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MANAGEMENT

Paying for Promises

After the shock of the big numbers, states and localities are finding ways to deal with the costs of their retirees' health care.

By JONATHAN WALTERS

Call it the six stages of GASB 45: anger, denial, sorrow, acceptance, study and action. That's been the general response to a new set of governmental accounting rules that ask state and local governments to spell out the costs of their promises to provide retired employees with health care as well as other post-employment benefits.

The new rules arrive courtesy of the Governmental Accounting Standards Board — the outfit in Norwalk, Connecticut, that sets all the accounting regulations for state and local governments — and are part of GASB's push to head these governments toward accounting for the long-range and cumulative consequences of financial obligations and promises made yesterday and today.

And when it comes to retiree health care, those promises carry quite a price tag. According to the 2006 Rockefeller Institute Report on State and Local Government Finances, aggregate state and local liabilities for retiree health care (as well as other non-pension post-employment benefits) come to around $1 trillion, with some individual eye-poppers such as the Los Angeles Unified School District's $5 billion and the state of California's $70 billion.

The new GASB rules don't require that states or localities actually do anything to close the liability gap. However, the gap will, over the next few years, become part of a jurisdiction's comprehensive annual financial report, and rating agencies will be watching to see how various governments deal with the new red ink being splashed across governmental ledgers.

According to Parry Young, head of public finance for the rating agency Standard & Poor's, his company is not expecting miracle fixes for what he acknowledges is a large and vexing new hole in public ledgers. "What we're looking for," Young says, "is a thoughtful plan on how they're going to manage this liability."

Figuring out how to react to GASB 45 has certainly been a sobering experience, says David Manning, chief financial officer for Nashville's metro government. Back-of-the-envelope calculations there indicate that Nashville is on the hook for about $1.5 billion. The city can tack on another half-billion or so if it includes teachers in the equation.

Nashville is currently where most states and localities are: They've done the quick and dirty calculation, and now they're trying to home in on a more exact number and figure out what to do about it. "Right now, we're updating our actuarial estimates to try and get a handle on what the implications are for us," says Manning. The city has a GASB 45 task force that was created by Mayor Bill Purcell to consider alternatives for dealing with the new directive. That task force has yet to report.

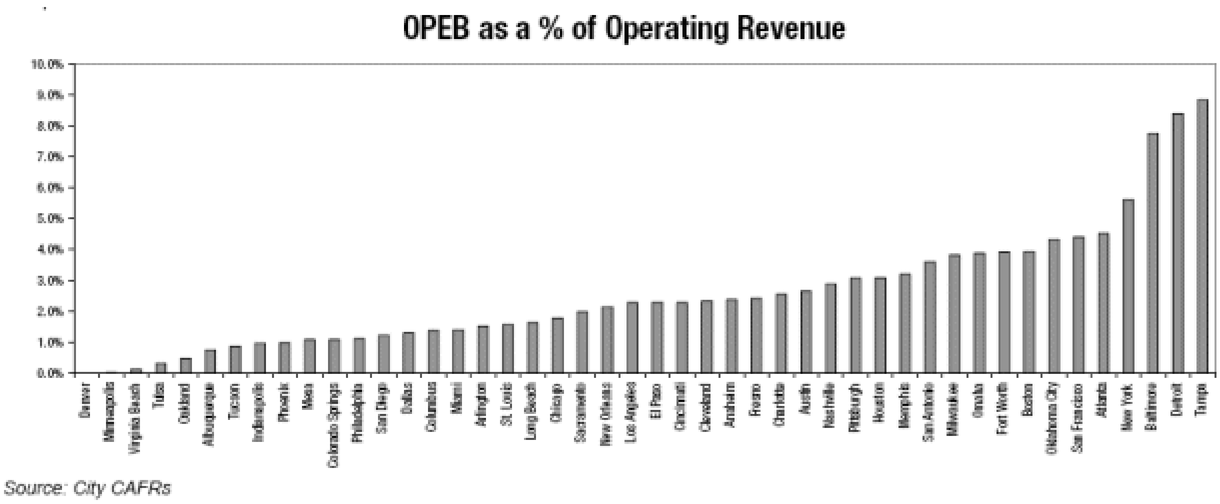
What's clear though, is that most states and localities are past the anger, denial and sorrow phase of GASB 45, and are developing concrete ways to deal with the new rule. Those responses have ranged from paying down the liability by digging directly into general funds to floating more debt. Governments are also taking a hard look at what, exactly, has been promised to retirees by way of benefits, with an eye toward cutting back and thereby reducing long-range liability. Some jurisdictions, meanwhile, have decided to try to slide some of their liability onto the feds.

TRUST FUNDING

Those public entities that have decided to begin pre-funding the liability are turning to the same vehicle they now use for pension obligations. In California, for example, the Public Employees' Retirement System (CalPERS) has created investment funds for governments that already participate in the CalPERS health care system, allowing localities to start putting money away for down-the-road health care payouts. Where necessary, states have passed or are in the process of developing legislation authorizing localities to create their own liability trust funds for "other post-employment benefits" — known as "OPEBs" in the accounting world.

Numerous states and localities have either begun to pay into such accounts or are in the final stages of working out how much to set aside. One of the first items of business for the new Massachusetts governor and legislature, for instance, is passing legislation to set up and begin funding an OPEB liability trust to cover that state's $7.6 billion obligation, says Eric Berman, who is part of a network of state officials who have been looking at the new rule. South Carolina Governor Mark Sanford has recommended that this year's budget include around $250 million to go into a dedicated OPEB trust fund to begin paying up his state's estimated $23.5 billion liability. Wisconsin, meanwhile, was prescient: Two years ago, it floated a bond to begin covering its post-retirement liabilities.

Localities, likewise, are facing facts. In New York City, Mayor Michael Bloomberg has said the city is ready to commit $2.2 billion of its current budget surplus to a down payment on its estimated $53.5 billion in OPEB liabilities. Plano, Texas, is already setting aside $7.6 million per year from its general fund to cover that city's $150 million OPEB hole. "We opted



Source for chart: ***Moody's Investors Service***

for advanced funding," says Plano CFO John McGrain. "We felt that it was fiscally sound reasoning for Plano to go ahead and do that." The city has set up an irrevocable trust in which to collect the OPEB's cash. McGrain acknowledges that Plano is lucky in one respect: It's not that generous when it comes to OPEBs and so isn't facing the same level of liability as many other jurisdictions.

SETTING LIMITS

The other widespread response to GASB 45 is to look at a range of options related to the benefits themselves — from scaling back, to boosting co-pays, to lengthening vesting periods or even to sloughing some of the long-term liability off onto someone else. The San Diego County Board of Supervisors, for instance, is trying to cut $50 million in annual health care subsidies for all post-March 2002 retirees. North Carolina has extended from five to 20 years the time it will take for state employees to become fully vested for health care benefits. In Chicago, the city is trying to negotiate both higher employee health care contributions and benefit cuts with its transit workers.

The heightened profile of the cost of retiree benefits — a fallout from the accounting rule — is very much on the minds of those who represent public employees. "We're very concerned," says Bill Cunningham, a lobbyist for the American Federation of Teachers. "We have members who've retired or who are about to retire who believe they had a commitment from their employer. This is clearly a problem that is going to have substantive fiscal and political ramifications."

It's not only the rank and file who find themselves in a hot seat over benefits, though. For example, a few years back, the Nashville Metro Council promised that any of its members who serve at least two terms would be granted a lifetime's worth of health care benefits after they leave office. That's a commitment that CFO David Manning bets would have been of interest to voters had reporting on the long-range cost associated with the promise been required.

Meanwhile, some jurisdictions are considering strategies that have nothing to do with cutting benefits. In West Virginia, the state pension board recently approved a plan to shift prescription drug coverage for state retirees to Medicare Part D, which the board says will carve $3 billion off the state's estimated $8 billion OPEB liability.

Critics of that strategy argue that the fiscal and administrative complexity of such a switch may make it less attractive than it first appears and suggest caution in trying to push OPEB costs onto the feds. Underlying such notes of caution, of course, is the stark fact that Medicare itself is amassing trillions of dollars in unfunded liabilities, which could put its long-range fiscal viability in doubt.

BREAKING AWAY

Despite the flurry of action in the field, there are still those jurisdictions that seem stuck in the "denial" phase of GASB 45. In Travis County, Texas, the chief auditor, Susan Spataro, has taken a defiant position on 45. In the first place, she argues, OPEBs in Travis County have always been handled on a pay-as-you-go basis, delivered year to year at the discretion of the county commission. For that reason, Spataro contends, they don't represent any long-range fiscal liability at all.

Furthermore, in trying to calculate the county's OPEB liability, her office — in concert with a variety of outside actuaries — has come up with numbers that are all over the map, ranging from $89 million to $380 million. Therefore, she thinks any number the county were to settle on and report in its comprehensive annual financial report would for all intents and purposes be false. "And it's a criminal offense to falsify a government record," says Spataro. So she's not planning on entering any number at all. Rather, she hopes to persuade the Texas legislature to pass a law pulling Texas out from under GASB rules and placing it under a system of generally accepted accounting rules developed and administered by the state.

It's a novel argument and strategy for sure, says Massachusetts' Eric Berman. But Berman, like many who are in the throes of responding to the new rule, doesn't think such a "head in the sand" approach serves government or citizens very well.

According to Steven Gauthier, point man on GASB 45 for the Government Finance Officers Association, most jurisdictions are, like Berman's shop, stepping up and dealing with the future cost of OPEBs. "Most of my colleagues understand and agree with the fundamental notion that a financial statement should show you that you've incurred these obligations."