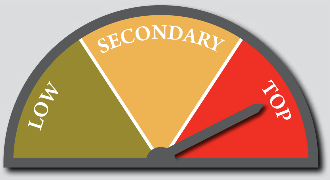
Retirement Health Plan

Priority



Original Article

This chapter is a condensed and updated version of the 2010 publication. For the fully developed work, see http://tax.i2i.org/files/2010/11/CB_PERA.pdf.

Overview

The material describes the magnitude of the overpromise for public pensions' additional benefit that pays for retirement health insurance, and makes recommendations. It is the second time this chapter has appeared in a Citizen's Budget.

Recommendations/Savings

Recommendation	Savings
• Revise defined benefit to defined contribution for health care benefits	$10 million
• Eliminate health care benefits to retirees who are already Medicare-eligible	

Legislation Offered

House Bill12-1250 PERA Health Care Trust Fund Employer Contributions. Prime sponsor was Chris Holbert. http://www.leg.state.co.us/clics/clics2012a/csl.nsf/fsbillcont/79E8367F60F0989887257981007F345B?Open&file=1250_01.pdf.

Savings

- Total Recommended Savings = $10 million
- Avoids = $1 billion in unfunded liabilities
- Additional Savings to Other Government Employers = $42 million

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.

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

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When the section was originally written in 2010, the retiree health plan was not meeting rules that must be followed, as laid down the Government Accounting Standard Board (GASB). 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 was 39 years. There is no reason to believe that this problem has significantly improved.

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. Unfortunately, there are a number of reasons why the funding status in the plan is likely to deteriorate for the foreseeable future.

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

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The Case for a Defined Contribution Retiree Health Plan

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. In other cases the promise is made as a percentage of health insurance premiums paid by the government.

Most private sector employers have now either eliminated defined benefit retiree health plans, or replaced them with defined contribution plans.[2] 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.

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.

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There are several flaws in the design of defined benefit plans in the public sector. One flaw is 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.

The fatal flaw in defined benefit retiree health plans in the public sector is moral hazard. **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. Public sector employee unions encourage this activity because it is less likely to generate taxpayer resistance than higher salary compensation, which must be funded from current revenue. Only with the transparency created by GASB rules are taxpayers honestly informed 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.[3]

Learning from Idaho's experience

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

Faced with revenue and budgets problems much like Colorado, Idaho enacted a successful reform. With about one-fifth the population of Colorado, it shed over $300 million in unfunded liabilities and reduced the annual cost to the State.

To follow the Idaho plan, **Colorado would replace the current retiree health plan with a defined contribution plan.** It would reduce the dollar amount that 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 who are under the age of 65 and who are not eligible for Medicare. Setting the **maximum amount of that subsidy per benefit recipient at $155 per month** would reduce the cost of that health insurance to employers by almost half.[4]

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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.**[5]

Acknowledgements

Barry W. Poulson, Ph.D. was primarily responsible for the content of this chapter. Dr. Poulson is retired Professor of Economics at the University of Colorado. He has been a Visiting Professor at universities in Mexico, United Kingdom, Japan and Spain.

He is the author of numerous books and articles in the fields of economic development and economic history. His current research focuses on fiscal policies and fiscal constitutions. Professor Poulson is currently Americans for Prosperity Foundation's Distinguished Scholar. His studies and articles for AFPF include research and analysis of the Taxpayer's Bill of Rights.

He has served on the Colorado Tax Commission and as Vice Chair of the State Treasurer's Advisory Group on Constitutional Amendments in Colorado. Professor Poulson is Past President of the North American Economics and Finance Association. He is an Adjunct Scholar of the Heritage Foundation, advises the Task Force on Tax and Fiscal Policy of the American Legislative Exchange Council and serves as a consultant on fiscal policy and fiscal constitutions to a number of state and national think tanks, including Colorado's Independence Institute.

Endnotes

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

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

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

4 Comprehensive Annual Financial Report, State of Colorado, 2009, Colorado Legislature.

5 Ibid.