Statement of
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to the Post Employment Benefits Commission
September 21, 2007

IMPACT ON STATE BUDGET AND POTENTIAL SOLUTIONS

Thank you, Chairman Parsky and members of the Commission for having me here today. I would like to start by thanking each of you for committing your time, attention and expertise to helping our state work through some very difficult and important issues.

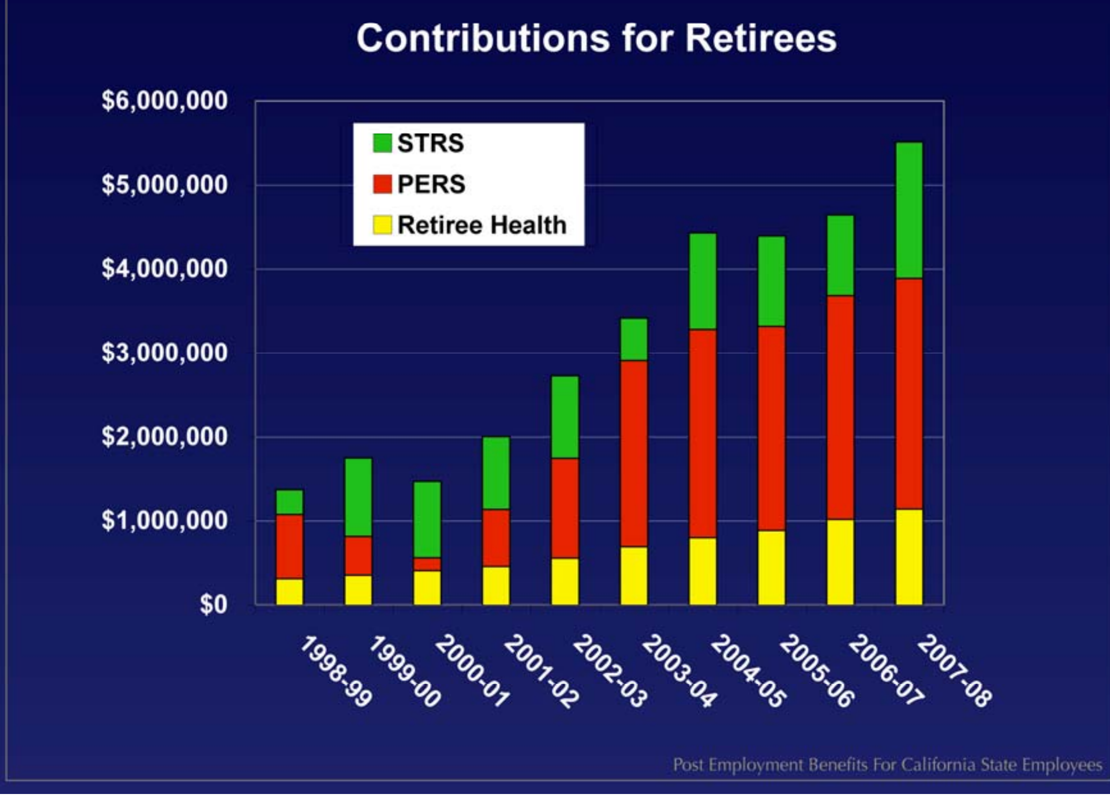
While the issues before the Commission have been building for years, the Governor created this Commission primarily in response to two events. The first was the difficulty the administration and Legislature had in finding ways to slow the growth in the state's costs to support post-employment benefits provided by the California Public Employees Retirement System (PERS) and the State Teachers' Retirement System (STRS). The second was the publication by the Government Accounting Standards Board of Statement 45 (GASB 45) relative to accounting for the costs of Other Post-Employment Benefits (OPEB).

California State Government's Costs for Post-Employment Benefits

When Governor Schwarzenegger took office, the state's budget was in the midst of the worst crisis in its history. The state was forced to borrow $9.2 billion to cover operating costs in the previous year and our future looked bleak, with an operating deficit of $14 billion, which equated to 19 percent of the state's General Fund revenues.

The rising costs of PERS benefits for our employees and of health care for our retirees, together with the continuing costs of the state's contributions to STRS, were three of many factors that contributed to the operating deficit. Chart 1 displays these costs from 1998-99 to 2007-08.

Chart 1



As the chart shows, these costs were growing dramatically when the Governor took office and they continue to increase at alarming rates. As a result, this administration, from its inception, has been interested in finding ways to control the costs of post-employment benefits for teachers and state employees.

In the Governor's first year in office, he signed SB 1105 (Chapter 214, Statutes of 2004), the alternative retirement program, under which new miscellaneous employees pay into a 401(a) account for two years rather than joining CalPERS. After their first two years, employees are enrolled in CalPERS and have the option of using the money in their 401(a) account to purchase credit for their first two years, with the State paying any additional actuarial costs, or withdrawing the amount in the 401(a) account. This program was designed to reduce new PERS costs. However, it is too soon to know what the actual savings have been. In addition, the administration has made several proposals to reduce the state's costs for STRS.

In his second year in office, the Governor worked on various proposals to change the PERS retirement system, but these were ultimately dropped -- not because of any sense that change was not needed, but because of the policy and, frankly, the political difficulties of shaping specific proposals. The administration remains interested in finding ways to stabilize or slow the growth in the state's costs for both PERS and STRS, and we look forward to receiving the Commission’s findings in that regard.

School districts and other local governments are key partners for the state in providing a variety of critical services. As such, we are also concerned with their fiscal health now and in the long term. Therefore, we look forward to receiving the Commission’s findings on ways to address local governments’ costs of post-employment benefits.

State Retiree Health Care Costs

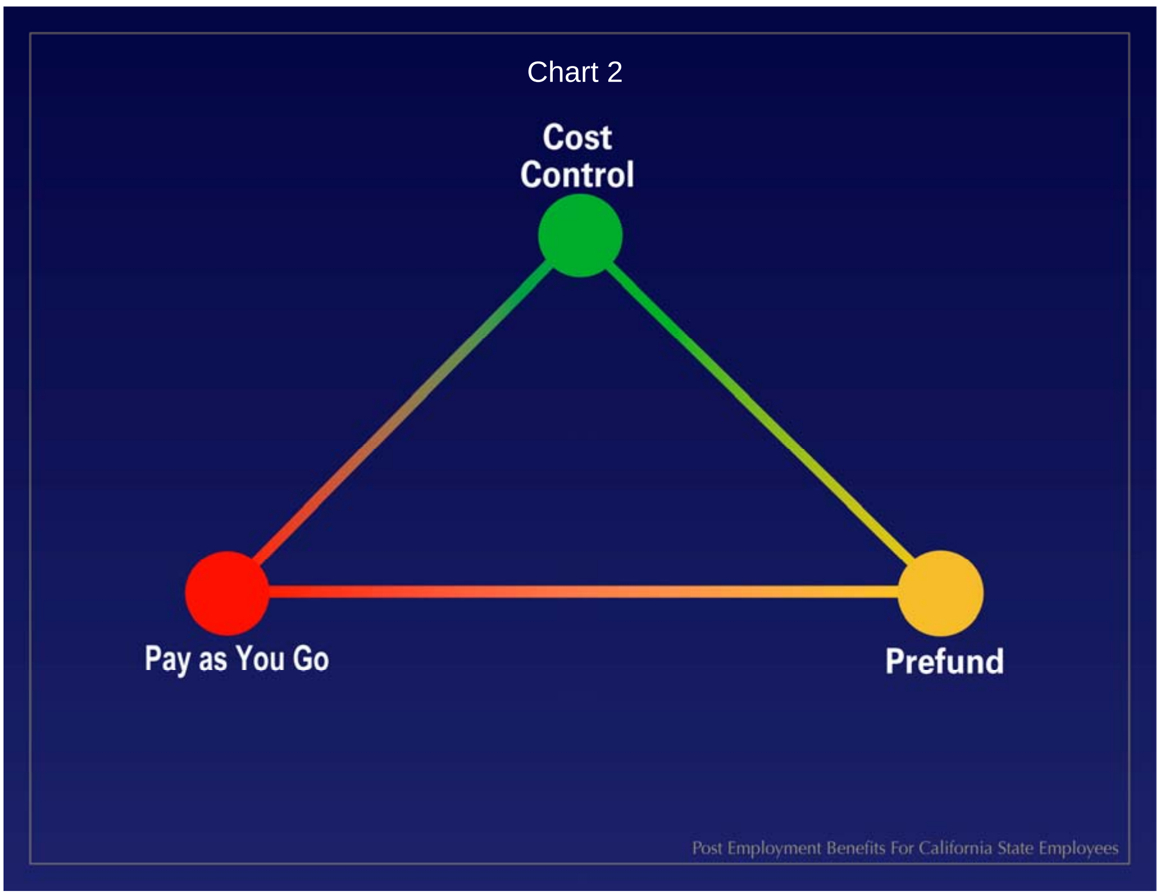
As I have already noted, one of the major events that led to the formation of this Commission was the publication of GASB 45, which of course addresses the way we must account for the costs of retiree health care. Specifically, California will be required to include a statement of its unfunded liability for retiree health care in our Comprehensive Annual Financial Report for this fiscal year. That report is due out in early 2009.

It is this administration’s intent to propose a plan to address the unfunded liability for retiree health care in the Governor’s Budget for 2008-09, which will be published in early January of next year. In fact, the reason the Governor set such an ambitious deadline for the Commission was to ensure that we will have the benefit of your findings for the next state budget.

The Budget Act of 2007 is the fourth balanced budget signed by Governor Schwarzenegger. This does NOT mean, however, that we have solved the state’s persistent structural budget problem. In fact, our baseline projections for next year show a General Fund shortfall of over $6 billion. That figure is based on our revenue estimates from May. Since that time, economic growth has slowed and cash collections have come in more than a billion dollars below our projections. It is important to note that our projected shortfall does ***not*** take into account any additional funding beyond "pay-as-you-go" for retiree health and dental benefits.

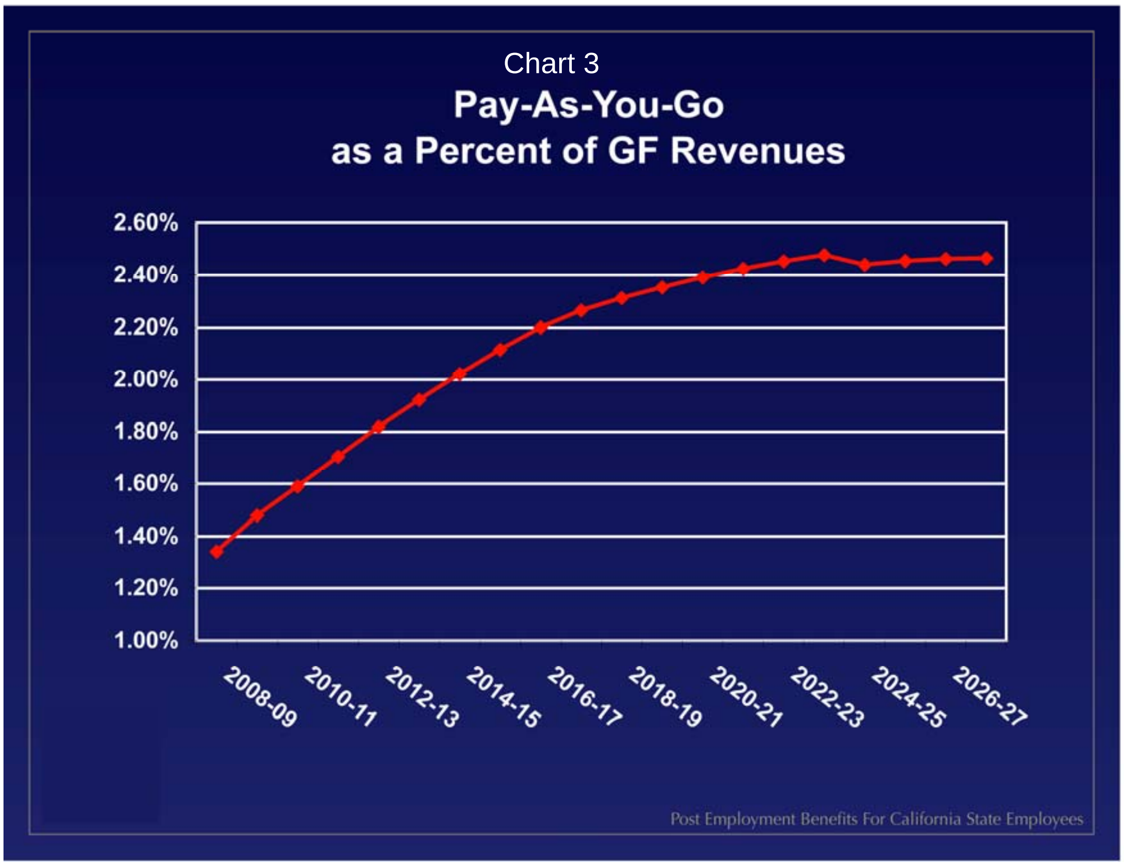
Given these projections, the state will have little or no capacity to absorb significant increases in outlays next year, such as converting to a “full funding” approach to retiree health care.

I would like to suggest that the set of all logically possible solutions to the problem of the OPEB unfunded liability is bounded by the triangle displayed on Chart 2. This triangle is defined by three points – continued pay-as-you-go, pre-funding of the unfunded liability, and cost control.



Pay-As-You-Go

For years, this state like most other states has simply paid for the health benefits of retirees from current revenues. Chart 3 shows the actuary's forecast of what these costs would be over the next 20 years. The costs are expressed as a percent of projected General Fund revenues. As the chart shows, pay-as-you-go costs would take an increasing share of the state's revenues. In addition, continuing the pay-as-you-go approach would result in a continued unfunded actuarially accrued liability, currently estimated at $47.9 billion.



Pre-Funding

At another extreme, we could eliminate annual contributions for the current accrued liabilities by depositing $31.28 billion into a properly governed account. This would also eliminate the current $47.9 billion unfunded liability associated with pay-as-you-go. Of course, the only way to achieve pre-funding in practice would be to borrow the $31.28

billion and deposit it into a retiree benefit trust fund. It is not clear, however, that this would ultimately be less costly than simply continuing to use the pay-as-you-go approach. This is because the lower cost is due entirely to the difference between the 4.5 percent discount rate used to calculate the unfunded liability for pay-as-you-go and the 7.75 percent discount rate that the actuary assumed for trust fund investments. Since borrowing to retire the unfunded liability would be on a taxable basis, the interest rate on the loan would be around 5 percent at current market rates. This spread between borrowing costs and potential investment returns presents a tempting prospect of reducing budgetary costs in the near term and total costs to the state in the longer term. However, such a high-risk strategy of borrowing and arbitrage, while tempting from a budgetary perspective, would ***not*** be appropriate from a conservative financial management perspective.

Full Funding

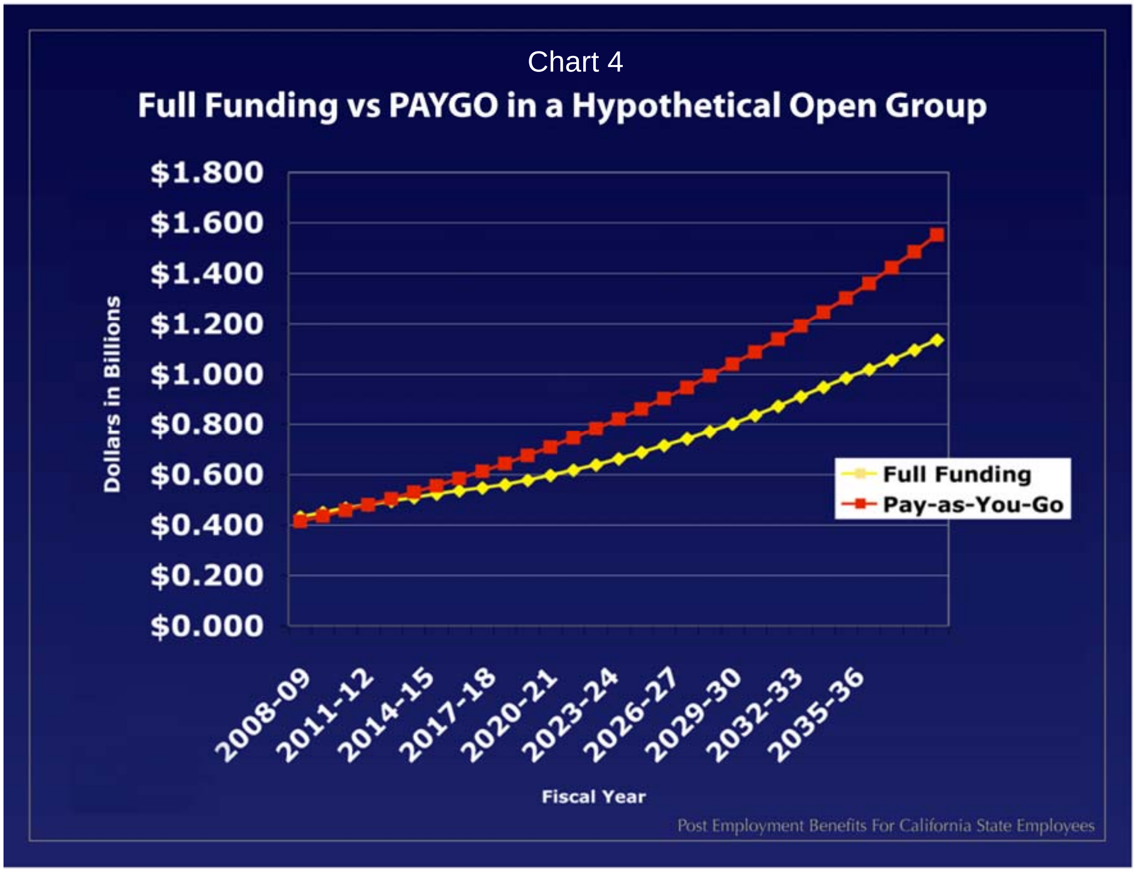
Between the two extremes of continuing to pay benefits from current revenues and prepaying them outright, is the approach that the actuary calls “full funding”. Under full funding, the state would pay into a retiree benefit trust fund an amount sufficient to cover annual retiree health care costs plus an amount sufficient to amortize the accrued liability. While this approach is ideal in theory, it has major adverse budgetary implications, at least for several years. Specifically, it would require committing $2.59 billion annually, or 90 percent more than pay-as-you go. The actuary’s report does not provide a forecast of the ongoing costs of full funding. We are working with the actuary to develop an estimate of those costs. It is likely, however, that the annual full-funding cost would remain substantially higher than the pay-as-you-go cost for several years, even given the rather steep increases in pay-as-you-go cost depicted on chart 3.

A Hybrid Approach

While full-funding of current employees future costs is extremely expensive, the situation is materially different for new employees. The actuary’s report provides an estimate of the costs of full funding for a “closed group”. A “closed group” covers only the costs of the current employees, not new employees.

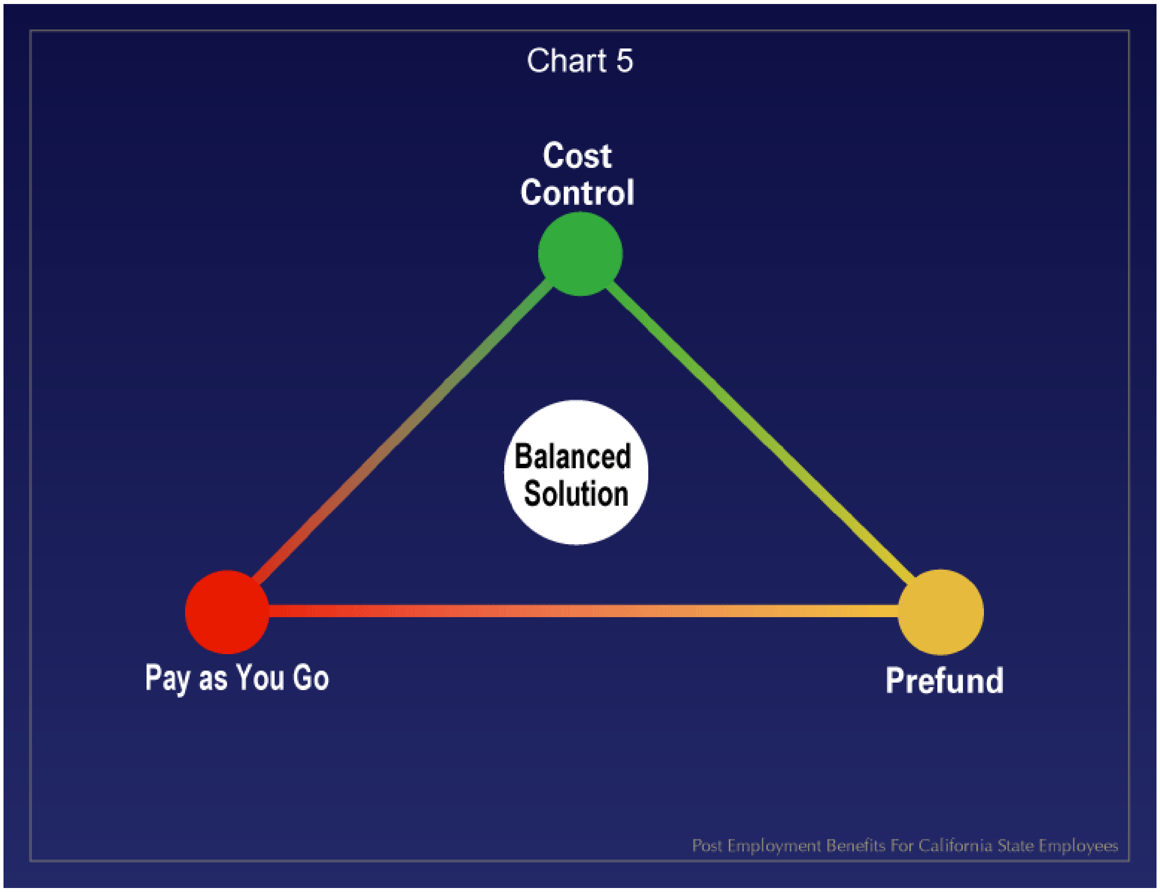
We have asked the actuary to develop an estimate of the costs of the full funding approach for an open group valuation for California state government. We expect to have that estimate by mid-November. For now, we can see how an open group valuation works by using a hypothetical provided to us by the actuary. Chart 4 compares a hypothetical open system under a pay-as-you-go approach versus a full funding approach. As the Chart shows, full funding may not result in substantially higher costs in the early years, but it would result in significant budgetary savings in future years. In the hypothetical, the budgetary advantages of full funding begin to be evident in just a few years.

This leads me to conclude that it may be possible to design a hybrid system that couples pay-as-you-go for existing employees with full funding for new employees. Such a system might minimize near term costs while at the same time reducing out-year costs. Of course, this would mean the state would continue to report an unfunded liability for years to come, but it would ***not*** continue to grow with the addition of new employees. I urge the Commission to include such a hybrid approach among the options you consider.



Cost Reduction

I do not believe that any solution found on that bottom leg of the triangle shown on Chart 2 will ultimately be affordable in the absence of vigorous efforts to reduce costs, or at least to limit their growth. I would suggest that the only affordable and balanced solutions are those located in the middle of the triangle. In other words, to be affordable, a solution must involve cost reductions.



The actuary's estimate of the accrued liability already assumes a substantial reduction in the rate of growth in health care costs, from annual inflation rates of ten percent in the early years to 4.5 percent in the out-years. This assumption is based on the belief that the national economy cannot indefinitely continue to accommodate the current rate of health care cost increases. I believe we need to take positive and aggressive action to ensure that these reductions in growth are actually achieved. Beyond that, there are strategies we can pursue to reduce costs even further.

Options for Reducing Costs

For both active and retired employees, the state provides a contribution toward the premiums for health benefits. The plans available to active employees and retirees are the same until the retirees join Medicare, so changes in the costs for one group will have a corresponding affect on the costs for the other group. Given the linkage between employee and retiree benefits, cost containment or reduction will affect both active employees and retirees similarly and reductions in both categories of costs can result in budgetary savings for the state.

Cost containment measures fall into three categories -- benefit restructuring, chronic disease management and promoting wellness. The most obvious type of benefit restructuring would be to reduce the current menu of benefits that the state provides to its employees and retirees. Employees and retirees would, of course, have the option to buy back any benefits with their own funds.

Another type of benefit restructuring would be increases in the co-payments and deductibles for employees. These can lead to premium savings due to both reduced provider costs and more judicious consumer choices. Increasing the retirement age would also reduce costs dramatically, but this option could only be effective for new employees since current employees are already vested in the current system.

It is an axiom of health care that 20 percent of the patients account for 80 percent of the costs. In fact, this disparity can be even greater. It is driven to a large extent by the costs associated with chronic diseases. One of the major trends in health care today is to find ways to more effectively manage these diseases and all employers including the state should encourage that effort among their health care plans.

One of the major components of the Governor’s health care reform proposal is wellness promotion. Many employers and health plans have begun offering innovative wellness promotion plans that include financial incentives for healthier lifestyle choices and providing wellness education and information. The state could achieve substantial long-term savings in health care costs by more actively pursuing wellness promotion with its employees and retirees.

Conclusion

As the state’s Director of Finance, it is my job to focus on the budget and the costs that drive it. I want to add, however, that I am also a state employee, a manager of state employees and, God willing, a future retiree.

As a state employee, I recognize the importance of adequate health care and I want the state to be able to continue providing access to health care.

As a manager of state employees, I recognize that for us to continue to attract and retain the quality of people we need to serve the people of California, we need adequate compensation. Health care and post employment benefits are a key part of the total package of compensation.

As a future retiree, I want the state to be fiscally strong enough to continue providing access to care and I realize that prudent funding strategies and cost control are critical to ensuring our continued ability to do so.

In conclusion, Mr. Chairman and members of the Commission, the administration looks forward to receiving your findings and we will take them into account as we prepare next year's budget. Given the state's fiscal situation, I would hope that you will explore balanced options that include not just different funding approaches, but also reasonable cost control strategies.