Passing the Buck

Maryland's Unfunded Liabilities for State and Local Retirees

The Maryland Public Policy Institute

Calvert Institute

Passing the Buck: Maryland's Unfunded Liabilities for State and Local Retirees

The Maryland Public Policy Institute

Calvert Institute

Published by
The Maryland Public Policy Institute
1 Research Court
Suite 450
Rockville, Maryland 20850
(240) 686-3510

mdpolicy.org

SUMMARY

Maryland's state and local pension and retirement benefits plans are in for some hard times ahead. Facing budget shortfalls, governments are underfunding their retirement plans, while at the same time expanding the benefit promises to public employees. This unsustainable financing places both taxpayers and public employees at risk.

Today, the Maryland State Retirement and Pension System suffers from an unfunded deficit of over $11 billion. The State's unfunded liabilities for non-pension retirement benefits (such as retirees' health care) are estimated to range anywhere from $8 billion to $15 billion. Many county and local government entities face similarly severe deficits. Those liabilities will constrain state and local budgets in the decades ahead.

To make matters worse, with the implementation of the Governmental Accounting Standards Board Statement 45, state and local governments will be required for the first time to calculate and make public their retirement benefit liabilities. Those liabilities will reduce the governments' creditworthiness and increase their borrowing costs.

This joint study by the Maryland Public Policy Institute and the Calvert Institute evaluates Maryland's unfunded retirement liabilities for its public employees. The first report, by George Liebmann, specifically examines pension liabilities, while the second report, by Gabriel Michael, examines liabilities for other retirement benefits.

Maryland's State and Local Pension Liabilities

George W. Liebmann

Maryland State Fund

The State of Maryland and its subdivisions face equally large hidden contingent liabilities in their defined benefit pension plans.

The response of both the Robert Ehrlich and Martin O'Malley administrations to this impending crisis has been defined by the principle, "When you're in a hole, dig deeper." The Ehrlich administration, under pressure from Democrats in the 2006 election year, signed into law a major expansion of the state's defined benefit pension program for teachers. Even the outgoing president of the Maryland State Teachers' Association, Patricia Foerster, noted how remarkable this lobbying achievement was, in that Maryland was actually expanding its defined benefit program while other states were converting to sounder, defined contribution systems. Furthermore, the expansion was enacted on the premise that it was needed to bring Maryland teacher compensation in line with compensation elsewhere, a proposition promptly deflated in a careful study by the Abell Foundation and the Maryland Public Policy Institute: *Is It Time To Rethink Teacher Pensions in Maryland?* (2006).[1] Moreover, in a feat of misplaced egalitarianism, the increases made available to teachers were also made available to state employees generally.

The result is recorded in purposefully obscure notations in "The Ninety-Day Report" issued by the Department of Legislative Services after the 2008 General Assembly. The report notes that the state's structural deficit or annual recurring shortfall was recently increased because of "an actuarial error in retirement contributions which adds nearly $70 million per year in additional spending for teachers' retirement costs."[2]

Projecting increases for fiscal 2009, the report notes: "Teachers' retirement, which is paid by the state on behalf of local school systems, will grow from $566.4 million to $621.8 million, an increase of $55.4 million or 9.8 percent...The increase of nearly ten percent in the teachers' retirement program is mostly due to an 8.8 percent increase in the salary bases for local boards of education." These include seniority increments, with the increase far exceeding the rate of inflation.[3] Similarly, state retirement contributions for local employees, chiefly those in community colleges and libraries, increased from $36 million to $39.3 million.[4]

---

1. Available at http://www.abell.org/publications/detail.asp?ID=123.
2. "The Ninety-Day Report," Department of Legislative Services, p. A-17.
3. *Ibid.*, A-24 and A-85.

Notwithstanding the melancholy experience with affirmative action for investment firms, notably those of Nathan Chapman and Alan Bond,[5] the 2008 legislature passed and the governor signed S.B. 606, mandating affirmative action for such firms.[6] In addition, urged on by some neoconservative organizations in Washington, D.C., the General Assembly required divestiture from companies doing business with Iran and Sudan, thus reducing yields and enlarging administrative costs.[7] Although the Chapman firm allegedly did not actually lose money during a five-year period when peer pension funds were enjoying 5.13 percent average annual yields, another affirmative action manager, Progressive, lost more than half the funds confided to its care.

The dimensions of the actuarial deficit of the Maryland State Retirement and Pension System are disclosed in its report for the year ending June 30, 2007.[8] As of that date, the actuarial liabilities of the fund were $49.3 billion, an increase of $6 billion in one year, while actuarial assets were $37.9 billion, an increase of $2.1 billion. The actuarial deficit was thus $11.4 billion, and the funding ratio was 76.8 percent. The origins of much of this deficit are found in the years 2000 to 2005, when the five-year rate of return for the State Retirement System was an annual 3.21 percent as against 5.13 percent for peer funds,[9] translating into a shortfall in investment earnings of $2.5 billion over that five-year period. The calculation of actuarial value assumes (with some qualifications) a constant investment return of 7.75 percent. Many authorities regard this sort of projected return over time as over-optimistic, though the projected return was far exceeded in 2006-2007.

"While anything is possible, does anyone really believe this is the most likely outcome?" Warren Buffett wrote in the most recent annual report of his firm, Berkshire Hathaway. A growing number of leading investors are warning that the return rates used by state and local governments are unreasonably optimistic. Buffett, for one, has pointed out that over the twentieth century, when the Dow Jones Industrial Average soared from 60 points to 13,000, the stock market produced a 5.3 percent annual return for investors. Over the next century, the Dow would have to explode to 2.4 million to produce a similar rate of return.[10]

4. *Ibid.*, A-81.
5. See Calvert Institute, *The Baltimore City Retirement Systems: Heading for Trouble*, March 2006, 25, n. 3.
6. Chapter 601 of the Acts of 2008, enacting Sec. 21-116(D)(1) of the State Personnel and Pensions article.
7. Chapter 342 of the Acts of 2008, enacting Sec. 21-123.1 of the State Personnel and Pensions article.
8. P. 66.
9. 2002-2003 *Maryland State Budget*, vol. I, 582.
10. David Cho, "Growing Deficits Threaten Pensions: Accounting Tactics Conceal a Crisis for Public Workers," *The Washington Post*, May 11, 2008, A-1.

The state actuarial deficit was 115 percent of covered payroll as of June 30, 2007. The fund had an actuarial surplus as recently as 2000.[11] One of the three causes of the sharp increase in the actuarial deficit is "the benefit enhancements recognized in 2006."[12] In 2007, the system shifted from "the aggregate entry age normal cost method to the individual entry age normal cost method." Absent this change, the funding ratio as of June 30, 2007, would have been 84.6 percent, rather than the 76.8 percent reported. As at June 30, 2007, the funding deficit was equal to 115 percent of payroll. The funding ratio as of June 30, 2006, was 82.78 percent as against 88.21 percent as of June 30, 2005. Between June 30, 2005, and June 30, 2006, actuarial liabilities increased by $4.1 billion and the actuarial deficit by $3.8 billion. This sizable one-year change, unlike the one that followed, appears to have been due to the benefit improvements secured at the behest of the teachers' unions.

In the 2007 fiscal year, the State Fund had investment returns of 17.6 percent. This seemingly glittering performance, however, compares unfavorably with the 18.33 percent return of the Baltimore City Employees' Retirement System and the 19.8 percent return of the Baltimore City Fire and Police Retirement System. The benchmark used by the latter system (45 percent Russell 3000, 20 percent MSCI ACWI Free Ex-US, 25 percent Lehman Aggregate, and 10 percent NCREIF Property Index) had a return of 18.2 percent.

The state's formula for funding these deficits is recognized by its board as being inadequate. The situation was aggravated by the Ehrlich administration's failure to make $267.5 million in required contributions over a three-year period as a "budget balancing" measure.[13] The contributions not made were $52 million in 2003, $78 million in 2004, and $137 million in 2005. The new O'Malley administration, not to be outdone, withheld required contributions of $157 million in 2006 and $195 million in 2007. In the latter year, only 81 percent of the required contribution was made.[14] Maryland adopted a funding formula in 1992 that prompted a sharp drop in pension funding levels.[15]

Anne Arundel County Funds

Anne Arundel County's annual expenditures for pensions have increased from $23.8 million in fiscal 2003 to $35.7 million in fiscal 2007, a more modest increase than in other subdivisions. Its four funds have funding ratios as of June 30, 2007, of between 87.2 percent and 97.1 percent; the overall funding ratio is a

11. P. 71.

12. P. 68.

13. Maryland State Retirement System, 2004-2005 *Annual Report*, p. 35.

14. Maryland State Retirement Systems, 2006-2007 *Annual Report*, p. 34.

15. David Cho, "Growing Deficits Threaten Pensions: Accounting Tactics Conceal a Crisis for Public Workers," *The Washington Post*, May 11, 2008, p. A-1.

solid 95.2 percent. The funds total $1.28 billion; the total actuarial deficit is $62.1 million.

Baltimore City Funds

The Baltimore City Employees Retirement System had an actuarial deficit as of June 30, 2007, of $151.5 million, up from $119.4 million in the preceding year. There was an actuarial surplus position as recently as June 30, 2003. The funding ratio as of June 30, 2007, was 90.5 percent, the actuarial deficit being 43.7 percent of covered payroll. Annual required contributions by the City escalated from $17.7 million in 2003 to $36.8 million in 2007.

The Baltimore City Fire and Police System had an actuarial deficit as of June 30, 2007, of $235.2 million, up from $204.5 million in the preceding year. There was an actuarial surplus position as of June 30, 2001. The funding ratio as of June 30, 2007 was 91.9 percent, the actuarial deficit being 92.4 percent of covered payroll. Annual required contributions by the city increased from $34.7 million in 2003 to $54.6 million in 2007, in which year the city contributed an additional $5.4 million toward the accrued deficit. Thus, the city's combined contributions to the two systems virtually doubled in four years, from $52.4 million in 2003 to $96.8 million in 2007.

The two city systems used the same investment manager, Callan and Associates, until June 30, 2002. Thereafter, the Fire and Police System used a different manager, Summit and Associates, and dispensed also with its affirmative action-oriented Equity Fund of Funds, managed by FIS Funds Management, Inc. The result has been something in the nature of a controlled experiment. In the ensuing five years, the Fire and Police portfolio outperformed that of the ERS. The divergence in the last year was 1.47 percent; over the five-year period there was an average of 1.18 percent, or an aggregate 5.9 percent. As applied to the ERS's $1.6 billion portfolio, this difference represents $94 million in lost potential yield, enough to eradicate more than half the ERS actuarial deficit.

The ERS has endeavored to conceal its poor relative performance by frequently altering its "benchmarks."[16] Its composite benchmark for 2006-07 was 16.26 percent, as against 18.2 percent for the benchmark used by the Fire and Police system. The ERS's composite benchmark "is comprised of 41.0 percent Russell 3000, 26.0 percent LB Aggregate, 9.0 percent CPI-W plus 6 percent, l 5.0 percent 3 month Treasury bill plus 5 percent, 5.0 percent ERS Alternative Investment and 14.0 percent MSCI ACW ex US Free index."[17]

By contrast, the Fire and Police benchmark is made up of only four components: Russell, MSCI, Lehman, and the NCREIF property index. Inclusion of CPI and three-month Treasury bill-based numbers in the ERS formula has no justification, nor does inclusion of ERS's own Alternate Investment (affirmative action)

16. See Calvert Institute, *Maryland's Pension Scandals*, October 2006, p. 4.

17. ERS 2006-07 Report, 45.

yields. The 19 percent of the ERS benchmark made up of these three items is explainable only by a purpose to depress the composite benchmark to make the fund managers look good: had the Fire and Police benchmarks been used, the ERS would have outperformed by 0.13 percent in 2007, and would have underperformed by 0.17 percent annually over three years and 0.68 percent annually over 5 years.

Baltimore County Fund

The Baltimore County Retirement System as of June 30, 2007, had a funding ratio of 91.8 percent, down from 102.3 percent in 2002; assets of $2.1 billion; and a funding deficit of $188.4 million, or 42.8 percent of covered payroll appears to be fully funded. The liberality of benefits has caused costs to the operating budget to escalate from $16.2 million in 2003 to $36.0 million in 2007.[18]

Carroll County Fund

The Carroll County pension plan as of July 1, 2006, had a commendable funding ratio of 94.2 percent as a result of a one-time contribution in fiscal 2006, raising the ratio from 55.9 percent in the preceding year. The remaining deficit is $0.9 million (3.2 percent of payroll); assets are $15.6 million.

Frederick County Fund

The Frederick County Employees Retirement Fund as of July 1, 2005, amounted to $134.5 million and had an unfunded liability of $39.4 million (52.5 percent of covered payroll) and a funding ratio of 77.3 percent, having declined from 86.4 percent as of July 1, 2000.

Howard County Funds

According to the prospectus for Howard County's 2007 General Obligation Bonds, Series B, County contributions to its two pension funds increased from $12.5 million in 2003 to $24.6 million in fiscal 2008. The Police and Fire Fund, which was only 37 percent funded when established in 1990, was 73.4 percent funded as of July 1, 2006, with its funding deficit amounting to $65.3 million. The County Plan for other employees was 91.5 percent funded and had a deficit of $15.3 million.

Montgomery County Fund

The Montgomery County retirement system has recently been the subject of substantial controversy as a result of union efforts to gain added influence over its board. Those efforts have been strenuously resisted by its staff director, Stephen Farber, a respected official who was formerly executive director of the National Governors' Conference. Montgomery County adopted a defined contribution sys-

18. Baltimore County, *Five-Year Summary of General Fund Revenues and Expenditures*.

tem for all employees other than public safety employees in 1994. The defined benefit fund for public safety employees had assets of about $2 billion as of 2005. The plan was 98.9 percent funded as of June 30, 2000, but as a result of benefit liberalizations enacted by County Executive Doug Duncan during his abortive campaign for governor, the funding ratio declined to 75.7 percent as of June 30, 2005, at which point the actuarial deficit amounted to $674.5 million.[19]

As of June 5, 2008, presumably using June 30, 2007, figures, the defined benefit plan had assets of $2.8 billion, unfunded liability was $631 million, and the funding ratio was 79.5 percent.[20] In August 2008, the fund was found to be $2.5 billion and the funding ratio was 79.7 percent.[21]

Prince George's County Retirement Systems

Current reports for the eleven plans making up the Prince George's County Retirement Systems are not readily available; in 2006, the Calvert Institute was obliged to use a Public Information Act request to obtain the July 1, 2004–June 30, 2005 report. That report revealed combined plan actuarial assets of just under a billion dollars, $992 million, and combined actuarial deficits of $397.6 million, producing a combined funding ratio of 59.92 percent, as follows:

	Fund Actuarial	**Assets Funded**	**Ratio Deficit as % of Payroll**
Police	$571.1	75.48%	243.48%
Fire	261.8	73.16%	238.48%
Deputy Sheriffs	23.6	50.19%	363.05%
Correctional Officers	39.4	60.24%	154.52%
Other	96.1	59.06%	55.04%

The position of at least the two largest funds, the police and fire funds, has since deteriorated. The Fitch Bond Rating Agency reported on May 20, 2008, "The County's funded portion of its pension systems for police and fire are well below average at approximately 65 percent and 60 percent respectively." This suggests that deficits have increased by about $100 million, to $500 million, since June 30, 2005.

Washington County Fund

The Washington County fund as of July 1, 2005 had a funding ratio of 76.1 percent, a deficit of $13.6 million (56 percent of covered payroll), and assets of 43.2 million.

---

19. Montgomery County Retirement System, 2004-05 *Report*, p. 32.
20. Addendum to Memorandum of Stephen B. Farber to Management and Fiscal Policy Committee, Montgomery County, June 9, 2008.
21. K. Miller, "Montgomery Paid to Scrutinize Retired Officers' Disability Pay," *The Washington Post*, August 28, 2008.

Wicomico County Fund

The Wicomico County fund had a funding ratio of 84.4 percent, up from 56.8 percent in 2002, total assets of $25.6 million, and an actuarial deficit of $4.7 million (25.2 percent of payroll).

Ongoing Problems

Defined Benefit Plans. The case for conversion of the deficit-laden defined benefit plans to defined-contribution plans is manifest. Making this change eliminates government's responsibility to manage retirement fund investing, a responsibility that many governments have failed to meet. Many other states are making this change; Montgomery County has already done so with respect to all employees save public safety personnel.

Hedge Fund Investing. The Calvert Institute warned against moves toward high-risk hedge fund investing by the Retirement Systems' essentially amateur boards.[22] These warnings have not been heeded. The most recent Baltimore City ERS report discloses that approximately $69 million, or 6 percent of the portfolio, was committed to hedge funds, which returned 12.91 percent as against 18.33 percent for the portfolio as a whole.[23] The Fire and Police fund committed $136.3 million to hedge funds, 7.1 percent of the portfolio, achieving a yield of 15 percent as against 19.8 percent for the total portfolio.[24]

A recent report by the Maryland Tax Education Foundation[25] reaffirms these warnings.[26] The MTEF report emphasizes that hedge fund investments are rendered unprofitable by the high commission rates paid to their managers, typically 2 percent of corpus and 20 percent of gains. As if in perverse response to this report, the 2008 General Assembly repealed a preexisting 1.2 percent cap on compensation of real estate and alternative investment managers.[27] This statute boldly declares: "The Board of Trustees is not limited in the amount of investment manager fees that the board of trustees may pay as necessary for

22. See *The Baltimore City Retirement Systems: Heading for Trouble*, The Calvert Institute, 2006, P. 25-26.

23. Baltimore City *ERS Report*, 2006-2007 Report, 45.

24. 2006-2007 *Report*, 48.

25. "Latest Research Concludes that Private Equity Funds Fail to Deliver Premium Returns," Maryland Tax Education Foundation, July 23, 2008.

26. Cites L. Phalippou and O. Gottschalg, *Performance of Private Equity Funds: Another Puzzle,* University of Florida, Warrington College of Business Administration, 2005, and A. Metrick and A. Yasuda, *The Economics of Private Equity Funds*, The Swedish Institute for Financial Research Conference, 2007.

27. S.B.384, H.B. 481, C-19, 2008 *Ninety-Day Report*, enacting chapter 506 of the Acts of 2008, section 21-315(d)(2) of the State Personnel and Pensions article.

external real estate or alternative investment management services." The effect of this change will not be to improve the state's investment return but to further endow hedge fund managers with personal incomes in the hundreds of millions a year, nearly all taxable as capital gains as a product of the 20 percent profit sharing.[28] There are few if any provisions, however, for repayment of 20 percent of the losses produced by hedge fund managers in recession years.

The State Retirement System, though slower in moving into hedge funds, now has 1 percent of its portfolio, or $386 million, in private equity as of June 30, 2007, and has a new affirmative action Emerging Manager program containing $340 million as of June 30, 2007.

Inadequate Fiduciary Standards. The 2006 Calvert Report urged extension in Maryland of the Uniform Management of Public Employees Retirement Systems Act with its duties of loyalty to preexisting as well as new systems.[29] This has not happened: see section 40-101 of the State Personnel and Pensions article as enacted by Chapter 146 of the Acts of 2005, which exempts both the state system and pre-existing local systems.

Politically-Influenced Investing. The 2006 Calvert Report urged a ban on 'affirmative action' investing. Instead, the General Assembly has encouraged it, and the state comptroller has attended a convention of the Jesse Jackson Wall Street Project and has urged affirmative action for minority investment bankers.[30]

Amateur Boards. The 2006 Calvert Report urged that boards be constituted primarily of financial professionals. Governor O'Malley's appointments to the Board of the State Retirement Systems, including that of Thurman Zollicofer, his former 'point man' for politicizing City investment policy, do not further that objective. Union agitation in Montgomery County seeks to end the tradition of apolitical investing there, despite its excellent results and the inferior results of union-controlled funds demonstrated in the Farber report referenced above.

Industry Entertainment and Travel Abuses. The 2006 and 2007 Calvert Reports criticized the practice of the Baltimore ERS board of extensive travel to industry-sponsored conventions. Although cosmetic reforms were instituted, limiting attendance at foreign conventions to one per member per year, and limiting to three the number of board members at any conference, proposals to reduce the $10,000 travel allowance per member to $7,500 or $8,500 were rejected at the board's meeting on July 20, 2006. The ERS budget for "Trustee Education" for its small board is still twice that of the larger Fire and Police Board ($43,328 for seven members as against $22,213 for nine).

---

28. See Appendix.

29. P. 29.

30. See http://www.marylandtaxes.com/publications/nr/current/pr32.asp.

Brokerage and Management Fees. The 2006 report urged in-house internet execution of trades and replacement of investment advisers by index funds. This has not happened. The Baltimore Fire and Police fund in 2006–2007, with $2.3 billion in assets, spent $1.3 million on brokerage fees and $7.5 million on managers' fees; the ERS with $1.5 billion in assets spent $0.6 million on brokerage fees and $5.6 million on managers' fees. The State Retirement Systems spent $9.7 million on brokerage commissions in 2006-2007.

Summary

The combined actuarial pension deficits of the State and Baltimore City, Montgomery County, Howard County, and Prince George's County thus amount to about $13 billion. The state health benefits deficit and the combined local health benefits deficits are each around $15 billion. Recent estimates of the state's health deficit by Credit Suisse and the Cato Institute are $5 billion to $7 billion higher than the state's estimate of $15 billion. Amortization of these combined deficits of more than $45 billion could require annual sums equal to 12 percent of the present state budget, more than twice Maryland's total state public safety expenditures. The need for alteration at least for new employees of the retirement health programs and the need for converting the defined benefit pension programs into defined contribution programs is manifest. The consequences of such changes are benign: de-emphasis of fringe benefits in favor of salaried compensation will provide a less immobile state work force, with fewer "time servers" and more opportunities for new entrants.

At the least, both state and local governments must adopt credible formulas for funding both health and pension deficits and must adhere to them. Failure to confront such problems potentially induces not merely inflation, but hyper-inflation. Some European and Latin American countries have seen democracy swamped by the political consequences of inflation unleashed by improvident and unredeemed promises by the state. The way Maryland's elected state and local officials deal with these issues is a sure litmus test of their political morality as individuals. Hit and run politics will not suffice.

—*George Liebmann is volunteer executive director of the Calvert Institute for Policy Research.*

Maryland's State and Local Retirement Benefit Liabilities

Gabriel J. Michael

The cost of providing non-pension retirement benefits for government employees, commonly referred to as "other post-employment benefits" (OPEB),[31] is steadily increasing. During FY 2007, the State of Maryland paid over $255 million to subsidize its retirees' health insurance premiums, an amount that has increased by 220 percent since 1997, while the number of retirees receiving these benefits has only increased by 54 percent.

Table 1 – Maryland's OPEB Pay-As-You-Go Funding, 1997-2007

Year	PAYGO	% change	Beneficiaries	% change
1997	$79,840,000	n/a	21,991	n/a
1998	$59,179,293	-25.9%	22,055	0.3%
1999	$79,885,000	35.0%	22,100	0.2%
2000	$84,475,000	5.7%	35,382	60.1%
2001	$95,447,000	13.0%	29,792	-15.8%
2002	$109,838,000	15.1%	29,670	-0.4%
2003	$125,209,000	14.0%	31,080	4.8%
2004	$135,806,000	8.5%	32,451	4.4%
2005	$145,919,000	7.4%	33,641	3.7%
2006	$236,328,000	62.0%	33,953	0.9%
2007	$255,929,000	8.3%	33,939	0.0%

Source: State CAFRs

Unlike pension systems, which rely on investments and are funded by contributions from employees and employers that are paid in during the workers' years of employment, OPEB have traditionally been provided on a pay-as-you-go (PAYGO) basis. That is, funding for FY 2007 OPEB expenditures came from the FY 2007 state budget. However, Maryland must be compliant with the Governmental Accounting Standards Board Statement 45 (GASB 45) beginning in FY 2008, and that standard requires governments to assess and disclose estimates of their total OPEB liabilities. As has been reported elsewhere, preliminary estimates are staggering, and are likely to present serious fiscal challenges to state and local

31. The major portion of OPEB consists of health care benefits; however, depending upon the employer, OPEB may also include dental benefits, vision benefits, life insurance, prescription drug plans, and other types of benefits.

governments in coming years. More than simply the challenge of paying for promises made in the past, a government's inability to begin paying down its OPEB liabilities has the potential to adversely affect that government's bond ratings.[32] This increases the cost of borrowing for that government.

As of 2007, various sources have estimated the State of Maryland's OPEB unfunded actuarial accrued liability (UAAL) to be anywhere from $14.5 billion to $22.9 billion.[33] In order to obtain a more up-to-date figure, I contacted the State of Maryland's Department of Legislative Services Office of Policy Analysis. The Office provided a more up-to-date figure—an actuarial valuation conducted for FY 2007. This figure represents the most recent actuarial valuation available at the time of writing. Since GASB 45 will be implemented for the first time this year, a new actuarial valuation may be completed in time for inclusion in Maryland's FY 2008 Comprehensive Annual Financial Report (CAFR).

The report examines Maryland's liabilities for future OPEB for state and local employees. This information is important for two reasons: First, it indicates how much future government revenue will be directed toward compensating retired government employees instead of to other public purposes. Second, it informs the regular debates on employee compensation; there are strong incentives for both government personnel managers and union leaders to agree to currently unfunded future compensation for government employees, but those agreements impose considerable cost and uncertainty on both taxpayers and employees. It is hoped that this report will lead to a more transparent and sustainable OPEB system in Maryland.

The State of Maryland

The State of Maryland's most recent actuarial valuation was performed by Buck Consultants in December 2007 and presents estimates as of July 1, 2007. What follows is a brief overview of this valuation that will aid the reader in understanding the results of other actuarial valuations as they are reported.

32. For example, Fitch, a credit rating agency, has stated: "[S]teady progress toward reaching the actuarially determined annual contribution level will be critical to sound credit quality. An absence of action taken to fund OPEB liabilities or otherwise manage them will be viewed as a negative rating factor." For further statements from credit rating agencies, see The Pew Center on the States, *Promises with a Price: Public Sector Retirement Benefits*, 20.

33. See *Promises with a Price*; Cato Institute, *Unfunded State and Local Health Costs: $1.4 Trillion*; Credit Suisse, *You Dropped a Bomb on Me, GASB*.

Table 2 – Maryland's OPEB Liabilities and ARC
($ in billions)

	UAAL	ARC	Discount Rate
Method 1	$15.193	$1.193	4.25%
	$9.172	$0.809	7.75%
Method 2	$14.977	$1.169	4.25%
	$8.666	$0.794	7.75%

Source: GASB 45, July 1, 2007 Actuarial Valuation

By their very nature, actuarial valuations attempt to measure the unknown. They rely on a large number of assumptions, and even a small change in any one of these can result in a vastly different estimate. As a result, it is important to keep in mind that no one figure can tell the whole story. Usually, as is the case here, actuarial valuations will provide several different estimates of the UAAL based on differing discount rates.[34] Changes in the discount rate drastically affect the calculation of the UAAL, with the result that showing the UAAL without its accompanying discount rate is essentially meaningless and often misleading.

This valuation provides estimates based on two different discount rates: an unfunded rate of 4.25 percent, and a funded rate of 7.75 percent. These two rates reflect the differing returns on investments governments can expect if they continue to use a PAYGO method (unfunded), which relies on general government funds with an earning potential limited by strict investment policies, versus establishing an irrevocable trust to pay for OPEB liabilities (funded). In reality, however, the actual discount rate is likely to fall somewhere between the low (unfunded) and high (funded) figures, reflecting partial funding. Method 1 and Method 2 refer to two different methods of calculation, resulting in slightly different estimates. The worst-case scenario, then, estimates a $15.2 billion liability that would necessitate a $1.2 billion annual required contribution (ARC).[35]

Another important assumption besides the discount rate is the expected rate of increase of the cost of health care. This rate has been so exceedingly high in recent

34. In this context, the discount rate is "the interest rate assumption the state is allowed to apply to current assets used to pay future bills" (*Promises with a Price*, 52).

35. The ARC is "The amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period. (This calculation assumes the employer will continue contributing the ARC on a consistent basis.) The ARC is made up of 'normal cost' (sometimes referred to as 'service cost')—the cost of benefits earned by employees in the current year—and an additional amount that will enable the government to reduce unfunded past service costs to zero by the end of the amortization period" (*Promises with a Price*, 14).

years that a linear increase over the next several years is considered unsustainable.[36] To take account of the high rates of increase in recent years but still provide meaningful estimates, "standard actuarial practice…is to assume an initial rate consistent with recent increases decreasing gradually to an 'ultimate trend,' which is consistent with the best estimate of GNP growth."[37] However, if the rate of increase of health care cost does not stabilize as expected, current estimates of OPEB liabilities will be understated, perhaps greatly so.

This valuation, for example, provides three estimates, each calculated with a different rate of increase in health care cost. The $15.2 billion figure assumes a "baseline" rate of increase. If costs rise more quickly than expected, the UAAL would increase to $16.9 billion; however, if costs rise less quickly than expected, the UAAL would decrease to $13.7 billion. These three figures all assume the unfunded discount rate of 4.25 percent. Most actuarial valuations provide a "sensitivity analysis" that offers adjusted estimates of OPEB liabilities in the event that health care costs rise more quickly than expected. While these adjusted estimates will not be reported below, they can be found online at *http://www.mdpolicy.org/research/pubID.215/pub_detail.asp*.

To provide another data point, compare the information reported in Maryland's FY 2007 CAFR. The CAFR refers to an earlier actuarial report, prepared for June 30, 2006, and estimates the state's actuarial accrued liability (AAL)[38] to be $14.5 billion at a 4.3 percent discount rate, and $9.0 billion at a 7.8 percent discount rate. Thus, while the state's estimates have increased slightly over the course of a year, they are still significantly less than the $20.4 billion to $22.9 billion in liabilities estimated by the Cato Institute and Credit Suisse respectively.

Finally, note the size of the ARC. Even under the most liberal assumptions (a 7.75 percent discount rate), the ARC represents more than a 210 percent increase over FY 2007's PAYGO amount, while at a conservative discount rate of 4.25 percent, the ARC represents a 366 percent increase. An ARC of $1.2 billion would have accounted for approximately 4 percent of FY 2008's total expenditures. While 4 percent may not seem very high, to put that number in perspective, consider that Maryland's public safety–related expenses accounted for 6 percent of FY 2008's total expenditures.[39]

36. Consider the argument made in Howard County's actuarial valuation: "To assume per capita claim trends will continue to increase indefinitely as they have in the last few years would result in costs that are so large as to be implausible. Increases of this magnitude cannot be sustained indefinitely because, if they do so, health care expenditures will eventually consume an unacceptable percentage of the gross national product" (Howard County, *GASB 45 Task Force Final Report*, 7). Similar statements are to be found in almost every actuarial valuation of OPEB liabilities.

37. Howard County, *GASB 45 Task Force Final Report*, 7.

38. Note that in this case, the AAL and the UAAL are the same, because there has been no funding set aside.

The legislature balanced the budget by excising "$99.7 million in funds set aside toward the State's unfunded retiree health care liability. After this action, the State is appropriating about $100.0 million per year toward this liability in each of fiscal 2008 and 2009.[40] Furthermore, according to the Department of Legislative Services,

> The fiscal 2009 proposed budget allocated $207.8 million across all fund types to pre-fund the OPEB liability, which chiefly represents the estimated value of health insurance subsidies for future retirees. Revenue write downs prompted reductions to this level of funding and $105.2 million will be appropriated for transfer to an irrevocable OPEB trust, where the monies will be invested by the State Retirement Agency. Senate Bill 540 (passed) moves $100.0 million from the DPA leaving $100 million as the fiscal 2008 contribution to OPEB pre-funding, thus creating continuity in the State's approach to addressing this future financial obligation.[41]

'Continuity' is achieved by reducing appropriations to half those originally thought to be necessary.

The Counties and Baltimore City

In addition to the OPEB liabilities of state government, it is crucial to consider the liabilities of local governments that, according to Credit Suisse analysts, account for nearly two-thirds of the nation's total liabilities.[42] Senate Bill 945, originally introduced in the Maryland State Senate on February 25, 2008, includes a fiscal and policy note with estimates of OPEB liabilities for most of Maryland's 23 counties and Baltimore City. These estimates were obtained from the Maryland Association of Counties (MACo). Michael Sanderson, MACo's legislative director, indicated that MACo obtained these estimates unofficially, essentially by calling each county's finance office and asking for an estimate over the telephone. The estimates thus vary widely as to accuracy and age, and as to whether they include the liabilities of component units such as school boards, libraries, and community colleges. Additionally, MACo's estimates do not include any information for Baltimore City and Kent, Somerset, and Talbot Counties. Mr. Sanderson also indicated that MACo had no more recent estimates of any of the counties' OPEB liabilities.

The most recent CAFR for 22 counties and Baltimore City provided more up-to-date information on each county's liabilities.[43] Almost all of the CAFRs contain

39. Maryland Department of Budget and Management, *FY 2009 Budget Highlights*.
40. *Ninety-Day Report*, The Department of Legislative Services 2008, A-13.
41. *Ibid.*, A-32.
42. *You Dropped a Bomb on Me, GASB*, 3.
43. The only county for which I could not obtain a CAFR was Somerset County.

at least a passing mention of the OPEB liability issue, and a statement on the implementation of GASB 45; counties are also required to disclose the amount of money spent during the year on a pay-as-you-go basis for the provision of OPEB. Some CAFRs contain detailed statements regarding OPEB liabilities, including estimates of the total UAAL and the necessary annual required contribution to fully fund the UAAL over a period of time, typically 30 years.

Because of the legal distinction between a county government and its component units, entities such as school boards, libraries, and community colleges are required to produce their own CAFRs. Recognizing that appropriations for school boards often make up nearly half of a county's budget, and that school boards are often one of the largest employers in a county, the most recent CAFRs for 14 counties' school boards and the Baltimore City Public School System were needed. Those 14 counties include all 10 counties originally estimated by MACo to have OPEB liabilities exceeding $200 million.

Finally, many counties have contracted to have actuarial valuations performed to assess their OPEB liabilities. These valuations, while public information, are usually not made easily accessible but are available under the Maryland Public Information Act (MPIA) for the 10 counties that were originally estimated by MACo to have OPEB liabilities exceeding $200 million, and for Baltimore City. The actuarial valuations for Dorchester and Garrett Counties were available without filing MPIA requests. Of the 11 MPIA requests sent, all were fulfilled within the 30-day window required by Maryland law.

MACo's estimates for 20 counties already approach $11 billion, and do not include Baltimore City, which Credit Suisse analysts estimate to have a $2.7 billion liability alone. Just as the cost of providing OPEB for state government retirees has been dramatically increasing, the cost of providing OPEB for local government retirees has also been increasing. Table 3 indicates the rising cost of OPEB for two counties and Baltimore City over the past several years. From 2002 to 2007, the pay-as-you-go expenditures of Baltimore City, Montgomery County, and Prince George's County increased by 85 percent, 77 percent, and 89 percent respectively, while during the same length of time, the number of beneficiaries only increased by 27 percent, 30 percent, and 25 percent.

Table 3 – OPEB Pay-As-You-Go Funding for Two Counties and Baltimore City

Entity		2002	2003	2004	2005	2006	2007
Baltimore City	PAYGO	$63,321,000	$70,747,000	$55,230,000	$102,791,000	$120,646,000	$116,923,777
	Beneficiaries	19,434	19,556	20,114	20,415	19,976	24,761
Montgomery	PAYGO	$13,481,000	$13,970,000	$17,763,240	$16,512,900	$21,587,860	$23,924,080
	Beneficiaries	3,685	3,900	4,105	4,270	4,493	4,790
Prince George's	PAYGO	$10,400,000	$12,400,000	$14,300,000	$16,000,000	$18,000,000	$19,700,000
	Beneficiaries	2,619	2,743	2,857	3,043	3,179	3,279

Source: County CAFRs

Directly comparing the OPEB liabilities of Maryland's counties is difficult. Some actuarial valuations contain estimates for the primary government as well as all of its component units (school boards, community colleges, libraries, et cetera), whereas other valuations only contain information for the primary government.[44] This is problematic because a school board's liabilities alone may easily dwarf the rest of a county's liabilities. The discount rates and health care cost trend assumptions vary from county to county, and in several instances are not provided. With these limitations in mind, however, Table 4 offers a summary of the most recent estimates for 12 of Maryland's counties and Baltimore City. Where multiple discount rates were used, the resulting multiple estimates have all been included.

Table 4 – OPEB Liabilities and ARC for 12 Counties and Baltimore City

Entity	UAAL	ARC	Discount Rate	County	School	College	Library
Anne Arundel	$2,341,238,155	$179,422,000	4.00%	X	X	X	X
	$1,679,962,532	$139,825,000	6.00%	X	X	X	X
	$1,270,024,474	$117,573,000	8.00%	X	X	X	X
Baltimore	$1,765,553,000	$148,893,000	7.88%	X	X	X	X
Baltimore City	$2,149,800,000	$164,600,000	6.70%	X	X		
Carroll	$161,006,000	$15,609,000	4.00%	X			
	$130,235,824	$12,949,370	5.20%	X			
	$98,197,000	$10,277,000	7.00%	X			
Charles	$159,294,000	$15,162,000	4.00%	X			
	$73,905,000	$7,980,000	8.00%	X			
Dorchester	$19,302,364	$1,732,488	4.50%	X			
Frederick	$292,278,000	$23,331,000	4.00%	X			
	$148,969,000	$13,858,000	7.75%	X			
Garrett	$40,987,000	$3,814,000	4.50%	X	X	X	X
	$31,576,000	$2,851,000	7.00%	X	X	X	X
Harford	$264,193,000	$25,820,000	4.00%	X			
	$126,613,000	$14,198,000	8.00%	X			
Howard	$897,300,000	$91,500,000	4.00%	X	X	X	X
	$476,600,000	$53,200,000	7.50%	X	X	X	X
Montgomery	$2,080,618,000	$173,449,000	4.00%	X			
	$1,086,143,000	$103,401,000	8.00%	X			
	$2,600,000,000	$240,000,000	*	X	X	X	X
Prince George's	$762,335,239	$66,158,240	7.00%	X			X
	$708,171,354	$63,077,351	7.50%	X			X
St. Mary's	$111,845,000	$8,664,000	4.00%	X			
	$50,135,000	$4,617,000	7.75%	X			

* The discount rate is unknown.
Source: County Actuarial Valuations and County CAFRS

44. Sometimes it is unclear whether the estimates provided are only for a primary government, or include component units. In these cases, I assumed the estimates only included the primary government.

The few estimates that are directly comparable to MACo's estimates in Senate Bill 945 paint a very different picture. For example, MACo estimated Anne Arundel County's total liability for all major component units to be approximately $1.3 billion. However, MACo did not specify the discount rate for this estimate. By referring to the actuarial valuation from which this estimate is taken, we can see that the $1.3 billion figure was calculated using an 8 percent discount rate, i.e., assuming full funding. This is unrealistic, and Anne Arundel County's actuarial valuation states as much.[45] A more realistic discount rate of 6 percent increases the county's liability to about $1.7 billion, while a very conservative rate of 4 percent puts the liability at approximately $2.3 billion.

We encounter the same problem with MACo's estimates of Howard County's total liability. The $477 million figure assumes a generous discount rate of 7.5 percent. If the liability is calculated with a 4 percent discount rate, it nearly doubles to $897 million. As noted above, the actual liability is likely to fall somewhere in between these two figures. These two examples clearly show why any estimate of OPEB liabilities without an accompanying discount rate is likely to be misleading.

Only five counties have provided estimates for both the primary government and all major component units. In some cases, other sources provide estimates of the liabilities of other component units, typically school boards. However, it is improper to combine these estimates with the estimates for the primary government, either because different actuarial assumptions were used to calculate them, or it is unknown what actuarial assumptions were used. Estimates from other sources for other component units are therefore provided in Table 5.

---

45. "[I]t is unlikely that the County's OPEB liability will be able to be fully funded for FY2008. It is more likely that some 'blended' rate of return will be dictated by the GASB rules. This blended rate will likely be closer to the 'true' rate of about 6.0% than either the 'unfunded' or the 'funded' rates" (Anne Arundel County, *GASB 45 Task Force Final Report*, 16).

Table 5 – OPEB Liabilities and ARC for Some Component Units

Entity	UAAL	ARC	Discount Rate
Charles County Public Schools	$122,900,000	$11,300,000	**
	$110,900,000	$10,100,000	**
Harford County Public Schools	$361,962,000	$34,905,000	6.75%
	$305,466,000	$31,180,000	8.00%
Prince George's County Public Schools	$1,500,000,000	*	**
St. Mary's County Public Schools	$160,684,000	$14,390,000	4.00%
	$81,154,000	$7,991,000	7.75%
St. Mary's County Library	$3,246,000	$277,000	4.00%
	$1,707,000	$169,000	7.75%
St. Mary's County Metropolitan Commission	$9,459,000	$1,013,000	4.00%
	$4,232,000	$506,000	7.75%
Wicomico County Public Schools	$30,475,000	$2,432,000	7.50%

* The ARC is specified as 12.6 percent of general payroll. 12.6 percent of FY 2008's compensation expenditures is $133,512,322.
** The discount rate is unknown.
Source: County Actuarial Valuations and County CAFRs

By referring to Tables 4 and 5, we see that for the four counties with separate estimates for the primary government and public schools (Charles, Harford, Prince George's, and St. Mary's Counties), in each case the OPEB liabilities of the public school system significantly exceed the OPEB liabilities of the primary government. This is to be expected, as the public school system typically employs significantly more people than the primary government. Unfortunately, this means that for all of the counties in Table 4 whose estimates do not include the public school system, we should expect OPEB liabilities for these school systems that are at least as high, and probably much higher, than the reported OPEB liabilities of their county's primary government. A more accurate assessment of the school systems' liabilities will require obtaining those systems' actuarial valuations or waiting until the schools disclose the liabilities in their CAFRs.

Table 6 contains data revealing the amount that each of Maryland's counties (except Somerset) and Baltimore City spent to provide OPEB on a pay-as-you-go basis in FY 2007. The counties are required to disclose this information in their CAFRs. For counties that provide historical CAFRs, the PAYGO amount for FY 2006 is also reported. Between 2006 and 2007, of the 14 counties for which there are data, the PAYGO amount increased in 11 and decreased in three. Year to year decreases in the PAYGO amount are inconsistent with historical trends, and may be the result of an unusually high PAYGO amount in 2006.

Table 6 – OPEB PAYGO for 22 Counties and Baltimore City

Entity	PAYGO 2006	PAYGO 2007	ARC as a Percentage of PAYGO 2007
Allegany	$749,310	$765,608	
Anne Arundel*	$34,225,840	$39,072,057	301%
Baltimore	$25,100,000	$25,400,000	
Baltimore City	$120,646,000	$116,923,777	141%
Calvert	n/a	$647,670	417%
Caroline	n/a	$125,576	
Carroll	$1,674,165	$1,746,590	588%
Cecil**	$50,515	$52,425	
Charles	$845,633	$983,056	812%
Dorchester	$249,007	$241,955	716%
Frederick	$2,531,589	$2,624,502	528%
Garrett	n/a	$403,074	
Harford	n/a	$1,244,031	1141%
Howard	$1,678,917	$1,921,775	
Kent*	n/a	$367,788	
Montgomery	$21,587,860	$23,924,080	432%
Prince George's	$18,000,000	$19,700,000	320%
Queen Anne's	n/a	$403,037	
St. Mary's	$1,248,602	$1,338,914	345%
Talbot	n/a	$317,612	
Washington	$333,146	$171,867	
Wicomico	n/a	$648,863	
Worcester	n/a	$640,077	

* Includes primary government and all major component units
** Includes primary government, community college, and library
Source: County Actuarial Valuations and County CAFRs

In an attempt to make clear the difficulty for counties to fully fund their ARC, Table 6 also expresses the ARC as a percentage of 2007's PAYGO amount for each county for which data are available. The ARC ranges anywhere from about one and a half to 11 times a county's 2007 PAYGO amount, presenting an extremely heavy financial burden.

Many counties and some of their component units have taken steps to offset the effects of implementing GASB 45 by setting aside money for an OPEB trust. An OPEB trust, much like a pension trust, would invest its assets with the intention of paying for OPEB out of the investment returns, instead of diverting more and more taxpayer money from the general fund each year, as is currently the practice with pay-as-you-go. The money for OPEB "prefunding," as it is called, typically is designated from a previous year's budget surplus.

With the passage of Senate Bill 945 in May 2008, local governments are now authorized to create these OPEB trusts. Table 7 indicates the amounts that various counties have set aside for the prefunding of OPEB trusts. It also expresses the

OPEB trust prefunding as a percentage of a county's ARC. This provides some insight into what the various prefunding figures actually mean. Note that this is not an exhaustive list; just because a county is not listed here does not mean that it has not designated any money for prefunding of an OPEB trust. Furthermore, since many of these figures are taken from annual reports, they do not necessarily represent the entire balance of any prefunding; for example, Baltimore City's actuarial report states that FY 2008's funding is $76 million, indicating that there may be additional prefunding that has been set aside in previous years.

Table 7 – Prefunding of OPEB Trusts

Entity	Prefunding	Prefunding as a Percentage of ARC
Anne Arundel	$5,000,000	4%
Baltimore	$156,300,000	105%
Baltimore City	$76,000,000	46%
Calvert	$647,670	24%
Carroll	$3,000,000	29%
Frederick	$6,530,983	47%
Harford County Public Schools	$12,126,000	39%
Howard	$15,000,000	28%
Prince George's	$25,000,000	40%
St. Mary's	$10,000,000	217%
Talbot	$6,350,000	*
Wicomico	$210,000	9%

* The ARC is unknown.

Source: County Actuarial Valuations and County CAFRs

It is important to note that unless OPEB trust prefunding has actually been placed into an irrevocable trust, it is not secure. Prefunding that has been "designated" for an OPEB trust from a previous year's budget surplus can easily be designated for another purpose in the next year.[46] For this reason, GASB 45 only allows funds that have been set aside in an irrevocable trust to count as assets against OPEB liabilities.

Montgomery County has been playing similar games with its $3 billion retiree health care liabilities. In the county, which has promised to pay $3 billion in

46. For example, in order to cover budget shortfalls, the State of Maryland recently drew $100 million from a fund that had been "designated" to pay for OPEB liabilities (AFSCME MD, *Voice* Spring 2008, 7). In another instance, Howard County's FY 2006 CAFR states, "The County… has designated $30 million from the FY 2006 surplus for this liability." The FY 2007 CAFR, however, states, "The County… has designated $15 million from the FY 2007 surplus for this liability." It is unclear what happened to the original $30 million earmarked for OPEB liabilities.

health care benefits to retirees, government officials accepted the advice of consultants who urged the county to nearly quadruple the amount it sets aside to cover this commitment. Nevertheless, the county council voted to delay this full funding for five years. Now the council, which claims wide legal latitude, is considering whether to postpone it for another three years. "The biggest issue is the lack of standards in regards to government pensions," said Timothy L. Firestine, Chief Administrative Officer in Montgomery County. "You can make up your assumptions as you go.'"[47]

The Council thereupon agreed to stretch the amortization from five years to eight, thus, according to County Executive Leggett, "free[ing] up tax supported resources that can be invested in preserving existing services."[48] This is a euphemism for 'kicking the can down the road.' In Montgomery County, "pension and health care costs are already higher than the combined budgets for the departments of transportation and human resources."[49] Baltimore City for its part in 2007 set aside only $15 million as an annual contribution toward the City's $2.9 billion retiree health deficit, and confided its management to the Employees Retirement System, the least capable of the City's two pension boards.[50]

Municipalities

In addition to the OPEB liabilities of the various county governments and their component units, Maryland's municipalities will have their own OPEB liabilities. Excluding Baltimore City, there are 156 incorporated municipalities in Maryland. Table 8 provides the 2007 PAYGO amounts for the four largest municipalities other than Baltimore City, each estimated to have between 50,000 and 60,000 residents.

Table 8 – OPEB PAYGO for Four Municipalities

Entity	PAYGO	Beneficiaries
City of Frederick	$1,491,000	375
City of Gaithersburg	$193,453	27
City of Rockville	$60,723	14
City of Bowie	$8,896	2

Source: City CAFRs

47. "The Other Retirement Nightmare," May 11, 2008, available at: www.financialarmageddon.com/the_retirement_system.
48. FY 2009 Recommended Operating Budget, County Executive, p. 9.
49. David Cho, "Growing Deficits Threaten Pensions: Accounting Tactics Conceal a Crisis for Public Workers," *The Washington Post*, May 11, 2008, p. A-1.
50. S. Janis, "City faces $2.9 billion gap in retiree health benefits," *Baltimore Examiner*, June 14, 2007, p. 8.

Of these four municipalities, only Gaithersburg's CAFR provides any detailed information about the implementation of GASB 45. Gaithersburg estimates its OPEB liability to be $9,788,000 at an 8.0 percent discount rate. The city established a trust fund for OPEB in April 2007 and made an initial contribution of $2,552,050 to the fund. While Gaithersburg has clearly been proactive in addressing the implementation of GASB 45, as a whole, the progress of Maryland's municipalities in addressing their OPEB liabilities is unclear and warrants concern.

Conclusion

Maryland's OPEB liabilities must be addressed at all levels of government: state, county, and municipal. The issue is likely to garner more attention over the next year because GASB 45 will require entities with annual revenues in excess of $100 million to report their OPEB liabilities for the first time in FY 2008's CAFRs.

While some governments have been proactively addressing the issue, even for those governments that have set aside prefunding for an OPEB trust, the amounts so designated are typically paltry when compared to the estimated ARC. While some politicians might think it more palatable to simply continue funding OPEB on a pay-as-you-go basis, the long-term costs of this approach are extremely high. Furthermore, as previously noted, not addressing OPEB liabilities is likely to adversely affect a government's bond ratings, making it more expensive for that government to borrow money.

One way to reduce OPEB liabilities is to reduce the benefits offered to employees and retirees. First, governments can cut back on the OPEB offered to new employees, which many governments have in fact already done. Second, governments can establish cost-saving measures in their provision of OPEB, which may mean reducing the OPEB being supplied to current and future retirees. For example, most governments do not pay the full amount of a retiree's health insurance premium, but instead pay a portion prorated over the number of years of that retiree's service. These pro rata schedules could be adjusted to reduce the government's portion of the cost. However, employees need to know about this change while they are still employed, so that they can adjust their retirement planning.

The legal viability of this second approach will vary from one government to another. Some governments have made it clear that in their opinion, non-pension retirement benefits are not guaranteed. For example, Prince George's County states in its FY 2007 CAFR: "Retirees have no vested rights to these benefits, which are subject to modification during the budgetary process or by collective bargaining agreement."[51] However, depending upon the way in which the benefits were enacted, the provision of OPEB might be considered a contract, which could create legal difficulties in modifying the benefits. Moreover, the lack of vested rights

51. Prince George's County, *2007 Comprehensive Annual Financial Report*, 67.

introduces considerable uncertainty and risk for employees, severely reducing the OPEB's value as compensation.

Some governments may be hesitant to establish irrevocable trusts to fund OPEB liabilities because of the legal implications of such trusts. In Anne Arundel County's actuarial valuation, for example, it is asked if establishing an OPEB trust might create a contractual or property right for employees and retirees to these benefits.[52] Furthermore, as the Pew report notes, "government officials wonder what will happen to money that has been 'irrevocably' dedicated to retiree health care if the federal government passes some kind of universal health insurance."[53]

In July 2006, the Maryland General Assembly created the Blue Ribbon Commission to Study Retiree Health-Care Funding Options. Active since 2007, the purpose of the Commission is to obtain an actuarial valuation of the state's OPEB liabilities and to examine the legal obligations of the state regarding these benefits. The commission, chaired by State Senator Edward J. Kasemeyer and Delegate Melony G. Griffith, met twice in 2007, though no minutes of those meetings were kept. The commission is required to produce an interim report by the end of 2008, and a final report by the end of 2009. Michael Rubenstein of the Office of Policy Analysis, also a staff member of the commission, stated that this year's interim report is unlikely to contain any substantive information, and instead will likely be a simple overview of the commission's activities thus far. There are currently no drafts of this interim report available; however, one of Delegate Griffith's staff members stated that the commission is scheduled to meet at least once before the end of the year.

In a time when governments are seeking to trim budgets wherever possible, funding for OPEB liabilities is rarely high on the list of priorities. For example, on October 15, 2008, Governor Martin O'Malley's office indicated that the state will not be making any additional contributions towards OPEB liabilities, thus saving $46 million. But while this is a savings in the short term, in the long term it simply increases the cost of OPEB that the state, and ultimately taxpayers, will have to bear. When OPEB liabilities are recognized in financial statements this fiscal year, state and local governments that take the shortsighted position of refusing to fund such liabilities are risking downgraded bonds, an increased cost of borrowing, and severe budgetary difficulties in the coming years. [54]

—Gabriel J. Michael is a 2008 intern at the Maryland Public Policy Institute and a graduate student at Yale University.

---

52. Anne Arundel County, *GASB 45 Task Force Final Report*, 13.

53. *Promises with a Price*, 50.

54. The Appendix for this report may be found online at *http://www.mdpolicy.org/research/pubID.215/pub_detail.asp.*

THE MARYLAND PUBLIC POLICY INSTITUTE

Founded in 2001, the Maryland Public Policy Institute is a nonpartisan public policy research and education organization that focuses on state policy issues. Our goal is to provide accurate and timely research analysis of Maryland policy issues and market these findings to key primary audiences.

The mission of the Maryland Public Policy Institute is to formulate and promote public policies at all levels of government based on the principles of free enterprise, limited government, and civil society. The institute is a member of the State Policy Network. In order to maintain objectivity and independence, the institute accepts no government funding and does not perform contract research. The Maryland Public Policy Institute is recognized as a 501(c)(3) research and education organization under the Internal Revenue Code.

THE CALVERT INSTITUTE

The Calvert Institute for Policy Research is a non-partisan, educational institution dedicated to the research and propagation of solutions to Maryland state and local public-policy concerns based upon the principles of free markets and personal responsibility. It is a tax-exempt 501(c)(3) organization.

The institute is named for George Calvert, founder of the Maryland colony and the author of its experiment in freedom of conscience. The institute seeks to replicate his vision of a Maryland where a diversity of views is encouraged and disseminated.