

A \$2-Trillion Fiscal Hole

By CHRIS EDWARDS and JAGADEESH GOKHALE
Wall Street Journal *October 12, 2006; Page A18*

State and local governments are amassing huge obligations in the form of unfunded retirement benefits for their workers. Aside from underfunded pension plans, governments have also run up large obligations from their retiree health plans. While a new Governmental Accounting Standards Board rule will kick in next year and reveal exactly how large this problem is, *we estimate that retiree health benefits are a \$1.4 trillion fiscal time bomb.*

The new GASB regulations will require accrual accounting of state and local retiree health benefits, thus revealing to taxpayers the true costs of the large bureaucracies that they fund. We reviewed unfunded health costs across 16 states and 11 local governments that have made actuarial estimates, and found *an average accrued liability per covered worker of \$135,000.* Multiplying that by the number of covered state and local employees in the country yields a total unfunded obligation of \$1.4 trillion -- twice the reported underfunding in state and local pension plans at \$700 billion.

To put these costs in context, consider the explicit net debt of state and local governments. According to the Federal Reserve Board, state and local credit market debt has risen rapidly in recent years, from \$313 billion in 2001 to \$568 billion in 2005. *But unfunded obligations from state and local pension and retiree health plans -- about \$2 trillion -- are still more than three times this net debt amount.*

The key problem is that the great majority of state and local governments finance their retiree health benefits on a pay-as-you-go basis. In coming years that will create pressure to raise taxes as Baby Boomers age and government employees retire in droves. New Jersey's accrued unfunded obligations in its retiree health plan now stand at \$20 billion, and the overall costs of its employee health plan are expected to grow at 18% annually for the next four years.

To compound the problem, defined-benefit pension and retirement health plans are much more common and generous in the public sector than the private sector. Out of 15.9 million state and local workers, about 65% are covered under retirement health plans, compared to just 24% of workers in large firms in the private sector.

The prospect of funding \$2 trillion of obligations with higher taxes is frightening, especially when you consider that state politicians would be imposing them on the same income base as federal politicians trying to finance massive shortfalls in Social Security and Medicare. Hopefully, most state policy makers appreciate that hiking taxes in today's highly competitive global economy is a losing proposition.

The only good options are to cut benefits and move state and local retirement plans to a pre-funded basis with personal savings plans. Two states, Alaska and Michigan, have

moved to savings-based (defined-contribution) pension plans for their new employees. Alaska has also implemented a health-care plan for new state employees, which includes high-deductible insurance and a Health Savings Account. Expect to see more states following Alaska's lead.

State and local governments also need to cut retirement benefits, which were greatly expanded during the 1990s boom. From a fairness perspective, cutting benefits especially of younger workers is reasonable given the generosity of state and local plans. Federal data shows that state and local governments spend an average of \$3.91 per hour worked on employee health benefits, compared to \$1.72 in the private sector.

Underfunded -- or more accurately, over-promised -- retirement plans for state and local workers have created a \$2 trillion fiscal hole. Every year that policy makers put off the tough decisions, the hole gets bigger. Hopefully, the new GASB rules will prompt them to enact the reforms needed to avert job-destroying tax increases on the next generation.