Public Employee "Other Post Employment Benefit" Plans

A Case for Shifting to a Defined-Contribution Approach

American Legislative Exchange Council

ALEC

WWW.ALEC.ORG

Authors:
Barry W. Poulson
Arthur P. Hall

Edited by:
Jonathan Williams

About the American Legislative Exchange Council

Public Employee "Other Post Employment Benefit" Plans – A Case for Shifting to a Defined-Contribution Approach has been published by the American Legislative Exchange Council (ALEC) as part of its mission to discuss, develop, and disseminate public policies, which expand free markets, promote economic growth, limit the size of government, and preserve individual liberty. ALEC is the nation's largest nonpartisan, voluntary membership organization of state legislators, with 2,000 members across the nation. ALEC is governed by a Board of Directors of state legislators, which is advised by a Private Enterprise Board representing major corporate and foundation sponsors. ALEC is classified by the Internal Revenue Service as a 501(c)(3) nonprofit, public policy and educational organization. Individuals, philanthropic foundations, corporations, companies, or associations are eligible to support ALEC's work through tax-deductible gifts.

About ALEC's Tax and Fiscal Policy Task Force

The mission of ALEC's Tax and Fiscal Policy Task Force is to explore policy solutions that reduce excessive government spending, lower the overall tax burden, enhance transparency of government operations, and promote free-market fiscal policies.

Public Sector Chairman: Indiana Sen. Jim Buck
Private Sector Chairman: Bob Williams
Task Force Director: Jonathan Williams

Public Employee "Other Post Employment Benefit" Plans – A Case for Shifting to a Defined-Contribution Approach

Barry W. Poulson
Professor Emeritus, University of Colorado
Senior Fellow, Center for Applied Economics
University of Kansas School of Business

Arthur P. Hall
Executive Director
Center for Applied Economics
University of Kansas School of Business

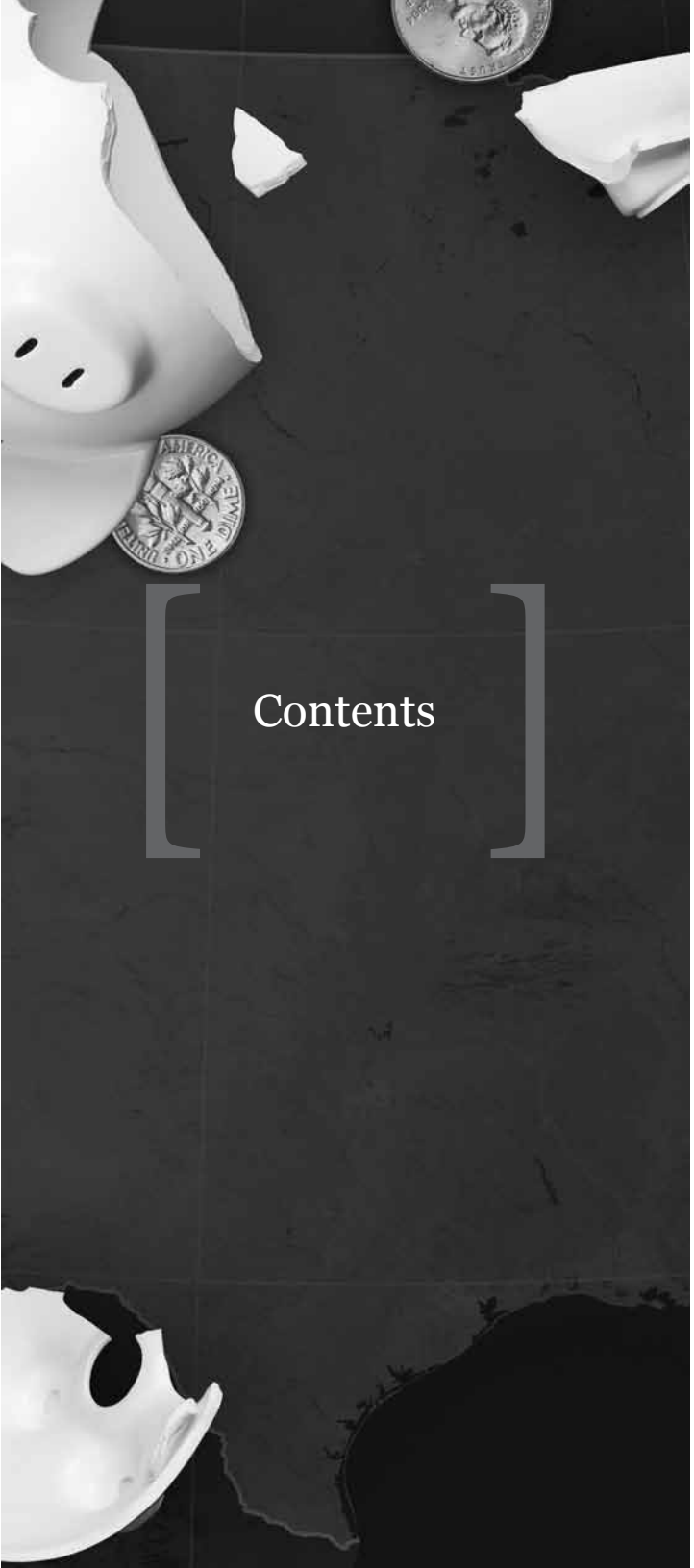
Edited by Jonathan Williams
Director, Tax and Fiscal Policy Task Force
American Legislative Exchange Council

Published by
American Legislative Exchange Council
1101 Vermont Ave., NW, 11th Floor
Washington, D.C. 20005

Phone: (202) 466.3800
Fax: (202) 466.3801

www.alec.org

Designed for ALEC by
Joel Sorrell



Contents

TABLE OF CONTENTS


American Legislative Exchange Council
ALEC

Executive Summary

This study surveys the financial condition of Other Post Employment Benefit (OPEB) plans for a sample of states. The accumulation of trillions of dollars in unfunded liabilities in OPEB plans is contributing to the financial crises encountered in many states during the current economic downturn. The major cause of the increase in unfunded liabilities in OPEB plans is the failure of states to properly reform their plans to mitigate the escalating cost of health care.

Currently, public sector employees are receiving almost double the amount of health insurance benefits received by employees in the private sector. Recently, private sector employers have significantly scaled back retiree health benefits offered to their employees. This survey reveals that some states are enacting reforms to bring retiree health benefits offered to public employees in line with those offered to employees in the private sector.

Much of the literature on the funding crises in OPEB plans focuses on pre-funding. States have attempted to set aside assets in a trust fund to pay for the growing liabilities in their plans. The survey of retiree health plans reveals that pre-funding has done little to reduce unfunded liabilities.

The survey reveals that, with few exceptions, states with defined-contribution retiree health plans have the lowest levels of unfunded liabilities per capita in their plans. Defined-benefit retiree health plans tend to have higher costs and accumulate higher levels of unfunded liabilities per capita.

States with defined-contribution retiree health plans have more successfully constrained the cost of health insurance and have required retirees to assume a reasonable amount of the cost of insurance. As a result, these states are better able to meet their obligations with actual contributions to the retiree health plan equal to or exceeding the required contribution.

Many states have now introduced defined-contribution health plans for their retirees. One of the most successful of these reforms was introduced in Idaho, which has the lowest level of unfunded liabilities per capita in their OPEB plan of any of the states in our sample. In 2009, Idaho enacted reforms that significantly reduced the state's cost of the retiree health plan. Idaho restricted eligibility and increased the share of health insurance cost paid for by retirees. State contributions to the plan now exceed the required contributions, and the state is on track to eliminate unfunded liabilities in the plan over the actuarial (30-year) time period.

This type of defined-contribution retiree health plan is the solution to the funding crises in OPEB plans. If other states follow Idaho's example and enact the reforms in their own retiree health plans, they could eliminate the estimated $1 trillion in unfunded liabilities in OPEB plans over an actuarial time period.

Introduction

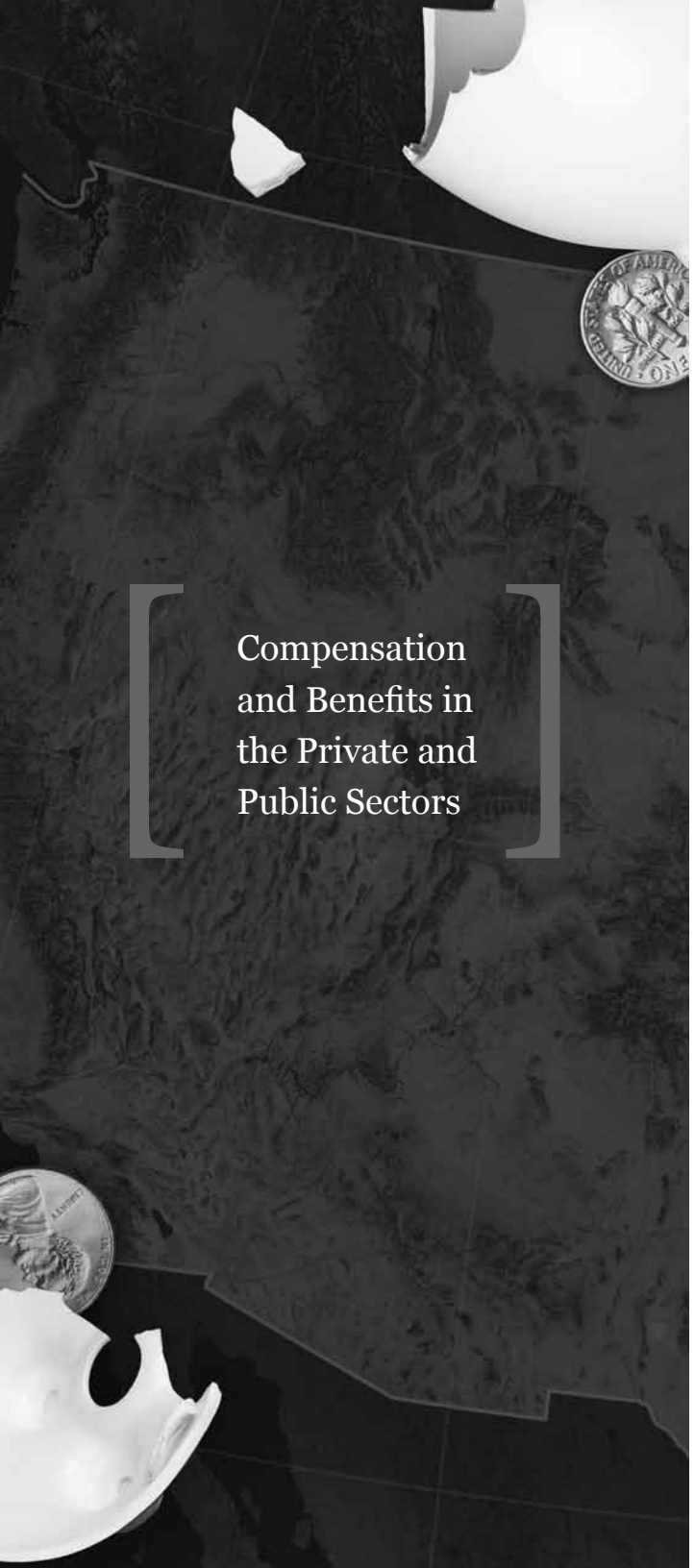
Only recently have states begun to focus on the funding crises in OPEB plans. The new accounting rules for these plans, introduced by the Governmental Accounting Standards Board (GASB), require the states to report the liabilities in these plans on an accrual basis. In their Comprehensive Annual Financial Reports (CAFR) for fiscal years 2008 and 2009, states estimated these liabilities for the first time.

Estimates of the magnitude of the funding crises differ in recent studies. The Pew Foundation estimates the unfunded liabilities in OPEB plans at $1 trillion (The Pew Center on the States, 2010). Other studies have estimated these unfunded liabilities as high as $1.5 trillion (Zion and Varshney, 2007; and Edwards and Gokhale, 2006). Unfunded liabilities in these plans are projected to continue to increase in coming years.

While many factors have contributed to the growth in unfunded liabilities in OPEB plans, the major factor is the failure of states to properly reform their plans to mitigate the escalating cost of health care. With health care costs increasing at double digit rates, the cost of providing health insurance for retirees will continue to increase, accompanied by even greater unfunded liabilities in these health care plans.

"With health care costs increasing at double digit rates, the cost of providing health insurance for retirees will continue to increase, accompanied by even greater unfunded liabilities in these health care plans."

In this study, we will (1) endeavor to quantify (for a sample of states) the financial condition of state and local government OPEB plans and (2) make a case for moving from defined-benefit to defined-contribution approaches to funding OPEB plans. The states that have had the most success in addressing the funding problems in their OPEB plans have introduced defined-contribution health plans for retirees. These plans minimize the risks to the states of high and volatile health care costs. This finding is reflected in lower levels of unfunded liabilities per capita and lower required contributions per capita.



Compensation and Benefits in the Private and Public Sectors

Total Compensation

A wealth of evidence documents the more generous compensation of employees in the public sector relative to that in the private sector. Table 1 shows that the average state and local government employee earns $39.60 in total compensation per hour compared to $27.42 for private employees. While public sector employees receive more in wages and salary, the primary difference is in greater benefits. Total state and local employee benefits are 69 percent higher than those of employees in the private sector.

"State and local employee benefits are 69 percent higher than those of employees in the private sector."

Table 1. Total Compensation (Per Hour): State and Local Government Employees and Private Sector Employees, June 2009

	State and Local Government Employees		Private Industry Employees	
	Dollars ($)	Percent	Dollars ($)	Percent
Total Compensation	39.60	100.00	27.42	100.00
Wages and Salaries	26.11	65.90	19.41	70.80
Total Benefits	13.49	34.10	8.01	29.20

Source: Bureau of Labor Statistics

Pension and Health Costs

Table 2 reveals that the major source of this differential in benefits between public and private sector employees is in defined-benefit pension plans. The benefits captured by public sector employees enrolled in defined-benefit pension plans are seven times that accruing to private sector employees enrolled in these plans.

The health insurance benefits of public sector employees are more than double that accruing to private sector employees.

"Taxpayers are asking the obvious question: Why are more tax dollars being used to finance pension and health benefits for public sector retirees that are more generous than those available to employees in the private sector?"

Table 2. Retirement and Health Care Costs Per Hour: State and Local Government Employees and Private Sector Employees, June 2009

	State and Local Government Employees		Private Industry Employees	
	Dollars ($)	Percent	Dollars ($)	Percent
Retirement	3.19	8.10	0.92	3.40
Defined-Benefit	2.86	7.20	0.38	1.40
Defined-Contribution	0.33	0.80	0.55	2.00
Health Insurance	4.45	11.20	2.01	7.30

Source: Bureau of Labor Statistics

Pension and Health Benefit Plans

According to the most recent employee benefit survey conducted by the Bureau of Labor Statistics (BLS), there has been a dramatic shift in pension plans offered to employees in the private sector from defined-benefit plans to defined-contribution plans. Table 3 reports that only 21 percent of private sector employees now have access to a defined-benefit pension plan, while 61 percent of those employees have access to a defined-contribution plan (National Compensation Survey Benefits Series, 2009).

In contrast, most state and local governments continue to offer employees a defined-benefit pension plan. According to that survey, 84 percent of state and local government employees have access to a defined-benefit pension plan, while only 30 percent of those employees have access to a defined-contribution pension plan.

The disparity in benefits offered to employees in the public and private sector is most evident in the case of retiree health benefits. According to the BLS survey, as shown in Table 4 (see page 10), the percentage of private sector employees with access to employer-provided health benefits in retirement fell to 26 percent for those under 65 and 23 percent for those over 65. The share of state and local government employees with access to employer-provided health care benefits in retirement is 70 percent for those under 65 and 64 percent for those over 65.

Table 3. Pension and Health Benefits: State and Local Government Employees and Private Sector Employees, March 2008

	State and Local Government Employees	Private Industry Employees
Retirement Benefits	Percent	Percent
Defined-Benefit		
Access	84	21
Participation	79	20
Defined-Contribution		
Access	30	61
Participation	17	43
Medical Care Benefits		
Access	88	71
Participation	73	52

Source: Bureau of Labor Statistics

In the private sector, increased accounting transparency revealed that generous pension and health benefits promised to retirees were not sustainable in the increasingly competitive global economy. In recent decades, as private corporations encountered increasing financial stress from the burdens imposed by their pension and health plans for retirees, they dramatically scaled back those promises.

State and local governments have also encountered financial stress from the more generous pension and retiree health benefits promised to employees, often as a result of collective bargaining agreements with public sector unions. For many states, the current recession has resulted in the largest revenue contraction and revenue shortfalls since the Great Depression. After a steep revenue falloff in FY 2009, revenues continue to fall below targets in many states in the current fiscal year.

As state and local governments conform financial reports to Governmental Accounting Standards Board (GASB) rules, it is clear that pension and health benefits promised to retirees will absorb larger shares of their budgets. Given that these jurisdictions must balance their budget and are constrained in issuing debt, meeting these obligations would require either raising taxes or cutting expenditures for other programs. As the cost of pension and health benefits promised to retirees increases to 30 percent or more of their salary budgets, state and local governments have encountered pushback from taxpayers.

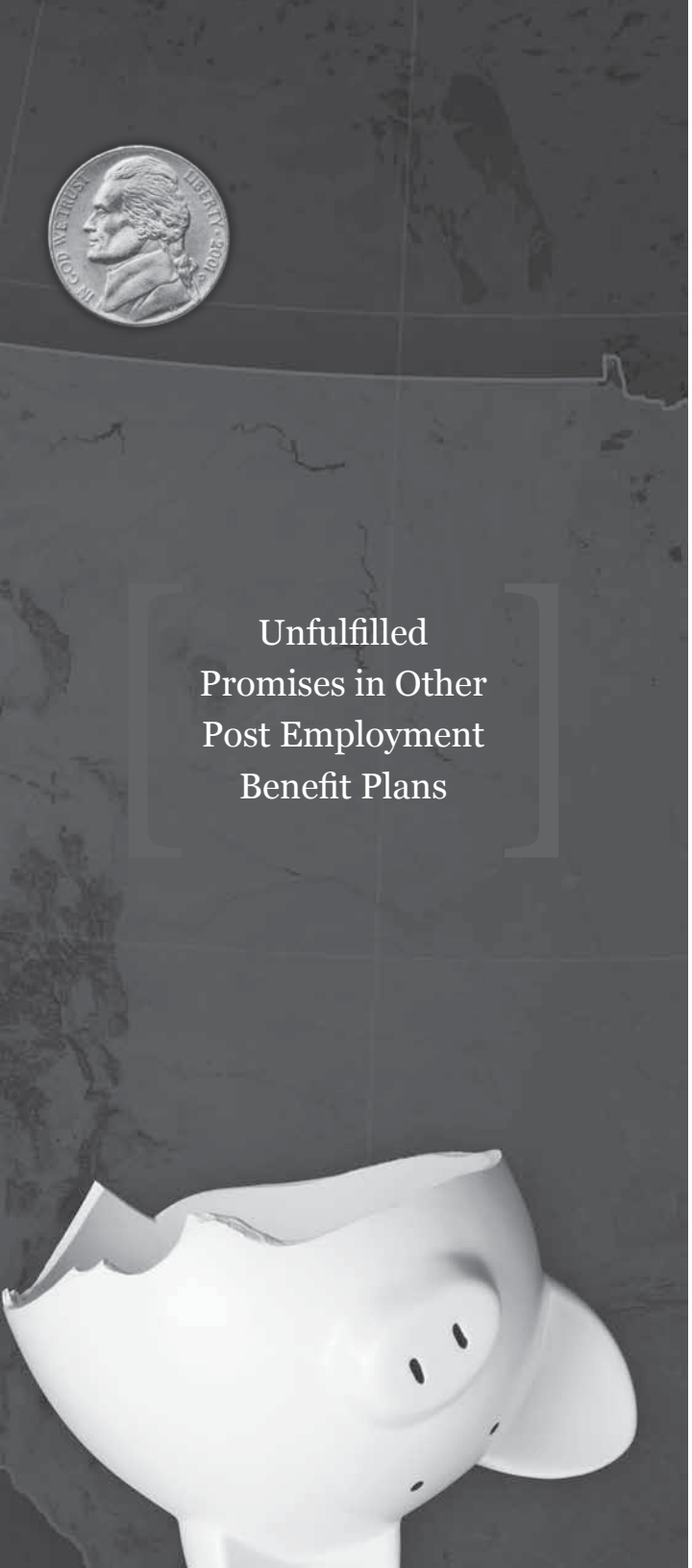
Table 4. | Health-Related Benefits: State and Local Government Employees and Private Sector Employees, March 2008

	State and Local Government Employees	Private Industry Employees
	Percent	Percent
Health Related Benefits		
Under Age 65	70	26
Age 65 and over	64	23
Long Term Care Insurance	27	16

Source: Bureau of Labor Statistics

Taxpayers are asking the obvious question: Why are more tax dollars being used to finance pension and health benefits for public sector retirees that are more generous than those available to employees in the private sector? The position taken in this paper is that the disparity in pay and benefits between public sector and private sector employees will not persist. Many states statutorily mandate a salary survey comparing pay and benefits with those in the private sector (National Compensation Survey Benefits Series, 2009).

These salary surveys are used to bring salary and benefits in the public sector into line with those in the private sector. Because state and local governments cannot sustain current arrangements, our expectation is that state and local governments will follow the lead of the private sector in replacing their defined-benefit pension and health plans for retirees with defined-contribution plans. In a companion study, we explore evidence for this reform in state pension plans (Poulson and Hall, The American Legislative Exchange Council, 2010).



Unfulfilled Promises in Other Post Employment Benefit Plans

The New Governmental Accounting Standards Board (GASB) Guidelines

GASB 45, introduced in 2004, requires state and local governments to account for OPEB expenses in their financial statements. OPEB expenses primarily include promises to retirees in the form of health care benefits and life and disability insurance. Historically, states funded OPEB expenses on a pay-as-you-go basis. GASB maintains that OPEB expenses are part of the total compensation of employees and should be included in the cost of providing government services on an accrual basis, the same treatment recommended for pension benefits. The new rules require that OPEB costs include normal OPEB costs—plus a component for amortization of the total actuarial accrued liabilities over a period not to exceed 30 years.

GASB 45 has resulted in greater transparency in state OPEB plans. Many states now include this required supplementary information in their annual Comprehensive Annual Financial Report (CAFR). However, a number of states do not comply with the new GASB standards—either as a matter of policy, or due to long lags in the compilation of the data. In a number of states, the most recent OPEB data reported in their financial statements is for 2007.

It is important to emphasize that the GASB standards are not mandatory; GASB has no enforcement provisions. Rather, the evidence provided in these financial reports is used by financial institutions, including bond ratings agencies. Failure to meet GASB standards will likely have a negative impact on the ratings for bonds issued by these state and local governments. For this reason, elected officials have an incentive to met GASB standards in the administration of their OPEB plans.

In this study, we have selected a sample of state OPEB plans for analysis. The sample is chosen to provide recent and uniform data on these OPEB plans. The sample includes states that have reported the funding status for the OPEB plans for FY 2008. This sample is likely to give a more accurate picture of OPEB plans than other studies. Other studies often combine data for different fiscal years, including data from FY 2007 or earlier. That data is not likely to reflect the more recent changes that affected the funding status of OPEB plans. In recent years, states have enacted reforms in their OPEB plans designed to meet GASB standards. This includes changes in the design of the plans as well as pre-funding of future liabilities.

Unfunded Liabilities in OPEB Plans

The magnitude of underfunding in state OPEB plans is revealed in several measures of funding status in these plans. The most important of these measures are the Unfunded Actuarial Accrued Liabilities (UAAL) and the Annual Required Contributions (ARC). The UAAL is the difference between the accrued actuarial liabilities and the assets an employer has set aside to fund those liabilities. The ARC includes normal OPEB costs, plus a component for amortization of the total actuarial accrued liabilities over a period not to exceed 30 years. Both UAALs and ARCs have been increasing rapidly in most states in recent years. As a result, most states now find it difficult to meet GASB standards.

The causes for the rapid growth in unfunded liabilities in OPEB plans include the same factors that have caused deterioration in the funding status of pension plans: an aging work force, generous benefits promised to retirees, and a history of underfunding those promises. However, there is an additional factor driving up the cost of OPEB plans: escalating health care costs. Many health care plans assume that health care costs will increase at a modest rate compared to recent experience. This explains the disparity in different estimates of unfunded liabilities in OPEB plans. Additionally, this is why OPEB liabilities are likely to be more volatile and burdensome in future years than is reported in these financial statements.

State	Unfunded Liabilities ($ Millions)	Funded Ratio (Percent)	Unfunded Liabilities (Per Capita)
Alaska	9,184	29.4	13,381
Connecticut	26,019	0.0	7,432
Delaware	5,410	1.4	6,197
Louisiana	13,727	0.0	3,112
North Carolina	27,854	1.5	3,020
Kentucky	11,659	10.4	2,731
Maryland	14,733	0.8	2,615
Vermont	1,615	0.2	2,601
New York	47,252	0.0	2,424
South Carolina	9,008	3.1	2,011
New Hampshire	2,471	0.0	1,878
Maine	2,188	4.3	1,663
Pennsylvania	16,261	0.5	1,306
Texas	29,919	2.6	1,230
Montana	1,048	0.0	1,084
Washington	4,014	0.0	613
Missouri	2,626	1.9	444
Virginia	2,703	36.1	348
Wyoming	174	0.0	326
Colorado	1,113	18.7	225
Mississippi	570	0.0	194
Utah	393	12.1	144
Minnesota	659	0.0	126
Oregon	323	0.0	85
Kansas	237	0.0	85
Iowa	220	0.0	73
Indiana	462	0.0	72
North Dakota	45	48.5	70
Arizona	207	85.7	32
Idaho	22	0.0	14

Table 5. Unfunded Liabilities Per Capita, Selected States

Table 5 ranks our sample of states with respect to unfunded liabilities per capita. This measure provides a basis for comparing the tax burdens imposed by OPEB plans on the citizens of the state.

There are great disparities in the magnitude of unfunded liabilities per capita of OPEB plans in the states. The outlier is Alaska, with more than $13,000 in unfunded liabilities per capita. In contrast, seven states have unfunded liabilities per capita less than $100.

Source: Actuarial reports for various states, FY 2008 and FY 2009.

Annual Required Contributions

GASB standards require not only that states report unfunded liabilities in OPEB plans, but also that they show progress in funding these liabilities over a 30-year amortization period. To meet these standards, states must calculate an Annual Required Contribution (ARC). The ARC is equal to the sum of the normal accrual accounting OPEB cost plus the component for amortization of unfunded actuarial liabilities for that year. Therefore, the ARC is a measure of the annual burden of unfunded liabilities in OPEB plans to meet GASB standards.

State	Required Contribution ($ Millions)	Required Contribution (Per Capita)
Louisiana	1,141	867
Texas	1,656	551
Alaska	370	540
Connecticut	1,719	390
Washington	334	219
Pennsylvania	1,065	204
Vermont	119	185
South Carolina	493	176
North Carolina	2,674	110
Maine	138	105
Arizona	91	104
Maryland	1,149	92
Minnesota	74	76
Delaware	516	56
Virginia	282	43
Missouri	225	34
New Hampshire	195	25
Montana	92	16
Colorado	73	15
Oregon	36	13
Mississippi	44	12
Utah	54	8
Wyoming	20	5
North Dakota	9	2
Idaho	3	1

Table 6.

Annual Required Contribution, Total and Per Capita

Table 6 ranks our sample of states with respect to the ARC per capita. Citizens in Louisiana, Texas, and Alaska may be surprised to know that they each have a tax bill to fund OPEB obligations in excess of $500 per year.

Source: Actuarial reports for various states, FY 2008 and FY 2009.

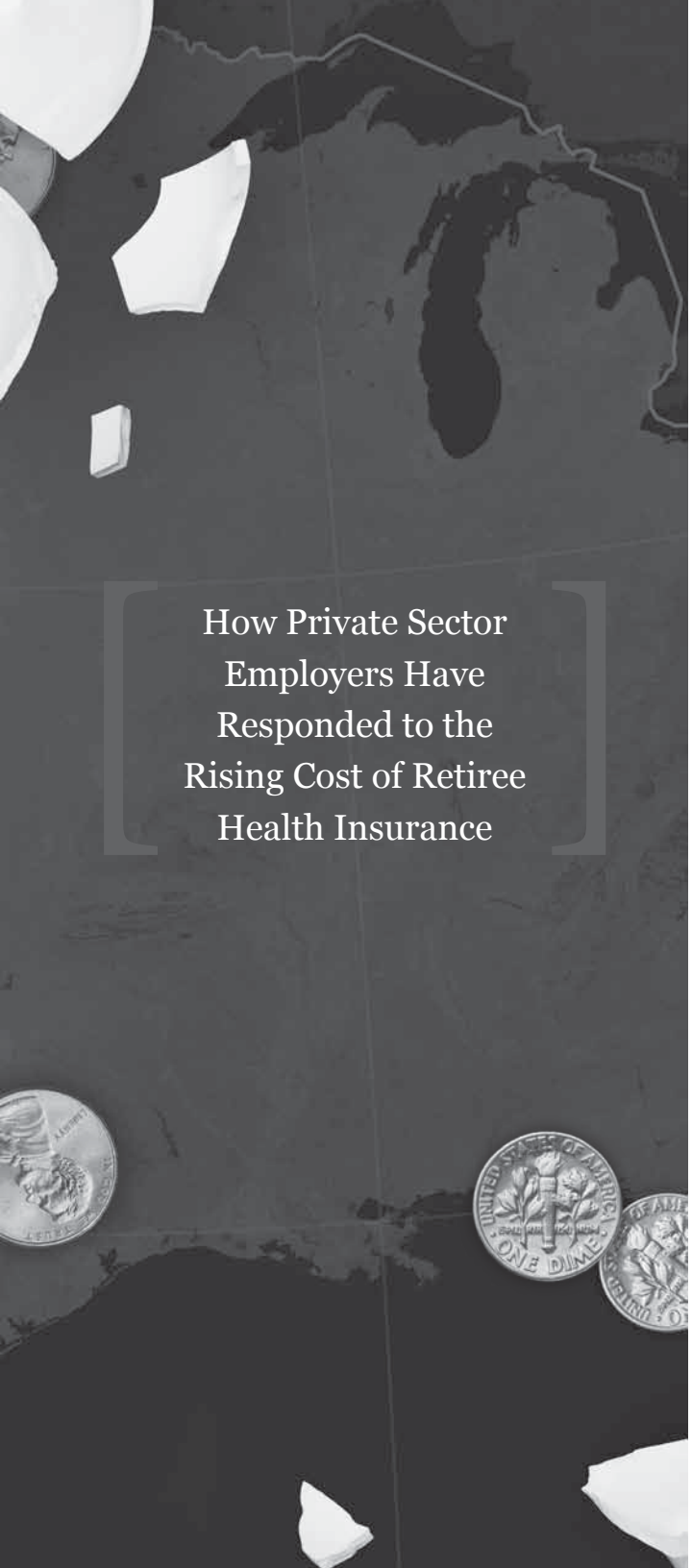
State	Required Contribution ($ Millions)	Actual Contribution ($ Millions)	Actual Contribution/ Required Contribution (Percent)
North Dakota	5.8	6.8	116.7
Alaska	370.5	397.9	107.4
Arizona	90.5	90.5	100.0
Utah	53.5	53.5	100.0
Colorado	73.3	72.4	99.0
Idaho	3.3	3.2	96.7
Wyoming	20.4	14.1	68.9
Virginia	282.0	175.8	62.3
Pennsylvania	1,064.7	593.0	55.7
South Carolina	493.4	262.9	53.3
Missouri	224.6	119.2	53.0
Maine	138.0	69.0	50.0
Oregon	35.8	16.0	44.7
Minnesota	73.7	28.0	38.0
Maryland	1,148.6	366.4	31.9
Delaware	516.2	160.0	31.0
North Carolina	2,674.4	829.1	31.0
New Hampshire	195.4	57.0	29.2
Texas	1,655.6	478.6	28.9
Connecticut	1,718.9	484.5	28.2
Washington	334.4	86.6	25.9
Louisiana	1,141.1	209.5	18.3
Vermont	118.8	19.9	16.7
Mississippi	43.6	0	0.0
Montana	92.0	0	0.0

Table 7. | Required Contribution, Actual Contribution, and Ratio of Actual to Required Contribution

Table 7 ranks our sample of states with respect to the ratio of actual to required contributions in the OPEB plans. The actual contribution relative to the required contribution is a measure of the extent to which the states are meeting their OPEB obligations. Six states are at or close to fully funding their required contribution rate. But most states are contributing less than half the required contribution rate. This includes states with high levels of unfunded liabilities per capita.

Most states are unwilling or unable to fully fund the health care promises they have made to retirees. As these states fall further behind in funding the health care they have promised to retirees, the financial stress will only increase. Even with economic recovery, the prospect is for further deterioration in the funding status of their OPEB plans.

Source: Actuarial reports for various states, FY 2008 and FY 2009.



How Private Sector Employers Have Responded to the Rising Cost of Retiree Health Insurance

The Impact of New Financial Accounting Board (FASB) Standards

To put OPEB plans in perspective, it is important to understand what has happened to retiree health plans in the private sector. Prior to 1965, when Medicare was enacted, almost all Americans assumed responsibility for their own health insurance, including out-of-pocket payments in retirement.

After Medicare was enacted, some private sector employers began to offer health benefits to supplement Medicare. By 1988, about one-third of private sector employees were eligible for retiree health insurance from their employer. Generally, retiree health benefits were offered by the largest employers (Fronstin, 2010).

Over the last two decades, there has been a significant decrease in the availability of health benefits in the private sector. A major factor in this decline was a 1990 accounting rule change issued by the Financial Accounting Standards Board (FASB). The rule requires that companies report retiree health benefit liabilities on an accrual basis in their financial statements. This rule had a dramatic impact on a company's profit and loss statement, particularly for large employers.

Meeting the new accounting rules for retiree health plans required a significant increase in employer contributions to these plans. Private employers encountered greater financial burdens in shifting a larger share of their budgets toward these plans.

The Decrease in Private Sector Retiree Health Benefits

Not surprisingly, private sector companies began to reform their retiree health benefits to reduce or eliminate these costs. From 1997 to 2008, the share of workers in the private sector who were offered health benefits in early retirement fell from 31 percent to 22 percent. Over this same time period, the share of workers eligible for Medicare in the private sector who were offered health benefits in retirement decreased from 28 percent to 17 percent (Fronstin, 2010).

This trend away from retiree health benefits was even greater in large private firms with more than 500 employees. The share of these firms offering health benefits to early retirees decreased from 46 percent to 28 percent while the retiree health benefits to Medicare eligible retirees in these firms decreased from 40 percent to 21 percent (Fronstin, 2010).

By 2006, more than half of large private sector employers had closed their subsidized retiree health benefits to new employees. Many firms continued to offer retiree health plans, but required employees to pay the full cost of the health insurance. These are referred to as "access only" plans. In 2009, 46 percent of private sector employers offered "access only" plans to early retirees and 41 percent offered these plans to Medicare-eligible retirees. Many retirees continue to enroll in these "access only" plans

because the group-based premium for health insurance is lower than that available in the non-group market (Fronstin, 2010).

Restricting Eligibility for Retiree Health Benefits

Private sector employers have also restricted eligibility for retiree health benefits. This usually involves requirements that employees reach a minimum age or a number of years of service to qualify for these benefits.

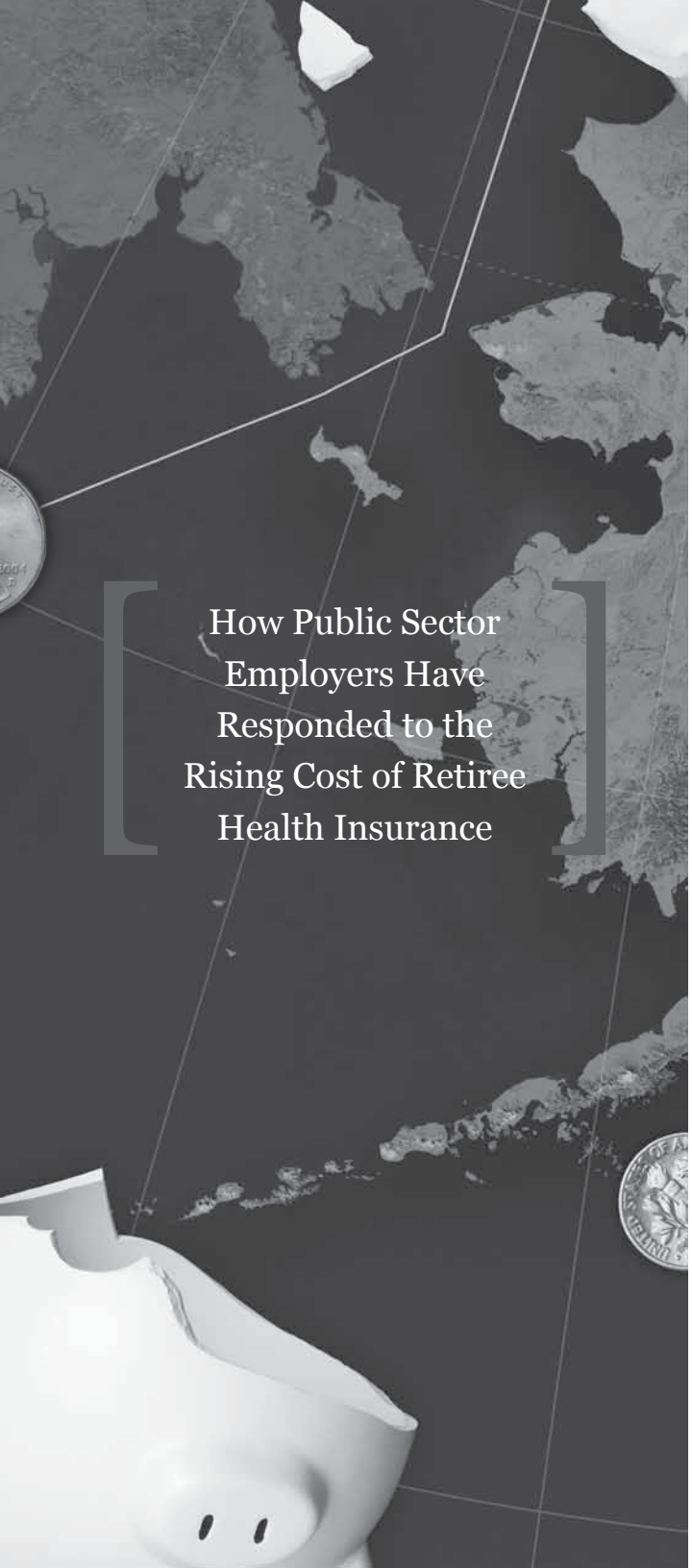
Between 1996 and 2009, the percentage of private employers requiring a minimum age of 55 and at least ten years of service increased from 30 percent to 37 percent. The percentage of these employers requiring a minimum age of 55 and at least 15 years of service increased from five percent to nine percent (Fronstin, 2010).

A Shift to Defined-Contribution Retiree Health Benefit Plans

The majority of private firms that continue to offer retiree health plans provide a defined-contribution plan. These plans usually take the form of caps or ceilings on the dollar amount that employers are willing to spend on retiree health benefits. The cap may be defined as a maximum per employee, or as a maximum for the entire group of employees. Once the cap is reached, the employer subsidy for the health benefit will not increase. The employee is then responsible for the cost of health insurance premiums in excess of that cap.

As the cost of health insurance premiums has increased, employees in the private sector have assumed a greater share of the cost. By 2009, only one-fourth of private sector employers offered retiree health benefits with no cap on employer contributions to the plan. As a result, a significant number of retirees in the private sector have dropped their health insurance coverage (Fronstin, 2010).

"As the cost of health insurance premiums has increased, employees in the private sector have assumed a greater share of the cost."



How Public Sector Employers Have Responded to the Rising Cost of Retiree Health Insurance

The Impact of the New GASB Standards

While GASB 45 was introduced in 2004, states were given a long lead time to conform to the new accounting standards. In their Comprehensive Annual Financial Reports for fiscal 2008 and 2009, states reported accrued liabilities in retiree health plans for the first time. The magnitude of these unfunded liabilities has come as something of a shock in most states. The new GASB accounting rules have imposed a greater burden on the public sector than similar rules have in the private sector. This is because a higher percentage of public sector employers offer health benefits to retirees and also because these health benefits tend to be more generous than those offered to employees in the private sector. Meeting the new accounting standards will require a significant increase in employer contributions to these plans.

There is little doubt that politicians in many states have promised their retirees pension and health benefits that the state government cannot afford. A recent study estimates that some large state pension funds will not last through this decade, and that many pension funds will run out of money over the next two decades (Rauh, 2010). If these states cannot meet their pension obligations, they are not likely to meet obligations to their retiree health plans either. With fiscal constraints likely to continue, these states will face immense pressure to turn to the federal government to bail out their pension and retiree health plans.

The California Public Employee Retirement System (CalPERS): A Failed Pension and Retiree Health Plan

The California Public Employee Retirement System (CalPERS) is a defined-benefit plan, promising generous pension and health benefits to its members. Actuarial liabilities have been increasing more rapidly than assets, resulting in the accumulation of billions of dollars in unfunded liabilities.

A major factor in the accumulation of unfunded liabilities in the CalPERS plan is the generous, defined-benefit health plan offered to retirees. The cost of the CalPERS retiree health plan has more than tripled over the past decade. Average annual retiree health expenditures increased 17 percent, more than five times the rate of growth in state spending. Retiree health costs now exceed $1 billion per year and are projected to continue to grow at double digit rates each year to $1.6 billion in 2010-11 (Dickerson, 2006).

The explanation for this rapid growth in retiree health expenditures is the generous defined-benefit plan offered to retirees. Many retirees from state service who are not yet eligible for Medicare can remain in the same CalPERS basic health plan they had when they worked for the state. These retirees and their families typically receive benefits using a 100/90

"It would be difficult to find any retiree health plan in the private sector with benefits as generous as those offered to CalPERS retirees."

formula, which is more generous than the formula used to calculate benefits for current employees (Dickerson, 2006).

When retirees reach the age of 65, they must enroll in Medicare and then become eligible for CalPERS Medicare health plans. The premiums for CalPERS Medicare health plans are lower than those for CalPERS basic health plan offered to current employees. For many retirees over the age of 65, the state contribution covers all monthly costs for CalPERS Medicare plans. Unused portions of the state contribution may be used to pay for all or part of Medicare Part B premiums. It would be difficult to find any retiree health plan in the private sector with benefits as generous as those offered to CalPERS retirees (Dickerson, 2006).

Solving the funding crises in CalPERS would be a major step toward eliminating deficits in the state budget and reducing state debt. Unfortunately, California has not had much success in reforming CalPERS. In 2005, Governor Schwarzenegger argued that California's defined-benefit plans promised state workers "more than it should and more than it could." He proposed a defined-contribution plan similar to that introduced in a number of states and in the private sector. Immediately, 20 unions mobilized a "pension protection coalition" to defeat the plan, and Governor Schwarzenegger abandoned it in the spring of that year. Failure to enact reforms in CalPERS continues to undermine fiscal stability as unfunded liabilities in the plan accumulate.

More recently, Governor Schwarzenegger has appealed to Congress to provide more federal aid to help California solve its fiscal crises. This introduces another moral hazard as state legislators pursue profligate fiscal policies with the expectation that the federal government will bail them out. Federal stimulus money undermines what little fiscal discipline is left in California and other states. When those stimulus dollars disappear next year, state budgets will fall off a cliff (Laffer, Moore, and Williams, 2010).

Until California imposes fiscal discipline, it is not likely to address the funding crises in CalPERS and the other sources of fiscal instability. The governor, the legislature, and the citizens know that their fiscal policies are not sustainable, but they are unwilling or unable to enact the fiscal reforms required to restore economic growth and prosperity.

For the first time in modern American history, we are witnessing the prospect of a failed state. In California, fiscal profligacy is driving the state toward insolvency, and the results are not pretty. Despite having one of the highest tax burdens in the country, California cannot balance its budget—and persistent deficits and debt undermine fiscal stability. The bonds issued by CalPERS and the state have been downgraded, increasing the cost of issuing that debt. The state cannot pay for the generous pension and health benefits promised to retirees and at the same time deliver essential services. Last year, when the state could not pay its bills, it was forced to issue script, which is essentially an "IOU" from the state. Therefore, the state experiences stagnation in economic growth as businesses and people leave the state in search of lower tax burdens (Laffer, Moore, and Williams, 2010).

Reforming Other Post Employment Benefit Plans

Some public sector employers have responded to the financial burdens imposed by their retiree health plans by enacting reforms in those plans, but the response has been slower than that in the private sector. In part, this reflects the fact that the new GASB accounting standards have only recently been imposed on public sector employers.

Public sector employers have also found it more difficult to enact reforms in their retiree health plans. These employers have encountered opposition to reforms because retiree health benefits are often covered by collective bargaining agreements. The benefits offered in retiree health plans in the public sector

are in some states protected by constitutional and statutory provisions. However, the courts have not subjected retiree health plans to legal protection to the extent that they have pension benefits. This has allowed some states to enact fundamental reforms in the structure of retiree health benefits.

A number of recent studies have surveyed reforms in retiree health plans enacted in the states. One of the most comprehensive surveys of OPEB plans is that published by the U.S. Government Accountability Office (GAO) (GAO, 2009). This survey reveals that public sector employers have enacted many of the same reforms in retiree health plans as those in OPEB plans by private employers.

The GAO study reported many minor changes in retiree health plans. Some of these were routine changes in benefits, e.g. changes in co-payments, deductibles, and covered benefits. States also modified benefits in these plans by changing cost of living adjustments. States reported changes in eligibility based on age or years of service. Some states, such as Illinois, attempted to reduce costs by buying out some employees with a lump sum payment, just as General Motors did in the private sector. These minor reforms have little impact on the unfunded liabilities accumulating in these retiree health plans.

Pre-Funding Retiree Health Plans

When the new GASB standards were introduced, much of the focus was on pre-funding retiree health plans as well as pension plans in the public sector. States would fund the liabilities in these plans on an accrual basis rather than as a pay-as-you-go basis. Funding would be set aside in a trust fund to pay for these liabilities as they are earned.

> ". . . few states have successfully used pre-funding to pay for the liabilities accruing in their OPEB plans."

The GAO study reveals that few states have successfully used pre-funding to pay for the liabilities accruing in their OPEB plans. About 35 percent of the 89 governments surveyed by the GAO study reported pre-funding at least a portion of their OPEB plans. Some of these governments used the Annual Required Contribution (ARC) to determine the pre-funding levels. However, most governments reported that pre-funding was tied to the availability of resources.

In the GAO study, governments reported many challenges in pre-funding their OPEB plans. The major factors cited were budgetary constraints and limited resources available for pre-funding. Some governments cited rising health insurance costs and changing demographics in the workforce.

A Shift from Defined-Benefit Retiree Health Plans to Defined-Contribution Plans in the Public Sector

Earlier in this study, we cited evidence that private sector employers have significantly reduced the health benefits they promised to retirees. While state and local governments have not eliminated health plans for their retirees, they have enacted a number of reforms to reduce the cost of those plans. Perhaps the most important of those reforms is to replace defined-benefit with defined-contribution health plans.

A defined-benefit plan specifies the amount of benefits provided either as a dollar amount or as a percentage of health insurance premiums paid by the government. Abstracting from the complex health insurance plans offered to retirees, we can identify plans in which the employer contracts to cover most of the cost of the health insurance premium through defined-benefit plans. In a defined-benefit plan, the state is exposed to the risk of high and volatile levels of health care costs. This exposure makes it difficult for the state to project the unfunded liabilities that will be incurred by the plans, and to fund those liabilities.

There are several flaws in the design of defined-benefit plans in the public sector. One flaw is assumptions regarding health care costs. Government plans continue to assume a rate of inflation in the cost of

State	Value of Assets ($ Millions)	Liabilities ($ Millions)	Unfunded Liabilities ($ Millions)	Funded Ratio (Percent)
Arizona	1,239	1,446	207	85.7
North Dakota	43	88	45	48.5
Virginia	1,525	4,228	2,703	36.1
Alaska	3,829	13,013	9,184	29.4
Colorado	256	1,369	1,113	18.7
Utah	54	447	393	12.1
Kentucky	1,348	13,009	11,659	10.4
Maine	98	2,286	2,188	4.3
South Carolina	297	9,306	9,008	3.1
Texas	800	30,719	29,919	2.6
Missouri	49	2,675	2,626	1.9
North Carolina	435	28,288	27,854	1.5
Delaware	79	5,489	5,410	1.4
Maryland	119	14,852	14,733	0.8
Pennsylvania	88	16,349	16,261	0.5
Vermont	4	1,619	1,615	0.2
Connecticut	0	26,019	26,019	0
Louisiana	0	13,727	13,727	0
New York	0	47,252	47,252	0
New Hampshire	0	2,471	2,471	0
Montana	0	1,048	1,048	0
Washington	0	4,014	4,014	0
Wyoming	0	174	174	0
Mississippi	0	570	570	0
Minnesota	0	659	659	0
Oregon	0	323	323	0
Kansas	0	237	237	0
Iowa	0	220	220	0
Indiana	0	462	462	0
Idaho	0	22	22	0

Table 8.

Assets, Liabilities, Unfunded Liabilities, and Funded Ratio in State OPEB Plans

Table 8 ranks our sample of states with respect to their funded ratio. This table reveals the limited extent to which the states have been successful in pre-funding their OPEB liabilities. Pre-funding has been an important factor in reducing the burden of unfunded liabilities in some states including: Virginia, Colorado, Utah, North Dakota, and Arizona. Other states have had less success in using pre-funding to reduce the burden of unfunded liabilities. While half of the states in the sample have begun to set aside assets to pre-fund liabilities, this has had a limited impact on their funding ratios. The one exception is Arizona, which has come close to fully funding its liabilities. Most states in the sample have funding ratios of less than ten percent, and 14 states have provided no pre-funding of their liabilities. The limited success that these states have had in pre-funding suggests that other reforms in their OPEB plans may be necessary to reduce the burden of unfunded liabilities.

Few states are meeting the pre-funding that would be required to meet GASB standards. Such pre-funding would require an annual contribution that is on average three times what states are currently contributing to OPEB plans. In states with defined-benefit retiree health plans, where the state covers most of the cost of retiree health insurance, the required annual contribution is even higher. A tripling of the annual required contribution is politically unfeasible. Such contributions would require reductions in spending for other state programs or increased taxes that would prove to be unacceptable to citizens.

Source: Actuarial reports for various states, FY 2008 and FY 2009.

health service far below the actual inflation rate. Health care costs have been increasing at double digit rates in recent years, and there is no reason to expect this to change in the future. This is especially true with the new federal health legislation that will significantly increase the demand for health care services while restricting the supply.

Another flaw in defined-benefit plans in the public sector is unrealistic assumptions regarding the rate of return on assets. Most of these plans assume a rate of return of eight percent or more. In some states, the assets in retiree health plans are combined with those in pension plans. During the current recession, the assets in such plans have fallen dramatically and have yet to recover to pre-recession levels. Over the past decade, the rate of return on assets in these plans has been zero or negative. The best economic analysis projects that the long run rate of return on these assets is likely to be half or less than the assumed eight percent rate of return. Because these plans assume an unrealistic rate of return, they engage in risky investment strategies with a high share of the portfolio in equities. As a result, these plans are projected to continue to experience volatility and deterioration in funding status in the long run (Rauh, 2010).

The fatal flaw in defined-benefit retiree health plans in the public sector is moral hazard: Politicians have promised retiree health benefits they cannot afford. They offer public sector retirees generous health benefits as an alternative to better compensation because the cost of these benefits is deferred to future generations. Public sector employee unions encourage this because it is less likely to generate taxpayer resistance than higher compensation, which must be funded from current revenue. Because of the transparency rules created by GASB, taxpayers are more aware of the magnitude of unfunded liabilities accumulating in these plans. It is increasingly clear that defined-benefit retiree health plans in many states are not sustainable in the long run.

In a defined-benefit health plan, retirees are more likely to end up in a high cost plan with the state picking up most of the cost. For example, actuarial reports for Missouri and Louisiana reveal that they have the highest premium cost for health insurance for retirees in our sample. These costs range from $1,668 to $1,692 per month in Missouri and from $934 to $1,012 per month in Louisiana. Those premium costs are about double the premium costs for health insurance offered by other states in the sample. In both Missouri and Louisiana, the state covers most of the cost of the health insurance premium. Therefore, it is not surprising that retirees end up with very expensive health insurance.

Some governments have shifted from defined-benefit retiree health plans to defined-contribution plans. The basic principle of a defined-contribution health plan is similar to that for defined-contribution pension plans. Instead of a promise to cover all or most of the cost of health insurance, the state contracts to make a contribution toward that cost. The contribution may take different forms. Most often, it is a contract to pay a dollar amount towards the health care premium. That dollar amount may be specified in absolute dollars or relative to the employee's years of service. In some cases, the dollar amount is linked to funds the employee has accumulated in sick leave, disability, or other accounts.

The GAO study reports that some governments have reduced the amount of health insurance premiums paid for by the government. In effect, this reform can convert the retiree health plan into a defined-contribution plan to the extent that employees are expected to pay for most of the cost of health insurance. The effect is to shift the cost of rising health insurance premiums to retirees. In most states, the share of premium contributions paid for by employees has increased.

"Politicians have promised retiree health benefits they cannot afford."

The rationale for a defined-contribution health plan for retirees is clear. The employer limits unfunded liabilities by minimizing the risk of high and volatile health care cost inflation. Then, the state is enabled to project unfunded liabilities and fund these liabilities to meet GASB standards, while motivating beneficiaries to economize. In states with defined-contribution health plans for retirees, the premium cost is generally less than $500 per month. This suggests that when employees must cover more of the cost of those premiums, they tend to choose lower cost plans.

A Survey of Defined-Benefit and Defined-Contribution OPEB Plans

Our survey distinguishes between defined-benefit and defined-contribution OPEB plans using the definitions on the following page.

* The state appropriates money on an annual basis to subsidize the purchase of health insurance.

** The state is transitioning from a defined-benefit to defined-contribution health plan.

*** The Kansas KPERS Plan includes a death and disability plan but no health plan.

State	Unfunded Liabilities ($ Per Capita)	Defined-Benefit Plans Contribution Rates (Percent)	Defined-Contribution Plan Contribution Rates	
			Without Medicare	With Medicare
Alaska	13,381	100	---	---
Connecticut	7,432	33	---	---
Delaware	6,197	100	---	---
Louisiana	3,112	75	---	---
North Carolina	3,020	---	$346	---
Kentucky	2,731	100	---	---
Maryland	2,615	100	---	---
Vermont	2,601	80	---	---
New York	2,424	90	---	---
South Carolina	2,011	---	$261	---
New Hampshire	1,878	n.a.	---	---
Maine	1,663	100	---	---
Pennsylvania	1,306	100	---	---
Texas	1,230	100	---	---
Montana	1,084	---	*	---
Washington	613	---	$253	$164
Missouri	444	63	---	---
Virginia	348	---	$4/per years of service	---
Wyoming	326	---	$487	---
Colorado	225	---	*	---
Mississippi	194	---	$0	---
Utah	144	---	**	---
Minnesota	126	---	*	---
Oregon	85	---	$126-$253	$60
Kansas	85	---	***	---
Iowa	73	---	$0	---
Indiana	72	n.a.	---	---
North Dakota	70	---	$4.50/year of service	---
Arizona	32	---	$75-$150	$50-$100
Idaho	14	---	**	---

Table 9. Defined-Benefit and Defined-Contribution OPEB Plans

In Table 9, the states in the sample are identified as having defined-benefit or defined-contribution health plans for retirees (not all the states in the sample provide sufficient data to make this distinction). The states are again ranked by the level of unfunded liabilities per capita in the OPEB plans. Since health plans account for most of the cost of these OPEB plans, the ranking is consistent with unfunded liabilities in health plans.

Of the states with the highest levels of unfunded liabilities per capita, only two have defined-contribution health plans. Ten of those states cover all or most of the cost of the health insurance premium. The only exception is Connecticut, where the state covers a third of the cost of the health insurance premium. North Carolina and South Carolina have defined-contribution plans in which the state contracts a dollar amount which also covers most of the cost of the health insurance premium.

Of the states with the lowest levels of unfunded liabilities per capita, only one state has a defined-benefit health plan: Missouri covers one-third of the premium for health insurance.

Two states, Idaho and Utah, are transitioning from defined-benefit to defined-contribution health plans for their retirees. Most of these states have a defined-contribution plan in which the state contracts to contribute a dollar amount to the health insurance premium. In Virginia and North Dakota, that dollar amount is tied to years of service. In only two states, Wyoming and Washington, that dollar amount covers most of the cost of the health insurance premium. In the other states, most of the cost of the health insurance premium is paid for by retirees. Two states, Mississippi and Iowa, do not contribute to the health insurance plans for retirees.

Thus, most states in the sample that have adopted (or are transitioning to) defined-contribution health plans for retirees have low levels of unfunded liabilities per capita. Taxpayers in these states have been able to minimize the burden of health insurance for public sector retirees by adopting defined-contribution health insurance plans. If states want to lower the financial stress imposed by generous, defined-benefit health plans for retirees, they should consider shifting to a defined-contribution health plan.

Source: Actuarial reports for various states, FY 2008 and FY 2009.

The Idaho Defined-Contribution Retiree Health Plan

In 2009, the Idaho legislature faced skyrocketing state retiree health insurance costs. In the 2008 CAFR, the state's unfunded liabilities in the retiree health plan were estimated at $353 million. The legislative staff projected that unfunded liabilities would escalate to $515 million by 2010, and $810 million by 2016 (Lake, 2009).

> "The defined-contribution retiree health plan in Idaho creates an incentive to reduce premium costs for health insurance . . ."

The 2008 CAFR also estimated the ARC to the retiree health plan at $33 million. The actual contribution to the plan that year was $8 million, resulting in a further increase in unfunded liabilities in the plan of $25 million. The actual contribution was only 23.5 percent of the required contribution to meet GASB standards. Like many states, Idaho was not meeting the promises made to retirees in their health plan.

The Idaho retiree health plan is a pay-as-you-go plan; no assets are set aside to pay for future liabilities. Eligible state employees who retire may purchase retiree health insurance for themselves and their dependents. Retirees eligible for health insurance pay the majority of the premium cost; however, these costs are subsidized by the active employee plan.

In 2009, faced with revenue shortfalls and tighter budgets, Idaho enacted a successful reform of their health plan (Legislature of the State of Idaho, 2009). House Bill 173 required that the Department of Administration develop a plan or plans for health insurance for active employees and retirees. Retirees were pooled with active employees for rating purposes.

The bill clarified the administrative structure of the health insurance plan. The Department of Administration formed an advisory committee comprising members from all branches of government, including an active and retired employee. This brought the design and implementation of the health insurance plan within the purview of the executive branch of government.

This legislation increased the share of the health insurance premium paid by retirees. At that time, the retiree plan members contributed 65.7 percent of the premium cost, while employers contributed 34.3 percent of the cost. The bill set an absolute dollar amount that employers were required to contribute to the health insurance premium. Beginning July 1, 2009, eligible retirees began to receive $155 per month or $1,860 per year toward their premium for health insurance.

As a result of this 2009 reform, retiree plan members contributed 83.3 percent of the total premium cost, while employers contributed 16.7 percent of the total cost. The employer cost was financed from a charge per state employee. The legislation reduced that charge from $32.83 per month to $26.00 (Comprehensive Annual Financial Report, State of Idaho, 2009).

The defined-contribution retiree health plan in Idaho creates an incentive to reduce premium costs for health insurance because retirees bear most of the cost of that insurance. When this reform was introduced in Idaho, the premium for health insurance for non-Medicaid eligible retirees was between $383 and $480 per month.

The reform introduced in Idaho also restricted eligibility for the state-sponsored health insurance plan for retirees. Prior to this reform, state employees eligible for Medicare were also eligible for the state-sponsored health insurance plan. The reform

restricted eligibility for the state-sponsored plan to retirees not eligible for Medicare beginning in 2010. A non-Medicare eligible spouse can receive the subsidy for the state-sponsored health insurance plan until they become eligible for Medicare.

This reform set stricter requirements for an employee to be eligible for the state-sponsored health insurance plan. The employee must:

1. Have been an active employee on or before June 30, 2009
2. Be eligible for a retirement benefit from a public employee retirement service or a retirement service for education with at least 20,800 hours of credited state service
3. Retire directly from state service

The reform eliminated eligibility for the state-sponsored retiree health plan for employees with previous state employment who retire from another employer. State employees who are rehired are eligible for the state-sponsored retiree health plan only if they have ten years of previous state service credit prior to June 30, 2009, accumulate an additional three years of creditable service, and are otherwise eligible.

Only employees with significant state service prior to June 30, 2009 will continue to receive the state subsidy. If employees leave state service for other employment they lose their eligibility. In effect, the reform closes the state-sponsored health insurance plan to all new employees and to state employees with less than ten years of service prior to June 30, 2009.

The 2009 CAFR reveals that reforms in the retiree health plan have significantly reduced annual OPEB cost.

Table 10. Annual OPEB Cost of the Retiree Health Plan

	($ in thousands)
Annual Required Contribution (ARC)	$3,272
Interest on Net OPEB Obligation	1,139
Adjustment to ARC	(1,560)
Annual OPEB cost	2,851

Table 11. Comparison of Annual OPEB Cost, Contributions, and Net OPEB Obligation in the Idaho Retiree Health Plan, 2008 and 2009

($ in thousands)

Year	Annual OPEB Cost	Actual Contribution	Percent Contributed (2)/(1)	Increase in Net OPEB Obligation (1)-(2)	Net OPEB Obligation
2008	$33,311	$7,828	23.5%	$25,483	$25,476
2009	2,851	3,165	111.0	(314)	25,162

Source: Comprehensive Annual Financial Report, State of Idaho, 2009

The ARC into the retiree health plan was reduced by $1,560,000. As a result, the annual OPEB cost of the retiree health plan was reduced from $33,311,000 in 2008 to $2,851,000 in 2009.

"The Idaho reform significantly reduced unfunded liabilities in the retiree health plan."

In 2008, the actual contribution to the retirement plan was $7,828,000, which was only 23.7 percent of the annual OPEB cost. The net OPEB obligation increased by $25,483,000 in that year.

In 2009, after the reform of the retiree health plan, the actual contribution to the plan was $3,165,000, which was 111.0 percent of the annual OPEB cost. The net OPEB obligation was reduced by $314,000.

The Idaho reform significantly reduced unfunded liabilities in the retiree health plan. Estimates of unfunded liabilities reflect the impact of these reforms over the entire actuarial time period. As of the actuarial date July 1, 2006, the unfunded liabilities were estimated at $353,159,000. The most recent estimate of unfunded liabilities for actuarial date July 1, 2008, which reflects the impact of these reforms was, $21,603,000 (Comprehensive Annual Financial Report, State of Idaho, 2009).

Note that no assets have been set aside to pay for liabilities in the Idaho plan. Idaho continues to finance the retiree health plan on a pay-as-you-go basis. The reduction in unfunded liabilities is due entirely to the reforms introduced in the defined-contribution plan.

Table 12. Other Post Employment Benefits: Schedule of Funding Progress in the Retiree Health Plan

	Actuarial Valuation Date	Actuarial Accrued Liability **($ in thousands)**
	7/1/2006	$353,159
	7/1/2008	21,603

Source: Comprehensive Annual Financial Report, State of Idaho, 2009

Conclusion

The accumulation of trillions of dollars in unfunded liabilities in Other Post Employment Benefit (OPEB) plans significantly contributes to the financial crises many states face today. States are required to significantly increase the Annual Required Contribution (ARC) into their retiree health plans in order to meet the requirements of the Governmental Accounting Board (GASB). With revenue shortfalls resulting from the recession, states are finding it increasingly difficult to meet these obligations.

As the unfunded liabilities accumulate, the increase in taxes required to fund generous retiree health benefits will become unfeasible. Citizens and businesses will vote with their feet, fleeing to states with lower marginal tax rates. The loss in tax base will exacerbate the fiscal crises in these states. As states exhaust the assets accumulated in their pension and OPEB plans, they will turn to the federal government to bail out these plans. This phenomenon is already underway in California.

While many factors have contributed to the growth in unfunded liabilities in OPEB plans, the major factor is the failure of states to properly reform their defined benefit plans to mitigate the escalating cost of health care. In the current economic environment in which states are encountering revenue shortfalls, they are searching for ways to constrain the rising cost of retiree health insurance. States can constrain the cost and reduce unfunded liabilities in their retiree health plans; and some have already enacted these reforms. Our survey reveals that, with few exceptions, states with defined-contribution retiree health plans have the lowest levels of unfunded liabilities per capita in their plans. Defined-benefit retiree health plans tend to have higher costs and accumulate higher levels of unfunded liabilities per capita.

In defined-benefit plans, the state assumes most of the cost of health insurance, and in some cases pays for all of the cost. This introduces moral hazard in the provision of health insurance to retirees. This flaw is common to all health insurance plans in which third parties bear the cost of the insurance. When the state assumes most of the cost, employees opt for more expensive health insurance plans.

Legislators have an incentive to offer generous retiree health insurance plans as an alternative to higher wages and salaries. The latter must be paid for out of current budgets while the cost of retiree health insurance is deferred to the future. If unfunded liabilities accumulate in these plans, those costs will also be incurred by future generations. Another moral hazard is introduced if state legislators anticipate that the federal government will bail them out when they cannot pay for the generous pension and health benefits they have promised to retirees. In short, all the incentives are wrong in defined-benefit retiree health plans. Rather than address the problem of growing unfunded liabilities in OPEB plans, the incentive is to defer the problem to future generations.

Much of the literature on the funding crises in OPEB plans focuses on pre-funding. States have attempted to set aside assets in a trust fund to pay for the growing liabilities in their plans. Our survey of retiree

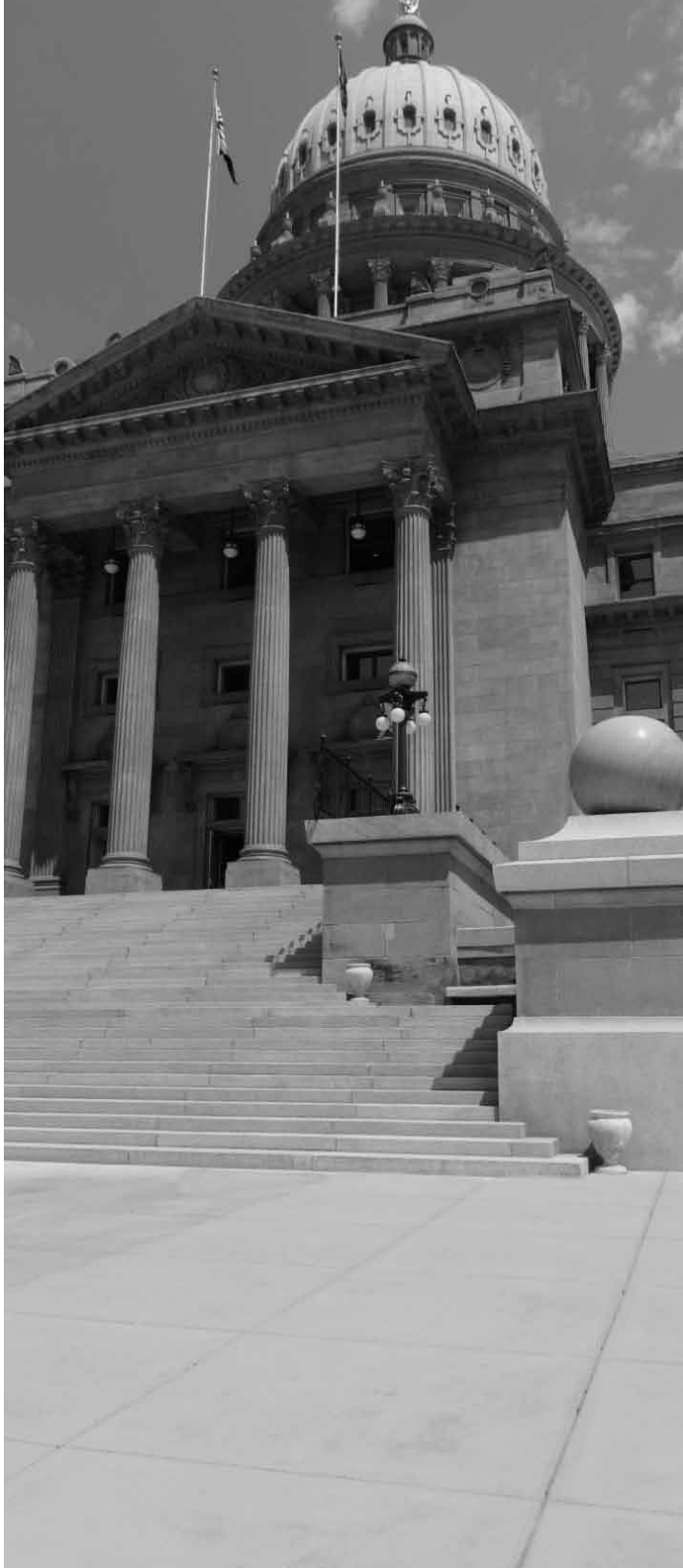
health plans reveals that pre-funding has done little to reduce the unfunded liabilities in these plans. While many states with defined-benefit retiree health plans have accumulated significant assets in those plans, they also continue to accumulate high levels of unfunded liabilities. Therefore, pre-funding has not proven to be the solution to growing unfunded liabilities in defined-benefit plans.

> "If states want to lower the financial stress imposed by generous, defined-benefit health plans for retirees, they should consider shifting to a defined-contribution health plan."

Our survey reveals that states with defined-contribution retiree health plans have been more successful in limiting and reducing unfunded liabilities in their plans. Most of these states have not attempted to accumulate significant assets in their plans, choosing instead to rely on a pay-as-you-go basis. However, these states have been more successful in constraining the cost of health insurance and in requiring retirees to assume most of the cost of that insurance. As a result, these states are better able to meet their obligations with actual contributions to the retiree health plan equal to or exceeding the required contribution.

As our survey reveals, many states have now introduced defined-contribution health plans for their retirees. One of the most successful of these reforms was introduced in Idaho. In 2009, Idaho enacted reforms that significantly reduced the cost to the state of their retiree health plan. The state restricted eligibility and increased the share of health insurance cost paid by retirees. Unfunded liabilities in the plan were reduced from $353 million to $22 million. State contributions; to the plan now exceed the required contributions and the state is on track to eliminate unfunded liabilities in the plan over the actuarial time period. Idaho has the lowest level of unfunded liabilities per capita in their OPEB plan of any of the states in our sample.

The solution to the funding crises in OPEB plans is a defined-contribution retiree health plan. If other states enacted the reforms in their retiree health plans that were introduced in Idaho, they could collectively eliminate the $1 trillion in unfunded liabilities in OPEB plans over the actuarial (30-year) time period.



References

Comprehensive Annual Financial Report, State of Idaho, 2009.

Dickerson, Jason, "Retiree Health Care: A Growing Cost for Government," The Legislative Analyst's Office (LAO), State of California, 2006.

Edwards, Chris, and Jagadeesh Gokhale, "Unfunded State and Local Health Costs: $1.4 Trillion," CATO Institute Tax and Budget Bulletin, no. 40, October 2006. Washington: CATO Institute.

Fronstin, Paul, "Implications of Health Reform for Retiree Health Benefits," Issue Brief no. 338, Employee Benefit Research Institute, January 2010.

Government Accounting Office (GAO), "State and Local Government Retiree Health Benefits: Liabilities are Largely Unfunded, But Some Governments Are Taking Action," Report to the Chairman, Special Committee on Aging, U.S. Senate, 2009.

Laffer, Arthur, Stephen Moore, and Jonathan Williams, "Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index," American Legislative Exchange Council, 2010.

Lake, Dennis, "Statement of Purpose/Fiscal Note House Bill 173," Legislative Staff, Idaho Legislature, 2009.

Legislature of the State of Idaho, House Bill No. 173, House of Representatives, Sixtieth Legislature, First Regular Session, 2009.

National Compensation Survey Benefits Series, U.S. Bureau of Labor Statistics (March), Washington D.C., 2009.

National Conference of State Legislatures, "Projected Revenue Growth in FY 2010," Washington D.C., May 2010.

Novy-Marx, Robert, and Joshua Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?," University of Chicago Working Paper, 2010.

Novy-Marx, Robert, and Joshua Rauh, "The Liabilities and Risks of State Sponsored Pension Plans," Journal of Economic Perspectives, 23 (4), 191-210, 2009a.

Novy-Marx, Robert, and Joshua Rauh, "Fiscal Imbalances and Borrowing Costs: Evidence From State Investment Losses," Kellogg School of Management Working Paper, 2009b.

Poulson, Barry W. and Arthur P. Hall, "State Pension Funds Fall Off a Cliff," American Legislative Exchange Council, Washington D.C., January 2010.

Rauh, Joshua, "Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities," Kellogg School of Management Working Paper, 2010.

Standard and Poor's, "U.S. States are Quantifying OPEB Liabilities and Developing Strategies as the GASB Deadline Nears," November 12, 2007.

The Pew Center on the States, "The Trillion Dollar Gap: Unfunded State Retirement Systems and the Roads to Reform," Washington D.C., February 2010.

Zion, David, and Amit Varshney, "You Dropped a Bomb on Me GASB," Credit Suisse Americas/ United States Equity Research Accounting and Tax, March 22, 2007.

American Legislative Exchange Council

1101 Vermont Ave., NW, 11th Floor
Washington, D.C. 20005

P: (202) 466.3800
F: (202) 466.3801

WWW.ALEC.ORG