State and Local Pension, Retiree Health Funding Issues Gaining Attention in Congress; Report Offers Benchmarks

A recent Government Accountability Office (GAO) report on the funding status and financial security of state and local government retiree benefits may lead to closer Congressional scrutiny in this area. Data contained in the document also may offer state and local pension officials a useful frame of reference to compare the financial health of their own retiree benefits to the trends and benchmarks reported in the GAO study.

In general, the GAO report highlighted negative funding trends and pointed to the high aggregate liability of state and local government public employers for retiree health benefits.

Commenting specifically on retiree medical funding, the report noted that "while few state and local governments have yet officially reported these unfunded liabilities, some studies have estimated that they may exceed $1 trillion nationwide in present value terms." The report was prepared at the request of the Senate Finance Committee.

"Such estimates raise concerns about the fiscal challenges that state and local governments will face in the coming decades."

The report's authors also acknowledged the challenge public officials may face in coming to grips with retiree health costs. "Estimates of unfunded liabilities for retiree health benefits are subject to change because projecting future costs of health care is difficult," they stated.

High liabilities associated with retiree health benefits stem from the general practice of covering benefit obligations on a pay-as-you-go basis. When the GAO last compared public employers' annual outlays for retiree health benefits to their payments to fund pensions in 2006, the agency estimated a 2% -of-salary average for retiree health, versus 9% for pensions. In that context, the "pay-as-you-go" approach may have appeared reasonable to public employers, according to the GAO.

"However," the current report states, "if retiree health continues to be financed on a pay-as-you-go basis, the amount is estimated to more than double to 5% of salaries by 2050 to keep up with the growth in health costs, adding to budgetary stress." Recognition of that fact, of course, was behind the Governmental Accounting Standards Board's (GASB) Statements 43 and 45, which public employers have been scrambling to comply with and which are prompting some public employers to begin pre-funding those liabilities and evaluate the benefits structure of their programs.

Although the federal government does not directly regulate state and local government pensions and retiree health benefits, "the federal government has an interest in assuring that all Americans have a secure retirement," according to the document, titled "State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits." (Click here to read the full report.)

Federal bail-out?

Commenting on the GAO report's findings, Sen. Max Baucus, chairman of the Senate Finance Committee, told a reporter that he doesn't want a state fund "collapsing and looking to the federal government for a bailout."

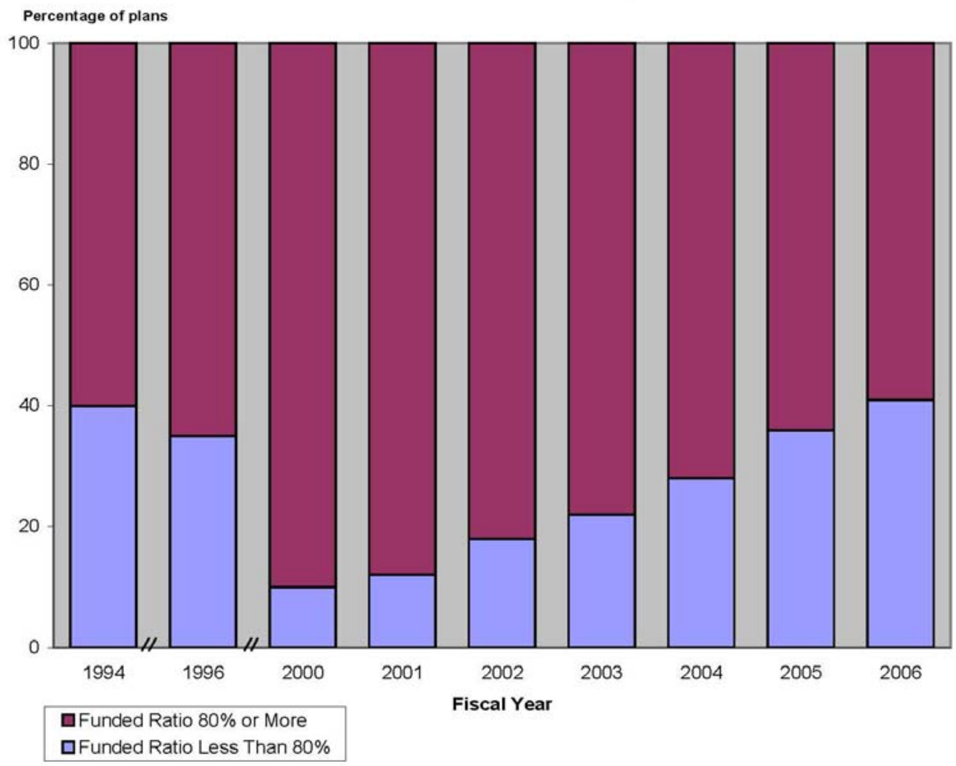
With respect to pensions, the GAO report focused on trends involving funds with funding ratios below 80 percent. Drawing largely from the National Association of State Retirement Administrators' Public Fund Survey, the GAO reported that the percentage of pensions whose funded ratio is below 80% grew from less than 10% in 2000, to 41% in fiscal 2006 (see Figure 1).

(It must be noted, however, that the survey data was drawn from voluntary self-reporting by members of the National Association of State Retirement Administrators and the National Council on Teacher Retirement. Although a majority of members of those organizations participated in the surveys, results were not weighted according to the size of each public entity.)

In the year 2000, the funding ratio was a high-water mark for the funding status of many pensions in part due to the high stock market values prior to the bursting of the "Internet bubble."

Figure 1

Percentage of State and Local Government Pension Plans with Funded Ratios above or below 80 Percent, by Fiscal Year

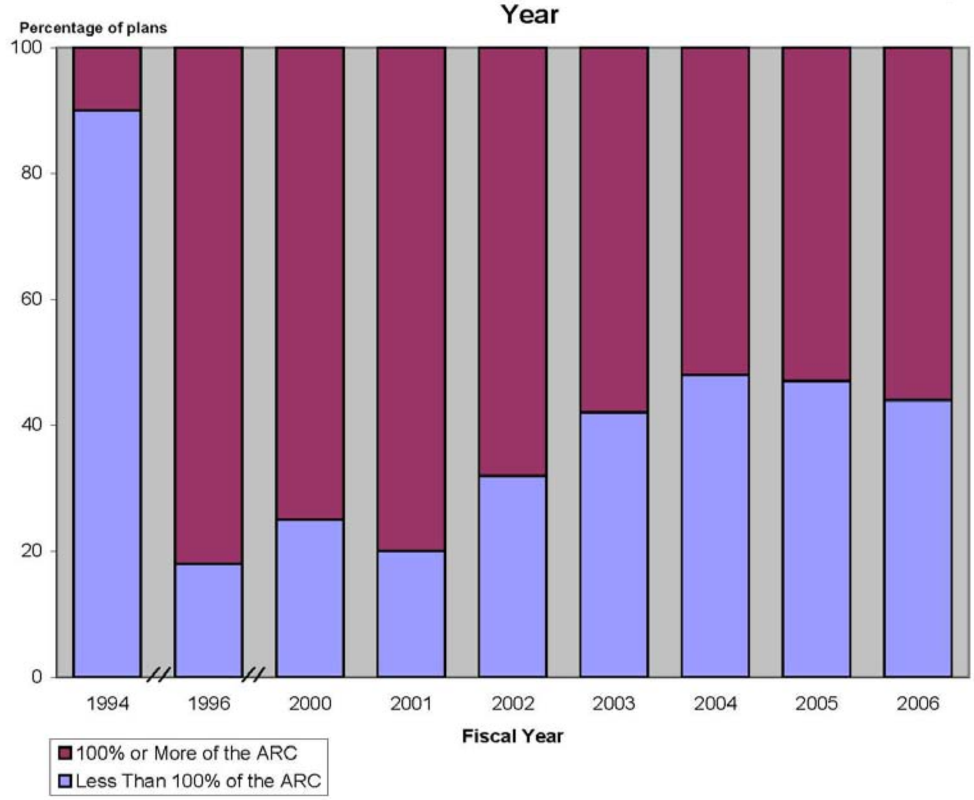


Source: GAO analysis of PFS, PENDATA data.

The GAO report also examined pension funding from the perspective of annual contributions to pension funds relative to annual required contribution levels (ARCs). In particular, the GAO report traced the growth in the percentage of state and local funds contributing less than 100 percent of their ARC. In 2006, that percentage was 46% -- approximately the same as it had been for the prior three years (see Figure 2).

Figure 2

Percentage of State and Local Government Pension Plans for which Governments Contributed More or Less Than 100 Percent of the ARC, by Fiscal Year



Source: GAO analysis of PFS, PENDAT data.

However, that figure had been below 20% as recently as 1996. But only two years before, in 1994, only about 10% of the funds surveyed had contributed their full ARC. The dramatic (but relatively short-lived) improvement in funding after 1996 was in part due to a reduction in funding requirements due to strong pension portfolio investment performance.

The GAO report cited several reasons why state and local pension officials may choose not to contribute the full ARC in a given year, including fiscal challenges, and a simple lack of commitment to pre-funding due to "other priorities, regardless of fiscal conditions." It is also true that for various reasons funds may choose to fund at a level higher than the ARC figure in one year, and below it the next.

Indeed, the phrase behind the acronym ARC, "annual *required* contribution" is a misnomer in that the number it describes is an accounting expense figure; no pension sponsor is "required" per se to make that contribution.

With respect to pensions, the GAO report concluded with the observation that "the funded status of state and local government pensions overall is reasonably sound, though recent deterioration underscores the importance of keeping up with contributions."

On retiree health plans, the GAO concluded that state and local governments "need to find strategies for dealing with unfunded liabilities, and such strategies will take time, require difficult choices, and could be affected by changes in national health policy."

Cheiron's public sector consulting staff can assist state and local plan officials devise and evaluate alternative financial strategies to address the issues raised by the GAO report. To begin that dialog, email info@cheiron.us