POLICY brief

Washington Research Council

PB 06-14 April 5, 2006

Fully Recognizing the Benefits of Retirement

BRIEFLY

The majority of governments fund post-employment benefits other than pensions on a pay-as-you-go basis. However, going forward, agencies are required to account for these obligations at the time that they are incurred.

Most governments are still in the early stages of calculating obligations, but large liabilities are projected. Washington authorities have yet to complete their actuarial valuations. But, considering our history of generous benefits, state and local agencies will likely face significant unfunded liabilities.

While public employers may continue to delay funding, failure to implement reform is expected to have a negative impact on credit ratings and could increase long-term costs.

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Over the next several years, new accounting standards will require the financial statements of Washington's state and local governments to fully reflect the cost of providing health care and certain other retirement benefits to its employees. The value of the omitted costs is largely unknown but potentially quite large.

In June 2004, the Governmental Accounting Standards Board (GASB) issued Statement No. 45 to provide state and local governments guidance on how to account for non-pension retirement benefits. The rules continue a national trend towards increased government accountability and transparency.

The new standard will require public employers to account for post-retirement benefits during an employee's career instead of using the current "pay-as-you-go" practice. While employers are not required to pre-fund these benefits, they are required to disclose costs.

According to J. L. Boyle International, when postemployment benefits were first adopted, retiree health care benefits amounted to a very small fraction of total payroll spending, but "These benefits now rival pension benefits in their cost, and their funding is becoming a major fiscal problem" (2005, p. 7).

Analysts and government agencies are scrambling to meet the new standards. National experts expect total liabilities to be significant. According to GASB Project Manager Dean Mead, the financial impact of these benefits will likely amount to "hundreds of billions of dollars of commitments that are not reported at all and for which virtually no assets are currently provided" (Mead, 2004). Once realized, Jan Lazar of Benefit Evaluation and Retirement Services Inc. warns that "It's going to cause people to freak" (as cited in MAC, 2005).

The new accounting standards come at a time when pensions, health care costs, and demographic pressures are all mounting.

Several states have already conducted preliminary actuarial studies and the "numbers are shocking" (O'Connor, 2005 p. 17). Washington authorities have yet to complete their valuations. But, considering our history of generous benefits, state and local agencies likely face large unfunded liabilities.

Demographic Challenges

Over the next several decades, the number of public employees eligible to retire will substantially increase. Along with the potential loss of institutional memory and expertise, state and local governments anticipate a substantial drain on their retirement benefit plans.

In 2005, state and local governments employed an estimated 16 million workers, more than 10 percent of the national workforce (Brainard, 2005 p. 2).

In 2002, the Rockefeller Institute of Government reported that 46.3 percent of government workers were 45 years of age or older, compared to 31.2 percent of private sector workers (Abbey & Boyd, 2002).

With an aging government workforce, the number of inactive participants as a proportion of total participants is increasing. In 1993, 89 percent of total participants were active. By 2002, the level dropped to 82 percent (CanagaRetna, 2004 p. 39).

In Washington, more than 50 percent of government workers were 45 or older in 2000 (DOP, 2000). According to the Pew Charitable Trust's Government Performance Project, 63.7 percent of Washington's full-time public employees are eligible for retirement within the next ten years – the highest rate in the nation (GPP, 2005; OSA, 2005a p. 41). While many retirement-eligible employees will choose to remain in the workforce, the number of retirements is projected to steadily increase.

"OTHER POSTEMPLOYMENT BENEFITS"

In addition to pensions and salaries, many public employers provide "other postemployment benefits" (OPEB) as part of the total compensation offered to attract and retain employees. OPEB includes benefits such as medical, prescription drug, dental, vision, life insurance, disability, and long-term care (SCPP, 2005 p. 1). Of these benefits, health care is the most common and generally the most costly.

Coverage. The benefit packages offered by governments vary greatly across states and plans. While some employers offer lifetime benefits for retirees and their families, others offer little or no coverage. But, according to the Select Committee on Pension Policy (SCPP), every state makes health insurance available to retirees up to the age of 65, and 48 states – including Washington – provide coverage for retirees age 65 and older (2005 p. 13). In total, actuaries estimate that approximately 5.5 million retired public employees have health benefits of some kind (Freudenheim & Walsh, 2005).

OPEB generally take the form of direct indemnity payments or full or partial cost sharing of annual insurance premiums (Mason et al., 2005).

Upon reaching age 65, retirees become eligible to receive Medicare coverage. However, many public employers continue to provide OPEB benefits to these retirees by supplementing the federal government's health care coverage (CLAO, 2006).

Cost. The cost of providing postemploymment benefits is increasing rapidly as a result of rising health care costs, rising employer health care premiums, and increased rates of retirement. With the "baby boomer" generation beginning to retire and with beneficiaries living longer, cost pressures are further exacerbated. (See boxes on page two and three for details.)

Funding. While many governments have promised employees generous retirement benefits, very few have kept track of the mounting liabilities. And, unlike pensions – which are funded during an employee's working years – most public employers pay for OPEB in the year the benefits are used by retirees, through what is known as the pay-as-you-go approach.

GASB 43

GASB recently issued two statements regarding other postemployment benefit plans. The statements are intended to improve information regarding the cost of providing these benefits, the commitments that governments have made, and the extent to which those commitments have been funded.

Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, was issued in April 2004 to establish uniform financial reporting standards for OPEB plans. In the statement, GASB requires public employers to provide actuarially determined historical trend information about the funded status of these plans, the progress being made in accumulating sufficient assets to pay benefits when due, and employer contributions to the plans.

Rising Health Care Costs

While personal health care expenditure growth is decelerating, it continues to outpace inflation and increases in governmental budgets. By 2014 total spending is projected to constitute 18.7 percent of GDP (Heffler et al., 2005 p. 74).

Rapid advances in technology, increased utilization, growth in prices, demographic changes, and the expansion of health care programs are a few of the many factors contributing to the growth in health care spending. In 1995, national health expenditure totaled $990.2 billion. In 2005, health care spending rose to an estimated $1,936.5 billion. And by 2014, the Centers for Medicare and Medicaid Services projects that spending will reach $3,585.7 billion (CMS, 2005).

Like the rest of the nation, health care expenditure in Washington has increased as a percent of total state expenditures. In 2000, health related costs totaled $2.7 billion and accounted for 21.7 percent of state expenditures. By 2005, health related expenditures increased to $4.17 billion and accounted for 28.3 percent of the budget (Office of the Governor, 2005).

While medical expenditures are rising for everyone, they are growing at an even faster rate for retirees. (See Diagnosing Health Care Spending Growth, http://researchcouncil.blogs.com/weblog/files/health_care_cost_pb_0604_final.pdf)

GASB 45

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. According to this statement, the current reporting practice fails to recognize the cost of benefits in the period when the related service is received, provide sufficient information about the actuarial accrued liabilities, and provide information useful in assessing potential demands on future employer cash flows. To change this, GASB 45 provides guidance on the disclosure and expense of liabilities.

What. The new accounting standards apply to all public employers (such as state and local governments) that follow GASB's accounting standards and offer postemployment benefits other than pensions. Performing the new valuations is similar to performing public pension plan actuarial valuations, with minor adjustments made for the difference in OPEB structure and funding. It is also similar to the accounting standards adopted by the private sector under the Financial Accounting Standards Board's SFAS 106. (See boxes on page four and five for details.)

GASB 45 requires employers to disclose the annual OPEB cost on an accrual or modified accrual basis for accounting purposes. The annual OPEB cost is equal to an employer's annual required contribution (ARC) to the plan, with certain adjustments made for past under – or over – contributions (GASB, 2004). The ARC consists of both the current normal cost (the amount required to fund future retiree benefits earned in the current year) and the unfunded liability costs (the amount needed to pay for already accumulated retiree benefits, with a maximum 30-year amortization period).

Employers must also disclose their Net OPEB Obligation (NOO). The NOO is the cumulative difference between OPEB expenses and contributions. Initially it is set at zero but an employer can elect to calculate the obligation retroactively (GASB, 2004).

Employers are also required to disclose information about each defined

Public Employee Pension Plans

Government pension systems are funded by employer and employee contributions during an employee's career. By 2005, state and local pension assets exceeded $2.5 trillion (Brainard, 2005 p. 2).

GASB 27. GASB issued Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, in November 1994. The provision became effective June 15, 1997 and established standards for the measurement, recognition, and display of pension expenditures and related liabilities.

Liabilities. Because employers prefund pension benefits, the ratio of assets to liabilities has increased, allowing investment returns to provide the majority of needed revenue. However, the past few years have experienced a sharp reversal in this funding trend. And today government pension systems are faced with large budget shortfalls.

Fiscal experts link pension liabilities to a number of factors, including poor returns on investments during the recent economic downturn, past underfunding of programs, recent suspension of catch-up payments, unfunded benefit expansions, and an aging and rapidly retiring workforce.

Compared to FY 2000, when the average pension system had little or no unfunded liability, as of June 30, 2004, Standard & Poor's estimates that the average state pension funding level was 84 percent; the gross unfunded accrued actuarial liability was about $284 billion (2006).

Washington. Like the rest of the nation, Washington state's pension costs will continue to increase. Under the current funding structure, pensions are projected to take up more than five percent of the 2021-2023 GF-S operating budget (Smith, 2005 p. 15). The state is already faced with a $4 billion unfunded pension liability (OSA, 2005a). Still, in preparing the budgets, lawmakers have repeatedly voted to underfund the pension system by delaying cost recognition, payments, and contribution rate increases. (See Misguided Pension Benefit May Cost Billions, http://researchcouncil.blogs.com/weblog/files/gainsharing_report_jan_26_ 2006.pdf)

benefit plan in which they participate, changes in net obligations, the funded status of each plan, and the nature of the actuarial valuation process (GASB, 2004). While past unfunded plan liabilities must be reported, governments are only required to disclose their compliance in meeting the ARC on a going-forward basis (Mason et al., 2005).

Requirements vary slightly depending on the type of public employer, and a sole employer with less than 100 plan members can apply a simpler alternative measurement method.

Assumptions. The liability is the amount which, if invested today, would cover the future cost of OPEB benefits already earned by current and past employees. Actuaries and accountants will determine this liability based on certain assumptions regarding such factors as future health care costs, retirement rates and ages, retiree mortality, contributions, benefit utilization, and Medicare coverage (SCPP, 2005 p. 17).

The size of the OPEB liability also depends on the interest rate used to discount future benefit payments to the present. GASB requires employers to select a discount rate or interest rate that reflects anticipated returns. If benefits are prefunded, the discount rate may be between seven and eight percent but if employers continue under the pay-as-you-go method the discount rate will likely be between two and five percent (SCPP, 2005 p. 6-7). According to Milligan, a one percent decrease in the discount rate may cause a 15 to 20 percent increase in liabilities (Botsford, 2005).

Projected Costs. To prepare for the implementation of the new accounting standards, governments are conducting preliminary cost evaluations. While projected numbers are highly speculative, the unfunded liabilities are expected to be significant.

Freudenheim and Walsh report that the reported OPEB costs for a particular year could be anywhere from two to 20 times the pay-as-you-go cost (2005). Fitch Ratings report that the actuarially determined annual contributions could be five to 10 times higher than current expenses (Mason et al., 2005).

The national totals being projected are alarming. Stephen T. McElhaney, an actuary at Mercer Human Resources, estimates that the national total

Private Sector Postemployment Benefits

An accounting standards change in the early 1990s required corporations to account for retiree OPEB liabilities. Sine then, many private sector employees have chosen to either fund, drop or reduce these benefits.

According to California's Legislative Analyst's Office, the percent of large U.S. firms offering retiree health benefits dropped from around 66 percent in 1988 to about 33 percent in 2005 (CLAO, 2006).

In Washington, retirement benefits for private sector workers fell from nearly 55 percent of workers in the late 1990s to 46 percent in 2003 (U.S. Census cited in Watkins, Vandergrift & Stokley, 2005 p. 5).

While the private sector is required to account for OPEB benefits, these obligations are still largely underfunded. According to Mattoon, of the 337 S&P 500 companies that have OPEB obligations, the total funding ratio is around 27 percent (2006).

could be as high as $1 trillion (as cited in Freudenheim & Walsh, 2005). Another source places the unfunded liability at around $700 billion (Mattoon, 2006).

But while the total will be large, specific liabilities will vary greatly across states and plans because of differences in workforce demographics and the types of benefits offered.

Timeline. GASB 45 will be phased in during the upcoming fiscal years, depending on a government's total annual revenue for the first fiscal year that ended after June 15, 1999. Governments with annual revenues of $100 million or more are required to implement GASB 45 for periods beginning after December 15, 2006. Governments with annual revenues of $10 million or more begin after December 15, 2007 and governments with less than $10 million begin after December 15, 2008. Early implementation is encouraged.

An actuarial valuation is required at least biennially for plans with a total membership of 200 or more, and triennially for plans with a total membership of less than 200.

GASB IMPLICATIONS

While GASB 45 governs the rules that auditors must follow when preparing and reporting government financial statements, GASB does not have the power to change how governments fund benefits. So while public employers will be required to lay out a theoretical funding framework, governments still do not have to set aside money for future OPEB promises. However, the difference between the pay-as-you-go cost and the prefunding cost will have significant financial, political, legal, and bond rating implications (Standard & Poor's, 2005b).

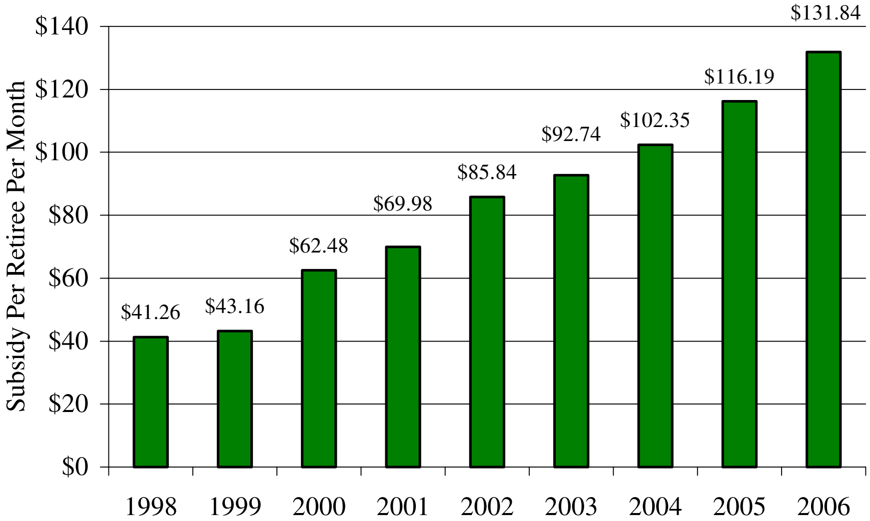
Credit Rating. Rating agencies will monitor GASB 45 liabilities to determine if bond ratings need adjusting. If they are affected, the cost of borrowing will increase. Several major credit rating agencies have indicated that they will judge the creditworthiness of governments based in part on their plan for meeting OPEB liabilities rather than simply on the size of the liability (Mattoon, 2006).

WASHINGTON

Washington authorities have yet to complete their OPEB actuarial valuations but the SCPP released a report last year highlighting the potential implications of GASB 45 implementation.

According to the SCPP, the new accounting standards will impact the financial statements of public employers who subsidize retiree medical premiums, including Washington state and its local governments, as well as

Figure 1. Increase in Washington PEBB Retiree Subsidies for Medicare Eligible Members



Source: http://www.pebb.hca.wa.gov/doc/meetings/071205presentation.ppt

the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 1 (LEOFF 1).

LEOFF 1. LEOFF 1 provides 100 percent employer funded medical benefits and long-term care to law enforcement officers and fire fighters who entered eligible employment before September 30, 1977. The fiscal liability of providing these benefits was recently estimated at over $1 billion for cities, counties and fire districts (AWC, 2006).

On March 8, 2006, the legislature passed SHB 2688. Section two of this bill established a joint executive task force to study funding postemployment medical benefits for LEOFF 1 members. However, on March 30, Governor Gregoire vetoed this section, arguing that the task force would need more time than given and that a broader range of funding possibilities need to be considered. Gregoire has directed the Department of Retirement Systems and the Health Care Authority to lay the groundwork for studying OPEB funding.

Implicit and Explicit Subsidies. Retired state, K-12, and higher education employees are eligible to continue receiving medical benefits at a subsidized rate through the Public Employees Benefits Board (PEBB). PEBB also covers select local governments, including Thurston County.

Retirees in PEBB not yet eligible for Medicare receive an implicit subsidy because their premiums are based on the experience of the community-rated risk pool. This blended rate is less than the rate that would apply to the retirees by themselves (SCPP, 2005 p. 2).

Retirees in PEBB that are eligible for Medicare receive an explicit subsidy because, while their premiums are calculated based on experience from their own risk pool, the employer pays part of the cost (SCPP, 2005 p. 3).

The cost of both implicit and explicit subsidies must be accounted for under GASB 45.

Cost of Subsidies. In 2006, Medicare retirees participating in PEBB will receive an explicit subsidy of $132 per month. Likewise, pre-Medicare retirees participating in PEBB will receive an implicit subsidy of $375 a month (SCPP, 2005 p. 5). See Figure 1.

For the 2003-2005 biennium, the total state subsidy for retirees in PEBB was approximately $223 million. Using the rule of thumb that OPEB expense will be between five and 10 times the pay-as-you-go cost, the SCPP projects that the GASB 45 expense for PEBB in the 2003-2005 biennium would have been between $1 and $2 billion (p. 7). “In absence of effective cost containment strategies, this subsidy may grow sharply in the near future” (p. 3).

Other Plans. There are a number of additional plans in Washington that offer public employees postretirement benefits. For example, the city of Seattle administers its own healthcare plan, allowing retirees to purchase medical insurance at a subsidized rate.

Other Benefits. In addition to retiree health care, state and local governments offer employees a number of post-retirement benefits, including dental, life insurance, and long-term care. However, the type of benefits offered varies by plan. According to Martin McCaulay, Senior Pension Actuary with Washington's Office of the State Actuary (OSA), "OSA is currently meeting on a regular basis with OFM and HCA to coordinate the work on the reporting requirements for these benefits" (personal communication, March 14, 2006).

OPEB FUNDING OPTIONS

Governments are expected to approach GASB 45 in the same way that they approached changes in pension accounting and actuarial standards, by steadily increasing contributions, altering benefit plans, or implementing other strategies that will guarantee long-term solvency (Mason et al., 2005).

Plan Changes. While pension benefits are constitutionally protected in many states, governments have greater control over OPEB plans so may choose to seek concessions from future, current, and retired employees. This could be accomplished by decreasing benefits, capping employer-provided benefits, closing off existing benefit levels for new employees, converting plans from defined benefit to defined contribution, instituting or increasing contributions from current members, or increasing employee co-pays.

Some public managers oppose reducing or altering benefits, arguing that they help to attract and retain qualified employees. And unions argue that constitutional protection of pension benefits apply to other postemployment benefits as well (Freudenheim & Walsh, 2005).

Prefunding: While the new accounting rules do not require OPEB funding, GASB 45 does establish a framework for prefunding future costs.

Prefunding offers several advantages. If the funds are invested, the investment returns can be used to reduce annual contributions and could result in lower long-term costs. And if the funds are placed in a qualifying trust, employers can take advantage of better discount rates when reporting liabilities. Prefunding also enhances intergenerational equity.

Funding vehicles. In order to use a long-term investment return assumption, governments must set aside the prefunded plan assets in an irrevocable trust (Mason, 2005). Setting up and administering some of these programs can be difficult and may require Internal Revenue Service approval (Harper, 2005).

One option is to establish a Section 401(h) account. These accounts are separate accounts established within a qualified pension plan and are dedicated to pay medical expenses for retirees, spouses and their dependents. Investments are able to accumulate tax free but contributions to the account may not exceed 25 percent of total pension contributions (SCPP, 2005 p. 8).

Another investment tool is Section 115 funds. Contributions to such a trust are not limited and the funds are tax exempt (Botsford, 2005).

Governments can also use section 501(c)(9) trusts. These trusts, also known as Voluntary Employees' Beneficiary Associations, are separate trusts designed specifically to pay OPEB benefits (Botsford, 2005). Like 401(h) accounts, they are tax exempt (SCPP, 2005 p. 9).

Section 420 Transfers allow surplus pension assets to be transferred to a 401(h) account. Only a portion of these assets may be transferred and governments are limited to one transfer per year (SCPP, 2005 p. 9).

Another option is to establish Health Savings Accounts (SCPP, 2005 p. 9).

Governments can also issue OPEB obligation bonds. This allows for investment in potentially higher yielding investment vehicles such as equities. If the investment yield from the bond asset exceeds the interest that will be paid to bond holders, the bond proceeds can be used to cover part of the government's liability. However, issuing bonds is risky and could increase liabilities if investment returns do not meet expectations. And, according to Standard & Poor's, some states will have to adopt enabling legislation or get voter approval before issuing bonds (2005a).

Washington. Washington is likely to respond to the new GASB rules in a manner similar to that of the rest of the nation. This means quantifying OPEB liabilities, determining funding policy, developing strategies for managing liabilities, and discussing costs and strategies with bond rating agencies (SCPP, 2005 p. 11).

DISCUSSION

The new accounting standards bring greater transparency and further efforts to disclose the total compensation earned by public employees. According to Eric Lupher, Director of Local Affairs with the Citizens Research Council of Michigan, "People are recognizing that [the new standards] will change the way we see government finance" (personal communication, April 3, 2006). So while there will be a large difference between accounting and actual expenditures in the short term, in the long run governments will likely consider ways to manage the cost of OPEB benefits. Although GASB 45 doesn't require pre-funding, setting funds aside now allows employers to use today's tax dollars – and the earnings on those tax dollars – to pay for today's employees.

If Washington continues to fund OPEB on a pay-as-you-go basis and if current benefit levels remain intact, state and local governments will find themselves having to divert greater shares of current revenues to meet obligations, reducing funding for other public programs.

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