Post Employment Benefit Costs of the Defined Benefits Retiree Health Plan

The Colorado Public Employees' Retirement Association (PERA) administers a retiree health plan. The PERA Health Care Program is a cost sharing multiple-employer plan. The "employers" in this context are the various governments that hire most public employees, such as public school teachers, fire fighters, police officers and state employees. Under this program, PERA subsidizes a portion of the premium for health care coverage, and the retiree pays any remaining amount of that premium.

The State government continues to promise public employees that the retiree health care benefit will be part of their total remuneration. As the predicted shortfall in funding for the retiree health plan materializes, taxpayers will be on the hook to make up the funding deficiency.

As the predicted shortfall in funding for the retiree health plan materializes, taxpayers will be on the hook to make up the funding deficiency.

More than $1 billion in unfunded liabilities have been incurred in the PERA retiree health plan. An additional $79 million in unfunded liabilities was incurred in 2008, reflecting a rapid growth in retiree benefits, and losses in the assets held in the Health Care Trust Fund. Prospects are for continued volatility and deterioration in the funding status of PERA's retiree health plan.

Colorado should replace PERA's retiree health plan with a defined contribution plan, similar to that enacted in Idaho. We estimate that in the short run this reform would reduce the employer annual required contribution to the plan from $72.6 million to $29.0 million. In addition, the annual subsidy from the State to the PERA Trust Fund would be reduced from $24.6 million to $14.5 million, a savings of $10.1 million per year. More importantly, an Idaho-style reform would reduce the accrued actuarial liabilities in the plan, and enable the state to pay off the $1 billion in unfunded liabilities over a 30-year period.

The Budgetary Impact of a Defined Contribution Retiree Health Plan

With the defined contribution retiree health plan in place, the state contribution to the plan could also be significantly reduced. Currently the state contributes 1.02 percent of gross covered wages to the Health Care Trust. In fiscal year 2008-09 the state contributed $24.6 million to the plan. The State's savings rise if it shares proportionately with employers, thereby achieving the 59 percent reduction.

More important than the immediate budgetary impact is the long-run savings that would result from the proposed defined contribution retiree health plan.

More important than the immediate budgetary impact is the long-run savings that would result from the proposed defined contribution retiree health plan. It is difficult to estimate long-term savings because of the dynamic response of employees and employers to the new incentives created by this reform. For example, when employees assume responsibility for costs we expect them to purchase less costly health insurance plans.

The proposed reform would significantly reduce the long-term cost of the retiree health plan to the government. The savings estimate above would be captured over the actuarial life of the plan. Note the dramatic reduction in actuarial accrued liabilities in the Idaho plan following a similar reform. We would expect a similar reduction in actuarial accrued liabilities in the proposed defined contribution

Table 1. Health Care Trust Fund Schedule of Funding Progress (dollars in millions)						
	2008	2007	2006	2005	2004	2003
Actuarial value of assets	255.6	258.8	214.8	191.3	166.6	160.4
Actuarial accrued liability	1368.6	1303.6	1248.0	1116.6	1102.6	897.5
Total unfunded actuarial						
Accrued liability	1112.7	1044.8	1033.1	925.4	936.0	737.0
Funded ratio (percent)	18.7	19.9	17.2	17.1	15.1	17.9

retiree health proposed for Colorado. Most importantly, Colorado would be able to pay of these liabilities over the 30-year amortization period required by GASB standards. Colorado could eliminate $1 billion in actuarial accrued liabilities in the current retiree health plan.

PERA's Retiree Health Plan

Like most states, Colorado only recently has begun to report liabilities in Other Post-Employment Benefit (OPEB) plans, in response to Government Accounting Board Standards Board (GASB) Statement NO. 45. Before the change in accounting standards, States could ignore the unfunded liabilities and recognize only the annual ongoing expenditures. The change forced governments to copy pension reporting standards in the private sector and essentially changed the accounting from a cash basis to a more honest and complete accrual picture of these large costs.

The 2009 Comprehensive Annual Financial Report (CAFR) provides the following schedule of funding progress in the Health Care Trust Fund. Total unfunded actuarial accrued liabilities have increased to more than $1 billion.

For the most recent fiscal year, 2008, additions to the Health Care Trust Fund fell below payments by more than $79 million. This shortfall was in part due to the rapid growth in benefit payments. Over the past four years benefit payments have increased more than 50 percent.

The shortfall was also the result of an investment loss for the Trust Fund equal to $72 million. As a result of this decrease

Table 2. Health Care Trust Fund Additions and Deductions (dollars in millions)						
	2008	2007	2006	2005	2004	2003
Additions						
Employer contributions	72.6	68.5	64.5	61.2	60.5	64.4
Employee contributions	102.6	96.3	85.7	62.9	59.5	55.7
Medicare retire						
drug subsidy	13.7	12.4	12.5			
Investment income (loss)	-72.4	23.9	30.9	17.7	23.1	33.4
Other	12.8	12.5	13.0	13.6	16.1	2.1
Total additions	129.4	213.6	206.6	155.3	159.2	155.7
Deductions						
Benefit payments	196.8	159.9	164.8	135.6	130.9	120.8
Administrative expenses	11.8	11.1	8.1	8.2	6.6	6.2
Total deductions	208.6	171	172.9	143.8	137.6	127
Changes in net assets	-79.2	42.6	33.7	11.6	21.6	28.7
Net assets	190.2	269.4	226.9	193.1	181.6	160

Note: The changes in net assets are equal to total additions less total deductions.
Source: 2009 Comprehensive Annual Financial Report

in the value of assets in the Fund, net assets fell 42 percent, from $269 million to $190 million. Even with recovery in the stock market, the prospects are for continued volatility and deterioration in the funding status of the Health Care Trust Fund.

At this point the retiree health plan is not meeting GASB standards. The GASB guidelines require that employers amortize unfunded liabilities in the plan over a 30-year actuarial time period. The estimated amortization for the Colorado plan is 39 years.

The $1 billion in unfunded liabilities in the Health Care Trust Fund would not appear to be a crisis if there was some prospect that the liabilities could be paid off within 30 years to meet GASB standards.

The $1 billion in unfunded liabilities in the Health Care Trust Fund would not appear to be a crisis if there were some prospect the liabilities could be paid off within 30 years to meet GASB standards. Unfortunately, there are a number of reasons why the funding status in the plan is likely to deteriorate for the foreseeable future.

The current funding status in the Health Care Trust Fund is actually worse than that reported in the CAFR because the actuarial assumptions used by PERA in administering the Health Care Trust Fund are similar to those used in administering pension funds. A four-year smoothing technique is used to estimate the actuarial value of assets in the plan. Thus some, but not all, of the decrease in the market value of assets in 2008 is reflected in the actuarial value of assets for that year. The loss in the market values of assets in more recent years is, of course, not reflected in the actuarial value of assets in 2008. These losses in the market values of assets in the plan will be reflected in the actuarial value of assets over the next four years. As a result, even with recovery in the stock market we are likely to see an increase in unfunded liabilities in the plan over the next four years.

There is a fatal flaw in PERA's administration of the Health Care Trust Fund, as well as its administration of pension funds.

A fatal flaw in PERA's administration of the Health Care Trust Fund, as well as its administration of pension funds, is the assumed 8.0 percent rate of return on assets in these plans. The actual rate of return has been zero or negative over the past decade. The best economic analysis of public sector pension and health plans, such as PERA, suggests a more realistic rate of return on assets that is about half or less than that assumed by PERA.[1]

Because PERA assumes an unrealistically high rate of return on assets, it engages in a risky investment strategy, with 70 percent or more of assets in equities. The best economic analysis projects that such pension and retiree health plans will continue to experience volatility and deterioration in funding status in future years. A recent study projects many of these funds will exhaust their assets and go bankrupt over the next two decades.[2]

The Case for a Defined Contribution Retiree Health Plan

Most private sector employers now either have eliminated defined benefit retiree health plans, or replaced them with defined contribution plans.[3] While most 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, including replacing defined benefit plans with defined contribution 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 as 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 relates to assumptions regarding health care costs. These government plans continue to assume a rate of inflation in the cost of health service far below the actual rate of inflation. Health care costs have been increasing at double-digit rates in recent years, and there is no reason to assume they will increase less rapidly in future years. This forecast is especially true with the new federal health legislation that will significantly increase demand for health care services, while restricting the supply.

Politicians have promised retiree health benefits they can't pay for. They offer public sector retirees generous health benefits as an alternative to better compensation because the cost of retiree health benefits is deferred to future generations.

A second flaw in defined benefit plans in the public sector was discussed above: the unrealistic assumptions regarding the rate of return on assets accumulated in these plans.

The fatal flaw in defined benefit retiree health plans in the public sector is moral hazard. Politicians have promised retiree health benefits they cannot pay for. They offer public sector retirees generous health benefits as an alternative to better compensation because the cost of retiree health benefits is deferred to future generations. Public sector employee unions encourage this activity because it is less likely to generate taxpayer resistance than higher compensation, which must be funded from current revenue. Only with the transparency created by GASB rules are taxpayers 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.[4]

A recent federal Government Accounting Office (GAO) study reports that some governments have shifted from defined benefit retiree health plans to defined contribution plans.[5] The basic principle of a defined contribution health plan is similar to that for a defined contribution pension plan. 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 toward the health care premium. That dollar amount may be specified in absolute dollars, or relative to the 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 or percentage of health insurance premium 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 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.

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. The State is then better able to project unfunded liabilities and fund 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.[6]

This fact suggests that when employees must cover more of the cost of those health insurance premiums, they tend to choose lower cost plans.

Learning from Idaho's Experience

Among the most successful public sector retiree health benefit reforms is the one enacted in Idaho. In 2009 the Idaho legislature faced unfunded liabilities of $353 million, with skyrocketing numbers forecast for out-years. Like many states Idaho was not meeting the promises made to retirees in their health plan.

Among the most successful public sector retiree health benefit reforms is that enacted in Idaho.

Faced with revenue and budgets problems much like Colorado, Idaho enacted a successful reform we have followed in our recommendations for this report (see "How to Save a Billion Dollars in Other Post-Employment Benefit Costs: A Case for Shifting to a Defined Contribution Retiree Health Plan"[7] for full details). The State of Idaho, with about one-fifth the population of Colorado, shed over $300 million in unfunded liabilities and reduced the annual cost to the State.

To follow Idaho's example, Colorado would replace the current retiree health plan with a defined contribution plan. The change would reduce the dollar amount employers are required to contribute to the retiree health plan. Currently, PERA subsidizes a portion of the monthly premium for health insurance. The subsidy is $230 per month for benefit recipients under the age of 65 who are not eligible for Medicare. Setting the maximum amount of the subsidy per benefit recipient at $155 per month would reduce employer's cost for that health insurance by almost half.[8]

Colorado also must restrict eligibility. Currently, retirees who are eligible for Medicare are also covered by PERA's retiree health plan. The subsidy is $115 per month for Medicare-eligible retirees. Limiting eligibility in the defined contribution plan to retirees under the age of 65 who are not eligible for Medicare would eliminate this cost to employers.[9]

Colorado could restrict eligibility for the defined contribution retiree health plan to employees with a minimum of 10 years of service. The maximum contribution could be limited to employees with 20 years of service, subject to a 10 percent reduction for each year of service less than 20 years. Currently, the maximum subsidy is paid to employees with 20 years of service, and is subject to a reduction of 5 percent for each year less than 20 years.[10]

Eligibility for the defined contribution retiree health plan could be limited to employees who retire directly from government service. If employees are rehired, they would have to have 10 years of prior service and accumulate an additional three years of service after they are rehired to be eligible. The retiree health plan would be closed to new employees.

Acknowledgements

Dr. Barry Poulson was primarily responsible for the content of this section. See his biographical material in the Authors section.

The Independence Institute appreciates and acknowledges the reviews and comments from the following people:

The **Honorable Mark Hillman**. See his biographical material in the Authors section.

Dick Murphy has made a career as an institutional money manager and financial advisor, operating his own firm since 1991. He earned a Ph.D. in Economics from Iowa State University and taught at various colleges and universities before coming to Colo-

rado in 1974. Dr. Murphy provided expertise in Colorado in public school finance, and under the tenure of different Colorado State Treasurers, managed the State Treasury from 1976-1980 and again in 2003-2004. Dr. Murphy managed institutional taxable sales and trading operations for regional brokerages before starting his own firm.

The **Honorable Penn R. Pfiffner**. See his biographical material in the Authors section.

ENDNOTES

[1] Robert Novy-Marx and Joshua Rauh, "The Liabilities and Risks of State Sponsored Pension Plans," *Journal of Economic Perspectives*, 23 (4), 191-210, 2009. Also, Robert Novy-Marx and Joshua Rauh, "Fiscal Imbalances and Borrowing Costs: Evidence From State Investment Losses," Kellogg School of Management Working Paper, 2009. Also, Robert Novy-Marx and Joshua Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?," University of Chicago Working Paper, 2010.

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

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

[4] Barry W. Poulson and Arthur P. Hall, "Public Employee 'Other Post Employment Benefit Plans: A Case for Shifting to a Defined Contribution Plan," forthcoming, American Legislative Exchange Council, Washington DC, December 2010.

[5] Government Accounting Office, "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.

[6] Poulson and Hall, idem.

[7] [TRACY - Citation – Independence Paper number, date]

[8] Comprehensive Annual Financial Report, State of Colorado, 2009, Colorado Legislature.

[9] Ibid.

[10] Ibid.