AGENDA

ASSEMBLY BUDGET SUBCOMMITTEE NO. 4
STATE ADMINISTRATION

ASSEMBLYMEMBER JIM COOPER, CHAIR

TUESDAY, MARCH 5, 2019
1:30 P.M. - STATE CAPITOL ROOM 447

Informational Hearing
Liabilities, Debt, and Reserves and the 2019-20 Budget

Panel 1: Reserves

- Ann Hollingshead, Senior Fiscal and Policy Analyst, Legislative Analyst's Office
- Greg Bruss, Principal Program Budget Analyst, Department of Finance
- Susan Wekanda, Principal Program Budget Analyst, Department of Finance

Panel 2: Debt

- Ann Hollingshead, Senior Fiscal and Policy Analyst, Legislative Analyst's Office
- Greg Bruss, Principal Program Budget Analyst, Department of Finance
- Susan Wekanda, Principal Program Budget Analyst, Department of Finance

Panel 3: Pensions

- Ann Hollingshead, Senior Fiscal and Policy Analyst, Legislative Analyst's Office
- Evelyn Suess, Principal Program Budget Analyst, Department of Finance
- Scott Terando, Chief Actuary, California Public Employees' Retirement System
- Kerry J. Worgan, Supervising Pension Actuary, California Public Employees' Retirement System
- David Lamoureux, Deputy System Actuary, California State Teachers' Retirement System

Public Comment

BACKGROUND

After many consecutive years of economic growth, California's budget continues to be on strong footing. The nearly $21 billion surplus available in the Governor's January budget proposal reflects the strong fiscal position of the state and affords the Legislature options to build reserves and fund legislative priorities.

The State Constitution requires the Legislature to pass a balanced budget each year, meaning that a budget bill cannot be enacted that would appropriate more in General Fund expenditures than are available in resources. The two main components of resources are: 1) revenues and 2) reserves. There are three main components of expenditures: 1) constitutional spending for schools and community colleges; 2) spending on debts and liabilities; and 3) other spending.

Key Considerations in Structuring the Budget

In some years the State faces a budget problem (a deficit) and in other years it has additional discretionary resources available (a surplus). In years a surplus exists, the Legislature must determine how to allocate the resources among reserves and one-time and ongoing commitments. There are various things for the Legislature to consider as it determines the distribution of resources across these structural components. The figure below from the LAO summarizes these considerations.

Figure 8

Key Considerations in Structuring the Budget

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

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

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

Source: Legislative Analyst's Office

Governor's 2019-20 Budget Proposals

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

- ***Increases Reserves by $2.1 Billion.*** Under the Governor's proposed budget and revenue estimates, 2019-20 would end with $18 billion in reserves—about $2.1 billion greater than the level enacted in 2018-19. This represents about 12.6 percent of General Fund revenues and transfers--somewhat higher than the enacted 2018-19 level of nearly 12 percent. Also, the Administration proposes to continue to use the SFEU to pay for disaster-related costs and has estimated the State will incur $1 billion in costs after reimbursements from the 2018 wildfires.

Figure 10

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

(In Millions)

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

Source: Legislative Analyst's Office

Proposition 2 passed in 2014 requires annual deposits into the Budget Stabilization Account (BSA) until deposits reach 10 percent of the fund's balance. In addition to required deposits, the State has made twice additional, optional deposits into the account. Under Prop 2 when the BSA reaches a threshold of 10 percent of General Fund taxes, additional required funding must be spent on infrastructure. Under one interpretation of Prop 2, the State would reach this threshold at the end of the year, however, the Administration has taken an alternative interpretation of Proposition 2 that does not count optional deposits toward the threshold.

- ***Pays Down $10.8 Billion in Debts and Liabilities.*** The Governor proposes repaying $10.8 billion in debts and liabilities in 2019-20 (as shown on the next page), including constitutionally required debt payments. These repayments include $3.0 billion for the State's CalPERS unfunded liability and $1.1 billion for the State's CalSTRS unfunded liability, as well as $2.3 billion on behalf of districts for their share of the CalSTRS unfunded liability. The Governor also proposes undoing actions taken to help the State's fiscal condition during the Great Recession by undoing the June to July payroll deferral and the deferral of the fourth quarter payment to CalPERS, in addition to repaying outstanding special fund loans.

Figure 11

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

(In Millions)

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

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

Source: Legislative Analyst's Office

- ***Provides $5.1 Billion in Discretionary One-Time Spending.*** After satisfying constitutional requirements and funding current law policies, the LAO estimates the Governor's budget allocates $5.1 billion in available discretionary resources on a one-time or temporary basis for a variety of programmatic expansions.
- ***Provides $2.7 Billion in Discretionary Ongoing Spending.*** The Governor's discretionary spending proposals include $2.7 billion in ongoing spending with an estimated ongoing cost of $3.5 billion upon full implementation.

LAO Recommendations Regarding Reserves and Debts and Liabilities

Overall, the LAO finds the Governor's plan to improve the budget's fiscal position largely is based on a roughly $11 billion plan to pay down retirement liabilities and budgetary borrowing. In addition, the Governor increases reserves, devotes most of his new spending proposals to one-time commitments, and adds roughly $3 billion in ongoing spending to the budget.

The LAO generally thinks the Governor's focus on paying down debt is commendable and that the budget's overall structure puts the budget on better footing. The LAO provides options for improving the Governor's plan that would likely save the state more money and would put the state in an *even better* fiscal position. Below is a summary and discussion of the LAO's recommendations.

Figure 9

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

Building Reserves

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

Options for building more reserves:

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

Paying Down Retirement Liabilities

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

Maximize state General Fund savings when using General Fund resources.

Options that maximize General Fund savings:

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

Addressing Budgetary Borrowing

Recommend rejecting proposal to undo deferrals.

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

POFF = Peace Officers and Firefighters.

Source: Legislative Analyst's Office

As shown above, the LAO's recommendations fall into three areas 1) Reserves, 2) Retirement Liabilities, and 3) Budgetary Borrowing.

- ***Building More Reserves.*** The LAO has estimated the range of resources needed to weather various types of recessions. Specifically, they estimate the State would need about $20 billion in reserves to weather a mild recession and $40 billion to cover a moderate recession. When the LAO made its multiyear forecast of expenditures last November it assumed $25 billion in reserves.

  The LAO finds that if new ongoing spending commitments are made, a larger reserve than the $18 billion proposed by the Administration would be prudent. In addition, more reserves would also be better if reserve funds are available to cover the costs of disasters AND a recession.

  One way to increase reserves above the level proposed by the Governor would be to reduce spending on one-time programmatic proposals. Spending less on one-time proposals would free up cash that the Legislature could direct to be deposited into one of the state's several reserve accounts.

  Alternatively, the Legislature could increase reserves by prepaying CalPERS retirement liabilities using a Section 115 Trust. This would allow money to be set aside, and invested, and at a future date these funds could be used to make payments to CalPERS. This option involves more risk, but has the potential benefit of money in the Section 115 trust earning a higher rate of return than the State would earn by holding it in reserves. It is also possible that in the case of a recession there would be less money available in the trust for pension payments, due to a lower rate a return.

- ***Paying Down Retirement Liabilities to Maximize State Savings.*** The Governor proposes using more than $6 billion General Fund to make supplemental payments to reduce the unfunded liability associated with state employee pensions (CalPERS) and teachers (CalSTRS). Of this total, about $4.1 billion would address the State's share of these systems' liabilities. On these proposals, the LAO suggests the Legislature:
    - **<u>Consider Goal of Supplemental Payments.</u>** A supplemental payment to the State's CalSTRS unfunded liability likely would yield a lower savings rate over the next few decades than a payment of the same magnitude to CalPERS. This is because CalSTRS has less authority than CalPERS to increase contribution rates in response to investment losses until 2046, which contributes to the state savings likely being lower than from a comparable payment to CalPERS. This raises a trade-off for the Legislature. If it would prefer to maximize state savings, then funding CalPERS rather than CalSTRS would be preferable. If, instead, its goal is to address the unfunded liability at both systems, then the Governor's approach is reasonable.
    - **<u>Maximize General Fund Savings When Using General Fund Resources.</u>** The Governor's plan to make a $3 billion supplemental payment to CalPERS relies exclusively on General Fund money, but achieves savings for both the General Fund and special funds. The LAO offers two options to maximize the General Fund benefit: (1) devote the entire supplemental payment to one CalPERS plan which is nearly entirely paid for by the General Fund (Peace Officers and Fire Fighters) or (2) distribute the payment to all state plans and require other funds that benefit from the General Fund payment to repay the General Fund. Under the second option, the benefit to other funds likely would exceed the cost of repaying the General Fund.
- ***Modifying the Governor's Proposals to Address Budgetary Borrowing.*** The Governor also uses $4.5 billion to address budgetary borrowing, including to repay all outstanding special fund loans, undo two budgetary deferrals, and repay all outstanding settle up owed to schools and community colleges. On these proposals, the LAO has two recommendations:

- **Reject Proposal to Pay Outstanding Special Fund Loans in 2019-20.** The LAO recommends the Legislature pay down high-interest liabilities, like retirement liabilities, instead of using $2.1 billion to repay lower-interest outstanding special fund loans. For example, the Legislature could maintain the State's current plan to repay these loans over the next few years and instead use the funds to pay additional amounts toward CalPERS. This would save the state hundreds of millions of dollars relative to the Governor's current plan.
- **Reject Deferrals**. The LAO recommends the Legislature reject the Governor's proposal to undo two payment deferrals and consider instead using those resources ($1.7 billion) to build more reserves.

For more information on the LAO report see *Structuring the Budget: Reserves, Debt and Liabilities* https://lao.ca.gov/Publications/Report/3925

STAFF COMMENTS

Staff agrees with the LAO's overall findings that the Governor's approach to balancing one-time and ongoing expenditures and building more reserves and paying down liabilities makes sense. Staff also finds the LAO's emphasis on reducing one-time General Fund expenditure proposals or rejecting the proposals to undo deferrals or pay off special fund loans this year would help to build a greater amount of reserves, which is prudent. Given that under the Administration's approach, reserves could be used for both an economic downturn and to pay for disaster-related costs, consideration of alternative ways of ensuring there is adequate funding both an economic downturn and significant disaster costs is warranted.

One approach the Legislature may want to consider is establishing a separate reserve for paying for disaster-related costs. This approach would better enable the State to track disaster costs and federal reimbursements for these costs, thereby providing greater transparency. Since the State is often reimbursed at a later time for much of the disaster expenditures, a disaster reserve could be structured as a clearing account that provides access to cash in emergencies and then is replenished when reimbursements are received.

Regarding the proposals to paydown PERS and STRS unfunded pension liabilities there are different objectives that can be accomplished depending on how and where the funds are directed. Finally, it is possible that some of these proposals will be modified significantly depending on the estimated level of state revenues as we get close to the Governor's May Revision. At that time, we will have a better estimate of current and budget year revenues and accordingly, if there are changes in the anticipated levels of revenues or other needs arise, many of these proposals will have to be reconsidered.

The State should also consider how paydowns of liabilities interact with the State's cash position. Currently, the State is in a fantastic cash position, but historically cash shortages have plagued the State in economic downturns, resulting in expensive borrowing for cash purposes. In scheduling the paydown of liabilities in future months, the Assembly should consider adding language that gives the State flexibility to delay payments if these payments would jeopardize the State's overall cash position for any given month.