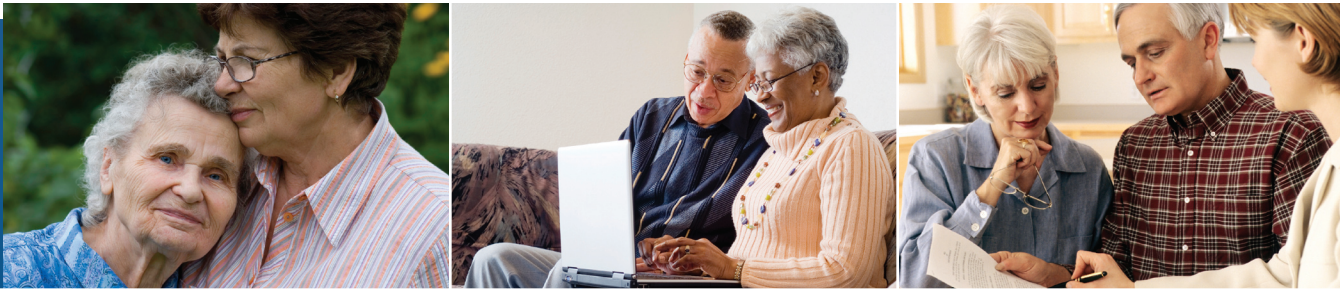




ISSUE BRIEF

The Crisis in State and Local Government Retiree Health Benefit Plans: Myths and Realities



2009 Update

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The Crisis in State and Local Government Retiree Health Benefit Plans: Myths and Realities: 2009 Update

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All states and many local governments provide health benefit programs for their retired employees. These programs vary widely in their provisions, degree of government subsidy, the cost to the government, and the method of funding. Some states and localities require retirees to pay the full cost of participating in the health plan¹, while others offer health insurance that does not require any premium payment by the retiree. As a result of these differences, the annual cost of providing retiree health insurance varies substantially among public employers. The annual cost per retiree can range from a modest subsidy associated with allowing retirees to buy into the health plan for current employees to the full cost of medical insurance for retirees, which can exceed \$10,000. In a study that examined the Comprehensive Annual Financial Reports of the New England states, the Federal Reserve Bank of Boston (2007) found that annual benefit payments per eligible retiree in 2006 ranged from \$3,300 in Maine to \$11,000 for Connecticut.

Recently, retiree health plans in the public sector have become the target for closer scrutiny and concern for their financial impact on budgets and debts. The annual government expenditure on these plans has been increasing rapidly due to the general rise in medical costs and the increase in the number of retired public employees. Even as state and local leaders have struggled to find the funds to finance the annual cost of retiree health insurance, changes in accounting standards have shifted policy debates from the current cost of these programs to the long-term liabilities associated with the promise of health insurance in retirement to today's public employees. To some, the recently reported estimates of unfunded liabilities associated with retiree health benefit plans represent a fiscal crisis for many states and municipalities.

This issue brief reports the financial status of retiree health plans covering general state employees as presented in their Governmental Accounting Standards Board (GASB) 45 actuarial statements. As part of a grant from the Center for State and Local Government Excellence, we have obtained the actuarial reports from each state and compiled data illustrating the financial status of these programs. This report focuses only on the plans that cover general state employees and does not include the additional liabilities associated with plans covering other types of public sector workers. In addition, some of the most important perceptions associated with retiree health plans and the new GASB accounting standards are explored, and we assess whether these beliefs are myths or realities. Sorting fact from fiction is central to determining the optimum public policies and the likelihood that retiree health benefit plans will remain an important component of the compensation for public sector employees.

GASB 45 and Accounting for Retiree Health

On June 21, 2004, the Government Accounting Standards Board approved Statement No. 45 (GASB 45). This statement requires public employers to produce an actuarial statement for retiree health benefit plans using generally accepted accounting standards as set forth by GASB.² In general, GASB 45 requires states and local governments to report the present discounted value for the future liability of health care promises to current workers as these benefits are accrued along with the present value of these promises to current retirees.³ In addition, the actuarial report must indicate the annual required contribution that is needed to pay the normal cost of the plan plus the amount needed to amortize current unfunded liabilities.

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A common belief is that GASB 45 requires public sector employers to establish trust funds for their retiree health plans and to move toward full funding. This is a myth. GASB 45 does not require public employers to establish irrevocable trusts or to begin moving toward full funding of their liabilities. The goal of GASB 45 is to provide a transparent assessment of the liabilities associated with health care promises to public employees. However, establishing a trust fund and contributing sufficient monies to cover current costs and accrued liabilities may be prudent public policies as it requires today's taxpayers to bear the full cost of today's public services.

This issue brief focuses on the current financial status of state retiree health plans and reports *unfunded actuarial accrued liabilities* (UAAL), *annual required contributions* (ARC), and the current method of financing these plans. The UAAL is the difference between all *actuarial accrued liabilities* (AAL) and any assets that the employer has set aside in an irrevocable trust. Obviously, if the plan is completely pay-as-you-go, the UAAL is equal to the AAL because there are no assets held by the employer with which to pay for the future health insurance of today's employees. The UAALs for many states and local governments are large in absolute value and relative to total state expenditures, debt, and state per capita income.

Annual required contributions are how much the employer would need to contribute to cover this year's normal cost of the plan plus the amount needed to amortize the existing unfunded liability over a 30-year period. Thus, if a government were to establish a trust fund for its retiree health benefit plan and contribute monies each year equivalent to the ARC, the state or locality would be on pace to fully fund the plan. Obviously, this level of financing will exceed the pay-as-you-go cost of these programs in the short run but will reduce the new funds needed in future years as returns on the trust fund will help finance future payments.

ARCs and UAALs have been growing over time in most states and are now a major public policy issue for many. For example, in California, the annual cost to the state for retiree health and dental benefits more than tripled between 1998–99 and 2006–07 as the retiree health expenditure rose by an annual average rate of 17 percent, which was more than five times the rate of growth of state spending. The costs were expected to exceed \$1 billion in 2006–07 (Legislative Analyst's Office, California, 2006).

The present value of promised benefits based on current provisions of the health plans is determined by projecting the future age and service structure of the state labor force and retired state employees, and the cost of the health care promises made to these workers and retirees. The future liabilities are then discounted back to the date of the report. The actuarial accrued liabilities (AAL) represent the total cost associated with providing health insurance to current retirees and the expected cost of retiree health insurance earned to date by current employees.

In addition to the demographic projections, key assumptions used by the actuarial consulting firm or the in-house actuaries to calculate the UAAL and the ARC are the rate of medical inflation and the discount rate used to determine the present value of future retiree health benefits. Assumptions made by the actuary have a large impact on the projected discounted liabilities of retiree health plans. All actuarial statements project a rapid decline in the rate of medical inflation. Such declines are more likely to be wishful thinking or a myth. The rate of inflation for health care is uncertain and will depend on national health care policies. There is a common belief, which reflects current practice allowed by GASB 45, that funding reduces the UAAL because trust funds prudently invested will yield higher returns than the risk-free discount rate used when there is no fund. This is a myth, as actual expenditures in future years are unchanged. However, using a higher discount rate associated with pre-funding these plans lowers the reported discounted liabilities. The impact and desirability of using higher discount rates to determine UAALs is currently being debated by practicing actuaries and financial economists. Clark (2008) discusses how these assumptions are made and their importance in determining the projected liabilities of retiree health benefit plans.

The AAL indicates the amount of money needed to pay all these future liabilities. Alternatively, this means that if the state or local government had a dedicated fund with assets equaling the AAL, then all currently accrued liabilities could be paid from the fund without any further contributions from the state. This is similar to having a fully funded pension plan or stating that the pension has a funding ratio of 100 percent. GASB 45 does not require that governments actually establish trust funds for these programs; however, several states have enacted trust fund legislation for their retiree medical plans as well as those of local entities in the state. Data in the state GASB 45 actuarial reports indicate that

ten states have assets in existing funds, with seven of these having funding ratios over 10 percent.⁴

GASB requires that the actuarial statements assume that the current provisions of the retiree health plan will remain in effect. *There is a common belief that retiree benefits are protected by law and cannot be altered. This is a myth.* Most states have been amending their health plans for active workers and retirees in response to rising health care costs. Changes include higher premiums, higher deductibles, higher co-payments, and more years of service to qualify for retiree health plans. The ability to modify retiree health plans provides states with some options to moderate their projected costs and thus reduce the UAAL and ARC presented in these actuarial statements.

GAO (2008) reports that all states have legal protections for their pension plans that limit the ability of a legislature to substantially alter the generosity of the pension. The majority of states have constitutional provisions that describe how their retirement plans are to be “funded, protected, managed, or governed.” However, retiree health plans are not accorded similar status. Reductions in or the elimination of retiree health benefits may be constrained by collective bargaining contracts but, in general, legislatures have more flexibility to reduce and modify retiree health benefit plans for public sector employees. Clark and Morrill (2009) provide evidence that some states have made modifications to their plans that have substantially lowered their UAALs. If governments can significantly reduce benefits and thus liabilities, should these promises be considered liabilities at the same level as state and municipal bonds?

Is There a Funding Crisis?

Recent press reports spawned by GASB 45 statements and other assessments of the unfunded liabilities associated with retiree health have painted a picture of a major fiscal crisis. This is a reality in some states while in others it is simply a myth. There are substantial differences in the total liabilities of state retiree health plans stemming from the generosity of the plan and the size of the public sector.⁵ To assess the reality of a funding crisis, we consider only the data reported in the actuarial statements that have been completed in response to the GASB requirements by the 50 states.

We have obtained and examined the actuarial reports for plans covering general state employees for 49 states.⁶ States with the lowest unfunded liabilities

are North Dakota (\$31 million), Wyoming (\$72 million), South Dakota (\$76 million), Iowa (\$220 million), Oregon (\$264 million), Kansas (\$293 million), and Idaho (\$362 million). In comparison, New Jersey (\$68.8 billion), New York (\$49.7 billion), California (\$47.9 billion), North Carolina (\$23.8 billion), Illinois (\$24.2 billion), Connecticut (\$21.7 billion), Louisiana (\$19.6 billion), Ohio (\$18.2 billion), and Texas (\$17.7 billion) have the highest UAALs. A complete listing of the UAALs and the ARCs for each state is presented in Table 1 (page 6).

The substantial variation in unfunded liabilities is a function of the size of the state workforce, the generosity of the retiree health plan, the portion of the total cost of the health program paid for by the state, and what type of employees are included in the plan. For example, the retiree health plans of some states also include teachers and local government retirees while in other states only the retired employees of the state are included in the plan. In these states, teachers and local retirees may be included in other plans. Clark (2009a) examines the importance of including teachers in the state plans and the unfunded liabilities of teacher-only plans. On average, teachers account for about half of the UAAL when they are included in state retiree health plans.

To better illustrate the size of these liabilities and their importance to the various states, we examine the magnitude of the UAAL and ARC relative to various important financial variables. Several of the actuarial statements indicate the UAAL and the ARC as a percent of payroll. The highest reported values for UAAL as a percent of payroll are found in Hawaii (359.6 percent), Maryland (351.1 percent), and Rhode Island (292.5 percent). The highest values for the ARC as a percent of payroll are Maryland (26.9 percent), Hawaii (26.2 percent), and Rhode Island (24.9 percent). These latter numbers are particularly impressive as they indicate the proportion of state payroll needed to pay for the normal cost of retiree health plans and the cost of amortizing the unfunded liability. Thus, to move toward a fully funded plan, these three states would have to allocate funds equal to one quarter of their annual cash payroll to finance the retiree health plan. These data indicate that for some states the annual cost and the unfunded liabilities associated with retiree health plans represent a major fiscal challenge.

We derive two additional measures of the relative size of the cost of retiree health benefit plans. The unfunded liability per capita and the ARC per capita

Table 1. State Liabilities for Retiree Health, Summary Information*

| State | Unfunded Liability (millions) | ARC (millions) | Rank UAAL | State | Unfunded Liability (millions) | ARC (millions) | Rank UAAL |
|---------------|-------------------------------|----------------|-----------|----------------|-------------------------------|----------------|-----------|
| | (1a) | (2a) | (3a) | | (1b) | (2b) | (3b) |
| Alabama | \$3,104 | \$211 | 28 | Montana | \$449 | \$42 | 11 |
| Alaska | 3,139 | 370 | 29 | Nebraska | Minimal | n/a | 1 |
| Arizona | 438 | 104 | 9 | Nevada | 2,295 | 273 | 24 |
| Arkansas | 1,224 | 167 | 18 | New Hampshire | 2,859 | 235 | 25 |
| California | 47,878 | 3,593 | 48 | New Jersey | 68,834 | 5,840 | 50 |
| Colorado | 1,033 | 71 | 17 | New Mexico | 4,110 | 383 | 30 |
| Connecticut | 21,681 | 1,598 | 45 | New York | 49,663 | 3,810 | 49 |
| Delaware | 3,100 | 286 | 27 | North Carolina | 23,786 | 2,390 | 46 |
| Florida | 3,082 | 201 | 26 | North Dakota | 31 | 4 | 2 |
| Georgia | 15,035 | 1,262 | 41 | Ohio | 18,723 | 2,046 | 43 |
| Hawaii | 9,679 | 705 | 36 | Oklahoma | 814 | 87 | 16 |
| Idaho | 362 | 34 | 8 | Oregon | 264 | 41 | 6 |
| Illinois | 24,210 | 1,743 | 47 | Pennsylvania | 8,659 | 720 | 35 |
| Indiana | 442 | 46 | 10 | Rhode Island | 480 | 41 | 12 |
| Iowa | 220 | 23 | 5 | South Carolina | 10,048 | 777 | 37 |
| Kansas | 293 | 34 | 7 | South Dakota | 76 | 9 | 4 |
| Kentucky | 4,833 | 397 | 32 | Tennessee | 2,146 | 212 | 22 |
| Louisiana | 19,609 | 2,069 | 44 | Texas | 17,675 | 1,482 | 42 |
| Maine | 4,756 | 356 | 31 | Utah | 569 | 54 | 14 |
| Maryland | 14,543 | 1,114 | 40 | Vermont | 1,419 | 113 | 19 |
| Massachusetts | 13,287 | 1,062 | 38 | Virginia | 1,616 | 123 | 21 |
| Michigan | 13,925 | 879 | 39 | Washington | 7,495 | 634 | 33 |
| Minnesota | 565 | 56 | 13 | West Virginia | 7,761 | 824 | 34 |
| Mississippi | 570 | 43 | 15 | Wisconsin | 1,473 | 148 | 20 |
| Missouri | 2,186 | 159 | 23 | Wyoming | 72 | 6 | 3 |

*The reports included in this table are for retiree health plans that cover general state employees. Some of these plans also cover teachers and other public sector employees in the state.

Source: Actuarial reports prepared by the various states to conform to GASB 45 requirements. Nebraska chose not to prepare a GASB 45 statement.

Table 2. UAAL and ARC: Total and Per Capita

| State | UAAL (millions) | Rank UAAL | UAAL Per Capita | Rank UAAL Per Capita | ARC (millions) | Rank by ARC | ARC per capita | Rank ARC Per Capita |
|-------------|-----------------|-----------|-----------------|----------------------|----------------|-------------|----------------|---------------------|
| Alabama | \$3,104 | 28 | \$683.76 | 24 | \$211 | 24 | \$46.48 | 23 |
| Alaska | 3,139 | 29 | 4,689.20 | 47 | 370 | 30 | 552.72 | 48 |
| Arizona | 438 | 9 | 73.59 | 5 | 104 | 17 | 17.47 | 14 |
| Arkansas | 1,224 | 18 | 441.53 | 21 | 167 | 22 | 60.24 | 25 |
| California | 47,878 | 48 | 1,330.30 | 30 | 3,593 | 48 | 99.83 | 29 |
| Colorado | 1,033 | 17 | 221.02 | 14 | 71 | 15 | 15.19 | 12 |
| Connecticut | 21,681 | 45 | 6,218.58 | 48 | 1,598 | 43 | 458.34 | 46 |
| Delaware | 3,100 | 27 | 3,688.03 | 44 | 286 | 28 | 340.25 | 44 |

Table 2. UAAL and ARC: Total and Per Capita (continued)

| State | UAAL (millions) | Rank UAAL | UAAL Per Capita | Rank UAAL Per Capita | ARC (millions) | Rank by ARC | ARC per capita | Rank ARC Per Capita |
|----------------|-----------------|-----------|-----------------|----------------------|----------------|-------------|----------------|---------------------|
| Florida | 3,082 | 26 | 173.77 | 11 | 201 | 23 | 11.33 | 7 |
| Georgia | 15,035 | 41 | 1,650.80 | 33 | 1,262 | 41 | 138.56 | 33 |
| Hawaii | 9,679 | 36 | 7,635.80 | 49 | 705 | 34 | 556.18 | 49 |
| Idaho | 362 | 8 | 253.88 | 17 | 34 | 7 | 23.84 | 16 |
| Illinois | 24,210 | 47 | 1,903.37 | 34 | 1,743 | 44 | 137.03 | 32 |
| Indiana | 442 | 10 | 70.64 | 3 | 46 | 12 | 7.35 | 3 |
| Iowa | 220 | 5 | 74.44 | 6 | 23 | 5 | 7.78 | 4 |
| Kansas | 293 | 7 | 106.87 | 8 | 34 | 7 | 12.40 | 10 |
| Kentucky | 4,833 | 32 | 1,158.71 | 28 | 397 | 32 | 95.18 | 28 |
| Louisiana | 19,609 | 44 | 4,361.75 | 46 | 2,069 | 46 | 460.22 | 47 |
| Maine | 4,756 | 31 | 3,624.39 | 43 | 356 | 29 | 271.30 | 42 |
| Maryland | 14,543 | 40 | 2,609.47 | 41 | 1,114 | 40 | 199.89 | 41 |
| Massachusetts | 13,287 | 38 | 2,066.68 | 35 | 1,062 | 39 | 165.19 | 34 |
| Michigan | 13,925 | 39 | 1,377.63 | 31 | 879 | 38 | 86.96 | 27 |
| Minnesota | 565 | 13 | 110.48 | 9 | 56 | 14 | 10.95 | 5 |
| Mississippi | 570 | 15 | 196.52 | 12 | 43 | 11 | 14.83 | 11 |
| Missouri | 2,186 | 23 | 377.69 | 20 | 159 | 21 | 27.47 | 19 |
| Montana | 449 | 11 | 479.81 | 23 | 42 | 10 | 44.88 | 22 |
| Nebraska | No report | 1 | No report | 1 | No report | 1 | No report | 1 |
| Nevada | 2,295 | 24 | 952.7 | 27 | 273 | 27 | 113.33 | 31 |
| New Hampshire | 2,859 | 25 | 2,193.98 | 37 | 235 | 26 | 180.34 | 36 |
| New Jersey | 68,834 | 50 | 7,950.84 | 50 | 5,840 | 50 | 674.56 | 50 |
| New Mexico | 4,110 | 30 | 2,144.72 | 36 | 383 | 31 | 199.86 | 40 |
| New York | 49,663 | 49 | 2,578.22 | 40 | 3,810 | 49 | 197.79 | 39 |
| North Carolina | 23,786 | 46 | 2,740.61 | 42 | 2,390 | 47 | 275.37 | 43 |
| North Dakota | 31 | 2 | 48.75 | 2 | 4 | 2 | 6.29 | 2 |
| Ohio | 18,723 | 43 | 1,633.80 | 32 | 2,046 | 45 | 178.54 | 35 |
| Oklahoma | 814 | 16 | 230.21 | 16 | 87 | 16 | 24.60 | 17 |
| Oregon | 264 | 6 | 72.73 | 4 | 41 | 9 | 11.29 | 6 |
| Pennsylvania | 8,659 | 35 | 700.15 | 25 | 720 | 35 | 58.22 | 24 |
| Rhode Island | 480 | 12 | 449.98 | 22 | 41 | 9 | 38.44 | 21 |
| South Carolina | 10,048 | 37 | 2,361.46 | 39 | 777 | 36 | 182.61 | 38 |
| South Dakota | 76 | 4 | 97.43 | 7 | 9 | 4 | 11.54 | 8 |
| Tennessee | 2,146 | 22 | 358.31 | 19 | 212 | 25 | 35.40 | 20 |
| Texas | 17,675 | 42 | 773.73 | 26 | 1,482 | 42 | 64.87 | 26 |
| Utah | 569 | 14 | 227.14 | 15 | 54 | 13 | 21.56 | 15 |
| Vermont | 1,419 | 19 | 2,289.68 | 38 | 113 | 18 | 182.34 | 37 |
| Virginia | 1,616 | 21 | 213.82 | 13 | 123 | 19 | 16.28 | 13 |
| Washington | 7,495 | 33 | 1,195.22 | 29 | 634 | 33 | 101.10 | 30 |
| West Virginia | 7,761 | 34 | 4,298.23 | 45 | 824 | 37 | 456.35 | 45 |
| Wisconsin | 1,473 | 20 | 265.86 | 18 | 148 | 20 | 26.71 | 18 |
| Wyoming | 72 | 3 | 142.14 | 10 | 6 | 3 | 11.85 | 9 |

for each state are reported in Table 2 (pages 6–7) along with the ranking by state. The total UAAL and ARC are also presented in the table, thus allowing a direct comparison of the relative size of the liabilities by state to the total unfunded liability. States with the lowest UAAL per capita are North Dakota (\$49), Indiana (\$71),

Oregon (\$73), Arizona (\$74), and Iowa (\$74). In stark contrast, the states with the highest UAAL per capita are New Jersey (\$7,951), Hawaii (\$7,636), Connecticut (\$6,219), Alaska (\$4,689), Louisiana (\$4,362), and West Virginia (\$4,298). A similar ranking is observed for the ARC per capita.

Table 3: Percent of Premium Paid for High and Low UAAL States

| State Name | UAAL Per Capita | Description of Coverage from State Actuarial Reports |
|--|-----------------|--|
| Ten States with the Lowest UAAL Per Capita | | |
| Nebraska | N/A | State deemed that the liability for its retiree medical plan were too small to justify the expense of producing a report. |
| North Dakota | \$48.75 | Partially subsidized, contributions are required for both retiree and dependent coverage. |
| Indiana | \$70.64 | Implicit subsidy only. |
| Oregon | \$72.73 | Under 8 years of service, no explicit subsidy; 8–9 years 50% of the explicit subsidy; 100% of the explicit subsidy for those with 30 years of service. |
| Arizona | \$73.59 | Capped benefit set to \$150 per month if the retiree is under age 65 and \$100 per month if the retiree is 65 or over. Dollars amounts reduced for less years of service. |
| Iowa | \$74.44 | Retirees over age 65 are in a separate risk pool and pay full premium, no explicit subsidy. |
| South Dakota | \$97.43 | Separate risk pool for retirees, only partial subsidy. |
| Kansas | \$106.87 | Retirees pay full cost of premiums if age 65 or older, otherwise partial subsidy. |
| Minnesota | \$110.48 | Implicit subsidy only for retirees under the age of 65. Medicare eligible retirees are a separate pool, so no implicit or explicit subsidy. |
| Wyoming | \$142.14 | Implicit subsidy only. |
| Ten States with the Highest UAAL Per Capita | | |
| New Jersey | \$7,950.84 | Retired teachers pay no premium; retired state employees pay 2% of the cost of the health insurance. |
| Hawaii | \$7,635.80 | If hired before 1996, state pays between 50% and 100% coverage based on years of service. For retirees hired after 1996, the state pays between 0% and 100% for retirees. |
| Connecticut | \$6,218.58 | For retirees after 1997, some plans require 3% contribution. All other retirees pay no premium. |
| Alaska | \$4,689.20 | The Retirement Systems pay the medical premiums for recipients hired before July 1, 1986. Employees hired after 1986 with five years of service pay the full monthly premium if they are under age 60 (and do not have 30 years of service) and receive benefits at no premium cost if they are over age 60. |
| Louisiana | \$4,361.75 | Retirees pay a scaled portion of the premium. |
| West Virginia | \$4,298.23 | Retirees pay a scaled portion of the premium. |
| Delaware | \$3,688.03 | Retirees pay a scaled portion of the premium. |
| Maine | \$3,624.39 | Qualified retirees pay no premium. Retirees pay a scaled portion of the premium if they have less than 10 years of service or are teachers. |
| North Carolina | \$2,740.61 | Qualified retirees pay no premium. Retirees hired after 2006 need 20 years of service to qualify. |
| Maryland | \$2,609.47 | Retirees with 16 years of service receive 100% subsidy from state; otherwise retirees pay a scaled portion of the premium. Persons who retired prior to 1984 receive 100% subsidy. |

The significant differences in the absolute and relative magnitudes of the liabilities for retiree health plans clearly indicates that some states face major financial challenges to continue these programs in the future, while in other states the impact of retiree health on public debt is rather minor. In total, there is a large and growing unfunded liability associated with nonfederal public sector retiree health plans. In states and localities with generous plans, retiree health plans represent an expanding problem for the fiscal health of the states and cities. GASB 45 statements in these states represent a wake-up call for policy makers to consider their options in how to deal with these liabilities. However, for many other states the reality is that the GASB statements certified that they have small liabilities associated with these plans and there is no cause for alarm.

The primary determinant of the differences in the relative size of the UAALs across the states is the proportion of the premium paid by the state compared to that paid by the retiree. States that require the employee to pay the full premium have very low UAALs associated only with the implicit subsidy. In contrast, states that pay all or most of the insurance premium for a large proportion of retirees have much higher UAALs. Table 3 (page 8) presents the description of coverage and premium data for the states with the 10 lowest and 10 highest UAAL per capita. The information in the table clearly indicates the importance of the decision by a state concerning the proportion of the premium that it will pay. See Robinson, et al (2008) for a more detailed description of the benefits provided by each state plan.

Myths, Realities, and Policies

In comparison with the private sector, state and local governments tend to provide their employees with more generous retirement benefits. Most public employees are covered by defined benefit pension plans and retiree health benefit plans. Funding rules and expectations for pension plans are clearly defined, liabilities are recognized, trust funds have been established, and state constitutions and laws limit or restrain changes in the plans that would reduce retirement benefits. In contrast, retiree health plans are a more recent employee benefit, typically no trust fund has been established, and the extent of the unfunded liabilities has only recently been recognized in conjunction with GASB 45.

Recent events have created a series of perceptions about the financial status of these plans; some are myths and some are realities. This issue brief has identified some of the most important perceptions concern-

ing retiree health plans in the public sector and has shown some to be fact, while others are merely myths based on a lack of data or understanding of key aspects of these plans.

Myth: All states face a funding crisis associated with their retiree health plans.

Reality: Many states face substantial future liabilities associated with these programs; however, for many other states, the unfunded liabilities are relatively small, should be easily manageable in future years, and do not require any major new policies to cope with these plans.

Myth: GASB 45 requires public sector employers to establish irrevocable trusts for their retiree health plans.

Reality: GASB standards do not require the establishment of trusts nor do they require full funding for those with such trusts. To date, relatively few states have established trust fund legislation to help finance these future costs and even fewer are making use of laws that allow funding. A more interesting public finance question is whether, in light of the GASB 45 requirements, governments should move toward full funding of their retiree health plans.

Myth: The explicit recognition of the unfunded liabilities reported in the GASB 45 statements will adversely affect the bond rating of governments and investors will exert market pressure for state and local governments to begin to prefund these plans.

Reality: The key determination of whether this perception is fact or fiction depends on whether the retiree health liabilities were already known to market analysts and had previously been factored into the bond ratings. If so, one could argue that these liabilities do matter but that the GASB 45 statements do not matter because investors already were aware of them. Moody's Investors Service (2005) stated that "Moody's does not anticipate that the liability disclosures will cause immediate rating adjustments of a broad scale" and that "Moody's therefore will exclude OPEB liabilities from calculations of state or local debt burdens, but include them as a factor in the overall credit assessment of an issuer. This practice is consistent with Moody's approach to municipal pension liabilities." The reality of the impact of GASB 45 statements will become more apparent in the next few years.

Myth: Retirement benefits are protected by state laws and provisions in state constitutions.

Reality: In general, no such protection exists for retiree health plans. Public sector employers have constantly been making changes to these plans that reduce the generosity of the benefits and raise the cost to retirees. The expectation is that public sector employers will continue to amend their plans in ways that reduce their cost to the government. However, political realities limit the ability of government to reduce compensation for public sector employees and promised benefits to retirees.

Several other important issues remain concerning public perceptions of the cost and liabilities of retiree health plans. GASB 45 requires an assessment and acknowledgement of the cost and accrued liabilities associated with retiree health plans using approved accounting standards. Estimates of the annual required contributions and the unfunded actuarial accrued liabilities provide an important benchmark for evaluating these plans and determining future policy decisions. One should keep in mind that these are estimates of future costs. Obviously, future projections can be altered by amending the plans or by future national health insurance initiatives. The projections will be much higher if medical inflation does not decline as assumed in the reports and pre-funding would alter the need for new tax monies to be devoted to these plans.

These substantial liabilities pose a serious financial problem for many states and municipalities. These unfunded liabilities will confront policy makers with difficult choices in the future. In 2006, the annual cost to state and local governments for retiree health plans averaged about 2 percent of employee salaries. If public sector employers continue to pay for these benefits on a pay-as-you-go basis, the cost of retiree health plans is projected to rise to 5 percent of payroll in 2050 (GAO, 2008).

As the annual cost rises, the ability to finance these programs may cause other priorities to be unmet and the overhang of billion dollar retiree health insurance liabilities may influence future bond ratings. There are a number of options that states can adopt to address the impending financial burden. The choices are clear for those state and local governments that have large liabilities. Governments can either increase total revenues to support the current programs, shift funds from other priorities to finance retiree health plans, or reduce benefits associated with these programs.

In response to GASB 45 and the financial pressures associated with retiree health plans, states and local governments are considering many policy responses.

For some governmental units, the unfunded liabilities and the annual cost of retiree health plans are very large and threaten their financial stability. These public employers are likely to focus on reducing the future cost of their retiree health plans even as they struggle to pay for the promises made to current workers and retirees. States and municipalities with less generous benefits are under much less fiscal pressure. Understanding the realities of the current financial status of individual plans is a key to developing new policies. We should expect that these policies will vary across governmental units and that they will reflect the substantial differences in the generosity of today's plans and the accompanying liabilities.

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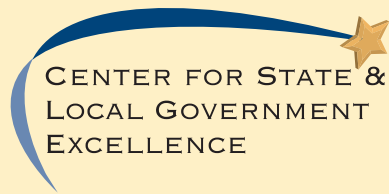
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Endnotes

- 1 Typically, the "full cost" of a retiree health plan paid by retirees would be the average cost of all participants in the health plan for active workers and retirees. Due to age-related differences in the cost of health insurance, allowing retirees to pay the same premium for participating in the plan involves an implicit subsidy. The new GASB standards require measurement and reporting of this subsidy to retirees.
- 2 *GASB Statement 45, Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions (OPEB)* was issued by the Governmental Accounting Standards Board in 2004. Basically, GASB 45 requires public employers to account for the cost of retiree health plans using the same methods used to estimate the liabilities associated with pensions. The complete standard can be seen at <http://www.gasb.org/st/summary/gstsm45.html>. Earlier in 2004, GASB issued Statement No. 43, *Financial Reporting for Post-employment Benefit Plans Other than Pension Plans*. GASB 43 sought to establish uniform reporting standards for retiree health plans.
- 3 Vicente (2006) provides a useful explanation of the new accounting standards and a summary of the issues raised by GASB 45.
- 4 The GASB 45 actuarial statements of the following states indicate that they have assets (measured in billions) for use by their retiree health plans and we have calculated funding ratios for these plans: Alaska: \$3.2 billion, 50 percent funding ratio; Arizona: \$1.2, 73 percent; Colorado: \$0.2, 17 percent; Delaware: \$0.03, 0.01 percent; Kentucky: \$0.9, 15 percent; New Mexico: \$0.2, 7 percent; North Carolina: \$0.1, 0.6 percent; Ohio: \$12.0, 39 percent; Oregon: \$0.3, 50 percent; Virginia: \$0.2, 11 percent. Since none of the other states report any assets, their funding ratios would be zero.
- 5 Studies that have estimated the UAAL and ARC for state retiree health plans include Goldman Sachs (2007), Pew (2007), Standard & Poor's (2007), and Zion and Varshney (2007). Also see GAO (2007).
- 6 Nebraska decided not to commission a GASB 45 report because of the limited liability associated with its program. Early retirees are eligible to stay in the state health plan by paying the full premium until they reach age 65 and qualify for Medicare. Thus, there is an implicit subsidy for retirees under age 65. It is likely that the UAAL associated with this subsidy is similar to states with UAALs of less than \$100 million.



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