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State and Local Governments Must Address Unfunded Health Care Liabilities

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State and local taxpayers are in trouble. Over the years, state and local governments have promised, but not paid for, roughly \$1.5 trillion dollars in retiree health care and other non-pension post-employment benefits—and the bill is coming due as millions of baby boomers begin to retire. Until recently, few officials even knew the size of their obligations but a new accounting rule will, for the first time, hold state and local governments to a similar standard that applies to private sector employers, forcing them to calculate their unfunded liabilities and publicly disclose them on their financial statements. David Walker, Comptroller General of the United States, warns, “there are no quick fixes” and that stark fiscal challenges need to be “addressed with a greater sense of urgency by policymakers since time is currently working against us.”¹ State and local officials should not expect a bailout from Washington, which is facing its own challenges with the rising costs of Medicare, Medicaid, and Social Security. State and local officials must solve this problem themselves. Fortunately, there are several creative, market-based solutions that could fit the bill.

How Governments Calculate Retiree Health Benefit Costs. For decades, state and local governments failed to accurately account the costs and obligations of retiree health and other non-pension benefits. Most officials relied upon a “pay-as-you-go” accounting approach. Under this approach, officials report these costs when benefits are received by retirees instead of each year as employees render services in exchange for compensation,

including promised retirement benefits. Pay-as-you-go accounting, therefore, obscures and under-reports the true costs and obligations that state and local governments have accrued. For private companies, this sort of obfuscation would be illegal and in violation of their fiduciary responsibilities.

In 2004, the Government Accounting Standards Board corrected this problem. The Board issued a new accounting standard (GASB 45)²—similar to the Financial Accounting Standards Board’s (FAS 106) statement issued for publicly traded private companies in the early 1990s or current financial practices for pensions—which established an accrual accounting approach. By following this approach, government officials will now be required to calculate and report the cost of benefits as an expense during the years in which an employee is providing services in exchange for future benefits.

This change will more accurately reveal the total cost of services a state or local government provides, make transparent the annual cost of health care and other non-pension post-employment benefits, and disclose the amount that these benefits are funded each year. The new accrual accounting approach will report changes in the funding status of benefits

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over time and then prospectively disclose the unfunded actuarial accrued liabilities of state and local governments.

The Size of the Unfunded Liabilities. Although state and local governments began calculating estimates of their expected costs and obligations for retiree health care and other non-pension post-employment benefits in 2007, the first reports on their liabilities will not be disclosed until fiscal year 2008, when those financial reports are released between December 2008 and March 2009. In the meantime, actuaries and other experts have completed preliminary estimates of the size of the bill that is facing the taxpayers.

In 2006, analysts for J.P. Morgan estimated that state and local governments' unfunded liabilities for non-pension post employment benefits—primarily retiree health care—were between \$600 million and \$1.3 trillion.³ Since the initial J.P. Morgan estimate, two subsequent studies have corroborated the higher estimates. In October 2006, the Cato Institute put the figure at \$1.4 trillion,⁴ and in March 2007 Credit Suisse uncovered \$1.5 trillion in unfunded liabilities—\$558 billion for state and \$951 billion for local governments.⁵ The most recent study on the topic, by the Pew Charitable Trust,⁶ conservatively estimated the unfunded liabilities for only state governments to be \$370 billion. If the Pew study had included local governments in its analysis, it would have confirmed that the total liabilities of state and local governments add up to more than one trillion dollars.

What State and Local Officials Should Do. It is quite possible that many state legislators and local officials will do nothing. But taxpayers should realize that this irresponsibility would come at a high price: State and local governments will have to substantially increase taxes or cut other spending as the bill for retiree health care and other non-pension benefits comes due. Also, state and local officials who fail to act to scale back the size of these obligations will see their bond ratings drop and the cost of borrowing rise commensurately.

State and local officials may try to pressure the President and Congress to intervene with a bailout. Under no circumstances, however, should the federal government agree to divert increasingly scarce federal tax dollars to any kind of bailout for state or local unfunded liabilities. Taxpayers should hold state and local officials directly accountable for the decisions they have made and the rising costs of those decisions. Those officials should be forced to solve the problem themselves.

The first thing state officials can do is to start converting their current and promised health benefits for their workers and retirees from a defined benefit model to a defined contribution model. This would make health costs reliable and predictable. In addition, a defined-contribution model could harness market forces to help control costs while ensuring the delivery of high-quality health care.

To complement such a change in financing, state officials should also reform their states' health insurance markets. Many states' health insurance markets are dysfunctional, burdened with over-reg-

1. U.S. Government Accountability Office, *State and Local Governments: Growing Fiscal Challenges Will Emerge during the Next Ten Years*, GAO-08-317, January 2008, at www.gao.gov/new.items/d08317.pdf.
2. While GASB 45 addresses accounting and reporting of benefits by public sector employers, GASB also issued statement 43 which addresses reporting on other post-employment benefit plan assets by a trustee or plan administrator. For more information on these and other GASB accounting standards, see www.gasb.org/.
3. Bob Porterfield, "Retiree Health Care May Overwhelm Governments," Associated Press, September, 25, 2006, at www.usatoday.com/news/health/2006-09-24-retiree-benefits_x.htm.
4. Chris Edwards and Jagadeesh Gokhale, "Unfunded State and Local Health Costs: \$1.4 Trillion," *Cato Institute Tax and Budget Bulletin* No. 40, (October 2006), at www.cato.org/pubs/tbb/tbb_0925-40.pdf.
5. David Zion and Amit Varshney, "You Dropped a Bomb on Me, GASB," *Credit Suisse, Equity Research* March 22, 2007, at <http://online.wsj.com/public/resources/documents/DroppedB.pdf> (April 23, 2007).
6. "Promises with a Price: Public Sector Retirement Benefits," The Pew Center on the States, at www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/State_policy/pension_report.pdf.

ulation, excessive mandates, and underwriting rules that drive up health care costs. The best fix is for state officials to create statewide health insurance exchanges to enable state employees and retirees to choose from among competing private health plans, while keeping the generous federal tax benefits that accrue to group health insurance, thus making plan choices more affordable and fully portable.⁷ This can be done in accordance with applicable federal employment law. An exchange should also be part of a larger statewide health insurance market reform that reduces the number of benefit mandates and creates superior pooling mechanisms to assure both choice and coverage options for high-risk individuals.⁸

Within a properly designed exchange, state and local employees, joining with employees of private businesses, could benefit from more affordable coverage in a statewide market where risks are more broadly distributed than they are today.

Conclusion. Taxpayers are increasingly becoming aware of a new challenge: The rising costs of retiree health care and other non-pension, post-employment benefits for state and local employees, which amount to approximately \$1.5 trillion in unfunded liabilities. State and local officials must somehow pay for these promised benefits, while reforming the way these benefits are financed and delivered. A failure to act responsibly guarantees a

negative impact on the state and local government bond ratings.

Meanwhile, the challenge offers an opportunity for state and local officials to become creative in addressing the problem. Rather than pressure the President and Congress for a federal bailout—substituting federal tax dollars for state tax dollars—they can start to make changes in the way in which they finance and deliver health care benefits to both employees and retirees. One option is to move from a defined-benefit system to a defined contribution system, which would make the cost of health benefits more predictable and reliable. A related measure would be to reform the state health insurance market in a way that enables employees and retirees to purchase health plans of their choice, with pre-tax dollars, and own these policies regardless of their employment status. This could be done within the strict confines of federal employment law and could result in affordable, personally owned and controlled health insurance policies that would be fully portable.

There are no quick fixes and no escape from the consequences of inaction. This is another reason taxpayers should keep a close watch on their local and state elected officials.

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7. For a description of this option, see Robert E. Moffit, Ph.D., "The Rationale for A Statewide Health Insurance Exchange," Heritage Foundation *WebMemo* No.1230, October 5, 2006, at www.heritage.org/Research/HealthCare/wm1230.cfm.
8. For a discussion of pooling arrangements, see Edmund F. Haislmaier, "State Health Reform: How Pooling Arrangements Can Increase Small-Business Coverage," Heritage Foundation *WebMemo* No.1563, July 23, 2007, at www.heritage.org/Research/HealthCare/wm1563.cfm and Edmund F. Haislmaier, "State Health Reform: The Benefits and Limits of 'Reinsurance'," Heritage Foundation *WebMemo* No.1568, July 26, 2007, at www.heritage.org/Research/HealthCare/wm1568.cfm.