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Highlights

Highlights of GAO-07-1156, a report to the Committee on Finance, U.S. Senate

STATE AND LOCAL GOVERNMENT RETIREE BENEFITS

Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs

Why GAO Did This Study

State and local retiree benefits are not subject, for the most part, to federal laws governing private sector retiree benefits. Nevertheless, there is a federal interest in ensuring that all Americans have a secure retirement, as reflected in the special tax treatment provided for both private and public pension funds. In 2004, new government accounting standards were issued, calling for the reporting of liabilities for future retiree health costs. As these standards are implemented and the extent of the related liabilities become known, questions have been raised about whether the public sector can continue to provide the current level of benefits to its retirees.

GAO was asked to provide an overview of state and local government retiree benefits, including the following:
(1) the types of benefits provided and how they are structured,
(2) how retiree benefits are protected and managed, and
(3) the fiscal outlook for retiree benefits and what governments are doing to ensure they can meet their future commitments.

For this overview, GAO obtained data from various organizations, used our model that simulates the fiscal outlook for the state and local sector, and conducted site visits to three states that illustrate a range of benefit structures, protections, and fiscal outlooks.

Cognizant agency officials provided technical comments which were incorporated as appropriate.

To view the full product, including the scope and methodology, click on GAO-07-1156. For more information, contact Barbara D. Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

What GAO Found

The systems for providing retiree benefits to state and local workers—who account for about 12 percent of the nation's workforce—are composed of two main components: pensions and retiree health care. These two components are often structured quite differently, as summarized in the table below. Importantly, state and local governments generally have established protections and routinely set aside monies to fund their retirees' future pension costs, but this typically has not been the practice for retiree health benefits.

Typical Differences in State and Local Government Retirement Systems

	Pensions	Retiree health benefits
How structured	Mostly a defined benefit based on a formula; once accrued, cannot be diminished.	Extent of premium cost sharing varies widely, and benefit plans can change for current as well as future retirees.
How managed	As trusts, with oversight by boards of trustees.	As operating expenses, managed with other employee benefits.
How funded	Prefunded—that is, monies set aside and invested.	Pay-as-you-go—that is, paid from annual operating funds as costs are incurred.

Source: GAO analysis.

A model GAO developed to simulate the fiscal outlook for state and local governments indicates that, for the sector as a whole,

- estimated future pension costs (currently about 9 percent of employee pay) would require an increase in annual government contribution rates of less than a half percent, and

- estimated future retiree health care costs (currently about 2 percent of employee pay) would more than double by the year 2050 if they continue to be funded on a pay-as-you-go basis.

Because the estimates are very sensitive to the assumed rates of return and projected rates of health care inflation, the model also indicates that if rates were to fall below historical averages, the funding requirements necessary to meet future pension and health care costs could become much higher. Nevertheless, state and local governments generally have strategies to manage future pension costs. In contrast, many are just beginning to respond to the newly issued standards calling for the reporting of retiree health liabilities, and they generally have not yet developed strategies to manage escalating retiree health care costs.

Across the state and local government sector, the ability to maintain current levels of retiree benefits will depend, in large part, on the nature and extent of the fiscal challenges that lie ahead—challenges driven primarily by the growth in health-related costs for Medicaid, and for active employees as well as retirees. In future debates on retiree benefits, policy makers, voters, and beneficiaries will need to decide how to control costs, the appropriate level of benefits, and who should pay the cost—especially for health care.