LAO
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July 30, 2009

Hon. Juan Arambula
Assembly Member, 31st District
Room 2141, State Capitol
Sacramento, California 95814

Dear Assembly Member Arambula:

You asked our office to provide a list of the state's key liabilities—that is, debt, deferred payments, and other liabilities that will affect the state's financial health in the future. Below, we divide these liabilities into three categories:

- ***Budget-Related Liabilities.*** These include actions taken by the state that have resulted in future budgetary obligations.
- ***Infrastructure-Related Liabilities.*** These include both general obligation (GO) and lease-revenue bond (LRB) debt.
- ***Retirement-Related Liabilities.*** These include unfunded actuarially accrued liabilities for pensions and retiree health benefits.

Budget-Related Liabilities

These liabilities—consisting of budgetary deferrals and loans—total about $35 billion.

Employee Pay and Benefit Deferrals. The July 2009 budget package includes a one-day delay of the June 2010 payroll to July 1, 2010. This delay will defer approximately $0.9 billion of General Fund expenses from 2009-10 to 2010-11.

Proposition 98 Deferrals. In recent years, the Legislature increasingly has resorted to deferring payment of Proposition 98 expenses to the subsequent fiscal year. About $6.3 billion of such deferrals were included in the 2009-10 budget package, as recently amended by the Legislature.

Special Fund Budgetary Loan Repayments. In addition to special fund cash-flow borrowing, the General Fund also undertakes budgetary borrowing from special funds. Unlike cash-flow borrowing, these budgetary loans generally remain outstanding for several years. These General Fund repayment obligations to the state's various special funds currently total around $2 billion.

Mandate Reimbursements. Currently, the state owes about $1 billion to local governments (excluding school and community college districts) for mandate claims and about $1.5 billion for education-related mandates.

Quality Education Investment Act (QEIA) Obligations. The Legislature created QEIA in response to a settlement the administration reached with the California Teachers' Association regarding the suspension of Proposition 98 that occurred in 2004-05. Currently, about $2.1 billion of QEIA obligations remain outstanding to be repaid in future fiscal years.

K-12 Revenue Limits and Proposition 98 Maintenance Factor. The state has a statutory obligation to pay school districts $7.3 billion in "deficit factor" revenue limit payments in future years. (These arose from the state not making statutorily required payments—for example, by foregoing a cost-of-living adjustment in recent years.) In addition, in the July budget package, the Legislature committed the state to make $11.2 billion in future "maintenance factor" payments to education as a result of funding reductions in 2008-09. These obligations, however, are not cumulative, inasmuch as the Legislature could choose to meet its maintenance factor obligations in the future by reducing its revenue limit obligations.

Proposition 1A Repayments. The July 2009 budget package borrows local property taxes in the amount of $2 billion, to be repaid with interest within three years pursuant to a constitutional requirement.

Economic Recovery Bonds (ERBs). Authorized by Proposition 57 of 2004, ERBs were used to retire accumulated General Fund deficits from earlier in the decade. About $8 billion of outstanding ERBs remain.

Infrastructure-Related Liabilities

These liabilities—consisting of the state's major categories of bonded indebtedness—total about $69 billion.

GO Bonds. Used principally for infrastructure purposes, GO bonds currently are outstanding in the amount of $61 billion. They are paid principally from the General Fund.

LRBs. Used mainly for construction of state facilities, LRBs currently are outstanding in the amount of $8 billion and are paid principally from the General Fund.

Retirement-Related Liabilities

Retirement-related liabilities to be paid by the state's General Fund are difficult to quantify precisely for several reasons discussed below. In total, unfunded retirement-related liabilities of entities connected with the state exceed $100 billion. Because of recent investment value declines for retirement systems, these unfunded liabilities may actually exceed $130 billion once the declines are fully incorporated into the systems' actuarial valuations.

California Public Employees' Retirement System (CalPERS). The state—along with school districts and other local governments—participates in CalPERS' Public Employees' Retirement Fund (PERF). As of June 30, 2008, the state's share of the PERF's assets was valued at $89 billion on an actuarial basis, and the state's share of the PERF's accrued pension liabilities was estimated to be $108 billion. This means the state's unfunded actuarial accrued liability (UAAL) in the PERF totaled about $18 billion. In addition to the PERF, UAALs also exist in the Judges' Retirement Funds administered by CalPERS totaling around $2.9 billion. There is no UAAL in the Legislators' Retirement System, which was essentially closed when voters prohibited legislators from earning state retirement benefits beginning in 1990. Accordingly, the state's share of CalPERS' UAALs totaled around $21 billion as of June 30, 2008. A significant share of these liabilities—perhaps over 40 percent—are likely to be paid from state funds other than the General Fund.

California State Teachers' Retirement System (CalSTRS). As of June 30, 2007, CalSTRS' UAAL totaled $21 billion. Under current law, the state, school districts, and teachers and administrators contribute to CalSTRS to cover the normal cost of accruing pension benefits, as well as a part of the costs to amortize CalSTRS' UAAL. Accordingly, it is difficult to predict precisely what portion of the UAAL will be paid by the state and which will be paid by school districts or employees. Because the state has funding responsibilities, however, for school districts, it is likely that a significant portion of these costs will be borne by the General Fund either directly (through continued state contributions) or indirectly (through payments to school districts).

State Retiree Health Benefits. As of June 30, 2008, the state's UAAL for state government and California State University retiree health benefits totaled $48 billion. As you know, the state pays for these benefits on a "pay-as-you-go" basis and has never set aside funds to begin to retire unfunded accrued liabilities from prior years. As with pension liabilities, a significant portion of these liabilities is likely to be paid from state funds outside of the General Fund.

University of California (UC) Retirement Benefits. As of July 1, 2008, the actuarial value of assets for UC's pension plan was $44 billion, and the actuarial value of its liabilities was $43 billion. While the resulting actuarial surplus of over $1 billion seems like good news, it is important to remember (as we discussed beginning on page 62 of the *2009-10 Budget Analysis Series: Higher Education)* that neither UC employees nor the university nor the state have contributed significant funds to the plan since 1990. The combined effects of this continuing funding holiday and the recent investment market declines mean that the plan's July 1, 2009 valuation will reveal a UAAL for the system for the first time since 1987. As part of the February 2009 budget package, the Legislature indicated its intent not to provide contributions to the UC plan in the future, but did not specify how UC should fund the significant UAALs that will emerge shortly and likely grow substantially thereafter. In addition to the issues with UC's pension plan, UC—like the state and most other state and local governments—has typically paid retiree health benefits on a pay-as-you-go basis and has a $13 billion UAAL for these benefits.

Effects of 2008-09 Investment Market Declines. There are various difficulties in quantifying the state General Fund's share of retirement-related liabilities, and these difficulties have increased recently due to the large declines of stock market, real estate, private equity, and other investment values during 2008-09. The preliminary report of returns for CalPERS' portfolio in 2008-09, for example, showed that the system's asset value declined by 23.4 percent during the fiscal year. Once fully included in CalPERS' UAAL calculations, this could increase the state's share of PERF liabilities by as much as $20 billion. Similarly, CalSTRS' UAAL could increase by over $10 billion, and the market declines will contribute to the reemergence of a UAAL for UC's pension plan. The state will begin to pay higher contributions to CalPERS and CalSTRS in 2010-11 to begin to retire unfunded liabilities resulting from the 2008-09 market losses.

Summary

While certain liabilities are difficult to quantify precisely, it appears the state has over $200 billion of short-term, longer-term, and retirement-related liabilities to retire in future years. These liabilities will continue to put pressure on the state's finances for years to come.

If you have additional questions, please do not hesitate to call me at (916) 445-4656 or Jason Dickerson at (916) 319-8361.

Sincerely,

Mac Taylor
Legislative Analyst