A MONTHLY REPORT FROM STATE CONTROLLER BETTY T. YEE

California Fiscal Focus

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CA Controller Reports "Big Three" State Revenue Sources Fell Below Budget Estimates for December

California revenues of $12.85 billion for December missed projections in the 2016-17 Budget Act that Governor Jerry Brown signed in June by $1.87 billion, a shortfall of 12.7 percent, State Controller Betty T. Yee reported—just as the Governor's Department of Finance released its proposed 2017-18 budget.

"Given the state's revenue shortfall and an inevitable future economic downturn, coupled with unpredictable federal funding under the new president, Governor Brown is right to be cautious," said Controller Yee. "After CalPERS' recent action to reduce the discount rate, I am pleased the proposed 2017-18 state budget would increase the state employer contribution by $172 million. This will help to stabilize the pension fund as the Board continues to work judiciously to secure public employees' earned benefits."

The "big three" sources of California general fund dollars—personal income taxes, corporation taxes, and retail sales and use taxes—all missed the monthly mark and are now behind fiscal year-to-date estimates. For the first half of the fiscal year that began in July, total revenues of $51.72 billion are $1.66 billion below budget estimates.

December personal income tax (PIT) receipts of $8.58 billion fell short of budget projections by $1.38 billion, or 13.9 percent—roughly the same percentage by which November PIT receipts topped estimates. Six months into the new fiscal year, California has collected total PIT receipts of $34.58 billion, missing estimates by $824.1 million, or 2.3 percent.

Corporation tax receipts of $1.77 billion for December were $29.4 million lower than expected. Fiscal year-to-date corporation tax receipts of $3.23 billion are $347.7 million below projections in the 2016-17 Budget Act—a shortfall of 9.7 percent.

Retail sales and use tax receipts of $2.14 billion for December missed expectations by $372.1 million, or 14.8 percent. For the fiscal year-to-date, sales tax receipts of $12.06 billion are $610.4 million below estimates, or 4.8 percent.

For more details, read the monthly cash report.

Inside this issue

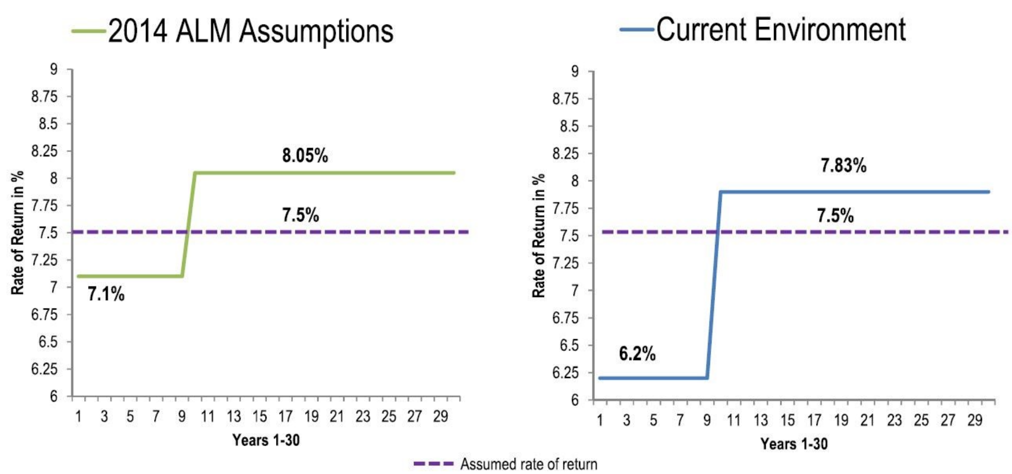
CalPERS Lowers Discount Rate to Safeguard Retirement Benefits

As California's chief fiscal officer, State Controller Yee serves on the board of the California Public Employees' Retirement System (CalPERS). In December 2016, the CalPERS board acted to safeguard retirement benefits promised to 1.8 million state and local government employees by gradually lowering the expected rate of return ("discount rate") to 7.0 percent over the next three years. After a months-long process involving staff, employer and employee stakeholder groups, and outside investment experts, the board concluded this action was necessary to stabilize the fund, as changing market conditions have resulted in a drop in expected 10-year investment returns from 7.1 percent to 6.2 percent.

Figure 1

Change in Market Conditions

Source: CalPERS (December 2016)



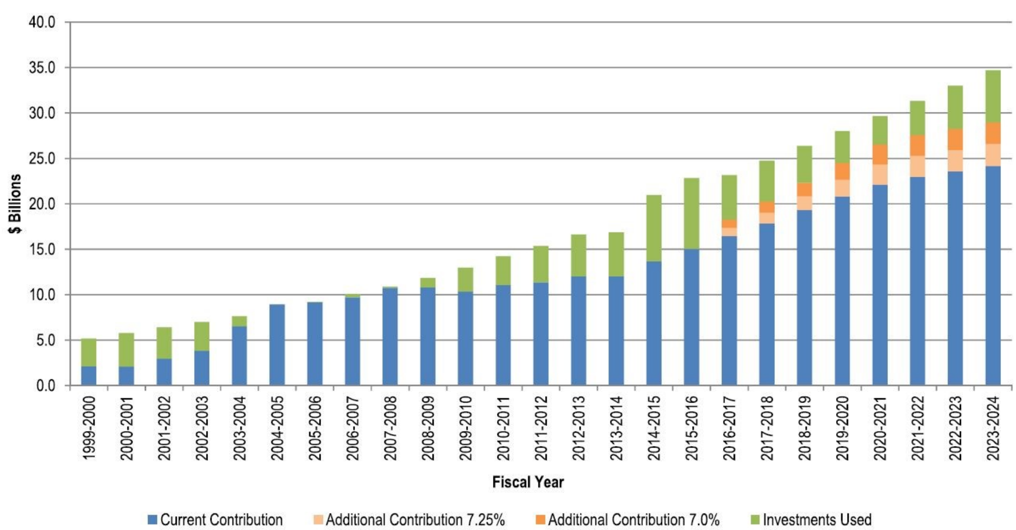
CalPERS is a long-term investor; however, the next 10 years are consequential to close the cash-flow funding gap and increase the fund's stability. For every dollar of retirement benefit, investment earnings account for 62 cents, employers pay 25 cents, and employees contribute 13 cents.

When investment earnings on the $303 billion portfolio are far lower than expected over a sustained period of time, the shortfall to fund benefits is filled by selling CalPERS assets. This negatively affects the fund in two ways: fewer invested assets results in less interest earnings, and

Figure 2

Historical & Projected Public Employees' Retirement Fund Contributions & Investments for Benefit Payments

Source: CalPERS (December 2016)



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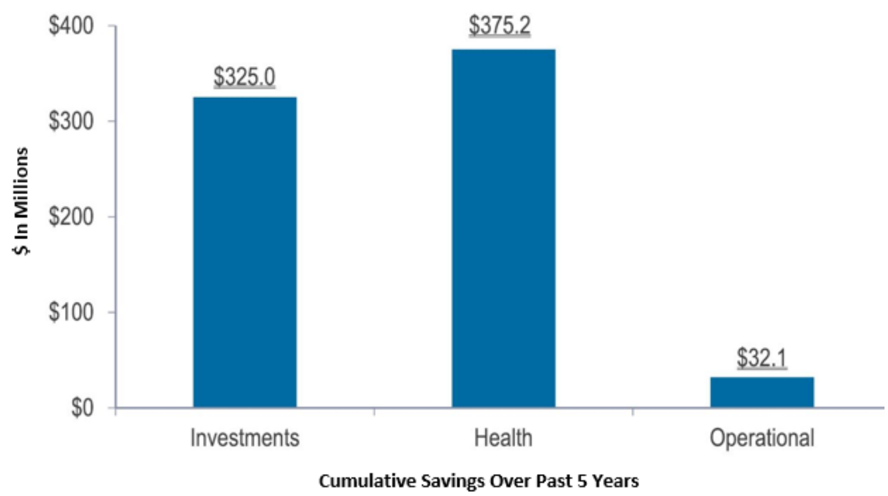
CalPERS Strives to Contain Costs

Financial stability of CalPERS is the top priority of the board and staff. In addition to lowering the discount rate to bring more revenue into the system, CalPERS is striving to contain costs. Over the last five years, these efforts led to $732.3 million in cost efficiency and savings—nearly double the fund's $421.5 million FY 2015-16 operating budget.

Figure 3

CalPERS Cost Efficiencies by Program Since FY 2011-12

Source: CalPERS (November 2016)



Health services staff generated savings of $375.2 million since FY 2011-12. The main cost efficiencies include a redesign of the pharmaceutical management practices and a reduction in administrative fees for the flex-funded health plans.

A dependent eligibility verification audit achieved additional savings by removing ineligible people from individual employee health plans. CalPERS staff continue to look at innovative methods to deliver quality health care while reducing costs, such as standardizing pricing among providers for certain medical procedures like hip and knee surgery.

During the same five-year period, the Investment Office realized $325.0 million in savings by reducing external consultants and renegotiating investment fees. Another large cost savings was realized by the shift from external investment managers to CalPERS investment staff.

Systemwide, CalPERS staff saved another $32.1 million in operational costs, primarily by hiring state information technology staff instead of consultants for the my|CalPERS online member services project.

As employer contributions increase, CalPERS is committed to decreasing costs in order to minimize administrative expenses and pass savings on to employers and members. The board and staff continue to monitor and evaluate efforts to find additional savings.

(DISCOUNT, continued from page 2)

CalPERS loses an opportunity to invest in additional assets at low prices.

As part of the review and outreach process, CalPERS staff surveyed employers and found an overwhelming majority agreed the discount rate needed to be lowered. However, employers requested time to build the higher contribution rate into their budgets. Considering these views, the CalPERS board voted to lower the discount rate to 7.375 percent in FY 2017-18, 7.25 percent in FY 2018-19, and 7.0 percent in FY 2019-20 for the state, with implementation of the same rate changes for local employers to lag by one year.

Most employer rates will increase by between 1 and 3 percent of payroll for miscellaneous employees and by 2 to 5 percent for safety employees. In addition, employers' funded status and CalPERS' funded status will drop as a result of the lower discount rate.

Incorporating the lowered expected rate of return more accurately reflects the current investment market and will help to put the fund on a firmer footing by paying down more future liability now.

CalPERS also will proceed with its scheduled Asset Liability Management review in February. This year-long evaluation occurs every four years to ensure the fund's investment mix correctly matches expected risk tolerance and return. The process will include another review of the discount rate, which may lead to further changes.

CalPERS continually balances acceptable investment risk with projected returns to meet benefit payments and increase the fund's stability. Over the past five years, the fund took the following steps to safeguard members' benefits:

- Lowered the discount rate from 7.75 percent to 7.5 percent in 2012;

- Changed the amortization and smoothing policy to spread discount rate increases or decreases over a five-year period to limit volatility for employers and employees;

- Adopted new demographic assumptions that show retirees are living longer (which requires additional contributions to securely fund benefits); and

- Approved a new funding risk mitigation policy to incrementally lower the discount rate when investment returns exceed the discount rate.

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www.sco.ca.gov

EOinquiry@sco.ca.gov

P.O. Box 942850
Sacramento, California 94250-5872
(916) 445-2636