Public Money

Failing to Fund Retirement Benefits

The downside of "pay-as-you-go"

By Girard Miller | June 18, 2009

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As June 30 rapidly approaches, many state and local governments will close their books without making an actuarially based annual contribution to a trust fund for retiree medical benefits (now called OPEB, for "other post employment benefits"). Instead, they will continue to pay-as-they-go by contributing the minimum amount necessary to pay current benefits. In essence, they are taking yet another "holiday" from a sustainable funding system.

Citing the recessionary slump in revenues, and reverting to inertia, public employers have not done much to fund their OPEB. Surprisingly few governments have even created the independent trust fund that would qualify them to benefit from advantageous accounting under the Governmental Accounting Standards Board Statement 45. Most of those who planned to inaugurate an OPEB trust this year have decided to defer action for yet another year. The path of least resistance has been to do nothing, and let their unfunded liabilities and Net OPEB Obligation (NOO) grow larger. (Financial statements must show these expenses and liabilities, even if left unfunded.) After all, who wants to furlough or lay off yet more workers — just for the sake of new accounting rules and traditional actuarial principles that have been ignored for decades?

Unfortunately, there is a very real cost of doing nothing. Actuarial cost estimates are based on the assumption that an employer makes annual contributions to pre-fund a plan, just like a normal pension contribution. When the employer fails to make its annual required contribution (ARC), the liabilities continue to grow as employees age, while the investment income assumed by the actuary is not realized. The net result is zero growth in assets and further growth of liabilities, hence an increase in unfunded liabilities and a yet-higher ARC next year.

In addition to digging a deeper hole, there are three other consequences of pay-as-you-go: higher liabilities and expenses in financial statements; lost and lower investment earnings; and a weakened collective bargaining position.

Without a GASB-qualified trust fund, the actuary must now calculate the present value of the OPEB liability using a discount rate that is based on the expected rate of return from the employer's cash management investment policy. In today's world of 1 percent short-term investment returns and 3 percent intermediate Treasury yields, actuaries will be hard pressed to assume sustainable long-term returns on cash investments above 4 percent without being censored by the profession. The result of this low discount rate is that the actuarial accrued liability (AAL) and the ARC must all be higher than they would be if the plan were properly funded in a qualified trust. In many cases, the actuarial liabilities and ARC could be reduced by 30 to 40 percent by simply implementing a qualified trust fund with a long-term investment portfolio.

Inaction thus inflates accounting expenses. When the footnotes to this year's financial statements are presented to elected officials, public managers should make a point to note the increase in liabilities that resulted from this past year's failure to manage this plan properly, and the opportunity to reduce these numbers through proper funding structures.

This is not just an accounting issue, however. The second downside of a policy of benign neglect is that long-term investment returns will not be realized — and the ultimate long-term costs of the plan will be higher than they would be if the plan were properly pre-funded. In a mature pension plan, about 70 percent of its total revenues are derived from investment income. This revenue is not available to an OPEB plan that continues its policy of pay as you go, forcing taxpayers to bear ever-larger burdens. And with stocks annually returning about 600 basis points (6 percent of principal) more than bonds over the past 83 years, this forgone revenue is a real opportunity cost to future taxpayers and creates an intergenerational inequity through what is now approaching the brink of fiscal negligence.

Today's depressed stock market may not have hit the bottom, but historical chances are very strong that over the next two or three years of economic malaise, the investment returns for those who now invest for the long term will be superior to those who delay the creation of their OPEB trust. Historical research from the analogous Depression era of the 1930s certainly supports this thesis: 30-year portfolio returns during that era were the highest in the 83-year period from 1926 to present. Dollar-cost-averaging during recessions has long proved to produce superior long-term investment returns, and those who purchase stocks only during business expansions will underperform the long-term averages for portfolio returns.

Third, the failure to establish a qualified trust also deprives employers of an opportunity to begin bargaining with employee groups to demand that they share in making the ongoing contributions to support this benefit plan. Without a qualified trust fund, employees would be foolhardy to entrust their dollars to an employer's payroll-withholding system. But with a qualified trust fund that is exclusively devoted to providing the promised benefit and protected from creditors, the groundwork is laid for negotiators to demand genuine cost-sharing, as I have discussed in a previous column.

As state and local governments enter the next fiscal year, and they right-size their cost structures with workforce reductions and other painful measures, it will be important for them to lay the groundwork for sustainable OPEB benefits plans in coming years. This requires three actions:

• Establish a qualified OPEB trust fund, even if it is funded only with some initial seed capital of less than the entire year's ARC.

> — Appropriate or transfer start-up seed capital
> — Set an asset allocation and investment policy
> — Establish a governance structure
> — Select an investment advisor and a custodian

• Prepare and adopt an OPEB strategic plan for how you will attain long-term funding, including:

> — Ramp-up strategy to achieve full ARC funding
> — Cost mitigation and plan redesign (see next bullet)
> — Use of OPEB bonds where appropriate
> — Dedicated share of future revenues and budget surpluses to fund OPEB

• Develop a multi-year labor relations strategy for re-structuring your OPEB plan in ways that future taxpayers can eventually afford, including such measures as:

> — Moving employee contributions into the OPEB trust fund, with a goal of raising them over time to represent half of the normal service costs (50-50 cost sharing for new hires and younger employees)
> — Putting a hard dollar cap on retiree medical benefits
> — Limiting inflation increases to the CPI or less
> — Requiring a full career of service to receive full benefits (30 years civilian, 25 years for first responders) with pro-rated or actuarially reduced benefits for earlier retirements
> — Converting to a defined contribution plan for all or some benefits and enabling employees to save for their share of future costs

With only a few weeks left in the current June 30 fiscal year, few governments can act quickly enough to implement a qualified trust fund for this year's financial statements. But for those with other fiscal year-ends, and certainly in the new fiscal year, the time has come to establish a qualified OPEB trust, and formalize plans for labor relations and longer-term funding strategies.

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