant budget problem, as well as some specific conditions related to the state's CalSTRS contributions for this year, we think there is a policy argument for the Legislature to use Proposition 2 to achieve budget savings in both 2024-25 and 2025-26. (Relative to the Governor's budget, these alternatives would yield similar savings in 2024-25 and additional savings in 2025-26. Like the Governor's proposal, both of these alternatives would result in less long-term savings for the state.) However, after the state emerges from this period of more acute budget problems, we would urge the Legislature to return to its longstanding policy of maximizing long-term benefits associated with Proposition 2.

INTRODUCTION

This report evaluates the Governor's Proposition 2-related debt and liabilities payment proposals. First, we provide background on: (1) some of the state's pension systems and retirement-related liabilities; (2) Proposition 2; and (3) how supplemental pension payments work, including those that have been made under Proposition 2 requirements in recent years. Second, we describe the Governor's Proposition 2 debt-related proposals. Third, we provide an assessment of these proposals. Finally, because this proposal appears to be unconstitutional, we outline some alternatives for the Legislature to consider.

BACKGROUND

STATE PENSION SYSTEMS

CalPERS

CalPERS administers pension benefits for more than 900,000 active employees and nearly 700,000 retired members. As of January 2024, the system has $483 billion in assets. The state represents about 30 percent of active employees in the system and 35 percent of retired CalPERS members. (Local government employees represent the rest of the membership.)

Three Funding Sources. CalPERS pension benefits have three main funding sources, discussed below.

- ***Investment Returns.*** Under the California Constitution, the CalPERS Board has plenary authority and fiduciary responsibility to invest the pension system's assets. The returns on these invested assets constitute the largest funding source for the system. Revenues from investment returns vary significantly year to year depending on market performance; however, CalPERS assumes an annual return of 6.8 percent.
- ***Employee and Employer Contributions to "Normal Cost."*** The normal cost is the amount actuaries determine must be contributed to the system in a given year to fund the benefit earned by state employees in that year. The normal cost is developed using various actuarial assumptions including assumptions about investment returns on the assets and the life expectancy of members. Under the Public Employees' Pension Reform Act of 2013 (PEPRA), the state has a standard—implemented through collective bargaining—that the state and its employees each pay one-half of the normal cost.
- ***Employer Contributions for "Unfunded Liabilities."*** An unfunded liability means that the projected value of pension benefits earned to date exceeds the projected assets of the pension system. While the state shares normal cost with employees, unfunded liabilities generally are the state's responsibility. One way unfunded liabilities come about is when actual experience differs from what was assumed by actuaries in order for the pension plan to be fully funded. Actuaries spread (or amortize) the effect of these actuarial losses (resulting in higher costs) over a time period specified by CalPERS Board policy. For example, if investment returns are lower than assumed, the actuarial loss creates a new unfunded liability that actuaries amortize over a 20-year period. The amortized cost of paying off the unfunded liability is larger than the actuarial loss itself. This is because the actuarial loss accrues "interest" over time that also must be paid. This interest reflects the gains that otherwise would have accrued had there been no actuarial loss in the first place.

Pension Board Has Full Rate Setting Authority. The CalPERS Board has full rate-setting authority to establish required employer contributions. As we discuss later in this analysis, employers may not pay less than the amount established by CalPERS; however, employers can choose to pay more than the CalPERS Board establishes as the actuarially determined contribution.

California State Teachers' Retirement System (CalSTRS)

Pension System Administers Pension Benefits for Teachers. CalSTRS is the world's largest educator-only pension system, administering the $315 billion Teachers' Retirement Fund for more than 1 million members and beneficiaries (as of June 2023). CalSTRS' 12-member Teachers' Retirement Board (CalSTRS Board) administers the fund and is constitutionally responsible for overseeing the system's investment policies and ensuring that benefit payments are made on time and according to law. An important component of this responsibility is establishing the state's and employers' annual contribution rates, based on actuarial requirements. (CalSTRS Board's contribution rate-setting authority is limited by the law, which we describe in more detail

in later paragraphs.) Similar to CalPERS, CalSTRS receives employee and employer contributions (along with contributions from the state) and relies on investment returns to fund pension benefits through its Defined Benefit Program. However, some elements of CalSTRS' funding structure are distinct from CalPERS', particularly related to unfunded liabilities, as described more in the subsequent paragraphs.

Funding of Pension System Dictated by Funding Plan. Prior to 2014, contribution rates for CalSTRS' Defined Benefit Program were set in statute and the CalSTRS Board had virtually no authority to adjust those rates. Accordingly, even as actuarially required contribution rates changed over the years in response to investment performance, shifts in the teacher and retiree population, and other changes, CalSTRS rates remained essentially static. By 2014, actuaries projected CalSTRS' assets would be depleted within a few decades. The Legislature passed Chapter 46 of 2014 (AB 1469, Bonta), establishing a funding plan with the aim of reversing that projection and fully eliminating the Defined Benefit Program's unfunded liabilities by 2046.

State, School Districts, and Members Pay Base Rate... Under the funding plan, the state, employers, and members all pay annual base rates. The static base rates, which are calculated as percentages of annual creditable compensation, are set in statute and are approximately equivalent to the normal cost of benefits for the CalSTRS' Defined Benefit Program.

...And State and School Districts Share Responsibility for Unfunded Liabilities. In addition, the funding plan divides responsibility for unfunded liabilities between the state and employers, and increases CalSTRS' authority to adjust required annual contribution rates to meet the goal of eliminating unfunded liabilities by 2046. Specifically, the funding plan dictates that, as long as unfunded liabilities remain (during the time that the funding plan is in place), the state and employers pay annual "supplemental rates" to pay down the unfunded liabilities over time. The CalSTRS Board may increase the state's supplemental rate by no more than 0.5 percent of creditable compensation annually, and may increase or decrease employers' supplemental rate by no more than 1 percent of creditable compensation annually. As a result of how CalSTRS implements the division of responsibility for unfunded liabilities between the state and employers, the state's share—and consequently the state's supplemental rate—is particularly sensitive to investment return volatility. (For a more detailed overview of how unfunded liabilities are divided and other aspects of the funding plan, refer to our prior publication, *Strengthening the CalSTRS Funding Plan*.)

Aspects of Funding Plan Result in Years When CalSTRS Cannot Increase State Rate Quickly Enough... The combination of the CalSTRS Board's limited ability to increase the state's supplemental rate and the disproportionate impact of investment return volatility on the state's share of unfunded liabilities can result in years when CalSTRS is unable to collect what is needed from the state. In other words, in some years, the maximum supplemental rate that the CalSTRS Board is able to set for the state in that year is lower than what is actuarially required to eliminate unfunded liabilities by 2046. This is most likely to be the case in years when CalSTRS experiences a significant actuarial loss from lower-than-assumed investment returns.

...And Other Years When CalSTRS Sets State Rate Higher Than What Otherwise Would Be Actuarially Required. In contrast, in some other years, the combination of funding plan factors results in the CalSTRS Board—based on recommendations from system actuaries—electing to set the state's supplemental rate higher than what would be actuarially required in that year to pay down unfunded liabilities by 2046. The CalSTRS Board does this to ensure the state can reach full funding by 2046 given its limited ability to increase the state's supplemental rate in years of actuarial loss, and the outsized impact of investment return volatility on the state's share of unfunded liabilities. This is the current scenario. In 2023-24, the CalSTRS Board set the state's supplemental rate to 6.311 percent (the same rate the state has paid for the past few years), while the "unconstrained" actuarially required rate—what the CalSTRS Board could set as the state's rate if it had full rate-setting authority to meet the goal of eliminating unfunded liabilities by 2046—would be around 3.5 percent according to CalSTRS' most recent actuarial valuation.

Supplemental Pensions Payments

Employers May Contribute Any Amount of Money* Above *What Is Required. Pension boards determine—either according to actuarial standards or statutory requirements—how much money employers must contribute to the pension system each year to address any existing unfunded liabilities. These annual employer contributions are the net effect of actuarial gains and losses amortized over time in order to pay off the entire unfunded liability over time. For some pension plans, such as CalSTRS' Defined Benefit Program and CalPERS' School Pool, assets and liabilities from multiple employers are aggregated together and employers pay toward the collective unfunded liabilities. Other plans—for example the pensions earned by state employees—comprise assets and liabilities accrued by a single employer. While employers, like the state, generally are required to pay the amount specified by pension boards to address unfunded liabilities, in some cases employers can choose to pay *more* than what is required in any given year. These supplemental payments are used to directly pay down existing unfunded liabilities above what otherwise would be required.

Depending on Application of Supplemental Pension Payments, Short- or Long-Term Budgetary Benefits Accrue. A supplemental pension payment can benefit an employer over the short- or long-term, depending on how the payment is applied to the employer's unfunded liability. Often, actuaries amortize a new unfunded liability over decades. Over the course of the amortization period, employers pay down the principal of the unfunded liability as well as interest on the unfunded liability. If an employer wants to maximize savings, given the option, a supplemental payment likely would be applied to the unfunded liability with the longest remaining amortization period—essentially, paying down the principal in order to minimize the interest costs. This action would significantly reduce the employer's costs over decades by avoiding future interest payments but has less of an effect on the short-term costs. On the other hand, if an employer wants to reduce its short-term costs, the payment might be applied to a shorter amortization base. This action would reduce near-term costs but would achieve lower levels of savings overall than applying the payment to a longer base.

Two Common Motivations for Supplemental Pension Payments. There are two common motivations for an employer to pay down pension unfunded liabilities faster than required: (1) reducing future budgetary costs and (2) reducing reported liabilities in annual financial statements. A supplemental pension payment allows pension systems to invest more money sooner. This, in turn, allows for higher investment returns than otherwise would be the case. These higher investment returns reduce future required contributions from employers to the unfunded liability than would otherwise be the case. Accordingly, it is not uncommon for a governmental employer to apply budgetary surpluses towards pension unfunded liabilities in an effort to reduce *future* budgetary costs. In addition to the budgetary benefits, governmental employers might be motivated to make supplemental payments to reduce their reported unfunded liabilities, improving their net position. (The Governmental Accounting Standards Board requires public entities to report their pension unfunded liabilities as part of their annual financial statements.)

State Law Requires Regular State Supplemental Pension Payments. The state has made fully discretionary supplemental pension payments in the past with similar motivations as discussed above. However, state law also requires the state to make regular payments toward existing unfunded liabilities.

- ***PEPRA Requires Limited Payments Above CalPERS Requirements.*** PEPRA established a standard that state employees contribute one-half of the normal cost to fund their pension benefits. Under Section 20683.2 of the Government Code pertaining to CalPERS, any savings that otherwise would have been realized by the state employer as a result of employees contributing more towards their pensions is, instead, directed towards paying down the unfunded liabilities. As a result of this statute, the state regularly contributes a percentage of pay above what is actuarially required and established by the CalPERS Board. In 2024-25, the state's supplemental payment under this section ranges from 0.1 percent of pay for Miscellaneous employees to 1.65 percent of pay for employees in the

Peace Officer and Firefighter pension and is expected to total less than $100 million General Fund.

- ***Constitutionally Required Debt Repayments.*** As we discuss in greater detail below, the voters approved Proposition 2 in 2014 to establish a constitutional requirement that, among other requirements, requires the state to make specified levels of debt payments, including towards pension unfunded liabilities. Accordingly, the state annually makes supplemental pension payments from the General Fund towards the state's pension unfunded liabilities.

PROPOSITION 2

Proposition 2 Contains Annual Debt Payment Requirement. Proposition 2 created new rules regarding: (1) deposits into the state's rainy-day fund and (2) accelerating payments toward certain eligible debts. A formula dictates these requirements on an annual basis. In general, the requirements tend to increase when revenues are growing more quickly and decline when revenue growth is lower. Unlike reserve deposits, which can be suspended in response to a budget emergency, Proposition 2-related debt payments are required every year until 2029-30. (Thereafter, these debt payments become optional, but amounts not spent on debt must be deposited into the rainy-day reserve.)

Annual Payments Required for Pension Unfunded Liabilities or Prefunding Retiree Health Benefits. Originally, eligible debts under Proposition 2 included both budgetary debts and retirement liabilities. However, the state repaid all of the outstanding eligible budgetary debts in 2019-20. The remaining eligible uses of Proposition 2 debt payments are related to prefunding state retiree health benefits and unfunded liabilities associated with state-level pension plans. In past practice, the state has generally interpreted the latter to include the pension systems for: state and California State University employees (CalPERS), teachers (CalSTRS), and the University of California Retirement Plan. In addition, the 2017-18 budget package authorized a plan to borrow $6 billion from the state's cash resources to make a one-time supplemental payment to CalPERS. The state's repayments on this borrowing plan, although not technically pension payments, are also considered eligible for Proposition 2 requirements. (For more information about this debt, see: *The 2017-18 Budget: The Governor's CalPERS Borrowing Proposal* and *The 2018-19 Budget: Repaying the CalPERS Borrowing Plan*.)

Debt Payments Must Supplement—Not Supplant—Funding for Two Years. Proposition 2 includes two requirements limiting how the state can direct payments toward retiree health and pensions. First, Proposition 2 requires these payments to be "in excess" of "current base amounts." The measure defines current base amounts as those amounts that are required to be paid under current law, approved memorandum of understanding, and benefit schedules. Second, Proposition 2 requires that the payments "supplement and not supplant funding that would otherwise be made available [...] for the fiscal year or the subsequent fiscal year."

State Has Focused Proposition 2 Payments on Unfunded Liabilities in Recent Years. Between 2020-21 and 2023-24, the state has made about $10 billion in debt repayments pursuant to the requirements of Proposition 2. Of this total, about 20 percent have been devoted to prefunding retiree health benefits and 65 percent, nearly $7 billion, have been used for supplemental pension payments to reduce the state's unfunded liabilities associated with CalPERS. (The remainder has been used to repay the CalPERS borrowing plan.) For example, as part of the 2023-24 budget, the state made a $1.7 billion transfer to CalPERS to fulfill its Proposition 2 requirements.

These Payments Have Resulted in Long-Term Savings. As discussed earlier, employers have choices about how to apply supplemental pension payments. In particular, they face a trade-off about whether to achieve more total savings over a longer period of time (resulting in less savings in the short term) or more savings over a shorter period of time (resulting in less total savings). In the case of the state's supplemental pension payments to CalPERS made under Proposition 2, the state has chosen to direct the recent payments toward longer amortization bases, resulting in more total savings over a longer period, rather than maximizing near-term benefits.

GOVERNOR'S PROPOSAL

Governor Proposes Using the 2023-24 Payment to CalPERS to Reduce the 2024-25 State Contribution. Although the state has already transferred the $1.7 billion payment to CalPERS associated with the 2023-24 Proposition 2 requirement, how the funds would be applied to the state's unfunded liability has not yet been determined. (Typically, each April the Board adopts final rates, which reflects the application of these supplemental payments.) The Governor proposes applying the state's 2023-24 CalPERS payment to reduce the state's payments toward unfunded liabilities in 2024-25. This results in $1.3 billion in budgetary savings for the General Fund (the remainder of the $1.7 billion in payments would accrue to other state funds) in 2024-25.

Governor Proposes Allocating the 2024-25 Requirement to Various Other Allowable Uses. As is typical, the Governor's budget includes a calculation of the state's Proposition 2 debt payment requirements under the administration's revenue estimates and a proposed allocation for these requirements. (These calculations and proposals will be adjusted in response to changed budget estimates at the time of the May Revision.) Under the administration's revenue forecast, the state has a roughly $2 billion Proposition 2 debt payment requirement in 2024-25. Of this total, the Governor proposes the state allocate: $375 million to prefunding retiree health benefits, $836 million to repay the CalPERS borrowing plan, and $885 million to pay down CalPERS' unfunded liabilities.

ASSESSMENT

No Significant Concerns With the 2024-25 Allocation Plan. We do not have any concerns with the Governor's proposal for allocating the 2024-25 Proposition 2 requirements. As always, the precise amounts of these allocations will change in response to updated revenue estimates later this year.

Proposed Application of 2023-24 Payment Assumed to Reduce State Costs in 2024-25 by $1.3 Billion General Fund... The administration's plan to apply the state's 2023-24 payment toward unfunded liability payments in 2024-25 results in $1.3 billion in savings for the General Fund in that year, helping the state to address the budget problem by that amount. These are amounts that the state otherwise would have been required to pay through the state's annual required contributions under CalPERS policy. In short, savings are achieved because, under the proposal, the state is offsetting the amount the state otherwise would have paid in that year.

...And Provides No Benefit to Future Years. While previous CalPERS payments under Proposition 2 resulted in savings over time, the Governor's proposed application of the 2023-24 payment would mean the state does not yield *any* future savings (after 2024-25) from this payment. That is, all of the savings associated with the payment would accrue to 2024-25 with zero benefit to future years.

Proposed Use of 2023-24 Payment Appears to Violate Constitution by Supplanting State Contribution in 2024-25. The CalPERS Board has full rate setting authority to establish required employer contributions, which means that the final rates adopted by the CalPERS Board for 2024-25 would be required under law. The Governor also proposes to use the 2023-24 payment to supplant the state's actuarially required contributions to CalPERS in 2024-25. This appears to violate the constitution's requirement that the payment supplement, and not supplant, the amounts otherwise provided for the fiscal year and following fiscal year.

ALTERNATIVES

Given that the Governor's proposal appears to be unconstitutional, we outline some alternatives for the Legislature that would also achieve budget savings while adhering to the constitutional requirements of Proposition 2. All of these options involve trade-offs. The first set of options would maximize savings in the budget window—potentially at a similar level as the Governor's proposal—but result in lower savings for future years. The second option results in more savings in the multiyear window, but lower savings for the long term. The final option includes essentially no short-term budgetary savings, but would improve the condition of the state's budget over the very long term. Ultimately, the Legislature will need to balance the trade-offs of any potential option with the need to address the significant budget problem facing the state.

Maximize Savings in the Budget Window

The main benefit of the combination of these alternatives is that it would result in approximately the same General Fund savings as assumed in the Governor's budget. The main trade-off is that it would mean the state pays less toward unfunded liabilities in aggregate compared to recent Proposition 2-related actions.

Use 2024-25 Requirement to Pay for Portion of State's CalSTRS Contribution. As described above, to help ensure CalSTRS is able to meet its statutory goal of fully eliminating the unfunded liability by 2046 within the limitations of the funding plan, in 2023-24 the CalSTRS Board has set the supplemental portion of the state's rate to 6.311 percent. There is an argument that some amount of the state's 2024-25 contribution to CalSTRS could count toward Proposition 2 debt requirements, depending on interpretations and actions by the Legislature. Given this unique situation, the state could explore using Proposition 2 debt payment funding to pay for a portion of its required contribution to CalSTRS in 2024-25. Depending on how the Legislature implemented this option, the state could offset around $1 billion General Fund in 2024-25 by using Proposition 2 funds for this purpose.

Use 2024-25 Requirement to Pay for CalPERS Contributions Above Actuarial Requirements Mandated by PEPRA. As we discussed above, the state makes regular supplemental pension payments required under PEPRA. The Legislature could use a portion of the state's Proposition 2 debt repayment to pay for these supplemental pension payments in 2024-25. Specifically, the Legislature could adopt budget bill language that suspends Section 20683.2 of the Government Code for 2024-25 and directs that a portion of the 2024-25 Proposition 2 debt repayment be applied towards the General Fund payment that otherwise would be paid pursuant to Section 20683.2. This would have the effect of reducing state General Fund costs by about $90 million to $100 million in 2024-25.

Maximizing Savings in the Multiyear

The main benefit of this alternative is that it would help address the state's multiyear deficits. The main trade-off is that it would mean the state pays less toward unfunded liabilities in aggregate compared to recent Proposition 2 related actions.

Apply 2023-24 and 2024-25 Proposition 2 Payments to Supplant State CalPERS Contributions in 2024-25 and 2025-26. Proposition 2 prevents the state from using a required debt repayment from supplanting funding that would otherwise be made available in the "fiscal year or the subsequent fiscal year." In this case, the 2023-24 Proposition 2 payment cannot supplant the state's payments in 2023-24 or 2024-25. However, we think there is an argument that the state could apply the 2023-24 Proposition 2 payment to supplant—meaning directly offset—the state's 2025-26 CalPERS contributions. Similarly, the state could use the 2024-25 Proposition 2 payment to supplant the state's 2026-27 CalPERS contributions. While this action could help address the multiyear deficits that both our office and Department of Finance project for the coming years, it would not (1) help the state address the significant budget problem the state faces in 2024-25 or (2) pay down unfunded liabilities faster than otherwise would be the case.

Maximize Savings Across the Long Horizon

The main benefit of this alternative is that the state would pay down the most unfunded liabilities over the long term. The main trade-off is that additional budget solutions would be required in 2024-25 and beyond.

Keep Policy Consistent With Recent Past. Unfunded liabilities affect the state's finances for decades. Past supplemental pension payments to CalPERS have been used with the goal of having the greatest long-term benefit for the state. For example, applying the payment to the longest amortization base can create the greatest savings for the state over a multi-decade period. In broad terms, policies like these achieve a 2-to-1 savings ratio for the state over the long term. While such action produces the greatest savings to the state over a long period of time, it does not necessarily create budgetary savings in the short term. Rather than looking to Proposition 2 requirements for a budget solution to help address short-term budget problems, the Legislature could use Proposition 2 debt repayments to reduce the state's costs the most over the next few decades.

BALANCING TRADE-OFFS

Rejecting the Governor's Proposition 2 debt proposal—without adopting an alternative solution—would mean $1.3 billion in additional budget solutions would be required in other areas of the budget. As a result, we think there is a policy argument for the Legislature to deviate from its prior approach—that is, maximizing long-term budget savings—this year given the budget's condition. In particular, this year, the CalSTRS Board has approved a rate for the state that is somewhat above the actuarially required contribution. This, in effect, could be considered a supplemental pension payment that the state would be making to CalSTRS for 2024-25. As such, it would be reasonable for the Legislature to choose to fund this difference using Proposition 2 requirements. This could achieve about $1 billion in savings for the state, depending on how it is implemented.

In future years, when the state is paying the actuarially required contributions for both pension systems, the policy rationale for using Proposition 2 to fund the state's otherwise required contributions to CalSTRS would be less clear. Nonetheless, the state is expected to face significant budget problems in the coming years, which means the Legislature might wish to prioritize short-term savings over long-term benefit on a temporary basis. If that is the case, the Legislature could *also* choose to apply the 2023-24 CalPERS payments to supplant state contributions in 2025-26 (the second option among the three we list above). In addition to the $1 billion in savings for 2024-25 associated with the CalSTRS payment, this would generate additional savings, likely of around $1.3 billion, in 2025-26.

That said, after the state emerges from this period of more acute budget problems, we would urge the Legislature return to its longstanding policy of maximizing long-term benefit associated with Proposition 2.

LAO PUBLICATIONS

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

To request publications call (916) 445-4656. This report and others, as well as an e-mail subscription service, are available on the LAO's website at www.lao.ca.gov. The LAO is located at 925 L Street, Suite 1000, Sacramento, California 95814.