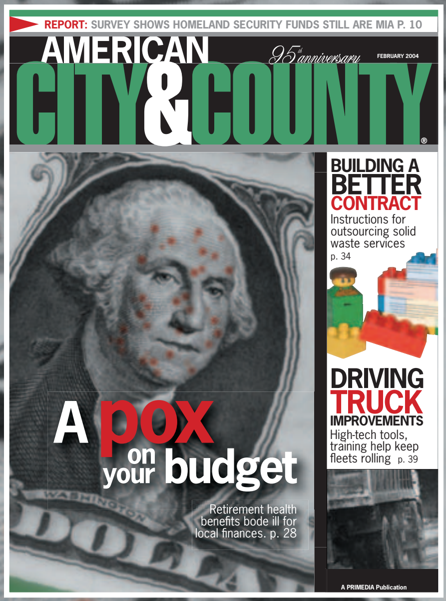


By Kathy Harm

A pox on your budget

Retirement health benefits bode ill for local finances.

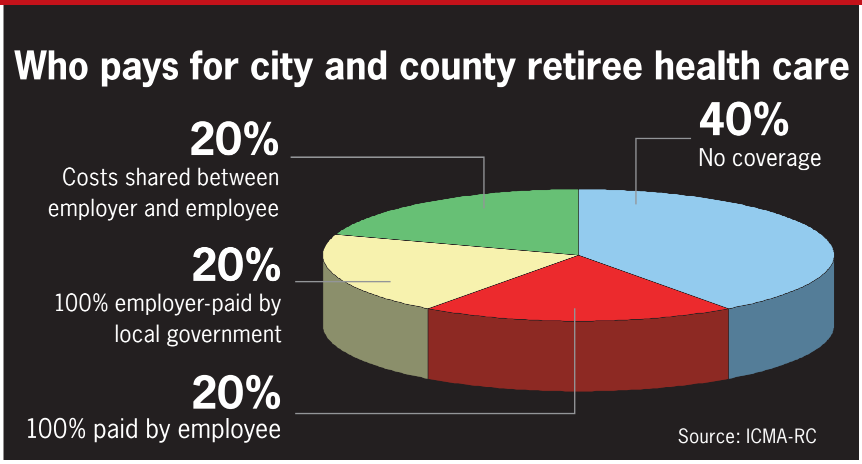
For many years, most cities and counties have provided their employees with some form of retiree health care, but few have addressed the benefits' long-term costs. That has the potential to create a financial liability that may weaken many local governments' balance sheets, which already are under pressure from budget shortfalls. The problem may be easy to explain, but the solution may be challenging for local communities who could be forced to choose between maintaining retiree health care and drastically cutting personnel or decreasing services to residents.

Two elements are converging to dramatically increase the pressure on local governments' finances. First, of the 60 percent of city and county governments that provide health care benefits to retirees, roughly one-third pay 100 percent of the cost, one-third require the retiree to bear all the costs and one-third share the costs with the retiree (see "Who pays for city and county retiree health care," on p. 30). Even when the vast majority of employers that pay for health care benefits fund them on a pay-as-you-go basis, they end up with large, unfunded liabilities, which to date have not been reflected on their balance sheets.

The dramatic increase in the cost for health care benefits is the other element adding pressure on local governmental resources. The average cost to insure someone in 2003 was 62.5 percent greater than the equivalent coverage in 1998 (see "Health insurance premium increases," on p. 30). In addition, longer life expectancies and early retirement incentives are increasing how long the benefits must be paid.

Formally recognizing the unfunded liabilities phenomenon, a new Governmental Accounting Standards Board (GASB) rule will require the full cost of retiree health benefits, earned in the current and prior years, to be reflected yearly in financial statements. GASB, which dictates the financial reporting for governments, issued a draft of the rule in February 2003 that specifies the financial disclosure requirements for reporting the funding status of Other Post Employment Benefits (OPEB), which mostly are retiree health care costs.

The proposed GASB standard requires that the costs for retiree health care benefits earned by individuals while employed should be accrued while they are employed. Additionally, employers who have been promising those benefits and not setting aside assets to pay for them have created an accrued unfunded liability that must be accounted for under the new standard.

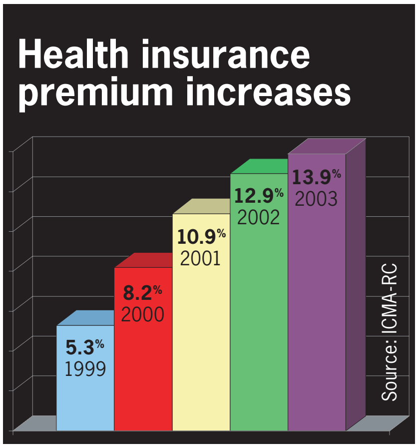


Those two elements — the currently accruing and the previously accrued OPEB liability, which must be amortized over a period as long as 30 years — make up a current year's required funding that must be reported on financial statements under the GASB proposal. The employer can use assets maintained in a trust dedicated solely to retiree health benefits to offset the liability.

No time to waste

GASB expects to issue its new OPEB reporting standard this year. The first reporting year for disclosure is determined by the local government's gross annual revenue (see "Dates for implementing reporting requirement," on p. 32). Employers exceeding $100 million in revenue will be required to comply with the new standard in the first fiscal year beginning after June 15, 2006. Employers with revenues between $10 million and $100 million will report the following year, and employers with revenues less than $10 million will report for the year beginning after June 15, 2008. Governments with separate OPEB plans, which are created to provide only health care benefits, are required to report one year earlier than governmental employers of the same revenue size.

Employers with more than 200 plan members (both active employees and retirees) must conduct actuarial studies every two years to determine the full funding requirement. Employers with fewer than 200 plan members must perform actuarial studies every three years, and those with fewer than 100 members would be allowed to estimate the liability using simplified methods and assumptions. Few local government employers have performed the actuarial calculations necessary to determine their unfunded liability for previously earned benefits and the cost for benefits earned by employees in the current year, less any assets dedicated to the benefits.



Employers have several options to deal with GASB's new disclosure requirement, and all have consequences. Employers can ignore the requirement and not provide the disclosure. However, the financial statements would not conform to standard financial reporting rules, and credit-rating agencies likely would consider that a material weakness in disclosure. Alternatively, employers might perform the necessary calculations, provide the disclosure and make no substantial efforts to fund the accrued liability. However, ratings agencies have indicated that they would view the lack of funding as a sign of financial weakness, especially if it continues. The government's credit ratings likely would fall, and its cost to borrow would increase.

Employers could follow all reporting requirements and fund the necessary

Dates for implementing reporting requirement

Local government gross revenue	Reporting will start
More than $100 million	First fiscal year beginning after June 15, 2006
$10 million to $100 million	First fiscal year beginning after June 15, 2007
Under $10 million	First fiscal year beginning after June 15, 2008

Source: ICMA-RC

additions to their health care trusts by increasing taxes or reducing services to residents. As a result of the lack of attractive options, employers increasingly are taking steps to reduce their retiree health care liability over time (see "Healthy choices," on p. 29). Satisfying all the disparate interests that are involved — the employer, the governmental employee or retiree, the ratings agencies, the bond purchasers, and the taxpayer — may be difficult.

Journalists in several cities have highlighted the new rule's potential impact on their local governments over the last year. Recently, San Diego newspapers published articles on the city's total unfunded liability for retirement health care benefits of $1.1 billion and the current annual budget cost of $54 million. The Milwaukee Journal Sentinel published a series of articles on the unfunded liabilities for retiree health care and the cost of employee benefits for several governmental units, such as the Milwaukee Public Schools' $1.45 billion unfunded liability.

Start preparing now

Governments can begin to formulate strategies to meet the demands of the new GASB standard, beginning with:

- Determining the first reporting year for OPEB liability based on the number of active and retired employees;
- Providing government leaders with information on the new reporting requirements;
- Consulting with the entity's actuary to determine the value of performing a preliminary study before the requirements become effective;
- Creating a retiree health trust to segregate assets from the general fund and using them to offset the OPEB liability;
- Educating employees on why retiree health coverage will become a more high-profile and contentious issue;
- Shifting more retiree health coverage to a defined contribution-type plan, which does not produce an unfunded liability and gives employees more flexibility in covering retirement expenses;
- Developing a public information strategy to address the media on the budget impact of unfunded liability disclosure;
- Monitoring collective bargaining agreements for their effect on retiree health obligations; and
- Reviewing cost-containment measures, such as increasing deductibles.

Additional approaches also may be considered, including funding a dedicated retiree health trust through a general obligation bond issue or promoting Roth IRA accumulations to pay for retiree health. Local governments also might promote new funding mechanisms that allow individuals to gain tax advantages for retiree health care, such as Health Reimbursement Arrangements and Health Savings Accounts, which offer tax breaks to individuals with high deductibles who accumulate funds to pay for medical expenses. Additionally, Integral Part Trusts for tax-exempt organizations (including governments) allow tax-free contributions of compensation and leave to accumulate tax-deferred during working years and to be used tax-free for health care costs in retirement.

Cities and counties now have just a few years to prepare for the inevitable. Taking steps sooner rather than later may help keep their balance sheets from deteriorating. **ACC**

Kathy Harm is director, retiree health, for the Washington, D.C.-based International City Management Association Retirement Corp.(ICMA-RC). Visit the company's web site at www.icmarc.org.

Healthy choices

Local governments have several ways to comply with the new Governmental Accounting Standards Board policy for reporting current and past employee health care retirement costs including:

- **Change the health care plan to make it less expensive — increasing co-pays and deductibles, decreasing prescription coverage and making other program changes — which may result in moderate cost reductions.**

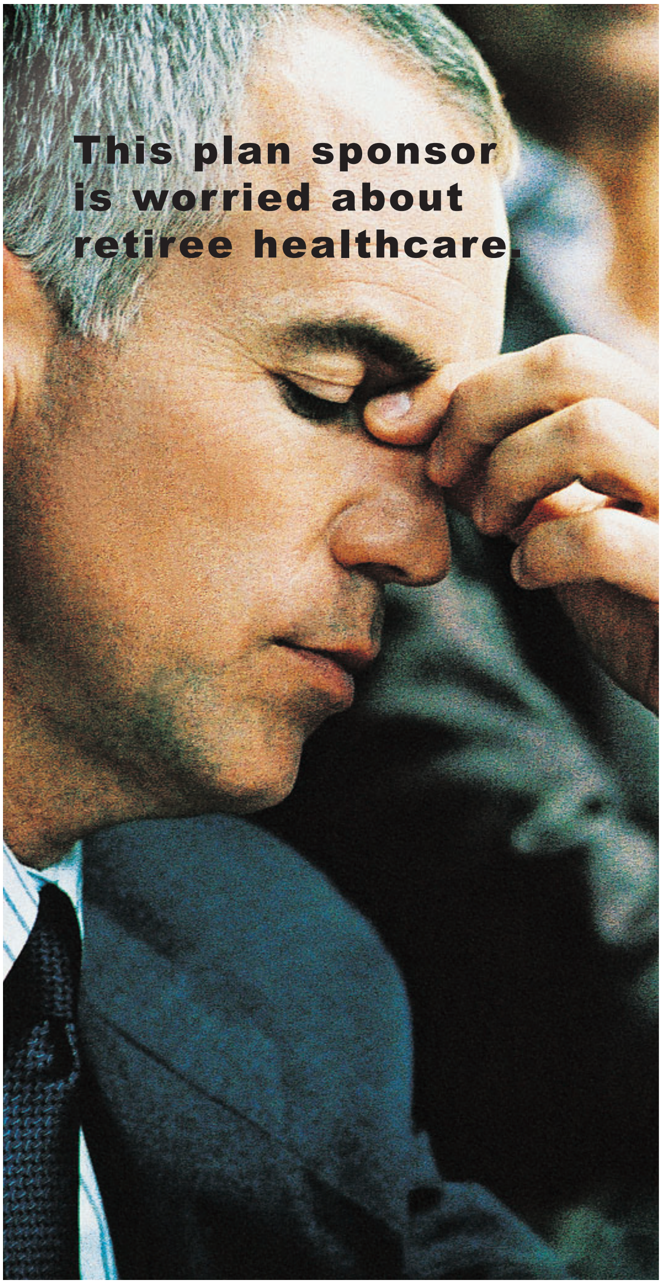
- **Move from the employer paying a percentage of the health care retirement cost to the employer paying a flat dollar amount with an inflation factor based on the consumer price index rather than medical inflation.**

- **Decrease the employer portion of health care retirement costs. Maintaining employee retirement health benefits at the current level may not be possible. Collective bargaining on retirement health benefits will be contentious, but ultimately layoffs and other drastic budget cuts may be required if the costs to fund the program are not reduced.**

- **Change/institute a vesting schedule for benefits. Employers may increase the years of service required for retiree benefits and create a schedule of the percentage of costs the employer will pay.**

- **Provide employees with a vehicle to pay for their growing portion of costs. As their insurance premium and out-of-pocket costs grow, employees are increasingly interested in the opportunity to accumulate pre-tax assets to pay for health care expenses in retirement.**

—Kathy Harm



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