United States Government Accountability Office

GAO

Report to the Committee on Finance, U.S. Senate

September 2007

STATE AND LOCAL GOVERNMENT RETIREE BENEFITS

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

G A O

Accountability * Integrity * Reliability

GAO-07-1156

September 2007

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Highlights

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

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.

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Abbreviations

CalPERS	California Public Employees' Retirement System
CBO	Congressional Budget Office
COLA	cost-of-living adjustment
CPIU	consumer price index for all urban consumers
DROP	deferred retirement option plan
ECI	employment cost index
ERISA	Employee Retirement Income Security Act
FASB	Financial Accounting Standards Board
GAAP	generally accepted accounting principles
GASB	Governmental Accounting Standards Board
GDP	gross domestic product
HRET	Health Research and Educational Trust
MEPS	Medical Expenditure Panel Survey
MSERS	Michigan State Employees' Retirement System
NASRA	National Association of State Retirement Administrators
NIPA	National Income and Product Accounts
OASDI	Old-Age and Survivors Insurance and Disability Insurance
OPEB	other postemployment benefits
OPERS	Oregon Public Employees' Retirement System
VEBA	Voluntary Employees' Beneficiary Association

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United States Government Accountability Office
Washington, DC 20548

September 24, 2007

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

Over the past half-century, the number of state and local government workers has grown significantly. In 2006, this sector accounted for about 12 percent of the nation's workforce. Since 1996, accounting standards calling for state and local governments to report their liabilities for future pension costs have been in place, but standards calling for similar treatment of the future costs of retiree health benefits have only recently been issued. It is unclear, as yet, what actions state and local governments may take once the future costs of these benefits are known. However, future decisions about the appropriate levels of benefits for retirees will likely occur in a broader context of persistent fiscal challenges that state and local governments will face in the next decade. Hence, concerns have been raised about the public sector's capacity to meet the rising cost of providing its retirees with promised pension and other postemployment benefits, such as retiree health care.

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, an interest that is reflected in preferential tax treatment for contributions and investment earnings associated with qualified pension plans in both the public and the private sectors. To better understand these benefits and the future challenge state and local governments may face, you requested that we provide an overview of state and local government pension plans and retiree health benefit programs.[1] Specifically, we examined

[1] This report reflects the findings of one of two GAO studies that were conducted in response to this request. The other study is focused on providing a more detailed look at the funding status of state and local retiree benefit plans, with a report estimated to be published in late 2007. Other ongoing GAO work is focused on examining pension fund investment choices in the public and private sector.

(1) the types of state and local retiree benefits provided and how they are structured,

(2) how state and local retiree benefits are protected and managed, and

(3) the fiscal outlook for state and local retiree benefits and what governments are doing to ensure they can meet their future commitments.

For nationwide information about state and local retiree benefits, we spoke with experts, advocacy groups, and union officials from various national organizations and associations (see app. I). To profile the types of governance and benefits provided, we obtained data from these organizations, from various federal agencies, and from various nongovernmental entities that analyze government data and conduct surveys on these topics. (See the selected bibliography at the end of this report for brief descriptions of each of these studies.) Much of the available data are self-reported, but we conducted data reliability assessments and determined that the data are sufficiently reliable for our purposes. We also used our model that simulates the fiscal outlook for the state and local government sector to develop projections for funding state and local government retiree benefits in aggregate nationwide (see app. II). In addition, we conducted site visits and gathered detailed information about the benefits provided and the future fiscal implications in three states (California, Michigan, and Oregon) and two local governments (San Francisco and Detroit). We selected these sites to illustrate various types of plan structures, legal protections, and levels of employer funding commitments. For example, in California, the primary pension plan for most state and local government employees is a defined benefit plan, with protections in the state constitution,[2] and with a funded ratio of 87.3 percent in 2005. In Michigan, the primary pension plan for general state employees hired on or after March 31, 1997, is a defined contribution plan, which is covered by the same state constitutional provision applicable to the previous defined benefit plan; the previous plan, now closed to new members, had a funded ratio of 79.8 percent in 2005. In Oregon, the primary pension plan for most state and local government employees includes both a defined benefit and a defined contribution component,

[2] Throughout this report, our discussion of constitutional protections refers only to provisions specifically applicable to the funding, protection, management, or governance of employee benefit plans.

with no explicit protections in the state constitution; the defined benefit component's funded ratio was 104.2 percent in 2005. (See app. III for an overview of retiree benefit plans in our site visit locations.) Finally, to illustrate a wider range of retiree benefit system characteristics, in some instances, we complemented information from our site visit locations with information gathered about retiree benefits provided in other state and local jurisdictions. We conducted our work from November 2006 to August 2007 in accordance with generally accepted government auditing standards.

Results in Brief

State and local entities typically provide a pension plan with defined benefits, a supplemental defined contribution plan for voluntary savings, and partially paid health coverage. As of 2007, most states still have traditional defined benefit plans as the primary retirement plans for their workers. Only two states (Alaska and Michigan) and the District of Columbia had adopted defined contribution plans as their primary plans for general public employees; two states (Indiana and Oregon) had adopted primary plans with both defined benefit and defined contribution components; and one state (Nebraska) had adopted a cash balance defined benefit plan as its primary plan. State and local entities also typically offer tax-deferred supplemental voluntary plans to encourage workers to save toward retirement. In terms of health benefits, for virtually all state and local retirees age 65 or older, Medicare provides the primary coverage. Survey data gathered by Workplace Economics, Inc., indicate that most state and local government employers provide supplemental health coverage for Medicare-eligible retirees. For state and local retirees who are under age 65 (that is, not yet Medicare-eligible), state and local employers generally provide access to group health coverage with varying levels of support. As of 2006, 14 states provided no employer contribution for retirees' coverage, while 14 other states picked up the entire cost, and the remainder fell somewhere in between. States also typically provide access to group rates for other postemployment benefits such as dental and vision coverage, long-term care, and life insurance, but the cost of these other benefits is often paid primarily, if not entirely, by retirees.

How both pension plans and retiree health benefits are protected and managed is typically spelled out in state statutes or in local ordinances, but these laws generally provide greater protection for pensions than for retiree health benefits. State or local statutes, and state constitutions or local charters, often include explicit protections for pension benefits, such as provisions stating that pensions promised to public employees cannot

be eliminated or diminished. In addition, state constitutions and/or statutes often require pension plans to be managed as trust funds and overseen by boards of trustees. Our analysis of national organization data on pension boards indicates that the size, composition, and responsibilities of these boards vary. For example, we found that the size of these boards ranged from 5 to 19 members, with various combinations of those representing active members, retirees, union members, state or local governments, or others having technical knowledge such as investment specialists. Moreover, boards of trustees typically establish overall policies for the operation and management of the pension plans, which can include adopting actuarial assumptions for calculating liabilities, establishing procedures for financial control and reporting, and setting investment strategy. In contrast to pensions, state and local law provides less legal protection for other state and local government retiree benefits, such as retiree health care, and any such protections more frequently stem from negotiated agreements between unions and government employers. In addition, state and local governments have generally treated their costs for retiree health benefits as an operating expense on a pay-as-you-go basis, and managed these benefits together with active employee benefits.

In general, we found that state and local governments have set aside funds to meet most of their future pension costs, but have not yet developed long-term strategies to finance future escalating health care costs for retirees. We analyzed the expected future costs of pensions and retiree health benefits for the state and local government sector as a whole and found that, assuming that certain historical trends continue, state and local governments would need to raise their contribution rates only slightly to meet future pension costs. However, this estimate is particularly sensitive to changes in rates of return, and if rates were to fall below historical averages, the funding requirements to meet future costs could become much more significant. Moreover, according to our sector analysis, we found that future retiree health care costs would likely more than double as a percentage of salaries between 2006 and 2050, if the costs continued to be funded on a pay-as-you-go basis. As with pensions, this estimate is particularly sensitive to assumptions about the growth in health care costs, and costs could rise more rapidly than projected. In addition, the actual forecasts and outcomes for individual state and local governments will, of course, vary from our analysis. For example, although nationwide data gathered by the National Association of State Retirement Administrators (NASRA) indicates that most state and local governments are on track toward full funding of their pension plans, a few plans have failed to maintain what is generally viewed as an acceptable funding level.

If efforts are not made to improve the funding status of those plans, tough choices lie ahead about whether and how to maintain the current level of pension benefits for future retirees. State and local governments may be faced with the need to raise taxes, cut spending, or reduce benefits in order to meet their obligations. Across our site visit locations, we found that state and local governments employ a variety of strategies to keep the funding status of their pension plans on track, but that long-term strategies to address escalating health care costs for retirees are generally lacking. Officials told us that they are just beginning to estimate the amount of their unfunded liability for retiree health care costs in response to the newly issued accounting standards and that they had not yet developed strategies to manage these future costs.

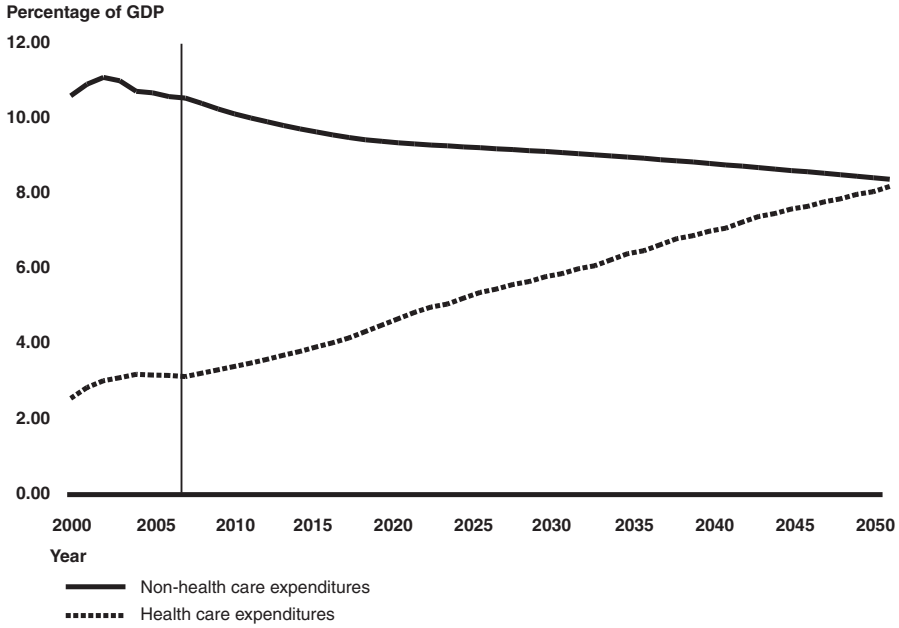
The Internal Revenue Service, state and local officials, and experts in the field provided technical comments which we incorporated as appropriate.

Background

The state and local government sector is likely to face persistent fiscal challenges within the next decade. In July 2007, we issued a report based on simulations for the state and local government sector that indicated that in the absence of policy changes, large and growing fiscal challenges will likely emerge within a decade.[3] Our report found that, as is true for the federal sector, the growth in health-related costs is a primary driver of these fiscal challenges (see fig. 1). Two types of health-related costs are of particular concern at the state and local level: (1) Medicaid expenditures, and (2) the cost of health insurance for state and local government employees, retirees, and their beneficiaries.

[3] GAO, *State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge within the Next Decade*, GAO-07-1080SP (Washington, D.C.: July 18, 2007).

Figure 1: Projected Health and Non-Health Expenditures of State and Local Governments through 2050



Source: GAO analysis.

Note: Historical data through 2006, projections from 2007 through 2050. The primary data source is the National Income and Product Accounts (NIPA). Interest expense is not included in this analysis. (GDP = gross domestic product.)

Retirement benefits consist primarily of two components: pensions and retiree health benefits. According to Census data, in fiscal year 2004-2005, state and local governments provided retirement benefits to nearly 7 million retirees and their families. In addition to supporting a secure retirement for state and local government employees and their families, such benefits constitute an important component of the total compensation package state and local governments offer to attract and retain the skilled workers needed to protect lives and health, and to promote the general welfare. These workers include highway patrol officers, local police, firefighters, school teachers, and judges, as well as general state and local government employees who staff the broad array of state and local agencies.

Pension plans can generally be characterized as either defined benefit or defined contribution plans. In a defined benefit plan, the amount of the benefit payment is determined by a formula typically based on the retiree's years of service and final average salary, and is most often provided as a

lifetime annuity. In defined benefit plans for state and local government retirees, postretirement cost-of-living adjustments (COLA) are frequently provided. But benefit payments are generally reduced for early retirement, and in some cases, payments may be offset for receipt of Social Security.[4] State and local government employees are generally required to contribute a percentage of their salaries to their defined benefit plans, unlike private sector employees, who generally make no contribution when they participate in defined benefit plans. According to a 50-state survey conducted by Workplace Economics, Inc., 43 of 48 states with defined benefit plans reported that general state employees were required to make contributions ranging from 1.25 to 10.5 percent of their salaries. Nevertheless, these contributions have no influence on the amount of benefits paid because benefits are based solely on the formula.

In a defined contribution plan, the key determinants of the benefit amount are the employee's and employer's contribution rates, and the rate of return achieved on the amounts contributed to an individual's account over time. The employee assumes the investment risk: The account balance at the time of retirement is the total amount of funds available, and unlike with defined benefit plans, there are generally no COLAs. Until depleted, however, a defined contribution account balance may continue to earn investment returns after retirement, and a retiree could use the balance to purchase an inflation-protected annuity. Also, defined contribution plans are more portable than defined benefit plans, as employees own their accounts individually and can generally take their balances with them when they leave government employment. There are no reductions based on early retirement or for participation in Social Security.[5]

Accounting standards governing public sector pensions were established by the Governmental Accounting Standards Board (GASB) in 1994. Comprehensive accounting and financial reporting standards governing other postemployment benefits (OPEB) in the public sector, such as health care, were issued in 2004 (superseding the interim standards issued

[4] Unlike in the private sector, there are large groups of state and local government workers who are not covered by Social Security. According to data from the Social Security Administration, about 30 percent of all state and local government workers nationwide are not covered, although the extent of coverage varies widely by state and by occupation.

[5] There could, however, be federal tax penalties if funds are withdrawn before the employee reaches a certain age. 26 U.S.C. § 72(t).

previously). Implementation of the new OPEB standards is currently being phased in (see app. IV). The purpose of these standards is to prescribe accounting and financial reporting requirements that apply broadly to state and local government employers' benefit plans. Reporting by employers and plan administrators helps keep the municipal bond market, taxpayers, elected public officials, plan members, and other interested parties informed about employers' OPEB costs and obligations, and the operation and funded status of the plans. As with the Financial Accounting Standards Board (FASB) in the private sector, it is not the GASB's function to enforce compliance with the standards it promulgates. Rather, the GASB functions as an independent standard setter, and its statements and interpretations constitute the highest source of generally accepted accounting principles (GAAP) for state and local governments, as specified in the Code of Professional Conduct of the American Institute of Certified Public Accountants. State and local governmental entities issue annual financial reports prepared in conformity with GAAP for a variety of reasons—such as to comply with general or specific state laws requiring GAAP financial reporting, or to protect the highest possible credit rating on the government's bonds in order to reduce the government's cost of borrowing. Compliance with GASB standards is necessary in order to obtain an independent auditor's report that the financial statements are fairly presented in conformity with GAAP, and a failure to do so would result in a modification of the auditor's report if the effects were material.

Although the Employee Retirement Income Security Act of 1974 (ERISA) imposes participation, vesting, and other requirements directly upon employee pension plans, governmental plans such as those provided by state and local governments to their employees are excepted from these requirements. In addition, ERISA established an insurance program for defined benefit plans under which promised benefits are paid (up to a statutorily set amount), if an employer cannot pay them—but this too does not apply to governmental plans. However, for participants in governmental pension plans to receive preferential tax treatment (that is, for plan contributions and investment earnings to be tax-deferred), plans must be deemed qualified by the Internal Revenue Service.[6]

[6] Contributions to qualified pension plans that meet certain requirements—whether defined benefit or defined contribution—are not counted as taxable income to employees when the contributions are made. However, when pension benefits are paid, amounts not previously taxed are subject to federal and perhaps state tax. This also applies to the interest income such contributions generate.

State and Local Retiree Benefits Typically Include a Defined Benefit Plan, a Voluntary Savings Plan, and Partially Paid Health Coverage

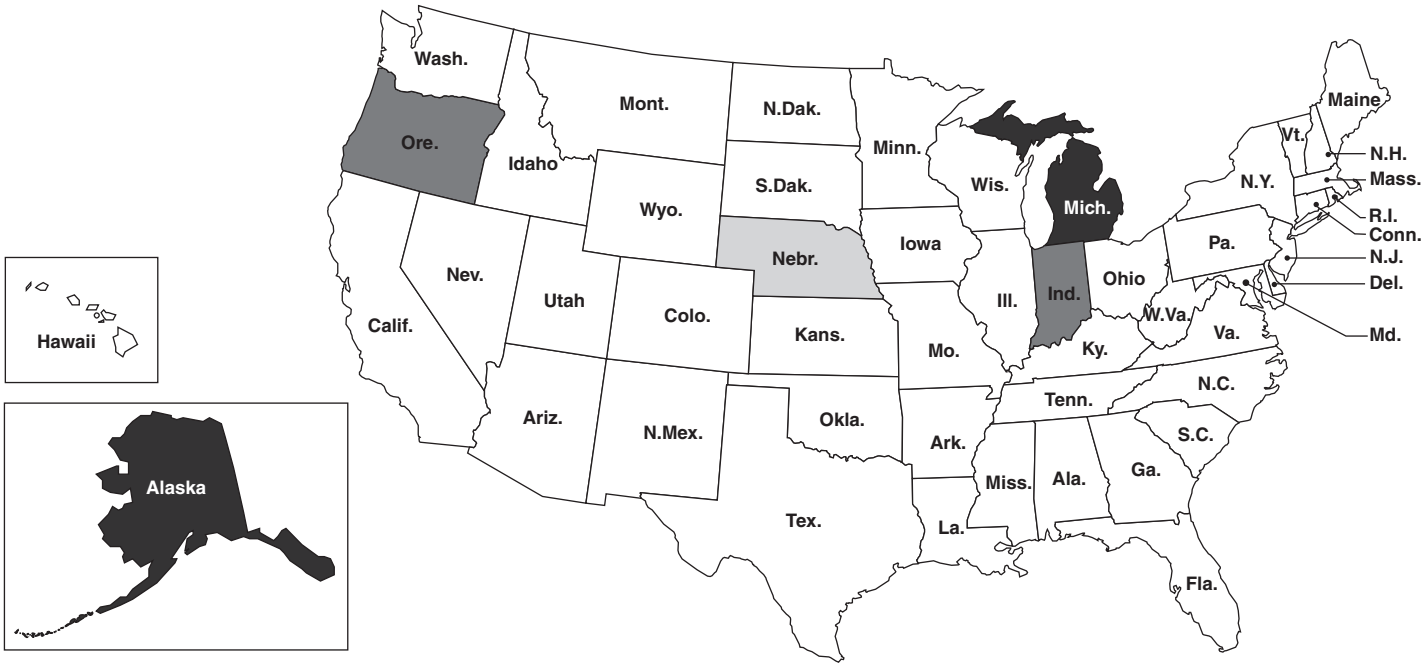
State and local governments typically provide their employees with retirement benefits that include a defined benefit plan, a supplemental defined contribution plan for voluntary savings, and group health coverage. However, the way each of these components is structured and the level of benefits provided varies widely—both across states, and within states based on such things as date of hire, employee occupation, and local jurisdiction.

Defined Benefit Plans Still Provide the Core Benefits for Most Retirees

Most state and local government workers still are provided traditional pension plans with defined benefits. In 1998, all states had defined benefit plans as their primary pension plans for their general state workers except for Michigan and Nebraska (and the District of Columbia), which had defined contribution plans as their primary plans, and Indiana, which had a combined plan with both defined benefit and defined contribution components as its primary plan.[7] Almost a decade later, we found that as of 2007, only one additional state (Alaska) had adopted a defined contribution plan as its primary plan; one additional state (Oregon) had adopted a combined plan, and Nebraska had replaced its defined contribution plan with a cash balance defined benefit plan. (See fig. 2.) Although still providing defined benefit plans as their primary plans for general state employees, some states also offer defined contribution plans (or combined plans) as optional alternatives to their primary plans. These states include Colorado, Florida, Montana, Ohio, South Carolina, and Washington.

[7] See GAO, *State Pension Plans: Similarities and Differences Between Federal and State Designs*, GAO/GGD-99-45 (Washington, D.C.: Mar. 19, 1999). Also, as of 1998, across all state and local employees nationwide, Bureau of Labor Statistics survey data indicate that 90 percent were covered by defined benefit plans. (For further details on this survey, see the selected bibliography at the end of this report. The survey is to be updated again in 2008.)

Figure 2: Types of Pension Plans in Place for Newly Hired General State Employees, as of 2007



Source: GAO analysis of data from various national organizations and from individual states' reports and publications.

Note: Plans depicted are those in which newly hired general state employees in each state are required to participate as their primary pension plan. In some states, employees may opt to participate in alternative or supplementary defined contribution plans, but participation in these plans is not mandatory.

In the states that have adopted defined contribution plans as their primary plans, most employees continue to participate in defined benefit plans because employees are allowed to continue their participation in their

previous plans (which is rare in the private sector).[8] Thus, in contrast to the private sector, which has moved increasingly away from defined benefit plans over the past several decades, the overwhelming majority of states continue to provide defined benefit plans for their general state employees.

Most states have multiple pension plans providing benefits to different groups of state and local government workers based on occupation (such as police officer or teacher) and/or local jurisdiction. According to the most recent Census data available, in fiscal year 2004-2005, there were a total of 2,656 state and local government pension plans. We found that defined benefit plans were still prevalent for most of these other state and local employees as well. For example, a nationwide study conducted by the National Education Association in 2006 found that of 99 large pension plans serving teachers and other school employees,[9] 79 were defined benefit plans, 3 were defined contribution plans, and the remainder offered a range of alternative, optional, or combined plan designs with both defined benefit and defined contribution features.

Supplementary Savings Plans Are Largely Voluntary, with No Employer Match

In addition to primary pension plans (whether defined benefit or defined contribution), data we gathered from various national organizations show that each of the 50 states has also established a defined contribution plan as a supplementary, voluntary option for tax-deferred retirement savings for their general state employees, and such plans appear to be common among other employee groups as well.[10] These supplementary defined

[8] In the private sector, when a new plan is adopted, the previous plan is often frozen. Existing employees keep the benefits they have accrued to date, but cannot continue to participate in the previous plan from that point forward. In the public sector, when a new plan is adopted, existing employees generally are allowed to continue to participate in the previous plan. Generally only new employees, hired after adoption of the new plan, are required to participate in the new plan from that point forward.

[9] For further details on the National Education Association study, see the selected bibliography at the end of this report.

[10] In addition, over the past 10 years, many public sector employers have established deferred retirement option plans (DROP). DROPs were created to retain experienced employees by permitting those eligible to retire to stay on the job and earn a lump-sum payment at retirement in addition to their defined benefit annuity.

contribution plans are typically voluntary deferred compensation plans under section 457(b) of the federal tax code.[11] (See table 1.)

Table 1: Different Types of Defined Contribution Plans for Voluntary Tax-Deferred Savings for State and Local Government Employees

Plan name (based on section of the Internal Revenue Code)	Description of plan
401(k) plans	Cash or deferred arrangements that permit employees to defer a portion of their pay to a qualified tax-deferred plan. Employee deferrals are held in trust for the sole benefit of the participants and their beneficiaries. The employee typically directs the investments. Employers may also make contributions. These plans are intended primarily for private sector employees; the Tax Reform Act of 1986 prohibited state and local governments from establishing any new 401(k) plans after May 6, 1986, but existing plans were allowed to continue. (Pub. L. No. 99-514, § 1116(b)(3), 100 Stat. 2085, 2455.)
403(b) plans	Tax-sheltered annuity plans that permit public education employees to defer a portion of their pay to a qualified tax-deferred plan. Employee deferrals are invested in annuity contracts provided through insurance companies or custodial accounts invested in mutual funds. Employers may also make contributions, and employee rights under such plans generally are not forfeitable.
457(b) plans	Deferred compensation plans that permit employees to defer a portion of their pay, which is immediately vested and set aside for their exclusive benefit. Since taxation of the amounts in 457(b) accounts is deferred, this portion of the employee's pay is not taxed until the funds are paid from the plan. Most state and local government employees today have such plans available to them as supplementary retirement plans.

Source: Internal Revenue Code.

Note: This table describes the various types of defined contribution plans that may be used for supplemental retirement saving plans for state and local government workers. When the defined contribution plan is the primary retirement plan, it is generally a 401(a) plan.

States Providing Matched Contributions to Supplementary Voluntary Savings Plans

State	Maximum monthly match
Colorado	1.0% of salary
Delaware	$10.00
Indiana	$32.50
Iowa	$50.00
Minnesota	$25.00
Missouri	$25.00
Oklahoma	$25.00
South Carolina	$30.00
Tennessee	$30.00
Utah	1.5% of salary
Virginia	$40.00
Wyoming	$20.00

Source: Workplace Economics, Inc., *2006 State Employee Benefits Survey,* and individual states' reports and publications.

While these defined contribution plans are fairly universally available, state and local worker participation in the plans has been modest. In a 2006 nationwide survey conducted by the National Association of Government Defined Contribution Administrators,[12] the average participation rate for all defined contribution plans was 21.6 percent.

One reason cited for low participation rates in these supplementary plans is that, unlike in the private sector, it has been relatively rare for employers to match workers' contributions to these plans, but the number of states offering a match has been increasing. According to a state

[11] 26 U.S.C. § 457(b).

[12] For further details on the National Association of Government Defined Contribution Administrators' 2006 survey, see the selected bibliography at the end of this report.

employee benefit survey of all 50 states conducted by Workplace Economics, Inc., in 2006, 12 states match the employee's contribution up to a specified percent or dollar amount.[13] Among our site visit states, none made contributions to the supplementary savings plans for their general state employees, and employee participation rates generally ranged between 20 to 50 percent. In San Francisco, however, despite the lack of an employer match, 75 percent of employees had established 457(b) accounts. The executive director of the city's retirement system attributed this success to several factors, including (1) that the plan had been in place for over 25 years, (2) that the plan offers good investment options for employees to choose from, and (3) that plan administrators have a strong outreach program. In the private sector, a growing number of employers are attempting to increase participation rates and retirement savings in defined contribution plans by automatically enrolling workers and offering new types of investment funds.[14]

Group Health Coverage Is Widely Available with Varying Levels of Employer Support

State and local governments typically provide their active employees with health coverage,[15] and they often pay the bulk of their premiums. According to the Workplace Economics, Inc., 2006 survey, on average, state employers paid over 90 percent of the cost for single employee coverage, and over 80 percent of the cost of family coverage, for active workers. Once workers retire, access to group coverage generally continues, but the extent of the employer contribution often declines, and

[13] The Workplace Economics, Inc., 2006 survey instructed states to provide information on benefits that cover the largest number of employees, or that were otherwise deemed representative. For further details on this survey, see the selected bibliography at the end of this report.

[14] GAO, *Employer-Sponsored Health and Retirement Benefits: Efforts to Control Employer Costs and the Implications for Workers*, GAO-07-355 (Washington, D.C.: March 30, 2007).

[15] About 82 percent of state and local governments with 200 or more employees offer health benefits to active workers, according to a 2006 survey conducted by the Kaiser Family Foundation and the Health Research and Educational Trust (HRET). (For further details on the Kaiser/HRET 2006 survey, see the selected bibliography at the end of this report.)

different benefits are often provided depending on whether or not the retiree is eligible for Medicare.[16]

For virtually all state and local retirees age 65 or older, Medicare provides the primary coverage. Most state and large local government employers offer supplemental group health coverage, but do not always contribute to the cost of the premiums. According to the Workforce Economics, Inc., 2006 survey, all states but one provide access to such supplemental coverage. Only Nebraska provides no access to group coverage for retirees age 65 and over.[17] In 12 states, retirees are provided access to coverage through a state health care program, but the state provides no support for the coverage.[18] At the other end of the spectrum, in 16 states, employers pay the entire cost for at least one coverage plan under some circumstances. Of those states contributing to the premium costs, the maximum employer payments for employee-only coverage ranged from $40 per month (in Tennessee) to $850 per month (in Alaska).

For state and local retirees who are under age 65 (that is, not yet Medicare-eligible), most state and large local employers provide the primary health care coverage. According to the Workplace Economics, Inc., 2006 survey, all states provide access to group health coverage for pre-Medicare retirees,[19] but in 14 states, the plan participants pay the entire cost of the coverage (see fig. 3). In 14 other states, employers pay the

[16] According to a more comprehensive study of state retiree health benefits in 2004, some states offered a single health care plan statewide, but typically retirees had about three or four plans available. The plans offered to pre-Medicare retirees were generally similar to those for active employees, while Medicare-eligible retirees had somewhat different plans available. For further details, see Stan Wisniewski and Lorel Wisniewski, *State Government Retiree Health Benefits: Current Status and Potential Impact of New Accounting Standards*, Workplace Economics, Inc., #2004-08, AARP, Washington, D.C.: July 2004. (For further details on this survey, see the selected bibliography at the end of this report.)

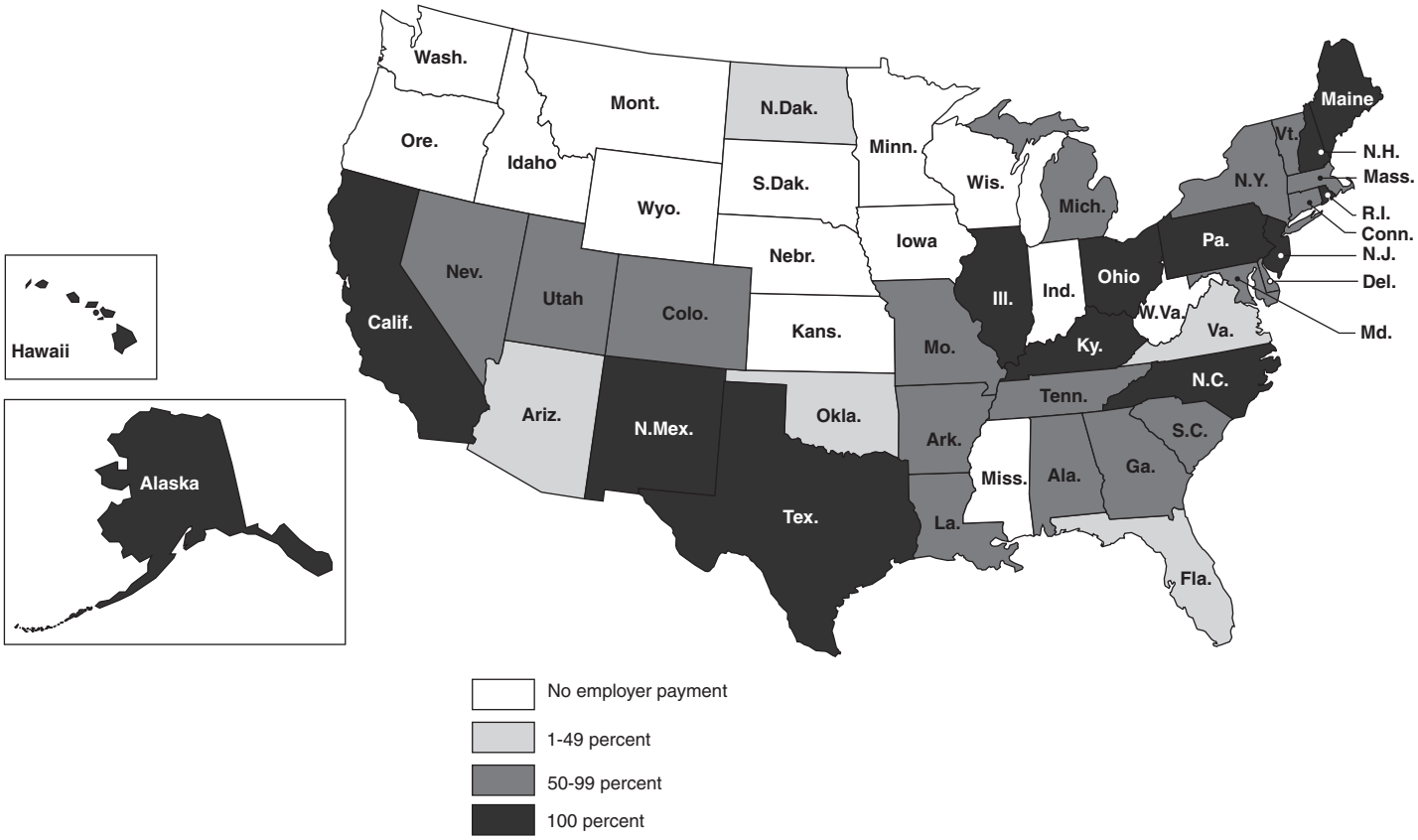
[17] Indiana also provides no coverage under a state plan, but provides access to a Medicare complementary plan that retirees can purchase on their own. In addition, Oregon provides no coverage under a state plan for retirees eligible for Medicare if they were hired on or after August 29, 2003.

[18] In four additional states, no employer funding is provided unless the retiree meets certain years of service or other requirements. Similar requirements generally exist for both pre-Medicare and Medicare-eligible retirees. For example, in Arizona, a retiree must have 10 years of service to receive any employer contribution in either case.

[19] Often state and local employees are eligible to retire before age 65. According the Workplace Economics, Inc., 2006 survey, several states allow government employees to retire at age 50 or 55, or at any age with a specific number of years of service.

entire cost for at least one coverage plan in some circumstances. Of those states providing an employer contribution, the maximum payments for retiree-only coverage ranged from $105 per month (in Oklahoma) to $850 per month (in Alaska).

Figure 3: Percentage of Premium Paid by Employer for Health Insurance Coverage for Retirees under Age 65 (Pre-Medicare-Eligible), by State in 2006



Source: Workplace Economics, Inc., *2006 State Employee Benefits Survey,* and individual states' reports and publications

Note: When employer contributions to the cost of premiums vary for those hired or retired before a certain date, percentages depicted are for payments provided to the latest group of workers who retire. When contributions vary based on a retiree's years of service, plan selected, or other criteria, the maximum amount of payment is depicted. For states with no set maximum, the percentage shown is for retirees with 30 years of service. The Workplace Economics, Inc., 2006 survey instructed states to provide information on benefits that cover the largest number of employees, or that were otherwise deemed representative. For further details on this survey, see the selected bibliography at the end of this report.

In most cases, states are continuing to provide retirees with prescription drug coverage following the rollout of the Medicare prescription drug

program beginning in January 2006.[20] In May 2006, the Segal Company, in cooperation with the Public Sector HealthCare Roundtable, conducted a survey of 109 state and local entities concerning retiree health care, and found that most of the public entities surveyed continued to provide prescription drug coverage to their retirees, and that only one entity planned to eliminate drug coverage entirely.[21]

Nationwide survey data indicate that while the vast majority of state and local government active workers participate in employer-sponsored health benefit plans,[22] participation rates among retirees in these employer-sponsored health benefit programs are relatively low. According to data from the Department of Health and Human Services, in 2004, about 42 percent of state and local retirees participated in employer-sponsored health insurance programs.[23] Among our site visit locations, we found that participation rates varied widely based on level of employer cost sharing. For example, in California, where the state may pay up to the full premium in some cases (depending on the retiree's date of hire, years of service,

[20] The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 created a prescription drug benefit for beneficiaries called Medicare Part D. Pub. L. No. 108-173, tit. I, 117 Stat. 2066, 2066. Under Part D, sponsors of employment-based prescription drug benefit plans (including state and local governments) qualify for a federal subsidy payment if they provide benefits meeting certain requirements. For further information, see GAO, *Retiree Health Benefits: Majority of Sponsors Continued to Offer Prescription Drug Coverage and Chose the Retiree Drug Subsidy*, GAO-07-572 (Washington, D.C.: May 31, 2007).

[21] Although not changing the benefits they offer, almost half of the entities indicated that they now terminate prescription drug coverage for those retirees enrolled in a Medicare plan on their own, and a growing number of entities were considering contracting with a prescription drug plan or Medicare-Advantage prescription drug plan to provide prescription drug coverage for their retirees in the future. (For further details on Segal's 2006 survey, see the selected bibliography at the end of this report.)

[22] About 92 percent of eligible state and local workers participate in employer-sponsored health plans, according to the Kaiser/HRET 2006 survey. (For further details on this survey, see the selected bibliography at the end of this report.)

[23] This estimate is based on participation data from the Department of Health and Human Services, Agency for Healthcare Research and Quality, Medical Expenditure Panel Survey (MEPS); and data on the number of retired employees from the Census Bureau's annual survey, State and Local Governments Employee-Retirement Systems. (For further details on these surveys, see the selected bibliography at the end of this report.)

and choice of coverage plans);[24] and in Michigan, where the state pays as much as 95 percent of the retirees' premium for those under the defined benefit plan, we estimated participation rates to be approximately 70 percent and 90 percent of all state retirees, respectively. In contrast, in Oregon, where the state pays nothing toward retirees' premiums for coverage under the pre-Medicare-eligible health care program administered by the Public Employees Benefit Board, it has been estimated that the participation rate among eligible retirees is about 30 percent.

The Cost of Other Benefits, when Provided, Is Primarily Paid by Retirees

Beyond basic health care, other postemployment benefits (OPEB) that are sometimes offered to state and local government retirees include stand-alone supplemental dental or vision benefits, long-term care, or life insurance. When such benefits are made available, state and local government entities typically provide access to group rates, but the cost of the benefits is often paid primarily, if not entirely, by retirees.

For example, among our site visit locations, postemployment benefits provided to retirees in addition to health care include the following:

- State employees in California generally have access to group term life insurance with a lump-sum benefit of $5,000, paid by the state. Retirees also are provided access to group dental benefits, which may be partially funded by the state in some cases, and a retiree vision program with premiums fully paid by retirees. Long-term care insurance is also available to all public employees in the state (active or retired), as well as their family members, generally as a fully member-paid program with no state contribution.
- In Michigan, dental and vision (as well as health) coverage is provided to general state employees at retirement. For those under the defined contribution plan (that is, hired on or after March 31, 1997), payments range from none for those with less than 10 years of service, to 30

[24] In California, the state's contributions to retirees' health benefits are equal to 100 percent of a weighted average of retiree health premiums for single enrollees in the four basic health plans with the largest state employee enrollment during the prior year. Employees hired before January 1, 1985, vest for the full weighted average premium contribution at retirement after 5 years of service. Employees hired between January 1, 1985, and December 31, 1988, vest for the full weighted average premium contribution at retirement if they have at least 10 years of service. Employees hired after January 1, 1989, if represented (or January 1, 1990, if unrepresented) vest for the full weighted average premium contribution at retirement only after 20 years of service.

percent of the premium cost for those with 10 years of service, plus 3 percent per year additional up to a maximum of 90 percent of the premium cost for those who have 30 or more years of service. The state also negotiated a group plan for long-term care insurance for active and retired workers, and their family members, but it is administered completely through a third party with no state support.

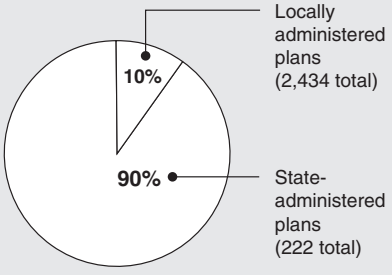
- Oregon's other postemployment benefits for state retirees include group coverage for dental and vision benefits, but not life insurance. Long-term care insurance is also available, but only for some retirees. No employer contribution is provided for any of these benefits.

State and Local Law Generally Provides Legal Protections for Pensions, but Less So for Other Retiree Benefits of Public Employees

How both pension plans and retiree health benefits are protected and managed is typically spelled out in statutes or in local ordinances, but these laws generally provide greater protections for pensions than for retiree health benefits. Laws protecting pensions are often anchored by provisions in state constitutions and local charters. Across the multiple plans providing benefits, state and local law typically requires that pensions be managed as trust funds and overseen by boards. In contrast, state and local law provides much less protection for retiree health benefits. Retiree health benefits are generally treated as an operating expense for that year's costs on a pay-as-you-go basis and managed together with active employee benefits.

Laws Protecting Pensions Are Often Anchored in State Constitutions and Local Charters

Percentage of State and Local Workers Served by State-Administered versus Locally Administered Pension Plans Nationwide



Source: GAO analysis based on fiscal year 2004-2005 Census data.

State and local laws generally provide the most direct source of any specific legal protections for the pensions of state and local workers. Provisions in state constitutions often protect pensions from being eliminated or diminished. In addition, constitutional provisions often specify how pension funds are to be managed, such as by mandating certain funding requirements and/or requiring that the funds be overseen by boards of trustees.[25] Moreover, we found that at the sites we visited, locally administered plans were generally governed by local laws. However, state employees, as well as the vast majority of local employees, are covered by state-administered plans.

Protections for pensions in state constitutions are the strongest form of legal protection states can provide because constitutions—which set out

[25] Given the ways in which defined contribution plans differ from defined benefit plans, these types of provisions may be less readily applicable or relevant to them.

the system of fundamental laws for the governance of each state—preempt state statutes and are difficult to change. Furthermore, changing a state constitution usually requires broad public support. For example, often a supermajority (such as three-fifths) of a state's legislature may need to first approve changes to its constitution. If a change passes the legislature, voters typically must approve it before it becomes part of the state's constitution.

The majority of states have some form of constitutional protection for their pensions. According to AARP data compiled in 2000, 31 states have a total of 93 constitutional provisions explicitly protecting pensions.[26] (The other 19 states all have pension protections in their statutes or recognize legal protections under common law.) These constitutional pension provisions prescribe some combination of how pension trusts are to be funded, protected, managed, or governed. (See table 2.)

Table 2: Constitutional Protections for Pension Benefits

Constitutional provisions requiring	States	Number of states
Certain standards are to be in place for how the retirement system should be funded.	Arizona, Florida, Georgia, Louisiana, Maine, Michigan, Mississippi, Montana, New Hampshire, New Mexico, North Dakota, South Carolina, Texas, and Virginia.	14
Assets in a trust fund are to be for the exclusive purpose of the retirement system.	Alabama, Arizona, California, Louisiana, Maine, Mississippi, Montana, New Hampshire, New Mexico, North Carolina, Oklahoma, Texas, Virginia, and Wyoming.	14
Trust fund assets are not to be diverted for nonretirement uses.	Alabama, Louisiana, Maine, Mississippi, Montana, Nevada, New Hampshire, New Mexico, North Carolina, Oklahoma, South Carolina, Texas, and Virginia.	13
Retirement system boards of trustees are to be off limits to the legislature.	California, Montana, Nevada, New Mexico, and Texas.	5
Participants in a retirement system have a guaranteed right to a benefit, and that accrued financial benefits cannot be eliminated or diminished.	Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, Missouri, New Mexico, and New York.	9
States have investment authority for their retirement systems.	Indiana, Michigan, Montana, Nebraska, South Carolina, Washington, and West Virginia.	7

[26]Although the AARP study focused on pension plans for a particular group of public employees (retired educators), our analysis revealed that the provisions identified in all but two states were applicable to pension plans for all state employees. (For further details about the AARP study, see the selected bibliography at the end of this report.) In addition, we learned that subsequent to this study, Oregon adopted a constitutional provision in 2003 to authorize the issuance of pension obligation bonds.

Constitutional provisions requiring	States	Number of states
Retirement system money is to be held in a separate trust fund.	Arizona, California, Nevada, New Mexico, and Virginia.	5
Retirement benefits may be increased.	Georgia, Nebraska, Pennsylvania, Washington, and Wisconsin.	5
A retirement system is required.	Louisiana, Texas, and Virginia.	3
The payment of retirement benefits is authorized.	Georgia and Oklahoma.	2
Other protections are in place, such as prohibiting constitutional changes to the retirement system through the initiative process.	Mississippi, Missouri, Nebraska, and Nevada.	4

Source: AARP, 2000.

Pension Benefits, Once Accrued, Are Generally Protected

In nine states, constitutional provisions take the form of a specific guarantee of the right to a benefit. In two of the states we visited, the state constitution provided protection for pension benefits. In California, for example, the state constitution provides that public plan assets are trust funds to be used only for providing pension benefits to plan participants.[27] In Michigan, the state constitution provides that public pension benefits are contractual obligations that cannot be diminished or impaired and must be funded annually.[28]

The basic features of pension plans—such as eligibility, contributions, and types of benefits—are often spelled out in state or local statute. State-administered plans are generally governed by state laws. For example, in California, the formulas used to calculate pension benefit levels for employees participating in the California Public Employees' Retirement System (CalPERS) are provided in state law.[29] Similarly, in Oregon, pension benefit formulas for state and local employees participating in the Oregon Public Employees Retirement System (OPERS) plans are provided in state statute.[30] In addition, we found that at the sites we visited locally administered plans were generally governed by local laws. For example, in San Francisco, contribution rates for employees participating in the San

[27]Cal. Const., art. XVI § 17.

[28]Mich. Const., art. IX § 19 and 24.

[29]For example, see Cal. Gov't. Code § 21353 (Deering 2007).

[30]Or. Rev. Stat. § 238.300 (2005).

Francisco City and County Employees' Retirement System are spelled out in the city charter.[31]

Legal protections usually apply to benefits for existing workers or benefits that have already accrued; thus, state and local governments generally can change the benefits for new hires by creating a series of new tiers or plans that apply to employees hired only after the date of the change. For example, the Oregon legislature changed the pension benefit for employees hired on or after January 1, 1996, and again for employees hired on or after August 29, 2003, each time increasing the retirement age for the new group of employees.

Role of Unions

The influence of unions on public employee benefits is stronger than in the private sector. Over 40 percent of public sector workers—including federal, state, and local government—are covered by union agreements, compared with about 10 percent of private sector workers. Across the nation, in 2005, the percentage of public sector workers covered ranged from lows of about 13 percent in North and South Carolina, to highs of about 70 percent in Rhode Island and 72 percent in New York.

Source: Bureau of National Affairs, Inc., 2006.

For some state and local workers whose benefit provisions are not laid out in detail in state or local statutes, specific provisions are left to be negotiated between employers and unions. For example, in California, according to state officials, various benefit formula options for local employees are laid out in state statutes, but the specific provisions adopted are generally determined through collective bargaining between the more than 1,500 different local public employers and rank-and-file bargaining units. In all three states we visited, unions also lobby the state legislature on behalf of their members. For example, in Michigan, according to officials from the Department of Management and Budget, unions marshal support for or against a proposal by taking such actions as initiating letter-writing campaigns to support or oppose legislative measures.

Pensions Are Typically Managed as Trust Funds with Board Oversight

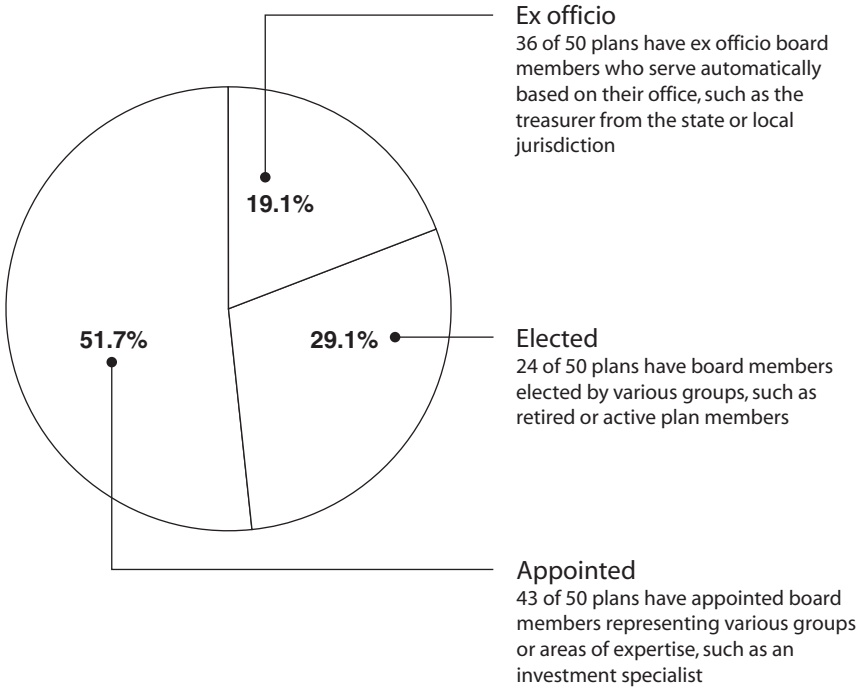
In accordance with state constitution and/or statute, the assets of state and local government pension plans are typically managed as trusts and overseen by boards of trustees to ensure that the assets are used for the sole purpose of meeting retirement system obligations and that the plans are in compliance with the federal tax code.[32] Boards of trustees, of varying size and composition, often serve the purpose of establishing the overall policies for the operation and management of the pension plans, which can include adopting actuarial assumptions, establishing procedures for financial control and reporting, and setting investment strategy. On the basis of our analysis of data from the National Education Association, the National Association of State Retirement Administrators

[31]San Francisco City Charter A8.525.

[32]A trust established by an employer for the exclusive benefit of its employees, and any income it generates, is exempt from federal income tax. 26 U.S.C. § 501(a).

(NASRA), and reports and publications from selected states, we found that 46 states had boards overseeing the administration of their pension plans for general state employees.[33] These boards ranged in size from 5 to 19 members, with various combinations of those elected by plan members, those appointed by a state official, and those who serve automatically based on their office in state government (known as ex officio members). (See fig. 4.)

Figure 4: Various Interests Represented on Boards of Each State's Pension Plan for General State Employees



Source: GAO analysis of board membership for the primary pension plans for general state employees in each state, based on data from various national organizations and from individual states' reports and publications.

Note: Percentages do not total 100 because of rounding.

Different types of members bring different perspectives to bear, and can help to balance competing demands on retirement system resources. For example, board members who are elected by active and retired members

[33]The four states that do not have boards overseeing the operation and management of their pension plans for general state employees are Florida, Iowa, New York, and Washington. (In addition, the District of Columbia does not have a board overseeing its pension plan for its general employees.)

of the retirement system, or who are union members, generally help to ensure that members' benefits are protected. Board members who are appointed sometimes are required to have some type of technical knowledge, such as investment expertise. Finally, ex officio board members generally represent the financial concerns of the state government.

Some pension boards do not have each of these perspectives represented. For example, boards governing the primary public employee pension plans in all three states we visited had various compositions and responsibilities. (See table 3.) At the local level, in Detroit, Michigan, a majority of the board of Detroit's General Retirement System is composed of members of the system. According to officials from the General Retirement System, this is thought to protect pension plan assets from being used for purposes other than providing benefits to members of the retirement system. Regarding responsibilities, the board administers the General Retirement System and, as specified in local city ordinances, is responsible for the system's proper operation and investment strategy.

Table 3: Composition and Responsibilities of Boards of Primary Public Employee Pension Plans in California, Michigan, and Oregon

State	Pension plan	Number of board members	Composition of board members	Board responsible for
California	California Public Employees' Retirement System (CalPERS)	13	3 appointed 6 elected 4 ex officio[a]	Management and control of CalPERS, including the exclusive control of the administration and investment of the retirement fund.[b]
Michigan	Michigan State Employees' Retirement System (MSERS)	9	4 appointed 5 ex officio[c]	Administering and managing the defined benefit plan by making investment decisions and arranging for an actuarial valuation.[d]
Oregon	Oregon Public Employees' Retirement System (OPERS)	5	5 appointed[e]	Managing the retirement system, including responsibilities such as arranging for actuarial services and publishing an annual report on the retirement system.

Source: Statutes, as cited below.

[a]Cal. Govt. Code § 20090 (Deering, 2007).

[b]Cal. Gov't. Code § 20120 (Deering, 2007).

[c]Mich. Comp. Laws § 38.3 (2007).

[d]Mich. Comp. Laws § 38.2 (2007). The defined contribution plan is administered and its assets invested by the state treasurer. Mich. Comp. Laws § 38.9 (2007).

[e]Or. Rev. Stat. § 238.660 (2005).

Pension boards of trustees typically serve as pension plan fiduciaries, and as fiduciaries, they usually have significant independence in terms of how they manage the funds. Boards make policy decisions within the framework of the plan's enabling statutes, which may include adopting actuarial assumptions,[34] establishing procedures for financial control and reporting, and setting investment policy. In the course of managing pension trusts, boards generally obtain the services of independent advisors, actuaries, or investment professionals.

Also, some states' pension plans have investment boards in addition to, or instead of, general oversight boards. For example, three of the four states without general oversight boards have investment boards responsible for setting investment policy. While public employees may have a broad mandate to serve all citizens, board members generally have a fiduciary duty to act solely in the interests of plan participants and beneficiaries. Likely at least partially because of this specific duty, one study of approximately 250 pension plans at the state and local level found that plans with boards overseeing them were associated with greater funding than those without boards.[35]

When state pension plans do not have a general oversight board, these responsibilities tend to be handled directly by legislators and/or senior executive officials. For example, in the state of Washington, the pension plan for general state employees is overseen by the Pension Funding Council—a six-member body whose membership, by statute, includes four state legislators.[36] The council adopts changes to economic assumptions and contribution rates for state retirement systems by majority vote. In Florida, the Florida Retirement System is not overseen by a separate independent board; instead, the pension plan is the responsibility of the State Board of Administration, composed of the governor, the chief financial officer of the state, and the state attorney general.[37] In New York, the state comptroller, appointed by the governor, serves as sole trustee

[34]Actuarial assumptions are assumptions as to the occurrence of future events affecting pension costs, such as mortality, retirement, and rates of investment earnings.

[35] Marguerite Schneider and Fariborz Damanpour, "Public Choice Economics and Public Pension Plan Funding: An Empirical Test," *Administration & Society*, vol. 34, no. 1 (2002). (For further details on this study, see the selected bibliography at the end of this report.)

[36] Wash. Rev. Code § 41.45.100 (2007).

[37] Fla. Stat. § 215.44 (2007).

and administrative head of the New York State and Local Employees' Retirement System.[38]

Laws Provide Less Protection for Retiree Health Benefits

In contrast with pensions, there are less likely to be statutory protections applicable to retiree health benefits. To the extent that any such legal protections exist, they more frequently stem from the negotiated agreements between unions and government employers. In addition, the cost of annual retiree health benefits typically have been treated as an operating expense and managed together with active employee benefits, although the benefits offered retirees may differ from those offered active employees. Despite the general absence of a fund to manage, retiree health programs frequently still have boards that help to determine the terms of the health plans to be offered.

Retiree Health Benefits Are Subject to Change

Unlike the law governing pensions, the law governing retiree health benefits for state and local government workers generally does not include the same type of explicit protections. To the extent retiree health benefits are legally protected, it is generally because they have been collectively bargained and are subject to current labor contracts.

In cases where reductions to retiree health benefits are challenged in court, the ultimate outcome depends on the specific facts and circumstances and the applicable state and/or local law in each jurisdiction. In Segal's 2006 survey of over 100 state and local plans, 62 percent of respondents said that statutory or regulatory obligations affected their ability to change retiree health coverage; 25 percent said that retiree health coverage was subject to collective bargaining; and 17 percent said that other factors affected their ability to change retiree health coverage.[39] In two recent cases, however, the courts have upheld the state's right to modify retiree health benefits (see sidebar).

Courts Uphold States Rights to Modify Retiree Health Benefits

Alaska

In 1999 and 2000, Alaska made changes in its health plan for retired state employees by improving coverage in some ways but also increasing the deductible and co-insurance, and retirees sued. The state supreme court held that plan coverage—not just a certain financial contribution—was protected under the Alaska Constitution. However, the court found that the benefits could still be modified so long as the changes resulted in equivalent coverage for the group and individuals who experienced serious hardships could retain their previous coverage. *Duncan v. Retired Pub. Emples. of Alaska, Inc.,* 71 P.3d 882 (Alaska 2003)

Michigan

In 2000, Michigan increased the co-payments and deductibles to be paid under its health plan for public school retirees, and retirees sued. The state supreme court held that retiree health benefits were not accrued financial benefits within the meaning of the Michigan Constitution and that the statute establishing the plan did not create a contractual right to such benefits. *Studier v. Mich. Pub. Sch. Emples. Ret Bd.,* 472 Mich. 642 (2005)

Source: GAO analysis of court cases, as cited.

[38] N.Y. Retire. & Soc. Sec. Law §§ 11 and 13 (Consol. 2007).

[39] Segal, *Results of the Segal Medicare Part D Survey of Public Sector Plans*. The Segal Group, Inc., New York, N.Y.: Summer 2006. (For further details on this survey, see the selected bibliography at the end of this report.)

Retiree Health Benefits Are Treated as an Operating Expense

Retiree health benefits generally have been treated by state and local governments as an operating expense for that year's costs on a pay-as-you-go basis. State and local governments typically do not set aside funds while employees are working to pay their future retiree health benefits. Moreover, retiree health benefits are mostly managed together with active employee benefits, although the actual benefits offered to retirees and to active employees may be different. In most cases, retiree health benefits are administered under the state or local employee benefit system.

Despite the general absence of a fund to manage, the administrators of retiree health benefits may still look to boards to help determine the health coverage to be offered. For example, in California, the same CalPERS board that oversees the pension fund also oversees a health care program. With respect to this health care program, the CalPERS board is responsible for selecting insurers through which participants can receive coverage.[40] The CalPERS board negotiates, for example, the specific services covered, premiums, and participant co-payments. Although many local governments participate in the CalPERS program, the City and County of San Francisco has chosen to administer its own separate program. The Health Service System (a city department) is responsible for administering the benefits for both active and retired employees, with oversight from the Health Service Board (a city board). The Health Service Board is charged with establishing rules and regulations for the Health Service System and for conducting an annual review of the costs for medical and hospital care. In Oregon, the Public Employees Benefit Board, a separate entity from OPERS, is responsible for managing the health benefits of both active and pre-Medicare-eligible retired employees, with authority to negotiate the terms of their coverage.[41]

[40] Cal. Govt Code § 22850 (Deering 2007).

[41] Or. Rev. Stat. § 238.410 (2005).

Strategies Exist to Manage Future Pension Costs, but Not to Meet Escalating Costs for Retiree Health Care

While state and local governments generally have strategies to manage future pension costs, they have not yet developed strategies to fund future health care costs for public sector retirees. We analyzed the state and local sector's fiscal outlook with respect to the sector's ability to maintain current retiree benefits—that is, the sector's ability to fund its future liabilities—from two perspectives and came to similar conclusions. First, in our simulation of the fiscal outlook for the state and local sector, we developed projections of the likely cost of pensions and retiree health benefits that already have been and will continue to be earned by employees. Our simulation shows that the additional pension contributions that state and local governments will need to make in future years to fully fund their pensions on an ongoing basis are only slightly higher than the current contribution rate. Our simulation also shows that health care costs for retirees will likely rise considerably as a component of state and local budgets, if these costs continue to be funded on a pay-as-you-go basis. Second, we analyzed data on the funded status of 126 of the nation's largest public sector retirement systems and found that with some notable exceptions, most are relatively well funded, but that long-term strategies to fund future health care costs for retirees are generally lacking.

Current Contribution Rates Are Generally on Track, but Could Still Fall Short of Future Pension Needs

Our simulation indicates that state and local governments, in aggregate, will need to make contributions to pension systems at a somewhat higher rate than in recent years in order to fully fund their pension obligations on an ongoing basis.[42] Assuming certain historical trends continue and that there is a steady level of pension contributions in the future, contribution rates would need to rise to 9.3 percent of salaries—less than a half percent more than the 9.0 percent contribution rate in 2006.

Our model is based on a variety of assumptions regarding employee contributions, future employment, retirement, wages, rates of return, pension characteristics, and other factors. For example, our analyses relate to defined benefit plans only. (For details on our assumptions and our model, see app. II.) We assume that employee contribution rates to

[42] By "ongoing basis" we mean that pension promises continue to be made to current and new employees, and that state and local hiring remains at a level such that the state-local workforce, relative to the population, remains constant. We estimated the steady level of employer contributions, relative to wages, that would need to be made in every year between 2006 and 2050 to fully fund promised pension benefits. (For further details, see app. II.)

these pension funds will remain the same, relative to wages, as in the past. We also assume that in the future, the real rate of return on pension assets will be about 5 percent, which is based on the real returns on various investment instruments over the last 40 years.

Sensitivity of Estimates to Various Future Rates of Return

Real returns on various investment instruments over the last 40 years have been about 5 percent, which is the rate of return used in our simulation. However, if future returns are lower, such as 4 percent, the necessary contribution rate would rise to 13.9 percent of salaries. Conversely, if returns are higher, such as 6 percent, the necessary contribution rate would fall by an equivalent amount—to 5.0 percent of salaries.

Some analysts believe that an analysis of this type should only consider riskless returns. Under such an approach, we would assume that all pension funds are invested in very safe financial instruments such as government bonds. If such a risk-free return were assumed, our analysis indicates that contribution rates would need to be much higher—nearly 18.6 percent of salaries.

Our findings regarding the required contribution to pension funds on an ongoing basis were, however, extremely sensitive to assumptions about the future rate of return on invested pension funds. Some economists and financial analysts have expressed concern that returns in the future may not be quite as high as those in the past. Future investment returns may not match past returns because, for example, slower labor force growth may lead to slower economic growth, which may, in turn, reduce investment returns. Also, pension managers may choose to invest in less risky, lower-return investments in the future. If future rates of return are more or less in line with historic experience, then our simulation should provide a reasonable estimate of the contribution rates that will be needed in the future. But if future rates of return decline, then contribution rates would need to be higher than 9.3 percent of salaries, as indicated by our base case simulation results. (See table 4.) Moreover, the results for individual state and local governments may vary substantially.

Table 4: GAO Simulation of the Projected Government Contribution Level Needed to Fully Fund the Liability for Pension Benefits for the State and Local Government Sector, in Aggregate

Simulation assumption for the rate of return on investment[a]	Projected government contribution level needed to fully fund the liability for pension benefits on an ongoing basis	Difference between the projected ongoing government contribution level needed and the actual contribution level in 2006 (at 9.0 percent of salaries)
Higher return scenario: 6 percent real rate of return	5.0 percent of salaries per year	- 4.0 percent of salaries per year
Base case: 5 percent real rate of return	**9.3 percent of salaries per year**	**+ 0.3 percent of salaries per year**
Lower-return scenario: 4 percent real rate of return	13.9 percent of salaries per year	+ 4.9 percent of salaries per year
Risk-free scenario: 3 percent real rate of return	18.6 percent of salaries per year	+ 9.6 percent of salaries

Source: GAO simulation. For details, see appendix II.

Note: All scenarios assume prefunded pension funds across the sector.

[a]According to NASRA's Public Fund Survey, the predominant rate of return used by states in determining their unfunded liabilities is 8 percent.

Retiree Health Care Costs Could More than Double as a Percentage of Salaries over the Next Several Decades

Our simulation indicates that projected costs for retiree health benefits, while not as large a component of state and local government budgets as pensions, will more than double as a percentage of salaries over the next several decades, if these costs continue to be funded on a pay-as-you-go basis. In 2006, these costs amounted to approximately 2.0 percent of salaries, but according to our simulation, by 2050, they will grow to 5.0 percent of salaries—a 150 percent increase. The key reason for this substantial increase is the more general rise in health care costs, which, if left unconstrained, will continue to cause costs to rise as a percentage of salaries.

As with the projections of necessary pension contributions, our estimates of retiree health benefit costs are also dependent on certain assumptions, and are particularly sensitive to assumptions about the growth in health care costs. For example, on the basis of research and discussions with experts, we assumed that health care costs would grow at a higher rate than the growth in the nation's gross domestic product (GDP).[43] If health care costs were to rise only at the same rate as GDP, then by 2050, our projected costs would grow only from 2.0 percent to 2.9 percent of salaries, instead of 5.0 percent. Also, because our model is based on data that did not incorporate possible savings attributable to the Medicare Part D drug subsidy that began in 2006, the estimates may slightly overstate retiree health costs. However, if health care costs were to rise more rapidly than they have over the past 35 years, then the cost of retiree health benefits would exceed our projected costs of 5.0 percent of salaries. (See table 5.)

[43] Through 2050, the excess cost factor we used averages 1.2 percent per year above per capita GDP growth. By way of comparison, since the early 1970s, the excess cost factor for all medical expenditures in the economy has averaged 1.4 percent per year above per capita GDP growth.

Table 5: GAO Simulation of the Projected Government Cost for Retiree Health Benefits for the State and Local Government Sector, in Aggregate

Simulation assumption for the rate of "excess cost growth" of health care above per capita GDP growth	Projected government cost for retiree health benefits in 2050	Difference between the projected contribution level needed in 2050 and the actual contribution level in 2006 (at 2.0 percent of salaries)
Lower health care cost inflation: no excess cost growth	2.9 percent of salaries	+ 0.9 percent of salaries
Base case: average of 1.4 percent excess cost growth through 2035, declining to 0.6 percent by 2050	**5.0 percent of salaries**	**+ 3.0 percent of salaries**
Higher health care cost inflation: average of 2.8 percent excess cost growth through 2035, declining to 1.2 percent by 2050	8.4 percent of salaries	+ 6.4 percent of salaries

Source: GAO simulation. For details, see appendix II.

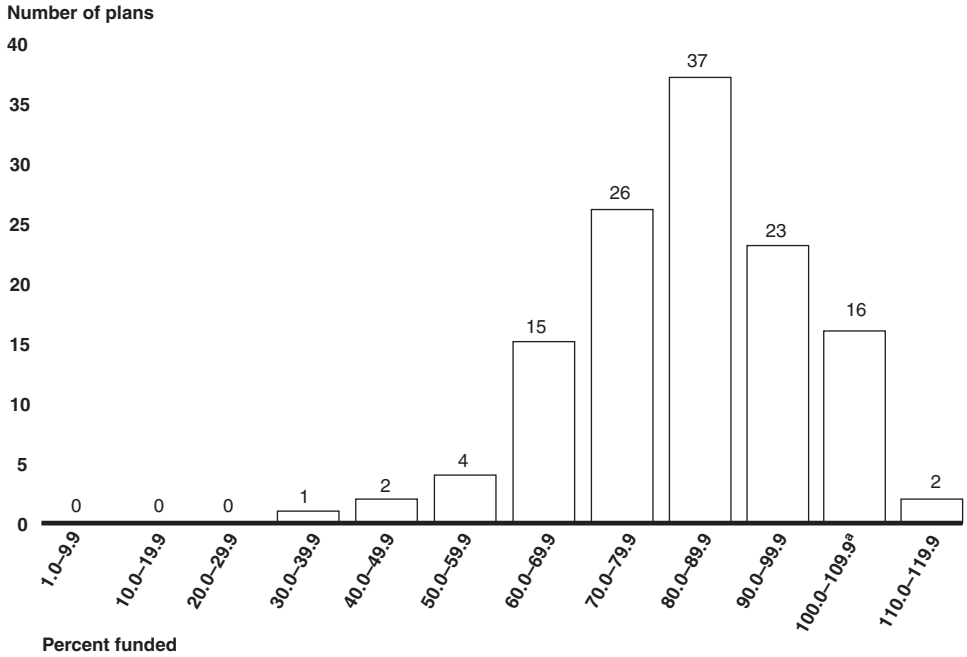
Note: All scenarios assume pay-as-you-go financing across the sector.

State and Local Governments Generally Have Strategies to Manage Costs for Their Future Pension Commitments

State and local governments typically set aside funds to finance the cost of future pension obligations and use a variety of strategies to keep the funding status of their plans on track. Funding status is a measure that captures a government's ongoing effort at one point in time to prefund its future pension liability, generally expressed as the ratio of assets to liabilities (also referred to as the funded ratio). Assessing the funding status of public sector pension plans provides a second perspective on the fiscal outlook of state and local government efforts to fund future pension benefits. According NASRA's Public Fund Survey as of 2007, the most recent reports from 126 of the largest state and local pension plans in the country indicate that over three-fifths of the plans were at least 80 percent funded—a level generally viewed as being acceptable to support future pension costs.[44] However, funding levels across the different plans ranged from about 32 to 113 percent. (See fig. 5.) Those state and local governments with plans that are funded below acceptable levels may face tough choices in the future between the need to raise taxes, cut spending, or reduce benefits in order to meet their obligations.

[44] A funded ratio of 80 percent or more is within the range that many public sector experts, union officials, and advocates view as a healthy pension system.

Figure 5: Distribution of the Funded Ratios of 126 of the Nation's Largest State and Local Defined Benefit Pension Plans



Source: GAO analysis of data from NASRA's Public Fund Survey, 2007.

Note: The Public Fund Survey updates its database continuously as new data become available. Nevertheless, as of July 2007, when we accessed the database, although most plans had reported actuarial valuations for 2005 or 2006, a small number of plans reflected earlier valuations. (For further details, see the selected bibliography at the end of this report.)

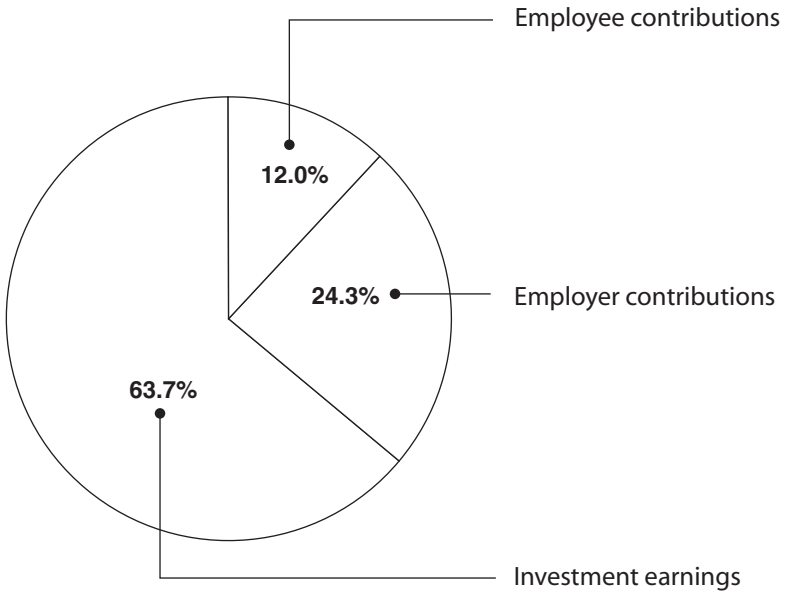
[a] Of nine plans reporting that they were 100 percent funded, eight used the aggregate cost valuation method. Under this method, the actuarial value of liabilities is equal to the actuarial value of assets and no unfunded liability is identified.

Governments Use Various Strategies to Keep Their Funding Status on Track

A primary way state and local governments keep the funding status of their pension funds on track is to make their actuarially required contributions. There are three sources of revenues for pension benefits: investment earnings, employee contributions, and employer contributions. Investment earnings provide the major source of funding (see fig. 6). The amount that employees are required to contribute is generally fixed by state statute as a percentage of salary, while state and local governments determine the level of employer contributions based on their plans' funding status—that is, the extent to which liabilities already accrued are funded. Actuaries calculate the contribution amount needed to cover the liability that accrues each year and to pay an installment on any unfunded liability. If a plan sponsor (that is, a state or local government employer) is making these actuarially required contributions, the plan can have a

funded ratio below 100 percent yet still be on track toward full actuarial funding.

Figure 6: Cumulative Percentage Distribution of Public Pension Fund Revenue Sources Nationwide, 1982 to 2005



Source: NASRA, 2007 (based on U.S. Census data).

Governments use various strategies to help them make their actuarially required pension fund contributions. One strategy that governments use to lessen the volatility of fluctuations in their actuarially required contribution is to average the value of plan assets over a number of years (referred to as "smoothing"). For example between 1999 and 2005, California's contribution rate for one of CalPERS' pension plans ranged from 1.5 percent of salaries to 17 percent of salaries. In 2005, California began using smoothing techniques, and the contribution rate over the last 2 years changed only slightly—from 15.9 percent of salaries in 2006 to an estimated 15.7 percent in 2007.

Another strategy government sponsors use to control their pension fund contribution rates is to implement new, less costly benefit levels for newly hired employees. Plan sponsors create a new "tier," with different benefits, for all employees hired after the date the new tier goes into effect. For example, New York has four tiers in its State and Local Retirement System, based on an employee's occupation and date of hire. General employees in tier 1 (hired before July 1, 1973) can retire at age 55 after 20

years of service with no reduction for early retirement. However, general employees in tier 3 (hired between July 26, 1973, and September 1, 1983) must be age 62 with 5 years of service or age 55 with 30 years of service to retire with no reduction in benefit.

In addition to creating new tiers within the same pension plan, government sponsors can also lower costs by adopting entirely new plans for future hires. For example, Alaska recently switched from its previous defined benefit plans to defined contribution plans for all general public employees and teachers hired on or after July 1, 2006. According to the state's 2006 comprehensive annual financial report, the new pension system was adopted to help stabilize contribution rates for all public employers within the state. Also, in 2003, Oregon adopted a new program with both a defined benefit and a defined contribution component as its primary plan for public employees. Under the new program, Oregon continues to provide a defined benefit funded by employer contributions (with a lower benefit formula for new employees), while the employees' contributions are now placed in individual accounts with no state matching (the defined contribution component). Oregon officials estimate that its pension reforms save public employers over $400 million per year.

Yet another strategy plan sponsors use to manage their costs is to seek higher contribution rates from its employees. For example, in 2005, Louisiana enacted legislation to raise the employee contribution rate for general state employees participating in the State Employees' Retirement System hired on or after July 1, 2006, from 7.5 to 8.0 percent.[45]

Finally, another strategy that some plan sponsors have used as part of an overall strategy for managing pension costs is to issue bonds to reduce their unfunded actuarial liabilities. If the interest rate on the bond is less than the rate of return earned on pension assets, sponsors can achieve some savings. For example, in 2005, Detroit issued $1.44 billion in bonds to pay down the unfunded accrued actuarial liabilities of its two retirement systems. Similarly, Oregon recently issued pension obligation bonds to help reduce its employer contribution rate for the Public Employees Retirement System. According to officials from Oregon's Legislative Fiscal Office, by issuing the pension bonds, they were paying a lower interest rate on the debt service for the bonds (about 5.75 percent) than they were currently earning on the bond proceeds. OPERS officials

[45] La. Rev. Stat. Ann. 11:62 (2007).

said that earnings on the bond proceeds have averaged over 15 percent over the last 4 years. However, it should be noted that issuing bonds to make the employer contribution increases the government's overall exposure to financial risks to the extent that the bond proceeds are invested in equities or highly leveraged portfolios for returns to exceed the borrowing costs. Also, if rates of return were to move lower than the bond rates, state and local governments would no longer realize an advantage to having issued the bonds, because the rate they could earn on the proceeds may no longer cover the debt service costs.

Failure to Maintain Acceptable Funding Levels May Place Future Taxpayers and/or Beneficiaries at Risk

Public pension plan funding levels are sensitive to a variety of external influences, such as the rate of return on the funds' investments, the annual stream of contributions to the fund, and changes to the levels of benefits that ultimately affect future liabilities. Although strategies are being used to keep the funding of most plans on track, we found some notable exceptions where the failure to use such strategies caused the funding status to drop significantly. Over time, state and local governments could be faced with the need to raise taxes, cut spending, or reduce benefits in order to meet their obligations.

As investment earnings are the major source of pension funding, timely payment of contributions is key to maximizing the compound interest earned. However, sometimes a combination of factors makes it difficult for state and local governments to make their actuarially required contribution, and funding levels can drop. For instance, the sharp and prolonged decline in the stock market that occurred in the early 2000s reduced the value of many plans' assets and increased the amount many states and local governments needed to contribute to remain on track toward full funding. Furthermore, to the extent state and local governments experience slower economic growth, revenues might not keep up with expenditures, making it difficult for the governments to meet their funding commitments for pensions. For example, from 2001 to 2007, Michigan's contribution rate for the State Employees' Retirement System (MSERS) dramatically increased—from 4.7 percent to 18.1 percent of payroll. During this period of slow revenue growth, Michigan used money transferred from a pension fund subaccount to supplement the amount it contributed to MSERS to make its full actuarially required contribution.

Even so, from 2002 through 2005, MSERS's funded ratio dropped steadily from 98.7 percent to 79.8 percent.[46]

In some cases, employers fell short of making their actuarially required contributions at the same time that they adopted significant increases in pension benefits for their employees, and did so for years. For example, a New Jersey state treasury department official told us that in 1997, the state viewed the status of its pension funds as "overfunded," and began substituting "excess" pension assets for their actuarially required contributions. The state skipped payments to the retirement plans over a 7-year period, totaling $8 billion. While in this "overfunded" position, the state also approved costly benefit enhancements and early retirement packages. According to the official, as a result of these enhancements and less than prudent funding arrangements, compounded by the downturn in the market conditions beginning in 2001, the funded ratios of several New Jersey pension plans fell below acceptable levels. For instance, since 1999, the funded ratio of New Jersey's Public Employees' Retirement System declined from 113.5 to 79.1 percent as of June 30, 2005. Overall, the state now faces an $18.9 billion unfunded liability for all of its retirement plans combined. Similarly, in San Diego, the city did not make its actuarially required contribution to the San Diego City Retirement System by about $80 million from 1999 through 2004. At the same time, the city increased benefits to current employees, and in a litigation settlement, increased benefits to current retirees. As of June 30, 2006, the actuarial valuation report for the system stated that the funding status had dropped from 97.3 percent in 2000 to a low of 65.8 percent in 2004, with an unfunded liability of $1.37 billion. However, as of 2006, the system had regained ground up to 79.9 percent, with an unfunded liability of about $1.0 billion.

Most State and Local Governments Have Yet to Develop Long-Term Strategies for Financing Future Health Care Costs for Retirees

Most state and local governments generally lack long-term strategies to address future health care costs. In addition, many of the governments are still in the process of responding to the new GASB statement calling for valuations of the liability for the future cost of other postemployment benefits (OPEB), including health care benefits for retirees, as the standard is being implemented in phases. Officials for the governments we

[46] When Michigan closed the defined benefit plan to new members in 1997, new actuarial methods were adopted, such as reporting investments at their fair market value rather than cost, and the funded ratio jumped from 91.5 to 109.0 percent. Since then, the funded ratio has been on a general decline.

visited said that once the valuations were completed, they would consider options for addressing these costs, if needed.

Effective Dates for Phased Implementation of GASB Statement 45 for Financial Reporting of Future OPEB Liabilities

Phase	In the first fiscal year ending after June 15, 1999, for governments with total annual revenues of	Statement effective for periods beginning after December 15
1	$100 million or more	2006
2	$10 million or more, but less than $100 million	2007
3	Less than $10 million	2008

Source: GASB.

Several funding vehicles are available under the federal tax code to help facilitate state and local government efforts to accumulate funds to meet their future health care liabilities. (See table 6.) As noted earlier, of the state and local governments that contribute to retiree health benefits, most treat the cost of the benefits as an operating expense and do not prefund the future obligation. Of the states that provide an explicit contribution to the premiums for retiree health coverage,[47] it has been reported that 13 partially prefund their future health care costs.[48] But these prefunding efforts have been slow to get started. For example, in 1989, the Connecticut Teacher's Retirement System created a Health Insurance Premium Account, using a 1 percent of salary contribution from active teachers to fund health benefits for retirees. The fund was facing insolvency by 1999. To address the shortfall, in 2004, Connecticut increased active teachers' contributions to the fund from 1 percent to 1.25 percent of salary. In Michigan, state budget officials said that they would like to prefund retiree health care benefits for state employees, but other state priorities have prevented them from doing so. However, a fund was recently set up for local employees in Michigan. In 2004, the Municipal Employees' Retirement System of Michigan created a Retiree Health Funding Vehicle to allow municipalities to contribute to a trust fund for retiree health benefits. As of September 2007, system officials reported that 55 employers were participating in the program, and that the fund had

[47] Employer-provided retiree health benefits include not only explicit employer contributions (that is, those that a government previously has identified and labeled as OPEB contributions), but also implicit employer contributions resulting from arrangements in which the age-adjusted premiums attributable to retirees exceed the contributions required from the retirees, and the employer effectively pays the difference. Thus, among those states not providing an explicit payment for a share of their retirees' health insurance premiums, some may still incur implicit costs that are to be included in their calculation of their annual costs and long-term obligations for OPEB under GASB standard 45. According to GASB, "In health insurance plans where a government's retirees and current employees are insured together as a group, the premiums paid by the retirees may be lower than they would have been if the retirees were insured separately—this is called an implicit rate subsidy." GASB adds, "Implicit rate subsidies should be included by governments . . . as OPEB."

[48] Survey conducted by Credit Suisse, Americas United States/Equity Research, 2007. (For further details on this study, see the selected bibliography at the end of this report.)

over $95 million available for retiree health care costs.[49] More recently, in March 2007, CalPERS launched the California Employers' Retiree Benefit Trust Fund, an investment vehicle that allows public employers that contract with CalPERS for employee health benefits to prefund their future OPEB costs.

Table 6: Different Vehicles for Prefunding Retiree Health Costs

Section of the Internal Revenue Code	Vehicle description
501(c)(9)	Voluntary Employees' Beneficiary Association (VEBA): A tax-advantaged exempt entity, usually a trust, for the benefit of a voluntary membership of active and retired employees, and from which tax-free distributions may be made for qualifying health care expenses of retirees.
401(h)	Health benefits subaccount: A separate subaccount of a defined benefit pension trust that allows up to 25 percent of the total employer contribution to the pension fund to be allocated to retiree health benefits. Investment income on assets in the subaccount accumulates tax free, and retiree health benefit payments made from the subaccount are not taxable to retirees.
115	Governmental trust: A trust established by a governmental employer to fund an essential government function, which may include providing retiree health benefits. Contributions to the trust are not limited, unlike contributions to a VEBA or health benefits subaccount. The investment income on the trust is not taxed, and the benefits ought to be tax free to the retiree when received, with confirmation from the Internal Revenue Service.

Source: Internal Revenue Code and Congressional Research Service, 2006.

At the sites we visited, state and local government officials we spoke with said that the rising cost of health care was one of the biggest fiscal challenges confronting them in the near term. They said the drivers of their health care costs mirror those of the nation as a whole: rapidly escalating costs for prescription drugs, medical care, and hospital care. Further, they noted that the health care industry's practice of shifting costs not paid by the Medicare and Medicaid programs to employers is causing

[49]Additionally, the Municipal Employees' Retirement System of Michigan offers a health care savings program from the same trust fund. This employer-sponsored program provides tax-favored individual medical savings accounts for tax-free reimbursement of postemployment medical expenses, including health insurance premiums. According to system officials, as of September 2007, this program had over 75 enrolled employers (representing over 2,000 employees) and about $10 million invested.

employers' costs for health insurance premiums to rise even faster. In addition to the costs associated with providing health care benefits for their active and retired workers, states also must contend with rising costs for their uninsured residents and federal changes to Medicaid. Officials who administer health benefits for California state and local governments noted that much of the cost increase for the health care market is due to health care inflation and demographic factors that are outside of their control. At the same time, with respect to health care, there are also factors that are within their control to help manage these costs, such as their program's benefit design and eligibility criteria.

Aside from prefunding through establishment of a trust, several states have taken steps to address escalating costs of retiree health benefits by negotiating lower premium costs and/or reducing benefits. For example, as in the private sector, some public employers have negotiated lower premiums by increasing the deductibles, co-payments, and coinsurance that employees must pay out of pocket. In addition, several states have introduced requirements that employees must work a certain number of years before becoming eligible for various levels of retiree health benefits. California introduced such vesting requirements for partially paid retiree health benefits for workers hired in 1985 and thereafter; and Michigan introduced similar requirements in 1997. In 2006, North Carolina enacted legislation requiring that employees hired after February 1, 2007, must have 20 years of service to be eligible for retiree health benefits.[50] Other states have reduced the benefits provided and/or instituted health savings accounts. Oregon has discontinued its retiree health care support for those hired since 2003. Also, to reduce state costs, Utah recently discontinued its policy of providing retirees a month of health insurance for every day of unused sick leave (a policy initiated when health insurance costs were substantially lower). Instead, Utah now deposits wage amounts equal to unused sick leave into health savings accounts that retirees can use to purchase their own health insurance.

Percentage of public employers indicating that they would be likely, or very likely, to take the following actions in response to GASB 45

Funding their retiree health plan	31%
Raise retiree contributions	21%
Cut other spending	9%
Raise taxes	6%
Cut retiree benefits	5%
Take no action	9%

Source: Mercer Health & Benefits LLC, 2006 (based on responses from 58 state, county, and city governments, public school boards, colleges, and universities).

State and local governments indicated that they may take a range of actions in response to the new GASB standards. At the locations we visited, all the officials we spoke with said that their governments were planning to comply with the new standards and report their liability for retiree health benefits. However, while various options were being discussed, none of the officials we spoke with said that their governments

[50] N.C. Gen. Stat. § 135-40.2(a)(2) (2007).

had developed plans to address their unfunded liabilities. In California, for example, the governor had established a 12-member Public Employee Post-Employment Benefits Commission to propose ways to address the state's growing postemployment benefits and retiree health care obligations, with a recommended plan due by January 1, 2008. According to Oregon retirement system officials, their state had also formed a workgroup to study options related to GASB 45. In Detroit, the city budget director said that city officials would wait to find out if any practices emerge that gain wide support before deciding their next steps. San Francisco is also taking a wait-and-see approach with respect to devising a strategy for dealing with the unfunded liability. A senior city official said that the city wants to have several years' experience estimating the unfunded liability to feel confident that the estimates are valid before negotiating any remedies with the unions. Otherwise, he noted, if the costs end up being greater than anticipated, it could be difficult to reopen negotiations with the unions and the city would then have to deal with the greater costs on its own.

Concluding Observations

Across the state and local government sector, the ability to maintain current levels of public sector retiree benefits will depend, in large part, on the nature and extent of the fiscal challenges these governments face in the years ahead. While public sector workers have thus far been relatively shielded from many of the changes that have occurred in the private sector, provisions that lend stability for public sector pensions and retiree health benefits are subject to change. Pension benefits are often protected by state constitutions and city charters, but these protections can be amended if voters feel the need to rebalance priorities as fiscal pressures increase. In fact, our recent work on state and local government fiscal conditions indicated that persistent fiscal challenges will likely emerge within the next decade. Retiree health benefits are generally easier to change simply through the annual budget process.

As we heard from some state officials, the impetus for changing retiree benefits often surfaces when the projected costs for these benefits starts to grow faster than expected. When this occurs, governments may eventually have little choice but to reduce future benefits or raise taxes. One way state and local governments can address unexpected gaps in funding is to prefund the promised benefits. Even though our simulation suggests that the sector as a whole is generally on track with funding its pension obligations, continued diligence will be necessary to ensure that funding is adequate in the future. When state and local governments take breaks from their regular contribution schedules, such as when

investment returns are high, they may be putting their ability to pay future retiree benefits at risk. According to our simulation for state and local governments, to ensure that they have the resources they need to meet future costs, they will have to maintain (and as a sector, increase slightly) their contributions to their pension funds. Moreover, our long-term projections indicate that if future returns turn out lower than expected, governments may need to ratchet up their contributions substantially.

The provision of retiree health benefits presents an entirely different scenario. Given that our simulations show that over the next several decades, the cost of providing health care benefits for public sector retirees will more than double as a share of salaries, state and local governments may find it difficult to maintain current benefits levels. It is clear from our model and from discussions with budget officials that health care inflation is driving these future costs. Budget officials with whom we spoke said that they will face challenges financing future health care benefits in general—including Medicaid benefits and health benefits for active government employees, not just for their retirees. As state and local governments begin to comply with GASB reporting standards, information about the future costs of the retiree health benefits will become more transparent. Policy makers, voters, and beneficiaries can use this new information to begin a debate on ways to control escalating health care costs, the appropriate level of future benefits to be provided to public sector retirees, and who should pay for them.

Agency Comments

We provided officials from the Internal Revenue Service with a draft of this report. These officials provided us with informal technical comments that we have incorporated in the report, where appropriate. In addition, we provided GASB officials and officials from the states and cities we visited with portions of the draft report that addressed aspects of the pension funds and retiree health benefit programs in their jurisdictions. They, too, provided us with comments that we incorporated in this report, where appropriate. Finally, we also benefited from comments provided by two external reviewers knowledgeable about the subject area.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to relevant congressional committees, the Acting Commissioner of Internal Revenue, and other interested parties. We will also make copies available to others

upon request. In addition, the report will be available at no charge on the GAO web site at http://www.gao.gov. If you or your staff have any questions concerning this report, please call me at (202) 512-7215. Key contributors are listed in appendix V.

Barbara D. Bovbjerg
Director, Education, Workforce, and
Income Security Issues

Appendix I: Organizations, Associations, and State and Local Agencies GAO Contacted

National Level

AARP (formerly, American Association of Retired Persons)
American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)
American Federation of State, County and Municipal Employees
American Federation of Teachers
Employee Benefit Research Institute
Fitch Ratings, credit rating firm
Governmental Accounting Standards Board
Gabriel, Roeder, Smith & Company, consulting firm
International Association of Fire Fighters
International Brotherhood of Teamsters
Lussier, Gregor, Vienna, & Associates, Inc., consulting firm
Moody's Investors Service, financial research firm
National Association of State Auditors, Comptrollers and Treasurers
National Association of State Budget Officers
National Association of State Retirement Administrators
National Conference of State Legislatures
National Conference on Public Employee Retirement Systems
National Coordinating Committee for Multiemployer Plans
National Education Association
Pew Center on the States
The Segal Company, consulting firm
Service Employees International Union
Standard & Poor's, credit rating firm

State and Local Level

California State

California Legislative Analyst's Office
California Public Employees' Retirement System
California State Controller's Office
California State Association of County Retirement Systems

California Local

Alameda County Employees' Retirement Association
Los Angeles County Employees Retirement Association
Orange County Retirement System
Sacramento County Employees' Retirement System
San Francisco Office of the Controller
San Francisco Employees' Retirement System
San Francisco Health Service System
San Joaquin County Employees' Retirement System

Michigan State	Michigan Department of Civil Service Michigan Office of the Auditor General Michigan Office of Retirement Services Michigan Office of the State Budget Michigan Senate Fiscal Agency Municipal Employees' Retirement System of Michigan
Michigan Local	Detroit Budget Department Detroit Finance Department, General Retirement System Detroit Finance Department, Policemen and Firemen Retirement System Detroit Human Resources Department Detroit City Council, Fiscal Analysis Division Detroit Office, American Federation of State, County and Municipal Employees (Council 25) Detroit Office of the Auditor General
Oregon State	Oregon, American Federation of State, County and Municipal Employees (Retirees Local 155) Oregon Department of Administrative Services, Budget and Management Division Oregon Department of Administrative Services, State Controller's Division Oregon Education Association Oregon Legislative Fiscal Office Oregon Office of the Secretary of State, Audits Division Oregon Public Employees' Benefit Board Oregon Public Employees Retirement System Oregon State Legislature, Office of the Legislative Counsel

Appendix II: Technical Background on Pension and Retiree Health Care Simulations

One of the primary costs of state and local governments is the salaries and benefits of employees, and part of those costs are the pensions and other postemployment benefits of retirees of state and local governments. This appendix provides information on the development of simulations of future pension and health care costs for retirees of state and local governments. These analyses are part of a larger GAO effort that examines the potential fiscal condition of the state and local sector for many years into the future,[1] and are an aggregate analysis of the entire state and local sector—no individual governments are examined. This appendix provides information on (1) the development of several key demographic and economic factors such as future employment, retirement, and wages for the state and local workforce that are necessary for the simulations of future pension and retiree health care costs; (2) how we project the necessary contribution rate to pension funds of state and local governments; and (3) how we project the future yearly pay-as-you-go costs of retiree health benefits.

Development of Factors for Employment, Retirement, Wages, and Benefits

Key underlying information for the pension and health care cost simulations relates to future levels of employment, retirees, and wages. In particular, to understand the postretirement promises that the sector has and will continue to make, we need to project the number of employees and retirees in each future year, as well as the dollar value of pension benefits that will be earned and the extent to which those benefits will be funded through employee contributions to pension funds.[2] These analyses relate to defined benefit plans only. We project the following key factors for each year during the simulation time frame: (1) the number of state and local government employees, (2) the state and local government real wages, (3) the number of pension beneficiaries, (4) average real benefits per beneficiary, and (5) yearly employee contributions to state and local government pension plans.

1. Steps to Project Future Employment Levels

Future growth in the number of state and local government retirees—many of whom will be entitled to pension and health care benefits—is largely driven by the size of the workforce in earlier years. To project the

[1] GAO, *State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge within the Next Decade*, GAO-07-1080SP (Washington, D.C.: July 18, 2007).

[2] The estimated cost of health care expenditures is described later in this appendix.

level of employment in each future year, we assume that state and local employment grows at the same rate as total population under the intermediate assumptions of the Old-Age and Survivors Insurance and Disability Insurance (OASDI) Trustees.[3] The implication of these assumptions is that the ratio of state and local employment to the total population remains constant.[4] The Trustees assume that population growth gradually declines from 0.8 percent during the next decade to a steady rate of 0.3 percent per year beginning in 2044. Accordingly, state and local government employment displays the same pattern in our projections. The relationship used to project total state and local government employment (*egslall*) is shown in equation 1:

$$1)\ egslall_t = egslall_{t-1}\frac{np_t}{np_{t-1}}$$

where: *np* is population in the indicated year

egslall is the number of state and local employees in the indicated year

2. Steps to Project Future State and Local Government Real Wage

The pension benefits that employees become entitled to are a function of the wages they earned during their working years. As described below, we developed a rolling average real wage index for different cohorts of workers to estimate the average real pension benefit of the recipient pool in each future year.

[3] See *The 2007 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.* Washington, D.C.: May 1, 2007, Table A2.

[4] This assumption implies that if there were no growth in the productivity of state and local workers, the output of services per person served would remain the same. As such, any increased growth in services provided per citizen hinges on the degree to which productivity in public sector services advances.

First, we assume that the real employment cost index for the state and local sector (*jecistlcr*) will grow at a rate equal to the difference between the Congressional Budget Office (CBO) assumptions for the growth in the employment cost index (ECI) for private sector wages and salaries and inflation as measured by the consumer price index for all urban consumers (CPIU), as published in the January 2007 *CBO Budget and Economic Outlook*. These data are available through 2017. For later years, we hold the growth rate constant at the rate that CBO assumes between 2016 and 2017.

CBO's assumptions for growth in the ECI and the CPIU are 3.3 percent and 2.2 percent per year respectively, implying a real wage growth of 1.1 percent per year during the simulation time frame. Since the analysis is scaled to the real wage bill over the simulation time frame, we calculate that aggregate amount for each future year. As shown in equation 2, aggregate real wages are assumed to grow at the combined rate of growth in the real employment cost index (*jecistlcr*) and employment (*egslall*).

$$2)\ gslcwageallr_t = gslcwageallr_{t-1} \frac{jecistlcr_t \cdot egslall_t}{jecistlcr_{t-1} \cdot egslall_{t-1}}$$

where: *jecistler* is the real employment cost index in a given year

gsclwageallr is the real wage bill of the state and local sector

As noted previously, population growth slows from 0.8 percent in the upcoming decade to a steady rate of 0.3 percent after 2044. Because population growth drives employment in our projections, this slowdown implies that aggregate real wage growth slows from 1.9 percent per year to a steady long-run rate of 1.4 percent.

3. Steps to Project Growth in the Number of Pension Beneficiaries

While actuaries use detailed information and assumptions regarding the age, earnings, service records, and mortality rates applicable to the entities they evaluate, information in such detail is not available for the state and local government sector as a whole. This lack of detailed data necessitated the development of a method of projecting aggregate state and local

beneficiary growth that is much simpler than the methods that actuaries employ.

The method we developed reflects the logic that each year's growth in the number of beneficiaries is linked to past growth in the number of employees. Total state and local government employment from 1929 through 2005 was obtained from the National Income and Product Accounts (NIPA) tables 6.4a, b, c, and d. The Census Bureau provided a continuous series of data on the number of state and local pension beneficiaries from 1992 through 2005 during which continuous observations were available.

Cyclical swings in the employment series were removed using a Hodrick-Prescott filter. Then, both the employment and beneficiary series were logged and first-differenced, transforming the data from levels to proportionate changes. We developed a routine that searched across 45 years of lagged employment growth to select a set of weights for the years in which past employment growth best explained a given year's growth in beneficiaries.[5] The routine included the restrictions that the weights must be non-negative and sum to 1. The method produced the relationship shown in equation 3, where beneficiaries is equal to the state and local pension benefit recipients, *eglsall* is state and local employees, and the coefficients are weights, derived from the estimation, that reflect the contribution of a particular past year's employment change in explaining a given year's change in retirees. In particular, the estimated relationship suggests that beneficiary growth in a given year is largely determined by employment growth 34, 21, 22, and 23 years prior to the given period. This pattern appears consistent with the categories of workers that the sector employs. Many fire and police positions, for example, offer faster pension accrual or early retirement due to the physical demands and risks of the work, while many other state and local workers have longer careers.

$$3)\ d\log(beneficiaries_t) = 0.56d\log(egslall_{t\text{-}34}) + 0.02d\log(egslall_{t\text{-}23}) + 0.19d\log(egslall_{t\text{-}22}) + 0.23d\log(egslall_{t\text{-}21})$$

where: beneficiaries is the number of retirees receiving pensions in the indicated year.

[5] The Excel Solver function was used to find the weights that minimized the sum of the squared residuals between actual and fitted beneficiaries.

4. Steps to Project Real Benefits per Beneficiary

While, in the long run, the average real benefit level should grow at the same rate as real wages—that is, at 1.1 percent per year—in the first decades of the projection the average real benefit will be affected by real wage changes that occurred before the projection period. Accordingly, we developed a relationship that reflects how the average real benefit level will change over time according to changes in the number and average real benefit level of three subsets of the retiree population: (1) new retirees entering the beneficiary pool, (2) new decedents leaving the pool, and (3) the majority of the previous year's retirees who continue to receive benefits during the given period. Each group's real benefit is linked to the real wage level in the average year of retirement for that group. Thus, to determine the average real benefit overall in any future year, we need weights and real wage indexes for the three groups that can be used to develop a rolling average real wage of the recipient pool in each future year.

Equation 3 above projects the percentage change in the total number of beneficiaries between two successive years, but this difference is actually composed of two elements: the percentage change in new retirees minus the percentage change in decedents. Therefore, to determine the weight for new retirees, we also need an estimate of the number of new decedents in each year. In order to estimate a "death rate," we utilize Social Security Administration data on terminated benefits[6] and total OASDI recipients, which excludes disability recipients.[7] Our estimate of the "death rate" for the forecast period is assumed to be equal to the number of terminated Social Security recipients divided by the total number of OASDI recipients in 2003 (3.67 percent). This analysis then enables a derivation of weights for each of the three groups as follows:

- weight for new retirees: the number of beneficiaries this year, less the number of beneficiaries last year who are still alive, divided by the number of beneficiaries this year ($W_{N,t}$)

[6]See *Annual Statistical Supplement to the Social Security Bulletin*, *2005* (Washington, D.C.: February, 2006), Table 6.F1: Number of benefits terminated, by type, 1940-2004.

[7] See *Annual Statistical Supplement to the Social Security Bulletin*, *2005* (Washington, D.C.: February, 2006) Table 5.A4 Number and total monthly benefits, by trust fund and type of benefit, December 1940–2004, selected years.

- weight for continuing recipients is equal to last year's beneficiaries divided by this year's beneficiaries ($w_{C,t}$)
- weight for the deceased is the death rate (3.67 percent) multiplied by last year's beneficiaries divided by this year's beneficiaries ($w_{D,t}$)

Mathematically the weights are calculated as follows:

$$4a)\ w_{N,t} = \frac{beneficiaries_t - (1-.0367)beneficiaries_{t-1}}{beneficiaries_t},\ w_{C,t} = \frac{beneficiaries_{t-1}}{beneficiaries_t},\ w_{D,t} = \frac{.0367 \cdot beneficiaries_{t-1}}{beneficiaries_t}$$

Next, we need to identify the real employment cost index that determines the real benefit level for each of these three groups. We do so by estimating the average retirement year applicable to each of the three groups. First, we assume the average retirement age is 60. We developed this estimate based on an analysis of the March Supplement to the Current Population Survey (CPS) for 2005-2006, which indicated that the average state and local government retiree had retired at 60 years of age. We also analyzed detailed data on the age distribution of OASDI recipients provided by the Office of the Actuary of the Social Security Administration. These data showed that the average age for new decedents is about 81 during the initial years of OASDI's simulations, and we thus used a 21-year lag—81 minus 60—to estimate the real wage applicable to this group. For the newly retired group, we use the current year's employment cost index. For the remaining retirees—those already retired and remaining in the group—we use information from CPS for 2005 that indicated that the average age of a retired state or local retiree was 68. Therefore, we apply an 8-year lag to the real employment cost index to determine real benefits of this group.

Using the weights shown in equation 4a and the appropriate periods' values for the real employment cost index (*jecistlcr*), the rolling average *jecistlcr* is constructed as follows:

$$4aa)\ (w_{N,t}\, jecistlcr_t + w_{C,t}\, jecistlcr_{t-8} - w_{D,t}\, jecistlcr_{t-21}) = wjecistlcrt$$

where: *wjecistlcr* is the rolling average employment cost index for retirees in year t.

This equation approximates the average employment cost index at retirement of the retiree pool in a given year. To do this we take the employment cost index 8 years prior to the given year and weight this by the portion of the total retirees in the given year who were already retired last year. We add to this a factor to account for new retirees who have a higher employment cost index because they just retired. Finally, because some of the retirees from last year have deceased, the first factor overstates the number of retirees, and therefore we subtract a factor for those who have died, weighted by the cost index 21 years ago, when, on average, this group entered retirement.

The ratio of the given year's weighted average real wage index to the previous year's weighted average real wage index should equal the ratio of the current to the previous year's average real benefit levels. Thus, as shown in equation 4b, a given year's average real benefit level grows at the same rate as the rolling index of real wages. The relationship has the desired property of capturing the effect of historical real wage growth in the initial decades of the projection before converging to a long-run average annual growth rate of 1.1 percent, which is consistent with our assumption for real wage growth. To calculate aggregate real pension benefit payments *penbenr*, the average real benefit derived using equation 4b is multiplied by the number of beneficiaries projected using equation 3.

$$4b)\ \frac{penbenr_t}{beneficiaries_t} = \frac{penbenr_{t-1}}{beneficiaries_{t-1}}\left[\frac{w_{N,t}\,jecistlcr_t + w_{C,t}\,jecistlcr_{t-8} - w_{D,t}\,jecistlcr_{t-21}}{w_{N,t-1}\,jecistlcr_{t-1} + w_{C,t-1}\,jecistlcr_{t-9} - w_{D,t-1}\,jecistlcr_{t-22}}\right]$$

5. Steps to Project Employee Contributions to Pension

Employee contributions represent an important funding source for state and local government pension plans. In 2006, for example, NIPA data indicate that employees contributed 4.7 percent of their wages and salaries to their retirement funds. To estimate future employee contributions, we simply assume that the 2006 contribution level is held constant as a share of aggregate wages (see equation 5).

$$5)\ \frac{eeconpenr_t}{gslcwageallr_t} = \frac{eeconpenr_{t-1}}{gslcwageallr_{t-1}}$$

where: *eeconpenr* is the real aggregate employee contribution to pension funds

Projections of Necessary Contributions to Pension Funds for State and Local Government Sector

The purpose of the pension simulations is to estimate the level of contribution that state and local governments would need to make each year going forward to ensure that their pension systems are fully funded on an ongoing basis. In the previous section we calculated a variety of critical demographic and economic factors that are necessary for this analysis. In the following section, we describe our basic formulation and sensitivity analysis for employer contributions to pension funds.

Basic Formulation of Necessary Steady Level of Employer Contributions

The necessary contribution rate can now be derived according to a simple concept: the present value of future pension benefits minus the sum of 2006 pension fund financial assets and the present value of employee contributions, all divided by the present value of future wages. The starting value of pension assets for state and local government pension plans—approximately $2.979 trillion in 2006—is obtained from the Federal Reserve Flow of Funds Accounts. Future wages are simulated within our model. The logic of this estimation is that the benefits that are promised to employees (including liabilities already made and promises that will be made in the future) must be paid from three sources: existing pension funds in 2006, contributions that employees will continue to make to those funds in the future, and contributions that employers will make to those funds in the future.

Our analysis estimates the steady level of employer contribution, relative to wages, that would need to be made *in every year between 2006 and 2050* to fully fund promised pension benefits. Although we are only interested in developing necessary contribution rates over the simulation time frame—that is, until 2050—we actually have to derive the contribution rate for a longer time frame in order to find the steady state level of necessary contributions. This longer time frame is required because the estimated contribution rate increases as the projection horizon increases and eventually converges in a steady state. If the projection period is of insufficient length, the steady level of contribution

is not attained and the contribution rate necessary is understated.[8] As such, all of the flows in the calculation extend 400 years into the future. We use a real rate of return on pension assets of 5.0 percent (*rpenreal*) to discount future flows when deriving present values.[9] Equation 6 shows mathematically the estimate of the employer contribution rate.

$$6)\ contributionrate = \left[\left(\sum_{i=1}^{400}\left(\frac{penbenr_i - eeconpenr_i}{(1+rpenreal)^i}\right)\right) - Assets\right] \Bigg/ \left[\sum_{i=1}^{400}\left(\frac{gslcwageallr_i}{(1+rpenreal)^i}\right)\right]$$

where: *rpenreal* is the real rate of return on pension assets

[8] Pension funds hold substantial assets, amounting to $3.0 trillion at year-end 2006. Because the calculation we make implies that all assets are used to pay benefits, the estimated contribution rate would be negative over short intervals. But, in fact, some of the assets already in the pension funds are related to liabilities that will not be paid for many years into the future. As the time horizon increases, the present value of liabilities grows relative to assets, resulting in an increase in the estimated contribution rate. When the projection horizon lengthens sufficiently, however, the contribution rate stabilizes. That is, at some point there is virtually no difference in contribution rates estimated over successively longer projection periods. A 400-year projection horizon is long enough to provide an estimated contribution rate invariant to further increases in the projection period. The result is an estimate of the contribution rate necessary to fund pension payments on a sustainable basis.

[9] When evaluating state and local government pensions, standard practice is to use a discount rate based on the expected rate of return on pension fund investments. To develop a measure of the expected pension return, we analyzed data from Flow of Funds Accounts table L.119 (State and Local Employee Government Retirement Funds.) We calculated each asset category's annual share of total fund assets and assigned a rate of return to each category. The asset groups included money-like assets (sum of checkable deposits and currency, time and savings deposits, money market mutual funds, and repurchase agreement securities), open market paper, Treasury securities, agency- and government-sponsored enterprise-backed securities, municipal securities, corporate and foreign bonds, mortgages, corporate equities, mutual fund shares, and other miscellaneous assets. Although data are available beginning in 1952 for pension fund assets, yields for all of the asset categories are only available starting in 1965. Accordingly, for each year from 1965 through 2005 we calculated the weighted average nominal return by summing the product of each asset's share and its return. Factoring out each year's CPIU increase provides an estimate of the real pension fund return. Because there has been a long-term shift in pension fund portfolios away from fixed assets toward equities, the average real return over this period is not representative of likely future returns. To find an estimated real pension yield more representative of the recent composition of retirement fund investments, we used the average asset shares during the most recent 10-year period as portfolio weights. Multiplying these 10-year weights by each asset category's average real return over the entire period from 1965 through 2005 and summing the products results in an estimated real pension return of 5.0 percent. In our base case, therefore, we use a real discount rate (*rpenreal*) of 5.0 percent to find the present value of future cash flows.

Applying this analysis, we found that in aggregate, state and local government contributions to pension funds would need to increase by less than half a percent to fund, on an ongoing basis, the pension liabilities they have and will continue to accrue. In particular, the 2006 pension contributions for the sector amounted to 9 percent of wages, and our base case estimate is that the level would need to be 9.3 percent each year to fully fund pensions.

Sensitivity Analyses of Necessary Steady Level of Employer Contributions

We altered certain of our assumptions to examine the sensitivity of our model results. We found that the model results are highly sensitive to our assumptions regarding the expected real yield. For our primary simulations, we based the expected real yield on actual returns on various investment instruments over the last 40 years as well as the disposition of the portfolio of assets held by the sector over the last 10 years. This generated a real yield of 5 percent. But some pension experts have expressed concern that returns on equities in the future may not be quite as high as those in the past. In fact, some analysts believe that an analysis of this type should consider only "riskless returns." Under such an approach we would assume that all pension funds are invested in very safe financial instruments such as government bonds. We estimated the necessary steady level of employer contributions holding all elements in the model stable except the real expected yield. In particular, we analyzed a 4 percent real yield and a 3 percent real yield—that latter of which is a reasonable proxy for a riskless rate of return. We found that if returns were only 4 percent, the necessary contribution rate would rise to 13.9 percent, and if we used a risk-free return of roughly 3 percent, the necessary contribution rates would need to be much higher—nearly 18.6 percent of wages. On the other hand, if real returns were higher than our base case level—perhaps 6 percent—the necessary contribution rate would only be only 5.0 percent, much lower than their current contribution rate.

Projections of Retiree Health Benefit Costs for State and Local Retirees

Most state and local government pay for retiree health benefits on a pay-as-you-go basis—that is, these benefits are generally not prefunded. We made projections of the pay-as-you-go cost of retiree health benefits for the sector, as a percentage of wages, in each year until 2050. To estimate the costs of retiree health benefits in future years, we made many of the same assumptions as for the pension analysis. In particular, we use the same method to develop projections of employment in the sector, the number of retirees, and the level of wages. An additional assumption for the health care analysis is that in future years, the same percentage of

retirees of state and local governments will be enrolled in health insurance through their previous employer as we observe were enrolled in 2004—the most recent year for which data were available. To develop this measure, we use data from two sources. The Census Bureau's State and Local Government Employee-Retirement System survey provided data on the total number of state and local retirees, and the Health and Human Services Department's Medical Expenditure Panel Survey provided data on state and local government retirees who are covered by prior employer-provided health insurance. On the basis of these data sources, we found that the share of retirees with health insurance is 42 percent, and we hold this constant through the simulations. From the latter data source we also obtain the most recent year state and local government spending on health care for retirees.

One of the most central assumptions we must make to estimate the pay-as-you-go health care costs for retirees in future years is the cost growth of health insurance. The cost of health care has been growing faster than gross domestic product (GDP) for many years. As such, we developed assumptions about how much faster health care costs would grow, relative to the economy, in future years. The extent to which the per person cost of health care is expected to grow beyond GDP per capita is called the "excess cost factor." We developed these estimates based on our own research and discussions with experts. In particular, we assume that the excess cost factor averages 1.4 percentage points per year through 2035, and then begins to decline, reaching 0.6 percentage points by 2050.

Using these assumptions, we develop a growth projection for the per capita costs of health care for retirees each year through 2050. The following equation shows that health care costs are assumed to grow with GDP per capita plus this excess cost factor.

7) $(retgslchlth / rethlth) = (retgslchlth(-1) / rethlth(-1)) *$

$(hlthnheexcgr) * ((gdp / np) / (gdp(-1) / np(-1)))$

where: *retgslchlth* is the aggregate health care cost for the sector

rethlth is the number of retirees with health insurance

hlthnheexcgr is the excess cost factor for health insurance

We found that the projected costs for retiree health benefits, while not a large component of state budgets, will more than double as a percentage of wages over the next several decades. In 2006, these costs amounted to approximately 2.0 percent of wages, and we project that by 2050, they will grow to nearly 5.0 percent of wages—a 150 percent increase. As with the projections of necessary pension contributions, our estimates of retiree health benefit costs are highly sensitive to certain of our assumptions. In particular, the assumptions regarding health care cost growth are critical. For example, if health costs were to only rise at the rate of GDP per capita, these costs would only grow, as a percentage of wages, from 2 percent today to 2.9 percent by 2050. Conversely, if health costs were to grow by twice the rate we assume in the base case, these costs, as a percentage of wages, would constitute 8.4 percent by 2050.[10]

[10]Because our state and local government retiree health care cost estimates are based on data that did not incorporate possible savings attributable to the Medicare Part D drug subsidy that began in 2006, the estimates may overstate retiree health slightly.

Appendix III: State and Local Government Retiree Benefit Plans in California, Michigan, and Oregon

CALIFORNIA	
State and local government workers	
Total number (2006)[a]	2,199,700
• State workers	473,500
• Local workers	1,726,200
Percentage covered by unions (2005)[b]	57.5%
Percentage participating Social Security (2004)[c]	42.0%

State and local government pension plans

Pension plans, by level of administration	Occupations covered	Number of members	Number of employers	Retiree health benefits
State-administered plans (6 total)[d]	Approximately 81% of all state and local workers statewide[e]			
(1) CalPERS Public Employees' Retirement Fund	• Safety (law enforcement, correctional officers, and firefighters) • Schools (nonteaching employees) • State industrial (non-sworn correctional employees) • Miscellaneous (all others)	1,490,172	1,545	CalPERS health care program provides coverage to state employees, retirees, and their families, by law. In addition, most local public agencies and school employers can contract to have CalPERS provide these benefits to their employees (whether or not they contract for CalPERS retirement program). As of 2006, 1,137 entities participated in the program. Health plans offered, covered benefits, monthly rates, and co-payments are determined by the CalPERS Board, which reviews health plan contracts annually. Employers make a contribution toward the member's monthly premiums, with members covering the difference between the employer's contribution and the actual premium amount. The employer contribution rate is normally established through collective bargaining agreements.
(2) CalPERS Judges' Retirement Fund • Tier I: Appointed/elected before 11/9/94 • Tier II: Appointed/elected on or after 11/9/94	• Supreme court judges • Courts of appeal judges • Superior courts judges	3,329	59	(CalPERS health care program—see above)

Pension plans, by level of administration	Occupations covered	Number of members	Number of employers	Retiree health benefits
(3) CalPERS Legislators' Retirement Fund	• State legislators (closed to legislators elected on or after 11/7/90) • Constitutional officers • Legislative statutory officers	309	1	(CalPERS health care program—see above)
(4) CalPERS Volunteer Firefighters' Award Fund	Volunteer firefighters	4,301	54	(Not eligible for CalPERS health care program)
(5) California State Teachers' Retirement System (CalSTRS)	Teachers/educators employed by • School districts • Community college districts • County offices of education • Regional occupational programs	794,812	About 1,400	According to a report from the Legislative Analyst's Office, schools and community college districts vary widely in the health benefits they provide their retirees. For example, in 2004 • 114 contracted with CalPERS for employee and retiree health coverage; • about 265 purchased coverage through 11 benefit trusts, which allow multiple districts to join together to achieve economies of scale; • 250 participate in the Self-Insured Schools of California joint powers agency, administered by Kern County; and • the remaining districts either secure health benefits on their own or do not provide these benefits.
(6) University of California Retirement Plan (UCRP)	• Senate faculty and non-faculty academics • Management/senior professional • Professional/support staff	212,154	1	The University of California offers continuation of medical, dental, and legal insurance to eligible members who elect monthly retirement income. Health and welfare benefits are not accrued or vested benefit entitlements. The University of California's contribution toward the cost of medical and dental coverage is determined by the University of California and may change or stop altogether. (If a retiree elects a lump-sum cashout, all rights to continue retiree medical, dental, and legal benefits are waived.)
Locally administered plans (55 total)[d] • 21 county • 24 city • 10 special district	Approximately 19% of all state and local workers statewide.[e]			A September 2005 survey by the California State Association of Counties found that of the 49 counties responding (of 58 total), including 8 of the 10 largest counties, 48 reported that retired employees are eligible for some type of health benefits.

Pension plans, by level of administration	Occupations covered	Number of members	Number of employers	Retiree health benefits
Locally administered example: • City and County of San Francisco	• Firefighters • Police • General (all others)	53,246	1	Retirees are entitled to continue membership in the city's Health Services System. Any premiums payable for coverage may be deducted from the retirement payment.

MICHIGAN	
State and local government workers	
Total number (2006)[a]	615,700
• State workers	170,700
• Local workers	445,000
Percentage covered by unions (2005)[b]	59.9%
Percentage participating Social Security (2004)[c]	88.0%

State and local government pension plans

Pension plans, by level of administration	Occupations covered	Number of members	Number of employers	Retiree health benefits
State-administered plans (6 total)[d]	Approximately 87% of all state and local workers statewide.[e]			
(1) Michigan State Employees Retirement System (MSERS) • Defined benefit plan: Hired before 3/31/97 • Defined contribution plan: Hired on or after 3/31/97	• State civil service employees • Executive appointed officials • Employees of the legislature and judiciary	85,772	1	Michigan's Department of Civil Service, Employee Benefits Division, administers health insurance contracts for both active and retired state employees. For those in the defined benefit retirement plan (i.e., those hired before 3/31/97), current health plan premiums are 95% state-paid for retirees under age 65, and 100% state-paid for Medicare-eligible retirees. Dental and vision premiums are 90% state-paid. For those in the defined contribution retirement plan, there is a 10-year vesting requirement with an employer contribution of 3% for each year of service, capped at 90%.

Pension plans, by level of administration	Occupations covered	Number of members	Number of employers	Retiree health benefits
(2) Michigan Public School Employees' Retirement System	Employees of • Kindergarten-through-12th-grade public school districts • Public school academies • District libraries • Tax-supported community colleges • Certain universities (7 total)	478,347	716	Retirees have the option of health coverage, which is funded on a cash disbursement basis by the employers. The system has contracted to provide the comprehensive group medical, hearing, dental, and vision coverage for retirees and beneficiaries. A significant portion of the premium is paid by the system, with the balance deducted from the monthly pension. (Pension recipients generally are eligible for fully paid master health plan coverage and 90% paid dental, vision, and hearing plan coverage.)
(3) Michigan State Police Retirement System	State police officers	4,530	1	Under the Michigan State Police Retirement Act, all retirees have the option of continuing health, dental, and vision coverage. Retirees with this coverage contribute 5%, 10%, and 10% of the monthly premium amount for the health, dental, and vision coverage, respectively. The state funds 95% of the health and 90% of the dental and vision insurance.
(4) Michigan Legislative Retirement System • Defined benefit plan: Elected before 3/31/97 • Defined contribution plan: Elected on or after 3/31/97	State legislators	351	1	Under state law, all retirees and their dependents and survivors receive health, dental, and vision insurance coverage.
(5) Michigan Judges Retirement System • Defined benefit plan: Hired before 3/31/97 • Defined contribution plan: Elected or appointed on or after 3/31/97	• State judges • Governor • Lieutenant governor • Secretary of state • Attorney general • Legislative auditor general • Constitutional court administrator	840	159	The Supreme Court Justice, Court of Appeals, or elected officials may enroll in the state health plan when they retire and their premium rate is subsidized. All other judges may enroll in the state health plan if they wish to, but they must pay the entire premium cost.
(6) Municipal Employees Retirement System (MERS)	Local government employees	65,100	685	MERS Premier Health provides group health coverage for public employers including employee and retiree medical, prescription drug, dental and vision benefits. (MERS also offers a Group Life and Disability Insurance Program.)

Pension plans, by level of administration	Occupations covered	Number of members	Number of employers	Retiree health benefits
Locally administered plans (134 total)[d] • 24 county • 101 city • 9 municipality	Approximately 13% of all state and local workers statewide[e]			
Locally administered example: • City of Detroit[f]	General city employees and those employed by • Department of Transportation • Water • Sewage • Housing • Library	21,216	1	The city will continue to pay the cost of hospitalization insurance, in accordance with collective bargaining agreements and city council resolutions in effect at the time of retirement. After age 65, if you are eligible for Medicare, the city will provide a supplement to your Medicare benefits. According to city officials, in the early 1980s, the city instituted a cost-sharing formula with general city employees and retirees for the cost of hospitalization insurance. The formula included multiple tiers reflecting various collective bargaining agreements and city council resolutions. In the last round of contract negotiations, however, the cost-sharing formula for general city employees was modified to an 80% city, 20% employee/retiree split.

OREGON	
State and local government workers	
Total number (2006)[a]	257,500
• State workers	75,000
• Local workers	182,500
Percentage covered by unions (2005)[b]	52.4%
Percentage participating Social Security (2004)[c]	91.0%

State and local government pension plans

Pension plans, by level of administration	Occupations covered	Number of members	Number of employers	Retiree health benefits
State-administered plans (1 total)[d]	Approximately 99% of all state and local workers statewide.[e]			

Pension plans, by level of administration	Occupations covered	Number of members	Number of employers	Retiree health benefits
Oregon Public Employees' Retirement System (OPERS) • Tier I: Hired before 1/1/96 • Tier II: Hired on or after 1/1/96 and before 8/29/03 • Oregon Public Service Retirement Plan: Hired on or after 8/29/03 • Judges	• State government employees • School district and community college employees • Employees of local political subdivisions (optional, but irrevocable once elected)	289,223	881	Under state law, the board contracts for medical and hospital insurance on behalf of retired members. Members and their dependents are eligible for OPERS health care coverage if the member is receiving a retirement allowance or benefit under the system.
Locally administered plans (3 total)[d] • 2 county • 1 city	Approximately 1% of all state and local workers statewide.[e]			

Sources: U.S. Bureau of Labor Statistics, U.S., Census Bureau, Bureau of National Affairs, Social Security Administration, and various state and local government 2006 comprehensive annual financial reports and other publications.

[a]U.S. Bureau of Labor Statistics Data. State and Area Employment, Hours, and Earnings. Not seasonally adjusted. State and Local Governments, 2006.

[b]Barry T. Hirsch and David A. Macpherson. *Union Membership and Earnings Data Book.* The Bureau of National Affairs, Inc., Washington, D.C.: 2006, Table 5a.

[c]Office of Research, Evaluation and Statistics, U.S. Social Security Administration. Table 1-8: Estimated Social Security Coverage of Workers with State and Local Government Employment..

[d]U.S. Census Bureau Data. State and Local Governments Employee-Retirement Systems. 2005 data file.

[e]U.S. Census Bureau. *Employee-Retirement Systems of State and Local Governments: 2002* (2002 Census of Governments, Volume 4, Number 6, GC02(4)-6) U.S. Government Printing Office, Washington, D.C.: December 2004, Table 10.

[f]As we went to press, the most recent annual report available online for the Detroit General Retirement System was for 2005.

Appendix IV: GASB Statements for Pensions and OPEB

The Governmental Accounting Standards Board (GASB) is an independent, private sector, not-for-profit organization that establishes standards of financial accounting and reporting for U.S. state and local governments. Governments and the accounting industry recognize the GASB as the official source of generally accepted accounting principles (GAAP) for state and local governments. GASB standards are intended to result in useful information for users of financial reports, and to guide and educate the public—including issuers, auditors, and users—about the implications of those financial reports. Standards relevant to state and local government retiree benefits are listed below.

Table 7: GASB Statements for Pensions and OPEB

Year issued	Statement number	Title and summary of statement
Statements for pensions		
1994	No. 25	*Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans:* Establishes financial reporting standards for defined benefit pension plans and for the notes to the financial statements of defined contribution plans of state and local governmental entities. (Effective for periods beginning after June 15, 1996.)
	No. 27	*Accounting for Pensions by State and Local Governmental Employers:* Establishes standards for the measurement, recognition, and display of pension expenditures/expense and related liabilities, assets, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. (Effective for periods beginning after June 15, 1997.)
2007	No. 50	*Pension Disclosures—an amendment of GASB Statements No. 25 and No. 27:* This statement more closely aligns the financial reporting requirements for pensions with those for OPEB and, in doing so, enhances information disclosed in notes to financial statements or presented as required supplementary information by pension plans and by employers that provide pension benefits. (Effective for periods beginning after June 15, 2007.)
Statements for other postemployment benefits (OPEB)		
2004	No. 43[a]	*Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans:* Establishes uniform financial reporting standards for OPEB plans and supersedes the interim guidance included in Statement No. 26. (Effective dates were phased in between 2005 and 2007 based on the government's total annual revenues.)
	No. 45	*Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions:* Establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. (Effective dates are being phased in between 2006 and 2008 based on the government's total annual revenues.)

Source: GASB, 2007.

[a]Statement No. 43 superseded previous statement No. 26, issued in 1994, entitled "Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans."

Appendix V: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Staff Acknowledgments

In addition to the contact named above, Bill J. Keller, Assistant Director; Amy D. Abramowitz; Joseph A. Applebaum; Susan C. Bernstein; Gregory J. Giusto; Richard S. Krashevski; Bryan G. Rogowski; Jeremy S. Schwartz; Margie K. Shields; Jacquelyn D. Stewart; Craig H. Winslow; and Walter K. Vance made important contributions to this report.

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