Planning Pensions

Big Changes Ahead in State and Local Retirement Funding

By Kristi Guillory

State and local governments will be required to report plans for fully funding post-employment benefits in fiscal 2008. The requirement is part of a 2004 ruling by the Governmental Accounting Standards Board, which effectively dictates accounting principles used by state and local governments.

States are grappling with how to implement a ruling by the Governmental Accounting Standards Board (GASB) that requires state and local governments to report and delineate the mechanism for fully funding post-employment benefits.

The GASB—an independent, private, nonprofit organization that effectively dictates accounting principles used by state and local governments—in June 2004 issued Statement No. 45, Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions (OPEB). Under Statement No. 45, state and local governments will be required to report a framework for funding retiree health care over the next 30 years as reflected in an established and defined plan for meeting this obligation.

For governments with June fiscal year-ends, reporting under GASB 45 will be required beginning in fiscal year 2008.

This improved financial reporting will result in more accurate data on the total costs of the benefits, as well as provide a better foundation for potential methods of financing these benefits. These benefits, known as OPEB, include retiree benefits that are not part of a pension plan and are largely comprised of health care benefits.

Governments previously operated on a "pay-as-you-go" (PAYGO) system of OPEB reporting where former employees' benefits were paid out of current revenues. Retiree benefits did not cost governmental entities anything until the employee retired. Localities were not required to estimate the size of their commitment to retiree health care on their annual budgets, which resulted in most governments failing to set aside sufficient funds to pay for retiree health benefits. Under GASB 45, local governments will still not be required to set aside funds to pay for these obligations, but will be required to provide a framework for how they anticipate funding these obligations over the next 30 years.

GASB 45 comes at a time when health care costs have risen dramatically. Health care spending has increased at three times the rate of inflation since 1999. This increase can be linked to

several factors, such as increases in hospital and physician care, but most notably, the increase in the cost of prescription drugs.

One strategy that governments have used to manage their OPEB costs under GASB 45 is a reduction in overall retiree health benefits. This strategy can be problematic because pension and retirement benefits are usually protected by state constitutions, and a reduction in benefits can also be limited by labor agreements.

The city of Arlington, Texas, decided to no longer offer retiree health benefits to any employee hired after 2006. This decision reduced Arlington's health care obligation from $196 million to $150 million. Alabama, Utah and Ohio also have scaled back benefits by raising health care premiums and increasing the length of time that employees must work before becoming eligible for retiree health care.

Another strategy available to localities is to modify employee retirement plans. An employer may be able to modify the number of years in which a retiree can receive health benefits. For example, a former lifetime benefit could be changed to end at age 65. Employment packages offered to new employees could include lower benefits and higher co-pays.

Retirement plans can also be changed to defined contribution plans which consist of individual accounts for plan members specifying how contributions are to be determined, rather than specifying the income or other benefits to be received after separation from employment. In 2005, Alaska became the first state in the country to automatically enroll all future public employees in a defined contribution plan.

Some states have been able to achieve consensus on how to address the reporting requirements under GASB 45, while others are still working on it. Nevada Gov. Kenny Guinn, was met with heavy opposition when he proposed to discontinue health benefits for any state government employee hired after July 1, 2006. This proposal ultimately failed in the Nevada State Assembly. In Alaska, Gov. Frank Murkowski called a special session to examine retirement funding. Changes were made in pension and retirement benefits for new state employees making them eligible for plans with higher deductibles along with participation in health savings accounts.

In addition to reducing benefits or modifying employee retirement plans, another alternative that localities can employ to manage OPEB costs under GASB 45 is to issue OPEB bonds to fund all or a portion of their unfunded liability. There are benefits associated with this strategy. Some state laws allow for a broader range of investments for this type of fund than for general governmental revenues. States can also experience immediate budget relief by issuing OPEB bonds because their current year contributions to a pension plan can be secured from the bond proceeds.

Along with benefits, there are risks associated with issuing OPEB bonds, such as possible state law uncertainty on the authority to issue bonds of this type and the risk that future unfunded liabilities could surface. There is always the possibility that the market may not generate sufficient revenues to cover the interest rate. Once a state issues a bond, they are locked into paying the debt. In 1997, New Jersey issued $2.8 billion in bonds in hopes of receiving returns exceeding 7.6 percent, which was the interest it was paying on the bonds. However, the state only saw 5.5 percent returns. As a result, the bonds cost New Jersey $10.3 billion.

While some states have yet to start calculating the cost of implementing GASB 45, some states have made great strides in funding their retiree health care liability. California has not yet determined its liability, but some predict its obligation could total in excess of $40 billion. New York is also yet to determine its liability. Ohio has put money aside to handle its liability by creating a health care trust fund valued at $12 billion, with active state employees contributing 4 percent of their salaries. Current retiree health costs are funded with the interest accrued from this account.

In addition to the legal and political implications of complying with GASB 45, there are also other important serious consequences to consider. While GASB cannot require that localities comply with its rulings, Fitch Ratings reported that if local governments fail to plan for OPEB funding or don't act quickly enough, they could see their credit ratings fall and their bonds downgraded. This will limit their ability to borrow at favorable rates and could potentially result in increased cost for taxpayers to fund capital improvements. If governments decide to reduce retiree health benefits, they may lose their ability to attract qualified applicants for positions.

The time for compliance with GASB 45 is approaching fast. Some of the methods state and local governments may use to comply with GASB 45 will be met with political opposition and others will be met with praise. Whatever the case may be, state and local governments will have to devote time and energy to thinking about how they will fund retiree health care benefits over the next 30 years.

—Kristi Guillory is senior policy analyst and assistant counsel in The Council of State Governments' Washington, D.C., office.