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The Next Retirement Time Bomb

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SINCE 1983, the city of Duluth, Minn., has been promising free lifetime health care to all of its retired workers, their spouses and their children up to age 26. No one really knew how much it would cost. Three years ago, the city decided to find out.

It took an actuary about three months to identify all the past and current city workers who qualified for the benefits. She tallied their data by age, sex, previous insurance claims and other factors. Then she estimated how much it would cost to provide free lifetime care to such a group.

The total came to about \$178 million, or more than double the city's operating budget. And the bill was growing.

"Then we knew we were looking down the barrel of a pretty high-caliber weapon," said Gary Meier, Duluth's human resources manager, who attended the meeting where the actuary presented her findings.

Mayor Herb Bergson was more direct. "We can't pay for it," he said in a recent interview. "The city isn't going to function because it's just going to be in the health care business."

Duluth's doleful discovery is about to be repeated across the country. Thousands of government bodies, including states, cities, towns, school districts and water authorities, are in for the same kind of shock in the next year or so. For years, governments have been promising generous medical benefits to millions of schoolteachers, firefighters and other employees when they retire, yet experts say that virtually none of these governments have kept track of the mounting price tag. The usual practice is to budget for health care a year at a time, and to leave the rest for the future.

Off the government balance sheets - out of sight and out of mind - those obligations have been ballooning as health care costs have spiraled and as the baby-boom generation has approached retirement. And now the accounting rulemaker for the public sector, the Governmental Accounting Standards Board, says it is time for every government to do what Duluth has done: to come to grips with the total value of its promises, and to report it to their taxpayers and bondholders.

The board has issued a new accounting rule that will take effect in less than two years. It has not yet drawn much attention outside specialists' circles, but it threatens to propel radical cutbacks for government retirees and to open the way for powerful economic and social repercussions. Some experts are warning of tax increases, or of an eventual decline in the quality of public services. States, cities and agencies that do not move quickly enough may see their credit ratings fall. In the worst instances, a city might even be forced into bankruptcy if it could not deliver on its promises to retirees.

"It's not going to be pretty, and it's not the fault of the workers," said Mayor Bergson, himself a former police officer from Duluth's sister city of Superior, Wis. "The people here who've retired did earn their benefits."

The new accounting rule is to be phased in over three years, with all 50 states and hundreds of large cities and counties required to comply first. Those governments are beginning to do the necessary research to determine the current costs and the future obligations of their longstanding promises to help pay for retirees' health care. Local health plans vary widely and have to be analyzed one by one. No one is sure what the total will be, only that it will be big.

Stephen T. McElhaney, an actuary and principal at Mercer Human Resources, a benefits consulting firm that advises states and local governments, estimated that the national total could be \$1 trillion. "This is a huge liability," said Jan Lazar, an independent benefits consultant in Lansing, Mich. "If anybody understands it, they'll freak out."

Last spring, the state of Alaska was the scene of a showdown over retirement benefits that those involved said was a precursor of fights to come. Conservative lawmakers who supported scaling back traditional retiree health care and pension benefits squared off against union lobbyists, advocates for the elderly and the schools superintendent of Juneau, the state capital, who defended the current benefits.

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The Next Retirement Time Bomb

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After saying that Alaska's future combined obligations for pensions and retiree health care were underfunded by \$5.7 billion, Gov. Frank H. Murkowski called a special session of the Legislature and pushed through changes in pension and retirement health care benefits for new state employees. (The state Constitution forbids changing the benefits of current employees.)

Instead of having comprehensive, subsidized medical coverage, new public workers will have a high-deductible plan and health savings accounts. The changes cleared the State Senate and passed by a one-vote margin in the House.

Even the White House weighed in on the Alaska problem. Ruben Barrales, President Bush's director of intergovernmental affairs, lobbied wavering Republican legislators, arguing in favor of replacing pensions and traditional retiree health benefits with private savings accounts for new employees. Mr. Barrales noted that the president was seeking similar changes in Social

Security, including a plan for private accounts.

The union that represents state employees in Alaska said the narrower benefits would make it harder to recruit qualified teachers and government workers. "They keep chiseling away" at school employees' pay and benefits, said Julia Black, a single mother and union activist who earns \$11 an hour as an aide in classes for disabled children in Juneau.

Actuaries say that about 5.5 million retired public employees have health benefits of some kind - and accountants joke that there are not enough actuaries in the country to do all the calculations necessary to estimate how much all these retirees have been promised.

Though it may seem strange after a decade of double-digit health cost inflation, hardly any public agencies have been tracking their programs' total costs, which must be paid out over many years. The promises seemed reasonable when they were initially made, officials say.

In Duluth, Mayor Bergson said the city actually offered free retiree health care as a cost-cutting measure back in 1983. At the time, Duluth was trying to get rid of another ballooning obligation to city workers: the value of unused sick leave and vacation days. Public workers then were in the habit of saving up this time over the course of their careers and cashing it in for a big payout upon retirement. Compared with the big obligations the city had to book for that unused time, substituting free retiree health care seemed cheap. "Basically, they traded one problem for another," Mayor Bergson said.

WITH some exceptions, most states and cities have set aside no money to pay for retiree medical benefits. Instead, they use the pay-as-you-go system - paying for former employees out of current revenue. Agencies did not have to estimate the total size of their commitment to retiree health care, so few did so.

Under the new accounting rule, local governments will still not have to set aside any money for those promises. But they will be required to lay out a theoretical framework for the funding of retiree health plans over the next 30 years, and to disclose what they are doing about it. If they fail to put money behind their promises to retirees, they may feel the unforgiving discipline of the financial markets. Their credit ratings may go down, making it harder and more expensive to sell bonds or otherwise borrow money.

Parry Young, a public finance director at Standard & Poor's, the credit rating agency, said his analysts look at total liabilities, including pension and now other "post-employment" obligations. Many governments, he added, have already been grappling with big deficits in their employee pension funds.

A few agencies are wrestling with the daunting task of estimating their total retiree health obligations and coming up with a way to slice it into a 30-year funding plan. They are finding that under the new method, the benefit costs for a particular year can be anywhere from 2 to 20 times the pay-as-you-go costs they have been showing on their books.

Maryland, for example, now spends about \$311 million annually on retiree health premiums. But when that state calculated the value of the retirement benefits it has promised to current employees, the total was \$20.4 billion. And the yearly cost will jump to \$1.9 billion under the new rule, according to an analysis for the state by actuaries at [Aon Consulting](#), which advises companies on benefits.

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That is because Maryland would not be recording just its insurance premiums as the year's expense, but instead would report the value of the coverage its employees have earned in that year as well as a portion of the \$20.4 billion they amassed in the past. After 30 years, the entire \$20.4 billion should be accounted for.

Michigan says it has made unfunded promises that are now valued at \$17 billion for teachers, part of a possible \$30 billion total for all public agency retirees. Other places that have done the math include the state of Alabama; the city of Arlington, Tex.; and the Los Angeles Unified School District. New York City has not yet completed an actuarial valuation of its many retiree benefit plans. But in its most recent financial statements, the city said it expected that the new rule would "result in significant additional expenses and liabilities being recorded" in the future.

The numbers can vary wildly by locality, depending on how rich its benefits are, what assumptions its actuary uses about future demographics and investment earnings, and that great unknown: the cost of health care 30 years in the future.

"Fifteen years ago, who would have projected 10 years of double-digit increases in health care costs?" said Frederick H. Nesbitt, executive director of the National Conference on Public Employee Retirement Systems, an advocacy group in Washington. Mr. Nesbitt pointed out that when the accounting rulemakers began requiring a similar change in financial reporting for companies in the 1990's, it was followed by a sharp decline in the retiree medical benefits provided by corporate America.

Today, only one in 20 companies still offers retiree benefits, according to Don Rueckert Jr., an Aon actuary. The rate for large companies is less than one in three, down from more than 40 percent before the private-sector accounting change, according to Mercer Human Resource Consulting. [General Motors](#) and Ford are among the big companies that still offer retiree health benefits. But G.M. recently persuaded the United Automobile Workers union to accept certain reductions, and Ford is seeking similar cuts.

"We expect the same thing in the public sector, unless we help employers do the right thing," said John Abraham, deputy research director for the American Federation of Teachers.

The Governmental Accounting Standards Board, known by the acronym GASB (pronounced GAZ-bee), is a nonprofit organization based in Norwalk, Conn., and a sister to the Financial Accounting Standards Board that writes accounting rules for the private sector. Karl Johnson, the project manager for the retiree-benefits rule, said GASB began hearing from public employees' unions as soon as it issued a first draft of its new standard. The unions said that if governments were forced to disclose the cost of their plans, they would probably cut or drop them, just as companies have done.

Mr. Johnson said the accounting board had no interest in trying to reduce anyone's benefits, and no power to dictate local policy even if it wanted to. "Accounting is just trying to hold up a good mirror to what's happening," he said. "These are very expensive benefits."

Under the new rule - outlined in the board's Statement No. 45 in June 2004, and known widely as GASB 45 - large public governments and school boards with large health care obligations to retirees will have to start reporting their overall benefits cost in 2007 - either on Jan. 1 of that year or, for most big governments, on the start of the fiscal year beginning June 1, 2007. Smaller governments will start using the new method in the two years after that.

The change comes at a rough time for state and local governments. Spending on Medicaid and education has been spiraling, and Congress continues to cut federal taxes and shift burdens of governing away from Washington. In some areas, including parts of Michigan, governments are also suffering from the financial difficulties of important local industries. Max B. Sawicky, an economist at the Economic Policy Institute, a liberal research group in Washington, called the new requirement "another straw on the camel's back" for state and local governments already straining under their budget burdens.

Mr. Johnson said the accounting board had tried to issue the retiree health care rule 10 years ago, when the economic picture was rosier. It did succeed then in issuing an accounting standard for government pension plans, but before it could turn to the related issue of retiree health care, other urgent accounting issues crowded onto its agenda. The board finally cleared its decks and voted to address retiree benefits in 1999. Coming up with the new methodology took five years.

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Now that it is here, "the general sense in the marketplace is that GASB 45 is going to lead to a watershed in public-sector health benefits," said Dallas L. Salisbury, president of the Employee Benefit Research Institute, a nonpartisan research center in Washington.

Indeed, the handful of states and cities that have already calculated their obligations to retirees have concluded they must also rein in the costs. Michigan, for example, with its possible \$30 billion in largely unfunded health care promises, is already considering legislation that would shift "a considerable amount of the cost for health insurance to the retiree," said Charles Agerstrand, a retirement consultant for the Michigan Education Association, a teachers union. The legislation would require teachers retiring after 20 years to pay 40 percent of their insurance premiums, as well as co-payments and deductibles, he said.

The pressure is greatest in places like Detroit, Flint and Lansing, where school systems offered especially rich benefits during the heyday of the auto plants, aiming to keep teachers from going to work in them. Away from those cities, retiree costs may be easier to manage. In the city of Cadillac, 100 miles north of Grand Rapids, government officials said they felt no urgent need to cut benefits because they promised very little to begin with. Instead, Cadillac has started putting money aside to take care of future retirement benefits for its 85 employees, said Dale M. Walker, the city finance director.

Ohio is one of a few states to set aside significant amounts. Its public employee retirement system has been building a health care trust fund for years, so it has money today to cover at least part of its promises. With active workers contributing 4 percent of their salary, the trust fund has \$12 billion. Investment income from the fund pays most current retiree health costs, said Scott Streater, health care director of the Ohio Public Employee Retirement System. "It doesn't mean we can just rest," he said. "It is our belief that almost every state across the country is underfunded." He said his system plans to begin increasing the employee contributions next year.

In Duluth, Mayor Bergson grew quiet for a moment at the thought of a robust trust fund. "There was not a nickel set aside" in Duluth, he said. "The reason was, if you set money aside, you'd do less 'pretty projects.' Less bricks and mortar. Fewer streets. Fewer parks. So no one set the money aside. "If the city had set \$1 million aside every year for those 22 years" since the promise was made, he added, "we'd be in really good shape right now."

Mayor Bergson said his city intends to start setting aside money for the first time in 2006, but he is also trying to rein in the growth of new obligations. He raised to 20 from 3 the number of years that an employee must work for the city in order to qualify for retirement benefits.

He also imposed a hiring freeze and pledged not to lift it until Duluth could hire employees without promising them free lifetime health care. As the city has lost police officers, firefighters, an operator of its huge aerial lift bridge and other workers, the remaining employees have racked up more than \$2 million in overtime. But Mayor Bergson says that this is still cheaper than dealing with free retirement health care once the new accounting rule takes effect.

Most recently, he reached out for what may prove a political third rail: he took issue with the idea that once a public employee has retired, his benefits can never be reduced. This idea, as applied to pensions, is rooted in the constitutions of about 20 states, and unions argue that it also protects retiree health care.

Active employees in Duluth have had to start paying more for their health care under the city plan, Mayor Bergson said. If active workers must make concessions, he said, retired workers should make concessions, too. Otherwise, in relative terms, they are pulling ahead of the active work force.

"That's not a popular thing to say," Mayor Bergson said. "I'm getting kicked hard by retirees. I'm getting beat up by active employees. The people who are kicking me are the ones I'm trying to protect."

ATTEMPTS to balance the competing interests of retirees, active workers and taxpayers are building tension. Ross Eisenbrey, a former Clinton administration official who is now at the Economic Policy Institute, said that "when taxpayers wake up to these obligations, their first inclination is often to escape them or reduce them."

The problem is that people have counted on those benefits, and many have accepted lower salaries in exchange for better retirement benefits, said Teresa Ghilarducci, an economics professor at the University of Notre Dame. If they are close to retirement, said William R. Pryor, a firefighters' union official who is an elected board member of the Los Angeles County Employees Retirement Association, it may well be too late for them to make up for the loss with their own savings.

The clock is ticking. In Duluth, a city official approached the actuary who made the city's estimate in 2002 and asked her to refine and update her numbers because economic conditions had changed and the new accounting rule had been announced. This time the obligations worked out to \$280 million, a 57 percent increase in less than three years.

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