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California's Neglected Promise:
How California has Failed to Prepare for its Accumulating Retiree Health Care Obligations

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Executive Summary

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Large unfunded liabilities associated with pensions provided to government employees have recently garnered much attention. However, while their overall numbers are smaller, unfunded obligations for other retiree benefits are growing at an even faster rate than pension obligations.

Retiree health care is the largest component of these Other Post-Employment Benefits (OPEBs). As the Baby Boomer generation has begun to retire, we have seen an upswing in the number of retirees accompanied by both longer predicted life spans for those retirees and an overall increase in health costs. In short, more people are earning benefits for longer periods of time at higher costs.

Together, these factors will make it increasingly difficult for California to pay for these benefits in the future. Unlike pensions, which the State pre-funds by setting aside money for benefits when they are earned, retiree health care benefits are currently paid out of the State's operational budget, forgoing potential savings from investment profits.

Should the State do nothing to address them, growing OPEB costs will eventually crowd out crucial state programs in the annual budget. Our analysis of the State's OPEB liabilities found the following:

- ***Rising annual costs to the State***. The State has seen the cost of benefits for current retirees double every five years since 1999, on average. Annual benefit payments have increased from $0.30 billion to $1.58 billion. At this rate, current-year OPEB costs will consume the entire state budget within 35 years.

- ***Pre-funding saves an estimated $21 billion***. If the State starts paying its full contribution, as determined by CalPERS, this year and continues to do so annually, it will save an estimated $21 billion in paying for benefits earned as of 2011. A single year of inaction will potentially cost almost $1.70 billion in missed investment savings over 15 years, or over $300,000 per day.

- ***More retirees and more to come***. The number of retirees receiving medical benefits has increased 11.7% since 2008, from 138,300 to 154,500. This is an early phase of the upswing in retirements by the Baby Boomer generation.

Because pre-funding is dictated by the simple idea that the costs of a benefit (such as pensions) should be recognized as they are earned, it discourages irresponsible political behavior that defers costs to future generations that may not be able to bear them. Further, pre-funding accumulates secure assets towards paying future costs and supplements them with investment profits.

Absent significant cost containment measures within the health care system, OPEB costs to the State will continue to increase in the coming years. To deal with this strain on the budget, the State can either restructure the way it pays for these long-term benefits or restructure the benefit plans themselves.

Options for restructuring funding plans include committing to either fully or partially paying required contributions to pre-fund the benefit plans. Options for restructuring benefit plans include restricting eligibility for full benefits based on time worked, reducing maximum premiums covered, transitioning from defined benefit to defined contribution plans, and introducing cost sharing plans with active employees. But even as it considers changes to its benefit plans, pre-funding still offers the State the opportunity to both reduce its future out-of-pocket costs and secure funding for its current and future retirees' health benefits.