CALIFORNIA STATE SENATE

COMMITTEE ON BUDGET AND FISCAL REVIEW

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Agenda

February 7, 2019
10:00 a.m. or Upon Adjournment of Session - State Capitol Room 4203

	BILL	**AUTHOR**	**SUBJECT**
1.	A.B. 72	Committee on Budget	Budget Act of 2018
2.	A.B. 73	Committee on Budget	Privacy: lodging and common carriers: state emergencies: Disaster Response-Emergency Operations Account

Informational Hearing

Budget Resiliency, Pension Payments, and Reserves

1. Panel

    a. Vivek Viswanathan, Chief Deputy Director, Budget, Department of Finance
    b. Ann Hollingshead, Senior Fiscal and Policy Analyst, Legislative Analyst's Office
    c. Scott Terando, Chief Actuary, California Public Employees' Retirement System
    d. Kerry J. Worgan, Supervising Pension Actuary, California Public Employees' Retirement System
    e. David Lamoureux, Deputy System Actuary, California State Teachers' Retirement System

2. Public Comment

SENATE COMMITTEE ON BUDGET AND FISCAL REVIEW
Senator Holly Mitchell, Chair
2019 - 2020 Regular

Bill No: AB 72 **Hearing Date:** February 7, 2019
Author: Committee on Budget
Version: January 28, 2019 As amended
Urgency: No **Fiscal:** Yes
Consultant: Joe Stephenshaw

Subject: Budget Act of 2018

Summary: Amends the 2018-19 budget act to provide resources relating to emergency and disaster events.

Proposed Law: Specifically, this bill:

1) Appropriates $50 million General Fund for an emergency preparedness campaign, as follows: a) $30 million for a statewide campaign through California Volunteers within the Office of Planning and Research, and b) $20 million for local grants for local grants through the Office of Emergency Services.

2) Loans $10 million from the General Fund to the State Emergency Telephone Number Account to enable the State to begin making immediate progress in upgrading the microwave network as part of Next Gen 911 system activities.

3) Appropriates $10 million General Fund to continue emergency water funding for emergency drinking water and technical assistance.

4) Adds $10 million General Fund to local water districts for technical assistance related to compliance with current drinking water standards.

5) Clarifies that funding in the 2018 budget to improve the quality of drinking water in public schools may be awarded as grants to public agencies, public water systems, or non-profit organizations and reappropriates the balance of funds provided in 2016 for the same purposes, clarifying that these funds are to be made available for contracts, as specified.

6) Provides $15 million General Fund to the Department of Finance to retain legal counsel and audit services for any public utility liability issue.

7) Appropriates $31.3 million General Fund to backfill property tax losses incurred as a result of wildfires, including: a) estimated budget year losses for Butte, Lake, Los Angeles, Orange, Riverside, Shasta and Siskiyou counties, and 2) estimated losses in 2019-20 and 2020-21 for the counties of Butte and Lake.

8) Creates the Rapid Response Reserve Fund to address costs arising from immigration and human trafficking emergency situations and deposits $5 million into this new account. This bill gives the Department of Finance authority to move this

funding to any existing general fund budget item and allows any allocation to a non-profit entity using these funds to be exempt from certain contracting requirements.

Fiscal Effect: This bill has a total cost of $131.3 million General Fund, and of this amount $116.3 million was assumed in the Governor's proposed 2019-20 budget package.

Support: None on file.

Opposed: None on file.

Comments: This bill amends the 2018 budget to take early action on items related to emergency and disaster expenditures. This bill, as well as its corresponding trailer bill AB 73, are intended to take immediate action to provide support and relief to communities across California that have or are continuing to experience unexpected costs due to emergency or disaster situations.

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SENATE COMMITTEE ON BUDGET AND FISCAL REVIEW
Senator Holly Mitchell, Chair
2019 - 2020 Regular

Bill No:	AB 73	**Hearing Date:**	February 7, 2019
Author:	Committee on Budget		
Version:	January 30, 2019 As amended		
Urgency:	No	**Fiscal:**	Yes
Consultant:	Joe Stephenshaw		

Subject: Privacy: lodging and common carriers: state emergencies: Disaster Response-Emergency Operations Account

Summary: This bill contains statutory provisions related to public safety and emergency operations necessary to implement the 2018 budget.

Proposed Law: Specifically, this bill:

1) Recreates the Disaster Response Emergency Operations Account (DREOA), which sunset on January 1, 2019, and allows the Director of Finance, subject to specified conditions and upon notification to the Legislature, to transfer money from the State's Special Fund for Economic Uncertainties reserve to the DREOA for expenses related to a disaster declared by the Governor.

2) Clarifies provisions related to the DREOA by defining disaster response operations costs as those that are immediate and necessary to deal with an ongoing or emerging crisis.

3) Specifies that DREOA funds may be expended for activities that occur within 120 days after a proclamation of emergency by the Governor. Allows for the extension of this time limit in up to 120 day increments, but not past the end of the fiscal year in which the Director of Finance first gave notice of an extension.

4) Specifies that the prohibition on places of lodging, bus companies, movie theaters, sports arenas, and performance venues from handing over the name or identifying information of guests, passengers, or audience members, except to California peace officers or in response to a court-issued subpoena, warrant, or order, shall not be construed to prevent a government entity from requiring a private business to provide business records for public health, civil rights, or consumer protection investigation or investigations under the purview of the Public Utilities Commission.

Fiscal Effect: No fiscal impact on the state is anticipated from the adoption of this bill.

Support: None on file.

Opposed: None on file.

Comments: This budget trailer bill is part of a package of two bills related to emergency assistance and disaster response, with AB 72 (Committee on Budget) which amends the 2018 Budget Act.

This bill reestablishes the Disaster Response Emergency Operations Account (DREOA), which was part of the 2018 Budget Conference Committee agreement. The reauthorization of DREOA provides continued flexibility for the state to fund necessary emergency responses. The proposed language also allows for extensions of the authority to use DREOA funding as needed and for up to an additional 120 days at a time, until the end of a fiscal year.

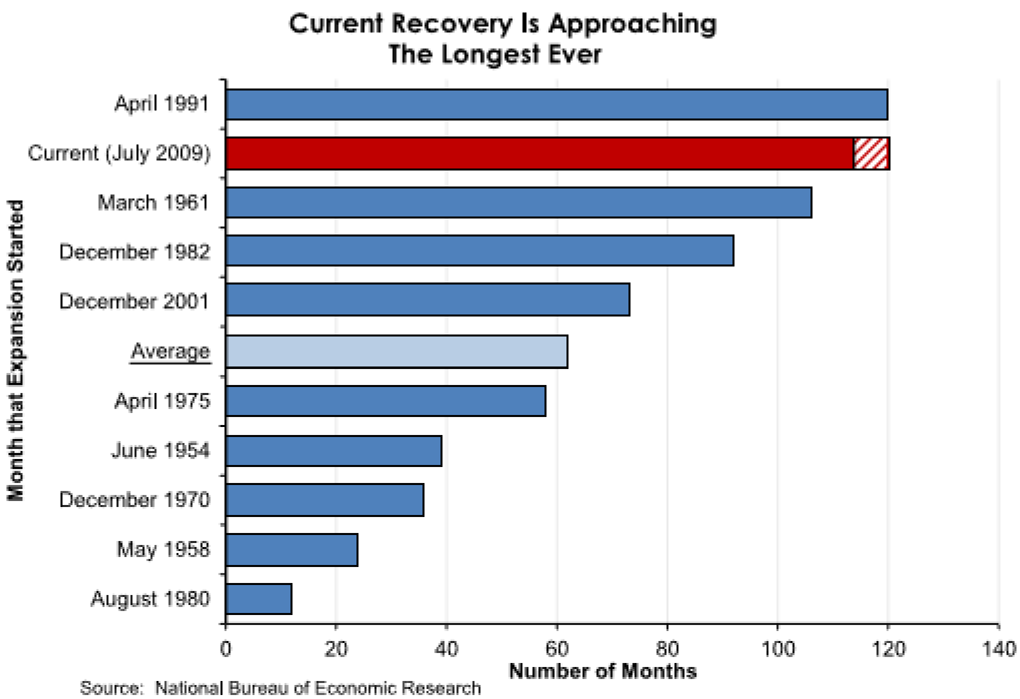
This bill also clarifies provisions of SB 1194 (Lara), Chapter 853, Statutes of 2018, to ensure that government entities have access to necessary information when conducting certain investigations. This amendment addresses an unintended consequence and is necessary to ensure that any investigations that are currently underway are able to proceed accordingly.

-- END --

Reserve Deposits and Debt Payments

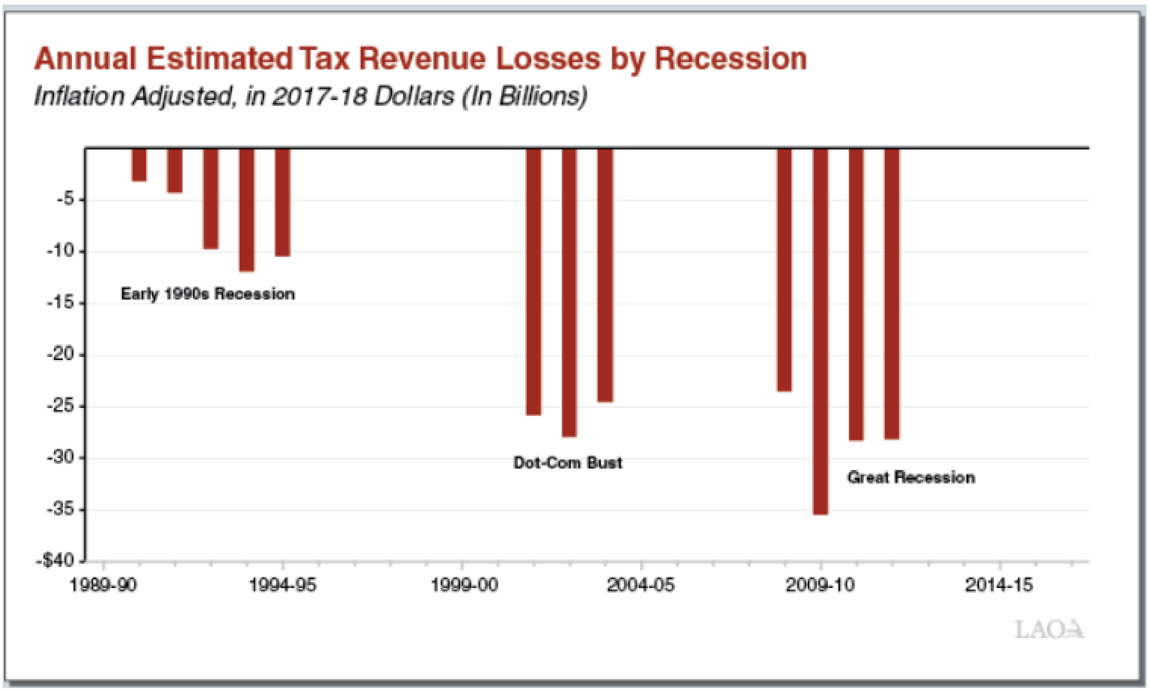
BACKGROUND

As many commentators have noted the last couple of years, the nation's economic expansion has exceeded and continues to exceed norms and expectations. In fact, as the Governor's budget points out (displayed in the below chart from the Governor's budget), by the time the budget year starts, the nation will have experienced 10 straight years of economic expansion—matching the longest economic expansion in modern history. As the state recovered from the last recession and through this expansion, California has built a strong fiscal foundation to mitigate the impacts of future economic downturns.

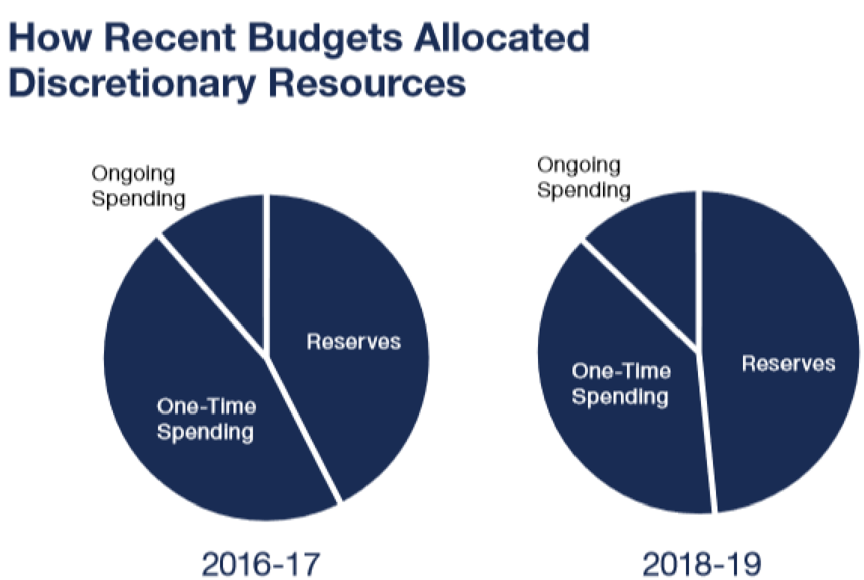


Even though California has strengthened our budgetary resiliency and restored many programs that were severely impacted during the last recession, we still must consider various uncertainties when planning for the state's financial future. Climate change, has factored into recent disasters that will continue to have financial implications and which continues to create threats, uncertainty around federal policies, and the recent volatility in the stock market are some of the major threats to our state's continued economic expansion. Although the Governor's budget assumes modest growth throughout the forecast period, it does also present a recession. That scenario demonstrates that a one-year recession in 2019-20 that is larger than the 2001 recession, but milder than the 2007 recession, could result in a nearly $70 billion revenue loss and a $40 billion budget deficit over three years. For context, the Legislative Analyst's Office (LAO) has estimated (as displayed in the

LAO's chart below) that revenue losses from prior recessions, in inflation-adjusted terms, totaled roughly $40 billion in the 1990s (averaging $8 billion per year across five years), $80 billion in the early 2000s ($26 billion per year across three years), and about $115 billion during and after the Great Recession ($30 billion per year across four years).



As such, the Governor has proposed a budget for the 2019-20 fiscal year that emphasizes resiliency and paying down debts and liabilities while at the same time focusing on one-time investments and limiting the amount of ongoing spending. This approach is similar to approaches in recent budgets. The following chart from the LAO displays approaches taken in two recent budgets.



Overall, the Governor's proposed 2019-20 budget includes $147.9 billion in General Fund revenues and other resources and $144.2 billion in total General Fund expenditures ($88.9 billion in non-Proposition 98 and $55.3 billion in Proposition 98 funds). The proposed budget would provide for a $1.8 billion[1] unencumbered reserve balance in the Special Fund for Economic Uncertainties (SFEU), a $900 million Safety Net Reserve, and reflect $15.3 billion in the Budget Stabilization Account (BSA) (including a $1.8 billion deposit in the budget year). The Governor's proposed 2019-20 budget strategically targets significant one-time investments while committing $3 billion to new expenditures on an ongoing basis.

Budget Stabilization Account (Rainy Day Fund)

The BSA, commonly referred to as the Rainy Day Fund, was created with the passage of Proposition 58, the California Balanced Budget Act, in 2004. Proposition 58 required that three percent of General Fund revenues be deposited into the BSA each fiscal year until the account reached $8 billion or five percent of General Fund revenues, whichever was greater. However, Proposition 58 allowed this annual transfer to be suspended or reduced for a fiscal year by an executive order issued by the Governor. No deposits into the BSA were made pursuant to Proposition 58 until the 2014-15 fiscal year, when the state deposited $1.6 billion. At the time that this 2014-15 deposit was planned, the Legislature had already approved the placement of Proposition 2, the Rainy Day Budget Stabilization Fund Act, on the ballot.

Proposition 2, which revised the state's BSA, was approved by the voters in November 2014. The measure changed the way the state sequesters money in reserves, as well as how it pays down debts and liabilities. Key components of Proposition 2 include that it:

- Requires the annual transfer of 1.5 percent of General Fund revenues to the BSA.
- Requires the additional transfer of personal capital gains tax revenues exceeding eight percent of General Fund revenues to the BSA and, under certain conditions, a dedicated K–14 school reserve fund.
- Requires that half of the BSA revenues be used to repay state debts and unfunded liabilities.
- Caps the BSA at 10 percent of General Fund revenues; directs the remainder to infrastructure.
- Established new conditions for withdrawing funds from the BSA. Specifically, the Governor has to call a budget emergency in situations where estimated resources are insufficient to maintain spending levels or in response to a disaster.
- Requires a "true-up" when the BSA deposit amount is reevaluated twice, once in each of the two subsequent budgets.

Required BSA deposits, pursuant to Proposition 2, began in the 2015-16 fiscal year. As the BSA's balance has increased since then and approached the constitutional maximum amount of 10 percent of General Fund revenues, the Legislature and Governor have elected to deposit additional or

[1] The Department of Finance has revised this amount from the amount presented with the 2019-20 Governor's Budget, $2.283 billion, due to the recognition of the need to reflect $475.3 million of a proposed settle-up payment as an expenditure against the prior year, pursuant to the Legislative Analyst's Offices observation in their overview of the Governor's Budget.

"supplemental" amounts into the BSA, above the constitutionally required minimums ($2 billion in 2016-17 and $2.6 billion in 2018-19).

The 2018-19 supplemental deposit was made to bring the balance of the BSA to the threshold of 10 percent of General Fund revenue (approximately $13.8 billion). In addition, an associated trailer bill appropriated the required infrastructure spending that would be triggered by reaching this threshold for three years, beginning in 2019-20. The funds were specifically dedicated to state capital outlay, rail projects, and multifamily housing. However, based on a Legislative Counsel opinion, the Governor's budget assumes that the constitutional maximum amount in the BSA has not been reached because the supplemental deposits do not count toward this amount. As such, the budget does not assume any funding is available for infrastructure from the BSA until 2022-23.

State Fund for Economic Uncertainties (SFEU)

The 1980-81 Budget Act established the Reserve for Economic Uncertainties within the General Fund. In 1985, the fund was renamed the SFEU. The SFEU is the state's discretionary reserve and is the difference between spending and available resources in any given fiscal year. Article IV of the California Constitution prohibits the Legislature from enacting a budget bill that would appropriate more in General Fund expenditures than are available in resources. This means that, at the time the budget is passed, the estimated balance of the SFEU cannot be lower than zero.

While healthy balances in the SFEU provide the state with a buffer to address unexpected issues in any given fiscal year, such as response and recovery related to the recent wildfires, there are two statutorily triggered reductions in the state's sales tax rate if balances in the SFEU reach a certain threshold. Under either statute, the state's sales tax rate would automatically decline by one-quarter cent for one calendar year. Under the first statute, the trigger would occur if the Director of Finance projects the SFEU to exceed about four percent of General Fund revenues in the prior and current year. Under the second statute, the trigger would occur if: 1) the General Fund reserve exceeds about three percent of revenues and 2) actual General Fund revenues between May 1st and September 30th exceed the Administration's forecasted amounts.

Safety Net Reserve

A budget trailer bill, AB 1830 (Committee on Budget), Chapter 42, Statutes of 2018, associated with the 2018-19 budget established the Safety Net Reserve. Specifically, AB 1830 established the Safety Net Reserve Fund in the State Treasury, created the Medi-Cal and CalWORKs subaccounts within the Safety Net Reserve Fund, and transferred $200 million from the General Fund to the CalWORKs subaccount. The trailer bill also specified that, upon appropriation by the Legislature, the Safety Net Reserve Fund and the Medi-Cal and CalWORKs subaccounts shall be utilized for purposes of maintaining existing program benefits and services for Medi-Cal and CalWORKs programs during economic downturns when caseload and cost-per-case related to these programs increase and state revenues decline. Finally, AB 1830 directed the Department of Finance to develop 1) a methodology, as specified, to calculate savings attributable to caseload and cost-per-case for funding the subaccounts, and 2) a process for the distribution of funds. As part of the Governor's budget, the Administration is proposing changes to the structure of the Safety Net Reserve, which are discussed below.

The purpose of the Safety Net Reserve is to provide another layer of protection for programs that are relied upon by the citizens of our state and are "counter-cyclical" in nature – meaning that as the economy and state revenues decline, caseload growth and overall demand increases.

Budgetary Debt

By the close of 2010-11, the Department of Finance (DOF) indicates that a total of $34.7 billion in loans and deferrals had accumulated and remained unpaid. This amount largely represents the debt overhang from prior year budgets adopted under the previous Administration and was formerly referred to as the "wall of debt." The DOF no longer formally calculates the "wall of debt"; however, the Governor's budget would pay-off the remaining amount outstanding special fund loans, deferrals and settle-up that were included within the calculation.

Some of these obligations required repayment in specified years due to constitutional requirements or due to scheduled bond debt service. Other debt payments have been more flexible and have been or can be repaid over time depending upon the budget condition, as long as borrowing does not interfere with the activities that a special fund loan supports.

GOVERNOR'S PROPOSAL

Budget Resiliency and Paying Down Retirement Liabilities – The Governor's proposed 2019-20 budget allocates $13.1 billion (including debt payments and BSA reserve deposits) to building budgetary resiliency and paying down the state's unfunded pension liabilities. This includes $4 billion to eliminate debts and reverse deferrals, $4.3 billion to build reserves, and an additional $4.8 billion to pay down unfunded retirement liabilities (these are discussed in more detail in the next section). These investments are intended to better enable the state to protect funding for schools and other core programs that serve the state's neediest individuals during the next economic slowdown.

The debt and deferral payments include:

- $2.4 billion to pay off the state's budgetary debts, including the elimination of all outstanding loans from special funds and transportation accounts. This would mark the first time in over a decade that the state would have completely paid off these debts. It is of note that the Governor plans to make these payments utilizing General Fund resources instead of continuing the use of Proposition 2 debt payment funds.
- $1 billion to eliminate the annual payroll deferral. The one-month deferral of the June payroll provided a one-time budget savings that was used to help balance the budget nine years ago. The state has been deferring this payment ever since; this action eliminates this long-standing practice.
- $700 million to eliminate the deferral of the fourth-quarter payment to the California Public Employees' Retirement System (CalPERS). Similar to the payroll deferral, this action reverses a one-time budget savings that was used to help balance the budget over a decade ago.

BSA Proposal

In order to continue to build the state's budgetary reserves, the Governor's budget assumes an additional $1.8 billion transfer to the BSA in the budget year. The following chart outlines the Governor's BSA assumptions for the budget year.

Proposal for Proposition 2 – Rainy Day Fund (Dollars in Millions)

	2019-20
1.5% of General Fund (GF) Revenues	
GF Revenues and Transfers (before BSA transfer)	$144,385
1.5% of GF Revenues and Transfers	**$2,166**
Capital Gains Revenues	
GF Tax Proceeds	$145,415
Personal Income Taxes from Capital Gains	13,845
Percent of GF Tax Proceeds from Above Line	9.5%
8% of GF Tax Proceeds	11,633
Excess of 8% from PIT Capital Gains	2,212
Prop 98 Share of Capital Gains above 8%	845
Non Prop 98 Share of Capital Gains above 8%	**$1,367**
Total Available	$3,533
Debt Repayment (50%)	1,767
Deposit to Rainy Day Fund (50%)	1,767
Discretionary Balance	***3,530***
Mandatory Balance	***11,772***
Cumulative Balance	**$15,302**

In addition to the reserve deposit, the Governor's budget proposes $1.8 billion in debt and liability payments pursuant to Proposition 2, as displayed in the following chart.

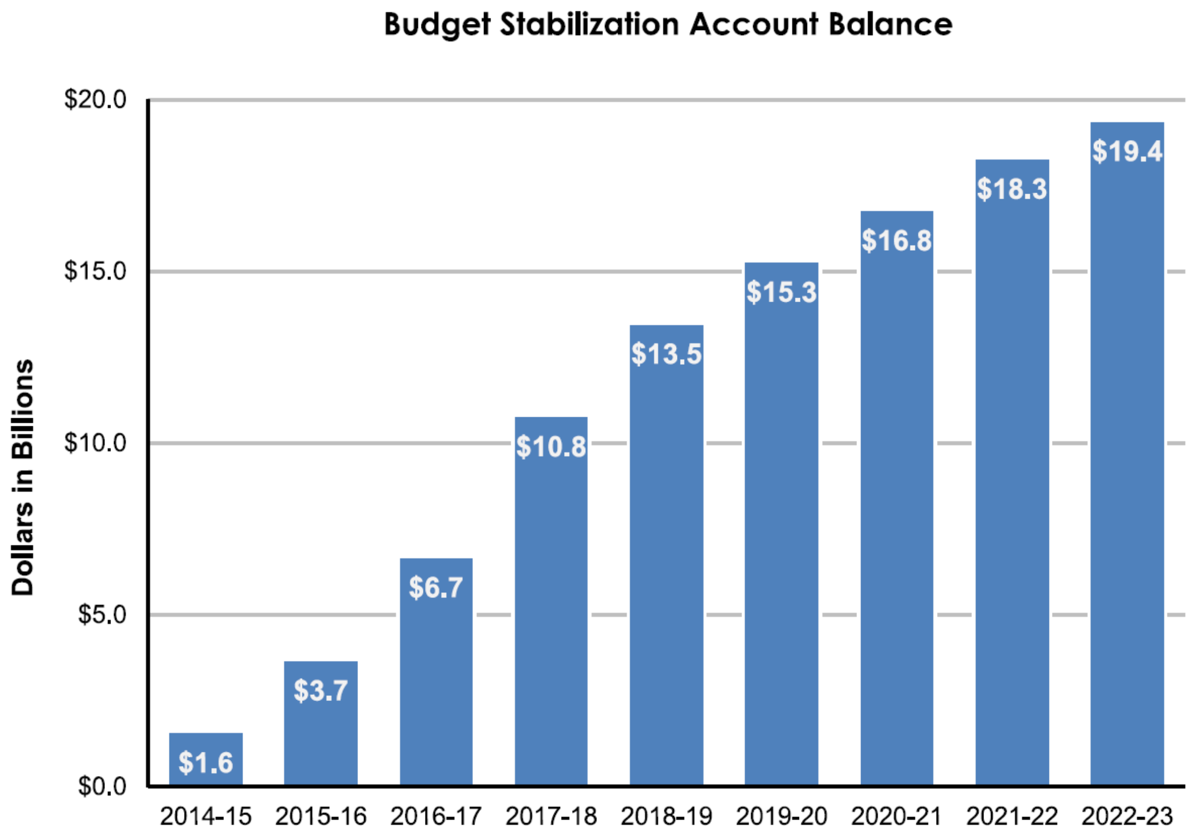
Proposal for Debts and Liabilities Payments (Dollars in Millions)

Category	**Amount Beginning of**	**Payment in 2019-20**
Retirement Liabilities		
State Retiree Health	$91,008	$260
State Employee Pensions	58,765	390
Teacher Pensions[1]	103,468	1,117
Judge's Pensions	3,277	0
Grand Total	**$256,518**	**$1,767**

[1] The state portion of the unfunded liability is $35.3 billion.

Beyond the budget year, the Governor's budget assumes an additional $4.1 billion over the remainder of the forecast period, bringing the Rainy Day Fund to $19.4 billion by 2022-23.

As noted above, of significance and per a legal opinion, the budget assumes that supplemental payments made in prior years do not count toward calculating the limit of 10 percent of General Fund tax revenues set in the Constitution. Consistent with this opinion, the budget continues to make required deposits in the Rainy Day Fund. The following table from DOF displays projected BSA balances under the Governor's budget proposal.



Safety Net Reserve

In addition to the BSA deposit, the Governor's proposed budget also adds $700 million to the Safety Net Reserve created in the 2018 Budget Act, bringing the total in this reserve to $900 million. This reserve sets aside funds specifically to protect safety net services during the next recession. The Governor has also proposed trailer bill language that would abolish the Medi-Cal and CalWORKs Subaccounts within the Safety Net Reserve, eliminate duties imposed upon DOF, and specify that use of funds in the account are subject to appropriation by the Legislature for purpose of maintaining existing program benefits and services for the Medi-Cal and CalWORKs programs during economic downturns.

Finally, the budget reserves $1.8 billion in the SFEU to address emergencies and unforeseen events.

CalPERS and CalSTRS

BACKGROUND

Over the last several years, the state implemented various reforms to address the state's unfunded pension liabilities. For example, the California Public Employees' Pension Reform Act of 2013 (PEPRA) capped benefits, increased the retirement age for new employees, and required them to pay at least half the normal costs to pay for future pension benefits. In 2014, the state enacted a funding plan to fully fund the California State Teachers' Retirement System (CalSTRS) by 2046. In 2017, the state provided California Public Employees' Retirement System (CalPERS) a $6 billion supplemental pension payment to address their unfunded liability. While the state's employee pension costs continue to grow, these efforts have placed the state in a better fiscal position to address them.

The California Public Employees' Retirement System

CalPERS administers retirement benefits for about two million active employees and retirees of state and local agencies in California as of June 30, 2018. Benefits include retirement, disability, and survivor retirement benefits. CalPERS also provides health benefits for approximately 1.5 million active and retired state, local government, and school employees and their family members as of June 30, 2018. CalPERS develops, negotiates, and administers contracts with health maintenance organizations, group hospitals, and medical insurance plans. In addition, CalPERS administers a long-term care program for members and eligible individuals. CalPERS is governed by a Board of Administration, which is composed of 13 members: six elected members, three appointed members, and four ex-officio members. The California Constitution provides the CalPERS Board of Administration authority over the administration of the retirement system with the exception of the Health Benefits Program.

CalPERS Budgeted Expenditures and Positions
(Dollars in Millions)

	2017-18	2018-19	2019-20
Retirement	$93.5	$106.3	$106.3
Health Benefits	$64.8	$74.4	$74.4
Investment Operations	$68.7	$74.1	$74.1
Administration	$192.7	$217.3	$218
Benefit Payments	$27,776	$29,480	$31,244
Unscheduled Items of Appropriation	N/A	$3,000*	N/A
Positions	**2,708**	**3,005**	**3,005**

*The Administration's 2019-20 budget proposes a supplemental payment of $3 billion General Fund payment in 2018-19 to address the CalPERS unfunded liability.

Public Employees' Pension Reform Act (PEPRA). In January 2013, PEPRA modified the way CalPERS retirement and health benefits are applied, placing compensation limits on members, with the greatest impact on new employees hired after January 1, 2013. Below is a brief summary of some of the components of PEPRA.

- Reduced Benefit Formulas and Increased Retirement Ages – PEPRA established retirement benefits of two percent of the employee's final compensation at age 62 for all new miscellaneous (non-public safety) members with an early retirement age of 52, and a maximum benefit factor of 2.5 percent at age 67. PEPRA also created three defined benefit formulas for new safety members. Previously, the benefit formula was two percent of the employees final compensation at age 55 for state employees hired between January 15, 2011 and December 31, 2012, and two percent of the final compensation at age 60 for new employees hired prior to January 11, 2011.

- Capped Pensionable Compensation – Caps the annual salary that can be used to calculate final compensation for new members, excluding judges, at $113,700 for employees that participate in Social Security, or $136,440 for those who do not, which may be adjusted based on changes to the consumer price index. Previously, first-time members hired after January 1, 1996 had a compensation cap, which was set by the Internal Revenue Service and was referred to as the 401(a)(17) limit.

- Equal Sharing for the Normal Costs – For public agencies, schools employers, the CSU, and the judicial branch, a new member's initial contribution rate will be at least 50 percent of the total normal cost rate or the current contribution rate of similarly situated employees, whichever is greater, except as provided in an existing memoranda of understanding.

  Starting January 1, 2018, public agency and school employers that collectively bargained may require classic members to pay up to 50 percent of the total normal cost of their pension benefit after certain conditions are met. However, the employee contribution can only be increased by specified percentages for various classifications.

  Additionally, CalPERS has rate setting authority and employer and member rates are examined every year in the fall. Changes are reported through the Annual Valuation Report provided to each employer.

Unfunded Liability. Unfunded liabilities occur when assets on hand are less than the estimated cost of benefits (liabilities) earned to date. According to the Department of Finance, the state's current unfunded pension liability for CalPERS is $58.7 billion. As of June 30, 2017, the funded status for CalPERS was 67 percent.

CalPERS Employer Contribution Rates Are Increasing. In December 2016, the CalPERS governing board voted to lower its discount rate (investment return assumption) from 7.5 percent to seven percent over three years. In 2019-20, the discount rate will be seven percent for state employers. By assuming less money comes into the system through investment gains, the state will be required to contribute more money to pay for current and future pension costs as well as a larger unfunded liability. As a result of this and other assumption changes, average employer contribution rates are projected to rise over the next few years.

The General Fund and nearly all other funds are used to pay some payroll costs to employ state workers, and therefore also cover associated pension costs. Each fund pays employer contributions to CalPERS based on its own state payroll costs. Some funds—like the Motor Vehicle Account—primarily support operations performed by state employees (such as registering vehicles), and therefore have relatively high associated state pension costs. Other funds—such as the Mental Health Services Fund—primarily pass funding through to local governments and therefore have low associated state pension costs. When employer contribution rates rise, the associated costs to each fund also rise.

The five state CalPERS plans are funded by a combination of General Fund, special funds, and nongovernmental cost funds, as displayed below.

State Plans and Contribution Sources in 2019-20
(Dollars in Millions)

	State Miscellaneous	State Industrial	State Safety	State Peace Officer	Highway Patrol	Total
General Fund Contributions	$1.8	$105.8	$231.4	$1,768.1	N/A	$3,893.3
Share of Total General Fund Contributions	46%	3%	6%	45%	N/A	100%
Special Fund Contributions	$1,265.9	$30.2	$179.9	$0	$532.8	$2,009
Share of Total Special Fund Contributions	63%	2%	9%	0%	27%	100%
Non-Governmental Cost (NGC) Contributions	$694.3	$15.1	$102.9	$35.8	$5.4	$853.4
Share of Total NGC Contributions	81%	2%	12%	4%	1%	100%
Total Required Contributions	$3,748.2	$151.1	$514.3	$1,804	$538.2	$6,755.6

2017-18 Pension Borrowing Plan. SB 84 (Committee on Budget and Fiscal Review), Chapter 50, Statues of 2017, approved the Governor's May Revision proposal to borrow $6 billion from the state's cash balances in the Pooled Money Investment Account (PMIA) to make a one-time supplemental payment to CalPERS. The Administration estimated gross savings of $11.8 billion ($4.8 million net savings) from this payment. While annual state pension contributions will continue to rise over the next several years, CalPERS estimates this supplemental payment would reduce the required contribution for 2018-19 by approximately $177.3 million. The Administration notes that of the $6 billion principal amount, the remaining balance is about $5.8 billion.

On September 28, 2017, the Department of Finance submitted a letter to the Joint Legislative Budget Committee regarding the supplemental payment, which included various stochastic models. According the analysis, the plan has a 95 percent chance to save the state money. The median scenario from the analysis suggests the plan would save the state $3.1 billion over 20 years. The actual savings associated with the plan may be higher or lower than this amount, potentially by billions of dollars, depending on a variety of factors, most notably CalPERS' future investment performance.

The California State Teachers' Retirement System

CalSTRS is governed by the Teachers' Retirement Board, which is composed of eight members and four ex-officio members. The California Constitution provides the Teachers' Retirement Board authority over the administration of the retirement system. CalSTRS provides pension benefits, including disability and survivor benefits, to California's full-time and part-time public school teachers from pre-kindergarten through community college and certain other employees of the public school system. As of June 30, 2018, there are approximately one million members, retirees, and beneficiaries of the State Teachers' Retirement Plan (STRP) Defined Benefit Program.

CalSTRS administers a defined benefit plan, two defined contribution plans, a post-employment benefit plan, and a fund used to account for ancillary activities associated with various deferred compensation plans and programs, including: (1) STRP, (2) CalSTRS Pension Program, (3) Teachers' Health Benefits Fund, and (4) Teachers' Deferred Compensation Fund.

CalSTRS does not provide health or dental insurance coverage as they are collectively bargained at the local school district level. Each district has its own policies. Existing law requires school districts, community colleges and county offices of education to offer retiring CalSTRS members and their spouses or registered domestic partners the opportunity to continue their medical and dental insurance at their own cost.

CalSTRS Budgeted Expenditures and Positions
(Dollars in Millions)

	2017-18	2018-19	2019-20
Service to Members and Employers	$382.0	$604.8	$571.6
Corporate Governance	$4.8	$36.2	$34.7
Benefit Payments	$14,462.5	$15,822.7	$16,759.1
Positions	1,134	1,294	1,313

Prior to 2014, CalSTRS faced a large unfunded liability with no plan in place to fund teachers pensions, and CalSTRS was expected to exhaust its assets in the mid-2040s. The state adopted a funding plan, described below, to fully fund the system by 2046. Currently, the overall unfunded liability for CalSTRS is $103.5 billion (of which the state's share is $35.3 billion). As of June 30, 2017, the funded status for CalSTRS was 64 percent, respectively, meaning the retirement systems only have approximately two-thirds of the funds required to make pension payments to retirees.

Assembly Bill 1469 (Bonta), Chapter 47, Statute of 2014, CalSTRS Funding Plan to Address Large Unfunded Liability. AB 1469 was adopted as a part of the 2014-15 budget, which set CalSTRS on a path towards full funding by 2046. Specifically, the plan phased in contribution rate increases for the state, employers and employees. The plan gives the board limited authority to adjust the employer and state contribution rates.

- District Contribution Rate. AB 1469 set the district contribution rate through 2020-21, which increases the rate from 14.4 percent of salary in 2017-18 to 16.3 percent in 2018-19. This is an increase of 1.9 percentage points. By 2020-21, the district rate is set to reach 19.1 percent. After 2020-21, CalSTRS can increase or decrease the rate by up to one percentage point per year; however, existing law states that the total district rate cannot exceed 20.25 percent.

- Employee Contribution Rate. As noted earlier, PEPRA requires employees hired after January 1, 2013, to pay half of the normal cost of their pension benefits. Due primarily to the assumption of lower investment returns, CalSTRS' estimate of the normal cost has increased. As a result, the contribution rate for PEPRA employees is increasing from 9.2 percent in 2017-18 to 10.2 percent in 2018-19.

  Absent future changes in the investment return and other assumptions, PEPRA employees' contribution rates will tend to remain more stable than the district and state rates. Compared to PEPRA employees, existing law specifies the rate for employees hired prior to January 1, 2013 to remain flat at 10.3 percent, rather than being tied to an estimate of normal cost.

- State Contribution Rate. The state's share of the unfunded liability has more than doubled in recent years, growing from $15 billion as of June 30, 2015 to over $35 billion as of June 30, 2017. Existing law limits the annual allowable increase in the state rate to 0.5 percentage point. The CalSTRS board approved a 0.5 percentage point increase in the state contribution rate for 2018-19, bringing the total state rate to 9.6 percent. Because of the rate adjustment limit in state law, CalSTRS projects that the state rate will continue increasing by 0.5 percentage point each year through 2023-24.

The chart from the Legislative Analyst's Office (LAO) below displays the projected CalSTRS contribution rates.

CalSTRS Projected Contribution Rates
(As a Percentage of Payroll, May 2018 Projections)

Year	District[a]	State[b]	Employees (Pre-PEPRA)[c]	Employees (PEPRA)[d]
2017-18	14.4%	9.1%	10.3%	9.2%
2018-19	16.3%	9.6%	10.3%	10.2%
2019-20	18.1%	10.1	10.3%	10.2%
2020-21	19.1%	10.6%	10.3%	10.2%
2021-22	18.6%	11.1%	10.3%	10.2%
2022-23	18.1%	11.6%	10.3%	10.2%

[a] Reflects statutory rate through 2020-21 and CalSTRS' projections thereafter.

[b] Reflects actual rate through 2018-19 and CalSTRS' projections thereafter. State contribution rate is based on payroll from the second preceding year. For example, the 2018-19 rate is applied to actual 2016-17 payroll. Includes roughly 2.5 percentage points related to a program that protects retirees' pensions from the effects of inflation.

[c] Reflects fixed statutory contribution rate for employees hired before January 1, 2013.

[d] Reflects actual rate through 2018-19 and CalSTRS' projections thereafter.

CalSTRS Unfunded Liability. The state is responsible for the share of the unfunded liability that would exist today if no changes had been made to benefits or contributions since 1990, and districts are responsible for the unfunded liability created by changes to pension benefits and contribution rates adopted after 1990, but only for benefits earned through 2013-14.

CalSTRS interprets the law so that district and state shares of the unfunded liability will change annually based on a complex formula. Specifically, the formula is based on hypothetical unfunded liability calculated by estimating what the defined benefit program's assets and liabilities would be today if the benefit improvements had never occurred after July 1, 1990, and if contributions to the pension fund had not been decreased. Under this formula, the calculations show that CalSTRS' unfunded liability would be smaller today. In general, the state will pay for these smaller theoretical unfunded liabilities, while the districts pay for the difference between the real world unfunded liabilities and the state's share. Because districts pay for the balance, the district share will increase when the state share decreases or vice versa. As a result, the state's share of the unfunded liability and the contribution rate is very sensitive to investment volatility.

Responsibility for a small amount of the unfunded liability that is associated with changes made after 1990 for benefits earned after 2013-14 remains unassigned to either the state or districts. As of June 30, 2018, CalSTRS estimates this to be approximately $200 million, and is expected to grow to about $1 billion by 2046. The funding formula does not include a mechanism for funding this unassigned unfunded liability.

Discount Rate. In February 2017, the CalSTRS board adopted changes to investment return assumptions over a two-year period. Specifically, for the June 30, 2016 actuarial valuation, the discount rate decreased from 7.50 to 7.25 percent, and for the June 30, 2017 actuarial valuation, the discount rate decreased from 7.25 to 7 percent.

Reporting Requirement. AB 1469 also requires CalSTRS to report to the Legislature on or before July 1, 2019, and every five years thereafter, on the fiscal health of the Defined Benefit Program and the unfunded actuarial obligation with respect to service credited to members of the program, before July 1, 2014. The report must identify adjustments required in contribution rates in order to eliminate, by June 30, 2046, the unfunded actuarial obligation of the Defined Benefit Program with respect to service credited to members of the program before July 1, 2014.

GOVERNOR'S PROPOSAL

Unfunded Pension Liabilities. The Governor proposes that the state make supplemental contributions from the General Fund to the pension systems to reduce CalPERS and CalSTRS unfunded liabilities and reduce state costs over the next few decades. Specifically:

- State's CalPERS Unfunded Liability. The Administration planned to introduce trailer bill language that would make a $3 billion General Fund supplemental payment to CalPERS in 2018-19. At the release of the Governor's budget, the Administration's proposal applied the supplemental payment proportionately towards the unfunded liabilities of the five state retirement plans.

  However, on January 30th, the Administration informed staff that the payment on each state plan would be a proportionate share of the required General Fund contribution.

- Districts' Share of CalSTRS Unfunded Liability. To reduce the districts' share of the CalSTRS unfunded liability, the Governor proposes for the state to pay CalSTRS an additional $2.3 billion General Fund, also attributed to 2018-19.

Restructures Proposition 2 Plan to Pay Down State's Share of CalSTRS Unfunded Liability. Proposition 2, the Rainy Day Budget Stabilization Fund Account (Assembly Constitutional Amendment 1 one the November 2014 ballot), requires specified state revenues to be dedicated to the Budget Stabilization Account (BSA) and partially used to repay state debts and unfunded liabilities. By paying down all remaining special fund loans with discretionary resources (discussed in an earlier section), the Administration creates capacity within Proposition 2 requirements for other debt payments. The Governor proposes using this new capacity to reduce the state's share of the CalSTRS unfunded liability.

The Governor proposes to pay an additional $1.1 billion in Proposition 2 to CalSTRS in 2019-20. Over the next few years, the Administration proposes an additional $1.8 billion in Proposition 2 funds through 2022-23, as follows: $802 million in 2020-21, $615 million in 2021-22, and $345 million in 2022-23, to be paid towards the state's share of the unfunded liability.

CalSTRS District Contribution Rates. The Governor proposes providing $700 million General Fund over the next two years ($350 million per year) to provide school and community college districts with immediate budget relief. Specifically, the funds would reduce districts' CalSTRS rates in 2019-20 and 2020-21—freeing up resources for other parts of districts' operating budgets.

Other Contributions. The budget also includes a statutorily required annual contribution of $6.8 billion ($3.9 billion General Fund) to CalPERS for state pension costs, of which $727.5 million General Fund is for California State University retirement costs. The estimated $566 million increase is the net effect of changes in actuarial assumptions, including the lower discount rate adopted by the CalPERS Board in 2016, savings from greater investment returns, and the $6 billion supplemental pension payment the state made to CalPERS in 2017-18.

An additional $390 million in Proposition 2 debt funding is included in the budget to pay down the General Fund's share of the loan that funded the 2017-18 supplemental pension payment.

Reversing Fourth Quarter CalPERS Payment Deferral. The state routinely defers its fourth-quarter contributions to CalPERS to the subsequent fiscal year. This means that the state does not incur each year's costs until the following fiscal year. The Administration estimates the cost to undo this action is $707 million General Fund in 2018-19 (other funds' fourth quarter CalPERS payments are not deferred.)

Reversing June-July Payroll Deferral. The 2009-10 budget package included an ongoing one-month deferral of June state payroll to early July, providing a one-time savings for the state. This accounting action did not affect when paychecks issued to state employees. The Administration estimates the cost to undo this action will be $973 million for the General Fund in 2018-19. Because payroll costs grow over time, the deferral provides ongoing savings for the state General Fund. For example, in 2016-17, this General Fund benefit was $65 million (savings vary from year to year depending on how payroll costs are growing).

ISSUES TO CONSIDER

Trailer bill language was released on February 1, 2018; as a result, staff was not able to provide an in-depth analysis on trailer bill language prior to the budget committee hearing. However, as budget hearings progress, both senate fiscal and policy staff will thoroughly analyze the language.

Estimated Savings from Supplemental Payment Proposal to CalPERS. When the Governor's January budget proposal was released, the Administration indicated that the $3 billion General Fund payment in 2018-19 would be applied proportionately towards the unfunded liabilities of the five state retirement plans. The Administration estimates $7.2 billion gross savings ($4.2 net savings) over the next 30 years, based on current actuarial assumptions, as well as a reduction in the average state contribution rate for the five state plans starting in 2019-20 by roughly 0.5 to one percent over that time period. The Administration indicates that the payment will tentatively be applied to the June 30, 2016 investment loss amortization base, which is the base with the longest remaining amortization period (28 years) that would maximize savings.

The Administration notes that the payment is proposed for 2018-19 due to the estimated availability of General Fund this year, and that there is no long-term savings impact if the payment is applied on June 30, 2019, as compared to January 1, 2020. The proposal also assumes an investment return of 8.6 percent for 2017-18 (which is based on the most recent actuarial report from June 30, 2017), and seven percent for 2018-19 and thereafter. The Administration also assumes a three percent growth in payroll, as well as other actuarial and demographic assumptions adopted in the June 30, 2017 CalPERS actuarial evaluation report.

Lastly, the Administration notes that the total savings ratio for the proposed payment is higher compared to the savings assumed in the 2017-18 supplemental pension payment due to a difference in assumed amortization base, which will be discussed in detail below.

Updated CalPERS Supplemental Pension Payment Proposal. Since releasing the Governor's budget proposal, the Administration has modified their proposal to apportion the supplemental payment to the state plans based on the General Fund each plan pays towards its annual required contributions. According to the Administration and CalPERS, the estimated savings of this action would be the same; however, the estimated savings by each state plan will be adjusted.

As noted previously, the share of the total General Fund for contributions that each plan pays towards its contributions in 2019-20 are as follows: 46 percent for state miscellaneous, three percent for state industrial, six percent for state safety, 45 percent for state peace officers, and zero percent for highway patrol. As a result of the Governor's proposal, highway patrol would not receive a direct benefit from the supplemental payment, because it is entirely funded by special funds. By contrast, the other plans would receive a share of the supplemental payment.

Moreover, the contributions to the miscellaneous plan are approximately 46 percent General Fund and 54 percent other funds. The special funds that contribute to the miscellaneous plan will benefit (through any resulting rate reductions) from the supplemental payment because the payment will reduce the entire unfunded liability for that plan, regardless of funding source. The miscellaneous plan has a funded ratio of about 68 percent, compared to the highway patrol plan which has a funded ratio of 60 percent. Additionally, the highway patrol plan has the highest and fastest growing employer contribution rate of the plans (projected to be 60 percent of pay in 2023-24 compared to the projection for the miscellaneous plan of at 33 percent in 2023-24).

The Administration's proposal appears to prioritize plans with higher funded ratios and lower projected growth in contribution rates, while providing no direct relief to special funds with lower funded ratios and faster growing contributions. The Administration informed staff that the proposal provides consistency with the existing funding structure for state CalPERS contributions.

CalPERS Amortization Base Period. As noted previously, the 2017-18 budget provided a $6 billion PMIA loan to pay down the CalPERS unfunded liability. DOF estimated that the $6 billion payment in 2017-18 would result in net savings of $4.8 billion. For the 2019-20 budget, DOF indicates that the proposed $3 billion supplemental pension payment would result in a net savings of $4.2 billion. The Administration notes that the difference in savings can be explained by how much savings can be achieved by the amortization base to which the payment is applied.

Actuarial gains/losses in each year are amortized over a period of time specified by CalPERS board policies. The gain or loss in each year is called an "amortization base." Previously, actuarial gains/losses were amortized over a 30-year period. However, in February 2018, the CalPERS board adopted a new policy that, beginning with the June 30, 2019 valuation (first affecting the 2020-21 contribution rates), will amortize any new gains/losses over a 20-year period. The 2017-18 $6 billion supplemental payment to CalPERS was amortized over a 20-year period.

The Governor's proposal applies the $3 billion supplemental payment to the 2016 amortization base, which had a 30-year amortization period. This base was chosen because it is the most recent amortization "loss" base. There are 27 years remaining in the amortization schedule to pay down this loss. By applying the payment to this amortization base, the benefit of the $3 billion supplemental payment would be spread out over 27 years to maximize savings.

Estimated Savings from the Proposed Supplemental Payment for the Employer Liability Share to CalSTRS. The Administration estimates that the proposed $3 billion General Fund ($2.3 billion to address the employer share of the CalSTRS unfunded liability, and $700 million to supplant the required contributions for school employers for 2019-20 and 2020-21) payment in 2018-19 would save school employers $6.9 billion ($3.9 net savings) over the next 30 years under current actuarial assumptions.

The Administration estimates that the $700 million to supplant the school employer contributions would result in a one percent reduction in the employer contribution for 2019-20 and 2020-21. Moreover, the $2.3 billion supplemental payment to the employer share of the unfunded liability would reduce the employer contribution rate by approximately 0.5 percent starting in 2021-22, over the next three decades. The Administration's chart below displays the impact of the supplemental payment towards the employer's contribution rate.

Supplemental Pension Payments to CalSTRS—School Employer Liability Share
Estimated Impact

	Current		With Supplemental Pension Payment		
Fiscal Year	Employer Contribution Rate	Employer Contribution (in Millions)	Employer Contribution Rate	Employer Contribution (in Millions)	Savings from Supplemental Pension Payment (in Millions)
2019-20	18.13%	$ 6,277	17.10%	$ 5,927	$ 350
2020-21	19.10%	$ 6,844	18.10%	$ 6,494	$ 350
2021-22	18.40%	$ 6,837	17.90%	$ 6,641	$ 196
2022-23	18.40%	$ 7,047	17.90%	$ 6,883	$ 164
2023-24	18.40%	$ 7,301	17.90%	$ 7,131	$ 170
Total Savings—2019-20 through 2023-24					$ 1,230
Total Savings—2024-25 through 2045-46					$ 5,691
Total Savings—2019-20 through 2045-46					$ 6,921

Note: The employer contribution rate, with and without the impact of the supplemental pension payments, is projected to remain constant from 2023-24 through 2045-46. Unlike the state contribution rate, asset smoothing (smoothing the impact of investment volatility on the rate) does not have a material impact on the employer contribution rate over this period.

Short- and Long-Term Trade-Off. The LAO notes that district pension costs typically are covered using Proposition 98 General Fund; however, the Governor proposes using non-Proposition 98 General Fund for this proposal. Whereas this proposal would provide districts with perceptible budget relief over the next two years, the LAO notes that using the $700 million instead to pay down more of the CalSTRS unfunded liability would provide a longer-term benefit. Although over the long term the districts' CalSTRS rate would be only slightly lower than it would be otherwise, the value of a making a $700 million unfunded liability payment now would grow over time. Such future relief could be important during the next economic downturn.

Estimated Savings from Supplemental Payment Proposal to the State Liability Share to CalSTRS. The Governor proposes a $1.1 billion Proposition 2 funds payment in 2019-20, and $1.8 million Proposition 2 funds payment through 2022-23 to pay down the state's share of the CalSTRS defined benefit unfunded liability. The Administration estimates a gross savings of $7.4 billion ($4.4 billion net), and will reduce the state contribution rates starting in 2022-23 by 0.5 to 0.6 percent over the next 30 years. The Administration notes that the impacts of these savings are contained within the CalSTRS Funding Plan, and will help improve the system's ability to reach fully funded status per the CalSTRS Funding Plan.

According to the Administration, the state's share of the CalSTRS defined benefit program is 85 percent funded as of June 30, 2017. The Administration's chart below displays the impact of the supplemental payment towards the state's contribution rate.

Supplemental Pension Payments to CalSTRS—State Liability Share Estimated Impact					
	Current		With Supplemental Pension Payments		
Fiscal Year	State Contribution Rate	State Contribution (in Millions)	State Contribution Rate	State Contribution (in Millions)	Savings from Supplemental Pension Payments (in Millions)
2019-20	7.83%	$ 2,569	7.83%	$ 2,569	$ -
2020-21	8.33%	$ 2,786	8.33%	$ 2,786	$ -
2021-22	8.83%	$ 3,057	8.83%	$ 3,057	$ -
2022-23	9.30%	$ 3,330	8.80%	$ 3,149	$ 181
2023-24	9.20%	$ 3,395	8.60%	$ 3,184	$ 211
Total Savings—2019-20 through 2023-24					$ 392
Total Savings—2024-25 through 2045-46					$ 7,057
Total Savings—2019-20 through 2045-46					$ 7,449

Note: It is projected that with the supplemental pension payments, the state contribution rate will continue to decrease slightly during the period from 2024-25 through 2045-46, to 8.2 percent. Absent the supplemental pension payments, it is projected that the state contribution rate will decrease to 8.8 percent by the end of this same period. The slight decrease in the state contribution rate over this time period can be attributed to asset smoothing (smoothing the impact of investment volatility on the rate).

FEBRUARY 7, 2019

Structuring the 2019-20 Budget: Reserves, Debt and Liabilities

PRESENTED TO: Senate Budget and Fiscal Review Committee
Hon. Holly J. Mitchell, Chair

LEGISLATIVE ANALYST'S OFFICE

The Governor's Proposed 2019-20 Budget Structure

- ***Increases Reserves by $2.1 Billion.***

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**

- ***Pays Down $10.8 Billion in Debts and Liabilities.*** Includes two components: (1) $6.4 billion for retirement liabilities and (2) $4.4 billion for budgetary borrowing.

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.

- ***Provides $5.1 Billion in One-Time Spending.***

- ***Provides $2.7 Billion in Ongoing Spending.*** Full implementation cost of these proposals would grow to $3.5 billion ongoing (under the administration's estimates).

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 Commitments Between Debt and Programs

- 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?

Reserves

Governor Proposes Total Reserves of $18.1 Billion

Reserve Targets Assuming No Other Actions

- Our past reports have estimated $20 billion in reserves would be needed to cover a budget problem associated with a mild recession and $40 billion would be needed for a moderate recession (assuming the Legislature prefers not to take other actions like increasing revenues or reducing spending).

- Our *Fiscal Outlook* from November found $3 billion in ongoing spending was feasible under two economic scenarios—provided the Legislature entered the recession scenario with $25 billion in reserves.

Building More Reserves Would Reduce the Need for Programmatic Cuts in the Future. 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.

LAO Options

- ***Build More Cash Reserves.***

- ***Prepay CalPERS Retirement Contribution.***

Debt and Liabilities: Retirement

Governor Proposes Making Three Supplemental Pension Payments:

- ***$3 Billion to CalPERS for Unfunded Liability.***

- ***$1.1 to CalSTRS for State Unfunded Liability.*** Also proposes additional payments over multiyear period.

- ***$2.3 Billion to CalSTRS for District Unfunded Liability.*** In addition, the Governor proposes providing another $700 million to CalSTRS for district rate relief.

State Savings From Supplemental Payments Likely to Vary

CalPERS Contribution Generates General Fund and Other Fund Benefit

(Dollars in Billions)

CalPERS Plan	General Fund Share of Contribution	Other Funds' Share of Contribution	Proposed Supplemental Payment	Expected Net Benefit (Savings)
Miscellaneous	48%	52%	$1.4	$2.9
Industrial	70	30	0.1	0.2
Safety	45	55	0.2	0.4
Peace Officer / Firefighter	98	2	1.4	2.7
Highway Patrol	0	100	0.0	0.0
Totals			**$3.0**	**$6.3**

Debt and Liabilities: Retirement

(Continued)

LAO Comments and Options

Consider Goal of Supplemental Payment. The Legislature may have the goal to: (1) address the systems' unfunded liabilities and/or (2) maximize state savings over the next few decades. If the Legislature has a preference to maximize state savings, making contributions to CalPERS—rather than CalSTRS—for the state's unfunded liability might be preferable.

Maximize General Fund Savings When Using General Fund Resources. The Governor's plan uses General Fund resources to generate savings for both the General Fund and other funds. Options to maximize General Fund savings are:

- Make Entire Contribution to Peace Officers / Firefighters Fund.
- Require Other Funds to Repay the General Fund.

Recommend Making These Transfers Later in the Fiscal Year.

Debt and Liabilities: Budgetary Borrowing

Governor's Proposals to Repay Budgetary Borrowing Repays

$2.1 Billion in Special Fund Loans. This would eliminate the multiyear plan to repay these debts under Proposition 2. The Governor uses capacity under Proposition 2 freed up by this proposal to make additional contributions to CalSTRS.

Uses $1.7 Billion to Undo Two Budgetary Deferrals. These are: (1) the June-July payroll deferral and (2) the fourth quarter payment to CalPERS. Undoing these deferrals would eliminate ongoing budgetary savings for the General Fund. (The June-July payroll deferral has no effect on when paychecks are issued to employees.)

LAO Recommendations

Recommend Prioritizing Retirement Liabilities Over Budgetary Borrowing. Instead of using $2.1 billion to repay special fund loans (a low-interest liability), we recommend the Legislature use these funds to pay down additional CalPERS liabilities (a high-interest liability), saving the state at least hundreds of millions of dollars.

Recommend Rejecting Proposal to Undo Deferrals. We suggest the Legislature instead consider using $1.7 billion to build more reserves.