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REPORT

# THE OPEB OFF-RAMP

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## HOW TO PHASE OUT STATE AND LOCAL GOVERNMENTS' RETIREE HEALTH CARE COSTS

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## Executive Summary

Public awareness of U.S. states' and cities' retirement cost burden has increased in recent years. Contrary to popular perception, the problem is not limited to pensions. The long-term bill for retiree health care (other post-employment benefits, or OPEB) has been estimated at over a trillion dollars. Costs have been growing rapidly and are crowding out room in budgets for other policy priorities. Such costs have even pushed some city governments into insolvency.

States and localities vary greatly in the type and generosity of the retiree health care that they offer. However, even the most modest package is more generous than what most workers in the private sector enjoy. Indeed, employer-sponsored health benefits for retirees have become increasingly rare for private workers. The public sector is now under financial pressure to align with the private sector. New accounting standards and straitened budget circumstances in the wake of the Great Recession have made governments' OPEB burdens impossible to ignore. This paper explains the nature and causes of state and local governments' OPEB problem and suggests substantive, practical reforms. **Key findings include:**

- ◆ **The persistence of retiree health care in state and local governments is partly a consequence of the influence of government unions.** States with unionization rates above that of the national average (28.5 percent) have nearly three times larger per-capita OPEB liabilities. Just six states—California, Connecticut, Illinois, New Jersey, New York, and Texas—accounted for 56 percent of all state governments' OPEB liabilities in 2014.
- ◆ **Union strength is a problem but not entirely to blame for large OPEB obligations.** Many southern states with weak labor unions have high OPEB liabilities. Southern states tend to have high public-employee density (i.e., public workers' share of the workforce)—a factor that may translate into high OPEB costs.
- ◆ **OPEB has been mismanaged by states and localities because fiscal and worker-compensation policies are often mismanaged in the public sector.** Governments have too much OPEB debt because of policymakers' willingness to promise benefits in the future to satisfy interest groups in the present. This problem is combined with the standard, and misguided, public-sector preference for back-loading compensation into retirement, as well as an inability or unwillingness to cut costs.

For these reasons, policymakers should:

1. Prioritize OPEB reform over pension reform.
2. Phase out OPEB entirely.
3. Frame the debate in ways that enhance reform's prospects.
4. Prepare for the legal battles that are likely to ensue.
5. Do not establish trust funds to prefund OPEB.
6. Put the Affordable Care Act's subsidized exchanges to use.

# THE OPEB OFF-RAMP

## HOW TO PHASE OUT STATE AND LOCAL GOVERNMENTS' RETIREE HEALTH CARE COSTS

### I. Introduction

U.S. state and local governments employ 19 million workers.<sup>1</sup> Around 70 percent qualify for some form of retiree health care, a package of benefits that varies widely among jurisdictions.<sup>2</sup> While government retirees may receive various employer-sponsored noncash benefits—such as vision, dental, and life insurance—the health insurance portion is by far the most expensive. OPEB and “retiree health care” are therefore used interchangeably.

#### ***Benefit Basics***

The most basic medical benefit is the “implicit rate subsidy,” whereby government employers allow former workers to remain on their insurance plan and pay the same premium rate as active employees. The value of this benefit increases with age and can exceed \$5,000 for a retiree above age 60,<sup>3</sup> even if the retiree funds the premium. If a dependent spouse is also covered, the implicit rate subsidy doubles in value. Government employers frequently pick up some, or all, of the cost of the premium.

Although most retirees transfer to Medicare at 65, they may see their Part B premiums (now \$105 per month)<sup>4</sup> reimbursed. Medicare Part B covers outpatient care, such as visits to the doctor, lab tests, supplies like blood sugar monitors and breathing aids, and other “medically necessary” services and equipment. For the post-65 cohort, state and local governments also often provide, through a private provider, Medicare supplemental or “Medigap” coverage. These benefits insure against Medicare’s out-of-pocket copays and deductibles. Because of how thoroughly it can insulate retirees from the cost of health care, OPEB is sometimes described as “lifetime medical.”

Unlike pensions, retiree medical benefits are “status benefits.” Once workers attain a certain status, usually a certain number of years on the job, they automatically qualify for benefits. In a pension system, an employee’s benefits vary, based on salary, job title, and years on the job, which leads to vastly different payouts. When it comes to retiree health benefits,

however, janitors and city managers, teachers and superintendents, prison guards and wardens all receive the same package when they retire. The only caveat: workers in the protective services (police, fire, and corrections) are likely to retire earlier, collect benefits for longer, and, thus, enjoy health coverage for longer.

### **Benefits Vary by State and Locality**

There is much variation in the retiree health benefits that government employers offer. Some government employers are remarkably generous; others hardly provide any retiree health care benefits at all. State and local governments can decide what to offer their employees, and there is little standardization. Many states offer group health insurance to workers who retire before 65. Workers' dependents are sometimes covered by such plans. In some places, the employer pays the entire premium; in others, the worker pays it; in still others, it is shared. Once a retiree qualifies for Medicare, many states offer supplemental coverage for prescription drugs. The level of deductibles and copays also varies greatly by state. Some retiree benefit plans include coverage for vision, dental, and life insurance. Though benefits for pre-Medicare-eligible retirees are more expensive than Medigap insurance, the former is more commonly provided, according to the National Compensation Survey and the Kaiser Foundation.<sup>5</sup>

New York City does not require pre-Medicare retirees to contribute to the plans that the city offers, which can cost up to \$17,220 for a family plan. For the Medicare-eligible cohort, New York provides Medigap coverage valued at up to \$1,900, in addition to the Part B pickup (\$1,260 per year).<sup>6</sup> New York's Independent Budget Office estimates that cutting the Part B pickup in half (currently, the city reimburses the full amount) would yield about \$150 million in savings by 2019.<sup>7</sup> California's contribution rate varies by date of hire and years of service, but even the most recent hires can qualify for a benefit valued at \$19,300.<sup>8</sup>

For Connecticut retirees, the average plan costs \$11,000, and premium cost-sharing is a function of years of service and how many years they are retired before 65. Retirees may have to contribute as much as 40 percent or as little as 2 percent.<sup>9</sup> State of Massachusetts retirees contribute 10 percent to 20 percent of the cost of their premiums, depending on their date of retirement. At an 80 percent contribution rate, Massachusetts taxpayers provide retired workers with a benefit worth \$7,800 for the most popular plan. For a state retiree receiving the average pension (\$30,800), a \$7,800 OPEB package increases his retirement benefit by 25 percent.<sup>10</sup>

## II. The Trouble with OPEB

Rising OPEB costs in many states and cities are an understudied issue.<sup>11</sup> The vast majority of public attention paid to public-employee benefits and their costs has been devoted to pensions. Many attributed Detroit's 2013–14 bankruptcy to its pension struggles—even though, according to official estimates, the city owed \$2 billion more for retiree health-care than for pensions.

### **Costs**

In 2014, Byron Lutz of the Federal Reserve and Louise Sheiner of the Brookings Institution estimated state and local governments' total OPEB unfunded liability to be \$1.1 trillion.<sup>12</sup> That is the value of the benefit promises to current workers and retirees not currently backed by any dedicated assets. For perspective, consider that state and local governments' total bonded debt obligations are \$2.9 trillion.<sup>13</sup> Unfunded state pension liabilities, when estimated using conservative accounting assumptions, exceed \$3 trillion.<sup>14</sup> Thus, state and local governments owe more for retirement benefits than bonds issued to fund capital needs such as roads, bridges, and school buildings.

While the aggregate liabilities are very large, they are unevenly distributed. Some states (such as New York, New Jersey, Texas, and Illinois) and localities (such as New York City, Boston, San Francisco, and Baltimore) are paying billions for retiree health care; but others (such as Wyoming, Idaho, Denver, Minneapolis, and Tampa) are paying comparatively little.<sup>15</sup> Small local governments (those with fewer than 200 employees) tend not to offer retiree health coverage, though many poor cities face massive OPEB debt burdens. When school employees are included, Buffalo owes \$3.2 billion, Springfield (MA) nearly \$900 million, and Syracuse \$1.5 billion.<sup>16</sup>

Costs are rising. In fiscal year 2015, New York City paid \$3.1 billion for retiree health insurance, a 244 percent increase from 2005. During this period, the city's overall budget grew only 48 percent.<sup>17</sup> Since 2001, California state government's OPEB costs have grown from \$458 million (0.6 percent of General Fund spending) to \$2 billion (1.7 percent).<sup>18</sup> Between 2015 and 2024, Massachusetts's retiree health payouts are expected to rise from \$519 million to \$904 million, a 74 percent increase.<sup>19</sup> Due to the imbalance between retirees and active workers, some governments are now paying more for health insurance for the former than the latter.<sup>20</sup>

### **Crowd-Out**

Since virtually all state and local governments are subject to balanced-budget requirements, when a major spending commitment increases faster than revenues, some other expenditure must be reduced. In short, the problem created by rising retiree health care costs is the “crowding out” of other government priorities. One area is personnel, which dominates local budgets and the non-Medicaid portion of state budgets.

Elevated OPEB costs have decreased public funds available for hiring and raises. The state and local jobs recovery is years behind the private sector’s. Private employers topped their prerecession peak (115.9 million)<sup>21</sup> in February 2014 and have since added more than 5 million jobs. State and local governments only stopped *losing* jobs in 2013, roughly three years after the private-employment trough. Even now, the state and local headcount is still more than 500,000 jobs off its pre-Recession peak.

Government salaries have flatlined, too, as ever more revenue is dedicated to retirement benefits. According to data from the U.S. Census’s Annual Survey of Public Employment and Payroll, the average “full-time equivalent” salary for state and local workers increased only 2.2 percent, in real terms, during 2005–14.<sup>22</sup>

Retiree health care costs have hindered infrastructure investment. Though borrowing rates for states and localities have been lower than at any point since the 1960s,<sup>23</sup> total government capital debt contracted each year during 2011–14.<sup>24</sup> Some in the public-finance community understandably felt that a golden opportunity was missed.<sup>25</sup> Crowd-out is part of the reason for the current fiscal conundrum of low borrowing costs and low borrowing levels. The \$1.1 trillion in retiree health care spending to which governments are officially committed will mean that much less money available for roads, bridges, tunnels, airports, buses, subways, trains, water, sewer, and school buildings.

New York City’s unfunded OPEB liability is \$85.5 billion;<sup>26</sup> the maintenance backlog for the New York City Housing Authority is \$18 billion;<sup>27</sup> and one recent estimate pegged the city’s three library systems’ capital deficit at \$1 billion.<sup>28</sup> In June, voters in Sonoma County, California voted down a proposed sales-tax increase that would have generated \$8.8 million in new recurring revenues to fix their dilapidated roads. Sonoma spends about three times that amount annually on OPEB (\$26.1 million).<sup>29</sup> A 2013 study of school districts, by Jeffrey Clemens of the University of California at San Diego and David Cutler of Harvard University, found that rising

health care costs were offset, in part, by increased transfers from other units of government—in some cases, monies that would otherwise have been used for special-needs students, remedial education, and school lunch. The study also found that, in more heavily unionized districts or those with large liabilities, as OPEB costs increased, student performance, as measured by dropout rates, declined.<sup>30</sup>

### **Equity and Tax Issues**

What makes OPEB-driven service reductions frustrating to taxpayers is that they must endure such reductions in order to pay for a benefit package that most of them do not receive from their employers. According to the National Compensation Survey, only 16 percent of private-sector workers have access to pre-Medicare OPEB, compared with 86 percent of state-government workers and 66 percent of local-government workers.<sup>31</sup> The Kaiser Family Foundation estimates that only 23 percent of all large U.S. employers (200-plus workers) that offer health coverage to active workers also offer it to retirees, down from 66 percent in 1988. However, 73 percent of large state and local employers offer health coverage to current and retired employees.<sup>32</sup>

OPEB continues to exert indirect and, in some cases, direct pressure on tax burdens. In 2014, voters in Newton, Massachusetts, approved a property-tax increase of \$8.4 million; but \$8.1 million was devoted to covering OPEB costs. That year, the city spent \$21 million on retiree health care. Stated differently, the average property-tax bill in Newton was \$9,907 in 2014,<sup>33</sup> of which \$750 was spent on OPEB costs.<sup>34</sup> OPEB is thus consuming 8 percent of the average Newton household’s property taxes. Because it is reckless to trim revenue when debt is not under control, OPEB pressure on budgets has kept taxes high. Unlike capital debt, retirement-benefit obligations are not subject to statutory limits or voter-approval restrictions, and, as if on autopilot, they increase nearly every year, as workers continue to accrue more benefits.

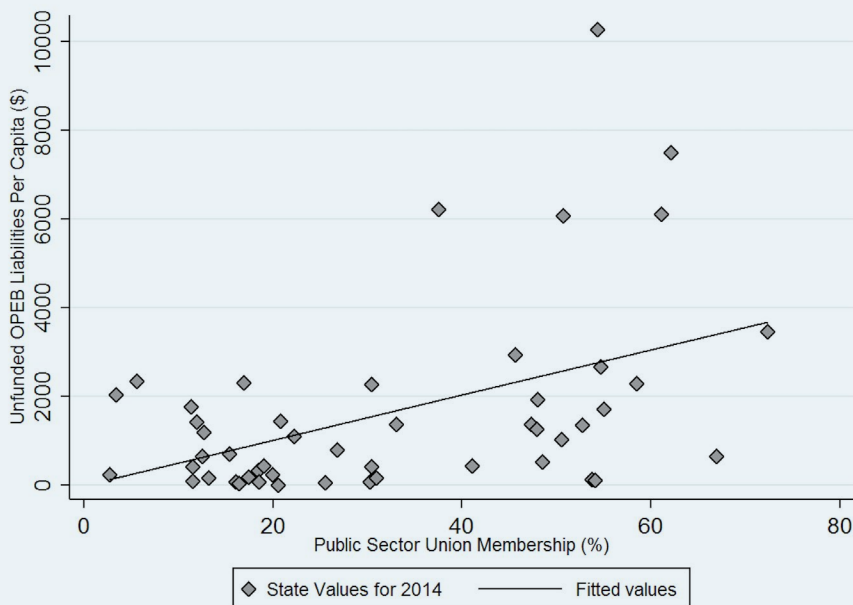
## **III. Sources of the OPEB Problem**

Rising OPEB costs are due to a confluence of factors, including the large number of public employees who are now retiring (with a spike in retirements predicted in the coming years); higher life expectancy; increased early retirement; and a rise in health care costs. Combined, these factors will likely make future OPEB provision extraordinarily expensive.<sup>35</sup>



FIGURE 1.

### Public-Union Membership and OPEB Liabilities per Capita, 50 U.S. States, 2014



Source: Standard & Poor's, "Diverging Trends Underlie Stable Overall US OPEB Liability," November 17, 2014; Bureau of Labor Statistics, "Community Population Survey," as compiled by [www.unionstats.com](http://www.unionstats.com).

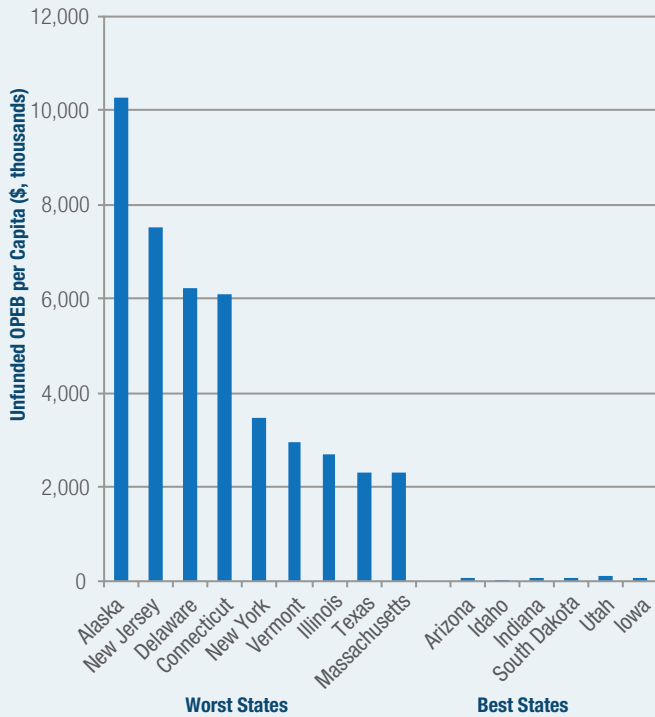
#### Public-Employee Unions

Though no single factor is responsible for states' and cities' OPEB problem, the role of public-employee unions cannot be ignored. **Figure 1** plots per-capita OPEB liabilities over the percentage of unionized public employees, along with a best-fit line.<sup>36</sup> Figure 1 shows a weak correlation (0.45) between the rate of public-union membership and OPEB per-capita liabilities. The reason for this is variation in southern states. Some of the southern states with the weakest unions—especially North Carolina, South Carolina, Georgia, and Louisiana—have large OPEB liabilities. This is because such



FIGURE 2.

### Per-Capita OPEB Liability— Best and Worst States, 2014



Source: Standard & Poor's, "Diverging Trends Underlie Stable Overall US OPEB Liability," November 17, 2014

states also have a large number of government employees. In fact, in the South, there is basically no correlation between public unionization and per-capita OPEB liabilities (0.08).<sup>37</sup> For the rest of the U.S., the correlation is a bit stronger (0.51). However, states with unionization rates above that of the U.S. average (28.5 percent for state and local government combined) have mean per-capita liabilities of \$2,495, while those below that threshold have an average liability of \$745. Put differently, strong union states have per-capita OPEB liabilities nearly three times larger than states that lack strong unions. This finding is supported by numerous studies that have documented the ability of government employees and their unions to influence state and local government policy.<sup>38</sup>

Not every state and local government has an OPEB problem. Indeed, in 2014, just six states—California, Connecticut, Illinois, New Jersey, New York, and Texas—accounted for 56 percent of all state governments' OPEB liabilities. **Figure 2** shows the variation in per-capita liabilities for state workers (municipal OPEB liabilities are excluded): states with OPEB

problems tend to be among the most populous and have strong unions. (Texas is an outlier.)

The public has a limited understanding of health care policy.<sup>39</sup> And it probably has even less knowledge of the type of plans offered to public employees when they retire.<sup>40</sup> As a result, taxpayers perceive such costs less than public employees value the benefits. This information asymmetry makes mobilizing voters to demand retrenchment difficult. Meanwhile, public employees and their unions are likely to remain vigilant about protecting, and even increasing, the generosity of OPEB. It is a classic case of what political scientist James Q. Wilson called concentrated benefits and diffuse costs.<sup>41</sup>

#### Public-Sector Density

Scholars have been divided over whether it is the political power of public employees, as channeled through unions, or simply the presence of large numbers of public employees in a given state that tends to drive up OPEB costs. For instance, one study found that the political and electoral clout of public-sector unions was the most important influence on governments' decisions to enhance retiree benefits.<sup>42</sup> However, another study found that public-employee density, not public-union strength, is a significant variable.<sup>43</sup> Regardless of whether the political influence of public employees is channeled through unions or derives from their presence in every legislative district, public employees clearly have a vested interest in the design and funding of OPEB.

#### Political Incentives

Part of the blame for excessive OPEB costs lies with policymakers. Government employment creates a particular mix of political incentives and policy structure. Governments became pervasive promisers of OPEB partly because of a political logic that mimics the expansion of public pensions:<sup>44</sup> state and local politicians make promises that will have to be paid for in the future when other voters will elect other politicians and the costs will be paid by other taxpayers; however, in the here and now, politicians are under pressure from public employees—often represented by unions—to do things for them.

Public employees live in every politician's district and tend to vote at higher than average rates. While they may care about many other things, public employees mainly care about their jobs, especially how much they are compensated. Health care benefits are an important part of public-employee compensation—even if they are not as important as salary or pensions. So workers want more generous health care benefits, especially if the employer cannot improve salary or pensions. According to a 2015 Gallup poll, 82 percent of public-sector employees, compared with only 54 percent of private-sector employees, report that they are satisfied with their retirement

packages,<sup>45</sup> which suggests that the former do not want their retirement packages altered.

Politicians, therefore, have at least one group in society—indeed, the one with the most tangible stake—willing to pressure them. At the same time, journalists and the media have devoted little attention to the OPEB issue. Government-mandated reporting requirements did not exist until 2004, so voters were completely in the dark. The ability to operate under the radar gave politicians more room to maneuver.

OPEB reflects the unique incentive structure of the public sector in other ways, too. Businesses can more easily push rising costs onto workers through cost-sharing, reducing insurance coverage, lowering employer contributions to plans, or holding the line on wage increases. Alternatively, businesses can usually pass along rising costs to consumers through higher prices. Governments generally have a harder time passing costs on to consumers through higher taxes, tolls, and fees. For politicians—of both parties—promising more benefits had almost no downsides. Workers and their union representatives were happy, there was no powerful group on the other side of the issue to run afoul of, and the public had no access to information about OPEB.

### ***Policy Structure***

Like public-employee benefits generally, OPEB is largely shrouded from view:<sup>46</sup> the public is less likely to be aware of the costs, but public workers are keenly aware of the benefits. Economists on the left and the right have long debated whether government workers are overpaid, after relevant factors, such as educational attainment and job protection, are taken into account. However, both sides agree that public-sector compensation tends to be weighted more heavily toward benefits than in the private sector. According to the Bureau of Labor Statistics' most recent "Employer Costs for Employee Compensation" survey, wages and salaries accounted for 69.7 percent of private workers' compensation but 63.7 percent for state and local workers.<sup>47</sup>

That arrangement is precisely the opposite of what it should be. Fiscal transparency suffers when costs are concentrated in retirement benefits, whose bills won't come due for many years and whose official estimates do not account for the substantial "risk premium" involved in employer guarantees.<sup>48</sup> (OPEB, like pensions, is a defined-benefit program, where "defined" means "guaranteed by taxpayers.") Because wages must be expensed in the present day, their cost is much more difficult to conceal.

It seems gratuitous that state and local governments, which already offer defined-benefit pension plans, also provide employees with defined-benefit health care plans. Since both are increasingly rare in the private sector, one should be enough to attract and retain quality employees. However, defined-benefit pensions increase the pressure to offer OPEB by incentivizing workers to retire early, before they are eligible for Medicare. Many pension systems use benefit formulas whose "multiplier"—the factor by which years of service are multiplied to determine what percentage of final average salary the retiree will receive—peaks before age 65.

In any event, OPEB is gratuitous. Early retirement is a huge boon for government retirees because it substantially increases their "pension wealth." A police officer who retires at 55 on a \$50,000 pension would receive even more in retirement income (\$2.5 million, factoring in a 3 percent annual cost-of-living increase) than one who retires at 65 on a \$70,000 pension (\$2 million, same cost-of-living increase), holding longevity constant (85). There is no compelling fiscal or labor-market reason to justify the argument that, if an employer incentivizes early retirement, it must also offer OPEB to further sweeten the deal.

## **IV. False Solutions**

When Detroit filed for bankruptcy in June 2013, half of the city's \$11.4 billion in unsecured claims were for OPEB.<sup>49</sup> Detroit wound up cutting OPEB much more deeply than pensions in its bankruptcy exit plan.<sup>50</sup> In their recent bankruptcies, Vallejo<sup>51</sup> and Stockton<sup>52</sup> left pensions intact and cut OPEB. For public employees, these cases should make it clear that, among the many other sources of uncertainty over OPEB, governments' willingness and ability to fund the benefit in coming decades should not be taken for granted. But the vast majority of state and local governments won't face insolvency anytime soon. Still, solvent governments also need to address their rising OPEB burdens.

### ***Tinkering with Existing Plans***

OPEB costs first gained widespread notice when the Government Accounting Standards Board (GASB) issued Rules 43 and 45 in 2004. These stipulated that states and localities must calculate and disclose their long-term OPEB obligations beginning in 2008.<sup>53</sup> The new GASB regulations, as well as the Great Recession, prompted some OPEB reform. In several recent annual surveys of government human-resources managers, the Center for State and Local Government Excellence found that 9 percent–14 percent reported

shifting health care costs from the employer to retirees; 6 percent–7.5 percent are setting funds aside to cover future retiree health costs; and 1 percent–3 percent have eliminated retiree health care benefits altogether.<sup>54</sup>

Changes to benefit structure include increasing employee contributions to premiums by active employees, retirees, or both. North Carolina, for example, reduced its OPEB liability by increasing employee-premium contributions during 2011–13. This is a deceptively attractive option: most public employees pay less for their health insurance than private-sector employees, and some 30 percent of state and local workers make no contribution to their health insurance at all.<sup>55</sup> However, the National Compensation Survey data show that these changes have not gone far enough to address the full magnitude of the OPEB problem.

The reality is that many state and local governments with expensive benefit plans have not pushed hard for serious retrenchment. And other states have reduced their OPEB liabilities through the accounting trick of simply increasing the discount rate, which inflates their expected return on any existing prefunding. Michigan and Hawaii have both used this tactic: the former changed its discount rate from 4 percent to 8 percent, after capping certain benefits, while the latter moved from a 4 percent to a 7 percent rate. Some have even used the perception of a lower OPEB debt burden as a justification for prefunding.<sup>56</sup>

Some states are even going in the opposite direction. The New York State Senate is currently considering a measure that would prevent local governments from reining in rising OPEB costs without first bargaining with public-employee unions.<sup>57</sup> And retirement benefit “reforms” sometimes save money by making a given system unfair to younger workers. Requiring more years on the job to become eligible for OPEB may seem like a prudent way to cut costs; but it’s an extremely unfair thing to do to workers who do not spend their entire careers in public service. A teacher who worked 15 years for two different school districts may make an equal, or even greater, contribution to the public good than one who worked for the same school district for three decades. But the former is likely to receive less in retirement benefits than the latter because of the way pensions<sup>58</sup>—and, increasingly, OPEB—are structured. Younger employees never receive higher pay to offset these benefit reductions. On the contrary, their benefits are lower, and, as mentioned, their wages are lower as well, because of OPEB-related crowd-out.

### **Prefunding**

Prefunding has emerged as the “good government” solution to the OPEB problem. Public pensions are financed on a prefund-

ed basis: employers and, often, employees make contributions, which are then invested, such that the combination of savings and returns covers the long-term cost of the benefit. But standard government practice with OPEB funding is pay-as-you-go<sup>59</sup> (i.e., budgetary appropriations cover only that year’s cost of benefits for current retirees). Because OPEB is deferred compensation, in picking up the tab for retired workers’ health benefits, taxpayers are essentially paying for services that were rendered to the public decades ago. This arrangement violates a cardinal principle of public finance—namely, that each generation of taxpayers should be responsible for funding the services that it enjoys.<sup>60</sup> Put differently, governments are borrowing for operating costs by promising compensation that they won’t fund until many years later. Governments should not borrow for operating costs.

Funding levels are still very low: a 2014 Standard & Poor’s report found that 93 percent of states’ total OPEB liabilities are still unfunded.<sup>61</sup> Yet the majority of American states have taken small steps toward prefunding OPEB.<sup>62</sup> Prefunding’s defenders emphasize its intergenerational equity, as well as its ability to relieve cost pressure by relying on the stock market to pay for a substantial portion of the benefit.<sup>63</sup> Over the last 30 years, public pension funds have derived more than 60 percent of their total revenues from investment return.<sup>64</sup> Governments generally don’t fully prefund OPEB for the obvious reason that it is more expensive to set aside funds for future as well as current retirees than to provide only for the latter. Thus, many view pay-as-you-go as pennywise and pound-foolish.

Prefunding’s advocates draw the wrong conclusion from the pension analogy. Governments have been prefunding pensions for decades, yet they are trillions in debt. To keep benefits generous without having to ask taxpayers for more money, they weight their investment portfolios heavily toward equities, which creates fiscal volatility;<sup>65</sup> the gap between what actuaries recommend that governments contribute annually, and what governments actually do contribute, has been growing in recent years;<sup>66</sup> when reform becomes politically unavoidable, they cut benefits and/or increase contributions for new employees; and when plans become comfortably funded, the tendency is to increase benefits. In short, pension prefunding has hardly made for sound fiscal policy. Further, by deepening governments’ commitment to OPEB, prefunding might also strengthen legal protections, especially if it relies on employee contributions as a source of revenues. Less legal flexibility spells more constraints on managing costs in future years.

Consider the example of the Los Angeles City Employees’ Retirement System (LACERS). It began prefunding OPEB in the

late 1980s. LACERS's OPEB plan boasts an 80 percent funded ratio, higher than some state and local governments' pension plans. Some \$2.1 billion in assets are available to fund OPEB in the short term, and Los Angeles paid its actuarially required annual contribution for LACERS in full in each of the last ten years.<sup>67</sup> But Los Angeles still has a significant OPEB problem: the total 2015 bill to the city was \$100.5 million, up from \$72.9 million in 2013, a 37.9 percent increase. LACERS's OPEB is also rich: the value of the subsidy can reach nearly \$19,000 a year.<sup>68</sup> If LACERS is the future, governments can expect to still be grappling with OPEB costs 30 years from now.

## V. OPEB and Federal Health Policy

OPEB's long-term costs are more uncertain than pensions' because health care is a service, not a "payment." The price of OPEB is made still more uncertain by the federal government's role in health care policy. Many government plans will be hit by the Affordable Care Act's (ACA) "Cadillac tax": a 40 percent excise on high-cost plans, beginning in 2020. At some point, the federal government might raise the Medicare eligibility age from 65 to 67, to align it with Social Security's age and save money. In 2012, the Congressional Budget Office (CBO) estimated that this change would lower the federal government's health care outlays by \$150 billion over the coming decade. Some of those savings would come at the expense of states and cities, which would wind up shouldering two more expensive years of retiree health care coverage.

However, federal health care policy may actually help governments deal with their OPEB problems. The ACA-mandated subsidized exchanges make health insurance available to those without access to group coverage from their employer or spouse. The prospect that pre-Medicare retirees might shift from relying on government employer-sponsored coverage to the subsidized exchanges has prompted some to call the ACA a "bailout" of state and local governments' OPEB problem.<sup>69</sup> In the summer of 2013, Detroit and Chicago announced plans to use the ACA to ease out of their OPEB commitments, though few other governments have followed suit.

The bailout rhetoric is unhelpful and overstated. State and local governments *should* view the ACA as creating an opportunity to phase out retiree health care. Many mitigating factors will ease the financial stress on the system as a whole. The subsidies vary, based on income level and household size. The figure of 400 percent of the federal poverty level—the upper end of incomes eligible for subsidies—would mean \$63,720 in 2015 for a married couple without dependents. California boasts tens of thousands of members of the "\$100k pension club";<sup>70</sup> the Empire Center for Public Policy's "seethroughny" database lists around 10,000 state and local retirees in New

York state making over \$100,000.<sup>71</sup> And those figures assume that the retiree in question and his spouse are exclusively reliant on one pension for their retirement income. Additional sources of income, such as a spouse's pension, would push subsidies still further out of reach. (Treasury and Labor Department guidelines stipulate that retirees covered by an existing government-sponsored health reimbursement arrangement will not be eligible for federal subsidies.)

With respect to lower-income pensioners, public workers who "retire" on a \$20,000 pension are less likely to be leaving the workforce when they separate from government work. The progressivity of the subsidies' structure will minimize the burden on federal taxpayers while providing significant relief to state and local taxpayers. Someone receiving \$4,040 in support from the ACA—the average subsidy in 2016<sup>72</sup>—would receive far less in "taxpayer-funded health care" than under a government employer-sponsored arrangement that pays for 100 percent of his premium.

It is true that many remain concerned about the ACA's enrollment trends, which are far lower than what the CBO projected.<sup>73</sup> ACA critics continue to warn of an "adverse selection" or "death spiral" effect, whereby exchange-facilitated insurance becomes too expensive, younger people do not buy in, and the pools, by becoming too weighted toward the old, wind up concentrating risk instead of diffusing it. An abrupt influx of retired teachers, cops, and firefighters onto the exchanges would, on the one hand, increase the chances of a death spiral; on the other hand, it would make insurance cheaper for government employers (and employees) by making their insurance pools younger and healthier.

But any shift that occurs would be gradual: governments will not be dropping all early-retiree coverage by next year. Given persistent fears about cost and enrollment trends for the exchanges, their design may have to be reassessed, anyway, to ensure the system's stability. If states and cities stop offering OPEB, that may create pressure on the ACA. At the same time, state and local governments cannot wait to make a decision on OPEB until federal health care policy has made good on its promise of affordable health care for all.

## VI. Guiding Principles for Reformers

What's been missing from the recent wave of OPEB reform is an honest reevaluation of why government employers need to offer this benefit. The classic rationale for offering OPEB was that it would help recruit and retain competent workers. Today, this is a weak argument, given how many private employers appear to be succeeding with their human-resource goals without offering OPEB. In a 2015 report, California's

Legislative Analyst's Office points out that the state began offering retiree medical benefits "more than a half-century ago" when far fewer guarantees to health insurance existed.

But with Medicare and the ACA—and because recent pension-reform legislation will incentivize retirement at a later date—"the [state] Legislature should consider whether this benefit should continue to be a part of the state employee compensation package for new hires. If prospective employees do not value this benefit as much as it costs, the state and the new employee might be better off if the state offered future employees an alternative form of compensation."<sup>74</sup>

As with private employers, governments are still likely to be able to recruit and retain solid performers without offering OPEB: in 2014, 90,000 people submitted applications to the New York City Sanitation Department, which typically hires about 500 people per year.<sup>75</sup> Because the ACA exchanges offer health care options for pre-Medicare retirees and because OPEB costs are crowding out other needs of state and local government, if OPEB is not necessary to attract and maintain a high-quality workforce, it is time to phase out OPEB entirely.

Reformers would do well to adhere to the following principles:

**1. Prioritize OPEB reform over pension reform.**

Though pensions are a larger fiscal problem than OPEB, the legal barriers to pension reform are more formidable. In most states, reducing future pension accruals for active employees (necessary to "freeze" a plan) is illegal.<sup>76</sup> Governments generally have more legal flexibility over OPEB,<sup>77</sup> typically established by individual collective bargaining contracts, which come up for renewal every few years. Substantive OPEB reform is better than superficial pension reform.

**2. Phase out OPEB entirely.** There is a case to be made that defined-benefit retirement plans are never appropriate in the public sector because of how they tempt politicians into giving out something for nothing. But even if one rejects that argument, OPEB is more difficult to justify than pensions. Any employer, in the private or the public sector, must offer some form of cash-retirement benefits and group health coverage to active employees to attract and retain a qualified workforce. But when fewer and fewer private employers offer retiree medical insurance, governments' insistence on preserving this benefit seems increasingly wasteful.

**3. Increase transparency and frame the debate.**

OPEB reform is, in part, a rhetorical challenge. Reformers and, ideally, public officials need to bring

the massive OPEB cost and debt figures to the public's attention. A model is Rhode Island governor Gina Raimondo's Truth in Numbers campaign (launched when she was state treasurer) for pension reform. Given OPEB's low profile, the terms of the debate have yet to be solidified, which provides reformers with an important advantage. The emphasis should be placed on public versus private inequities. Most people work in the private sector and, thus, have no expectation of employer-sponsored health care after they retire. In terms of what deal should be struck with unions, exchanging OPEB reductions for salary increases would be a good deal for taxpayers. Making public workers' compensation less backloaded would be a victory for transparency and, perhaps, also for worker recruitment and retention.

**4. Prepare for the legal battles that are likely**

**to ensue.** Though the legal barriers to OPEB reform are lower than those for pensions, public-employee unions and other groups will use every legal mechanism available to resist change. In general, OPEB-reform case law is limited, and legal protections will vary by state. Where OPEB is collectively bargained, policy-makers need to plan ahead. They should have a plan of action in place well before the contract expires and the next round of bargaining begins.

**5. Do not establish trust funds and prefund**

**OPEB.** First, this would amount to an unjustified affirmation of the status quo. Second, governments need to minimize their exposure to the increasingly volatile financial markets. Third, there is little reason to think that governments will be more responsible at funding their OPEB trusts than their pension trusts. The last thing that state and local governments need is *two* pension problems.

**6. Harness the ACA's subsidized exchanges.**

Any government that phases out OPEB could conceivably see some of its retirees obtain subsidized health insurance through the ACA exchanges. This development would *not* be a reason for states and localities to maintain employer-sponsored coverage for early retirees—making use of the ACA exchanges to phase out OPEB would be a perfectly respectable policy option, no more irresponsible than relying on Medicare to serve as the primary insurer for people 65 and older. Relying on the exchanges—inevitable under an OPEB phaseout scenario—would certainly be more fiscally responsible than prefunding OPEB.

## VII. Conclusion

Government workers and the unions that represent them have a clear interest in maintaining the most generous health benefits possible. However, such generosity is not in the public interest. State and local governments should close out their retiree health care programs—not make minor tweaks, or limit their liability through accounting tricks, or double-down through prefunding. Defined-benefit retirement plans, whether for pensions or health care, tempt public officials into fiscal folly. It is always more convenient to promise more in the present, and/or postpone reform, if the full bill won't be paid for decades. In the meantime, liabilities continue to expand, and their costs are reducing the funds needed to improve education, keep streets safe, maintain infrastructure, and improve states' and cities' quality of life.

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## Abstract

Public awareness of U.S. states' and cities' retirement cost burden has increased in recent years; but contrary to popular perception, the problem is not limited to pensions. The long-term bill for retiree health care (other post-employment benefits, or OPEB) has been estimated at over a trillion dollars.

## Key Findings

- 1.** The persistence of retiree health care in state and local governments is partly a consequence of the influence of government unions: states with unionization rates above that of the national average (28.5 percent) have nearly three times larger per-capita OPEB liabilities.
- 2.** Union strength is a problem but not entirely to blame for large OPEB obligations—many southern states with weak labor unions have high OPEB liabilities.
- 3.** Governments have too much OPEB debt because of policymakers' willingness to promise benefits in the future to satisfy interest groups in the present; this problem is combined with the standard, and misguided, public-sector preference for backloading compensation into retirement, as well as an inability or unwillingness to cut costs.