

Tax & Budget

BULLETIN

No. 40 • October 2006

Unfunded State and Local Health Costs: \$1.4 Trillion

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State and local governments have amassed large debts and unfunded obligations. Debt in the form of bonds has soared to \$1.9 trillion. State and local pension plans are underfunded by about \$700 billion. Underfunded retiree health plans for government workers represent another large fiscal hole. On the basis of our review of data for 27 jurisdictions, we estimate that state and local retiree health benefits are underfunded by \$1.4 trillion nationwide. All those liabilities represent a looming threat to taxpayers and indicate the need for major reforms of government benefit plans and other spending activities.

Bond Debt

State and local borrowing has soared in recent years. In the 1970s and 1980s, net borrowing by state and local governments was modest, averaging just 0.2 percent of gross domestic product.¹ During the 1990s, net borrowing increased to an average of 0.4 percent of GDP. During the 2000s, net borrowing has soared, averaging 0.8 percent of GDP the past six years. As a result, the value of outstanding state and local government debt increased from \$1.2 trillion in 2000 to \$1.9 trillion by 2005.² Unfortunately, the economic slowdown earlier this decade prompted states to go on a borrowing binge that has not yet stopped.

Underfunded Pension Benefits

State and local liabilities include more than just bond debt. They also include the underfunded benefits of government employee defined-benefit pension plans. The pension shortfall for the nation's state and local workforce is estimated at about \$700 billion.³ By contrast, the pension funding shortfall in the U.S. private sector is about \$450 billion.⁴ But note that the private workforce is seven times larger than the state and local workforce.

Unfunded Retiree Health Costs

State and local governments put aside assets to pre-fund their pension plans, and thus the level of

underfunding can be eased if plan assets rise in value. By contrast, retiree health benefits provided by state and local governments are generally not prefunded. (Instead, they are on a pay-as-you-go basis.) The problem is that the costs of those benefits will soar in coming years as large numbers of state and local workers retire. As an example, the state of New Jersey recently estimated that spending on its employee health plan will grow at 18 percent annually over the next four years, and the plan has built up unfunded obligations for retiree benefits of \$20 billion.⁵

In the past, few governments disclosed information about their unfunded health costs. But concern about the potential huge size of those costs has prompted the Government Accounting Standards Board to create new rules for all state and local governments to follow when reporting on the finances of their health plans and other postemployment benefits (OPEB).⁶ To comply with those rules, many jurisdictions are in the process of examining their unfunded health costs, but there has been no accurate data available on total costs nationwide.

Estimated Unfunded Health Costs: \$1.4 Trillion

Some jurisdictions have made public their estimates of unfunded retiree health costs, which are projections of future costs measured on a present value basis. Table 1 summarizes data we found for 16 states and 11 local governments.⁷ For each jurisdiction, we calculated the unfunded health costs per active employee in the related health plan. The average unfunded health costs for sampled governments was \$135,313 per employee.

We used this average to make a national estimate of unfunded state and local retiree health costs. There are 15.9 million state and local workers in the United States.⁸ About 10.3 million, or 65 percent, of those workers are covered by employer health plans during retirement.⁹ If the average of \$135,313 of unfunded costs per worker is representative of the total state and local workforce that receives retiree health benefits, it indicates a total unfunded cost of \$1.4 trillion.

Table 1. Unfunded Retiree Health Costs

| State or Local Jurisdiction | Costs (\$ billions) | Workers in Health Plan | Unfunded Costs per Worker |
|---|---------------------|------------------------|---------------------------|
| Alabama | \$5.3 | 38,500 | \$137,662 |
| Alaska | \$7.0 | 43,400 | \$161,290 |
| Delaware | \$3.9 | 30,000 | \$130,000 |
| California | \$70.0 | 357,800 | \$195,640 |
| Maryland | \$20.4 | 68,000 | \$300,000 |
| Massachusetts | \$13.3 | 71,900 | \$184,979 |
| Michigan | \$6.5 | 33,700 | \$192,878 |
| Nevada | \$4.1 | 25,000 | \$164,000 |
| New Jersey | \$20.0 | 104,900 | \$190,658 |
| New York | \$47.0 | 194,000 | \$242,268 |
| North Carolina | \$13.5 | 340,000 | \$39,706 |
| South Carolina | \$9.2 | 166,400 | \$55,288 |
| Utah | \$0.8 | 19,700 | \$38,071 |
| Virginia | \$5.0 | 92,100 | \$54,289 |
| West Virginia | \$9.2 | 79,000 | \$116,456 |
| Wyoming | \$0.1 | 13,000 | \$8,692 |
| Alabama public schools | \$14.60 | 100,000 | \$146,000 |
| Alexandria, VA | \$0.08 | 2,200 | \$37,273 |
| Duluth, MN | \$0.28 | 828 | \$338,164 |
| Fairfax Co., VA | \$0.83 | 32,000 | \$25,781 |
| Fort Worth, TX | \$0.77 | 5,800 | \$133,103 |
| Oakland Co., MI | \$0.49 | 3,600 | \$135,278 |
| Michigan public schools | \$15.80 | 321,100 | \$49,206 |
| Michigan state police | \$0.44 | 1,713 | \$256,859 |
| Montgomery Co., MD | \$2.00 | 32,000 | \$62,500 |
| New York City, NY | \$50.00 | 325,000 | \$153,846 |
| San Diego, CA | \$0.98 | 9,464 | \$103,550 |
| Average cost per worker in 27 jurisdictions | | | \$135,313 |

Source: Authors' compilation based mainly on state government sources.

Reform Options

The large funding gaps in retiree health and pension plans are putting state and local governments in a fiscal bind. If governments make no reforms, worker retirement costs will create a rapidly rising drain on state and local budgets. That, in turn, would create pressure for governments to raise taxes, which is a losing strategy in today's competitive global economy.

Another option is for states to issue bonds to convert some of their unfunded obligations into explicit debt. Many states have issued debt to partly cover future pension costs, and some are planning to do so for unfunded health costs. That increases transparency, but it does not cut overall liabilities, and it limits the flexibility to cut excessive benefits going forward.

A better option is to convert traditional pension and retiree health plans into individual savings-based systems so that workers prefund their own retirements. Two states, Alaska and Michigan, have moved to savings-based (or defined-contribution) pension plans for new employees.

In addition to that reform, state and local governments should begin to cut excess retirement benefits. For new hires, savings-based plans for pensions and health care should be adopted. For existing workers, there are often legal hurdles to cutting pension benefits, but most governments have substantial flexibility in cutting health benefits for workers and retirees.

From a fairness perspective, cutting benefits makes sense because state and local governments typically have much more generous benefit plans than those in the private sector. For example, while 65 percent of governments provide retiree health benefits, only about one-quarter of large private businesses do.¹⁰ Also, federal data show that the average cost of health benefits provided to state and local workers is \$3.91 per hour worked, which compares to an average of just \$1.72 in the U.S. private sector.¹¹

In sum, excessively generous pension and health plans for state and local workers have created a roughly \$2 trillion fiscal hole. To plug that hole, policymakers should cut back health benefits and transition to savings-based retirement systems for their workers.

¹ U.S. Bureau of Economic Analysis, National Income and Product Accounts, Table 3.3, www.bea.gov/bea/dn/nipaweb.

² See Chris Edwards, "State and Local Government Debt Is Soaring," Cato Institute, July 2006.

³ Estimate by Barclays Global Investors assuming government plans use similar accounting methods as private plans.

⁴ Pension Benefit Guaranty Corporation, "FAQ: Financial Statements," www.pbgc.gov/media/index.html.

⁵ www.state.nj.us/benefitsreview.

⁶ See GASB Statement no. 45, www.gasb.org/st. Most OPEB costs are retiree health benefits. For simplicity, we refer to "retiree health costs," but Table 1 generally reflects total OPEB costs ("unfunded actuarial accrued liabilities").

⁷ Data from state government reports, phone calls to state officials, and a recent survey by the National Association of State Comptrollers. Some states in Table 1 include local government workers in the state-run health plan.

⁸ Chris Edwards, "State Bureaucracy Update," Cato Institute, January 2006. As updated with 2005 data.

⁹ Based on various data from the Employee Benefit Research Institute, www.ebri.org.

¹⁰ Various EBRI reports.

¹¹ Bureau of Labor Statistics, "Employer Costs for Employee Compensation," June 21, 2006, Tables 3 and 5, www.bls.gov/news.release/ceec.toc.htm.