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Chiang Unveils Plan to Reduce State's $64.6 Billion Retiree Health Care Liability

SACRAMENTO – State Controller John Chiang today released a new report showing the unfunded liability of providing health and dental benefits for state retirees under the current funding policy is $64.6 billion. The amount, known as the actuarial accrued liability, represents the present value of benefits earned as of June 30, 2013, that is expected to be paid over the lifetime of current and future retirees.

The unfunded obligation as of June 30, 2013, grew $730 million from the $63.8 billion obligation identified as of June 30, 2012. However, the accrued liability grew $2.7 billion less than expected due to fewer health care claims, lower-than-expected health care inflation, and the adoption of strategies by the California Public Employees' Retirement System (CalPERS) to lower health care costs.

"Although the growth was far less than projected, the State invites unnecessary risk with every day it allows to pass without a fiscally-disciplined plan for how to manage this growing liability," Chiang said. "While most are focused on unfunded pension obligations, this is a sleeper problem that can become the next big fiscal threat if we continue to do nothing."

While state pensions are pre-funded, allowing investment returns to reduce liabilities, California pays for retiree health benefits on a "pay-as-you-go" basis, or only covering the minimum amount needed to fund the costs as they are due. The latest actuarial report provides estimates of California's obligation for retiree health and dental benefits, also referred to as Other Postemployment Benefits (OPEB), based on two different funding scenarios:

- The current pay-as-you-go policy results in an unfunded liability of $64.6 billion, which represents the total present value of the total necessary to pay for retiree health benefits earned by current and future state retirees. Based on this funding policy, California should pay more than $5 billion in 2013-14. However, the FY 2013-14 Budget Act provided $1.8 billion to only cover current retirees' health and dental benefits.
- If the State shifted to fully pre-funding the costs of future benefits, the unfunded liability would be cut by more than $22 billion (or 34%) to $42.5 billion. Under a full pre-funding approach, money would be set-aside in a separate trust solely for future retiree health care benefits. The investment income generated by the trust would be used to reduce future costs to the State and its employees of paying for retiree health care benefits. To take advantage of the tremendous reduction in liability from fully-prefunding, the State would need to contribute $3.6 billion in 2013-14, or $1.8 billion more than the State currently has budgeted.

Recognizing that fully pre-funding this obligation would be challenging, Controller Chiang proposes that the initial objective should be to fully pre-fund the costs of retiree benefits in the same year as they are earned by active employees.

"While it is not reasonable to expect that a liability that has been built-up over many decades can be erased in a year, we have to resolve ourselves to meaningful progress," said Chiang. "Let that first step be a commitment that any liabilities created by one generation of Californians be fully paid by that generation and not transferred to their children."

The Controller proposes a five-year implementation plan, at the end of which retiree medical and dental costs earned annually by its active workforce (often referred to as "normal costs") will be fully pre-funded, reducing the unfunded liability by $17.7 billion.

The following table details the level of pre-funding that will be achieved during each of the five years, the amount in annual contributions needed above and beyond the $1.8 billion pay-as-you-go amount, and by how much the $64.6 billion liability will be reduced.

Fiscal Year	Cumulative Amount of Annual Payments above Current Contribution	Level of Pre-funding of Costs Associated with Current Workforce	Reduction in Unfunded Liability Due to Additional Payment
2014-15	$220m	10%	$3.5b
2015-16	$570m	30%	$8.0b
2016-17	$850m	50%	$11.6b

2017-18	$1.09b	70%	$14.3b
2018-19	$1.37b	100%	$17.7b

To provide perspective, the following table shows how the additional payment compares to the annual surpluses estimated by the Legislative Analyst's Office (LAO) in its most recent 5-year forecast.

Fiscal Year	Additional Payment	LAO Projected Surplus	Additional Payment as % of Surplus
2014-15	$220m	$3.2b	7%
2015-16	$570m	$5.6b	10%
2016-17	$850m	$8.3b	10%
2017-18	$1.09b	$9.6b	11%
2018-19	$1.37b	$9.6b	14%

In addition to cutting costs by prefunding the obligation, Chiang said the State should continue to be aggressive in its efforts to contain health care costs by promoting prevention and wellness and innovations in health care delivery. The Controller recommends switching from the traditional fees-for-services payment model to one that pays providers based on performance and outcomes, noting that a pilot program implemented at the California Public Employees' Retirement System (CalPERS) helped produce $20 million in cost savings. CalPERS also is encouraging members to use surgery centers for certain elective surgeries and generic drugs over brand names to further reduce costs.

On the prevention side, a study commissioned by the Controller found that 22% of CalPERS' expenditures are related to conditions that can be prevented though changes in diet and exercise. Just a 15% reduction in these conditions would result in annual savings of $54 million.

"Improving the health of state employees will not only lead to a more productive workforce, but also to substantial taxpayer savings," Chiang said.

Read the actuarial report.

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