



# HOW BIG A BURDEN ARE STATE AND LOCAL OPEB BENEFITS?

By Alicia H. Munnell, Jean-Pierre Aubry, and Caroline V. Crawford\*

## INTRODUCTION

In addition to pensions, most state and local governments provide other post-employment benefits (OPEBs), the largest of which is retiree health insurance. Retiree health plans have received increased attention in recent years due to rapidly rising health costs and new reporting guidelines from the Governmental Accounting Standards Board (GASB). These guidelines, which were released in 2004 and became effective in 2007, require states and localities to change the way they account for the cost of retiree health plans from a cash to an accrual basis, essentially applying to OPEB plans the standards used for pensions.

This *brief* provides an updated accounting of OPEB commitments, with data for 2012 or 2013. These data cover virtually all OPEB plans administered at the state level as well as a large sample of plans administered by counties, cities, and school districts. The analysis also looks beyond the sample of local governments to estimate aggregate OPEB liabilities for all local governments excluded from our sample.

The discussion proceeds as follows. The first section describes the evolution of the new reporting framework. The second section discusses the OPEB sample and introduces our methodology for capturing OPEB liabilities for entities not in our sample. The third section compares OPEB and pension liabilities in the aggregate and discusses the need to use the same discount rate when comparing these liabilities. The fourth section puts the OPEB liabilities in perspective. The final section concludes that: 1) aggregate unfunded OPEB liabilities are estimated to be \$862 billion – nearly two thirds of which is held at the local level; 2) these liabilities are equivalent to 28 percent of unfunded pension liabilities – when pension liabilities are calculated with an interest rate comparable to OPEBs; and 3) while OPEB liabilities are large, several factors limit their potential drain on state and local resources.

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## THE ACCOUNTING ENVIRONMENT

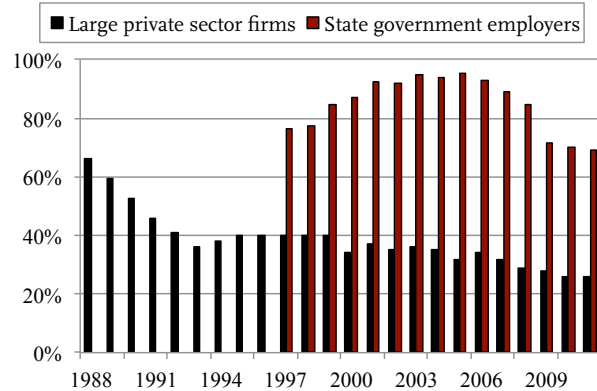
GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, represented a significant change in governmental accounting and financial reporting.<sup>1</sup> Historically, states and localities offering retiree health insurance and other benefits financed them on a pay-as-you-go basis and reported the annual benefit payment as an expense.<sup>2</sup> That changed with GASB 45, which essentially applied pension accounting standards to OPEBs.

Specifically, public sector employers must regularly report for their retiree health plans the actuarial accrued liability, the actuarial value of assets, the unfunded liability, the funded ratio, and the annual required contribution (ARC) payment. The ARC payment covers the plan's normal cost (the present value of retiree health benefits earned by employees for that year's employment) and amortizes the unfunded liability (the gap between existing assets and the present value of future benefits already promised to employees). Soon, GASB 75 will supersede GASB 45, and narrow the allowable actuarial cost methods that can be used for reporting liabilities as well as require the liability of cost-sharing OPEB plans to be apportioned to participating employers.<sup>3</sup>

Although GASB 45 does not *require* sponsors to establish trust funds or move toward full funding, it provides an incentive to fund by allowing them to use a higher rate to discount future benefit promises if they set up a trust and commit to paying the ARC.<sup>4</sup> That is, with funding, the actuary can discount obligations by the expected long-term return on plan assets rather than the lower short-term return used for plans without funding.

The introduction of new accounting standards can have a tangible effect on the behavior of plan sponsors.<sup>5</sup> In the private sector, the Financial Accounting Standards Board (FASB) ushered in accrual accounting for retiree health plans with the release of Statement No. 106 in 1990. Although the FASB and GASB standards differ in a number of ways, both made clear that employers had significant commitments for retiree health insurance and other benefits. The introduction of the new FASB standards coincided with a decline in the percentage of large firms offering retiree health benefits (see Figure 1). Similarly, after the release of GASB 45 in 2007, the percentage of state government employers offering retiree health benefits dropped noticeably. Of course, in both sectors, rising health costs may also have contributed to the decline.

FIGURE 1. PERCENTAGE OF LARGE PRIVATE FIRMS AND STATE EMPLOYERS OFFERING RETIREE HEALTH BENEFITS TO ACTIVE WORKERS, 1988-2013



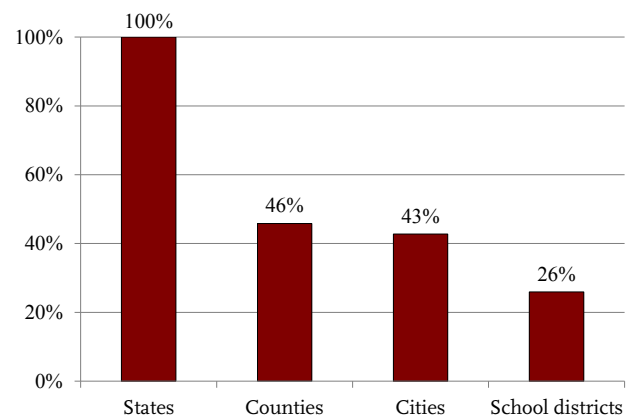
Note: Large firms are those with 200 or more workers.  
Sources: McArdle, Neuman, and Huang (2014); Franzel and Brown (2013); and Medical Expenditure Panel Survey (2014).

The question for our analysis is how big of a commitment are OPEBs for the public sector today.

## DATA AND METHODOLOGY

The data for this analysis include OPEB liabilities from 50 states, 160 counties, 173 major cities, and 415 school districts related to the sample cities. By payrolls, the sample accounts for 100 percent of states, 46 percent of counties, 43 percent of cities, and 26 percent of school districts (see Figure 2).

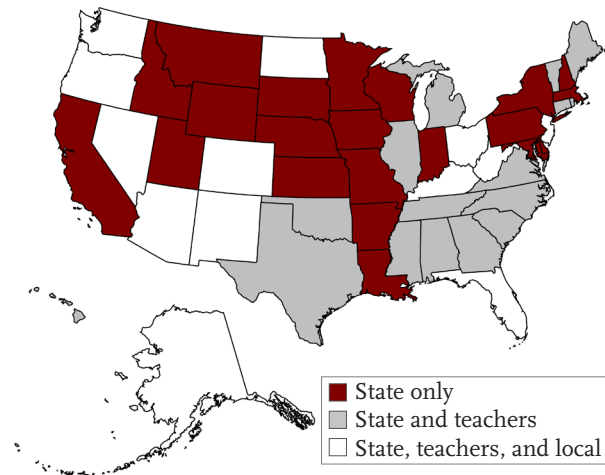
FIGURE 2. PERCENTAGE OF STATE, COUNTY, LOCAL, AND SCHOOL DISTRICT PAYROLLS COVERED BY SAMPLE, 2012



Source: Authors' calculations from U.S. Census Bureau (2012).

The provision of OPEB benefits is much less centralized than that of pensions. In the case of pensions, state-administered plans cover not only state employees, but also nearly all teachers and about 70 percent of local government employees (generally those in smaller cities and towns). With OPEBs, state-administered plans are often limited to state employees, excluding both local employees and teachers (see Figure 3). Thus, it is important to explore the extent to which both large and small localities provide their own retiree health insurance.<sup>6</sup> Large localities are included in our sample; small ones are not. So estimates are required for these excluded entities.

FIGURE 3. WORKERS COVERED BY STATE-ADMINISTERED OPEB PLANS, 2013



Source: Authors' calculations based on city and school district CAFRs and OPEB plan actuarial valuations.

To get a sense of our estimation procedure, consider Utah, where the state plan covers only state employees. Generally, we would report the total OPEB liability for Utah in 2013 as \$607 million: \$387 million for the Utah State OPEB plan, \$99 million for the Salt Lake County plan, \$113 million for the Salt Lake City and West Valley City plans, and \$8 million for the school districts of Salt Lake City and West Valley City. But only reporting these amounts would miss the vast majority of Utah's local government employees – our

sample includes only 22 percent of the total payrolls for counties, cities, and school districts in Utah. Therefore, to estimate the OPEB liabilities for the excluded local entities, we use the ratio of payrolls in our sample to the payrolls for the state as a whole (see Table 1). This method represents a maximum estimate of liabilities because some smaller jurisdictions do not provide employees any retiree health benefits.

TABLE 1. STATE AND LOCAL OPEB LIABILITIES FOR THE STATE OF UTAH, MILLIONS OF DOLLARS, 2013

Government entity	Annual payroll	OPEB liability
State	\$2,498	\$401
Counties	474	
CRR sample – Salt Lake County	213	99
Excluded Census counties	261	121
Cities	918	
CRR sample – Salt Lake & West Valley	191	113
Excluded Census cities	727	430
School districts	1,921	
CRR sample – Salt Lake & West Valley	341	8
Excluded Census school districts	1,580	37
Total in CRR sample	3,243	621
Total in CRR sample + excluded entities	5,812	1,209

Note: Numbers in italics are estimates.  
Sources: U.S. Census Bureau (2012); Salt Lake City and West Valley City CAFRs; Utah state OPEB actuarial valuations; and authors' estimates.

It is important to note two things about the Utah exercise. First, it is required only in states where local government employees are not covered by a state plan. In states where they are covered by a state plan, the liability of all local entities is already accounted for in state plan liabilities. Second, the adjustment for excluded school districts adds very little to Utah's overall OPEB liability. The reason is that school districts in our sample provide relatively little OPEB benefits, so the adjustment is made on a small base.<sup>7</sup>

## AN ANALYSIS OF OPEB LIABILITIES (AND A COMPARISON TO PENSIONS)

The OPEB data collected for each plan include liabilities, assets, and the discount rate (see Table 2). While the following discussion focuses on the results for the whole sample, a [separate Appendix](#) provides data for each state and local plan.<sup>8</sup> The analysis also allocates the liabilities of cost-sharing state plans to participating localities based on the methodology described in GASB 75.<sup>9</sup>

TABLE 2. CRR SAMPLE OF 2013 OPEB DATA BY LEVEL OF GOVERNMENT, BILLIONS OF DOLLARS

State/local plan	Liabilities	Assets	Unfunded liability	Avg. disc. rate
Total	\$702.3	\$49.5	\$652.8	4.8%
States	332.9	8.2	324.7	4.7
Counties	105.5	10.6	95.0	4.9
Cities	167.6	22.8	144.8	5.6
School districts	96.2	7.9	88.3	4.9

Source: Authors' calculations based on various CAFRs and OPEB actuarial valuations.

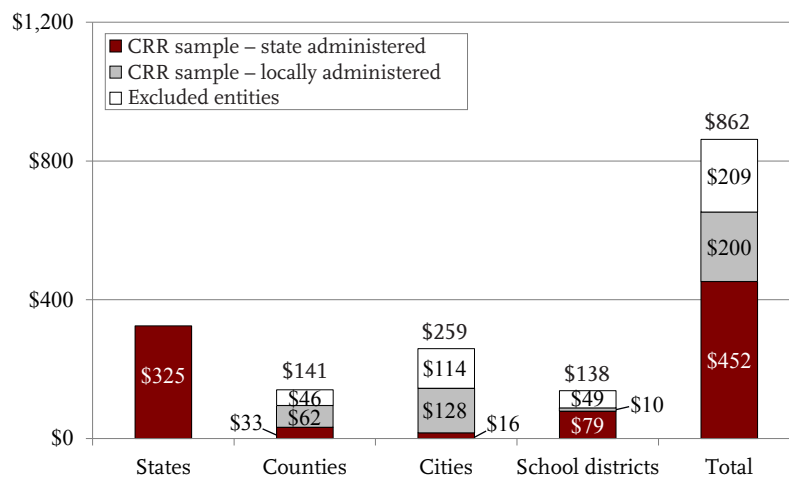
The total reported OPEB liabilities in our sample are \$702 billion. In comparison, because most plans are financed on a pay-as-you-go basis, the assets are a miniscule \$50 billion. Thus, the total unfunded liability that appears in the actuarial reports of plans in our sample is \$653 billion.

However, as noted above, many of the excluded localities are not covered by a state OPEB plan. Adding estimates of the assets and liabilities associated with these excluded jurisdictions (based on the ratio of payrolls as described above) increases the total OPEB unfunded liability by \$209 billion, producing a total of \$862 billion (see Figure 4).

The results also show that, after the adjustment for excluded entities, counties are responsible for \$141 billion, cities are responsible for \$259 billion, and school districts for \$138 billion. Combined, local governments are responsible for nearly two thirds of unfunded OPEB liabilities.

The central question is how big a problem retiree health insurance is for state and local governments. One metric is to compare the unfunded liabilities of the health plans with those of pension plans. Any exercise comparing the size of pension and OPEB liabilities requires using the same discount rate for both.<sup>10</sup> The discount rates used by pensions and OPEB plans are often very different – typically 7.75 percent for pensions and 4.80 percent for OPEB plans since retiree health benefits are usually not funded. Our comparison relies on the OPEB discount rate, so pension liabilities are adjusted using this rate.<sup>11</sup> Dividing the \$653 billion of unfunded liabilities of retiree health plans in our sample by the re-discounted unfunded liabilities of pensions shows that retiree health is equivalent to 21 percent of pensions (see Figure 5 on the next page). On the other hand, adding the excluded localities – which increases OPEB, but not pension, liabilities – raises the ratio to 28 percent.

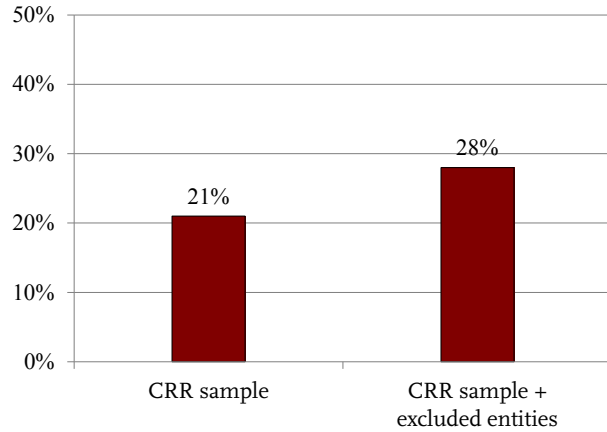
FIGURE 4. TOTAL STATE AND LOCAL UNFUNDED OPEB LIABILITIES, BILLIONS OF DOLLARS



Note: Some components do not add to totals due to rounding.

Sources: Authors' calculations based on U.S. Census Bureau (2012); various CAFRs; and OPEB actuarial valuations.

FIGURE 5. UNFUNDED OPEB LIABILITIES AS A PERCENTAGE OF UNFUNDED PENSION LIABILITIES, USING A 4.8-PERCENT DISCOUNT RATE



Sources: Authors' calculations based on U.S. Census Bureau (2012); various CAFRs, OPEB actuarial valuations; and Munnell and Aubry (2015).

## RETIREE HEALTH COSTS IN PERSPECTIVE

Although the unfunded liabilities associated with retiree health insurance are much larger than generally perceived, several factors should make them less worrisome than those associated with pensions.<sup>12</sup> These include manual levers, such as greater flexibility in adjusting benefits and increasing retirement ages, as well as market factors such as the recent decline in health care cost inflation. In addition, the notion that sponsors should be amortizing existing unfunded liabilities could use some additional thought.

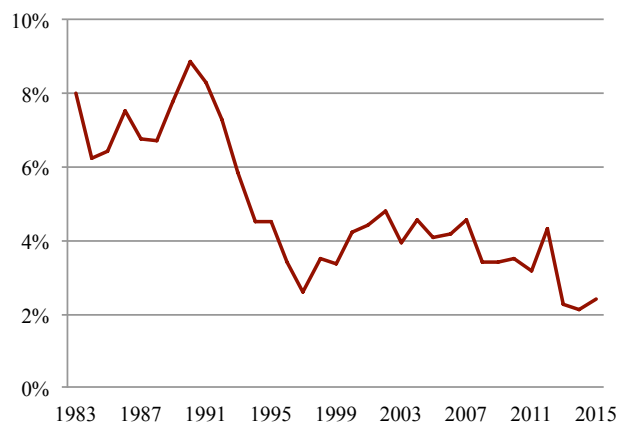
States and localities have some freedom to reduce their commitment to retiree health insurance, at least for new employees, and, indeed, have a rationale for doing so.<sup>13</sup> Many sponsors contend that the level of retiree health benefits, like pension benefits, should be based on how long the employee worked, instead of providing the same retiree health benefits regardless of years of service. As a result, a large number of states have delinked retirement and health benefits by either having different vesting rules for cash benefits and retiree health insurance benefits and/or pro-rating the contribution that they make towards retiree health benefits based on years of service. For example, some states pay 25 percent of the subsidy for people with 10 years of service and 100 percent for people with 25 years of service, with a sliding scale in between.

In addition to limiting who gets full retiree health care benefits, sponsors have taken a number of steps to limit costs. The most straightforward is to boost deductibles and co-pays and, most importantly, increase the share of the premium paid by the employee. Sponsors were shifting costs to employees even before GASB 45, so the pace is incremental.<sup>14</sup> State and local governments have also reduced their costs through wellness programs, such as annual physical exams, individual counseling, seminars, weight loss and exercise clinics, smoking cessation programs, and gatekeeping efforts.<sup>15</sup>

Another positive consideration is the fact that the really expensive component of retiree health insurance – coverage for those under 65 – may decline as sponsors increase retirement ages as part of their pension reforms. For participants over 65, plan sponsors usually require participants to sign up for Medicare, so the public plans simply provide supplementary benefits. In a recent survey of plan changes, 24 out of 32 state plans had increased their full retirement ages, which means that more retirees will be eligible for Medicare right away.<sup>16</sup>

The future burden depends crucially on the cost of health care. The good news is that health care costs have been increasing at a much slower pace than in the past (see Figure 6). At this time, the assumed long-run increase in health costs – roughly 5 percent – used in the actuarial valuations exceeds the annual growth in the Medical Care Component of the Consumer Price Index (CPI). Every 1-percentage-point reduction in the health care cost rate reduces the retiree health liability by about 15 percent.<sup>17</sup>

FIGURE 6. ANNUAL GROWTH IN MEDICAL CARE COMPONENT OF CPI-W, 1983-2015



Source: U.S. Bureau of Labor Statistics, CPI-W (2015).

The final issue is the question of funding. States and localities are criticized for not having prefunded their OPEB plans. In fact, as discussed, accrual accounting and prefunding were not an issue before the release of GASB 45 in 2004, and private sector firms *still* do not prefund.<sup>18</sup> Prefunding involves two components: putting aside money to fund future benefits earned each year (the normal cost) and paying off the unfunded liability. In the public sector, it makes good sense on equity grounds to both account for and pre-fund accruing benefits so that the people enjoying the services pay for the full cost of those services. But this principle may be less relevant to funding legacy costs – benefits earned before the recent switch to pre-funding. Current taxpayers did not enjoy the services associated with these costs, so they should not bear the full burden. Thus, for these legacy benefits, some governments may choose to continue to pay the bills as they come due. One could argue that plan sponsors who set up a trust and contribute their normal cost (in addition to paying off legacy benefits on a pay-go basis) are properly funding accruing benefits and, for those benefits, should be able to use the expected long-term return as the discount rate.

## CONCLUSION

Retiree health plans for state and local workers have been generating increased attention in recent years due to new GASB reporting guidelines, an aging population, and rising health costs. Our analysis of this issue provides a comprehensive estimate of OPEBs with the latest available data. The key take-aways are as follows. First, total unfunded OPEB liabilities are estimated to be \$862 billion, nearly two thirds of which is held at the local level. Second, unfunded OPEB benefits are equivalent to 28 percent of unfunded pension benefits – when pension benefits are calculated with an interest rate comparable to OPEBs. And, finally, while OPEB liabilities are large, several factors limit their potential drain on state and local resources.



## ENDNOTES

- 1 Implementation of GASB 45 was phased in over a three-year period, with the largest governments – those with total annual revenues of \$100 million or more – required to report their liabilities in their FY2008 financial statements; see U.S. Government Accountability Office (2009). Also relevant is GASB 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pensions*, which was released shortly before GASB 45.
- 2 OPEB costs also include dental, vision, life insurance, disability, and long-term care, but retiree health insurance is the largest component.
- 3 Like GASB 67 and 68 have already done for pensions, GASB 74 and 75 will introduce a blended discount rate and require unfunded liabilities to be reported on the plan sponsor's balance sheet for OPEBs.
- 4 Technically, setting up a trust is sufficient for the use of a higher discount rate under GASB 45. However, the use of the more favorable rate only applies to the extent that accumulated resources are estimated to be sufficient to fund required payments.
- 5 Amir and Ziv (1997).
- 6 Prior research explored retiree health for teachers at the state level only (Clark 2010).
- 7 In many jurisdictions, retired teachers often receive an implicit subsidy in that they can participate in the pool for active employees, but school districts make no explicit contributions towards retiree health insurance.
- 8 The separate appendix is available at: [http://crr.bc.edu/wp-content/uploads/2016/03/SLP48\\_Appendix.xlsx](http://crr.bc.edu/wp-content/uploads/2016/03/SLP48_Appendix.xlsx)
- 9 For further discussion of the method for apportioning liabilities, see Munnell and Aubry (2016).
- 10 The discount rate used for valuing future benefits does not dictate how benefits should be funded (i.e. actuarial costs). It values the retirement benefit based on the riskiness of the future benefit being provided. For the purposes of this *brief*, the lower discount rate used by OPEB plans better reflects the security of the promises made for both retiree health and pension benefits. For a discussion on valuing liabilities, see Munnell et al. (2010).
- 11 We revalue liabilities by applying a rule-of-thumb commonly used by actuaries that a 1-percentage-point change in the interest rate tends to yield a 12-15 percent change in accrued liabilities.
- 12 For further discussion, see Kearney et al. (2009) and Clark (2009).
- 13 As opposed to pension plans that have constitutional provisions securing benefit commitments, OPEB plans generally do not have the same type of explicit protections; see Daley and Cogburn (2008) and U.S. Government Accountability Office (2007).
- 14 Kearney et al. (2009).
- 15 See Kellar et al. (2014).
- 16 See Munnell et al. (2013).
- 17 See Keating and Berman (2007) and U.S. Government Accountability Office (2009).
- 18 The incentive to prefund OPEB benefits in the private sector is dampened by the few tax-favored funding options available to most firms. While non-profits are able to set up trusts that allow meaningful tax-preferred contributions, most private sector firms are legally constrained to trusts that restrict the level of tax-preferred contributions to insignificant amounts.

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