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The Mounting Cost of Deferred Responsibility in Government

The Future Impact in Wisconsin

REPORT FROM THE PRESIDENT:

We have all grown weary of the string of ethical indiscretions in the salons of Washington D.C. and legislative offices in Madison. Now we are finding that the ethos that spawned this questionable behavior has also led government to use questionable bookkeeping to cover its lavish, election-oriented spending.

This report explores the impact of the culture that lives from one election to the next, making commitments — especially to government employees — that have a hidden price tag that totals $3.5 trillion. That's right, trillions, the denomination usually reserved for federal spending.

This is the third report in a series prepared by George Lightbourn, Senior Fellow with the Wisconsin Policy Research Institute. The first two reports documented how Wisconsin state government's budget became unbalanced and how several governments skirted the balanced budget requirement. As Lightbourn details in this report, the root of the problem is elected officials' penchant for spending.

State and local governments are particularly bighearted toward their employees. Generous pensions and expensive health care coverage for retired government workers has been the hallmark of government employment. How generous? Until recently, no one was able to answer that question.

Abetted by an accounting slight-of-hand, state and local governments made promises to government employees far beyond what they could afford. Like a teenager buying a Lexus, government leaders knew they liked the acceleration and the smell of the leather but they were oblivious to the cost. So, unrealistic commitments were made to government employees. The commitments were made away from the glare of public scrutiny, yet it will be the public that will ultimately pay the price for government's extravagance. A new federal mandate, GASB 45, will require state and local governments to report their real budget shortfalls. Several communities, including San Diego and Minneapolis, are already feeling the sting of unaffordable past commitments. There will be hundreds of additional problems brought to light in the next few years as governments are forced to disclose the price of their commitments. Across Wisconsin local governments will need astronomical amounts of additional revenue to cover years of chicanery and neglect.

The picture painted in this report is unsettling. The culture of government that has yielded myopic fiscal planning and an addiction to spending that must be changed. Will our government leaders of today set aside their penchant for spending and restore the business of government to sound financial footing?

Lightbourn, based on his experience and his research, issues a pessimistic warning: "Given the record of accomplishment to date, taxpayers should be prepared for the worst."

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THE MOUNTING COST OF DEFERRED RESPONSIBILITY IN GOVERNMENT

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GEORGE LIGHTBOURN

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Executive Summary

Throughout history, there has been a conflict between the business of government and the politics of government. The political side of government has a time horizon that extends no further than the next election and an attraction to spending that borders on addiction. As a result, the business side of government has been handed a towering stack of IOUs. State and local governments throughout the U.S. have made promises that they cannot afford and have financed their decisions by passing IOUs along to future generations. The philosophy of government is best described as deferred responsibility: spend today and worry about the accounts payable tomorrow. Now those IOUs are coming due and the amount is staggering.

The IOUs discussed in this paper are the ones related to benefits promised to public employees when they retire. This paper will detail the price tag of the promises of pension and health care payments made to retired state and local government workers. How bad is it? The IOUs state and local governments around the U.S. are passing on to their successors stand at $3.5 trillion. This consists of:

Debt	$1.85 trillion
Unfunded Pension Liability	$0.34 trillion
Unfunded Retiree Health Care	$1.40 trillion

Wisconsin taxpayers will not escape the cost of deferred responsibility. This paper will show that state government will spend $3.6 billion to retire its unfunded liability for pension and retiree health care. Local governments, including schools, will pay an estimated $13.8 billion to retire its unfunded liabilities. The exact amount will not be known until 2009, but it is already clear that there are either tax hikes or program cuts in the future for Wisconsin taxpayers.

The IOUs will be particularly troublesome for Wisconsin public schools. Since the mid-1990s, school spending increases have been capped, so the repayment of IOUs for employee retirement benefits will directly affect classroom support. Either school boards across the state will cut staff or they will turn to the taxpayers via referenda to pay for their deferred responsibility.

The concept of deferred responsibility is engrained in Wisconsin government. In an earlier Wisconsin Policy Research Institute Report, it was shown that Wisconsin's budget is $2.2 billion in the red, meaning it has promised 17% more spending than it has money to pay.

Across the border in Illinois, a succession of governors and legislatures has deferred action on filling a hole in its pension fund for so long that one dour legislator lamented, "In coming years we will have an unbearable burden for money we owe the pension systems. All of our (revenue) growth will go to pensions. It will stagnate the state."

State and local governments' spending proclivities are most pronounced when the economy slumps. Early in this decade, as the economy struggled to recover from the 2001 recession, businesses went through multiple rounds of budget reductions and painful workforce cuts. At the same time, state and local government spending rose by 30% (from 2000 to 2004) and 711,000 new workers were added.

Fortunately, recent improvements in accounting standards have put government bookkeeping on a par with private industry. For the first time, the true magnitude of deferred responsibility is apparent. The emerging picture is that government has been spending beyond its means, especially on benefits for retired government workers.

This report offers a number of recommendations of steps government leaders need to take to prevent government's IOUs from taking over state and local budgets, as is the case in Illinois. The list includes:

- Bringing pension and retiree health care costs into line with what government can afford. Government must stop the practice of making promises to its employees for which there is no money.
- Moving retiree health care benefits from defined benefit to defined contribution programs.
- Creating a trust fund for the advance funding of employee benefits. Trust funds must be off limits for general spending. If government cannot afford the advance funding of benefits, it should reduce benefit levels.
- Keeping elected officials from participating in the retirement plans they control.

Looking ahead, a concern is that the same government leaders who have sat idly by watching the IOUs mount are the same leaders that expected to solve the problem. They have two clear choices. Either they can cut spending — especially spending on benefits that will rise in the future — or they can continue to spend and eventually turn to the taxpayers for more money. Given the record of accomplishment to date, taxpayers should be prepared for the worst.

INTRODUCTION

They agreed to hold the meeting at a local hotel because it was private and it represented neutral territory. The two principle negotiators sat across the table from one another, three minions flanking each man, almost like seconds in a duel. Slowly, the beefy union leader rose and extended a hand across the table to his bookish counterpart.

Another union contract was done. Government could look forward to a couple of years of labor peace and union members would see a pay increase, albeit a very slender increase. The union members had not expected much in the way of salary increases, given the trickle of revenue into the state treasury. But the union leader got what he came for. What was going to sell the contract to the union membership was not the pay increase, but rather an obscure health care sweetener union members could use when they retired.

When the contract was made public, the entire focus of attention was on the slender pay increase the union had accepted. It was indeed a tough bargain management had obtained. The provision increasing the cap on health care for retirees went unpriced and unnoticed. Yet that little sweetener represented a multi-million dollar IOU that would some day come due. No one on the management team lost any sleep over the IOU because that some day would be on someone else's watch.

Agreeing to this contract provision was easy for both labor and management. Government bookkeepers were unconcerned about obscure costs that might occur years into the future. In fact, the attitude among many high-ranking officials was: *carpe diem*— seize the day. Worry about costs you know, don't waste time worrying about costs that are maybes in the future. Therein lies the problem that is the basis for this report.

State and local governments are required to produce balanced budgets. Unlike the federal government, which no one expects to pass a balanced budget, every year the outer bounds of spending for state and local government are determined by the revenue collected that year. Or is it?

As the story of the union contract demonstrates, governments have become quite creative in finding ways to unhitch themselves from the balanced budget requirement. They are particularly creative during times of fiscal stress.

The most recent challenge to government revenues was the recession of 2001. Revenues declined throughout the economy, especially in state treasuries. Yet during that period, as revenues declined, expenditures continued to grow — well above the expected rate. How could this happen? Part of the explanation lies in government's ability to defer costs into the future.

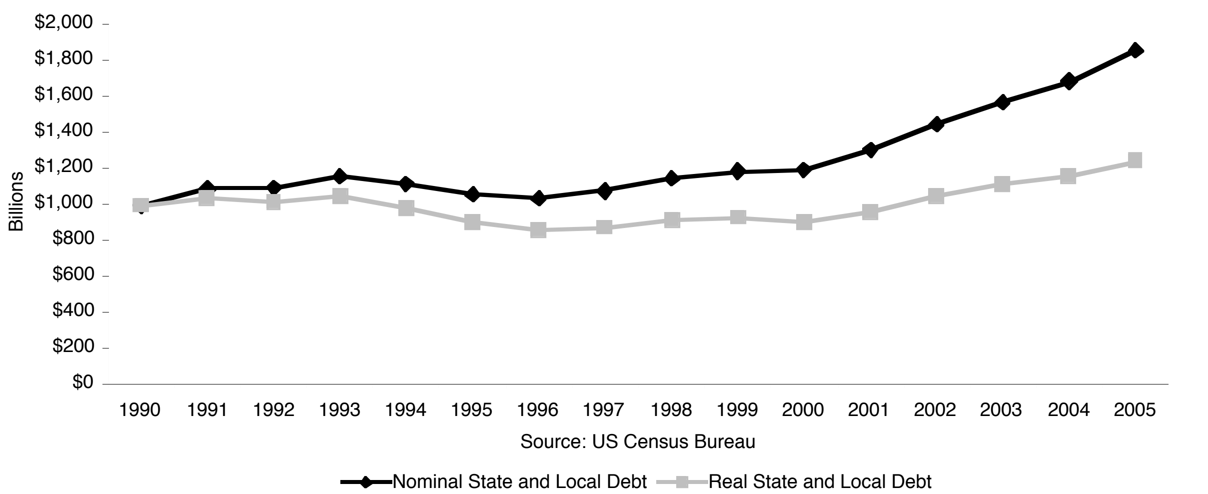
There are three ways government defers costs into the future. The first way is the limited life, hand-off. This typically involves the ramp-up or phase-in of a cost. For example, in 2001, with the state budget swimming in red ink, Wisconsin's governor and legislature authorized a popular new prescription drug benefit for senior citizens. Even though the cost of the benefit was estimated to be $78 million, the program was put in place with just $49 million in hand. The promise of a $78 million had been made to seniors; the rest of the money would have to found somewhere in the future.

Another example is the phase-in of a new tax treatment that benefited Wisconsin businesses. The legislature passed the single factor tax in 2003, knowing it would cost the state treasury $45 million per year, and also knowing the fiscal condition of the state couldn't afford the change. The solution proved simple; implementation was pushed off to 2006 with a four-year phase-in schedule. There was no clear idea where the funding for the initiative would come from, but pushing the obligation into the future handed the heavy lifting off to a future legislature.

The second way costs are deferred into the future is the issuance of debt. Where debt was once used exclusively for tangible brick-and-mortar purposes, the use of debt by government has expanded significantly. It now includes land purchases, environmental repair, pension obligation bonds, and many other non-traditional items. Nationally, outstanding state and local debt stands at $1.85 trillion, a **55% increase** since 2000. Chart 1 shows the growth in bonding, and its increased momentum since 2000.

The third way government defers spending is less determinant, but ultimately more costly. In this category are the costs of retirement benefits promised to public employees, not unlike the health care sweetener mentioned in the union contract story. Later in this report, the manner in which these funding obligations have been incurred as well as their cost will be detailed. The costs of retiree benefits, the same factors that have rendered U.S. automakers uncompetitive, represent huge IOUs for taxpayers everywhere. The public is just now finding out the full impact of these commitments.

CHART 1: STATE AND LOCAL GOVERNMENT DEBT



Concern that, by deferring costs, government was obscuring the full cost of retiree benefits, spurred the accounting profession to put its foot down. The Government Accounting Standards Board (GASB) took steps to make sure costs were fully disclosed. GASB has standardized the way government discloses costs. With full disclosure, an honest comparison of costs between governments will be possible. Investors in government bonds will have an accurate financial picture so they can accurately assess the risk of government bonds, and taxpayers will have an accurate picture of what their government costs. They will see the truth about what government is spending.

In a handful of extreme cases, government's old accounting standards were intentionally abused to hide government misdeeds. For example, the former personnel director for Milwaukee County was sent to prison for fudging the disclosure related to a major pension sweetener. The county executive was recalled.

Fortunately, that type of criminal activity remains rare. What was not so rare was the discreet passing of financial obligations on to taxpayers in the future. Oftentimes it was accomplished with no overt action by elected officials. They stood by while expensive employee benefits were under-priced and under-funded. In the future, thanks to the new accounting rules, the cost of deferred responsibility will be made clear, and that cost is enormous.

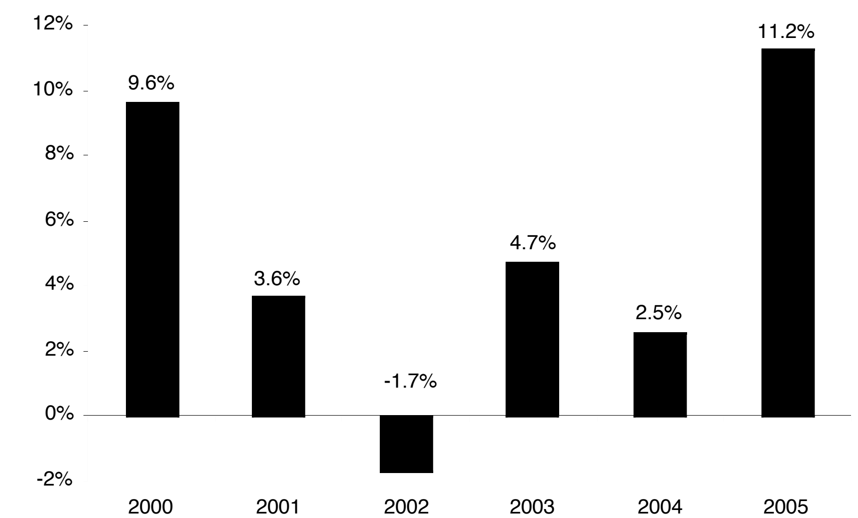
It is difficult for the average citizen to understand the complexity of government, much less the intricacies of government accounting. This paper will unravel those intricacies and show how pensions and other benefits are under-funded. It will also total up the staggering amount of IOUs to be repaid by American taxpayers.

Tight Budgets: The Vehicle for Deferred Responsibility

The tendency to move expenses into the future arose from a culture in government that evolved through the latter half of the twentieth century. It grew out of increasing expectations of government and the resulting build-up of pressure on spending. From 1980 to 1990, spending by state and local government outpaced the growth of population and inflation. Forty-nine of the fifty states increased real per-capita state and local spending by more than 15%. Then again in the 1990s, forty-eight of the fifty states continued to increase real per-capita spending — thirty-five of which had real growth rates exceeding 15%.[1] Citizens expected more support and services from government, but did not want taxes to take a bigger bite out of their incomes. The clash between spending and taxes, which has always colored American government, was raised to an art form late in the twentieth century. The challenge within the halls of government was how to spend without appearing to spend. Governmental accounting provided an answer to this dilemma. As a result, expenses were routinely deferred to the future.

Let's look at what happened to government spending when the U.S. economy went into recession in 2001. Coming on the heels of the robust economy of the 1990s, the recession of 2001 seemed particularly harsh. As equity markets plunged, the workforce was cut. Evidence of an "economic correction" was everywhere.

CHART 2: PERCENT GROWTH OF REVENUE IN THE STATE GENERAL FUNDS



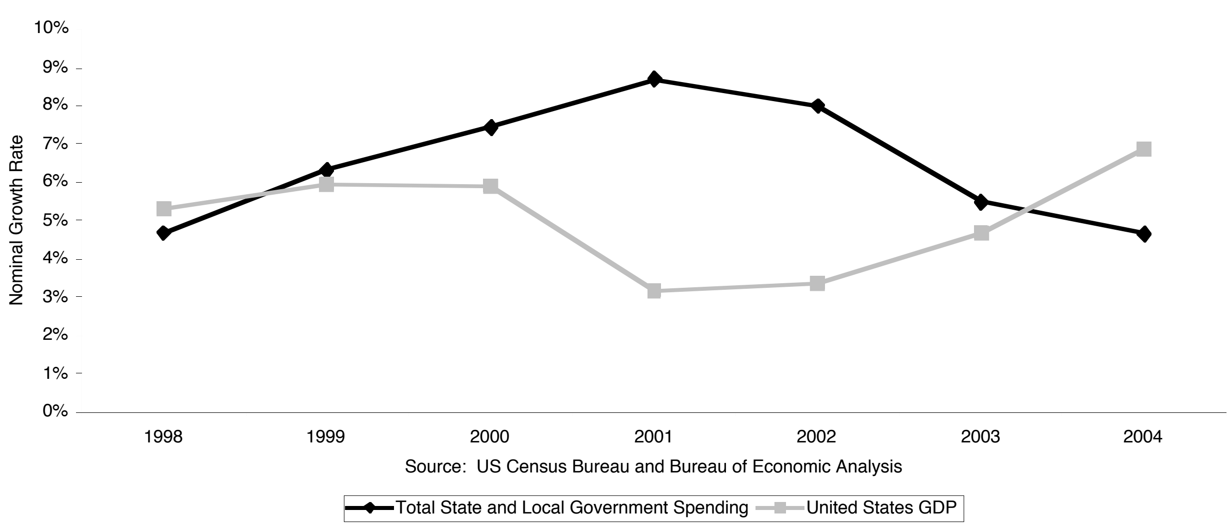
Source: National Association of State Budget Officers State Expenditure Report

Chart 2 shows the growth of revenues collected by state governments before, during, and after the 2001 recession. Clearly the recession slowed government revenues. In 2002, the year after the recession, revenues actually declined.

Yet through it all spending continued to rise. Chart 3 compares the growth of state and local spending to the U.S. gross domestic product. By any measure, state and local government spending growth was higher than would have been expected.

State and local governments showed a resiliency that the private sector must have envied. While government officials at every level warned of massive lay-offs and program cuts, the reality was that spending maintained its upward push and the number of government employees also increased.

CHART 3: COMPARISON OF STATE AND LOCAL SPENDING WITH U.S. GDP



Source: US Census Bureau and Bureau of Economic Analysis

By the time the U.S. economy went into recession in 2001, the spending culture in government was firmly established. Forces pushing spending upward included: a seemingly endless stream of new programs, inflation, and increasing volume (e.g., caseloads). At the helm of government was a generation of elected

TABLE 1: GROWTH OF STATE AND LOCAL EMPLOYEES (THOUSANDS)

Year	State and Local Employees	Percent Increase
1998	14,490	
1999	14,748	1.7%
2000	15,077	2.2%
2001	15,378	2.0%
2002	15,708	2.1%
2003	15,760	0.3%
2004	15,788	0.1%

Source: U.S. Census Bureau

officials, most of whom had never really experienced economic hard times. However, they did have a clear understanding of the short-term nature of the election cycle. As the 2001 recession approached, government was an industry dominated by short-term thinking and spending pressures that were ever upward. While the *rate* at which government spending would grow was often debated, the inevitability of growth was widely accepted.

Budget Culture

State and local governments do their most significant work in the construction of the budget. Budgets are the synthesis of every rhetorical point and every political position. Budgets are an opportunity for liberals and conservatives to advance their fundamental values.

Budgets also uncover the conflicts that exist in government. The National Conference of State Legislatures warned, "the central function of a budget — the decision of how much to spend for what — will always create disputes, and no budget will ever satisfy everyone."[2] Confrontations over principles and policies are common during budget preparation, and participants look for ways to finesse sticking points. Deferring expenses into the indefinite future has provided the grease needed to move many budgets past those sticking points. For conservatives deferred responsibility has yielded tax cuts phased-in over several years. Liberals have been willing to initiate new programs, patiently putting them on a glide path toward full implementation. It has become common practice for legislative bodies to pass IOUs along to their successors.

Budget Techniques

Government budgets are complicated and confusing. They are overflowing with mind-numbing detail that can make comprehension and analysis difficult. It is difficult to compare spending across states, or even to compare municipal budgets within the same county. In the 1970s and 1980s, with prodding from public interest foundations and public administration schools, there was a push to make policy choices more evident and to make the budgeting process more scientific. This was the era that spawned performance budgeting, zero-based budgeting, program budgeting, and enhanced revenue and expenditure forecasting.

The presentation of state and local budgets today is unquestionably superior to the manner in which budgets were presented twenty years ago. Yet, it is debatable whether they have achieved the crispness and clarity of private business. One observer noted, "Many of the values of (budget) reforms can be lost by expecting too much from them. They won't ever solve the real problem, which is that we voters want to spend more than we want to pay in taxes, and insist on elected officials who agree with us."[3]

With the clarity that comes from retrospect, it is apparent that the move to improve the government budget process diverted attention away from ensuring the basic fiscal soundness of budgets. At the same time government leaders were instituting program budgeting, they were approving budgets that were full of decisions that passed on growing obligations to future budgets. Across the country there was a drip, drip, drip of advance commitments, many of which were small, but all of which compounded over time. Like a snowball rolling downhill, the advance commitments have grown to $3.5 trillion and they're picking up momentum.

Counter intuitively, the taxpayer protection movement has also prodded decision-makers to offload expenses into the future. Several governments have adopted external spending limits. Either by strict formula or simply by practice, public officials have been caught up in efforts to restrict spending. The most prominent is Colorado which limits state government spending to inflation and population growth. Other states have passed spending limits on segments of government. Wisconsin, for example, has imposed strict caps on school spending since the mid-1990s. In any jurisdiction, it is a rare budget where elected officials do not present their budget in the context of restraint, usually relating budget growth to inflation. Spending restraint is the current watchword in government budgeting.

In an odd way, it is likely that the focus on restraint has encouraged more spending to be pushed into the future. Elected officials want to have their cake and eat it too. For example, Wisconsin Governor James Doyle signed into law a budget that included spending limits on state and local governments. Almost simultaneously, he introduced a brand new initiative that will provide free university tuition to thousands of eighth-grade students. When this new program is fully implemented, it will have an enormous cost. At the time he announced this idea Governor Doyle had no idea what the ultimate cost would be, he only knew that the financial burden would fall to future governors and legislators.

Clearly, government has a propensity to push obligations off into the future. Some would ask why that makes a difference. Why does it matter? It matters for two reasons: First, it obscures the true picture of government spending. Because the cost of some public employee benefits has been pushed into the future, no one can have a true picture of pension or health care costs for retirees. The truth is that many state and local governments have put in place programs that they cannot afford. Second, the bill will eventually come due. In fact, some governments are now confronting the crushing burden of unfunded liabilities. In the next few years state and local governments throughout the country will be finding out the IOU they have been handed, and the amounts will prove staggering.

Public Pensions: The Gift that Keeps on Costing

The government pension, that prototypical American institution, is edging toward crisis. While public sector pension systems have garnered little attention for several years, they are about to be put under the public policy spotlight. Pension funds that, just six years ago, enjoyed unheard of prosperity, have seen their balance sheets plunge into the red. While the public employees who participate in the pension plans have little to worry about, the taxpayers who ultimately fund the plans are due for some substantial sticker shock. The mismatch between pension revenues and pension obligations (unfunded liabilities) arose with unheard of speed, and stands to test the mettle of elected officials throughout the country.

The unfunded liability in state and local pension funds is estimated at between $340 billion[4] and $700 billion.[5] Many state and local governments currently confronting large unfunded pension liabilities have chosen to take a wait-and-see approach. As they wait and see, they are deferring responsibility to some undefined point in the future. Every year the unfunded liability remains unaddressed, the IOU passed into the future grows.

Rules Governing Pensions

In a bygone day, it might have been possible to ignore the unfunded liability because there was no standard way of revealing the liability on the balance sheet. However, this Governmental Accounting Standards Board (GASB), an obscure Norwalk, Connecticut organization, has made that impossible. GASB establishes the accounting rules used to document state and local government finances. In 1994, GASB issued GASB Statement 25, which mandates how the finances of public pension systems are recorded. Under GASB 25, both current and future pension costs must be quantified and included in the annual financial statement. This means that there is no hiding the financial health of pensions and their impact on government balance sheets. Full disclosure revealed the current state of underfunding of public pension systems.

Three aspects of public pension systems must be understood to put this discussion in the proper context. First, nearly all public pension systems are “defined benefit” plans. These plans assure a certain level of retirement benefits to each of the plan participants. Changing that benefit level requires legislative action and, as will be shown, benefit enhancements were quite common in the 1990s.

Second, under public pension systems, the defined benefits are permanent and irrevocable. Courts have found public pension benefits to be a property right, meaning they cannot be taken away or reduced. Benefit reductions can be made, but reductions can only affect future employees. What current employees and retirees have earned is their property, and it cannot be taken away.

Third, public pensions are not regulated by the Employee Retirement Income Security Act (ERISA). There is no financial backstop to distressed public pension funds the way that the Pension Benefit Guarantee Corporation provides a safety net for private sector funds. The implication is that the taxpayers will bail out pension systems unable to pay for the pension benefits of public employees.

This is why it is so significant that GASB moved to create Statement 25 requiring a comprehensive and uniform accounting of pension costs. By fully disclosing the costs, taxpayers will know what they will ultimately be obligated to pay. Under public pension systems, employers (state and local taxpayers) and employees make contributions to the pension plan under the theory that contributions made during an employee’s working life, and the investment earnings on those contributions, will cover the cost of pensions. (In many jurisdictions the government pays both the employer and employee contribution. There is a tax advantage for the employer to pay the employee share if, in lieu of a pay increase, the employer pays the employee share of pension contributions. Compensation increases are subject to federal Social Security and Medicare payments, but retirement contributions are not.[6])

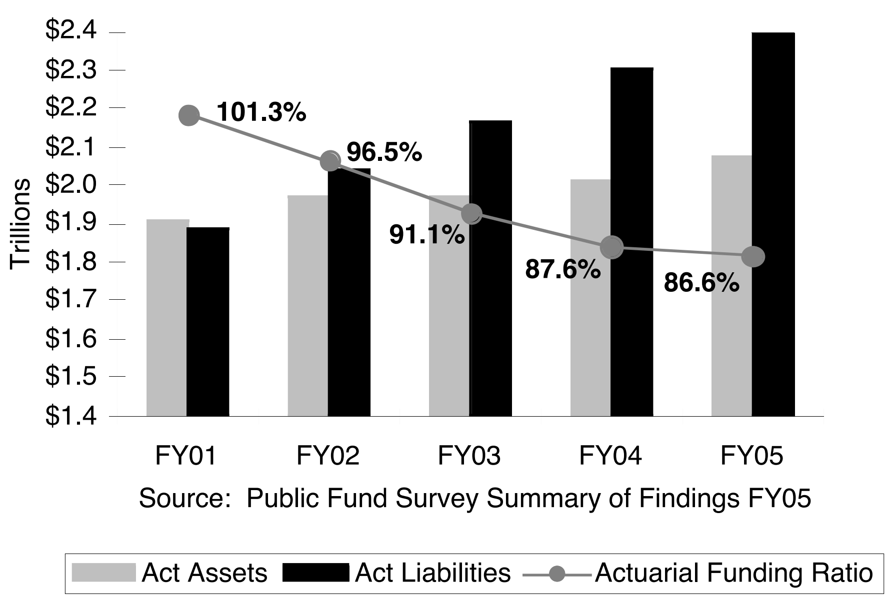
However, will enough money be there when the employees retire? The answer to that question depends on a number of factors including: the level of contributions, the earnings of those contributions, the benefit levels promised to workers, and the life expectancy of the employees. GASB 25 requires each state and local government to actuarially determine the cost (liabilities) of future retirement payments and compare it to the pension fund assets, assuming a certain rate of return (usually around 8%). The difference between these two is the unfunded liability.

Until the 1970s, many pension funds generally invested in fixed-return instruments such as government bonds. In many jurisdictions, it was a legal requirement that only fixed-return investments be used. However, in the 1970s it was found that that the average pension fund would only be able to cover about 50% of its obligations.[7] The returns from the fixed-fund investments were not keeping pace with promised retirement benefits. It was not long before funds changed their investment criteria and began migrating investments to the equity markets. Today, funds invest 40%-45% of their assets in U.S. equities. The investment in equities makes it possible for funds to expect annual returns averaging in the region of eight percent over a forty-year period.

Unfunded Liabilities: The Rising Crisis

As recently as 2001, most public pension funds were on sound financial footing, meaning that the average fund had assets that exceeded liabilities. However, that picture has changed significantly. The National Association of State Retirement Administrators (NASRA) does the most comprehensive survey of pension system finances, including nearly all of the large public pension systems. Their survey represents approximately 88% of the entire state and local government retirement system community.[8] NASRA data in Chart 4 shows that, in 2001, the average funding ratio (the ratio between assets and liabilities) stood at 101.3%. In other words, the average fund had more than enough assets from which to pay future benefits. As shown in Chart 4, by 2005, that ratio had dropped to 86.6%. The resulting unfunded liability is $340 billion. It should be noted that this is an average and many pension funds are in sound financial condition.

CHART 4: CHANGE IN AGGREGATE ACTUARIAL ASSETS, LIABILITIES, AND FUNDING LEVELS



The 2005 unfunded liability, which was just four years in the making, has become a crisis according to *Standard and Poors*.[9] Yet this crisis does not run to the beneficiaries of the pension systems since their pension benefits are assured. Rather, the crisis belongs to the sponsors of the funds — the state and local governments. *Standard and Poors* refers to the unfunded liability as a crisis because they view the unfunded pension liability the same as they view debt. It is as though state and local governments issued an additional $340 billion of debt to cover pension liabilities. The rating agencies factor in the unfunded pension liability when they are assessing a government's fiscal soundness.

The vital question in sizing up a pension system's financial plight is the degree to which the government can accommodate the unfunded liability. According to NASRA's Keith Brainard,

> The critical factor in assessing the current and future health of a pension plan is not so much the plan's actuarial funding level, as whether or not funding the plan's liabilities creates fiscal stress for pension plan sponsors.[10]

Standard and Poors understands that the rising unfunded liability is occurring simultaneously with rising debt while, at the same time, state and local governments are facing many other pressures to increase spending. The concern in financial circles is that government decision-makers will be tempted to avoid taking action to reduce an unfunded pension liability, something many politicians consider an obscure obligation. Indeed, as will be shown, some governments have not only chosen to ignore their unfunded liability, but they also have taken action that actually increases their unfunded liability.

Causes of the Problem

The rise in the unfunded pension liability is generally thought to be the result of disappointing earnings from the equities market during 2001. While the decline of the market, especially the technology sector, did contribute to the increase in the unfunded liability, the declining funding ratios is also attributable to an increase in the current and prospective payout from pension funds. Benefit levels have risen.

What are benefit enhancements that increase pension costs? One common benefit enhancement is early retirement. Especially when finances are stressed and governments are looking to reduce the workforce, incentives are put in place to lure higher-paid workers into retirement. Common incentive packages include higher pension payments or employer-paid health care until the employee is eligible for Medicare. These enhanced benefits, some of which can be permanent, increase the overall cost to the pension fund. The effectiveness of early retirement incentives has been called into question on many follow-up analyses. For example, the Minnesota State Auditor evaluated a 1993 early retirement incentive program that included higher pensions and health care coverage.[11] That evaluation showed that about 50% of the $132 million cost of the program was spent on employees who would have retired at the same time had the incentive program not been in place. The final analysis showed that the incentive program cost more than it saved, a finding which is quite common for early retirement incentives.

Other things that cause costs to increase are expanding the number of employees included in the public safety category (usually ensuring a lower retirement age) or a deferred retirement option program (DROP) whereby long-term employees accumulate pension benefits while remaining on the active payroll. These employees are then paid that accumulated lump sum when they finally retire. DROP payments can amount to a hefty windfall for eligible employees.

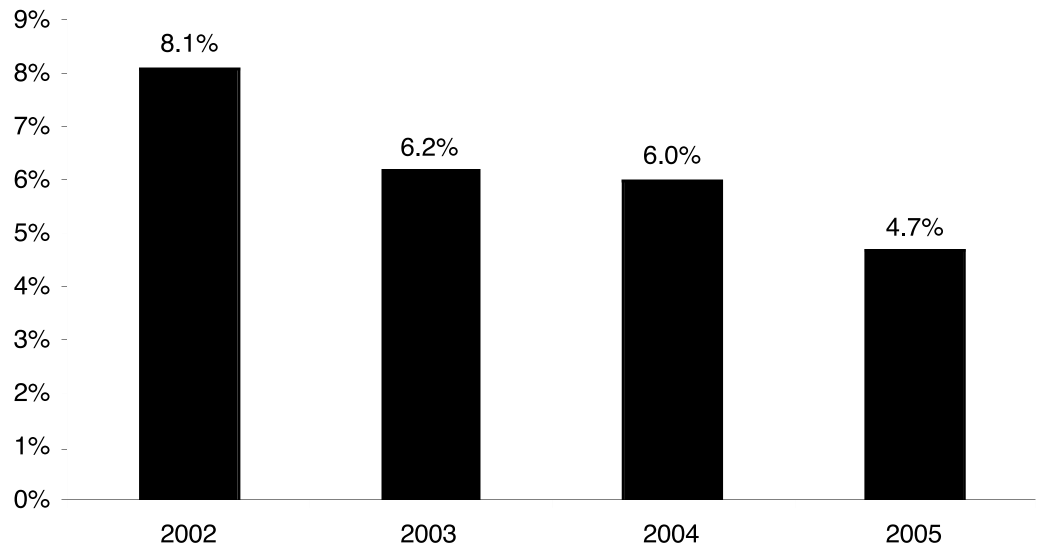
Chart 5 shows the actuarial value of liabilities increased by 8.1% in 2002, 6.2% in 2003, and 6% in 2004. The relatively high rate of annual increases is a reflection of benefit enhancements approved in the 1990s. It is likely that the decline in the rate of increase over that four-year period is due to reduced benefit enhancements, reduced early retirement incentives, and fewer or reduced cost-of-living adjustments. Clearly, due to the transparency of financial reporting required under GASB 25, governmental units across the country made the decision to halt the expansion of pension benefit enhancements.

The calculation of retirement benefits for each individual is dependent on many factors, including final salary, years of service, protective status (police, firefighters, etc.), and a multiplier. The multiplier essentially sets the percentage of the individual's salary each employee earns as a retirement annuity for each year of service. A higher multiplier means a higher retirement benefit. From 1996 to 2000, 37% of the eighty-five plans surveyed increased their benefit multiplier.[12] This helps explain the rise in benefit payments in subsequent years. In addition, several pension systems lowered the age at which an employee could begin collecting retirement benefits.[13]

Government Adjustment to Changing Times

Many state and local governments have been slow to adjust to the growing imbalance in their pension funds. The proximity to the 1990s might help explain this lethargic response. In the 1990s, pension funds were actually a positive contributor to state and local budgets. Between 1994 and 2002, as the stock market grew, pension funds grew to the extent that two-thirds of state governments were able to reduce their pension contributions relative to their tax revenues.[14] Reduced government contributions in the 1990s meant that those funds were available for other spending initiatives.

Chart 5: Annual Change in Aggregate Actuarial Value of Public Pension Liabilities 2002 - 2005



Source: Public Fund Survey Summary of Findings FY05

The 1990s were an unusual economic era for many aspects of American life. For state and local governments it was a time when they could have their cake and eat it too. Pension benefits were enhanced while, at the same time, the raging equity market offset the need to increase pension contributions. The decline begun in 2001 almost gave governments whiplash. The transition to an era of lower investment earnings and higher pension costs, occurred in such a short time period that many governments are still adapting to the new circumstances.

Earlier it was noted that in 2005 the average funding ratio had fallen to 86.6%. Informally, it is believed that an 80% ratio is the demarcation between a serious and a manageable underfunding situation. If a fund's ratio exceeds 80%, it is likely that investment returns combined with increased contributions will be able to restore the ratio to a level much closer to 100%. However, pension funds with ratios below 80% are likely to face a contribution increase that will significantly strain the budget of the underlying government. Further, if the requirement is not met, the problem is compounded. Like a snowball rolling down hill, the pension obligation then becomes difficult to manage and can significantly affect the government's operating budget. Later this report will document three pension funds that are experiencing difficulties of this magnitude. Appendix A lists those pension funds included in NASRA's survey that have funding ratios below 80%.

A number of state and local governments have begun to address the imbalance between pension assets and liabilities. Since 2001, pension contributions (from either employers or employees) have risen by 46%. Some pension funds like the Wisconsin Retirement System include triggers that automatically increase the employee and employer contributions when the actuarial data show the funding ratio dropping. Other funds require an active decision on the part of the legislative body to increase pension contributions. While the increased contributions are encouraging, even with these enhanced contributions, the funding ratios have continued to decline, providing a perspective on just how difficult it can be to maintain a responsible funding ratio in light of sluggish market returns and increased benefit payouts.

The challenge to maintain a funding ratio approaching 100% is further complicated by the growing imbalance between active and retired employees. Over the past several years the ratio of actives to retirees has been shrinking. Between 2001 and 2005 state and local governments experienced a 2.1% increase in active employees. During that time the number of retirees increased by 17.7%. Since increases in pension funding are generally shown as a percent of salaries, any increase would be portrayed as an increase in the fringe benefit rate for current employees.

Three Struggling Pension Plans

While declining funding ratios represent a warning sign, most funds will be able to recover, as the equities markets improve and as contributions are increased. However, taking steps to address a declining funding ratio poses a clash between the neat, proper world of accountants and the rough and tumble of politics. After all, increasing pension contributions competes against all of the other demands for public funds. There will forever be a temptation to simply live with a lower funding ratio and hope that things will improve. This attitude is a slippery slope that could lead to dire consequences for the governmental units.

What follows is a summary of three pension funds with distressed funding ratios. It is instructive to learn the history of these plans, and how their financial distress extends to the governmental units that sponsor the plans.

State of Illinois Retirement System

The Illinois Retirement System (which consists of five separate state systems) has a funding ratio of 59.9%, one of the lowest in the nation.[15] State government seems to anguish over the depressed condition of the pension system, but has yet to form a coherent strategy for how to improve the system. It is a system that has historically been underfunded and now has an unfunded liability of $45.8 billion. Further, there are no prospects for improvement on the horizon. In fact, analysts expect the funding ratio to decline to 57.7% in 2007.

A long list of mistakes and missed opportunities that led to the current condition include:

- Contribution shortfalls—from 1995 to 2003 contributions fell $10 billion short of what was required.
- Investment losses—experience in Illinois is similar to elsewhere.
- Benefit enhancements—from 1995 to 2003 state government approved $5.8 billion benefit enhancements, including an expansion of the employees included in the protective category to include highway maintenance workers.

Two other changes authorized by the Illinois legislature stand out. First, in 2002 they approved an early retirement incentive as a way to encourage high-cost employees to retire, thus freeing up dollars which were used to patch the state budget. However, the $70 million estimated cost of the early retirement program proved significantly wrong. An after-the-fact recalculation of the cost showed a $382 million price tag. Yet the benefit was already in place, employees had retired, and there was no way to revisit the decision. The Illinois taxpayers will have to live with the $312 million error.

Separately, in 2003 the state issued $10 billion of pension obligation bonds. Pension obligation bonds can be advantageous in that the interest rate on the bonds is usually lower than the growth rate of the unfunded liability. Illinois estimated the savings from the pension obligation bonds to be $860 million over the life of the bond. Yet, rather than applying the economic savings to the distressed pension funds, in 2005 the legislature "captured" 25% of the savings and applied $215 million of the savings to help balance the state budget. In the meantime the fiscal condition of the pension fund continues to decline, and the current $45.8 billion cost to the taxpayers of Illinois continues to grow. Illinois is approaching the day when all of the growth in the general fund will be needed to fill the hole in the state's pension system.[16] Years of under-funding the pension system could affect every service and benefit funded from the state budget.

Oklahoma State Pension System

In a March 2006 report to the governor and legislature, the Oklahoma state treasurer described the pension systems as being "in grave need of attention." He went on, "Without definitive action in the near future, the eventual cost of restoring the systems to financial health may be prohibitively expensive."[17] The seven systems sponsored by state government have a combined funding ratio of 60.5% and own a $10 billion unfunded liability.

The largest Oklahoma retirement system, Oklahoma Teachers, has the worst funding ratio among the seven plans. Reviewing financial projections for the Teachers system, the state treasurer noted that, in order simply to maintain the current funding ratio for the Teachers system, $731 million of contributions would be required. In 2005, the state contribution was $164 million — less than one-quarter of the need. Every year the contribution falls short, the cost of the unfunded liability compounds, and the price tag for the taxpayers of Oklahoma increases.

Unlike Illinois, Oklahoma's problem is not related to benefit levels or investment returns. Rather, it is directly attributable to a ticking time bomb planted prior to 1989. For forty years, employers made no contributions to the Teachers system. While the employers began making contributions in 1989, the underfunding that existed in 1989 was never addressed, leading to the problem described by the state treasurer in 2006. The decision to ignore the unfunded liability is now coming home to roost. There is no clearer example of how deferred responsibility in one era will ultimately impact a subsequent generation of legislators and taxpayers. A major taxpayer bailout of the Oklahoma pension systems is in the offing; it is only a question of when.

Minneapolis Teachers

Minnesota is home to several troubled pension systems with the Minneapolis Teachers being the worst. The Minnesota State Auditor commented,

> Contributions to public pension plans by state and local taxpayers have increased significantly over the past nine years, and yet funding shortfalls remain a serious problem. It appears that increased taxpayer contributions to the pension plans are being paid out to the beneficiaries in the form of increased benefit levels instead of being used to address any unfunded liabilities and shore up the overall solvency of the plans.[18]

The Minneapolis Teacher Retirement system provides a glimpse into the future that lies ahead for pension systems that are tempted to allow unfunded liabilities to linger. Decades of underfunding led to a funding ratio of just 44.6%.[19] The State Auditor predicted that the fund was just eight years away from insolvency. The unfunded liability of the Minneapolis Teachers Retirement system, combined with the unfunded liabilities of the other three Minneapolis pension funds, amounted to $1.1 billion — or $3,000 for every man, woman, and child in the city, even the children being taught by the Minneapolis teachers.

The Minneapolis Teachers Retirement system found itself so far down the slippery slope of underfunding that it had no prospects for recovery. In the summer of 2006, an exasperated Minnesota legislature acted and merged Minneapolis Teachers into the State Teachers Retirement system, thus spreading the burden over the entire state of Minnesota. Had the fund been in the private sector, it would either have dragged its sponsor into bankruptcy or retiree benefits would have been reduced to match available funding. However, since it is a public pension fund, the problem was intractable and transfer to a statewide system proved the only viable solution.

The analysts at *Standard and Poors* are correct: state and local governments that fail to address an unfunded liability in their pension funds are effectively issuing debt — for similar to debt, they are passing on a financial obligation to succeeding generations. The rapid decline of funding ratios shows how fragile is the balance of pension funds. While the decline in funding ratios is due to both poor equity market performance and increased benefits, the toolkit for recovery is limited and it does not include benefit adjustments. Recovery of equity markets will eventually improve the funding ratios, but in most instances, the taxpayers will have to step up and increase their contribution to public employee pensions.

Clearly, the manner in which governments choose to fund their employee pension systems can significantly affect the overall operation of government. Yet the accurate, public disclosure of a pension fund is directly attributable to the oversight of GASB. In recent years, GASB has turned its attention to the cost of health care benefits for public sector retirees, and the early returns suggest that the situation is worse than pension funding.

Retiree Health Care: The Emerging Crisis

GASB has now turned its attention to defining how the nation's 84,000 state and local governments account for the cost of "Other Post Employment Benefits (OPEB). By far the most significant post-retirement benefit is health care. While GASB 45, the OPEB disclosure requirement, is in the initial stages of implementation, the early signs point to an unfunded liability that will tower over unfunded pension liabilities. Whereas pension benefits have been pre-funded in most pension plans, only a handful of governments have pre-funded retiree health care benefits.

Government has provided retirees with health care benefits for decades. However, governments have been recording the expenses, as they are incurred, after the employee has retired. This bookkeeping approach is known as the pay-go method, an approach GASB found unacceptable. GASB suspected that the pay-go method understated the cost of the benefits, and, therefore, led to benefit levels beyond what government employers could afford. The early returns suggest that GASB's concerns were well-founded.

The new treatment of OPEB costs recognizes post-retirement benefits as part of an employee's compensation package (similar to pension benefits), even though the benefit is not received until retirement. GASB has issued detailed guidelines as to how state and local governments are to treat the expense, including a twenty-six page "plain language" explanation. Under GASB 45, each governmental unit will be required to make an actuarial determination of the amount they need to contribute each year to ensure that adequate funds will be available to pay the benefit when the employee retires.

The truth is that very few governments have funding set aside to pay for the health care benefit for retirees. The unfunded liability is the difference between the amount they do have available and what the actuarial calculation says should be provided. This unfunded liability is amortized over a thirty-year period, the assumed working life of each employee. Each year the sum of the normal contribution and 1/30 of the unfunded liability constitutes what GASB considers the annual required contribution. If annual contributions fall short of the required contribution, the unfunded liability will grow. Neglecting an unfunded OPEB liability presents the same slippery slope as an unfunded pension liability.

The requirement to comply with GASB 45 will be phased-in over three years. In 2007 state and local governments with budgets of $100 million or more must comply. Smaller units will have to comply over the next two years. Significantly, while requiring the accounting for the OPEB costs, *GASB 45 does not require governments to fund the liability.*

However, the rating agencies — the independent institutions that rate the credit worthiness of state and local governments — will be observing the manner in which each government addresses the unfunded OPEB liability. For example, *Fitch Ratings* considers OPEB a "soft" liability, akin to pensions, in that the determination of the liability is dependent on a number of assumptions. They expect that, once the liability is exposed, governments will take steps to address the problem. "Indefinite deferrals are damaging to credit quality."[20] Similarly, *Standard and Poors* said that they would treat both pension and OPEB liabilities similar to debt, as a long-term obligation of the government. Failure to adequately address the OPEB liabilities is likely to hit governments in a particularly painful area, in their ability to borrow money. At a minimum, governments that ignore substantial unfunded OPEB liabilities are likely to discover an increased cost of borrowing.[21]

Comparison to the Private Sector

Since 1992, private businesses have been required to disclose the cost of post-retirement benefits. The disclosure requirement was adopted in 1990 by the Financial Accounting Standards Board (FASB) for exactly the same reason GASB took action for the public sector. FASB felt that the costs of the benefits were not being fully disclosed and that the full cost was significantly higher than had been revealed up to that point. They were correct.

As a result of the disclosure requirement, many private sector employers saw that the health care benefits provided to their retirees were too costly, and they "began a major overhaul of retiree health benefit programs."[22] Caps on health care benefits were instituted, and many employers migrated their retiree health care to defined contribution health care plans.

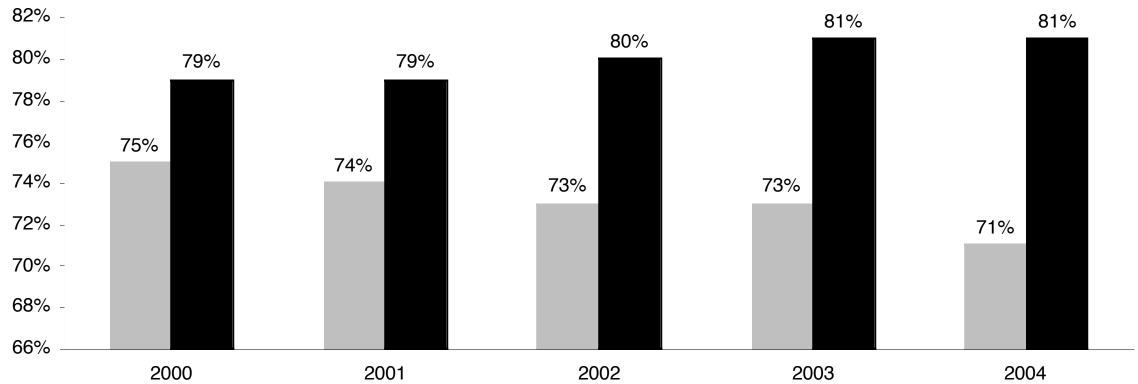
There was an urgency for private sector employers to address their OPEB liability that does not affect public employers. In the private sector, the liability had a direct affect on the bottom line, affecting the profit and loss statements. There was a real, tangible incentive to alter retiree health care benefits. In the public sector, there is no such urgency in addressing the unfunded OPEB liability. However, in the end, governments will have no choice but to address the OPEB liability.

So how does the public sector compare with the private sector in its approach to post-retirement health care? For one thing, health care benefits for retirees are much more prevalent in the public sector. According to the *Kaiser Family Foundation*, while 77% of "large" public sector employers provide the benefits, only 36% of comparable companies do.[23] In addition, Chart 6 shows the public sector employer pays a larger share of employees' health insurance, including health insurance for retirees.[24] Therefore, while the urgency might seem greater in the private sector, the cost implication is probably greater for the public sector employers.

How Big is the Problem?

Since the GASB 45 reporting requirement is in the early stages of implementation, there are no hard national data on the size of the problem. However, as the early returns trickle in, it is clear that it is a very big problem. For example, *Fitch Ratings*, one of the largest rating agencies, estimates that the required contributions could be five to ten times higher than current pay-go contributions.[25] A more conservative estimate in the Bernstein Journal is that

CHART 6: EMPLOYER SHARE OF HEALTH INSURANCE



Originally published by Bernstein Journal from data provided by the Department of Health and Human Services

municipalities will see their cost for post-retirement health care jump from 3% of operating budgets under the pay-go method to 8% under GASB 45.[26]

In California, where state government has estimated an unfunded liability of approximately $70 billion, school districts are facing severe OPEB sticker shock. One district found that its unfunded OPEB liability was equal to 80% of its annual budget, while another district's calculations came in at *double* the annual budget.[27]

The most up-to-date estimate of the unfunded OPEB liability was included in an October 2006 *Bulletin* from the Cato Institute. Basing their estimate on sixteen states and eleven local governments (including schools) that have performed a formal OPEB calculation, the Cato report found the average unfunded OPEB liability to be $135,000 per worker.[28] Extrapolating this cost across state and local governments, (taking into account that only 65% of state and local government workers are covered by this benefit), they determined that the unfunded liability would total $1.4 trillion. This estimate is considerably higher than previous estimates. Is the Cato estimate of $1.4 trillion in unfunded OPEB liabilities too high? While public officials across the country are hoping it is, an examination of the factors contributing to the estimate suggests that the country should brace itself for OPEB sticker shock of the magnitude estimated by Cato.

The reasons why the unfunded liability is so substantial are obvious. First, post-retirement health care benefits for public employees are generous. Benefits with values exceeding $100,000 per employee are common. Second, many benefit packages have no cap on total costs. As people retire earlier and live longer, the cost of the benefit rises. Third, health care cost increases are substantial. The inclusion of a retired population in a health care plan significantly increases employer costs. Fourth, there has been very little pre-funding of health care benefits. If the experience of the public sector mimics that of the private sector, pre-funding of OPEB will be well below that of pensions. Large, private sector companies had a funding ratio of 88% for pensions, but a mere 27% for post-retirement health care.[29]

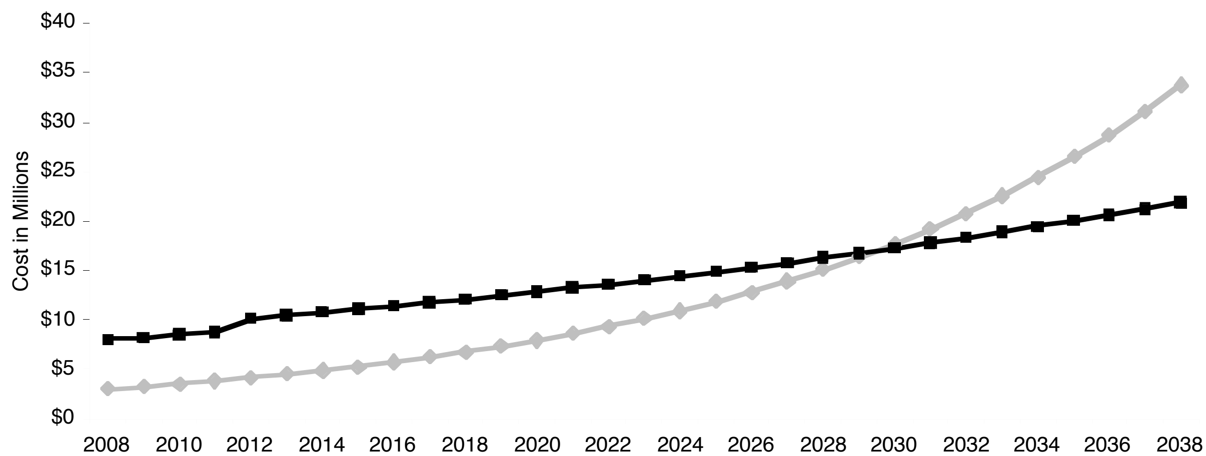
What Will State and Local Governments Do?

It is not often that accountants and actuaries take center stage in shaping public policy. When they do, it seems to involve a highly visible issue. The Enron accounting fiasco is probably the most pronounced example of accountants affecting the course of events. The unfunded OPEB liability will be the next visible, contentious public policy issue. It has two elements that stand to elevate the issue in the public eye. First, the amounts involved are staggering. Second, many people will see the unfunded OPEB liability as government's attempt to fly under the public radar. At a time when government resources are stretched and government's credibility is questioned, this obscure issue could become a visible public issue.

Taxpayer reaction to the unfunded OPEB liability could be harsh. What should government do with the disclosure of a substantial unfunded liability? It will be instructive to observe the reaction of contemporary elected officials who have been handed this problem by prior generations of officials. There are essentially three options available to them: do nothing, convert the liability into hard debt, or manage the expense that led to the liability.

The inclination for many state and local governments will simply be to acknowledge the unfunded liability, but continue only to make pay-go payments. After all, there is no requirement under GASB 45 that governments do anything to address the disclosed liability. However, every action, even if it is to do nothing, will be interpreted by the rating agencies as an overt action. Doing nothing will be interpreted as government's acceptance of a growing liability. It will be viewed the same as the issuance of debt. Chart 7 shows how the Pay-go method, while requiring lower payments in the short run, will increase substantially in the end. Over time, inaction on the unfunded OPEB liability will affect a government's credit rating, thus increasing the cost of accessing capital markets. In extreme cases, it might make those markets unavailable.

Chart 7: Retirement Benefits Cost Comparison



Source: Author Calculations Based on National Health Expenditure Data from US Department of Health and Human Services

The second option is to issue bonds to expunge some or all of the unfunded liability. This is referred to as converting a soft liability (unfunded OPEB) into a hard liability (debt). For example, the State of Wisconsin issued $600 million of bonds to retire its liability. Since the liability was compounding at a higher rate than the interest rate paid on the bonds, the state taxpayers saved money by converting the "soft" unfunded liability to "hard" debt.

The specific arbitrage circumstances will differ among governmental units. Oftentimes there are arbitrage benefits available by using debt to finance an unfunded OPEB liability. However, as shown earlier in this report, state and local government debt has been rising substantially, and the incursion of additional debt should be done with caution.

The third option to address an unfunded OPEB liability is to manage the underlying cost that drives the liability. Unlike an unfunded pension liability, **governments can take action to reduce their OPEB costs**. Whereas pension benefits are a property right, OPEB benefits are not. The benefits are contractually determined and can be modified. Private sector companies have made a number of changes including: capping benefits, requiring employees to make matching contributions, and converting retiree health care benefits from defined benefit to defined contribution plans.

Encouraging governments to reduce benefits to affordable levels is what GASB was encouraging governments to do when they instituted GASB 45. Although renegotiating retiree health care benefits with employee unions or changing statutes or ordinances is not easy, the alternative is for elected officials to either cut into the budgets of other programs or turn to the taxpayers for additional revenue. Thanks to GASB 45, the accountants and actuaries will force state and local governments everywhere to have this debate.

WISCONSIN

On the surface, it might appear that Wisconsin does not have the same unfunded liability as other places. However, a closer look shows that Wisconsin taxpayers face mounting bills for underfunded pension and health care benefits for retired public employees just like everywhere else. While part of the cost of the unfunded liability is already known, the full amount will not be known for another three years when all governments and school districts will have to calculate their health care liability.

The unfunded pension liability for Wisconsin taxpayers is mostly attributable to costs from the Wisconsin Retirement System (WRS). This system covers employees in state government, the University of Wisconsin System, all local school districts, and nearly all local governments. The two entities not included in the WRS are Milwaukee County and the City of Milwaukee. Data collected by the National Association of State Retirement Administrators shows the WRS sports a gaudy funding ratio of 99.4%. However, this healthy funding ratio is only possible because, in 2003, the governor and legislature acted to issue long-term bonds to liquidate state government's unfunded liability. While this move changed the liability from unfunded to funded, the taxpayers of Wisconsin will still have to pay dearly.

Here is how state government extinguished its unfunded liability for both pensions and retiree health care. In the 2003-2005 biennial budget, the state's unfunded pension liability was pegged at $729 million and its unfunded retiree health care liability at $600 million. The state's total unfunded liability was just over $1.3 billion. The governor and legislature put $1.3 billion of bonding authority in the budget to extinguish both of the liabilities. The rationale was that the interest rate the state would pay to retire the debt would be less than the 8% annual growth rate paid if the state continued to retire its unfunded liability one year at a time. While the move did save state taxpayers $324 million over the life of the bond, the bill to the taxpayers was far from eliminated.

The "refinancing" of the unfunded pension and health care liabilities left Wisconsin taxpayers with a hard and fast debt to pay. Specifically, over the life of the bonds, taxpayers will pay $3.6 billion to retire the bonds. In 2007, the amount required is $98 million and, because of the way the debt repayment was structured, the annual payment will escalate to over $200 million in 2026. Although the amount would have been $324 million more had the refinancing not occurred, the bill to Wisconsin taxpayers is still substantial.

At the same time state government refinanced its unfunded pension liability, it was estimated that local governments had an unfunded liability of $998 million. Some local governments have since refinanced their unfunded pension liability, but many have not. The Milwaukee Public School System operates three separate pension systems, one of which refinanced the unfunded pension liability and two of which did not. The total the unfunded pension liability and the bond liability for MPS is $294 million.

For all Wisconsin local governments, the retirement of the unfunded pension liabilities will require approximately $5 billion from Wisconsin taxpayers over the next twenty years.[30]

As noted above, these estimates do not include Milwaukee or Milwaukee County since they do not participate in the WRS. While the City of Milwaukee Pension system is well-funded, Milwaukee County has an unfunded liability of $455 million. Thus, local governments in Wisconsin will pay over $5.5 billion to address their unfunded pension liabilities.

More substantially, looming over local governments and school districts in Wisconsin is the pending obligation to identify the unfunded liability related to health care for retirees. It is uncertain what that liability will be. Those units with budgets exceeding $100 million must identify the liability in 2007. Most are in the process of doing the necessary actuarial evaluation. The smaller units will have to make their determination within the following two years. However, early indications are that the final tally of unfunded health care will be sizeable. For example, the Milwaukee Public School System in 2002 estimated its unfunded liability to be $1.45 billion. It is anticipated this will increase when the actuarial analysis is complete. Similarly, Milwaukee County has estimated its unfunded liability at $1.4 billion. The combination of the two dwarfs state government's $600 million liability.

How large might the unfunded liability be for the balance of local governments and school districts? We know that the unfunded pension liability for local governments is $998 million. If the relationship between unfunded pension and unfunded health care liabilities is similar to that experienced in state government (53% health care, 47% pension), the unfunded health care liabilities for local governments outside of Milwaukee could total $1.1 billion. This would require in excess of $5 billion over a twenty-year period. Is it likely that substantial unfunded health care liabilities will be discovered? The simple answer is yes. In every instance where retiree health care benefits are not pre-funded, an unfunded liability will exist. The size of the liability will depend on the richness of the health care benefit package, the cap on benefits, and the age of retirees. As early retirement incentives have succeeded in encouraging employees to retire at an early age, it is likely that the incentive packages have exacerbated the unfunded health care liability. Only time will tell.

In total then, state and local governments in Wisconsin will pay approximately $17.4 billion to get rid of their unfunded pension and retiree health care liabilities. While this estimate could be reduced a bit through advantageous refinancing, it could be even higher once the unfunded health care liability for local governments (including schools) is known.

RECOMMENDATIONS

The accounting rules handed down by GASB are doing exactly what they were intended to do, to get all of the cards on the table. With the full cost of pensions and retiree health care identified, each governmental entity can decide whether it can afford the current level of benefits provided to employees. That is a healthy discussion that will cause the fundamental underpinnings of employee benefits to change. It is a common perception that benefits for public employees are more expensive than those offered their counterparts in private industry. Now an apples-to-apples comparison will be possible. Just as General Motors and every other profit-driven business has been forced to evaluate the employee benefit package, so too will government have to evaluate and justify its benefits.

The ultimate goal for every government should be to keep debt within a manageable range and to work toward the liquidation of its unfunded liability. While liquidating an unfunded liability may take years, the goal of advance funding of both pension and post-retirement health care is good for taxpayers and good for employees. For taxpayers, it will mean that employee benefits are in line with what is affordable to the taxpayers. For employees, advance funding provides better assurances that the expected benefit will be funded when they retire.

For governments facing unfunded pension and OPEB liabilities, the following measures are suggested as an alternative to doing nothing:

1. Bring health care benefits into line with available funding. As noted, OPEB benefits can be modified. The experience of private businesses, which have been required to factor OPEB into the calculation of profits and losses, has shown that changes are possible. Cost containment measures to be encouraged include: capping benefits, reducing the years for which a retiree can collect the benefit, and increasing the service requirement for employees.
2. Convert retiree health care from a defined benefit plan to a defined contribution plan. Under this approach, employees and employers would contribute to an employee's post-retirement health care coverage, similar to creating a health care savings plan for each employee. The amount in the fund when the employee retires would be available to pay for health care in retirement. While it might be difficult to make this change for current employees and retirees, it would be advisable to make the change for new hires.

   Similarly, governments whose pension systems own weak funding ratios should move to replace defined benefit plans with defined contribution plans. While such a change would only apply to new employees and would thus only yield modest, short-term savings, it could yield substantial savings over the long run. Conceptually, it would prevent the common occurrence whereby pension contributions are derived based on market performance and other variables. Under defined contribution plans, contribution requirements for employers and employees would be more predictable.
3. Convert soft pension and OPEB liabilities into hard liabilities through debt finance. If the arbitrage advantages are available, this approach is an acceptable way for governments to reduce the cost of pre-funding retiree benefits. However, debt financing only affects embedded costs and does not address the underlying factors that drive the cost of post-retirement health care on a long-term basis. Shaving a few basis points off the long-term cost of unfunded liabilities should not divert attention from understanding the underlying cause for the unfunded liability; can government afford the benefits it has promised to its employees?
4. Create an OPEB trust fund. When a government makes the effort to pre-fund OPEB costs, it will undoubtedly be tempting for a future legislative body to use accumulated reserves to address budget shortfalls. Placing the funds in a trust fund will help ensure that these funds are used only for OPEB purposes.

5. Elected officials who have ultimate authority over the size and funding of retirement benefits should not be allowed to participate in the system they oversee. Even if the decisions are financially sound, the appearance of a conflict of interest will cast a shadow over every decision they reach.
6. Be cautious when contemplating early retirement incentives. Too often decisions to open an early retirement window is driven solely by the prospect of short-term savings.

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APPENDIX A—PUBLIC PENSION PLANS WITH FUNDING RATIOS BELOW 80%—2005

Plan	Funding Ratio	Unfunded Liability (000s)
W. Va. Teachers	24.6	4,990
Indiana Teachers	43.3	9,199
Minneapolis Teachers	44.6	972
Oklahoma Teachers	49.5	7,099
Connecticut SERS	53.3	7,469
Missouri DOT and Hwy. Ptrl.	53.9	1,210
Illinois SERS	54.4	8,810
Rhode Island ERS	59.4	3,785
Illinois Teachers	60.8	21,989
Louisiana SERS	61.5	4,173
Alaska Teachers	64.3	2,278
Louisiana Teachers	64.6	6,617
Connecticut Teachers	65.3	5,223
Illinois Universities	65.6	6,999
Hawaii ERS	68.6	4,071
Massachusetts Teachers	69.6	7,445
St. Paul Teachers	69.7	394
Kansas PERS	69.8	4,742
Nevada Police and Fire	69.8	1,470
Alaska PERS	70.2	3,413
New Mexico Teachers	70.4	3,134
N. Hampshire Ret.	71.1	1,454
Oklahoma PERS	72.0	2,124
Missouri PERS	72.4	6,546
Ohio Teachers	72.8	20,051
Colorado State and School	72.9	11,784
Montana Teachers	73.4	1,029
Ohio School Employees	74.3	3,068
Minnesota PERF	74.5	4,048
Kentucky ERS	74.6	2,034
North Dakota Teachers	74.8	495
Kentucky Teachers	76.3	4,536
Michigan Municipal	76.6	1,433
Washington PERS	77.2	2,927
Nevada Regular Employees	77.3	4,251
Colorado Municipal	78.0	663
City of Austin ERS	78.0	395
Chicago Teachers	79.0	2,789

Source: National Association of State Retirement Administrators, 2005 Public Fund Survey.

About the Institute

The **Wisconsin Policy Research Institute** is a not-for-profit institute established to study public-policy issues affecting the state of Wisconsin.

Under the new federalism, government policy increasingly is made at the state and local levels. These public-policy decisions affect the life of every citizen in the state. Our goal is to provide nonpartisan research on key issues affecting Wisconsinites, so that their elected representatives can make informed decisions to improve the quality of life and future of the state.

Our major priority is to increase the accountability of Wisconsin's government. State and local governments must be responsive to the citizenry, both in terms of the programs they devise and the tax money they spend. Accountability should apply in every area to which the state devotes the public's funds.

The Institute's agenda encompasses the following issues: education, welfare and social services, criminal justice, taxes and spending, and economic development.

We believe that the views of the citizens of Wisconsin should guide the decisions of government officials. To help accomplish this, we also conduct regular public-opinion polls that are designed to inform public officials about how the citizenry views major statewide issues. These polls are disseminated through the media and are made available to the general public and the legislative and executive branches of state government. It is essential that elected officials remember that all of the programs they create and all of the money they spend comes from the citizens of Wisconsin and is made available through their taxes. Public policy should reflect the real needs and concerns of all of the citizens of the state and not those of specific special-interest groups.