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Costly Promises

Paying Health Care From Pensions Proves Costly

By MARY WILLIAMS WALSH

Many local governments began turning to their pension funds to help pay for health care for retired public workers in the 1990s. Some are now regretting it.

When the financial markets were producing soaring returns, governments sought to use the gains in their pension funds to help cover rising health costs. Then came years of investment losses and double-digit increases in health care costs.

Now, in some places, money for retiree health care is running out, and money for pensions is dwindling fast, too. Rising medical costs are particularly wreaking havoc on public pension funds in Chicago; Battle Creek, Mich.; and the state of Alaska. They threaten longer-term harm in Cincinnati.

"The numbers are frightening to anyone who really looks," said Laurence Msall, president of the Civic Federation, a nonpartisan research group in Chicago, where three separate pension funds for public workers have been paying for health benefits along with the usual retirement stipends.

The troubles foreshadow broader government problems — not just in those that combined their pension and retiree medical accounts — as states and localities that never estimated the cost of their retirees' health care move to do so now.

Donald Rueckert Jr., senior vice president and an actuary with Aon Consulting who has been helping state and local governments with these calculations, said that when all the numbers are done, under a new accounting rule, the governments' total retiree health bill will probably turn out to be about $1.1 trillion.

Relieving the strain on government budgets from rising health care costs will probably mean taking one or more unwelcome steps: tax increases, union givebacks, sales of bonds or public assets, mass-transit fare increases, or increases in the cost of other local services. These measures are so unappealing that few who understand the problem are pushing them very hard.

The local troubles also offer a sense of the challenge in store on a national scale as the obligations of Medicare and Social Security rise sharply to cover the retirement of the baby boom generation. While the two federal programs maintain separate accounts, economists have warned repeatedly that they have both promised benefits well beyond what they can reasonably be expected to pay.

For the Chicago Transit Authority's pension fund, the problems are real now. A recent study showed that the plan, which covers nearly 20,000 people, could run out of money for retiree health care in early 2007 — and that the money to pay pensions could be gone by 2012.

"There were decisions taken years ago that seemed harmless at the time, but now they're very problematic," said John V. Kallianis, the plan's executive director.

One was the decision in 1980 to start paying retiree health benefits without setting aside enough money to cover the cost. "Anyone who has embedded their obligation for their retiree health plan in their pension fund and doesn't think it's going to be a big drain on the assets of that pension fund is crazy," said Lynn E.

Turner, a former chief accountant for the Securities and Exchange Commission who is now managing director of research at Glass, Lewis & Company, a proxy advisory firm.

But many local governments and their financial advisers did not see it that way in the 1980s and 1990s. While rules were established aimed at protecting pension assets, their investments were doing so well then that there seemed to be plenty of money to spare. Building a retiree health plan into a pension fund seemed an efficient way to use the "excess" and take pressure off the local budget at the same time.

Battle Creek's pension fund for police and firefighters has been paying for retiree health care since 1980, when the benefits cost about $60,000 a year; now they cost $1.8 million. The pension fund was to run out of money for retiree health at the end of this year, but officials obtained an emergency 90-day appropriation from the city while they seek a longer-term solution.

In Alaska, where the state Constitution guarantees retired public workers' health care, towns and school districts have been watching in amazement as their mandatory pension contributions doubled this year — even though Alaska tried to rein in costs by closing the state pension fund to new employees. The bills are growing to make up for prior years, when Alaska underestimated the cost of the health benefits by hundreds of millions of dollars.

Mr. Msall of the Civic Federation said it would be a mistake for these places to delay action in hopes that big pension investment returns could solve the problem. "There's no way the market is going to keep up with the inflationary pressures of unmanaged health care costs," he said.

Like many public pension funds, the Chicago transit plan receives contributions from both the workers and their employer. Currently, 3 percent of every worker's paycheck goes into the pension fund, while the Chicago Transit Authority puts in another 6 percent of its payroll.

But the employees have been told that the money going into the pension fund is not nearly enough to cover the pension and health payments coming out.

"Medical costs are shooting way out of control," said Jim Collins, a city bus driver, "and nobody is giving a whistle."

With the assets draining away, the transit authority and the Amalgamated Transit Union have been trying to negotiate a package of higher contributions or benefit cuts that could stop the bleeding. But the talks have stalled. The state legislature passed a law requiring the plan to be correctly funded starting in 2009 but did not make clear how this would happen.

Mr. Collins has been driving for 24 years and will qualify to retire next year, when he turns 55. He said he was tired of traffic jams, predawn shifts and workplace politics. By next year he will have earned a pension of about $2,800 a month.

But planning his retirement is impossible, he said, with the retiree health plan teetering on the brink. If he retired on schedule and the health plan failed, he could be left with no insurance for 10 years, until he turns 65 and qualifies for Medicare.

Transit workers are not the only ones in Chicago in this predicament. The pension plan for Cook County's roughly 40,000 government workers and retirees has been paying for retiree health care since 1991, at a cost currently running at about $37 million a year.

Cook County's chief financial officer, Thomas J. Glaser, said that the county never authorized this diversion — the pension trustees did it unilaterally, he contended. The nine-member pension board is dominated by locally influential people who represent the county's workers and retirees, and they can easily outvote the two trustees who represent the county.

Since the county never agreed to the provision, Mr. Glaser said, it was disavowing any obligation for retiree health. "No one can impose a liability on the county without the county's approval," he said.

If Cook County succeeds in bowing out, its 26,000 active government workers will be liable for their retired former co-workers' health care. Their contributions to the pension fund, now 8.5 percent of each paycheck, would have to rise. Employees have not yet been told of this possibility, but Mr. Glaser said he expected it to become apparent in the next few months when the county board debates next year's budget.

Elsewhere, plans have been tripped up by misreading actuarial projections and thinking there was "extra" pension money when there was not. One common error has been to spend investment income before it has been earned.

Another is to underestimate the rate of health cost inflation. Estimates typically assume the rate will taper off to 5 percent in the next few years, even though health inflation has been running at almost double that, with little sign of slowing.

The Internal Revenue Service permits pension money to be spent on health care only if certain rules are followed, to keep health payments from bleeding the pension assets. In recent years, governments have thought they could comply by creating a separate account for health benefits inside their pension funds and limiting their contributions to the health account to no more than 25 percent of the total.

But with gray areas in the tax law and the accounting rules for pensions, those steps may not have been enough to prevent violations.

Some cities have also promised comprehensive health coverage to all retirees, even those who retire in their 40s. Cities and states that offer narrower benefits, or do not permit such early retirement, are less likely to find themselves squeezed.

New York City never dipped into its pension fund to pay retiree health benefits but, like many places, it did not set aside any money to pay retiree health care obligations. Instead, it has used the pay-as-you-go method, taking money from each year's budget to pay current health bills.

Now that the new accounting rule has forced New York, along with other state and local governments, to look ahead, the city has just published the total estimated future cost of its retirees' health care: $53.5 billion in today's dollars.

Mayor Michael R. Bloomberg has said that the city will set up a new trust fund, separate from the pension fund, and prime it with $2.2 billion from the city's current surplus. While the down payment is small relative to what is owed, credit analysts expressed approval that New York, unlike most other places, was at least starting with a plan.

Still, not every government is in trouble. Alameda County, Calif., which includes Oakland, says it has kept its plans responsibly funded even though it uses pension money for retirees' health care. Still, the fund's executive director called the situation unusual.

Other places that have tried to set aside ample resources are running into problems anyway. The pension fund in Cincinnati, for one, shows an unusually large amount of money available to pay for promised pensions and health care.

The trouble is, those rosy numbers have recently encouraged the city to withhold contributions — effectively borrowing from the pension fund — to shift money to neighborhood development projects even as it is accelerating retirement benefits coming due. Cincinnati is downsizing its municipal work force and offering early retirees and their dependents health care at little or no cost.

“It’s like musical chairs,” said Christopher Smitherman, a former Cincinnati City Council member. “Whose lap is this whole problem going to fall into?”

Local officials dispute Mr. Smitherman’s contention, saying they are trying to strike a balance between the pension fund and other pressing needs, like hiring more police. When he issued his budget proposals last month, Mayor Mark Mallory said that he remained “committed to fully funding the retirement system.”

The Chicago Transit Authority’s problems are beyond dispute. The president of the union local representing its railway workers, Rick Harris, said that the workers could double their pension contributions — and the retirees could chip in for their health care — and it would still not be enough.

“We’re putting a Band-Aid on a bullet wound,” Mr. Harris said.