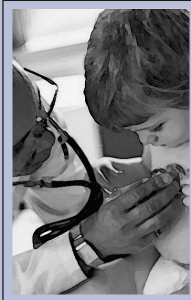
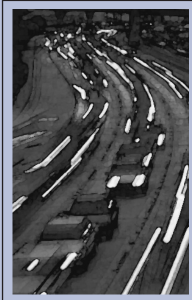
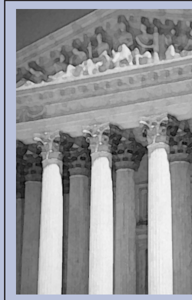
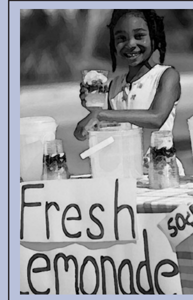

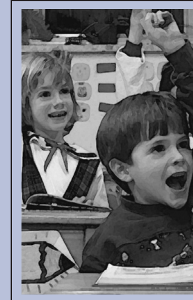

How to Save a Billion Dollars in Other Post-Employment Benefit Costs:

A Case for Shifting to a Defined Contribution Retiree Health Plan

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How to Save a Billion Dollars in Other Post-Employment Benefit Costs: A Case for Shifting to a Defined Contribution Retiree Health Plan

Introduction

This study focuses on the retiree health plan administered by the Colorado Public Employees' Retirement Association (PERA). The PERA Health Care Program is a cost sharing multiple-employer plan. The "employers" in this context are the various governments that hire most public employees, such as public school teachers, fire fighters, police officers and state employees. Under this program, PERA subsidizes a portion of the premium for health care coverage, and the retiree pays any remaining amount of that premium. The Colorado legislature created the Health Care Trust Fund in 1999 to provide state subsidies to the Health Care Program.

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

The issue has become more critical with repeated restraints being imposed on the State of Colorado's budget and the need to prioritize spending. The State government continues to promise public employees that the retiree health care benefit will be part of their total remuneration. As the predicted shortfall in funding for the retiree health plan materializes, taxpayers will be on the hook to make up the funding deficiency.

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

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

PERA's Retiree Health Plan

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

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

Table 1. Health Care Trust Fund Schedule of Funding Progress (dollars in millions)

	2008	2007	2006	2005	2004	2003
Actuarial value of assets	255.6	258.8	214.8	191.3	166.6	160.4
Actuarial accrued liability	1368.6	1303.6	1248.0	1116.6	1102.6	897.5
Total unfunded actuarial						
Accrued liability	1112.7	1044.8	1033.1	925.4	936.0	737.0
Funded ratio (percent)	18.7	19.9	17.2	17.1	15.1	17.9

Source: 2009 Comprehensive Annual Financial Report

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

Table 2. Health Care Trust Fund Additions and Deductions (dollars in millions)

		2008	2007	2006	2005	2004	2003
Additions							
Employer contributions		72.6	68.5	64.5	61.2	60.5	64.4
Employee contributions		102.6	96.3	85.7	62.9	59.5	55.7
Medicare retire							
Drug subsidy		13.7	12.4	12.5			
Investment income (loss)		-72.4	23.9	30.9	17.7	23.1	33.4
Other		12.8	12.5	13.0	13.6	16.1	2.1
Total additions		129.4	213.6	206.6	155.3	159.2	155.7
Deductions							
Benefit payments		196.8	159.9	164.8	135.6	130.9	120.8
Administrative expenses		11.8	11.1	8.1	8.2	6.6	6.2
Total deductions		208.6	171.0	172.9	143.8	137.6	127.0
Changes in net assets		-79.2	42.6	33.7	11.6	21.6	28.7
Net assets		190.2	269.4	226.9	193.1	181.6	160.0

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

The shortfall was also the result of an investment loss for the Trust Fund equal to $72 million. As a result of this decrease in the value of assets in the Fund, net assets fell 42 percent from $269 million to $190 million. Even with recovery in the stock market, the prospects are for continued volatility and deterioration in the funding status of the Health Care Trust Fund.

Even with recovery in the stock market, the prospects are for continued volatility and deterioration in the funding status of the Health Care Trust Fund.

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

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

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

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

Because PERA assumes an unrealistically high rate of return on assets, it engages in a risky investment strategy, with 70 percent or more of assets in equities. The best economic analysis projects that such pension and retiree

health plans will continue to experience volatility and deterioration in funding status in future years. A recent study projects that many of these funds will exhaust their assets and go bankrupt over the next two decades (Rauh, 2010).

The Case for a Defined Contribution Retiree Health Plan

Most private-sector employers now either have eliminated defined benefit retiree health plans, or have replaced them with defined contribution plans (Fronstin, 2010). While most state and local governments have not eliminated health plans for their retirees, they have enacted a number of reforms to reduce the cost of those plans, including replacing defined benefit plans with defined contribution plans.

A defined benefit plan specifies the amount of benefits provided either as a dollar amount, or as a percentage of health insurance premiums paid by the government.

Abstracting from the complex health insurance plans offered to retirees, we can identify plans in which the employer contracts to cover most of the cost of the health insurance premium as defined-benefit plans. In a defined-benefit plan the state is exposed to the risk of high and volatile levels of health care costs. This exposure makes it difficult for the state to project the unfunded liabilities that will be incurred by the plans, and to fund those liabilities.

There are several flaws in the design of public sector defined benefit plans. One flaw is assumptions regarding health care costs. These government plans continue to assume a rate of inflation in the cost of health service far below the actual rate of inflation. Health care costs have been increasing at double-digit rates in recent years, and there is no reason to assume that they will increase less rapidly in future years. This observation is especially true considering the new federal health legislation that will significantly increase demand for health care services, while restricting the supply.

These government plans continue to assume a rate of inflation in the cost of health service far below the actual rate of inflation.

Another flaw in public sector defined benefit plans consists of unrealistic assumptions regarding the rate of return on assets accumulated in the plans. Most of the plans assume a rate of return of 8.0 percent or more. In some states the assets in retirement health plans are combined with assets in pension plans. During the current recession the assets in such plans have fallen dramatically, and have yet to recover to pre-recession levels. Over the past decade the rate of return on assets has been zero or negative. The best economic analysis projects that the long-run rate of return on these assets is likely to be half or less than the 8.0 percent assumed rate of return (Novy-Marx and Rauh, 2009a, 2009b, 2010). Because the plans assume an unrealistic rate of return, they engage in risky investment strategies with a high share of the portfolio in equities. As a result, the plans are projected to continue to experience volatility and deterioration in funding status in the long run (Rauh, 2010).

With a defined benefit health package, retirees are more likely to end up in an expensive plan, with the state picking up most of the cost.

The fatal flaw in defined benefit retiree health plans in the public sector is moral hazard. The reality is that politicians have promised retiree health benefits for which they cannot pay. They offer public sector retirees generous health benefits as an alternative to better compensation because the cost of retiree health benefits is deferred to future generations. Public sector employee unions encourage this approach because it is less likely to generate taxpayer resistance than higher compensation, which must be funded from current revenue. Only with the transparency created by GASB rules are taxpayers more aware of the magnitude of unfunded liabilities accumulating in these plans. It is increasingly clear that defined benefit retiree health plans in many states are not sustainable in the long run.

With a defined benefit health package, retirees are more likely to end up in an expensive plan, with the state picking up most of the cost. For example, actuarial reports for Missouri and Louisiana reveal they have the highest premium cost for retiree health insurance—ranging from $1,668 to $1,692 per month in Missouri and $934 to $1,012 per month in Louisiana. These states' premium costs are about double the premium costs for health insurance offered by other states in the sample. In both Missouri and Louisiana, the state covers most of the cost of the health insurance premium. When the employer

covers most of the premium cost, it is not surprising that retirees end up with very expensive health insurance (Poulson and Hall, 2010).

A recent federal Government Accounting Office (GAO) study reports that some governments have shifted from defined benefit retiree health plans to defined contribution plans (GAO, 2009). The basic principle underlying a defined contribution health plan is similar to that for a defined contribution pension plan. Instead of a promise to cover all or most of the cost of health insurance, the state contracts to make a contribution toward that cost. The contribution may take different forms. Most often, it is a contract to pay a dollar amount toward the health care premium. The amount may be specified in absolute dollars, or relative to the years of service. In some cases the amount is linked to funds the employee has accumulated in sick leave, disability, or other accounts.

Idaho retirees have a pay-as-you-go health insurance plan; no assets are set aside to pay for future liabilities.

The GAO study reports some governments have reduced the amount or percentage of health insurance premium paid for by the government. In effect, this reform can convert the retiree health plan into a defined contribution plan to the extent that employees are expected to pay for most of the cost of health insurance. The effect is to shift the cost of rising health insurance premiums to retirees. In most states the share of premium contributions paid for by employees has increased.

The rationale for a defined contribution health plan for retirees is clear. The employer limits unfunded liabilities by minimizing the risk of high and volatile health care cost inflation. The State is then better able to project unfunded liabilities and fund liabilities to meet GASB standards, while motivating beneficiaries to economize. In states with defined contribution health plans for retirees, the premium cost is generally less than $500 per month (Poulson and Hall, 2010). This fact suggests that when employees must cover more of the premium cost, they tend to choose lower cost plans. Among the most successful of these reforms is the plan enacted in Idaho.

The Idaho Defined Contribution Retiree Health Plan

In 2009 the Idaho legislature faced skyrocketing state retiree health insurance costs. In the 2008 Comprehensive Annual Financial Report (CAFR), unfunded liabilities in the retiree health plan were estimated at $353 million. Legislative staff projected unfunded liabilities would escalate to $515 million by 2010, and $810 million by 2016 (Lake, 2009).

States with defined contribution retiree health plans, such as Idaho, have lower premium costs compared to states with defined benefit retiree health plans.

The 2008 CAFR also estimated the annual required contribution (ARC) to the retiree health plan at $33 million. The actual contribution to the plan that year was $8 million, resulting in a further increase in unfunded liabilities in the plan of $25 million. The actual contribution was only 23.5 percent of the required contribution to meet GASB standards. Like many states Idaho was not meeting the promises made to retirees in their health plan.

Idaho retirees have a pay-as-you-go health insurance plan; no assets are set aside to pay for future liabilities. State employees who retire and are eligible may purchase retiree health insurance for themselves and their dependents. Retirees eligible for health insurance pay the majority of the premium cost; however, these costs are subsidized by the active employee plan.

In 2009, faced with revenue shortfalls and tighter budgets, Idaho enacted a successful reform of the defined contribution retiree health plan (Legislature of the State of Idaho, 2009). House Bill 173 required the Department of Administration to develop a plan or plans for health insurance for active employees and retirees. Retirees were pooled with active employees for rating purposes.

The Bill clarified the plan's administrative structure. The Department of Administration was required to form an advisory committee comprising members from all branches of government, including an active and retired employee. This arrangement brought the design and implementation of the health insurance plan within the purview of the executive branch of government.

The Bill increased the share of the health insurance premium paid for by retirees. At that time the retiree plan members contributed 65.7 percent of the premium cost; while employers contributed 34.3 percent of the cost. The bill set an absolute dollar amount that employers were required to contribute to the health insurance premium. Beginning in July 1, 2009, an eligible retiree receives $155 per month or $1,860 per year toward his premium for health insurance.

As a result of this reform, in fiscal year 2009 retiree plan members contributed 83.3 percent of the total premium cost, while employers contributed the remaining 16.7 percent. The employer cost was financed from a charge per state employee. The Bill reduced that charge from $32.83 per month to $26.00 (Comprehensive Annual Financial Report, State of Idaho 2009).

The reform introduced in Idaho also restricted eligibility for the state-sponsored health insurance plan for retirees.

Idaho's defined contribution retiree health plan creates an incentive to reduce premium cost for health insurance because retirees bear most of the cost. States with defined contribution retiree health plans, such as Idaho, have lower premium costs compared to states with defined benefit retiree health plans. When this reform was introduced in Idaho, the premium for health insurance for non-Medicaid eligible retirees was between $383 and $480 per month.

The reform introduced in Idaho also restricted eligibility for the state-sponsored health insurance plan for retirees. Prior to this reform, state employees eligible for Medicaid were also eligible for state-sponsored health insurance. The reform restricted eligibility for the state-sponsored plan to retirees not eligible for Medicaid beginning in 2010. A non-Medicaid eligible spouse can receive the subsidy for state-sponsored health insurance until they become eligible for Medicaid.

The reform set stricter requirements for an employee to be eligible for the state sponsored health insurance plan. The employee must:

Have been an active employee on or before June 30, 2009; Be eligible for a retirement benefit from a public employee retirement service or a retirement service for education with at least 20,800 hours of credited state service; and Retire directly from state service.

The reform eliminated eligibility for the state-sponsored retiree health plan for employees with previous state employment who retire from another employer. State employees who are rehired are eligible for the state-sponsored plan only if they have 10 years of previous credit state service prior to June 30, 2009, accumulate an additional three years of creditable service, and are otherwise eligible.

Only employees with significant state service prior to June 30, 2009, will continue to receive the state subsidy. If employees leave state service for other employment they lose their eligibility. In effect, the reform closes the state-sponsored health insurance plan to state employees with less than 10 years of service prior to June 30, 2009, and to all new employees.

The 2009 CAFR reveals that reforms in the retiree health plan have significantly reduced annual Other Post-Employment Benefit (OPEB) cost.

Table 3. Annual OPEB Cost of the Retiree Health Plan 2009 (dollars in thousands)

Annual required contribution (ARC)	$3,272
Interest on net OPEB obligation	1,139
Adjustment to ARC	(1,560)
Annual OPEB cost	2,851

Table 4. Comparison of annual OPEB Cost, Contributions, and Net OPEB Obligation in the Idaho Retiree health Plan : 2008 and 2009

Year	(1) Annual OPEB Cost	(2) Actual Contribution	(3) Percent Contributed (2)/(1)	(4) Increase in Net OPEB Obligation (1)-(2)	(5) Net OPEB Obligation
2008	$33,311	$7,828	23.5%	$25,483	$25,476
2009	2,851	3,165	111.0	(314)	25,162

Source: Comprehensive Annual Financial Report, State of Idaho 2009)

The annual required contribution (ARC) into the retiree health plan was reduced by $1.56 million. As a result the annual OPEB cost was reduced from $33.3 million in 2008 to $2.85 million in 2009.

In 2008 the actual contribution to the retirement plan was $7,828,000, which was only 23.7 percent of the annual OPEB cost. The net OPEB obligation increased by $25,483,000 in that year.

In 2009, after the reform of the retiree health plan, the actual contribution to the plan was $3.17 million, or 111 percent of the annual OPEB cost. The net OPEB obligation was reduced by $314 million.

Table 5. Other Post Employment Benefits: Schedule of Funding Progress in the Retiree Health Plan (dollars in thousands)

Actuarial Valuation Date	(1) Actuarial Value of Assets	(2) Actuarial Accrued Liability	(3) Unfunded Actuarial Accrued Liability (2)-(1)	(4) Funded Ratios (1)/(2)
7/1/2006	$0	$353,159	$353,159	0%
7/1/2008	$0	21,603	21,603	0

Source: Comprehensive Annual Financial Report, State of Idaho 2009)

The Idaho reform significantly reduced unfunded liabilities in the retiree health plan. Estimates of unfunded liabilities reflect the impact of the reforms over the entire actuarial time period. As of the actuarial date July 1, 2006, the unfunded liabilities were estimated at $353 million. Reflecting the impact of the reforms, the most recent estimate of unfunded liabilities, for actuarial date July 1, 2008, which reflects the impact of these reforms, was $21 million (Comprehensive Annual Financial Report, State of Idaho 2009).

No assets have been set aside to pay for liabilities in the Idaho plan. Idaho continues to finance the retiree health plan on a pay-as-you-go basis. The reduction in unfunded liabilities is due entirely to the reforms introduced in the defined contribution plan.

A Defined Contribution Retiree Health Plan for Colorado

Colorado should seek to adopt a defined benefit retiree health plan similar to that enacted in Idaho. Such a reform would require a restructuring of the administration of the current plan. The Health Care Trust Fund is now administered by PERA, which has a quasi-independent status in the Colorado government. The proposed reform would require that the Health Care Trust Fund and the administration of the retiree health plan be brought within the purview of the executive branch of government, much as Idaho has done. This transfer would provide the legal basis for reform, and the oversight and accountability required to administer the plan.

The proposed reform would replace the current retiree health plan with a defined contribution plan similar to that in Idaho. The reform would reduce the dollar amount employers are required to contribute to the retiree health plan. Currently, PERA subsidizes a portion of the monthly premium for health insurance. The subsidy is $230 per month for benefit recipients who are under the age of 65 and ineligible for Medicare. Setting the maximum amount of the subsidy per benefit recipient at $155 per month would reduce the cost of health insurance to employers by almost half (Comprehensive Annual Financial Report, State of Colorado, 2009).

Setting the maximum amount of the subsidy per benefit recipient at $155 per month would reduce the cost of health insurance to employers by almost half (Comprehensive Annual Financial Report, State of Colorado, 2009).

Colorado also could restrict eligibility for retiree health insurance as Idaho has done. Current retirees eligible for Medicare also are covered by PERA's retiree health plan. The subsidy is $115 per month for Medicare eligible retirees. Limiting eligibility in the defined contribution plan to retirees under the age of 65 who are not eligible for Medicare would eliminate that cost to employers (Comprehensive Annual Financial Report, State of Colorado, 2009).

Colorado could restrict eligibility for the defined contribution retiree health plan to employees with a minimum of 10 years of service. The maximum contribution could be limited to employees with 20 years of service, subject to a 10 percent reduction for each year of service less than 20 years. Currently, the maximum subsidy is paid to employees with 20 years of service, and is subject to a reduction of 5.0 percent for each year fewer than 20 (Comprehensive Annual Financial Report, State of Colorado, 2009).

Eligibility for the defined contribution retiree health plan could be limited to employees who retire directly from government service. To be eligible, rehired employees

would have to have 10 years of prior service and accumulate an additional three years of service after they are rehired. The retiree health plan would be closed to new employees.

Budgetary Impact of a Defined Contribution Retiree Health Plan

The impact of the proposed reform on the Colorado budget would reflect many factors, including the response of retirees and employers to the new incentives created by the plan. Since the proposed defined contribution retiree health plan is modeled after that in Idaho, we would expect a similar impact on the Colorado budget.

The proposed reform would have both short-term and long-term impacts on the Colorado budget. The reform immediately would reduce the amount employers are required to contribute to the plan. The reform would reduce the employer required contribution by an estimated 59 percent, from $72.6 million to $29.0 million. The employer share of the total contribution would fall from 41.1 percent to 17.0 percent. The employee share would increase from 58.6 percent to 83.0 percent.

The proposed reform would have both short-term and long-term impacts on the Colorado budget.

With the defined contribution retiree health plan in place, the state contribution to the plan could be reduced significantly. Currently, the state contributes 1.02 percent of gross covered wages to the Health Care Trust. In fiscal year 2008-09 the state contributed $24.6 million. Assuming the state shares in the cost saving proportionately with employers, the annual state contribution to the plan could be reduced 59 percent to $10.1 million. Thus the immediate annual budget saving to the state from this reform is $14.5 million.

More important than the immediate budgetary impact is the long-run savings that would result from the proposed defined contribution retiree health plan. It is difficult to estimate long-term savings because of the dynamic response of employees and employers to the new incentives created by this reform. For example, when employees assume most of the cost we expect them to purchase less costly health insurance plans.
Savings from the reform would help to relieve the pressure on the state budget. Rather than just assuming taxpayers must pay higher taxes to fund an unrealistic level of benefits, it will free up overhead spending on personnel for high priority services to Colorado's citizens.
The proposed reform significantly would reduce the long-term cost of the retiree health plan to the government. The savings estimate above would be captured over the actuarial life of the plan. Following a similar reform, Idaho's actuarial accrued liabilities reduced dramatically. Colorado could expect a similar reduction in liabilities in the proposed retiree health plan. Most importantly, Colorado would be able to pay all of these liabilities over the 30-year amortization period required by GASB standards. Colorado could eliminate $1 billion in actuarial accrued liabilities in the current retiree health plan.

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The Honorable Phil Hart has represented the 3rd Legislative District (Coeur d'Alene) in the Idaho Legislature for six years. He currently is a member of the Revenue and Taxation Committee, which had oversight of the pension reform discussed here. He works as a licensed civil and structural engineer. In addition to his education in Engineering from the University of Utah, Mr. Hart holds an MBA in Finance from the University of Pennsylvania's Wharton School of Business.

The Honorable Mark Hillman was twice elected to the Colorado State Senate, where he was elevated by his peers to Majority Leader. He was appointed to a vacancy to serve for a year as the Colorado State Treasurer, and in that capacity served on the Board of Trustees of the Public Employees Retirement Association. Mr. Hillman is a wheat farmer and raises horses and cattle in Burlington. His first career was in journalism; he has been published in the Wall Street Journal, Rocky Mountain News, Denver Post, HYPERLINK Townhall.com and numerous other publications.

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