

*Report of the
State Budget Crisis Task Force*

CALIFORNIA REPORT



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Paul A. Volcker and Richard Ravitch introduced the July 2012 Full Report of the State Budget Crisis Task Force with the following statement:



A Statement From the Task Force Co-Chairs

July 17, 2012

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Our purpose in assembling the State Budget Crisis Task Force has been to understand the extent of the fiscal problems faced by the states of this nation in the aftermath of the global financial crisis. While the extent of the challenge varies significantly state by state, there can be no doubt that the magnitude of the problem is great and extends beyond the impact of the financial crisis and the lingering recession. The ability of the states to meet their obligations to public employees, to creditors and most critically to the education and well-being of their citizens is threatened.

The United States Constitution leaves to states the responsibility for most domestic governmental functions: states and their localities largely finance and build public infrastructure, educate our children, maintain public safety, and implement the social safety net. State and local governments spend \$2.5 trillion annually and employ over 19 million workers—15 percent of the national total and 6 times as many workers as the federal government. State governments are coping with unprecedented challenges in attempting to provide established levels of service with uncertain and constrained resources.

Within the limits of time and resources, we have examined the financial condition of six heavily populated states—California, Illinois, New Jersey, New York, Texas and Virginia. While each state varies in detail, a common thread runs through the analysis, supported by information available for states generally.

What we found will not be surprising to many knowledgeable observers, but the facts have never been assembled in a way that reflects the totality of the problems.

Certain large expenditures are growing at rates that exceed reasonable expectations for revenues:

- Medicaid programs are growing rapidly because of increasing enrollments, escalating health care costs and difficulty in implementing cost reduction proposals. At recent rates of growth, state Medicaid costs will outstrip revenue growth by a wide margin, and the gap will continue to expand.
- Pension funds for state and local government workers are underfunded by approximately a trillion dollars according to their actuaries and by as much as \$3 trillion or more if more conservative investment assumptions are used.

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- Unfunded liabilities for health care benefits for state and local government retirees amount to more than \$1 trillion.

The capacity to raise revenues is increasingly impaired:

- Untaxed transactions are eroding the sales tax base. Gasoline taxes are eroding as well, making it more difficult for states to finance roads, highways, and bridges.
- Income taxes have become increasingly volatile, particularly during and after the recent economic crisis.

The federal budget crisis will have serious spillover effects on state and local governments, and state actions will have spillover effects on local governments:

- Cuts in federal grant dollars, lower spending on federal installations, procurement, and infrastructure, and potential changes to the federal tax code all threaten states' fiscal stability.
- Pressures on local governments, caused by the weak economy and cuts in state aid, are constraining education spending, law enforcement, aid to the needy, and the institutions that make up the culture of our cities. Local government cuts pose a significant risk to the overall economic and social fabric of states.

State budget practices make achieving fiscal stability and sustainability difficult:

- While almost all states have constitutional or statutory balanced budget requirements, "revenue" and "expenditure" are not defined terms. The use of borrowed funds, off-budget agencies, and the proceeds of asset sales are not uncommon practices, often rendering balanced budgets illusory.
- The lack of financial transparency makes it more difficult for the public to understand the critical nature of problems such as pensions and other payment obligations. Temporary "one-shot" measures to avoid or delay hard fiscal decisions mask these underlying problems.
- Opaque and untimely reporting, coupled with nonexistent multiyear planning, severely hampers efforts to address these problems in a serious manner.

The Task Force is not in a position to propose changes in programmatic priorities, tax rates or structures to deal with budgetary problems. Such decisions are properly subject to the values and politics of a democratic society. Our essential goal is to inform the public of the gravity of the issues and the consequences of continuing to postpone actions to achieve structural balance. We do, however, believe that certain basic procedural approaches should be introduced and followed by all states and urge that prompt attention be given to financial relationships among all levels of government.

- The public needs transparent, accountable government. Individual states, existing associations of states, and advisory and standard-setting bodies should develop and adopt best practices to improve the quality and utility of financial reporting.

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- Multiyear planning and budgeting approaches should be a normal part of fiscal planning.
- States need better tools for managing over the business cycle. A priority for states should be better use of their existing counter-cyclical tools, including "rainy day" funds and repayment of debts in prosperous periods.
- Pension plans need to account clearly for the obligations they assume and disclose the potential shortfalls and risks they face. Legislators, administrators, and beneficiaries alike need to develop and adopt rules for the responsible management of pension plans and mechanisms to ensure that required contributions are paid. States should recognize and account for post-employment benefits, such as healthcare, that they intend to continue.
- Prompt attention is needed to the effects that federal deficit reduction and major changes in the federal tax system will have on states and localities.
- States that do not have suitable mechanisms to monitor and assist local governments experiencing fiscal distress should develop them.
- Looking ahead more broadly, the recurrent problems of state finances and the growing state fiscal imbalance suggest that more fundamental approaches require attention. Tax reform at the state level may be needed to achieve revenue systems that are adequate and predictable and that minimize volatility.
- The apparent growing gap between states' spending obligations and their available financial resources points toward a need to reexamine the relationship between the federal government and the states.

The threats and risks vary considerably from state to state, but the storm warnings are very serious. Only an informed public can demand that the political systems, federal, state and local, recognize these problems and take effective action. The costs, whether in service reductions or higher revenues, will be large. Deferring action can only make the ultimate costs even greater.

The conclusion of the Task Force is unambiguous. The existing trajectory of state spending, taxation, and administrative practices cannot be sustained. The basic problem is not cyclical. It is structural. The time to act is now.

Respectfully submitted,

Richard Ravitch



Chairmen

Paul Volcker





Foreword

Former New York Lieutenant Governor Richard Ravitch and former Federal Reserve Board Chair Paul Volcker created the State Budget Crisis Task Force because of their growing concern about the long-term fiscal sustainability of the states and the persistent structural imbalance in state budgets, which was accelerated by the financial collapse of 2008.

After extensive planning and fundraising in 2010 and early 2011, Messrs. Ravitch and Volcker recruited a board of individuals with extensive and varied careers in public service and public policy. The Task Force was officially launched in April 2011.

In addition to the co-chairs, the board of the State Budget Crisis Task Force includes these members:

Nicholas F. Brady	Joseph A. Califano, Jr.
Phillip L. Clay	David Crane
Peter Goldmark	Richard P. Nathan
Alice M. Rivlin	Marc V. Shaw
George P. Shultz	

The executive director of the Task Force is Donald Boyd, on leave from his responsibilities as senior fellow at the Rockefeller Institute of Government. Ravitch and Boyd worked together to assemble a core team of experts with budget and financial planning experience at the national, state, and local levels and practical experience derived from the management of previous fiscal crises. The names of the full project team can be found on the Acknowledgements page at the end of this report.

The Task Force decided to focus on the major threats to states' fiscal sustainability. Since it was not feasible to study each of the fifty states in depth, we decided to target six states — California, Illinois, New Jersey, New York, Texas, and Virginia — for in-depth, onsite analysis. In each state, the core team worked closely with experts who were deeply familiar with the substance, structure, procedures, documents, and politics of the state's budget. The names of budget experts consulted in each state can be found on the Acknowledgements page at the end of this report. The core team and state experts conducted detailed inquiries into major issue areas including Medicaid, pensions, tax revenues, debt, the fiscal problems of local governments, and state budgeting and planning procedures. In doing so, the core team and state experts reviewed budget documents and data from the respective states and interviewed key budget officials.

The Task Force released its main report in July 2012, focusing on issues that cut across the six states. The Task Force also is preparing reports on individual states, including this report on California.

Introduction

The economic, budgetary, and public service delivery challenges playing out in California have multiple origins. When the most recent recession hit California's economy like a hurricane, the state government's financial foundation was already weak.

The causes of this weakness are well documented:¹

- In years of strong economic growth, state and local spending was increased and taxes were cut, undermining long term fiscal balance.
- Over the last decade, internal and external borrowing was used to balance budgets in order to avoid major spending reductions or tax increases. Paying off this budgetary debt diverts resources that are needed to fund ongoing major state obligations in education, health and human services, and criminal justice.²
- Expanded public retirement and post-employment health benefits led to major pressures on employer obligations to make up for retirement systems' investment losses. This has been the case for both of the major retirement systems: the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS). Recently passed legislation reduces benefits and places caps on retirement allowances. These new limits apply to state and local employees hired after January 1, 2013. Although a significant step, more will need to be done to solve the long term unfunded liability of the retirement systems.
- Budgetary costs of Medicaid benefits have increased despite low provider rates and low per capita spending. Cost pressures included increases in the number of people eligible for services and medical cost inflation.
- The volatility of state revenues reflects the state's tax structure. With its heavy reliance on high income earners and capital gains, a narrow sales tax base, and a set of tax preferences that reduce corporate tax revenues, state revenue trends are amplified by swings in the economy that affect these sources.

No single magic elixir will solve the state's fiscal problems. It will likely require a steadily growing economy and a focus on the resources needed to finance the core responsibilities of the state. An assessment of those core responsibilities is a high priority. Also important is the continuing effort to pay down budgetary debt accumulated over the past decade, increase program oversight to insure that state spending focuses on improving results, continue to reshape the public employee retirement and health benefit programs, and create a new set of budgeting tools and practices that can deal with California's volatile tax structure.

As for the tax structure, more work needs to be done to match the tax base with the California economy. Governor Brown's 2012-13 budget includes an estimated net \$5.6 billion benefit to the general fund resulting from additional new temporary taxes that he believes will plug a gap over the next seven years. The pitfall in this approach is that this measure is temporary, like solutions enacted in the last decade that were used to plug budget gaps. Since most of the temporary taxes fall on higher income individuals it is likely to increase the volatility of the income tax. The adoption of this plan is in the hands of the voters at the November 2012 election.

On the spending side, major spending reductions have been implemented over the last five years that have slowed the growth of state general fund spending. Much of this slower growth is attributable to moving major programs from the general fund to special funds as well as reductions in education spending through deferring budget year obligations. Even when taking these actions into account, state spending on a per capita basis is about what the state was spending in 2006. If the revenue measures fail to pass, the governor and the legislature agreed to an additional set of expenditure reductions that will make up the loss from the proposed tax increases.

Finally, looming on the horizon is the potential impact of federal deficit reduction, which could have a negative impact on the state's economy and fiscal condition. Federal spending, including military spending, contributes about 4 percent to the California's economy.³ Federal funds finance about one third of total state spending.⁴

Outlook for the Economy and State Finances

The economic forecast that accompanied the enacted 2012-13 budget includes a cautiously optimistic view of the growth in the California economy. The forecast shows personal income growth of 3.4 percent in 2013 and an unemployment rate that declines slowly but remains above 10 percent.

The Legislative Analyst's Office (LAO) projects growth for the "big three" taxes (personal income, sales and use, and corporation taxes) at 4.7 percent for fiscal year (FY) 2012-13. Although Governor Brown has made it a priority to begin to solve the fiscal imbalance, budgetary pressures remain.

In March 2012, Standard and Poors revised its fiscal assessment of California upward, a sign that state policy leaders are finally beginning to deal with the imbalance of tax revenues and spending obligations, at least to the extent that imbalance threatens debt service. However, Standard and Poors does not usually express judgment on the ability to fund programs junior in priority to that debt service and additional budgetary pressures could complicate the continuing progress toward a sustainable fiscal balance.⁵

The 2012-13 budget that was adopted by the legislature and signed by the governor in June to close a \$15.7 billion gap between forecasted revenues and expenditures with a combination of revenue increases, expenditure reductions, and internal borrowing. It included a \$1 billion reserve (see Table 1). There remains significant uncertainty as to whether the budget will remain in balance.

Table 1 | Closing the 2012-13 Budget Gap (\$ billions)

Action	Two year total	Share of Total Solutions
Expenditure Reductions	\$8,089	49%
Revenues	\$6,033	36%
Other	\$2,518	15%
Total Solutions	\$16,640	
Source: California Department of Finance; Enacted State Budget 2012-13 Summary.		

A significant portion of the budget gap (about \$3 billion) was due to the inability of the state to implement expenditure reductions in health and social services in the 2011-12 fiscal year. Some of the reductions were prevented by the courts and others did not gain federal approval. In addition, revenues for the prior year were less than anticipated in the economic forecast. As shown in Table 1, these revenue proposals are balanced with expenditure reductions of \$8.1 billion. Even with a \$8.1 billion expenditure reduction, a significant amount of the reduction is attributable to deferring obligations into future years and making assumptions about spending levels that are as susceptible to the same challenges as those made in the 2011-12 budget.

One of the underlying budget problems is the amount of resources dedicated to paying down budget related borrowing that has accumulated over the last ten years. Referred to as the “Wall of Debt,” it is a combination of deferred payments to schools, debt service on bonds issued to finance budget deficits at the beginning of the last decade, and annual special fund borrowing. With the enactment of the 2012-13 budget, the budget-related debt yet to be financed stands at about \$28 billion.⁶ Overall, the governor projects both operating and fund balance surpluses for the General Fund for all years from FY 2013 through FY 2016. The governor also proposes funding the Budget Stabilization Account and a Special Fund for Economic Uncertainties in the combined amount of \$1.5 billion as of the end of FY 2015-16.

Table 2 | General Fund Multi-Year Projection at 2012 Budget Act (\$ millions)

	2011-12	2012-13	2013-14	2014-15	2015-16
Resources					
Prior Year Balance	(\$2,685)	(\$2,882)	\$1,667	\$1,695	\$1,836
Revenues/Transfers	86,830	95,887	96,117	106,705	111,769
<i>Total Resources</i>	<i>84,145</i>	<i>93,005</i>	<i>97,784</i>	<i>108,400</i>	<i>113,605</i>
Expenditures					
Proposition 98	33,089	36,804	39,430	46,372	49,431
Non-Proposition 98	53,938	54,534	56,659	60,192	61,988
<i>Total Expenditures</i>	<i>87,027</i>	<i>91,338</i>	<i>96,089</i>	<i>106,564</i>	<i>111,419</i>
Fund Balances	(\$2,882)	\$1,667	\$1,695	\$1,836	\$2,186
<i>Source: California Department of Finance, Multi-Year General Fund Budget Projection.</i>					

Multi-year forecasts are an art form and not a science. Although useful for planning purposes, they need to be understood in the context of the continued threats to the state’s fiscal balance from escalating expenditures and weaker than expected revenue growth as well as less than full accrual basis of government budgeting that doesn’t report the full extent of some costs. While the positive fund balances may be projected, a significant amount of revenue growth will be dedicated to paying off prior budget related borrowing and meeting retirement and post-retirement benefits. Both circumstances will keep pressure on state program spending.

Politics of the Budgetary Process

There was a time when the politics of the state budgetary process were confined inside the statehouse door. Statewide services were financed with statewide resources and local services were financed with local resources. State finance is now

an intricate weave of state and local program responsibilities and funding streams that have made state and local governments interdependent. As noted later, this is particularly true in the system of financing K-12 schools.

The popular initiative process has played a role in the evolution of a stronger state presence in local affairs. At the beginning of the twentieth century, the California Constitution was modified with a series of measures approved by the voters that reflected the “progressive” mood of the times, including the initiative, referendum, and recall system. These provisions have significantly influenced the state’s fiscal health. State fiscal policy makers find themselves setting policy in response to major policy changes approved by the voters and brought to them by a parallel policy making process often sponsored by narrow interests that have failed to accomplish the same objective in the legislative process.

Perhaps the most famous fiscal initiative was Proposition 13, “The People’s Initiative to Limit Property Taxation,” proposed by anti-tax activists Howard Jarvis and Paul Gann. This 1978 initiative capped the local property tax rate at 1 percent of full cash value, originally set at 1975 market value, and provided that the assessed value of property could only be increased to reflect the sale or new construction of the property. Overall annual increases in assessed value for individual properties are capped at 2 percent or inflation, whichever is less. To prevent the legislature from increasing state taxes to cover the loss in local property taxes, Proposition 13 raised the vote threshold to increase a state tax from a majority vote to two-thirds of the legislature. This threshold remains in place today. Proposition 13 severely limited local services financed by the property tax, particularly for schools, and transferred much of school funding to the state.

In 1988, California voters approved another initiative, Proposition 98, which guarantees a minimum level of state revenues and property taxes be provided to K-14 education. Some analysts contend that Proposition 98 is a ceiling rather than a floor for education spending. As the Legislative Analyst points out, Proposition 98 and associated supplemental funding is not a panacea to the education funding problems caused in part by the effects of Proposition 13, which brought a greater financial contribution from the state. “Despite these efforts, school districts’ programmatic per-pupil funding is lower today than five years ago ... per-pupil funding in 2011-12 was \$7,583 — lower than the 2007-08 level of \$8,235.”⁷

Budget Making in California

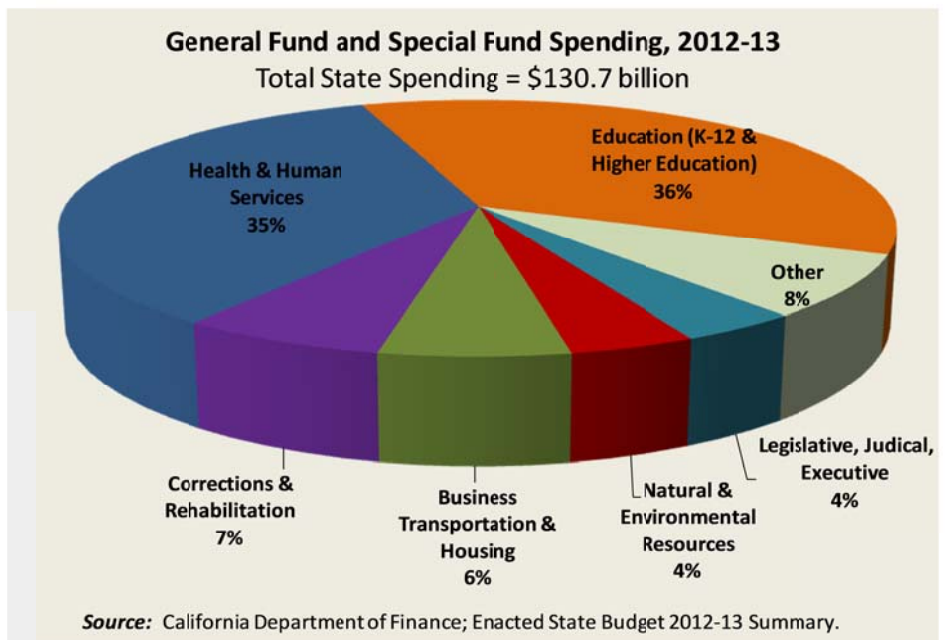
Understanding the Composition of State Spending and Revenue

The primary issue that confronts California budget making is that the state's revenue structure is insufficient to finance all of the current major obligations in education, health and human services, employee health and pension benefits, and criminal justice.

State Spending Structure

Since the 1960s the state budgeting system has used the "work load" budgeting model, which relies on the amount of money expended in the prior year as the basis for next year's spending. The policy debate often focuses on how much more funding a program should be granted as opposed to how results of the expenditure can be measured in order to improve results. Additionally, long term commitments from enhanced pension and employee benefits have made the "work load" budgeting system more difficult to manage. Voter approved initiative measures that earmark spending has complicated this process. The policy choices by the voters are often overlaid on existing budgetary obligations. Although current forecasts of revenue and spending show a smaller gap between expenditures and revenues, at root the problem is the lack of revenue to meet spending obligations over time.

Figure 1 | Composition of State Government Spending 2012-13



State Revenue Structure

The health of the private sector drives the health of the public sector. A direct link from one to the other is the state government's revenue structure. The purpose of the state's revenue system is to raise sufficient revenues to fund needed services and public investments over the long term. There are two issues related to the state revenue performance that should be of concern to state decision makers. One is how the revenue system performs over time relative to the state economy. Ideally, growth in the revenue system should keep pace with state economic growth without requiring tax increases. This especially is the case if the state's population is growing and if demand for other public services is increasing.

Figure 2 identifies the California tax structure that supports the operations of state government and funds statewide programs administered by local agencies. Although most of the revenue is spent on general fund activities, tax revenue is also dedicated to specific activities. In 2012-13 about 72 percent of state revenue supports general fund spending, with the remainder primarily dedicated through special funds to transportation, local health, social services, and criminal justice programs.

The mix of tax revenues has changed dramatically over the last fifty years as the economy and tax policies have adjusted the world of state finance. Note in Figure 3 that since 1990 the reliance on consumption taxes (sales tax) declined as the service sector rose and the share of disposable income for durable goods fell, and the changes in the income tax in the late 1980s increased reliance on the income tax. In the decade of the 1950s, over 70 percent of disposable income was spent on durable goods subject to the sales tax. It represented about 55 percent of state revenue. Today, about 57 percent of disposable income is spent on services; the sales tax on durable goods produces about 27 percent of total state tax revenue.⁸

Figure 2 | Composition of State Major Revenues, 2012-13

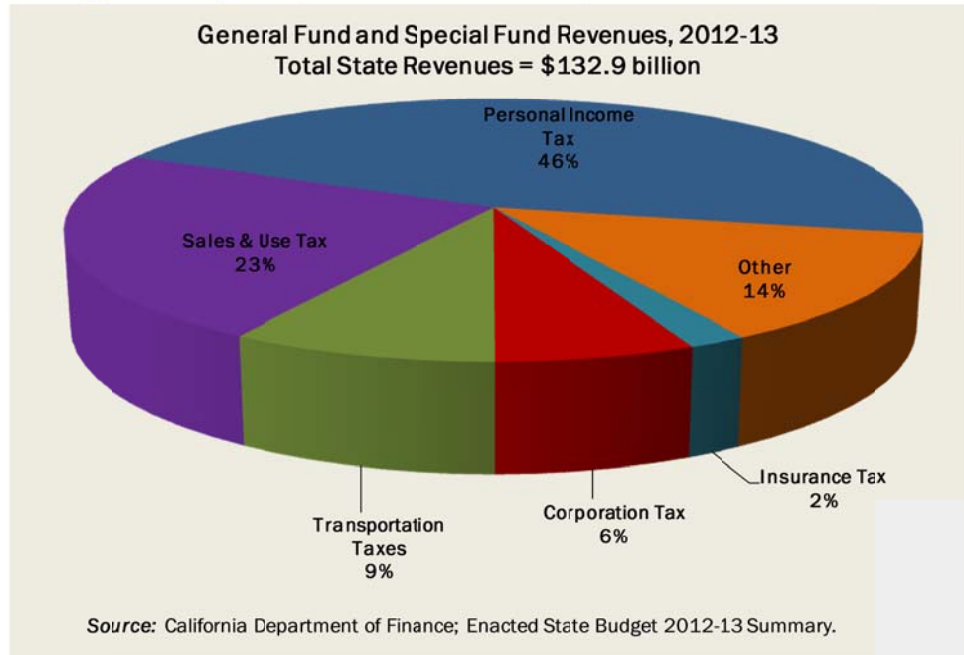
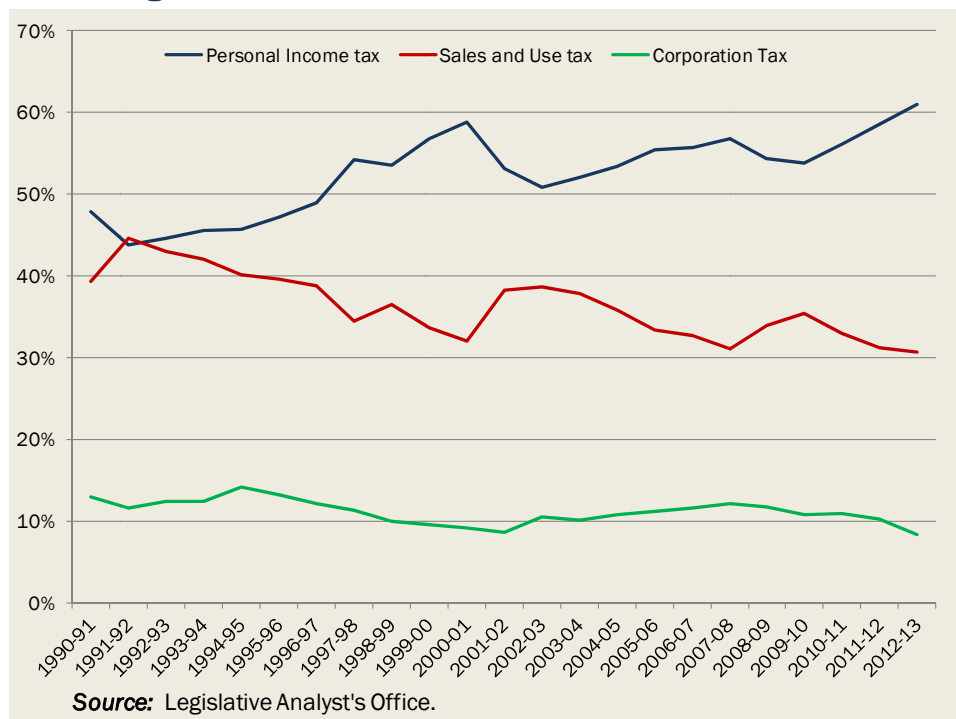


Figure 3 | Share of Major Tax Revenues, 1991-2013



Annual fluctuations in General Fund taxes have been quite significant. These fluctuations have been considerably more pronounced than the volatility in California's overall economy, and more substantial than the revenue fluctuations experienced in other states. This revenue volatility has contributed to major problems for state policy makers attempting to manage and balance California's state government budget.

Understanding Revenue Volatility

One of the effects of the high reliance on the income tax is its natural tendency toward volatility: both the size of fluctuations and their frequency. Ideally, a revenue system's growth pattern should be relatively stable and, therefore, predictable on an annual basis. It is one thing for a fiscal crisis to result from an economic recession and another for it to be from a "revenue surprise" caused by unanticipated fluctuations in tax receipts.

Volatility depends in large part on how a tax responds to changes in the broad economy. Some taxes, like the personal income tax, are more responsive to the economy than others. In this regard, a critical factor in determining the overall volatility of a tax system is the revenue mix. Since various taxes respond in different ways to the economy, an ideal state tax mix should be viewed as a portfolio of components that collectively follow a fairly predictable pattern. At times, factors outside normal economic growth can affect the performance of the individual components of the revenue system. California, like many other states, has had periodic declines in personal income tax revenues because of the capital gains component of the tax. Volatility in capital gains related revenues are partly a function of the economy, but they are also the product of other factors, including investor psychology and federal policy.

Figure 4 is a graphic display of the problem of having a high reliance on personal income taxes in a state that has a significant amount of personal income particularly at the high end of the income scale. It will naturally make the state revenue structure more volatile. In this case personal income changes respond to economic conditions which are less volatile than the personal income tax.

The swings in personal income tax revenue are primarily attributable to income from capital gains which move with economic conditions. Capital gains income is treated for tax purposes as regular income under the personal income tax.

Figure 4 | Year-Over-Year Change in Personal Income Tax vs. Personal Income, 1991-2010

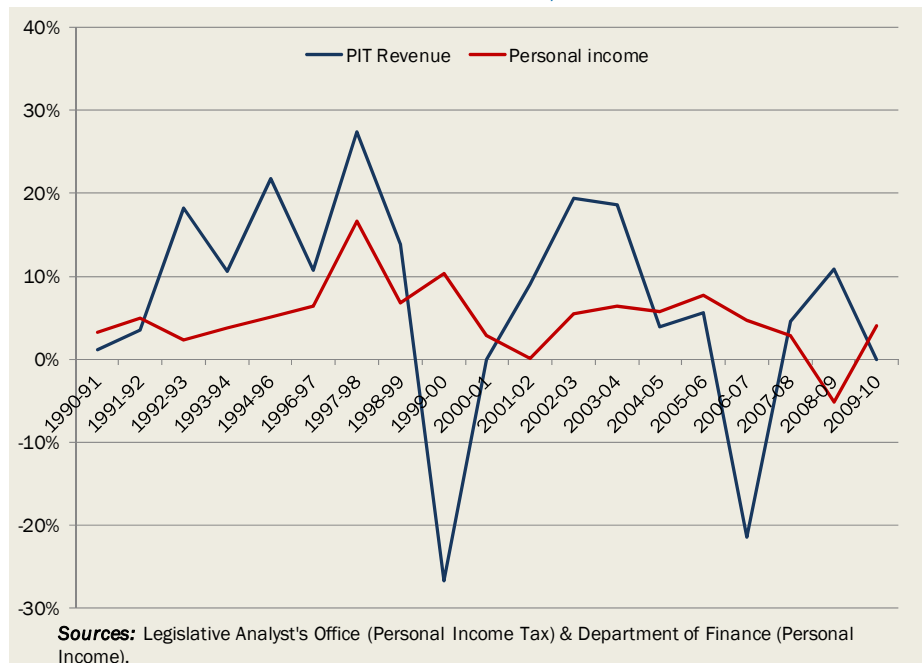
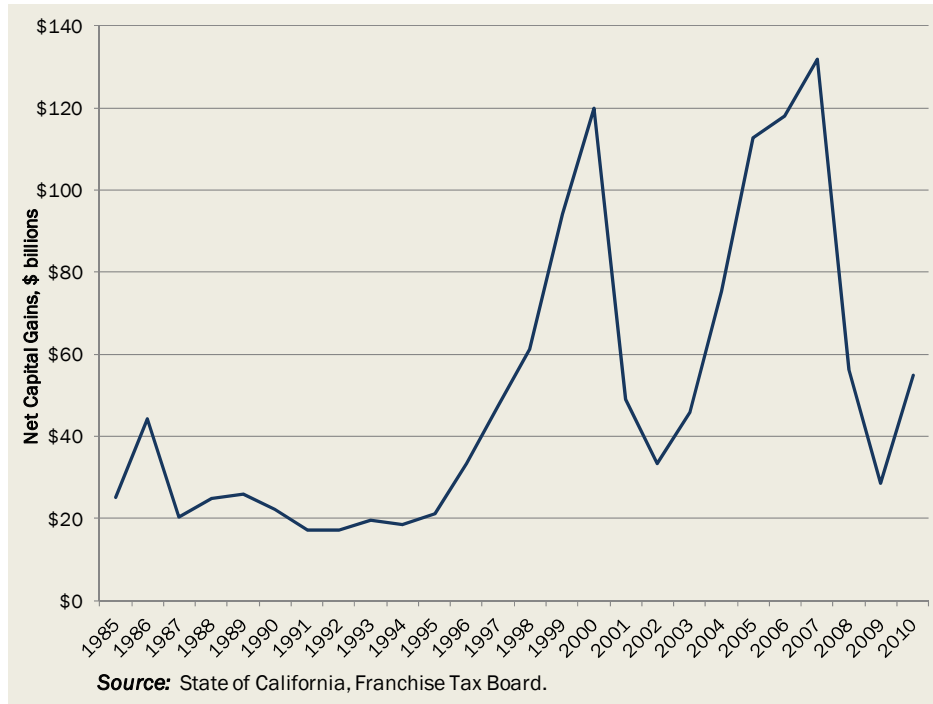


Figure 5 | Volatility — Capital Gains Are the Main Story

Understanding the Use and Nonuse of Reserves for a Rainy Day

Providing for budgetary reserves has been routinely avoided, in part due to weak constitutional rules for maintaining budgetary reserves. Proposition 98, which established the minimum funding requirement for K-14 education, also required that the annual budget include a “prudent reserve.” Without a meaningful definition of what constitutes the term “prudent,” the provision was generally ignored.

In 2004, as part of an effort to revise the state’s budgeting practices, a new reserve requirement was approved by the voters in the form of Proposition 58, a measure placed on the ballot by the legislature. Among other objectives, the measure strengthened the reserve or “rainy day fund.”

Specifically, the provision requires that a special reserve — referred to as the Budget Stabilization Account (BSA) — be established in the state’s General Fund. Annual transfers are made by the state controller of 3 percent of General Fund revenue, until the reserve balance reaches \$8 billion or 5 percent of General Fund revenues. The requirement may be suspended in a fiscal emergency called by the governor. The primary weakness of the 2004 measure is the ease with which the transfer from the General Fund into the reserve can be suspended. Although transfers were made in several years, the recent economic downturn eliminated any transfers into the reserve, resulting in limited resources in the reserve to help the state fiscal condition. In the final analysis, the reserve provisions in Proposition 58 did little to help the state even at the beginning of the recession.

As part of a budget agreement for the 2010-11 fiscal year, a constitutional amendment was approved by the legislature for the November 2014 ballot that, if approved by the voters, will bolster the reserve in the following ways:

- **Increase the size of the rainy day fund** — The rainy day fund would be capped at 10 percent of General Fund revenues, up from 5 percent.

- **Capture unanticipated revenues** — Unanticipated revenues would be captured and placed in the reserve. Unanticipated revenues are defined as revenues that exceed a twenty-year historical trend, after accounting for temporary tax changes. These unanticipated revenues can be used to pay down budgetary obligations or used for one time purposes once the reserve target reaches 10 percent of General Fund revenue.

Budgetary Borrowing and Other Temporary Measures

Prior to the 2001 recession, California achieved fiscal balance in difficult economic circumstances primarily with spending reductions and/or tax increases. Since that time budgetary solutions focused on a third category of options: borrowing money, deferring obligations, underestimating costs, and overestimating revenues. Here are examples of one time actions that increased resources or reduced expenditures without raising taxes and making major program changes that would result in decrease expenditures.

- **Temporary actions to close revenue and expenditure gaps:** Expenditure of increases in federal funds through the stimulus, or the American Recovery and Reinvestment Act (ARRA), helped maintain health and human service and education spending levels that otherwise would have been dramatically reduced.
- **Temporary taxes:** The FY 2009-10 budget agreement enacted a \$12.5 billion package of temporary increases: 1 percent in the state sales tax through FY 2010-11; 0.25 percent in the personal income tax through the 2010 tax year; and 0.5 percent in the vehicle license fee through FY 2010-11.
- **Budget-related borrowing and expenditure deferrals:** As noted earlier, one of the release valves to balancing budgets with spending reductions or tax increases is using borrowed funds or deferring spending obligations. With the adoption of the 2012-13 budget, those outstanding obligations represented about \$28 billion. Those obligations are noted in Table 3 below.

Table 3 | Remaining Budgetary Borrowing Obligation 2012-13

Borrowing Obligation	Amount (\$ millions)
Deferred Payments to Schools and Community Colleges	\$8,205
Economic Recovery Bonds	4,914
Loans from General Fund	4,110
Unpaid Costs of Local Government Mandates	5,055
Underfunding of the K-14 Min. Funding Requirement (Proposition 98)	2,756
Deferred Medical Costs	1,659
Deferral of State Payroll Costs from June to July	759
Deferred Payments to CalPERS	524
Borrowing from Transportation Funds	251
Total Budgetary Borrowing Obligations as of 2012-13	\$28,233
Source: California Department of Finance, Multi-Year General Fund Budget Projection.	

- **Revenue accelerations:** The state accelerated tax payments and temporarily restricted tax preferences (e.g., allowed net operating loss carry forwards for business taxes in particular years to be taken in later years).
- **Rosy scenarios (revenues and spending):** Annual revenue forecasts are based on economic forecasts that often rely on an optimistic view of the future. Since 1980, the large differences between forecast and actual revenues going into recessions were made up with strong growth in the rebound. This has not been the case since or during the Great Recession. The economic forecast that was the basis for the revenue forecast for the 2011-12 budget was overly optimistic. Expenses for employee pensions are determined using optimistic investment return assumptions.
- **Using nonrecurring actions in budgeting:** By definition, nonrecurring actions do not provide lasting fiscal solutions. Further, they worsen chronic fiscal imbalances. California has attempted to disprove this by continuing to use nonrecurring action to balance revenues and expenditures each year. The budget politics are to maximize the use of nonrecurring actions to minimize the negative reactions from constituent groups. One time changes are made with the assurance to constituent groups that *“you will get what you lost plus growth later.”* The result is that California is in its 11th year of operating deficits, and the recent LAO Fiscal Outlook shows continuing deficits, absent corrective action, through 2016-17.⁹

Program and Policy Risks

Potential Impact of Federal Actions on the Economy and California's State Budget

Looming large over California's fiscal condition is the impact of the automatic, across-the-board federal spending cuts contained in the Budget Control Act of 2011, otherwise known as "sequestration." The state is likely to feel a significant impact from the implementation of this statute if it is allowed to go into effect. Depending on implementation will mean an overall 10 percent reduction in federal grants to California which would cost the state more than \$6 billion, with most of this amount coming out of health and human services, as noted in Table 4 below. Federal procurement and salaries account for more than 4 percent of the state gross domestic product, so a significant reduction in federal spending could severely impact the state (see Table 5 below).

Table 4 | Potential Impact of a 10 Percent Reduction in Federal Grants

Potential cuts (\$ millions)							
	Total	Medicaid and selected other CMS programs	Highway Trust Fund	Temporary Assistance to Needy Families (TANF)	Title 1 education programs	Child nutrition programs	Potential cuts (\$ per capita)
United States	\$62,074	\$27,804	\$3,027	\$1,987	\$1,811	\$1,628	\$201
California	6,657	2,925	188	425	224	199	179
Illinois	2,319	984	86	73	83	62	181
New Jersey	1,631	684	62	61	35	33	186
New York	6,134	3,274	163	274	152	100	317
Texas	4,373	2,010	161	67	181	191	174
Virginia	1,065	422	85	17	28	24	133

Source: Task Force analysis of data from U.S. Census Bureau, Federal Aid to States for Fiscal Year 2010.

Table 5 | Federal Procurement, Federal Salaries, and Wages, 2010

State	Procurement			Salaries & wages		
	Procurement spending (\$ millions)	% of GDP	Rank, procurement amount	Salaries & wages (\$ millions)	% of GDP	Rank, salaries & wages amount
United States	\$474,204	3.3%		\$316,368	2.2%	
California	57,537	3.0%	2	24,585	1.3%	2
Illinois	11,601	1.8%	13	7,949	1.2%	13
New Jersey	10,236	2.1%	16	5,578	1.1%	19
New York	13,883	1.2%	8	13,936	1.2%	7
Texas	40,594	3.4%	3	29,926	2.5%	1
Virginia	58,338	13.8%	1	21,112	5.0%	3

Source: Task Force analysis of data from U.S. Census Bureau, Consolidated Federal Funds Report for Fiscal Year 2010 and U.S. Bureau of Economic Analysis, NIPA (GDP).

Education

For the last thirty years California has dedicated slightly over 50 percent of General Fund spending to K-12 and higher education. As with many state and local fiscal matters, the line of demarcation of state spending on K-12 education is court decisions in the 1960s that required a larger state presence due to significant variation in local property tax spending per pupil, and the passage of Proposition 13. The latter coupled with the former changed the funding of K-12 and community colleges by placing a cap on the local property tax and shifting the bulk of funding responsibility for both education segments to the state. Prior to Proposition 13 about 28 percent of General Fund spending was committed to K-12. Today it is about 40 percent. Prior to 1980 about 17 percent of general fund spending went to the three higher education segments: community colleges, the University of California, and the California State University system. Today higher education comprises about 12 percent of general fund spending. The primary cause of this reduction has been cost pressures of health, social services, and prisons.

The last three decades of local and school finance have created an intergovernmental ball of twine that few understand or can rationalize. Underlying this complex fiscal relationship between the state and community governments is the state-school fiscal system. It explains much of the tension between state control and desire for local flexibility that dominated the state's history from the early twentieth century until the late 1960s.

As noted earlier, Proposition 13 imposed a countywide property tax rate of 1 percent with the proceeds distributed among local governments, including schools by state statute. Since school districts are financed by a combination of local property taxes and state aid, any growth in local property taxes are a savings to state aid. As a result school districts are less interested in the economic health of their communities since any additional funding must come from the state.

In 1988, the voters adopted a minimum funding guarantee for K-12 through community colleges that is tied to growth in state personal income (Proposition 98). Although there are other components to the guarantee, the primary theory behind the guarantee is that spending on K-14 education should grow with the economy. However, this process allows plenty of room for political negotiation and value judgments, even though the objective of the provision is to provide a degree of stability and predictability to state education funding under normal budgetary circumstances.

There is considerable evidence that prior to the last recession many states were able to increase education aid on a per-student basis (see Table 6 below for growth in per student spending in the six study states); and some have been able to reduce teacher/student ratios and increase special education for disadvantaged students. (In most states revenues and property values were growing while the K-12 student population was flat, slightly declining, or only slightly increasing, though this was not the case in the study states of Texas and California.)

States vary tremendously in the extent to which they finance K-12 education — not only in the proportion of education costs financed by the state, but in state education spending as a percentage of state budgets. In Texas, state spending for K-12 education is more than 29 percent of total state spending, while in Illinois it is only 18 percent. The variations in state spending for higher education are even greater among the six study states, ranging from 4 percent of total spending in Illinois to more than 15 percent in Virginia (see Table 7 below).

Table 6 | Revenue Per Elementary and Secondary Pupil

Per student total revenues for public elementary & secondary education, 1999-2009								2009 shares (including ARRA)		
State	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09	% change, 1999-2009	State share	Local share	Federal share
United States	\$7,464	\$8,503	\$9,134	\$9,996	\$11,261	\$12,038	61%	47%	44%	10%
California	6,750	8,306	8,975	9,234	10,857	11,180	66%	57%	30%	13%
Illinois	7,625	8,892	9,190	10,146	11,342	12,508	64%	28%	61%	12%
New Jersey	11,178	12,157	13,825	15,602	17,418	18,302	64%	42%	54%	4%
New York	10,383	11,889	13,120	15,389	17,707	20,272	95%	46%	49%	6%
Texas	6,501	7,506	8,124	8,353	9,410	9,882	52%	43%	47%	11%
Virginia	7,436	8,135	8,735	9,952	11,440	12,109	63%	42%	52%	6%

Source: U.S. Department of Education, National Center for Education Statistics, Common Core of Data (CCD).

Table 7 | Education Spending as Percent of Total State General Fund Spending

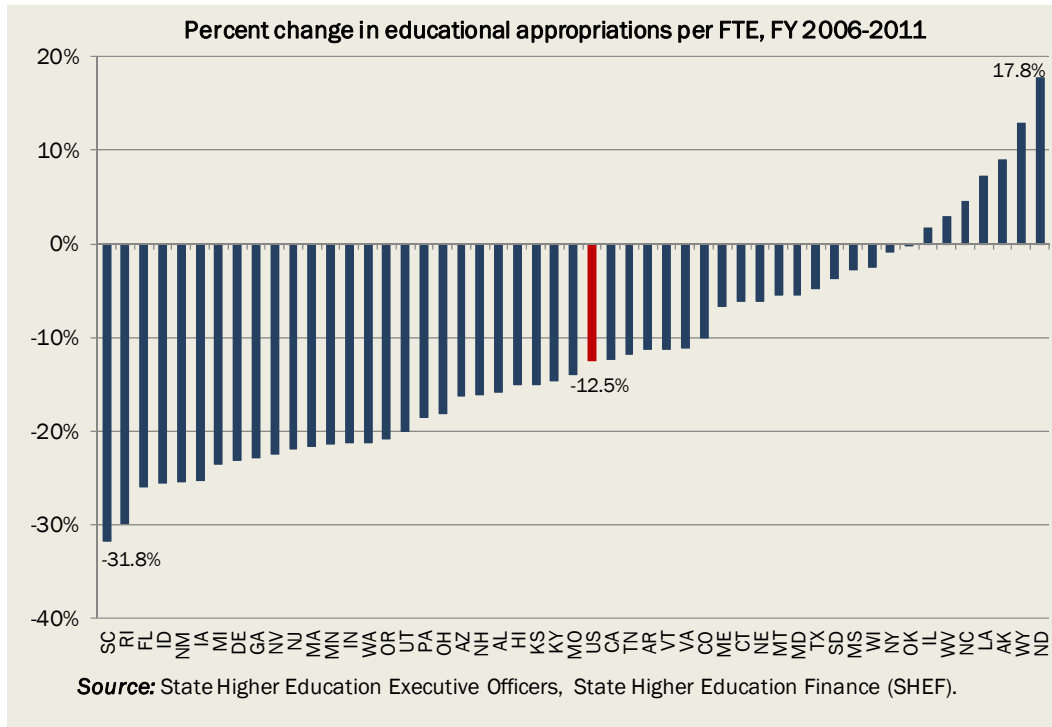
Education spending as share of total state & general fund spending							
Fiscal Year	Share of total funds		Share of general funds		State	Share of total funds, FY 2010	
	K-12	Higher Ed	K-12	Higher Ed		K-12	Higher Ed
FY 1998	22.0	10.3	35.2	13.1	CA	19.6	8.1
FY 2002	21.3	10.9	35.1	12.4	IL	18.2	4.5
FY 2008	22.0	10.7	35.0	11.7	NJ	24.6	7.9
FY 2009	21.5	10.5	35.2	11.5	NY	20.4	7.5
FY 2010	20.5	10.2	35.3	11.6	TX	29.3	10.0
FY 2011	20.1	10.1	35.0	11.5	VA	16.7	15.6

Source: National Association of State Budget Officers (NASBO), State Expenditure Report, 2010.

The reasons for these variations are rooted in the history and politics of each state. The variation in the share of total fund spending in California is attributable to an increase in nongeneral fund spending as general fund responsibilities have been transferred to special fund accounts. States such as Texas and California, which have experienced high levels of enrollment growth, cannot afford to increase spending per student simultaneously, while states such as New York and Illinois, with little or no enrollment growth, have significantly increased spending per student in the past decade.

Enrollment in California public higher education, which accounts for one-seventh of the nation's enrollees, grew by only 8 percent between fiscal years 2006 and 2011, compared to the national average of 17 percent, while Illinois enrollment grew by only 9 percent in the same period. New York and Texas had enrollment growth slightly below the national average, while New Jersey and Virginia had rates a little above average.

Figure 6 | Most States Have Been Cutting Support for Higher Education



Medicaid

California has a long history of expanding health care programs in particular, addressing the needs of the indigent, mentally and physically disabled, low income children and their parents, and low income elderly. Over the past several decades many of these state health care programs have been partially or wholly merged into the California Medical Assistance Program (Medi-Cal) in order to obtain federal reimbursement of at least 50 percent of their costs that are eligible under Medicaid.

As a state that has historically chosen to enact more generous eligibility criteria than most other states, California has funded its eligibility expansions through savings in other areas of the program. For example, provider rates average only 56 percent of Medicare rates, significantly lower than the national average of 72 percent.

Confronted with severe budget imbalances in the past several years, the state has pursued an aggressive program to reduce or at least contain Medi-Cal costs. But these efforts have been only partially successful in achieving cost savings due to lack of federal approval for many of the proposed changes and successful legal challenges.

According to Kaiser State Health Facts, total California Medicaid spending in federal fiscal year 2009 was \$41.7 billion. The California state share of this total was \$16.3 billion or 39 percent. Kaiser also reported California's Medicaid spending from the General Fund in FY 2010 to be \$10.3 billion or 11.8 percent of total General Fund spending, which is well below the national average of 15.8 percent. Most of Medicaid related state spending is from the general fund although new special funds have been created over the last several years to augment state participation in Medicaid.

Historical annual growth rates for total Medicaid spending in California averaged 8.5 percent in the FY 2001-2004 period, 5.1 percent in the FY 2004-2007 period, and 7.7 percent in the FY 2007-2009 period.¹⁰ While changes in funding structure and definitions in recent years make annual growth rates in General Fund spending for Medi-Cal difficult to compare, the

governor's budget proposal for FY 2013 says that annual growth has been about 6 percent since FY 2007 due to a combination of cost inflation and caseload growth.

California has one of the lowest levels of annual spending per enrollee in the country, at \$3,364, compared to the national average of \$5,337. The reason for this unusually low average is not that the state is parsimonious in delivering health care. Rather it results from a large percentage (40 percent) of children in the Medi-Cal program whose medical costs are far lower than elderly and adult costs, and from enrollees whose benefits are only partially reimbursable under Medicaid rules.

The governor's budget shows enrollment growing by 7.9 percent in FY 2013, but most of this is from the shift of children in the Healthy Families state program into Medi-Cal. Absent this shift, enrollment growth would have been 1.9 percent. Historical data show the usual pattern of high growth in years following the last two recessions and little or no growth in between.

The state estimates that annual state Medicaid costs under the federal Affordable Care Act (ACA) will increase by \$2.3 billion to \$2.8 billion at full implementation in FY 2018-2019.¹¹

Structure of Pension and Post-Retirement Benefits

California is home to the nation's largest public pension system, the California Public Employees' Retirement System (CalPERS), with more than \$260 billion in assets at year-end 2011.¹² It is also home to the nation's second largest public system, the California State Teachers' Retirement System (CalSTRS). CalPERS, CalSTRS, and the University of California Retirement Plan (UCRP) dominate pension-related fiscal issues for the state government. CalPERS provides benefits to state agency employees and to public agency employees in California's cities, counties, and special districts. Approximately 30 percent of CalPERS members are state employees, 38 percent are school employees, and 32 percent are local public employees.¹³ Although CalPERS administers three Defined Contribution (DC) plans, nearly all assets are held for its Defined Benefit retirement plans. CalPERS has a guaranteed draw on state funds for state agency employees: in other words, it simply submits a bill that the state must pay. State spending from all funds to CalPERS is estimated at \$3.6 billion in FY 2012, a substantial increase from earlier years. By contrast, payments to CalSTRS are set in statute and are not based on actuarial calculations.

Unlike most states California also has many large locally administered systems, 23 of which had more than \$1 billion in assets in 2009.¹⁴ These local systems generally are run by large counties, cities, and utility and transit systems, while most general purpose local governments contribute to CalPERS and school districts contribute to CalSTRS.

According to the U.S. Bureau of the Census, California's largest local system, the Los Angeles County Employees Retirement Association, had more than \$30 billion of assets in 2010 and was the nineteenth largest public retirement system in the nation, surpassing most state-run systems. Also according to the Census Bureau, there are 62 public pension systems in California, 5 administered by the state and 57 administered by local governments.¹⁵ Local systems accounted for 28 percent of public retirement system assets in California in 2010, compared with 17 percent for the nation as a whole.¹⁶ The proliferation of large local systems means that large California local governments face direct risks from underfunding of their own pension plans.

Funding Status

For the state as a whole, California's retirement systems' funded status (assets as a percentage of liabilities), using pension liabilities as reported under actuarial methods, is about the same as the national average: 77 percent, compared to 74 percent for the nation.¹⁷ (Actuarial methods generally underestimate true liabilities substantially. This can create incentives to enhance benefits or reduce contributions to pension funds, undermining their solvency; see Valuing Pension Liabilities. Table 8 below shows the aggregate percentage-funded status of 126 major state and local retirement plans for the nation as a whole and for the six study states for the most recent available year. These plans account for approximately 85 to 90 percent of the assets of the nation's 3,400 systems. Although California's percentage underfunding is similar to the national average, the unfunded liability per capita (the rightmost column of Table 8) is about 26 percent greater because pension benefits in California are greater than in the nation as a whole.

The actuarial funding system is designed to be self-correcting. It relies on assumptions about investment earnings, longevity of workers and retirees, inflation, and other hard-to-predict factors. Most of those assumptions will prove wrong to some degree. System actuaries or their outside consultants conduct periodic actuarial valuations in which they evaluate assumptions and determine whether the system is under- or over-funded by actuarial rules. (The retirement system board or, sometimes, the state legislature sets assumptions, informed by actuarial analysis.) If investment earnings or other assumptions are too optimistic, if all else is equal, employer contributions will rise in the future to make up for the shortfall. Because retirement promises generally have strong legal protections, employers will find it difficult to evade these increases by breaking pension promises. That said, this is an active area of litigation and the legal protections for pensions are evolving.

Table 8 | Funding Status of Major Retirement Systems Nationally and In Study States

State and local government retirement system funded status Major state plans and major local plans (\$ billions)					
Plan Name (asset value year)	Actuarial Liabilities	Market Value of Assets	Unfunded Liability (Surplus) Using Market Value of Assets	Funded Ratio Using Market Value of Assets (%)	Unfunded Liability Per Capita
United States totals, 126 plans	\$3,442.8	\$2,551.2	\$891.5	74.1%	\$2,882.1
Totals for 6 study states	1,542.2	1,156.0	386.2	75.0	3,459.2
California	597.4	461.6	135.8	77.3	3,635.9
Illinois	187.6	95.0	92.5	50.7	7,205.7
New Jersey	120.2	77.6	42.6	64.6	4,838.6
New York	348.0	301.2	46.8	86.6	2,411.8
Texas	214.0	167.7	46.3	78.3	1,835.2
Virginia	75.1	52.9	22.2	70.4	2,770.1

Source: Public Fund Survey for actuarial liabilities accessed June 19, 2012; market value of assets provided by National Association of State Retirement Administrators, June 19, 2012; Unfunded liabilities & funded ratios calculated by the Task Force.

Understanding which governments contribute to which systems is important to understanding the fiscal stress that could occur if required contributions rise significantly. Often there is pressure to shift fiscal stress to other governments. For example, CalSTRS is underfunded by \$64 billion, as reported under actuarial methods, because of investment income shortfalls and statutory contribution rates that are lower than annual required contributions (ARCs).¹⁸ Contribution rates are set by the state legislature. If and when the legislature approves higher rates, this could create stress for school districts. But because much school funding comes from the state and because the state could bear ultimate legal responsibility for benefit payments, California will face pressure to increase aid to school districts – either by explicitly helping districts make pension contributions or otherwise relieving their fiscal stress. According to its latest actuarial valuation, the legislature would need to approve contribution increases to CalSTRS of approximately \$3.5 billion annually to get onto a path toward eventual full funding.¹⁹ Economists expect CalSTRS to need roughly twice that much.²⁰

The most significant reason for pension underfunding is that investment earnings have fallen far short of previous assumptions. Many view the vagaries of the markets as being both outside the control of these pension systems and a short term event which, over the longer term, will be offset by gains. Most state and local government retirement systems use an earnings assumption that is at or near 8 percent. A retirement system's earnings may be reasonable by some standards but if it falls short of its assumptions, that is, if it earns less than what it assumes it will earn, unfunded liabilities accumulate relentlessly. Even during good times, pension underfunding can increase if investment income does not keep up with the amounts assumed. For example, if a pension assumes it will earn 8 percent annually but only earns 6 percent, then after ten years its investment income will be 32 percent short of what it assumed. And in bad times, underfunding can increase dramatically. During the 2008 financial market collapse, state and local government retirement funds lost nearly \$1 trillion of market value. The funded status of CalPERS fell from 100.1 percent in 2007 to 60.1 percent in 2009 on a market-value-of-assets basis, reflecting investment losses of 4.9 percent and 23.4 percent in 2008 and 2009, respectively.²¹ CalSTRS experienced similar declines during this period. Even setting aside the recent collapse, the pension systems have fallen short of their earnings assumptions over many different time periods.

In June 2012, the Governmental Accounting Standards Board (GASB) adopted new guidelines governing reporting of public pension liabilities and expenses.²² Those guidelines likely will lead to more realistic discounting of liabilities, although it will still be far from the economist's ideal (see Valuing Pension Liabilities).

Benefit Increases²³

When a pension system appears well funded, governments face pressure from workers and retirees, and sometimes from agencies recruiting workers with specialized skills, to enhance benefits – benefits that, once granted, have strong legal protections. After the rapid stock market growth of the 1990s, many funds reported actuarial surpluses and subsequently increased benefits.²⁴ If liabilities had been discounted using low-risk discount rates, systems would not have appeared as well funded.

California is an extraordinary example. The state and local governments expanded employee benefits substantially in 1999 and in 2001 following the passage of legislation on a bipartisan vote that increased retirement benefits for state workers by lowering the full retirement age and increased the benefit formula. It also defined final compensation as the highest twelve months of salary, provided up to a 6 percent increase in compensation *to those who had already retired*, and increased survivor benefits.

A CalPERS report stated that “no increase over current employer contributions is needed for these benefit improvements” and that the state’s annual pension costs would remain below \$766 million for “at least the next decade.”²⁵ However, since then, the pension system has earned an average annual rate of only 4.7 percent per year, far less than what was assumed.²⁶ The state has made up the difference, contributing \$27 billion – which was \$20 billion more than projected.

While there have been retroactive benefit increases in other states, many appear to have been less costly than the California case, often applying to a small number of retirees who receive relatively small pensions.²⁷

Outlook and Risks

Unfunded pension liabilities and associated contribution increases have been putting increasing strains on the state and on local governments in California. While the worst of the contribution increases soon could be over for governments contributing to CalPERS *if* it meets its actuarial assumptions, much larger increases will be required simply to put CalSTRS on a path toward full funding. When these increases finally occur, they will place strains on school districts and pressure on the state to help fund the increases.

And this is an optimistic view. It is based on underestimates of liabilities and assumes that investment returns will be sufficient to fund those liabilities – CalSTRS, for example, assumes it will earn 7.5 percent annual returns and CalPERS assumes it will earn 7.75 percent. If investment returns fall short, contributions will have to rise by much more.

In recognition of the pension issues faced by that state and local governments, the legislature and the governor agreed on changes in the CalPERS and CalSTRS pension programs that will limit costs of these programs over time. There are few savings to state and local budgets in the near term and limited efforts to deal with the unfunded liability of the systems. For the most part these changes apply to employees hired after January 1, 2013; none of the unfunded liability is related to new employees. It does not affect either the future benefit accruals of the existing workforce or the cost-of-living-adjustment (COLA) provisions for existing retirees – two provisions that can have substantial effects on unfunded liabilities. Major limitations include:

- Reduced Benefit Formulas and Increased Retirement Ages
- Cap Compensation Earnable for the Purposes of Calculating Pension Benefits
- Members to Contribute At Least One-Half of the Total Annual Normal Cost
- Prohibit Retroactive Pension Increases

Overall, the pension reform legislation is expected to generate savings gradually over time as new employees are hired. According to a CalPERS estimate over the next 30 years, the savings are expected to range between \$42 and \$55 billion for all State, schools and local agencies.

Valuing Pension Liabilities

One of the actuary's critical jobs is estimating the liability that a pension system has to its beneficiaries. This requires projecting benefits that will be paid in the future and "discounting" those benefits to the present. The choice of discount rate is critical. For example, the estimated liability today for a single-year's pension benefit of \$31,700, payable fifteen years hence, is approximately \$10,000 using an 8 percent discount rate, but more than \$15,000 using a 5 percent rate.²⁸ Put differently, using a 5 percent rate increases the estimated liability by about 50 percent relative to an 8 percent rate.²⁹

The impact on unfunded liabilities can be dramatic. In the example above, if a pension plan had \$8,000 in assets set aside for the future benefit it would have unfunded liabilities of \$2,000 at an 8 percent discount rate (given the liability of \$10,000). But with a 5 percent rate the plan would have \$7,000 in unfunded liabilities (given the liability of \$15,000) — the unfunded liability would be more than three times as large.

Under standard actuarial practice and accounting guidance from GASB, actuaries use a discount rate based on the expected return on assets held in the pension fund.³⁰ That is, the rate they use to discount liabilities is by definition the same as their investment earnings assumption, even though in concept they need not be the same. The vast majority of pension plans currently assume they will earn 8 percent. Economists and others have noted that the size of the liability has nothing to do with how much the funds will earn. As researchers Jeffrey Brown and David Wilcox noted, "This practice contrasts sharply with finance theory, which is unambiguous that the appropriate discount rate is one that reflects the riskiness of the liabilities, not the assets."³¹ The economics profession is virtually unanimous in this view.³²

There is no unanimity on what discount rate (or rates) would reflect the riskiness of pension liabilities, but given strong legal protections most researchers believe the risk of nonpayment is low, and some even believe benefits should be treated as risk free. This means that in current market conditions the discount rate would be far lower than 8 percent. The Center for Retirement Research at Boston College frequently uses 5 percent in its analyses.³³ Other researchers have used lower rates, which lead to even higher estimates of liabilities.³⁴ There is no definitive answer, and discount rates will vary with market conditions. There have been periods, particularly during the early 1980s, when risk-free or low-risk interests rates actually were higher than pension fund earnings assumptions.

Using a higher-than-appropriate discount rate can have at least three effects. First, pension plans will appear healthier than they otherwise would, potentially creating incentives to reduce contributions to plans or to enhance benefits. Second, it can create pressures for pension systems to invest in risky assets in an effort to achieve higher investment returns. A recent research paper on this topic concluded, "In the past two decades, U.S. public funds uniquely increased their allocation to riskier investment strategies in order to maintain high discount rates and present lower liabilities...."³⁵ Third, it can keep employer contributions artificially low, until and unless pension systems suffer investment shortfalls. Because these shortfalls often are associated with economic downturns and contribution increases follow shortly thereafter, the contribution increases can occur at the times governments are least able to afford them. Many governments in the six study states have not kept up with annual required contributions in recent years.

After several years of research and deliberation reflecting on these and other concerns and after hearing comments from stakeholders, in June 2012 GASB adopted new standards governing reporting of public pension liabilities and expenses.³⁶ Among other things, the standards would require pension systems to calculate liabilities using a blended discount rate

based upon a two-pronged approach. The portion of benefits that can be supported by existing assets, investment income, and contributions would implicitly be discounted using an interest earnings assumption, and the remaining “unfunded” portion would implicitly be discounted using a high-grade municipal bond yield, which typically would be much lower. In determining expected contributions, the plan would have to look to the history of governments making contribution and assess likely future contributions, which would not be easy to do given the history some governments have of contributing less than the annual required contribution. The effect generally would be to drive estimated liabilities upward for significantly underfunded plans, although the extent to which this would occur is not easy to estimate because it will depend on market interest rates, the details of each plan’s cash flow, and the extent to which retirement plans adjust their behavior in response. Many analysts have argued that this two-pronged approach has no theoretical basis and is subject to potential gaming; others have welcomed it as an imperfect improvement.³⁷

The Center for Retirement Research estimated that funded ratios for the plans in their database, which account for roughly 85 percent of assets, would fall from 76 percent to 57 percent if the then-proposed rules had been in place in 2010. The impact would vary dramatically from plan to plan, depending on its specific circumstances and contribution behavior. For example, the funded ratio of the main CalPERS fund was estimated to be unchanged at 65.4 percent, while the funded ratio of CalSTRS was estimated to drop from 59.7 percent to 41.2 percent.³⁸ (CalSTRS may be the exception in California. According to the CalPERS actuary, the “vast majority” of California public pension systems will not reach the crossover point’ at which they would have to use a lower discount rate.³⁹)

While declines in funded ratios could be quite significant, they pale in comparison to what would be reported if risk-free or low-risk discounting were used. For example, one recent analysis estimated that CalPERS’s funded ratio would be 45.1 percent at a 4.5 percent discount rate.⁴⁰

The use of lower-risk discount rates does not mean that pension funds should or will use earnings assumptions as low as the discount rate, or that they will eliminate risky assets from their portfolios. For several reasons, pension funds will continue to have investments in risky assets. Expected returns from those assets typically will be higher than the rate used to value liabilities.

The new GASB standards make many important changes in addition to those relating to discount rates. Among other things, they would make pension liabilities and expenses more visible and displayed on government statements of net assets and in operating statements, particularly in cases of “multi-employer cost-sharing” plans – plans where more than one employer participates and risks are pooled, so that there is not a separate account for each employer. Under previous standards the liabilities related to these plans were not well disclosed.

How, precisely, the new rules will affect government and pension system reporting and, ultimately, whether and how they will affect their behavior remains to be seen. The discount rate rules fall far short of what finance experts argue is appropriate and reported unfunded liabilities will not increase anywhere near as much as they would under a pure finance approach. On the other hand, in many ways, pension liabilities and expenses are likely to be far more visible than before.

Other Post-Employment Benefits⁴¹

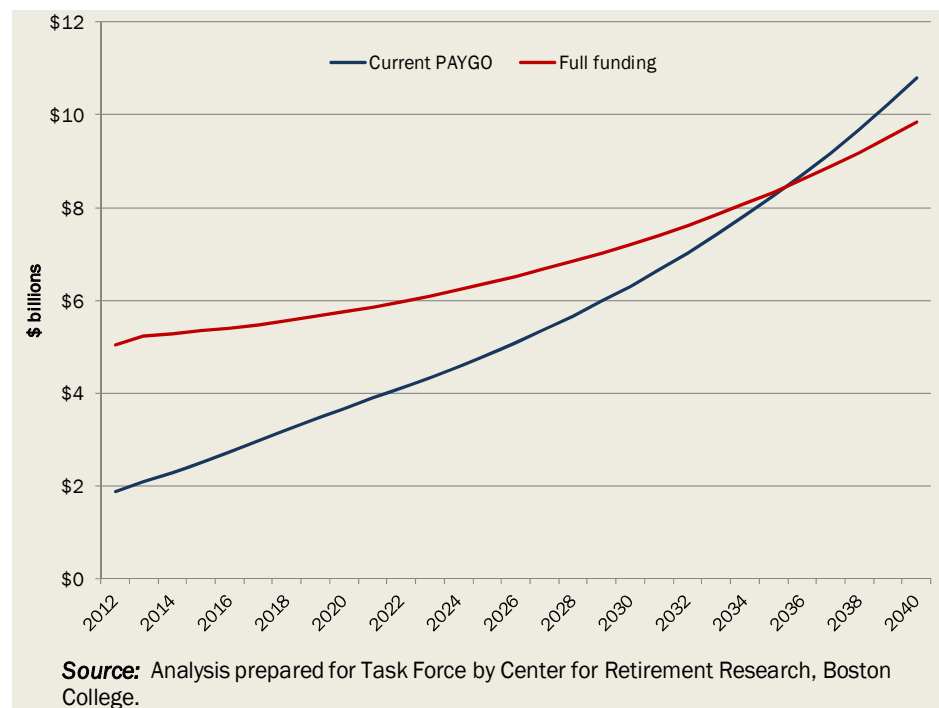
Pensions are one form of “post-employment benefit.” But governments also provide other post-employment benefits (OPEB), such as retiree health care. The State of California provides medical, prescription drug, and dental benefits to retired state employees through a defined benefit plan administered by CalPERS and the Department of Personnel Administration. Although the state offers life insurance, long-term care, and vision benefits to retirees, those benefits are completely paid for by retirees.

CalPERS retirees are eligible for a range of benefit plans after five years of service credit. The amount of the state subsidy depends on years of service and the date of hire. For example, retirees who began service before 1985 receive a 100 percent subsidy, regardless of the years of service. Retirees hired after 1989 with ten years of service receive a 50 percent subsidy; those with twenty years of service receive a 100 percent subsidy, subject to certain maximums.⁴² The state share of CalPERS retiree health benefits has been reduced somewhat over time.

The University of California currently contributes 86 percent of the health costs for retirees, but it is attempting to reduce that figure to 70 percent.⁴³ The subsidy level depends on an employee’s date of hire and tenure. Employees hired prior to 1999 with at least ten years of service receive a 100 percent subsidy. Those hired after 1990 receive a subsidy of 50 percent if the combined age plus years of service is 75. Employees hired after 1990 with at least twenty years of service will continue to receive a 100 percent subsidy.

California finances retiree health benefits on a pay-as-you-go (PAYGO) basis and thus, like most governments, its cash payments each year for current retirees are far lower than actual costs incurred (assuming that current benefits remain in place) as estimated by actuarial methods. The balance is “paid for” in new unfunded promises. If the assumptions about

Figure 7 | Annual Employer Payments to CalPERS for Retiree Health Under Current Pay-As-You-Go and Full-Funding Arrangements



health care costs, longevity, and other factors that underlie these estimates prove correct, and if governments do not change promised benefits, these liabilities will have to be paid in the future. California's PAYGO payments have been approximately one-third of the actuarially required contribution (ARC) in recent years. For example, for fiscal year 2012-13, California's retiree health benefit costs are \$4.7 billion, but only \$1.7 billion is being funded in cash. As a result, each year the unfunded liability increases. The state's unfunded actuarial accrued liability at the end of fiscal year 2011 totaled \$62.1 billion, an increase from \$51.8 billion at the end of 2010.⁴⁴ (In addition, the University of California Retiree Health Plan had an unfunded liability of \$16 billion.)

Pay-as-you-go amounts will tend to rise rapidly as more and more workers retire and health care costs rise. In contrast, ARCs will be much more stable. But for the typical plan, it will be many years before pay-as-you-go amounts will exceed ARCs. Figure 7, which is based on analysis conducted for the Task Force by the Center for Retirement Research, illustrates this fact for the retiree health plans in CalPERS: If employers were to fund the plan on an actuarial basis, annual contributions would rise almost immediately by more than \$3 billion. If they continue on a pay-as-you-go basis, it will be more than twenty years before payments rise to the level of the ARC. For governments focused on short-term planning, there is little incentive to prefund OPEB obligations.⁴⁵ As shown in Figure 7, it will be many years before PAYGO spending for retiree health benefits exceeds ARC payments under a full-funding approach.

In his 12-point plan, Governor Brown proposed reforms to retiree health care but the final legislation included no provisions addressing the problems. With the state spending on retiree health care growing at 12 percent per annum over the past ten years and the state scheduled to incur at least \$150 billion of retiree health benefits over the next thirty years, it is likely legislators will be back at the table soon.

As with most states, there are no definitive data on the unfunded retiree health care liabilities of state and local governments in California; states generally do not track the liabilities of their local governments. However, according to a survey conducted by California's Public Employee Post-Employment Benefits Commission in 2007, the amount state and local governments throughout California owe in retiree health care benefits (as self-reported by California state and local governments) was at least \$118 billion dollars.⁴⁶

Budgeting and Infrastructure

The state system for infrastructure planning, finance, and management is a mixture of state, regional, and local responsibilities. Statewide responsibilities extend to surface transportation, higher education, water and natural resources, and prisons. Shared funding responsibilities include public transit and K-12 education facilities. Under California law passed in 1999 the governor is required to annually submit a statewide five-year infrastructure plan along with a financing plan. The last time such a plan was submitted was as part of the 2008-09 state budget. For the categories of infrastructure discussed below, with the exception of highways and bridges, there is a consistent dearth of available data on the condition of assets, and existing forecasts indicate gaps in the funding necessary to bring and keep assets in a state of good repair.

Surface Transportation

According to the most recent federal data available, the conditions of California's highways are falling behind national averages. Although a greater percentage is in "good" condition, fewer are "very good," and more are ranked "mediocre" or "poor" than is true for highways nationwide.⁴⁷ Additionally, many of California's highway assets are reaching the end of their service lives, and most are at an age where they are deteriorating at an accelerating rate.⁴⁸ Based on data collected by the

Federal Highway Administration, 28.9 percent of California’s bridges are rated as either “structurally deficient” or “functionally obsolete,” which is 4 percent greater than the nationwide average. These ratings are the lowest of the five condition ratings available, and indicate a need for the repair or replacement of a certain component and/or that the existing configuration does not meet current standards and demands.⁴⁹

Mass Transit

There is no publicly available comprehensive assessment of the condition of California’s mass transit assets.⁵⁰ However, the San Francisco Bay Area Rapid Transit system (BART) was included in the Federal Transit Administration’s (FTA) 2009 Rail Modernization study, as it is one of the nation’s top seven transit agencies (based on ridership). Using data from BART’s FY 2008 Short Range Transit Plan and Capital Improvement Program, the FTA reported that to address deferred maintenance and keep up with normal repairs, the system would require average annual investments of \$386 million over twenty-five years. Expected annual funding levels through this period are only \$151 million, representing a gap of \$235 million each year for just this one transit system, one of thirty in the San Francisco Bay area and more than one hundred statewide.

Water

According to a 2007 U.S. Environmental Protection Agency (EPA) assessment, California makes up \$39,046.3 million, or more than 10 percent of the \$323,991.4 million nationwide total estimated capital needs for drinking water for the succeeding twenty years. California has a large wastewater infrastructure due to the state’s sheer size. No publicly available inventory and conditions assessment of wastewater collection piping throughout the state exists, but a 2011 Public Policy Institute of California study indicates significant costs associated with maintaining assets.

How to Pay for It?

Surface Transportation

Since 2008, California has lacked a central state capital planning document, even as under a 1999 statute, the governor is required to submit to the legislature annually a five-year infrastructure plan, incorporating the individual needs assessments from each state agency. However, in 2011 the California Transportation Commission conducted its own analysis, estimating the total cost of maintaining and expanding the state’s highway, bridge, and public transit assets over the next ten years to be approximately \$470 billion. This study estimates available revenues for transportation infrastructure over this same period at \$242 billion, leaving a shortfall of \$296 billion, or just over half of the projected need. Details are provided in Table 9 below.

Table 9 | California’s Transportation Infrastructure: A Ten-Year Cost Summary 2011-2021 (in \$ millions)

	Preservation & Maintenance	System Management	System Expansion	Total
Highways	\$79,660	\$7,545	\$78,740	\$165,945
Local Roads	102,900	2,295	24,156	129,351
Public Transit	142,357	1,270	30,904	174,531
Total	\$324,917	\$11,110	\$133,800	\$469,827

Source: California Transportation Commission, Statewide Transportation System Needs Assessment, November 2011, Table 1-1.

Historically, California has relied heavily on federal and state per-gallon excise taxes on transportation fuels to support its transportation systems. Inflation and rising fuel efficiency have eroded the value of these funding sources. In response, nineteen California counties have passed optional county sales taxes to try to fill some of the gap; but introducing or renewing local sales taxes dedicated to transportation has become more difficult after the passage of Proposition 218, which increased the required voter approval to two-thirds for these taxes.

Much of the state's infrastructure was built in the 1960s and 1970s and funded through user fees and current revenues. As these systems aged, this proved insufficient to fund the required maintenance and rehabilitation. To fill the gap, California, like most state and local governments, increasingly turned to general obligation bond financing.⁵¹

Today, nearly three-quarters of the state's revenues for infrastructure financing are estimated to come from bonds, compared with just over 40 percent in the mid-1960s.⁵² California applies a sales tax, in addition to levying a priced-based excise tax, to gasoline and diesel, though not at the general sales tax rate.

Water

California has a decentralized water management system. A lack of systematic control results in chronic groundwater overdrafts and inefficiencies in reservoir operations. According to the EPA, California has an estimated twenty-year need of \$39 billion for drinking water infrastructure and a \$29 billion need for wastewater treatment infrastructure. The lack of coordination among water agencies also results in gaps in the development and analysis of technical and scientific information, making statewide assessments of needs and forecasts difficult.⁵³ California's recent water-related spending has mostly been in response to increasingly stringent federal environmental regulations relating to local management or treatment of storm water runoff and wastewater. The State Water Resources Control Board has funded 296 new local wastewater treatment facilities in the past decade.⁵⁴ As of 2008, the average monthly wastewater user fee in California was \$33.82, with a highest reported monthly fee of \$231.92.⁵⁵ The state received more than \$280 million under the ARRA for wastewater projects.⁵⁶

Education

Created in 1998, a joint state and local school facility program has provided \$101.6 billion in local and state general obligation bond funds for new construction and major building renovations throughout the state. About 66 percent of this investment came from local general obligation bonds that are supported by property taxes. Department of Finance data projects about 83,000 new students by 2020. This translates into about 3,800 new classrooms. It is estimated that an additional \$18 billion investment in new classroom space including site costs plus building replacement costs of another \$18 billion will bring new construction cost forecasts to about \$36 billion. Rehabilitation of older existing facilities is estimated to cost \$36 billion. Add in the capital renewal of facility systems and the forecast for capital investment in K-12 between now and 2020 exceeds \$100 billion.⁵⁷

From 2000 to 2010, California invested more than \$40 billion in public higher education facilities: \$10 billion of this total came from state sources, mostly through general obligation bonds (80 percent) and, to a lesser extent, lease revenue bonds (19 percent). The remaining \$30 billion of higher education infrastructure spending comes from nonstate sources. For California's community colleges, local voters have approved \$22.8 billion for infrastructure over the past decade. Nonstate sources of funding also include fees for residence halls, parking, as well as overhead fees from research grants

and gifts. From these and other nonstate sources, the University of California (UC) spent about \$13 billion and the California State University system (CSU) about \$4.5 billion of nonstate funds over the past decade.⁵⁸

As of June 2010, California's Postsecondary Education Commission (CPEC) predicted enrollment of public higher education students would increase by 387,000 students over a ten-year period (2009-19); including 313,000 for community colleges, 54,000 for CSU, and 20,000 for UC. In their 2012 five-year plan, community college officials project approximately \$30.9 billion to meet projected needs: \$21.5 billion in the near term (\$12.75 billion for new facilities and about \$8.75 billion to modernize existing facilities); and an additional \$9.4 billion deferred to future years. Additionally, \$4.84 billion was identified for future phases of projects started in this time period.⁵⁹

UC and CSU cite backlogs of unfunded projects as a result of the lack of bond issuances over recent years. UC's Capital Budget proposal for 2012-13 is \$1.13 billion to make safety improvements, accommodate recent enrollment growth, renew facilities, and to make other program improvements.⁶⁰ CSU has not received funding for deferred maintenance since 2007-08, and report this has increased backlog of deferred maintenance from over \$39.8 million to \$453.41 million in 2012-13.⁶¹

Long Term Debt Structure

As shown in Table 10 below, California state and local governments have the largest amount of net tax supported debt (NTS) and the largest amount of total debt in the nation. However, on a per capita basis and when the state's gross domestic product is taken into account, the ranking is still within or near the top ten but not at the very top. California's NTS tends to be higher than other states because a significant portion of education capital expenditures is financed with state debt. By comparison, Texas has very low NTS but total debt on a per capita basis or as a percentage of GDP is more in line with national averages.

Table 10 | Total Debt All State and Local Governments (2009) and Net Tax Supported Debt (2011)

	US	CA	IL	NJ	NY	TX	VA
Long Term Debt Outstanding							
All Debt (\$ millions)	2,638,954	372,538	127,870	88,996	287,341	223,163	58,575
Rank		1	5	8	2	3	12
NTS (\$ millions)	509,500	96,436	32,999	34,971	62,441	15,104	9,466
Rank		1	4	3	2	9	15
Per Capita							
All Debt	8,634	10,079	9,992	10,164	14,883	8,998	7,390
Rank		7	9	6	1	15	27
NTS	1,408	2,559	2,564	3,964	3,208	588	1,169
Rank		9	8	3	5	39	21
Percent of GDP							
All Debt	19.00%	20.20%	20.20%	18.90%	26.30%	19.50%	14.30%
Rank		11	10	19	2	16	39
NTS	3.00%	5.10%	5.10%	5.40%	7.20%	1.30%	2.20%
Rank		9	10	6	4	40	29

Source: U.S. Census Bureau (debt and population); U.S. Bureau of Economic Analysis (GDP); Moody's Investor Service, 2012 State Debt Medians Report (NTS).

Long Term General Obligation Debt

The state has two major types of long term state supported debt: General Fund Supported and Self-Liquidating. As of October 2011, there were \$82.6 billion of General Fund Supported and \$8.39 billion of Self-Liquidating debt for a total of \$91 billion (see Table 11).

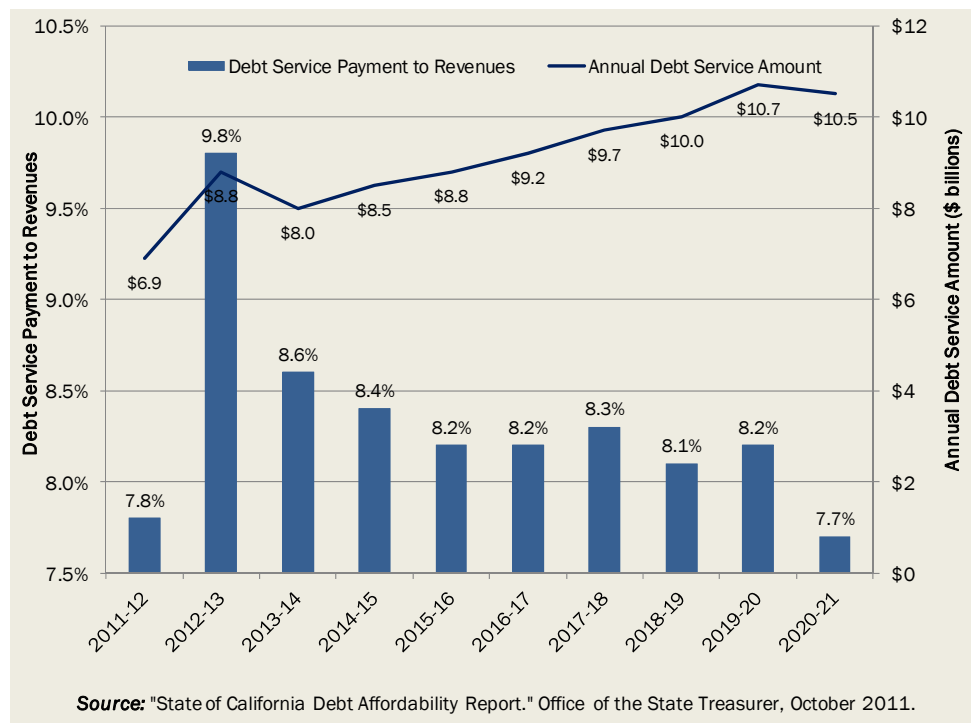
Table 11 | Summary of State’s Debt as of June 30, 2011 (\$ billions)

	Outstanding	Authorized but Unissued	Total
General Fund Supported Issues:			
General Obligation Bonds	\$71.3	\$37.1	\$108.3
Lease Revenue Bonds (b)	9.4	12.1	21.5
Proposition 1A Receivables Bonds	1.9	-	1.9
<i>Subtotal</i>	\$82.6	\$49.1	\$131.8
Special Fund/Self Liquidating Issues:			
Economic Recovery Bonds	\$7.2	-	\$7.2
Veterans General Obligation Bonds	0.8	1.1	1.9
Water Resources Development General Obligation Bonds	0.4	0.2	0.6
<i>Subtotal</i>	\$8.4	\$1.3	\$9.7
Total	\$91.0	\$50.5	\$141.5

Source: “State of California Debt Affordability Report.” Office of the State Treasurer, October 2011.

Figure 8 | Debt Service Payments With More SGP Debt Estimated General Fund Debt Service Payments to Revenues and Annual Debt

An additional \$50.45 billion has been authorized but unissued. The State Treasurer’s Debt Affordability Report of October 2011 presents three scenarios for future debt issuance and resulting debt service. One scenario assumes that the state issues the currently authorized but unissued General Obligation (GO) and Lease Revenue Bond debt, plus about \$20 billion of new, not yet authorized state supported bonds proposed by the California Strategic Growth Plan (SGP). The report estimates that this will result



Source: "State of California Debt Affordability Report." Office of the State Treasurer, October 2011.

in an initial increase in debt service as a percentage of revenues from 7.8 percent to between 8.2 percent and 8.6 percent. The scenario, shown in the Figure 8 below, further estimates that by 2020, debt service as a percentage of the budget is projected to fall to 7.7 percent.

Variable Rate Debt and Derivatives

The GO bond law permits the state to issue as variable rate indebtedness up to 20 percent of the aggregate amount of long term GO bonds outstanding. As of August 1, 2011, the state had outstanding \$4,844,275,000 principal amount of variable rate GO bonds, representing about 6.1 percent of the state's total outstanding GO bonds as of that date. There are no debt derivatives in the state's General Fund.

Short Term Debt

Since the majority of the state's General Fund revenues are received late in the fiscal year and expenditures are relatively continuous, the state General Fund experiences a negative cash flow. This timing difference is addressed by using external and internal borrowings. External borrowing is typically done with Revenue Anticipation Notes which are payable before the end of the fiscal year in which they are issued. External borrowing notes have been issued in all but one fiscal year since the mid-1980s and have always been paid at maturity (see Table 12).

The use of commercial paper is an additional short term borrowing mechanism to provide interim funding for its general obligation debt. As of September 20, 2011, the state had authorization to issue up to \$1.57 billion of commercial paper, although no commercial paper was outstanding at the time.

Internal borrowing for cash flow purposes within a fiscal year is done between funds. As of June 30, 2011, the state estimated that there were approximately \$18 billion of Internal Borrowable

Resources available.⁶² The state has also used a series of delayed payments to vendors and other governments to assure sufficient cash on hand to meet General Fund expenditures. In July 2009, because of difficulty in passing the state budget and lack of access to external capital markets, the state began issuing \$2.6 billion in registered warrants to pay certain obligations of the General Fund. These were tendered to vendors and others "not having payment priority under law." In essence these were IOUs backed by a future pledge to pay. All of them were redeemed prior to maturity on September 4, 2009.⁶³

Other Long Term Borrowing

Economic Recovery Bonds. The original amount of \$15 billion was approved by the voters and issued to be supported by a one-quarter percent sales and use tax redirected from the locally levied general purpose sales tax and use tax. In order to backfill the redirected sales tax, the state shifted an equal amount of property tax from K-12 school districts and then replaced the school district loss with an increase in the General Fund resources. The financing of the deficit bonds is

Table 12 | California Publicly Marketed Revenue Anticipation Notes by Year

Fiscal Year	Revenue Anticipation Notes
FY 2005-06	3.0
FY 2006-07	1.5
FY 2007-08	7.0
FY 2008-09	5.5
FY 2009-10	10.3
FY 2010-11	10.0
FY 2011-12	5.4

Source: State of California Revenue Anticipation Note Official Statement, September 2011.

ultimately the obligation of the General Fund. The purpose of these bonds was to fund the negative General Fund balance on June 30, 2004. There were about \$7 billion outstanding at June 30, 2011.

Tobacco Settlement Bonds. These were issued pursuant to the Master Settlement Agreement with tobacco companies signed in 1998. As of June 30, 2011, \$6.7 billion were outstanding. The proceeds of these bonds were used primarily for general fund purposes of plugging operating deficits. In addition to the pledge of tobacco settlement monies, the governor has an obligation to request an appropriation to pay debt service on approximately \$3.1 billion of the bonds issued in 2005 should tobacco revenues prove insufficient.⁶⁴

Proposition 1-A Bonds. The 2009 Budget Act authorized the borrowing of \$1.9 billion of monies that otherwise would go to local government in property tax revenues. This borrowing is due to be repaid in full in FY 2013.

Cal-Mortgage Loan Insurance. The Office of Statewide Planning and Development is authorized to guarantee up to \$3 billion in debt for health facilities projects. As of September 2011, \$1.8 billion in guarantees of loans had been made by this program. Recent actuarial studies indicate that there is no immediate likelihood of a call on the general fund.⁶⁵

Department of Water Resources. The department has outstanding revenue bonds totaling \$8.4 billion for electric power and \$2.5 billion for water. These are traditional revenue bonds secured solely by project revenues.

Local Government Fiscal Health

California has a long tradition of strong independent local governments that in most cases have the power to operate independently of the state on matters of local concern. In the case of counties, they often provide services as an agent for the state.

However, this local autonomy has been eroded since 1978 with enactment of Proposition 13. Increased centralization of fiscal authority for education and other programs at the state level has increased the normal tension between the state government's desire for statewide policy authority and localities' desire for autonomy.

Cities have been relatively independent of the state for the financing of municipal services since most of their resources come from user charges for such services. Only about one-third of their revenue comes from taxes, primarily transaction and property taxes. The amount they receive from property taxes depends on state policies which have varied over time, as the state until recently had plenary power to allocate property taxes among local governments. The state has also realigned responsibilities between the state and its counties and school districts with fiscal results sometimes benefitting the state and sometimes benefitting the counties and school districts, depending on the state fiscal condition. As a result the relationship between the state and its local governments is constantly shifting.

In the past, fiscal exposure to the state from the fiscal condition of local governments has been limited to school districts. All local governments except school districts have the right under state law to file for Chapter 9 bankruptcy, and a growing list have filed for bankruptcy protection, all with different circumstances that have brought them to that point. Orange County filed in 1996, and more recently the cities of Vallejo, Stockton, Mammoth Lakes, and San Bernardino have followed. In these proceedings the state has not committed any state funds. But a recently enacted law now requires cities to initiate a neutral evaluation process (mediation) before filing for bankruptcy to determine if the local government is, or is likely to, become unable to meet its financial obligations when due.⁶⁶ A variety of cities have confronted their fiscal problems without

heading down the path to bankruptcy protection. The City of San Jose addressed its growing pension obligation by going to voters with a city charter amendment that placed new limits on pension obligations. Similar actions have been taken in the City of San Diego. Since local fiscal circumstances are indeed local, the next several years will likely see more local agencies need to take drastic action to correct major fiscal imbalances. Common among those circumstances are cities that have relied on pension obligation bonds to meet pension payments, negative or flat growth in property values due to significant numbers of properties in foreclosure, extensive borrowing that was supported by economic forecasts that proved overly optimistic, and commitments to employee pensions that are not sustainable over time. As with many local agencies local fiscal pressures will force new retirement agreements with employees. As noted earlier, legislation enacted in 2012 places limits on retirement benefits for employees hired after January 1, 2013.

Conclusions and Observations

The recent recession and financial crisis have exposed structural fiscal problems in California. These problems are amplified by the state's revenue structure that is more volatile than the economy and is insufficient to finance the state's spending priorities. California, like many other states and their localities, faces major challenges due to the aging of the population, rising health care costs, unfunded promises, increasingly volatile revenue and an eroding sales tax base, and impending federal budget cuts. California needs to confront these challenges on several fronts. The following is an agenda that should be considered as California looks ahead.

Extend the Fiscal Horizon

For the past forty years the state government budgeting process has been an annual event with little effort to understand the long term needs of the state. The governor's spending plan containing the proposed budget focuses on the incremental growth of programs. The question most often asked is: "How much more does my program get than it got last year?" The more important question to answer is: "How will our spending plan invest in California's future and how can we use our budget expenditures to improve program performance?"

Here are three changes the state could make to its budgeting practices that would help refocus attention on the future as well as the present.

- Develop a two-year spending plan with annual appropriations.
- Include a five-year fiscal forecast (three years beyond the two year spending plan) that focuses on major program areas such as education, health and human services, and criminal justice.
- Develop and adopt a five-year strategic growth and infrastructure finance plan. Integrating the state's economic and demographic growth with expenditure and infrastructure forecasts would provide policy makers with the tools to consider the longer term needs of the state.

Provide Transparent, Accountable State Government Finance Systems That Focus on Results

Governor Brown took the first steps in moving toward a results oriented budgeting practice in the spring of 2012. An Executive Order⁶⁷ started the process of revising the budget making process to begin to focus on results. At the May Budget Revision a group of departments were chosen to begin the process of establishing metrics that will allow the public and the legislature to review the results of their investment. Over time this first step will hopefully bring about a major change in budgeting practices throughout state government.

Rethink California's State and Local Tax Structure

Although many commissions and task forces have come and gone over the last twenty years, California must again take a serious look at how it finances state and local services. Tax reform at the state level may be needed to achieve revenue systems that are adequate and predictable and that minimize volatility. The objective of this analysis should include:

- Broadening the base of taxation while lowering tax rates.
- Aligning the allocation of revenue to structural changes designed to improve results and accountability. The various levels of government responsible for providing services must have adequate fiscal control to set priorities and adjust strategies so they can achieve objectives and be held accountable for results.
- Aligning the tax structure to the new economy. California is transitioning to a knowledge- and service-based economy, which has ramifications for how tax structure influences investment decisions, and not simply determining the amount of revenue generated by the economic activity.

Rethink Pension and Post-Employment Benefits

Pension plans need to account clearly for the obligations they assume and disclose the potential shortfalls and risks they face. Legislators, administrators, and beneficiaries alike need to develop and adopt rules for the responsible management of pension plans and mechanisms to ensure that required contributions are paid. As it begins a process of revising state and local pension systems, California should recognize and account for post-employment benefits that they intend to continue, such as health care.

The state and many of its local governments are extremely stressed by underfunded retirement liabilities and rising pension contributions and health care costs. Some of this is the result of their own choices to underfund liabilities, but much is due to dramatic shortfalls in investment income relative to earnings assumptions. This has been abetted and encouraged by opaque reporting and accounting that understates liabilities and makes it difficult to know what a particular level of benefits costs and what it would take to afford those benefits. As a result, California has made expensive promises that are hard to change and it has underfunded those promises. Current adopted pension reform is unlikely to make a significant dent in these liabilities.

Work Together With the Federal Government to Control Health Care Costs and Medicaid Costs

State costs for existing Medicaid programs are likely to continue to grow faster than state revenues; many states already consider these costs unaffordable unless they scale back other essential functions or substantially raise taxes. Now that the Supreme Court has validated most of the Affordable Care Act, states that implement eligibility expansions will incur additional annual costs over the next eight years that could range from 0 to 5 percent of baseline Medicaid spending. California is on a path to implement the Affordable Care Act.

Monitor Local Fiscal Conditions

California has continued a long tradition of maintaining a fairly flexible municipal finance system, with the exception of school districts, although California has set up a local procedure for dealing with fiscal insolvency it has few effective procedures for monitoring the fiscal condition of local governments. There is no statewide system for state intervention in either county or municipal government. The state's system of local finance has enough flexibility that it may not be necessary for the state to establish an aggressive intervention program, one that it is not likely to afford.

Develop Realistic Multi-Year Strategic Plans to Fund Essential State and Local Infrastructure

Essential state and local infrastructure is starved of funding and necessary maintenance. This underfunding threatens competitiveness; the longer it is ignored, the larger the problem it will pose. An essential first step toward mitigating the problem will be to adopt and fund realistic annual capital budgets based on multi-year capital plans.

Develop Better Tools for Managing Over the Business Cycle

A priority for California should be better use of existing counter-cyclical tools, including “rainy day” funds and repayment of debts in prosperous periods. The measure that will be on the November 2014 ballot will help in this regard. As noted above, this new requirement will set aside “spikes” in revenue and keep them from falsely inflating the spending base.

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- 17 The economics profession is virtually unanimous in believing that these methods use inappropriate discount rates that, under current market conditions, underestimate liabilities quite significantly. See the discussion of this issue in the Report of the State Budget Crisis Task Force, July 2012, and the brief discussion later in this document.
- 18 Based on the 2011 actuarial valuation, using the actuarial value of assets.
- 19 Based on the 2011 actuarial valuation, assuming the system earns an average return of 7.5 percent per year.
- 20 Based on analysis prepared for the Task Force by the Center for Retirement Research, Boston College.
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