

REFORM BEFORE REVENUE: How to Fix California's Retiree Health-Care Problem

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While much attention has focused recently on the immense cost of pension benefits for government workers, an equally challenging problem has received much less discussion: the cost of retiree health care. This paper examines the ongoing fiscal crisis caused by health-care plans for retirees (known as “other post-employment benefits,” or OPEB) in one of the hardest-hit states: California. Already, government workers’ retirement costs have played a role in municipal bankruptcies in Stockton, San Bernardino, and Vallejo, and the pressure will only intensify as more workers retire in coming years. Collectively, California state and local governments face an unfunded retiree health-care liability of at least \$130 billion. Few governments have set aside sufficient funds to pay for these future costs.

Retiree health benefits in the public sector can exceed \$20,000 a year per person in value. Even the most basic form of government-employer-sponsored OPEB is more generous than what most private-sector retirees receive. In fact, only 25 percent of large American employers offer retiree health care; in the public sector, 77 percent of employers do so.

Fortunately, we now have a window of opportunity for effective OPEB reform in the public sector because state and local governments’ retiree health-care programs are relatively undeveloped. Pension obligations are often set in stone, but in the realm of OPEB, many important decisions have not yet been made regarding benefit structures, cost-sharing and funding arrangements, and the legal status of benefits. This helps governments avoid repeating the history of pension commitments, which locked governments into rigid and unsustainable benefit commitments.

OPEB is essentially a fiscal problem, and new revenues will be necessary to support these benefits. But it would be a grave mistake to simply fill in the fiscal gap with more taxpayer money. Instead, reform should precede revenue (especially since some reforms may generate revenues). Governments that seek to pay for OPEB only with taxes or budget cuts are being neither practical nor fair.

What is to be done? What actions should state and local governments take to manage OPEB? This paper describes the current crisis, analyzes current OPEB practices and their contribution to the problem, and outlines necessary reforms that should come before tax increases or cuts to government services. These reforms are:

- (1) **California state and local governments should reassess the need to offer OPEB.** Before restructuring their OPEB program, all governments should first evaluate the importance of this benefit. Are retiree health-care benefits necessary to attract and retain a skilled workforce? Cities such as Fresno, which never allowed its OPEB programs to become overly generous, now have manageable long-term liabilities. Governments should understand that they may have more flexibility to adjust retiree health-care benefits than they have for pensions, as was demonstrated in recent litigation between Orange County and its retirees.
- (2) **Think hybrid.** California cities should consider a hybrid model for OPEB, similar to the hybrid pension models recently adopted in Rhode Island, Utah, and the city of San Jose. Hybrids provide retirees with a basic level of retirement security while reducing employers’ overall liability.
- (3) **Raise revenues and begin prefunding.** A few governments have shifted from pay-as-you-go methods to a prefunded approach to OPEB (in which benefits are paid by money set aside and invested for that purpose, as is done with pensions). This trend must accelerate and become widespread. The move to prefunding will require that more money go into retiree health benefits. Who should provide it? The first and most obvious candidates are the employees who will benefit. Currently, most California government employees do not contribute to their retirement health-care benefits at all. They should be required to contribute half their OPEB’s actuarial normal cost—the amount set aside each year to ensure that the benefit will be adequately funded when the employee reaches retirement. Of course, all new revenues raised by this or any other method should be deposited into an irrevocable trust fund and invested.
- (4) **State government should provide local governments greater bargaining leverage for OPEB.** With the pension reform signed into law in September 2012, California state government requires that public employees pay half their pension costs, with their government employers picking up the rest. This 50/50 split is defined as the California standard, and local governments have the authority to implement it in cases where collective bargaining has come to an impasse on pension issues. This reform should be extended to OPEB.

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REFORM BEFORE REVENUE: HOW TO FIX CALIFORNIA'S RETIREE HEALTH-CARE PROBLEM

Stephen D. Eide

I. OPEB: THE NEGLECTED FISCAL MENACE

Most California local governments provide health-care benefits to their retirees (OPEB).¹ A 2008 survey of almost 1,200 public agencies in California found that 82 percent provided OPEB.²

This is in stark contrast to the private sector. According to the most recent edition of the Kaiser Foundation's annual "Health Benefits Survey,"³ 98 percent of large (200+ employees) American employers offer health benefits to their current employees, but only 25 percent offer retiree coverage. In contrast, Kaiser reports that this figure for state and local governments is 77 percent.

Private-sector retiree health benefits are largely confined to big employers. In fact, the larger a corporation is, the more likely it is to offer retiree health benefits. According to the Agency for Healthcare Research and Quality, 38 percent of private-sector establishments with more than 1,000 employees provide health insurance to retirees under the age of 65, and 32 percent provide it to retirees who are over 65.⁴ To put these figure in perspective, out of the 50 biggest cities in California, 25 have more than 1,000 employees. Yet nearly all offer OPEB.⁵

Though pension costs claim the lion's share of media attention about government's fiscal troubles, OPEB is a major challenge. According to a recent analysis by the nonpartisan research group California Common Sense, California state government's annual OPEB bill grew over 400 percent, from \$300 million to \$1.6 billion, between 1999 and 2011.⁶ Among the 20 largest cities in California, OPEB costs increased, on average, 36 percent in only a three-year span between the 2008 and 2011 fiscal years, and some cities saw increases of more than 50 percent. At these rates, it has been estimated that OPEB costs will consume some cities' entire budgets in 20–30 years.⁷

Our focus is on California; but nationally, the OPEB picture is equally bleak. The Pew Center on the States' most recent estimate of American states' total OPEB liability was \$660 billion, \$627 billion of which is unfunded.⁸ This is not much lower than the states' unfunded pension liability, which, according to Pew, is \$757 million (though this figure may be overly optimistic, based, as it is, on the states' own rosy estimates of future performance). The State Budget Crisis Task Force estimates American state and local governments' collective OPEB liability to be at least \$1 trillion.⁹ For comparison, state and local

governments' unfunded pension liabilities amount to \$1 trillion–\$3 trillion, depending on actuarial assumptions.¹⁰

Retirement benefit costs (pensions and OPEB) are squeezing out other priorities in California. Charts 1 and 2, based on data collected and organized by former state economic official David Crane,¹¹ illustrate this trend.

Much of California state government spending is nondiscretionary, mandated by various laws and obligations. Charts 1 and 2 show major categories within that part of the budget over which the government does have discretion; these account for 80 percent of total discretionary spending. A comparison between the two charts illustrates the growing burden of payments to retirees—OPEB as well as pensions. As the charts show, over a quarter (28 percent) of this spending will be devoted to retirement benefits in fiscal year 2013. That is up 3/4 the percentage in 2003 (16 percent). The impact of this increase has been felt in cuts to universities and other services, higher taxes in 2009, and proposed tax increases in 2012. The challenge of public-sector employment costs, then, isn't just a matter of pensions. There is

Chart 1: Major Discretionary Spending Categories in California State Government, FY03 (\$ in billions)

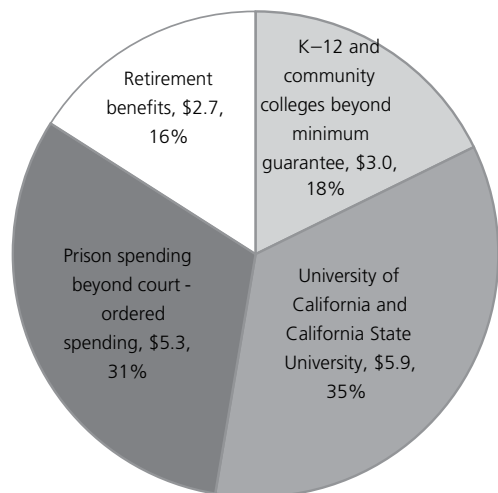
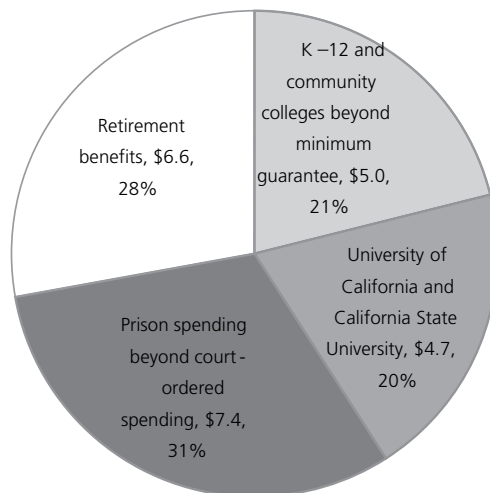


Chart 2: Major Discretionary Spending Categories in California State Government, FY13 (\$ in billions)



no surmounting the fiscal problem without an understanding of OPEB and its impact.

OPEB Mechanics

Retiree health benefits come in a few different forms, which may be sorted into two groups: those provided to pre-Medicare, or early, retirees; and those for Medicare-eligible retirees.

• Pre-Medicare-eligible

- The most basic form of retiree health-care benefit is simple: letting workers stay on their workplace health plan after they retire. For retirees too young for Medicare, this offers significant savings. Instead of having to purchase non-group health insurance in their late middle age, they can pool their risks with younger active employees, and their premiums are lower. This benefit is known as an “implicit rate subsidy.” The value of the implicit rate subsidy to a retiree increases with age. In San Jose, for a 64-year-old on the verge of Medicare, the value is typically \$5,000–6,000 a year.¹² Most private-sector employers do not offer this benefit, since it increases costs for employers as well as for active employees. Some California local governments *only* offer this benefit.
- Many governments also provide early retirees with an explicit subsidy, either through a flat stipend or picking up a certain share of the employees’ premium for new health coverage after they leave the employee plan. Depending on the subsidy’s value, this is potentially the costliest of all retiree health benefits.

• Medicare-eligible

- At age 65, the burden of funding retiree health care shifts from the employer to the federal government’s Medicare program. Medicare has three parts: A, B, and D, all of which require cost-sharing. Unlike most private insurance, Medicare does not offer a guaranteed cap on out-of-pocket costs for the individual. To

manage Medicare’s out-of-pocket costs, many retirees purchase supplemental, or Medigap, insurance from a private carrier. Another option is to enroll in Medicare Part C, a Medicare Advantage plan, through which federally funded private insurance replaces and supplements Medicare. Because the federal government assumes primary responsibility for most costs, Medicare supplemental benefits are much less expensive than coverage for pre-Medicare-eligible retirees. However, it is less common for an employer to provide them.¹³

- Some employers pick up the cost of Part B premiums (currently about \$100 per month for most retirees).

OPEB may also include health care for dependents and survivors, along with vision, life, and dental insurance.

Table 1 details the retiree health benefit packages provided by California state government and the five biggest cities in the state.¹⁴

OPEB benefits in California are employer-specific, and governments have wide latitude over what to offer. While California and other states have statewide systems for pensions (such as the California State Teachers’ Retirement System and the New York State Employees Retirement System), California has no such standardized approach to OPEB. Hence OPEB comes in a greater variety than pensions. Some retirement systems are extremely generous; some offer no retiree health benefits at all.¹⁵

The important exception to the general rule of OPEB diversity is the influence of the California Public Employees’ Retirement System, or CalPERS. Best known for running California’s \$226.6 billion pension fund,¹⁶ CalPERS also manages health care for state employees and retirees. It is also involved in local governments’ OPEB because governments may contract with CalPERS to manage health care for their employees and retirees, through what is known as the Public Employees’ Medical and Hospital Care Act (PEMHCA) program. More than 1,100 local gov-

Table I: Current OPEB Packages and Eligibility Standards for State Government and the Five Biggest Cities in California

System	Principal Benefit Package and Value	Eligibility
State government (CalPERS)	Pre-Medicare eligible: Implicit rate subsidy; for one-party plans, explicit subsidy of up to \$566 per month, two-party plans up to \$1,074 per month, and family plans up to \$1,382 per month; Medicare-eligible: same explicit subsidy; Part B premium is paid out of subsidy's surplus, which there will be, in nearly every case.	Hired before 1985: 100% of benefit upon retirement; 1985-1989: ten years merits full benefit, for each year less than ten, state reduces contribution by 10%; Hired after January 1989: ten years merits 50% of benefit, 20 years merits full benefit. (Some exceptions apply for California State University employees, judges, and legislators.)
Los Angeles (LACERS and LA Fire and Police)	Pre-Medicare eligible: No implicit rate subsidy (retirees are on a separate plan); explicit subsidy of up to \$1,097 (public safety) or \$1,190 (non public safety) per month; Medicare eligible: Part B premium reimbursement (\$96 per month) and explicit subsidy for single plan of up to \$423 per month, \$623 per month for two party plan and, in cases of "dual care" (dependent or dependents not on Medicare), up to \$805 per month (non public safety) or \$873 (public safety). All subsidies are now frozen for employees retiring after July 2011 unless they pay 2-4% of salary.	Pre-Medicare eligible: 55 with ten years of service merits 40% of full benefit, 25 years merits 100%; Medicare-eligible: 10 years merits 75% of full benefit, 20 years earns 100%.
San Diego (SDCERS)	No implicit rate subsidy (retirees are on a separate plan); Retired between October 1980-June 2009: Pre-Medicare eligible: up to \$897 per month; Medicare-eligible: Part B premium reimbursement (\$96 per month) and explicit subsidy of up to \$844 per month; Retired between July 2009-March 2012: Pre-Medicare eligible: up to \$740-\$804 per month (depending on bargaining unit and retirement date); Medicare-eligible: Part B premium reimbursement (\$96 per month) and explicit subsidy of up to \$697-727 per month, depending on bargaining unit and retirement date); Retired after April 2012 but hired before July 2005: Three "irrevocable" options: A-up to \$740 per month (2% annual escalator; requires monthly employee contribution of \$98-103 per month) B-up to \$458 per month (no escalator; requires monthly employee contribution of \$49-52 per month) C-employer-funded defined contribution plan, projected (but not guaranteed) to yield annual benefit of \$8,500 (based on assumption of 6% rate of investment return); A,B and C sums may then be put towards Pre-Medicare care, Part B premiums and/or Medigap.	Retired before 2009: pension-eligibility merits full benefit; Retired after 2009: ten years merits minimum (50%), 20 years merits the full benefit; Hired between July 2005 and July 2009-No retiree health care benefits; Hired after July 2009 (non-safety or elected)-participation in Retiree Medical Trust program, funded by mandatory employee and employer contributions of .25% of compensation.
San Jose (Federated and Police and Fire)	Pre-Medicare eligible: Implicit rate subsidy; city pays 100% cost of the lowest-price plan, which is \$531 per month for a single plan, \$1,323 per month for a family plan; Medicare-eligible-same explicit subsidy.	55 with 15 years of service, or eligible for monthly pension worth at least 37.5% final compensation.
San Francisco City and County	Pre-Medicare eligible: Implicit rate subsidy; explicit subsidy for single plan of up to \$1,308 per month, two-party plans of up to \$1,761 per month, and family plans of up to \$1,761 per month; Medicare-eligible: explicit subsidy for single plan of up to \$405 per month, up to \$1,066 per month for two party plans, up to \$1,066 per month for family plans.	Hired before January 2009: five years merits full benefit; Hired after January 2009: 50% of full benefit at 10 years, 20 years merits full benefit.
Fresno (general government employees and public safety)	Implicit rate subsidy; premium support provided through surplus pension fund earnings when available; employees can also devote accumulated leave time toward health insurance premiums in retirement.	55 and five years of service.
Source: plan documents and financial reports; Note these figures only represent the cash value of the subsidy; in some cases, this figure covers the entire premium, in other cases not; a full account of an OPEB package's value would include the implicit rate subsidy, survivor, vision and dental benefits.		

ernments (out of a state total of 4,350)¹⁷ participate, covering 421,709 active local government employees and their dependents, as well as 137,370 retirees and their dependents. The benefits to local governments are CalPERS' low administrative costs, access to a wide range of plan offerings, more risk pooling, and access to CalPERS' massive purchasing power—in 2011, CalPERS spent \$6.7 billion on health care, a sum second in the United States only to the federal government's medical spending.

Contracting governments must sacrifice some freedom over their benefit structures to participate in PEMHCA. Most notably, PEMHCA requires that “[t]he employer contribution shall be an equal amount for both employees and annuitants.”¹⁸ A government that does not contribute equal amounts to active and retired workers' health care may still join but, over time, must gradually equalize its contributions. PEMHCA sets a minimum employer contribution, currently \$112 per month.¹⁹

CalPERS also assists local governments to fund OPEB. In March 2007, the state legislature authorized CalPERS to establish the California Employers' Benefit Trust (CERBT), a collective, irrevocable trust through which local governments may pool and invest funds for OPEB. Governments need not contract with CalPERS for health benefits to participate in CERBT.²⁰ As of July 2012, 338 agencies had joined, and the trust had \$2.1 billion in assets under management.²¹

The variety of types of benefit packages among California's local government units makes it difficult to speak generally about OPEB. But at least three generalizations are warranted:

1. Even the sparest forms of OPEB (implicit rate subsidy, Medicare Part B pickup) are more generous than what most private-sector employers provide. In California, only 12 percent of all private-sector establishments offer health insurance to early retirees (55–64).²²
2. In California, scales that define OPEB eligibility (Table 1) tend to be much more compressed

than those for pensions. In many communities, an employee qualifies for minimum OPEB after ten or fewer years of service. Moreover, this minimum benefit is often fully 50 percent of the maximum, for which only ten more years are needed to qualify. Pension systems use a more graduated eligibility scale, so that it takes much longer than 20 years to max out for non-public-safety employees.

3. OPEB liabilities tend to grow. Retirement systems reevaluate their liabilities every two years, and, almost inevitably, OPEB estimates increase because more workers have qualified for benefits, and the value of those benefits has risen with the ever-mounting cost of health care. Most OPEB systems are pay-as-you-go, so they have no investment return to narrow the gap between assets and liabilities. As a general rule, OPEB costs have nowhere to go but up.

To grasp the fiscal and political impact of OPEB, it is important to understand how these benefits differ from pensions. Four distinctions matter for policymakers.

First, pensions are more valuable than health-care benefits, which is one reason they get much more attention. The most conceivably generous retiree health-care benefit—an employer picking up 100 percent of the premium for a family plan for a pre-Medicare-eligible retiree—would still tend, in dollar value, to be less than the average pension benefit in most systems. For example, the current average pension for all CalPERS retirees is \$28,000 a year, and it is \$37,000 for those retiring in the past year.²³ The average pension for all retired California teachers is about \$49,000.²⁴ By contrast, the Affordable Care Act's official definition of “excessive” (or “Cadillac”) spending on a family plan for 55–64-year-olds is \$30,950. At age 65, when Medicare kicks in, the cost of a beneficiary's OPEB drops.

So, compared with OPEB, pensions cost more and are a more familiar political issue. Then, too, certain outrageous abuses are possible with pensions that are not possible with OPEB. “Spiking”—manipu-

lating the benefit formula to increase payments, as when, for example, a worker adds pay for unused vacations to his last year's salary to increase the basis of his pension—has no equivalent in the OPEB world. There is no OPEB equivalent to the media story about the “\$100,000 club”²⁵ of retirees with enormous pensions.

It is important to remember that this lack of attention to OPEB is simply a consequence of this way in which health benefits differ from pensions. As we have mentioned, OPEB is a significant cost for governments and an exceptionally generous benefit for retirees. An OPEB benefit of \$415 a month for a retiree is a much smaller expenditure than a monthly pension check, but this should not obscure the fact that such a benefit (quite typical in California) far exceeds what is expected in the private sector.

Employees and unions will fight hard to keep OPEB as it is because paying for health care lately has become more expensive for retirees in general. Even Medicare costs more than it did for earlier generations. For example, out-of-pocket expenses for Medicare Part B, which were only 7.5 percent of the average Social Security benefit in 1983, are now 17 percent.²⁶ According to AARP, Medicare beneficiaries in California spent an average of \$4,000, 15 percent of their income, on all out-of-pocket health-care costs in 2011.²⁷

The second way in which OPEB differs from pension systems is that OPEB promises the same benefit to each retiree, without relation to salary or rank during the working years. Janitors' and cafeteria workers' benefits are equal in value to those of police chiefs and superintendents. Public-safety workers receive somewhat more benefits on average, only because these employees tend to retire sooner and draw on OPEB for longer—there is no premium for risky occupations, and within any given OPEB system, a retired clerk gets the same coverage as a retired firefighter. Of course, those who live longest will use the most health services, but because retirees tend to become eligible for OPEB sooner than they qualify for pensions, even the natural differences in individual life spans don't create big differences in the cost of OPEB from one employee to another.

Third, OPEB's long-term costs are far more uncertain than pension obligations. A pension is a payment of a predictable amount every month. By contrast, health care is a service whose cost changes every year.

Government policy compounds the inherent uncertainty of OPEB costs. At the federal level, two provisions of the 2010 Affordable Care Act can serve as examples. One imposes a tax, beginning in 2018, on exceptionally costly “Cadillac” health-insurance plans—those whose annual premiums cost over \$11,850 for a single plan or \$30,950 for a family plan. The policy aims to discourage expensive plans that cover so many services that beneficiaries have an incentive to overuse the medical system. But its effect on OPEB systems may well be to increase liabilities.²⁸ To avert that possibility, systems might respond as legislators hoped: reduce benefits to keep their plans below the Cadillac cost threshold. However, they might instead pass on the cost of the tax to retirees. Or they might simply drop coverage. The ACA provides another incentive to do so: in 2014, the law's new state health-care exchanges will go into effect. Some recent employer surveys have reported that many private-sector employers view the exchanges, which are accompanied by generous government subsidies, as an opportunity to exit their retiree health-care commitments.²⁹

Another source of uncertainty is potential Medicare reform. For example, one oft-discussed change to Medicare would raise the eligibility age from 65 to 67, thus aligning it with Social Security. For state and local governments, this change would oblige them to cover two more years of health care for a highly risk-prone and expensive population.

For the moment, governments have won a reprieve from the alarming health-care-cost trends of the 2000s. The rate at which costs rise has slowed: family health-insurance premiums grew 50 percent between 2002 and 2007, but only 30 percent between 2007 and 2012.³⁰ This could be because people have simply spent less on health care. Employers have shifted more out-of-pocket expenses to employees, and the recession has caused households to cut back spending on all goods and services. It's also possible

that health-care costs are down because of enhanced efficiencies in the health-care system.³¹ Whether this slowing trend will continue is unpredictable.

A fourth difference between pensions and OPEB is the most important: since the 1980s, government pensions have been “prefunded”—each year, governments set aside funds for an irrevocable trust that will pay for workers’ future retirement benefits. Present taxpayers thereby pay the future retirement costs of today’s workers. OPEB, though, is usually deemed an operating expense, with government appropriating only enough funds to cover that year’s benefits. With this pay-as-you-go approach, today’s taxpayers compensate retired workers for services rendered decades ago. Prefunding, of course, is more cost-effective than pay-as-you-go, since investment return relieves the pressure on taxpayers and employees, the only other two sources of funding for benefits. Depending on the stock market’s performance, prefunding can even allow for decreases in employer/taxpayer contributions to retirement systems.

But the majority of governments don’t prefund OPEB because it’s more expensive in the short term. For example, if California’s state government were to switch today from pay-as-you-go to prefunding for OPEB, it would have to pay more each year for the same benefits, and this extra cost would endure for over 20 years. According to the Center for Retirement Research at Boston College, prefunded OPEB would not begin to cost less than pay-as-you-go until 2036.³² Struggling even to fund current retirees’ benefits, governments are understandably disinclined to cut constituents’ services or to raise taxes to cover future OPEB costs.

Prefunding is certainly a critical part of the solution to the OPEB problem. But prefunding, no matter how widespread and no matter how well financed, is not and cannot be the single simple solution to the OPEB challenge. The experience of governments that have taken the first steps toward proper prefunding have made this clear, as we shall see below. Even adequate prefunding (of which there are few examples) does not change the fundamental imperative: reform must precede revenue.

OPEB: The Costs

Table 2³³ provides estimates for unfunded pension and OPEB liabilities for 50 of the biggest cities in California.³⁴

Shading in the table marks the 18 governments that have begun the process of prefunding. Their efforts are at a very early stage, and most of their funded ratios (the percentage of liabilities that would be covered by assets on hand) are low. The median OPEB-funded ratio among the 18 prefunded systems is 21.1 percent.

We have indicated the cost per household of OPEB costs to allow comparison of retirement-related burdens in different communities. However, these per-household figures do not represent the total bill for each family because OPEB liabilities exist at each layer of government (state, county, school district, special purpose entity). A household in Los Angeles thus has a \$3,201 bill for the health benefits of retired employees of the Los Angeles City government, but it also bears the burden of paying for health benefits for retired teachers, state university employees, and employees of Los Angeles County. The University of California Retiree Health Plan alone faces an unfunded OPEB liability of \$16 billion.³⁵ Hence, for any given home in California, the OPEB burden likely is thousands more than is found by tallying a single local government’s obligations.³⁶

Overall, California state government’s long-term unfunded OPEB liability is \$62 billion, over half the size of its total bonded debt (\$111.5 billion).³⁷ The unfunded liability for state and local governments combined is over \$130 billion.³⁸ These liabilities are in addition to state and local governments’ collective pension liability, estimates of which have ranged from \$135.8 to over \$630 billion.³⁹ This means that California cities’ “soft” debt (future obligations to retirees) is either equal to, or slightly more than, the fixed payments that they must make on bonds and loans, known as “hard” debt⁴⁰ (Chart 3).

California, with its spectacular fiscal crises and large population, is a premier example of the challenge

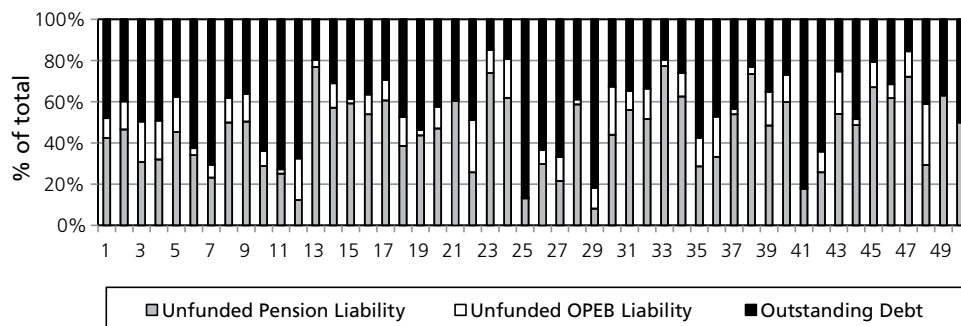
Table 2: Unfunded Pension and OPEB Liabilities in 50 of the Biggest Cities in California, FY11

City	Unfunded pension liability	Unfunded OPEB liability	Pension debt per household	OPEB debt per household	Total Pension and OPEB debt per household
Los Angeles	\$18,754,653,000	\$4,206,483,000	\$14,228	\$3,191	\$17,419
San Diego	\$4,103,917,000	\$1,204,090,000	\$8,495	\$2,492	\$10,988
San Francisco	\$6,748,068,000	\$4,364,273,000	\$19,514	\$12,620	\$32,134
San Jose	\$3,123,536,000	\$1,844,628,000	\$10,365	\$6,121	\$16,485
Sacramento	\$1,007,487,000	\$376,417,000	\$5,769	\$2,156	\$7,925
Long Beach	\$1,292,539,000	\$130,252,000	\$7,904	\$796	\$8,700
Fresno	\$315,017,000	\$84,252,000	\$1,989	\$532	\$2,521
Oakland	\$2,160,579,000	\$520,882,000	\$14,049	\$3,387	\$17,436
Bakersfield	\$384,992,000	\$101,431,000	\$3,464	\$913	\$4,377
Anaheim	\$829,006,000	\$206,994,000	\$8,434	\$2,106	\$10,540
Riverside	\$626,197,000	\$54,900,000	\$6,812	\$597	\$7,409
Stockton	\$331,932,000	\$543,702,000	\$3,664	\$6,001	\$9,664
Huntington Beach	\$440,391,000	\$19,164,000	\$5,928	\$258	\$6,186
Santa Ana	\$593,823,000	\$122,720,000	\$8,115	\$1,677	\$9,792
Chula Vista	\$305,637,000	\$11,885,000	\$40,670	\$1,582	\$42,252
Glendale	\$580,628,000	\$103,947,000	\$8,034	\$1,438	\$9,473
Fremont	\$403,769,000	\$67,049,000	\$5,457	\$906	\$6,363
Modesto	\$285,471,000	\$104,399,000	\$4,131	\$1,511	\$5,642
Santa Rosa	\$329,333,000	\$19,787,000	\$5,179	\$311	\$5,490
San Bernadino	\$390,999,000	\$87,850,000	\$6,595	\$1,482	\$8,077
Oceanside	\$263,251,000	\$4,564,000	\$4,444	\$77	\$4,521
Santa Clarita	\$41,813,000	\$41,425,000	\$703	\$696	\$1,399
Torrance	\$504,624,000	\$77,024,000	\$9,011	\$1,375	\$10,386
Pasadena	\$523,793,000	\$31,678,000	\$9,477	\$573	\$10,050
Sunnyvale	\$350,253,000	\$105,560,000	\$6,561	\$1,977	\$8,538
Rancho Cucamonga	\$62,475,000	\$2,646,000	\$1,149	\$49	\$1,197
Moreno Valley	\$64,300,000	\$14,516,000	\$1,246	\$281	\$1,528
Fontana	\$139,500,000	\$74,664,000	\$2,840	\$1,520	\$4,360
Berkeley	\$514,443,000	\$94,454,000	\$11,176	\$2,052	\$13,229
Garden Grove	\$249,408,000	\$10,273,000	\$5,418	\$223	\$5,641
Lancaster	\$28,336,000	\$35,872,000	\$603	\$763	\$1,366
Ontario	\$254,194,000	\$135,371,000	\$5,657	\$3,013	\$8,670
Fullerton	\$226,659,000	\$37,800,000	\$4,993	\$833	\$5,826
Concord	\$166,452,000	\$47,549,000	\$3,759	\$1,074	\$4,833
Escondido	\$252,911,000	\$0	\$5,560	\$0	\$5,560
Thousand Oaks	\$447,952,000	\$17,879,000	\$9,773	\$390	\$10,163
Hayward	\$367,020,000	\$68,438,000	\$8,090	\$1,509	\$9,599
Roseville	\$300,868,000	\$146,097,000	\$6,677	\$3,242	\$9,920
Corona	\$214,739,000	\$126,252,000	\$4,777	\$2,809	\$7,586
Santa Clara	\$503,103,000	\$23,855,000	\$11,694	\$554	\$12,249

Orange	\$267,723,000	\$12,497,000	\$6,173	\$288	\$6,462
Ventura	\$215,406,000	\$0	\$5,327	\$0	\$5,327
Vallejo	\$278,984,000	\$94,070,000	\$6,878	\$2,319	\$9,198
Simi Valley	\$145,331,000	\$32,621,000	\$3,524	\$791	\$4,315
Palmdale	\$50,343,000	\$2,315,000	\$1,172	\$54	\$1,226
Costa Mesa	\$207,637,000	\$35,492,000	\$5,198	\$888	\$6,086
Pomona	\$185,088,000	\$73,291,000	\$4,810	\$1,905	\$6,715
Inglewood	\$165,199,000	\$166,770,000	\$4,540	\$4,583	\$9,123
Downey	\$172,248,000	\$18,705,000	\$5,076	\$551	\$5,627
El Monte	\$170,020,000	\$64,759,000	\$6,113	\$2,328	\$8,441
Average			\$7,024	\$1,736	\$8,760
Median			\$5,713	\$1,225	\$7,756

Most figures date from June 2010 valuations, as reported in cities most recent (FY11) Comprehensive Annual Financial Reports; pension liabilities have been recalibrated from their 7-8% assumed rates of return to 6% rates of return; prefunded OPEB liabilities have also been recalibrated to 6%; unfunded OPEB systems have been left at 4-5%; all recalibrations assume a 15-year duration for liabilities.

Chart 3: Ratio of Hard to Soft Debt in 50 of California's Biggest Cities



posed by government's OPEB obligations. However, it is merely one example of a nationwide problem. In fact, on some measures, the OPEB problem is worse elsewhere. For instance, California cities' unfunded OPEB liabilities are smaller than those of cities in New York.⁴¹ The average per-household OPEB liability among New York's top 15 cities (not including New York City) is \$7,946 (median \$7,000).⁴² Among California's top 15, this figure is \$2,962 (median \$2,106).⁴³

II. THE ROLE OF OPEB IN LOCAL FISCAL DISTRESS IN CALIFORNIA

California state government has been in a sustained fiscal crisis for almost five years. In every year since 2008, the state government has faced

budget deficits ranging from \$10 billion to \$30 billion.⁴⁴ Expressed as a percentage of the total general fund budget, California's budget deficits have ranked among the largest of all state governments in both of the last two years.⁴⁵ All three credit ratings agencies have downgraded the state's bond rating by at least two notches since 2008.⁴⁶ California now has the lowest bond rating out of all 50 states.⁴⁷ A late-August survey of states' borrowing costs by *Barron's* found that California's were the second-highest among all 50 states.⁴⁸

Fiscal crisis at the local level is even more pronounced. Four California cities have declared bankruptcy since 2008—three in the summer of 2012 alone.

These fiscal problems cannot simply be attributed to California's weak economy, though that factor must

be acknowledged. California is one of only three American states whose unemployment rate is still above 10 percent. Of the 14 American metropolitan areas where unemployment is above 13 percent, 11 are in California.⁴⁹ California's GDP growth has trailed most other states in every year since 2008.⁵⁰ California cities made up seven out of the top ten metro areas with the highest rates of new foreclosures in the first half of 2012.⁵¹

But economic weakness alone cannot explain government's fiscal distress. Both unemployment and per-capita income are poor predictors of fiscal distress in a community, as measured by its percentage of workforce reduction between 2008 and 2011 (see **Charts 4 and 5**). Relatively wealthy communities

and communities with low unemployment rates have downsized by about the same amount as communities with lower per-capita incomes and high unemployment rates.

California state and local governments' deficit is more structural than cyclical. Certainly, high unemployment and the housing collapse have strained budgets. But cities' spending commitments have left them unable to adjust to changing economic conditions. Among those commitments, retirement-related costs are a major factor.

Unsustainable spending on retirement benefits has played a critical role in three out of the four Chapter 9 bankruptcy filings among California

Chart 4: Workforce Reduction vs. Per Capita Income in 50 of California's Biggest Cities

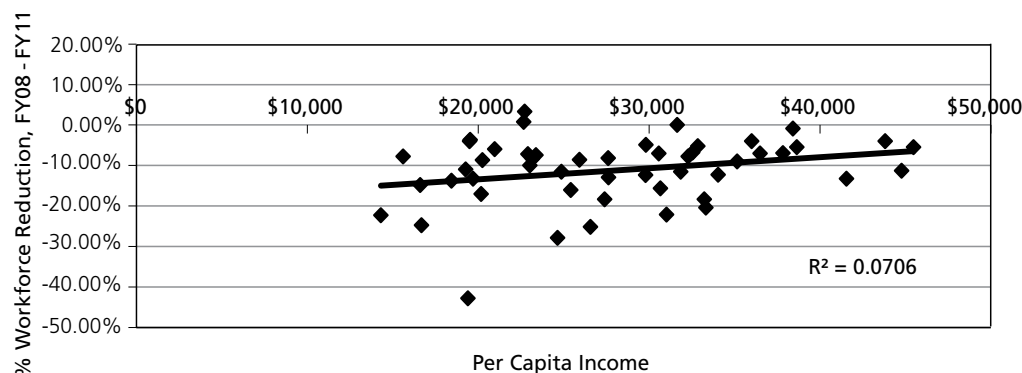
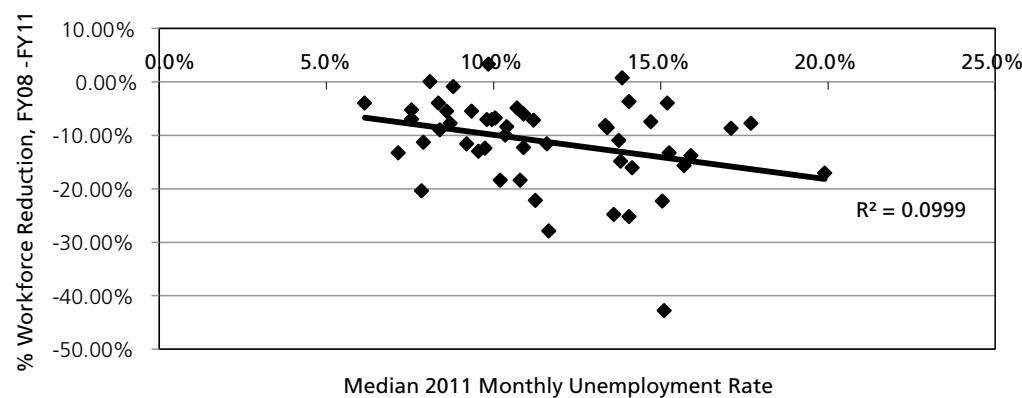


Chart 5: Workforce Reduction vs. Unemployment Rate in 50 of California's Biggest Cities



cities since 2008.⁵² In 2009, Vallejo became the first California local government to use the federal bankruptcy law's Chapter 9 (reserved for municipalities) to reduce retiree health-care benefits. Today, post-bankruptcy, Vallejo's benefits are \$300 per month per retiree, down from as high as \$1,500.⁵³ The city of Stockton, which filed for bankruptcy last summer, intends to go even further: it seeks to eliminate retiree health benefits entirely and thus erase the city's \$540 million unfunded OPEB liability.⁵⁴ San Bernardino, which also filed last summer, has proposed cutting retiree health payments while in bankruptcy.⁵⁵

When OPEB is unfunded (which, as we have noted, is the case in most California communities), costs in coming years are set to accelerate rapidly—likely more rapidly than pension costs. When a worker retires and begins to draw benefits, his pension comes out of the pension fund, whereas his health benefits continue to come directly out of the operating budget. Thus, for as long as governments fund OPEB on a pay-as-you-go basis, they will experience the combined force of the baby-boom retirement wave and rising health-care costs. In a prefunded system, the effect is filtered.⁵⁶

Consider what Stockton was up against before it adjusted OPEB in bankruptcy court (Chart 6).

Stockton's pay-as-you-go OPEB costs were set to nearly triple between 2009 and 2019. The city itself claimed that its "retiree medical benefit is one of the most generous in the state."⁵⁷ CalPERS was Stockton's largest unsecured creditor (\$147.5 million), and its second-largest unsecured creditor was Wells Fargo, the trustee for Stockton's \$124.3 million in pension obligation bonds.⁵⁸

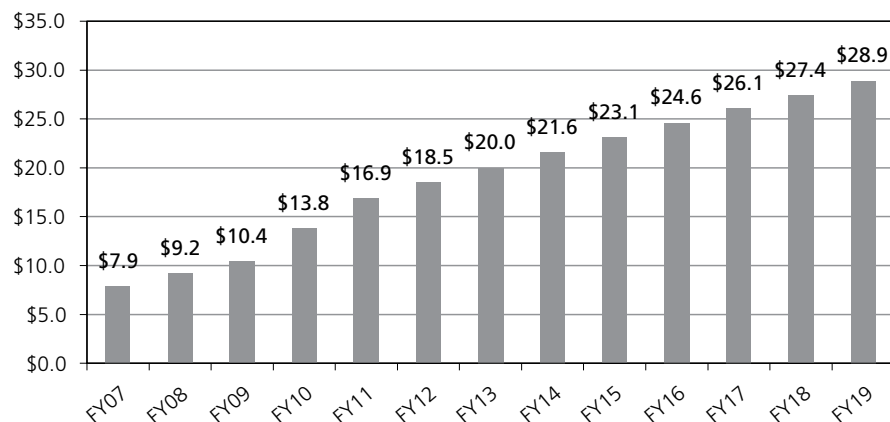
Although the size of the overall liabilities is smaller, managing the coming OPEB squeeze may prove just as challenging to public officials as managing pension costs.

III. WHAT IS TO BE DONE? THE REVENUE QUESTION AND THE LEGAL QUESTION

Despite evidence that governments are in an unsustainable spiral of spending for retirees, a strong current of opinion continues to interpret the California fiscal crisis as a revenue problem. In 2009, the state temporarily raised income, sales, and car taxes. (The hikes had all expired by June 2011, after efforts to make them permanent failed.)

The November 2012 ballot features two tax-increase initiatives: Proposition 30 and Proposition 38. Both would raise income taxes and direct all new revenues primarily to public education. Both contain spend-

Chart 6: Stockton's Past and Projected Pay-as-You-Go OPEB Costs, Prior to Bankruptcy (in millions)



ing restrictions to prevent the new revenues from being used for unauthorized purposes. Opponents have found these spending restrictions to be a “shell game.” As several argued in a statement in the state’s official voter guide, the legislature “can take existing money for schools and use it for other purposes and then replace that money with the money from the new taxes.... Prop. 30 does not guarantee one penny of new funding for schools.”⁵⁹ Although Proposition 38’s spending restrictions are tighter, they, too, are vulnerable to the shell-game critique.

In light of the looming OPEB crisis, it is fair to ask: Would more revenues be a bad thing? Perhaps what some have alleged to be a weakness of Prop. 30—that the real destination of its new revenues would be retirement benefits, not schools⁶⁰—is a reason to support it.

New revenues eventually will be needed to address OPEB. But new revenues need not mean new taxes. A fairer way to raise revenue for OPEB is glaringly obvious: require current employees to contribute to their future health care. In most of California’s government retirement systems, current employees still pay nothing for their postretirement health-care benefits.

Instead, it is popular this political season to promote increased taxes on higher incomes (as both Propositions 30 and 38 would do). But high-earner income is a uniquely poor source of revenue to support mounting OPEB costs because that income is volatile. Wealthier people earn more money from investments than do people in lower income brackets, which means that this income fluctuates with the ups and downs of financial markets. As long as new tax revenue comes from high-income earners, it will increase revenue volatility, already a well-documented problem in California.⁶¹

Governor Jerry Brown, Proposition 30’s chief backer, has focused on California public employees’ retirement benefits as a problem. When he presented his first tax-increase proposal last year, he paired it with a plan for pension reform. The implicit promise was “reform before revenue,” but the pension bill that

Brown eventually signed into law failed to fulfill that pledge for several reasons, not least because it did not address OPEB.⁶²

Recently, some California governments have acknowledged their OPEB problems and attempted to address them, through bargaining (San Diego), ballot initiative (San Francisco), bankruptcy (discussed above), and legislation (Orange County).⁶³

Out of all these options, legislative action—changing the retirement system’s obligations by an act of law—holds the greatest potential for savings. But simply changing the law on benefits represents a unilateral reduction, and this is legally controversial.

Pensions for current employees and retirees in California are protected by the “California rule.” Premised on the notion that pension promises are implicitly contractual, this long-standing legal doctrine mandates that all “detrimental changes” to pensions, whether increasing employees’ contributions or reducing their benefits, can be applied only to new hires.⁶⁴

Is there such a thing as an implied contractual right to OPEB? In principle, the answer is yes, according to the most recent, definitive statement on the matter by the California Supreme Court (see sidebar).⁶⁵ However, the ruling does not establish that all existing retiree health benefits are protected to the same degree to which pensions are. Local governments’ ability to adjust OPEB, for current employees and retirees, remains unsettled in law.

Some systems have explicitly argued that retiree health benefits amount to a “gratuity.” Like a gold watch at retirement, they claim, continuing health benefits may be expected as a gesture of employer beneficence and gratitude but not legally guaranteed. Before 1974’s Employee Retirement Income Security Act (ERISA) changed federal law, it was common for corporations to insert exculpatory clauses into retirement-benefits documents, to define pensions as gratuities and thereby limit liability.⁶⁶ ERISA forbade this; but ERISA does not apply to state and local governments.

Sidebar: *Retired Employees Association of Orange County, Inc. v. County of Orange*

Orange County had been pooling active workers and retirees in the same health plan since 1985, resulting in a benefit to retirees valued at \$3,000 per year per person (according to lawyers for retirees; the county disputed this).⁶⁷ In 2007, Orange County separated active workers and retirees, thus raising rates for retirees (who are more expensive to insure). This action cut the county's unfunded OPEB liability by \$815 million. Retirees sued, and in the course of the proceedings, a federal appellate court formally requested that the California Supreme Court rule on whether local ordinances or resolutions can create implied contracts for OPEB, as they can for pensions. That court unanimously held that local ordinances or resolution can create vested rights for OPEB, just as they do for pensions. With this principle settled, the case was returned to a U.S. District Court, to decide whether such a contract existed between Orange County and its retirees.

The Supreme Court ruling was largely viewed as a victory for retirees.⁶⁸ Many speculated that it will stifle future reforms and that past reforms previously viewed as legally secure (enacted, among other places, in Sonoma, Sacramento, and Contra Costa Counties) will now be vulnerable.

But reformers did discern one ray of hope in the ruling. The California Supreme Court wrote that, though implied contracts for OPEB can exist, courts should heed the advice of the U.S. Supreme Court and "proceed cautiously both in identifying a contract within the language of a ... statute and in defining the contours of any contractual obligation." The burden of proof is on the plaintiffs, who must furnish evidence of the implied contract in official acts of the local legislature.

Heeding this caution, a U.S. district judge in mid-August found in favor of Orange County, ruling that the retirees had not demonstrated a contractual right to be pooled permanently with the actives.⁶⁹ On the contrary, "the legislative language reflects the [County] Board [of Supervisors'] intent that the decision to continue granting the Subsidy, or not, was its to make anew each year."

Some local governments in California have placed exculpatory clauses like those once found in private industry in their employee-benefit documents. In upholding Orange County's right to reduce OPEB this past August, a U.S. district judge cited disclaimers that Orange County had appended to its documents over the years.

The legal confusion over what can and can't be done about OPEB is a consequence of the unsystematic nature of retiree health-care benefits. Pension commitments are relatively unambiguous: what was promised was a certain fixed percentage of the final salary.⁷⁰ But retiree health care comes in a few different forms. A court that determines that retirees have a contractual right to expect health benefits must wade into another question: Which ones? Medigap? Implicit subsidy? Part B reimbursement? Dependent and survivor coverage? An explicit subsidy? And, if the last, how generous do they have a right to expect?

What Has Already Been Done?

Given the financial and legal uncertainties, how can governments get a handle on their OPEB costs? In designing their approach to OPEB, local governments should look to their peers for what they have done and for what they have *not* done. Cities that provide nothing beyond the implicit rate subsidy often have strikingly low liabilities. Among the 50 cities surveyed in Table 2, the average OPEB debt per household is \$1,736. Oceanside (\$77),⁷¹ Fresno (\$532), Long Beach (\$796), and Riverside (\$597) are all implicit rate subsidy-only cities, and all have significantly lower levels of OPEB debt than their peers. And none have begun to prefund: the sole reason that their unfunded liability is so low is that their benefits are less generous.

The implicit rate subsidy need not be the exclusive retiree health-care benefit provided. An alternative is a

hybrid model that offers a basic defined benefit (such as an implicit rate subsidy) that is supplemented by a defined-contribution benefit.

This is essentially Fresno's approach. The city provides an implied subsidy to its retirees and explicit subsidies through its Post-Retirement Supplemental Benefit (PRSB) program. PRSB takes the "gratuity" concept seriously, by granting subsidies only when Fresno's pension plan is overfunded. (It has been for many years, which no doubt has helped sell this approach politically.) In the Fresno system, PRSB benefits are not only an effect of overfunding but a cause of it because retirees have an incentive to keep their pension plan well funded. The Fresno approach also lets the city deal responsibly with pension surpluses. At the moment, PRSB is in abeyance because of the general slump in equities. The city's pension plan remains overfunded, using official actuarial assumptions, but not enough to trigger OPEB payouts. Still, the PRSB approach has proved itself over the years: it provided monthly OPEB subsidies of \$200–\$300 per retiree even during the recent recession years.

Of course, overfunded pension systems are now quite rare. A more practical approach for the current economy would be to establish a "retiree medical trust": a collective defined-contribution plan for OPEB. The Internal Revenue Service gives preferential tax status to any compensation intended to pay for health care in retirement. Structured properly, neither contributions by employer/employee into a retiree medical trust nor withdrawals from it are taxed. A retiree medical trust collects fixed pretax contributions by employees, and sometimes the employer, during workers' active employment. Cashed-in vacation and sick leave may also be used in this manner.⁷² Contributions are then pooled and invested. A board, composed of employer and employee representatives, would oversee the trust. The board sets benefits and decides how to distribute funds in accordance with asset levels and cost trends. As with any other defined-contribution plan, the employer, and thus taxpayers, would not be liable.⁷³

In addition to seeking out the solutions that have worked or could work, California cities should look

to their peers to understand the limits of certain types of reform. This is especially important when considering prefunding, which is part of the OPEB solution but is not sufficient.

Los Angeles's experience illustrates the limits of prefunding alone. In that city, management of retiree health care for general government employees has been exemplary. OPEB and pension benefits for all general city government employees in Los Angeles are managed by LACERS, the Los Angeles City Employees' Retirement System. In the late 1980s, when many state and local governments across the United States were just beginning to address their pension liabilities, Los Angeles started setting money aside to prefund OPEB. Since 2006, Los Angeles has fully funded its annual actuarially required contribution to LACERS and was at least partially funding it in previous years. As of its most recent actuarial valuation, LACERS' OPEB liability was 78.6 percent funded, higher than many state and local governments' pension systems, including its own (which is 72.4 percent funded).⁷⁴

Even as it responsibly arranged to support OPEB, Los Angeles also reduced benefits and required employees to contribute. In 2011, the city capped its subsidy at \$1,190 per month per person for all employees who retire after that year. If future retirees want to exempt their benefits from the cap, they now must contribute 4 percent of annual pay. It is a forward-looking policy, in a state where most systems have still not asked current employees to contribute anything at all. Plenty of assets are available to fund benefits in the short term, and L.A. is in the habit of making its annual required Contribution to its health-benefit system. Mayor Antonio Villaraigosa wants to go further with OPEB, cutting the current cap in half (from \$1,190 to \$596), eliminating benefits for dependents and raising eligibility standards for reaching the maximum benefit.

Despite all this, Los Angeles still has an OPEB problem. Costs are still high and burdensome. Between 2008 and 2011, Los Angeles reduced its workforce by about 4,100 employees (8.2 percent) while spending, in FY2011 alone, about \$100 million on

OPEB for LACERS. Again, multiple overlapping entities involve the same governments in multiple OPEB dilemmas. While LACERS handles many retirees from Los Angeles City government service, two other systems are in place: one for fire and police; and the other for the Department of Water and Power. Hence the city's total OPEB expense in 2011 was over \$350 million.

At \$14,000 a year per retiree, LACERS benefits are generous. It may well be that prefunding actually enabled this excess. Perhaps benefits would not be so rich under pay-as-you-go. Here, too, the experience of pensions is instructive. Had pensions still been funded on a pay-as-you-go basis during the dot-com boom in California, the overheated equity market would not have tempted public officials into unsustainable benefit increases.

The moral of this tale is that prefunding, while more responsible and sustainable than pay-as-you-go, is definitely not a magic bullet that can solve cities' OPEB problem. If the LACERS approach is the future, systems can expect to still be facing an OPEB dilemma 30 years from now, even if they have started prefunding and scaling back benefits (necessary actions that most systems have not even begun to take). This is especially true in an environment in which opponents of reform will do all they can to stave off change. In March 2012, for example, the L.A. City Attorneys Association sued the city over its \$1,190 benefit cap.

This sort of political posturing is another reason that cities should seek OPEB reform. A reformed system frees up government time as well as government money. Struggles over OPEB are a distraction—a fight over benefits for those who no longer work for the government—that takes energy and attention away from government's actual work. Public officials must spend political capital reforming retirement-benefit systems that could otherwise have been spent solving problems that might make a difference in citizens' lives.

Los Angeles's experience shows that revenues alone, when unaccompanied by substantive reform, will

not be adequate. Were prefunding alone the solution to OPEB, cities would not have a pension problem.

CONCLUSION

This paper has addressed the nationwide fiscal crisis posed by government retiree health benefits by looking at the acute case of California. Though the press to reform OPEB has been overshadowed by concern about pension obligations, the health-benefit question must be addressed. Governments will be pressured to maintain current benefits by raising taxes and cutting services to constituents. They should resist, because throwing money at the problem is unfair and ineffectual. OPEB systems need reform before revenue. What those reforms entail is quite clear—and applicable beyond California, to the whole nation.

The time is ripe for OPEB reform not only because fiscal crises breed administrative opportunities but because OPEB programs remain relatively undeveloped, much more so than pension systems. With OPEB, governments have the chance to get it right this time, by developing sustainable cost-sharing arrangements, funding practices and benefit structures that avoid repeating the experience with pensions. Specifically, the following steps should be part of any OPEB policy:

Fundamentals: California state and local governments should reassess the need to offer OPEB.

It's frustrating enough that the soaring cost of health care has forced state and local governments to lay off some workers so that they can continue to afford to pay for the benefits of others. It's even worse that workforces are shrinking partly because of budgetary pressure caused by delayed-compensation payments to retirees.

It is time to question the premise of OPEB. Are retiree health-care benefits necessary to attract and retain a skilled workforce? Since the 1980s, private-sector corporations have drastically cut back on retiree health care. State and local governments have not

done so. Perhaps the public sector knows something that the private sector does not know. But governments should seriously consider that it may be the other way around.

The costs of retiree health care are burdensome, and the benefit is ambiguous. OPEB is clearly not a core function of state and local governments. In the long term, one part of the solution to the OPEB crisis in California, as elsewhere, will be to shift the burden of proof: rather than explain why they must provide less OPEB than they once did, governments should be pressed to explain why they must provide OPEB at all.

Benefits: Think hybrid.

Cities should consider a hybrid model for OPEB, which provides a scaled-back defined benefit pension with a defined-contribution supplement. A hybrid plan would reduce employer/taxpayer liability while still providing retirees with a basic level of retirement security. In the realm of pensions, several governments (Utah, San Jose, and Rhode Island) recently have restructured their formerly pure defined benefit pension systems into hybrid systems.

The defined benefit portion of a hybrid OPEB plan need not include anything more than an implicit rate subsidy. After all, the right of a retiree to remain on his employer's group plan is a real, distinct benefit worth thousands of dollars per year. Even when retirees receive no benefit beyond this, they still enjoy a retirement benefit that most private-sector employers do not provide.

The implicit rate subsidy could then be topped off by premium support provided through a defined-contribution vehicle such as a retiree medical trust. Employees and possibly their employer would make tax-exempt contributions into a trust fund overseen by management and labor. The value of the benefit would depend on the health of the trust fund. Such a system would mean that taxpayers would no longer be liable to make up shortfalls caused by bear markets.

Revenue: Demand employee and retiree contributions, and begin prefunding.

All reports on OPEB by policy centers, special commissions, government agencies, and scholars have agreed about the benefits of prefunding. It is fairer to taxpayers, more cost-effective, and—given rising health-care costs—inevitable in the long run.

But where should the needed extra revenues come from? Not every report addresses this question squarely. New revenues could come from only two sources: the employer, either through new taxes or budget cuts elsewhere; or the employee, through contributions.

The latter is preferable, politically and morally. Taxpayers are unlikely to support service cuts or tax increases to fund benefits that most of them do not enjoy. Today, most employees of most local governments in California do not contribute at all to their OPEB costs. Instead, employees should be required to contribute half the actuarial normal cost of their retiree health care. Requiring employees to contribute the actuarially determined half would generate new revenues that could be invested through CalPERS' CERBT or another irrevocable trust fund.

Current beneficiaries, the retirees, should also be required to contribute. The unfunded OPEB liability that now burdens city budgets is associated with benefits already earned. It would be unfair to ask current employees to cover all that cost.

All new revenues raised should be deposited into an irrevocable trust fund and invested.

Legal framework: The state legislature should grant local governments special authority to break through bargaining impasses over OPEB.

As we have seen, the legal status of OPEB commitments by governments remains unclear and could remain so for some time. This uncertainty may hinder efforts at reform. To head off this problem, the state legislature could bring clarity to the issue by granting the same enhanced bargaining authority to deal

with OPEB as it just granted to local governments for pensions.

As part of the Public Employee Pension Reform Act of 2012 just signed into law, California state government set a 50/50 cost-sharing arrangement (half of costs to be paid by the employer, half by the beneficiary) for all state and local government pensions. The legislature provided local governments with special authority to implement this arrangement in the absence of a contract, when and if collective bargaining comes to an impasse. State government should implement the same 50/50 standard for

OPEB, as discussed above, and similar authority should be granted to local governments.

In some cases, OPEB is formally bargained, in which case governments have no choice but to negotiate changes with unions. In others, the benefit is based in legislation. In these cases, governments may have the authority to adjust benefits unilaterally, but they may not. As we have seen, the legal issues are unsettled. Even in the worst-case scenario, where governments would be forced to negotiate changes, enhanced bargaining authority would provide a legal backstop to prevent unions from blocking reform.

ENDNOTES

¹ OPEB stands for “other post-employment benefits,” meaning other than pensions. In what follows, the term will be used interchangeably with “retiree health care.”

² The Public Employee Post-Employment Benefits Commission, January 2008.

³ “Employer Health Benefits: 2012 Annual Survey,” Kaiser Family Foundation and Health Research & Educational Trust, 2012, section 11.

⁴ Agency for Healthcare Research and Quality, Center for Financing, Access and Cost Trends, 2011 Medical Expenditure Panel Survey-Insurance Component, Table I.A.2.e(2011), “Percent of Private-Sector Establishments That Offer Health Insurance by Plan Options and Insurance Offerings to Retirees by Selected Characteristics: United States, 2011.” See also “Employers Offering Retiree Health Benefits to Early Retirees: How Has It Changed?,” Employee Benefit Research Institute, October 28, 2010; and “How Many Employers Offer Retiree Health Benefits to Early Retirees?,” Employee Benefit Research Institute, October 12, 2010.

⁵ The same drop-off occurs in the public sector. A 2011 survey of about 1,700 local governments by Cobalt Community Research found that 70 percent of governments with 250+ employees provided retiree health care, but only 50 percent did so among the 51–100 employee cohort, and this figure dropped even more among smaller governments; “Health & OPEB Funding Strategies: 2011 National Survey of Local Governments,” Cobalt Community Research, 2011, p. 29.

⁶ Adam Tatum, “California’s Neglected Promise: How California Has Failed to Prepare for Its Accumulating Retiree Health Care Obligations,” California Common Sense, July 2012.

⁷ Adam Tatum, “Our Cities Need Preventive Care Too,” California Common Sense, August 2, 2012.

⁸ “The Widening Gap Update,” Pew Center on the States, June 18, 2012.

⁹ “State Budget Crisis Task Force Report,” July 2012, full version, p. 43.

¹⁰ Ibid., p. 35.

¹¹ David Crane, “With Retirement Costs Consuming One-Fifth of Discretionary Spending, California Must Reduce Un-Accrued Pension Benefits,” advancingafreesociety.org, August 20, 2012; see also David Crane, “Rein in Benefits Now and Tax Californians Later,” *Bloomberg*, July 9, 2012.

¹² “City of San Jose Federated Retiree Health Care Plan, Actuarial Valuation as of June 30, 2011,” Cheiron, January 2012, appendix A.

¹³ Some 25 percent of employers surveyed by Mercer offered benefits to early retirees but only 19 percent to Medicare-eligible retirees; National Survey of Employer-Sponsored Health Plans 2010,” Mercer, February 16, 2011, p. 21. In Kaiser’s survey, among firms that offer retiree health coverage, 88 percent offer benefits to early retirees and 74 percent to Medicare-eligible retirees; “Employer Health Benefits: 2012 Annual Survey,” Kaiser Family Foundation and Health Research & Educational Trust, September 2012, section 11.

- ¹⁴ For broader surveys of OPEB packages in California, see “Funding Pensions & Retiree Health Care for Public Employees,” and “2009 District Health Benefits Survey,” CalSTRS, 2010, p. 38ff., San Diego County Taxpayers Association, “Retiree Health Care Benefits for CalPERS-Contracted Cities in San Diego County,” 2011.
- ¹⁵ Two examples among California’s biggest cities are Ventura (pop. 106,433) and Escondido (143,911) (Table 2 below).
- ¹⁶ CalPERS, “Facts at a Glance,” August 2012.
- ¹⁷ Census Bureau’s 2012 Census of Governments.
- ¹⁸ “California Public Employees’ Retirement Law” §22892(b)(1)).
- ¹⁹ See <http://www.calpers.ca.gov/eip-docs/employer/cir-ltrs/2012/600-006-12.pdf>.
- ²⁰ CalPERS, “Public Agency and Schools Reference Guide,” p. 154.
- ²¹ CalPERS, “Facts at a Glance,” August 2012.
- ²² Agency for Healthcare Research and Quality, Center for Financing, Access and Cost Trends, 2011 Medical Expenditure Panel Survey-Insurance Component, Table II.A.2.e(2011), “Percent of Private-Sector Establishments That Offer Health Insurance by Plan Options and Insurance Offerings to Retirees by State: United States, 2011.”
- ²³ CalPERS, “Facts at a Glance,” August 2012.
- ²⁴ CalSTRS, “Fast Facts.” Average pensions in other systems include San Jose Police and Fire: \$83,131; San Jose Federated: \$40,471; and San Diego: \$40,029.
- ²⁵ See <http://database.californiapensionreform.com>.
- ²⁶ Alicia Munnell, “2010 SCF Suggests Even Greater Retirement Risks,” Center for Retirement Research at Boston College, August 2012.
- ²⁷ “Fact Sheet: Why Social Security and Medicare Are Vital to California’s Seniors,” AARP Public Policy Institute, July 2012. For a detailed summary of all health-care costs in retirement, see Paul Fronstin, Dallas Salisbury, and Jack VanDerhei, “Savings Needed to Fund Health Insurance and Health Care Expenses in Retirement: Findings from a Simulation Model,” Employee Benefit Research Institute, Issue Brief No. 317, May 2008.
- ²⁸ The Los Angeles City Employees’ Retirement System (LACERS) estimates that the Cadillac tax will increase its unfunded liability by \$98.6 million and its annual required contribution by \$3.3 million; “City of Los Angeles Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2011,” p. 164.
- ²⁹ “Redefining Retiree Medical Strategy: Employer Actions in a Post-Reform Environment,” Towers Watson / ISCEBS Sixth Annual Retiree Health Survey, June 2011; see also “Performance in an Era of Uncertainty,” 17th Annual Towers Watson / National Business Group on Health Employer Survey on Purchasing Value in Health Care, 2012.
- ³⁰ Employer Health Benefits: 2012 Annual Survey,” Kaiser Family Foundation and Health Research & Educational Trust, 2012, section one.
- ³¹ Peter Orszag, “Slower Growth in Health Costs Saves U.S. Billions,” *Bloomberg*, October 16, 2012; Brett O’Hara and Kyle Caswell, “Health Status, Health Insurance and Medical Services Utilization: 2010,” U.S. Census Bureau, Current Population Reports, October 2012; and Charles Roehrig, Ani Turner, Paul Hughes-Cromwick, and George Miller, “When the Cost Curve Bent—Pre-Recession Moderation in Health Care Spending,” *New England Journal of Medicine*, August 16, 2012.
- ³² Quoted in “State Budget Crisis Task Force: California Report,” September 2012, p. 26, fig. 7.
- ³³ Table 2 recalculates systems’ pension liabilities using a 6 percent rate of return, as opposed to the more typical 7.75 percent. The methodology employed in this recalculation follows that of previous reports on pensions, such as Robert Novy-Marx and Joshua D. Rauh, “The Intergenerational Transfer of Public Pension Promises,” National Bureau of Economic Research, Working Paper 14343, September 2008; and Josh Barro and Stuart Buck, “Underfunded Teacher Pension Plans: It’s Worse than You Think,” Manhattan Institute Civic Report No. 1, April 2010. The purpose of the recalculation is to give a more accurate depiction of these systems’ funded status (see discussions in “The Intergenerational Transfer of Public Pension Promises,” and “Underfunded Teacher Pension Plans: It’s Worse than You Think”). OPEB systems that are not prefunded use very conservative discount rates, and their liabilities have thus not been recalculated. Prefunded OPEB systems use discount rates similar to those of pension systems. In Table 2, these systems’ liabilities have been recalculated when their rates exceed 6 percent.
- ³⁴ These are not technically the top 50 biggest cities in California, as Irvine, Oxnard, Elk Grove, Salinas, Visalia, and Victorville are not included. For those cities, full data were not available on pension, OPEB, or debt totals, all of which were necessary to ensure that the same cohort was used in Table 2 and Charts 1, 2, and 3. Accordingly, these six cities were replaced by El Monte, Berkeley, Downey, Costa Mesa, Inglewood, and Ventura, the next six largest cities for which all data were available.
- ³⁵ State Budget Crisis Task Force: California Report,” September 2012, p. 27.
- ³⁶ San Francisco’s liability is large because San Francisco city and county are one political entity. Thus, included in San Francisco’s liability figures are a range of workers not included in other systems’ calculations, such as airport and sheriff’s department employees.

- ³⁷ "State of Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2011," pp. 20 and 166.
- ³⁸ "Report of the State Budget Crisis Task Force," July 2012, p. 44, fig. 13.
- ³⁹ "State Budget Crisis Task Force Report," p. 36; Joe Nation, "Pension Math: How California's Retirement Spending Is Squeezing the State Budget," Stanford Institute for Economic Policy Research, December 13, 2011 (high-end state total on p. 19, table 10); and Joe Nation and Evan Storms, "More Pension Math: Funded Status, Benefits, and Spending Trends for California's Largest Independent Public Employee Pension Systems," February 21, 2012 (high-end local total on p. 7, table 3).
- ⁴⁰ All "outstanding debt" figures in Chart 3 are taken from the "outstanding debt by type" table in the "statistical section" of each city's comprehensive annual financial report. Pension and OPEB liabilities are the same as those in Table 2. Using an even lower, "risk-free" discount rate for pensions (5 percent or lower) would cause soft-debt totals in Chart 3 to increase. Also, cities have many other liabilities beyond the hard and soft debt discussed here. Examples include long-term leases, derivatives, compensated absences, and environmental remediation obligations. All are enumerated in cities' comprehensive annual financial reports.
- ⁴¹ What explains these disparities? One likely reason is that California municipalities offer less generous benefits. New York cities often only require ten years' employment to be eligible for the maximum benefit (a practice called "cliff-vesting"), whereas California cities typically impose a steady climb through several stages to reach full benefits. Then, too, systems that offer only the less costly implicit rate subsidy seem to be more common in California. These tentative explanations, though, should be replaced by further analysis of the disparities between state and local governments' OPEB liabilities.
- ⁴² E. J. McMahon, "Iceberg Ahead: The Hidden Cost of Public-Sector Retiree Health Benefits in New York," Empire Center for New York State Policy, September 2012, pp. 14–15 (table 3). New York City does not separate out its school- and municipal-side OPEB liabilities so is not comparable with other cities in this sample.
- ⁴³ Although New York's pension system is better funded than California's; "State Budget Crisis Task Force: California Report," September 2012. For a similar survey of liabilities among Massachusetts cities, see Massachusetts Taxpayers Foundation, "Retiree Health Care: The Brick That Broke Municipalities' Back," February 2011. However, OPEB liability figures in this survey are not directly comparable with the New York and California figures because Massachusetts cities include school employees in their OPEB totals.
- ⁴⁴ San Diego County Taxpayers' Association analysis of Legislative Analyst's Office research, "Proposition 30: The Schools and Local Public Safety Protection Act of 2012," August 2012.
- ⁴⁵ Center for Budget and Policy Priorities, via California Budget Project, "Measuring Up: The Social and Economic Context of the Governor's Proposed 2012–13 Budget," February 2012, p. 26; and "States Continue to Feel Recession's Impact," Center for Budget and Policy Priorities, June 27, 2012, p. 5.
- ⁴⁶ California Department of Finance, Chart K-5 : California Municipal Bonds Rating History, http://www.dof.ca.gov/budgeting/budget_faqs/information/documents/CHART-K5.pdf.
- ⁴⁷ Andrew Bary, "State of the States," *Barron's*, August 25, 2012.
- ⁴⁸ Ibid.
- ⁴⁹ Bureau of Labor Statistics, <http://www.bls.gov/web/metro/laummtrk.htm>.
- ⁵⁰ Bureau of Economic Analysis, http://www.bea.gov/newsreleases/regional/gdp_state/2012/pdf/gsp0612.pdf.
- ⁵¹ "California Still Dominates Foreclosure Scene," *cbsnews.com*, July 26, 2012. California has the third-highest foreclosure rate in the nation (after Illinois and Florida); Mark Glover, "California Foreclosures Improve, but Still Look Bad," *Sacramento Bee*, September 14, 2012.
- ⁵² "Local Government Bankruptcy in CA: Qs and As," Policy Brief, Legislative Analyst's Office, August 7, 2012, pp. 6–7; Sydney Evans, Bohdan Kosenko, and Mike Polyakov, "How Stockton Went Bust: A California City's Decade of Policies and the Financial Crisis That Followed," California Common Sense, June 2012; Steven C. Johnson and Chris Francescani, "U.S. Loves Cops and Firefighters—but Not Their Pensions," *Reuters*, July 29, 2012; Don Bellamante, David Denholm, and Ivan Osorio, "Vallejo con Dios: Why Public Sector Unionism Is a Bad Deal for Taxpayers and Representative Government," Cato Institute Policy Analysis No. 645, September 29, 2009; and Jeremy Rozansky, "San Bernardino's Route to Bankruptcy," *City Journal*, July 18, 2012.
- ⁵³ "Local Government Bankruptcy in California: Qs and As," Policy Brief, Legislative Analyst's Office, August 7, 2012; Jim Christie and Peter Henderson, "Court Lets Stockton, California Cut Retiree Health Care," *Reuters*, July 27, 2012; Ed Mendel, "City Bankruptcies Target Retiree Health Care Costs," August 6, 2012; and Ed Mendel, "Stockton Plan Cuts Bond Payment: \$197.5 million," July 23, 2012.
- ⁵⁴ Bob Deis, "A Message from the City That Went Bankrupt," *Wall Street Journal*, September 27, 2012.
- ⁵⁵ Peter Henderson, "Near-Bankrupt San Bernardino Targets Bonds, Retiree Health," *Reuters*, July 24, 2012; and Mendel, "City Bankruptcies Target Retiree Health Care Costs."

- ⁵⁶ For clear illustrations of the advantages of prefunding over pay-as-you-go, see "State Budget Crisis Task Force Report," July 2012, p. 44 (fig. 15); and Adam Tatum, "California's Neglected Promise: How California Has Failed to Prepare for Its Accumulating Retiree Health Care Obligations," California Common Sense, July 2012, pp. 7–8 (figs. 5 and 6). "State Budget Crisis Task Force: California Report," September 2012, p. 26, fig. 7.
- ⁵⁷ "City of Stockton, 2011/2012 Annual Budget," p. P-26.
- ⁵⁸ Steven Church, "Stockton Threatens to Be First City to Stiff Bondholders," *Bloomberg*, June 30, 2012.
- ⁵⁹ Proposition 30, "Official Title and Summary" and "Official Arguments and Rebuttals."
- ⁶⁰ David Crane, "New California Taxes Pay for Pensions, Not Schools," *Bloomberg*, April 23, 2012; and "California's Pension Tax," *Wall Street Journal*, April 22, 2012.
- ⁶¹ Legislative Analyst's Office, "Revenue Volatility in California," January 2005; and David Block and Scott Drenkard, "Governor Brown's Tax Proposal and the Folly of California's Income Tax," Tax Foundation Fiscal Fact No. 324, August 1, 2012.
- ⁶² Brown's initial 12-point pension reform plan would have made two modest changes to retiree health-care policy: first, increase eligibility for new state government employees from ten to 15 years for minimum health-care benefits and from 20 to 25 for the maximum. Second, Brown proposed addressing "the anomaly of retirees paying less for health care premiums than current employees." State retirees are eligible for an employer contribution of up to 100 percent of health-care premium costs (90 percent for dependents). The employer contribution rate to active workers' health care varies by bargaining unit but is generally 80 percent; "A Preliminary Analysis of Governor Brown's Twelve Point Pension Reform Plan," CalPERS, November 30, 2011.
- ⁶³ For a recent survey of the literature on state and local governments' OPEB changes, see Joshua Franzel and Alexander Brown, "Understanding Finances and Changes in Retiree Health Care," *Government Finance Review*, pp. 62–63. The most comprehensive source is probably the annual summaries of retirement benefits changes published by the National Conference of State Legislatures.
- ⁶⁴ For an extensive discussion and critique of the California Rule, see Amy Monahan, "Statutes as Contracts? The 'California Rule' and Its Impact on Public Pension Reform," *Iowa Law Review* 97 (2012): pp. 1029–1083.
- ⁶⁵ *Retired Employees Association of Orange County, Inc. v. County of Orange*, Supreme Court of California, November 21, 2011.
- ⁶⁶ Steven Sass, *The Promise of Private Pensions: The First Hundred Years* (Cambridge, Mass.: Harvard University Press, 1997), pp. 187–89, 272–73.
- ⁶⁷ Ed Mendel, "Court Strengthens Public Retiree Health Rights," Calpensions.com, November 28, 2011; and "Calif. Court Weighs in on Retiree Health Benefits," Thomson Reuters News and Insight, November 21, 2011.
- ⁶⁸ Mendel, "Court Strengthens Public Retiree Health Rights"; and Steven Greenhut, "Public Unions Send Medical Bills to Taxpayers," *Bloomberg*, March 15, 2012.
- ⁶⁹ *Retired Employees Association of Orange County, Inc. v. County of Orange*, U.S. District Court for the Central District of California, August 13, 2012.
- ⁷⁰ The only exception would be with COLAs. Recent court challenges to COLA reductions or eliminations have centered on whether COLAs are part of the core pension benefit, finding generally that they are not.
- ⁷¹ Oceanside does contribute to retired firefighters' premiums.
- ⁷² Fresno, as well as Long Beach, also allows retirees to devote accumulated leave time to be devoted toward retiree health care.
- ⁷³ Examples of governments in California that have set up retiree medical trusts include Burbank, Santa Monica, Irvine, and Elk Grove Unified School District. For more discussion of the mechanics of collective defined-contribution vehicles for OPEB, see "Creating a Retiree Medical Trust (3d report, 2d ed.)," National Conference on Public Employee Retirement Systems, 2006; Girard Miller, "OPEB's Silver Lining: Unlike with Pension Fund Investments, Nothing Ventured Means Nothing Lost," *Governing*, March 5, 2009; "Top 12 Pension and Benefits Plan Issues for 2009: Part II: Six More New Paradigms for a New Year," *Governing*, February 5, 2009; and "A New Way to Save an Apple a Day: A Better Voluntary Savings Vehicle for Retiree Health Coverage," *Governing*, April 23, 2009.
- ⁷⁴ Both these figures are estimated based on an assumed 7.75 percent rate of return. Los Angeles has two other separate retirement systems: the Department of Water and Power OPEB plan is almost (73 percent) as well funded, but the Fire and Police OPEB plan is only 34.5 percent funded; "City of Los Angeles Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2011," p. 207.

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