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Questions and Answers:

California's First Retiree Health Valuation

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The Legislature required the Controller to contract with actuaries for California's first valuation of unfunded state retiree health liabilities. On May 7, 2007, the Controller reported that the state's estimated unfunded liabilities total $48 billion. This report answers key questions concerning the valuation and identifies actions the Legislature could take to address the state's liabilities. ■

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INTRODUCTION

In *The 2006-07 Budget Act*, the Legislature required the State Controller to contract with actuaries for California's first valuation of its liabilities for health and dental benefits for retired state employees. (These benefits are referred to generally as "retiree health benefits.") The valuation is necessary for the state to comply with new public sector accounting rules that require the listing of retiree health benefit liabilities in the state's financial statements beginning no later than 2009 (when the state's 2007-08 financial records are finalized). Like the vast majority of governments across California and around the country, the state has not funded the estimated costs of future retiree health benefits as they accrue. As a result, a large unfunded liability for these benefits exists. The valuation, which was released by the State Controller's Office (SCO) on May 7, reports the size of this liability under several sets of actuarial assumptions. As we discussed in our February 2006 report, *Retiree Health Care: A Growing Cost for Government*, the Legislature will be facing key decisions on how to address these liabilities.

THE VALUATION: QUESTIONS AND ANSWERS

What Health Benefits Do State Retirees Receive?

Current law provides state contributions for retiree health benefits on the basis of a "100/90 formula." Under the formula, the state's maximum contribution to a retiree's health costs is equal to 100 percent of a weighted average of health premiums and 90 percent of a similar weighted average for additional premiums necessary to cover eligible family members of retirees. The formula bases payments on the weighted average of premium costs for single enrollees in the four basic health plans with the largest state employee enrollment during the prior year. This results in a 2007 maximum state contribution of $439 per month for a single retiree, $823 per month for a retiree and a family member, and $1,042 per month for a retiree family.

Most state employees hired since 1985 receive full state contributions only after a certain number of years of service. Retirees and their eligible family members generally receive no state health contributions with less than ten years of service. They receive 50 percent of the maximum contribution with ten years of service, increasing 5 percent annually until the 100 percent level is earned after 20 or more years of employment. State employees hired prior to 1985 receive the 100/90 formula for health benefits upon retirement. Legislative approval of funding for retiree health and dental benefits occurs in the annual budget bill, following the California Public Employees' Retirement System's (CalPERS') negotiation of health plan rates for the upcoming calendar year.

What Is an Unfunded Retiree Health Liability?

In simplified terms, a retirement liability is the estimated amount of funds that would need to be set aside today, which, when combined with assumed future investment returns, would be sufficient to cover costs of all future retirement benefits earned *to date* by current and past

employees. The unfunded portion of that liability is the amount remaining once existing assets are considered. In the past, unfunded liabilities have been discussed primarily in the context of public pension systems. The average public pension system in California has enough assets on hand to cover about 88 percent of its estimated liabilities for future pension benefits earned to date by current and past employees. Therefore, the average public pension system has an unfunded liability equal to about 12 percent of these liabilities. By contrast, in most cases, 100 percent of governments' retiree health liabilities are "unfunded" since no funds have been set aside to cover future benefit costs earned by current and past workers. Instead, governments fund the costs of these benefits on a "pay-as-you-go" basis. That is, the medical insurance costs of retirees (and their dependents) are paid from current revenues as the benefits are provided, not from funds set aside during the working life of that retiree.

What Is the State's Unfunded Retiree Health Liability?

The valuation indicates that the state's unfunded retiree health liability as of July 1, 2007, will be an estimated $47.9 billion. Under Governmental Accounting Standards Board (GASB) guidelines, the investment return (or "discount rate") that governments using a pay-as-you-go financing system may assume when reporting their liabilities is low. This is because there is no pension-type investment fund generating returns to help cover future costs. The $47.9 billion unfunded liability calculation assumes a discount rate of 4.5 percent, which is consistent with the historical earnings of the Pooled Money Investment Account (PMIA). The General Fund's balances are invested in short-term securities in the PMIA, which is administered by the State Treasurer's Office.

What Is the Liability if the State Starts To "Prefund" Retiree Health Costs?

In the valuation, the actuaries also report on what the state's unfunded liability would be under two different scenarios. Specifically, as required by the Legislature in the 2006-07 budget, SCO asked the actuaries to report on what the state's reported unfunded liabilities would be if the Legislature committed the state to prefunding the estimated future costs of retiree health benefits on a consistent annual basis, rather than the current pay-as-you-go funding practice. According to the valuation, if the state committed to *consistently* set aside funds each year—in addition to the over $1 billion spent for benefits under the pay-as-you-go system—the reported unfunded liability for retiree health benefits would be $31.3 billion. (This method to eliminate unfunded liabilities is known as the "full funding strategy.") In other words, the unfunded liability required to be reported in the state's financial statements under the full funding strategy is $16.6 billion less than the liability that would have to be reported under the current pay-as-you-go system. The reason for this difference is that if the state starts to set aside billions of dollars in assets to cover future benefit costs, these assets are assumed to generate a significant investment return (at a higher rate of 7.75 percent), which will cover a portion of the costs the state itself would have to pay under the current pay-as-you-go system. The final scenario reported is for a partial funding strategy. The values for this strategy are roughly halfway between the pay-as-you-go and full funding amounts.

How Much Does the State Spend Now on Retiree Health Benefits?

The valuation estimates that the state will spend about $1.4 billion on retiree health benefits in 2007-08 under its pay-as-you-go policy. This includes roughly $1 billion in explicit state payments toward retiree benefits (primarily through the retiree health and dental item [9650] in the annual budget act), as well as about $336 million as an "implicit subsidy." This implicit subsidy relates to the fact that some of the state's retirees are in the same insurance risk pool (with the same health care premiums) as active state employees. The retirees tend to utilize more and costlier health care services than active employees due largely to their ages. Premiums paid by the state on behalf of its active employees, therefore, subsidize the retirees to an extent. This is the implicit subsidy captured in the valuation under GASB guidelines; its costs have never previously been estimated for state retirees.

How Much Does the State Need to Set Aside to Address the Liabilities?

The valuation identifies what actuaries and accountants refer to as an "annual required contribution" (ARC) under each of its discount rate scenarios. The ARC consists of two parts:

- Estimated *normal costs* (the amount that needs to be set aside and invested in order to fund future retiree health benefits earned during that year by active employees).
- An amount estimated to be sufficient to retire existing unfunded liabilities over no more than 30 years. In general, *unfunded liabilities* exist because no funds have been set aside to cover past normal costs.

The ARC includes the costs necessary to provide each year's benefits to past retirees—those benefits currently funded under the pay-as-you-go system. Governments do not have to fund the ARC each year, but choosing to do so allows them to reduce and perhaps even eliminate their unfunded liabilities over the long term (thereby lowering long-term costs).

As shown in Figure 1, in the pay-as-you-go valuation scenario (which reports a $47.9 billion unfunded liability), the ARC is estimated to be $3.6 billion. This is $2.2 billion above what the actuaries estimate the state would spend in 2007-08 for annual retiree benefits under current funding policies. In the full funding scenario (with a $31.3 billion unfunded liability), the ARC is estimated to be $2.6 billion, or about $1.2 billion more than the state would spend for retiree benefits in 2007-08 under current funding poli-

Figure 1

Comparison of Pay-As-You-Go and Full Funding Scenarios

(Dollars in Billions)

	Pay-As-You-Go	Full Funding
Unfunded liability	$47.9	$31.3
Annual required contribution[a]	3.6	2.6
Assumed annual investment return	4.5%	7.75%

[a] State currently pays $1.4 billion of these amounts.

cies. This means that, according to the valuation, if the state (1) started committing $2.6 billion each year to retiree health benefits—or, about $1.2 billion more than currently budgeted beginning in 2007-08—and (2) invested the funds in an irrevocable, pension-type trust fund, retirees' benefits would be fully funded, and unfunded liabilities could be eliminated within 30 years. (The actual amounts to be spent in each future year under any scenario would tend to increase above the amounts listed in the valuation due to growth of the state workforce and the effects of inflation on wages and benefits.)

Which Employees and Retirees Are Included in the Valuation?

The valuation includes over 130,000 retired state and California State University (CSU) employees and nearly 250,000 active state and CSU employees, as well as their dependents who are eligible for retiree health benefits. This valuation does not include liabilities associated with University of California (UC) employees and retirees, who are covered in a separate plan. An October 2006 valuation identified UC's unfunded retiree health liability at $7.6 billion. Local government liabilities also are not addressed in the state's valuation. School districts, community college districts, cities, counties, and special districts all are beginning to report unfunded liabilities under the new accounting rules. Based on information known to date, we estimate that the unfunded aggregate retiree health liabilities of all of these local governments will be far in excess of the state's own liability. The Public Employee Post-Employment Benefits Commission—appointed by the Governor and legislative leaders—is currently surveying local governments on the size of their retiree health liabilities.

What Assumptions Do the Actuaries Use to Estimate the Liabilities?

Actuaries use a complex set of demographic, economic, and investment assumptions to make the estimates included in these valuations. There are no standard assumptions applied to every public employer, since each retiree health benefit program requires assumptions based on its particular characteristics. Above, we discussed the discount rate assumptions. In our opinion, the other key assumption in these valuations concerns annual employer health premium growth in the future. Assuming continuation of the state's current benefit package for its retired employees, the valuation assumes an average 10 percent increase in health plan premiums set by CalPERS in 2008. The valuation then assumes that the annual CalPERS premium increase declines steadily each year until it reaches 4.5 percent per year in 2017 and beyond. This assumption is consistent with those generally adopted by actuaries in these valuations.

LAO COMMENTS

Is the Valuation an Accurate Reflection of State Liabilities?

The valuation appears to conform to standard actuarial methods. Other retiree health valuations of state and local governments have been using assumptions similar to those used in this actuarial valuation. Accordingly, we believe that the valuation represents a solid initial estimate of the state's liabilities. As actuaries and accountants gain more experience analyzing the data concerning state retiree benefit costs and as additional data sources are developed to assist them in this effort, it is possible that reported liabilities and related cost calculations may increase or decrease—similar to the experiences of other governments after receiving their first retiree health valuations. In addition, liability valuations tend to change over time based on actual trends in health care inflation, investment return, and other factors. Finally, since unfunded liability estimates reflect costs related to benefits earned to date and, each year, employees earn additional future retiree health benefits, unfunded liabilities tend to increase each year unless funds are invested to cover each year's added costs as they accrue.

Is the Assumed Rate of Health Premium Growth Too Optimistic?

The valuation uses standard actuarial assumptions for future health care premium growth that are used across the country in similar reports. We are concerned that one assumption—specifically, that the annual rate of premium growth will decline considerably over the next decade and be sustained at a low level thereafter—is optimistic. These valuations effectively assume that health care reforms at the state or federal level will not only be enacted, but will reduce annual employer health care premium growth to a significantly lower level within the next decade. Should such reforms not prove successful and employer premiums continue to increase at high single-digit or double-digit rates each year, the state's unfunded liabilities may turn out to be tens of billions of dollars more than estimated in this valuation.

What Suggestions Does LAO Have for Future Valuations?

We expect that actuaries will work with SCO and CalPERS to refine and improve the data available to them concerning retiree health costs and utilization trends. Earlier, we described how the state's current funding approach for retiree health benefits includes both explicit and implicit costs. The valuation does not exactly match budgeted amounts for the explicit costs. Specifically, the *2007-08 Governor's Budget* estimates that 2007-08 direct state payments for retiree health benefits will total $1.14 billion, while the explicit costs listed in this initial valuation are $1.03 billion. Actuaries and SCO inform us that it is possible that some of these cost differences are already included in the reported estimate of implicit costs, but it will probably take some time and additional refinement of the data to make sure. As noted above, given the lack of prior experience in producing retiree health valuations, it is common for actuarial and accounting professionals to refine the data and report significantly higher or lower costs in subsequent valuations.

What Are the Benefits of a Full Funding Strategy?

A full funding strategy achieves two key objectives.

- First, it fulfills a fundamental tenet of public finance that *costs should be paid for as they accrue*. When governments agree to provide post-retirement benefits, it is critical that the estimated costs of those future benefits be fully acknowledged and funded.

- Second, by setting aside moneys to prefund future benefit costs, the state can take advantage of compounded investment returns to cover a portion of benefit costs and reduce the amount taxpayers must contribute to provide a given level of retiree benefits. This strategy has been the standard for public sector pensions in California for generations. It also makes sense for retiree health benefits.

What Legislative Actions Does the LAO Recommend?

The state's unfunded liability is within the range we projected in our February 2006 report. The costs identified by the actuaries to fund and eliminate the state's unfunded retiree health liability within 30 years, however, are much less than we expected. In the February 2006 report, we recommended that the Legislature ramp up to paying part of the ARC over several years as a first step to reducing unfunded liabilities. With this valuation's estimate that the state needs to commit to setting aside an additional $1.2 billion (in current dollars) each year in the future under a full funding strategy, we recommend that the Legislature ramp up state contributions to this identified amount over the next several years. The portion of the state's ARC payments not needed to fund current retiree benefits would be invested in a manner specified by the Legislature in order to generate investment returns to cover portions of future benefit costs. While fitting these expenditures into an already difficult budget would require prioritization, it would accurately reflect the accrual of new liabilities each year, as well as implement a plan to eliminate unfunded retiree health liabilities over the next 30 years. If the Legislature were to pursue such a full funding approach, it would face a number of technical policy issues—such as which entity should invest the funds, which entity should control those investment decisions, and how could the payments be structured to preserve future legislative flexibility.

What Other Strategies Are There for Addressing the Unfunded Liabilities?

There are two general strategies for addressing unfunded liabilities: (1) setting aside additional funds (as described above) and (2) changing benefits in some way to reduce future costs. The latter strategy generally involves shifting financial costs or financial risks for health benefits to employees or retirees. To the extent that the state has committed—in statute, collective bargaining agreements, or elsewhere—to paying a portion of these health care costs during retirement, it is not clear that such benefits can be unilaterally altered.

Whether the Legislature would want to change retiree health benefits for any group of past, current, or future employees depends on several factors, including (1) whether this part of the employee compensation package is necessary to recruit and retain qualified state workers,

(2) the preferences of state workers to receive compensation now or in a deferred manner, and (3) the ability to fund these benefits within the context of other state priorities.

Given the current legal uncertainty regarding the state's authority to modify health benefits, we recommend that the Legislature clarify whether it wishes the state to have the ability to change retiree health benefits for employees hired in the *future*. Legislative intent should be specified in statute as well as collective bargaining agreements. Whatever level of benefits is specified, these costs should be paid for as they accrue.

What Should the State Do About Other Unfunded Liabilities?

In addition to unfunded liabilities for retiree health benefits, there are existing or potential unfunded liability issues with other state retirement systems, such as the California State Teachers' Retirement System and the UC Retirement Plan, which the Legislature should address during the next few years in order to contain future costs of those systems. (Actions to address these systems' liabilities may involve additional state funds, as well as funds from other governmental entities and employees themselves.) While CalPERS' Public Employees' Retirement Fund has a $26 billion unfunded liability, there is already a mechanism in place—through state and local employer contributions—to address this liability over time. In addition to statewide retirement programs, school district, city, and county retiree health programs often have significant unfunded liabilities. In many cases, these unfunded retiree health liabilities would require payment of significant moneys by these local entities—often equivalent to a large percent of the local entity's annual budget—to be fully addressed over the long term. In the *Analysis of the 2007-08 Budget Bill*, we recommend that as part of a long-term Proposition 98 funding roadmap, the Legislature direct a portion of increased Proposition 98 moneys in coming years to school district fiscal solvency in order to address unfunded retiree health liabilities, among other fiscal issues.

CONCLUSION

Should the Legislature wish to continue providing eligible retired state employees with a comprehensive health benefits package, we recommend that it fund those benefits according to a long-term, actuarially based strategy. This has been the strategy used by state and local governments in California for defined pension benefits for generations. This strategy has allowed the state's public retirement systems to become substantially funded and to cover the majority of benefit costs using compounded investment returns, rather than relying solely on taxpayer and employee contributions. The retirement of the "baby boom" generation, the fiscal pressures on Social Security and Medicare benefits provided by the federal government, and the likelihood of scientific breakthroughs that will extend retirees' lives significantly all create major risks that future retirement costs could increase further for the state and other public employers. Because of these risks for additional costs in the future, *now* is the time to begin addressing the significant amount of unfunded retiree health liabilities that already exist. The state's first valuation is an important tool for policy makers to use in this task.