

A Tale of Six Cities

UNDERFUNDED RETIREE HEALTH CARE

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Introduction

State and city governments have generally promised to provide free or highly subsidized health care to their retired employees from the date they retire until they become covered by Medicare at age sixty-five. This is frequently a long period since many public employees retire at age fifty or fifty-five. Moreover, many local governments continue to subsidize their employees after age sixty-five by paying their premiums for Medicare or even Medigap, insurance that fills gaps in Medicare coverage.

These retiree health care plans are typically very generous compared to private sector plans for employees. Public retiree health care plans usually provide a broad range of high-quality services to a broad range of participants, often including members of the retiree's household. Yet many of these plans do not incorporate effective cost controls such as significant contributions to premiums, patient co-payments for doctor visits, or annual deductibles for retirees.

Nevertheless, for years, there was no requirement for state and local governments to report their obligations to provide retiree health care. Absent disclosure, state and city governments could promise generous health care benefits to their employees without being held accountable. In 2006, the Government Accounting Standards Board (GASB) finally adopted standards for disclosures by local governments in the footnotes of their financial statements.¹ Starting in 2017, as discussed later in this paper, GASB will mandate better disclosures for retiree health care liabilities on the balance sheets of local governments.²

However, states and cities generally do not advance-fund their retiree health care plans, as they typically do in their pension systems. In advance funding, a plan sponsor makes regular contributions to a separate trust, which invests these contributions to help pay benefits in the future. Thus, a public pension plan is considered grossly underfunded if, as in the case of Illinois, the plan's current assets only cover 50 percent of its long term liabilities under the state's own measurement standards.³ By contrast, few cities or states have funded more than 10 percent of the long-term liabilities of their retiree health care plans, and most have less than 2 percent advance funding of such plans.⁴

As a result, the aggregate unfunded liabilities of the retiree health care plans of the thirty largest American cities exceeded \$100 billion in 2013, according to the Pew Charitable



Trust.⁵ The retiree health care deficits of the fifty states were much larger: a total of \$566 billion in 2014, according to Standard and Poor's.⁶

In this paper, we attempt to shed more light on the current and future budget impact of retiree health care plans on city governments. We do this by analyzing in depth the OPEB benefits of six American cities: Boston, Minneapolis, Pittsburgh, San Francisco, San Antonio, and Tampa, Florida. OPEB technically includes all post-retirement benefits provided by local governments to their retirees, though almost all the benefits are related to health care.

In general, we find that the unfunded OPEB liabilities reported by these six cities substantially understate the actual severity of their OPEB problems. Therefore, we conclude that the OPEB benefit obligations of these cities, if not reformed soon, will begin to crowd out the use of tax revenues for other critical city services like education and police. While such reforms will be politically challenging, there are several recent developments that will likely pressure cities to adopt some cost-reducing measures for their OPEB plans.

This paper is organized into four main parts plus a conclusion. First, it explains our choice of cities and describes the key methodological issues involved in doing this study. Second, it looks at the OPEB reports of the six cities under existing accounting rules—estimating the current and future share of city revenues devoted to paying OPEB benefits. Third, it discusses recent developments that could trigger reforms of existing OPEB plans: new accounting rules, a recent Supreme Court decision on collective bargaining, and the Cadillac tax on expensive health care plans. Fourth, it evaluates the impacts if state and local governments were to switch OPEB plans to the health insurance exchanges established by the Affordable Care Act (ACA) and then suggests specific measures that could help cities substantially reduce their long-term OPEB liabilities.

Part 1

City Choices and Methodological Issues

We chose six cities both to represent the various parts of the country and to capture different underfunding levels of retiree health care plans. The latter was based on published reports by the Pew Charitable Trusts on unfunded retiree health care obligations per city resident.⁷

The two cities reporting large unfunded liabilities for retiree health care were Boston and San Francisco. On the other hand, Minneapolis and Tampa reported low liabilities for their retiree health care. In the middle of this liability spectrum were Pittsburgh and San Antonio.

All of these six cities had recently published an actuarial report on OPEB liabilities. Nevertheless, we soon confronted difficult challenges in obtaining the data needed to make

an independent estimate of the OPEB liabilities of these cities and the burden of OPEB liabilities on the cities' budgets.

First, the OPEB reports published by the cities calculated their unfunded liabilities based on questionable assumptions. Most critical was the discount rate used to determine the present value of the city's future liabilities for retiree health care. Many cities selected a much higher discount rate than could be justified in today's low-interest environment. Moreover, some cities with multiple OPEB plans use different rates for different plans. While this practice is allowed under GASB, particularly when plans pursue different funding policies, it is conceptually flawed. By using a higher discount rate, a city substantially reduces the amount of its reported OPEB liabilities. The higher discount rate substantially reduces the city's reported liabilities for retiree health care.⁸

Second, to make our own independent assessments of each city's OPEB liabilities, we needed to examine the data behind the OPEB reports. Most importantly, we needed the projected cash flows for retiree health care benefits over the next thirty years, which were used by each city's actuaries to determine its OPEB liabilities. But some cities were reluctant to hand over this data. In several cases, we obtained this data only by making a request under the relevant statutes on access to public records and going through a lengthy bureaucratic process.

Third, we realized that cities organize their retiree health care plans (and their overall activities) in different ways. The plans of most cities cover their own direct employees and those of city-run school systems. These plans may also include the police and firefighters working in the city, though sometimes these public safety employees have their own separate retiree health care plans. On the other hand, the reported liabilities of cities do not usually include the health care plans for retirees from public agencies operating within the city, such as airport or subway authorities. Nor do the reported liabilities of cities include their share of the retiree health care obligations of metropolitan or regional authorities, like the Metropolitan Council of Minneapolis-St. Paul.

Fourth, since we found that cities had multiple OPEB plans in related governmental units, we collected information on all units of city and related governmental units that sponsored OPEB plans, including school districts and transportation authorities where applicable. To assemble this list, we read city comprehensive annual financial reports and searched for all authorities providing city public services. For governmental entities, we collected general fund and governmental revenues from their comprehensive annual financial reports. For service authorities, we collected operating revenues. Table 1 shows the entities covered in our sample with revenue information.

Finally, as shown in table 1, in reviewing these financial reports, we distinguished among the different types of revenues received by different city-related units. The cities themselves,



Table 1: Entities and 2014 Revenues in \$000s

City Name	Entity	General Fund Revenue	Governmental Fund Revenue	Operating Revenues
San Francisco				
1.1	City and County of San Francisco	\$ 3,747,361	\$ 4,906,273	
1.2	San Francisco Unified School District	\$ 619,619	\$ 907,519	
1.3	Bay Area Rapid Transit (BART)			\$ 463,160
Boston				
2.1	City of Boston	\$ 2,780,060	\$ 3,134,680	
2.2	Massachusetts Bay Transportation Authority (MBTA)			\$ 643,389
Minneapolis				
3.1	City of Minneapolis	\$ 464,007	\$ 710,651	
3.2	Minneapolis Public Schools	\$ 495,466	\$ 654,075	
3.3	Metropolitan Council	\$ 21,180	\$ 246,630	
Tampa				
4.1	City of Tampa	\$ 280,472	\$ 418,491	
4.2	School District of Hillsborough County	\$ 1,505,378	\$ 1,984,460	
4.3	Hillsborough County	\$ 660,259	\$ 1,397,130	
4.4	Tampa Bay Water Authority			\$ 161,200
4.5	Hillsborough County Aviation Authority			\$ 194,605
San Antonio				
5.1	City of San Antonio	\$ 1,283,302	\$ 1,722,341	
5.2	City Public Services (CPS) Energy			\$ 2,424,071
5.3	San Antonio Water System (SAWS)			\$ 505,435
Pittsburgh				
6.1	City of Pittsburgh	\$ 412,494	\$ 537,984	
6.2	Pittsburgh School District	\$ 541,999	\$ 628,939	
6.3	Allegheny County	\$ 712,209	\$ 1,523,538	
6.4	Pittsburgh Parking Authority			\$ 988
6.5	Allegheny County Airport			\$ 151,326
6.6	Port Authority of Allegheny County			\$ 413,884

as well as the counties and the school districts, typically receive monies from both the general fund and the governmental fund. General fund revenues derive mainly from property taxes and other local taxes like auto excise taxes, as well as any unrestricted state or federal aid. Governmental fund revenues include revenues from the general fund (described above) plus two other sources—special revenues and capital projects. Special revenues may be used only for a specified purpose, such as state or federal grants for education or public security. Capital projects are revenues from bond proceeds and state or federal grants with spending restricted to a specific type of building or infrastructure, such as school buildings or subway lines. By contrast, the transportation authorities and utility systems typically receive operating revenues derived from user fees and other revenues for operating a facility.

Part 2

Share of Current and Future Budgets Absorbed by OPEB

The cities and related units that we study disclose information about their OPEB liabilities in both their comprehensive annual financial reports and in OPEB actuarial valuation reports. The municipal entities prepared these disclosures under GASB Statement 45, “Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.” New GASB standards that will apply to OPEB, Statements 74 and 75, will go into effect for the fiscal years beginning June 15, 2016, and June 15, 2017, respectively.⁹

Statements prepared under GASB 45 provide information on accrued liabilities, discount rates, assets, unfunded liabilities, health care cost projections, contributions, and benefit flows. In some cases, we were also able to obtain more detailed information about health plans from other descriptive documents available from the city governments.

A. What are the entities’ revenues, assets, and liabilities?

Table 2 shows OPEB plans and the total reported liabilities for the municipal entities in the sample. In most instances, the entities we study have more than one OPEB plan. For example, the Bay Area Rapid Transit Authority (BART) has both a retiree medical plan and an additional OPEB plan. The City of Boston has separate OPEB plans for the Public Health Commission and for the Boston Public Schools and other city departments.

Some entities in our sample have chosen to fund OPEB liabilities by setting aside assets in a dedicated trust. One example is the City Public Services (CPS) OPEB plans of San Antonio, which have prefunded to an extent that, under their chosen 7.75 percent discount rate, the plans are fully funded. Of course, 7.75 percent is a rather unlikely return to be achieved by the assets in these funds. One incentive that cities have to prefund OPEB liabilities is the fact that GASB 45 (and the successor GASB standards 74 and 75) allows them to use higher discount rates for the liabilities when they follow prefunding strategies.¹⁰

As highlighted in Novy-Marx and Rauh (2014), the notion that the discount rate for liabilities should be higher when the sponsor undertakes a prefunding strategy is logically flawed. The value of a liability has nothing to do with the assets chosen to fund that liability, but rather with the likelihood that the liability will be paid in full or defaulted on, and if defaulted on to what extent. From the perspective of a market or of the beneficiaries in the plan, a fully funded OPEB liability would have a much higher market value because it is collateralized by assets, whereas an unfunded OPEB liability may not be paid to the full extent of the OPEB promise.¹¹

Table 3 shows how much larger unfunded OPEB liabilities would be under a 3 percent discount rate, which is close to a current interest rate on municipal bonds with an AA rating and appropriate duration. As we will discuss in Part 3 (New Accounting Rules),



Table 2: OPEB Plans of Sample Cities and Related Entities

		Accrued Actuarial Liability (AAL)	Discount Rate	Assets	Unfunded Liability	End of Year
<i>All dollar amounts in \$000s</i>						
San Francisco						
1.1	City and County	\$ 3,997,762	4.45%	\$ 31,205	\$ 3,979,910	2012
1.2	SF Unified School District	\$ 680,925	5.00%	\$ -	\$ 680,925	2013
1.3.1	BART - Retiree Medical	\$ 331,352	6.75%	\$ 202,181	\$ 129,171	2014
1.3.2	BART - Additional OPEB	\$ 29,130	4.25%	\$ -	\$ 29,130	2014
Boston						
2.1.1	Public Schools and All Other Departments	\$ 2,257,699	7.50%	\$ 204,567	\$ 2,053,132	2013
2.1.2	Public Health Commission	\$ 94,402	5.75%	\$ 5,212	\$ 89,190	2013
2.2	MBTA Transport Authority	\$ 2,315,626	2.92%	\$ -	\$ 2,315,626	2014
Minneapolis						
3.1	Postemployment Benefits Plan ¹²	\$ 123,491	3.00%	\$ -	\$ 123,491	2014
3.2	Public Schools	\$ 70,587	4.50%	\$ 14,920	\$ 55,667	2013
3.3	Metropolitan Council	\$ 209,378	7.00%	\$ 207,839	\$ 85,439	2013
Tampa						
4.1	Tampa Health Care Benefits Plan	\$ 66,668	4.00%	\$ -	\$ 66,668	2014
4.2	School District Hillsborough County SDHC	\$ 191,669	3.50%	\$ -	\$ 191,669	2014
4.3	Hillsborough County OPEB	\$ 80,265	4.50%	\$ 17,326	\$ 62,939	2014
4.4	Tampa Bay Water	\$ 696	4.00%	\$ -	\$ 696	2013
4.5	Hillsborough County Aviation Authority	\$ 4,433	4.50%	\$ -	\$ 4,433	2013
San Antonio						
5.1.1	City	\$ 318,910	3.00%	\$ -	\$ 318,910	2013
5.1.2	Fire and Police	\$ 751,127	7.50%	\$ 307,232	\$ 443,895	2014
5.2	Water System SAWS	\$ 139,574	4.75%	\$ 19,259	\$ 120,315	2013
Pittsburgh						
6.1.1	Municipal OPEB - Health Insurance	\$ 558,722	4.50%	\$ 6,028	\$ 552,694	2013
6.1.2	Municipal OPEB - Life Insurance	\$ 11,541	4.50%	\$ 125	\$ 11,416	2013
6.2	School District OPEB	\$ 188,852	4.00%	\$ -	\$ 188,852	2013
6.3	Allegheny County	\$ 57,411	4.00%	\$ -	\$ 57,411	2012
6.4	Pittsburgh Parking Authority	\$ 603	6.00%	\$ -	\$ 603	2012
6.5	Allegheny County Airport	\$ 1,376	4.00%	\$ -	\$ 1,376	2012
6.6.1	Port Authority of Allegheny County - ATU	\$ 847,994	4.00%	\$ -	\$ 847,994	2012
6.6.2	Port Authority of Allegheny County - IBEW	\$ 23,638	4.00%	\$ -	\$ 23,638	2012
6.6.3	Port Authority of Allegheny County - Nonrep	\$ 79,153	4.00%	\$ -	\$ 79,153	2012

¹² As of January 1, 2015, the Minneapolis Public Housing Authority's retiree health care is no longer included under the City of Minneapolis. These figures do not yet reflect that change.

this is close to the rate that new GASB standards would suggest should be used to value unfunded liabilities. Unfunded liabilities rise for all of the plans in the sample except the Minneapolis post-employment benefits plan, which already uses the 3 percent rate.

Where possible, we also divide these more realistic measures of unfunded liabilities by the population of each city to get unfunded liability per capita. Table 3 shows this calculation

Table 3: OPEB Liabilities Per Capita at 3% Discount Rate

		AAL Under 3% Rate	UAL Under 3% Rate	UAAL Per Capita
San Francisco				
1.1	City and County	\$ 4,930,435	\$ 4,899,230	\$ 5,747.11
1.2	SF Unified School District	\$ 908,616	\$ 908,616	\$ 1,065.86
1.3.1	BART - Retiree Medical	\$ 566,565	\$ 364,384	
1.3.2	BART - Additional OPEB	\$ 34,908	\$ 34,908	
Boston				
2.1.1	Schools and All Other	\$ 4,287,801	\$ 4,083,234	\$ 6,225.25
2.1.2	Public Health Commission	\$ 140,162	\$ 134,950	\$ 205.75
2.2	MBTA Transport Authority	\$ 2,288,794	\$ 2,288,794	
Minneapolis				
3.1	Postemployment Benefits Plan	\$ 123,491	\$ 123,491	\$ 303.26
3.2	Public Schools	\$ 87,683	\$ 72,762	\$ 178.69
3.3	Metropolitan Council	\$ 370,791	\$ 162,952	\$ 231.19
Tampa				
4.1	Tampa Health Care Benefits Plan	\$ 77,065	\$ 77,065	\$ 214.86
4.2	School District Hillsborough County SDHC	\$ 206,110	\$ 206,110	\$ 574.65
4.3	Hillsborough County OPEB	\$ 99,704	\$ 82,378	\$ 62.58
4.4	Tampa Bay Water	\$ 804	\$ 804	
4.5	Hillsborough County Aviation Authority	\$ 5,507	\$ 5,507	
San Antonio				
5.1.1	City	\$ 318,910	\$ 318,910	\$ 221.97
5.1.2	Fire and Police	\$ 1,426,533	\$ 1,119,301	\$ 779.08
5.3	Water System SAWS	\$ 179,704	\$ 160,445	
Pittsburgh				
6.1.1	Municipal OPEB - Health Insurance	\$ 694,036	\$ 688,008	\$ 2,252.72
6.1.2	Municipal OPEB - Life Insurance	\$ 14,336	\$ 14,211	\$ 46.53
6.2	School District OPEB	\$ 218,305	\$ 218,305	\$ 714.79
6.3	Allegheny County	\$ 66,365	\$ 66,365	\$ 53.90
6.4	Pittsburgh Parking Authority	\$ 927	\$ 927	
6.5	Allegheny County Airport	\$ 1,590	\$ 1,590	
6.6.1	Port Authority of Allegheny County - ATU	\$ 980,245	\$ 980,245	
6.6.2	Port Authority of Allegheny County - IBEW	\$ 27,325	\$ 27,325	
6.6.3	Port Authority of Allegheny County - Nonrep	\$ 91,497	\$ 91,497	

in the right-most column. For this analysis, city plans are divided by city population. County plans are divided by county population. The Metro Council is the population of Minneapolis plus the population of St. Paul. No population figures are used for separate authorities, as it is difficult to estimate the population responsible for the unfunded liabilities of separate authorities such as transportation authorities and port authorities.

Unfunded liabilities are \$5,747 per capita for the San Francisco City and County OPEB plan and \$512 per capita for the San Francisco Unified School District. In Boston, they are \$6,225 per capita for the schools and all other, and an additional \$206 per capita for the Public Health Commission plan. Pittsburgh has unfunded liabilities of \$2,253 per capita



for its municipal OPEB health insurance and an additional \$715 per capita for the school district OPEB. Adding per capita OPEB liabilities by city, the total per capita OPEB liabilities for Minneapolis are the lowest at just under \$700 per capita, followed by Tampa at \$852 per capita and San Antonio at \$946 per capita.

For San Francisco, Boston, and Pittsburgh, the unfunded OPEB liabilities of the separate authorities are also quite substantial. In San Francisco, the BART OPEB liabilities are roughly of the same magnitude as the school district liabilities. In Boston, the MBTA OPEB liabilities are around half of the level of total liabilities the city has for the schools and all other city departments. In Pittsburgh's Allegheny County, the Port Authority OPEB liabilities are actually larger than the city's own OPEB liabilities.

B. What is the current share of the city budgets devoted to OPEB?

In table 4, we examine the share of city budgets that are devoted to OPEB, both for current benefits and for government contributions to the OPEB funds that are paid beyond current benefits. This only gives a sense of how much cities are devoting to OPEB on a cash basis and not a measure of their total costs.

The denominator for these calculations is general fund revenues, as opposed to the broader category of governmental fund revenues. Governmental fund revenues above and beyond general funds include revenues that are restricted to certain uses, so we assume that they cannot be used for retiree health care. As in table 3, we treat OPEB payments and revenues for other related units separately, as these OPEB benefits are not technically the obligations of the city. We therefore implicitly assume that separate entity OPEB liabilities (e.g., for schools or transportation or port authorities) are financed out of operating revenues of that entity.

San Francisco and Boston each have a primary OPEB plan to which they pay more than 4 percent of their city general revenues for current benefits only; Pittsburgh has a primary OPEB plan to which it pays over 5 percent of its revenues for current benefits only. However, Boston's OPEB includes public schools, while San Francisco contributes 5.5 percent of its school district revenues to OPEB and Pittsburgh contributes 3 percent of its school district revenues. Furthermore, all three of these cities make some contributions to an OPEB fund: San Francisco in the amount of 0.2 percent of its general fund revenues, Boston 1.4 percent of its general fund revenues, and Pittsburgh 0.6 percent of its general fund revenues.

The other cities—Minneapolis, Tampa, and San Antonio—contribute somewhat smaller percentages of their budgets to their primary OPEB plans. The Metro Council of Minneapolis and St. Paul, however, makes benefit payments of 4.5 percent of its revenues and contributions to its non-trust OPEB fund of 1.5 percent of its revenues.

Table 4: Share of Current Budgets Devoted to OPEB

	<i>Current Benefits Paid by Government</i>			<i>Government Contributions to OPEB Fund</i>		
	<i>\$000s</i>	<i>% General Revenue</i>	<i>% Operat. Revenue</i>	<i>\$000s</i>	<i>% of General Revenue</i>	<i>% of Operating Revenue</i>
San Francisco						
1.1	City and County	\$ 160,733	4.4%	\$ 5,895	0.2%	
1.2	SF Unified School District	\$ 34,362	5.5%	\$ -		
1.3.1	BART - Retiree Medical	\$ 16,337		3.5%	\$ 10,694	2.3%
1.3.2	BART - Additional OPEB	\$ 76		0.0%	\$ -	
Boston						
2.1.1	Schools and All Other	\$ 113,639	4.1%	\$ 40,000	1.4%	
2.1.2	Public Health Commission	\$ 1,695	0.1%	\$ 2,250	0.1%	
2.2	MBTA Transport Authority	\$ 58,757		9.1%	\$ -	
Minneapolis						
3.1	Postemployment Benefits Plan	\$ 5,118	1.1%	\$ -		
3.2	Public Schools	\$ 2,608	0.5%	\$ -		
3.3	Metropolitan Council	\$ 12,499	5.1%	\$ 4,118	1.7%	
Tampa						
4.1	Health Care Benefits Plan	\$ 3,139	1.1%	\$ -		
4.2	SDHC	\$ 4,218	0.3%	\$ -		
4.3	Hillsborough County OPEB	\$ 5,813	0.9%	\$ 455	0.1%	
4.4	Tampa Bay Water	\$ 49		0.0%	\$ -	
4.5	Hillsborough County Aviation Authority	\$ 239		0.1%	\$ -	
San Antonio						
5.1.1	City	\$ 5,797	0.5%	\$ -		
5.1.2	Fire and Police	\$ 25,969	2.0%	\$ 374	0.0%	
5.2	Water System SAWS	\$ 8,170		1.6%	\$ 6,000	1.2%
Pittsburgh						
6.1	Municipal OPEB - Health Insurance	\$ 21,959	5.3%	\$ 2,500	0.6%	
6.2	School District OPEB	\$ 10,970	3.0%	\$ -		
6.3	Allegheny County	\$ 1,721	0.2%	\$ -		
6.4	Parking Authority	\$ 32		3.2%	\$ -	
6.5	Allegheny County Airport	\$ 166		0.1%	\$ -	
6.6.1	Port Authority Allegheny County - ATU	\$ 32,086		7.8%	\$ -	
6.6.2	Port Authority Allegheny County - IBEW	\$ 825		0.2%	\$ -	
6.6.3	Port Authority Allegheny County - Nonr	\$ 4,323		1.0%	\$ -	



Of the separate entity plans, two stand out. Boston's MBTA contributes 9.1 percent of its budget to pay current OPEB obligations. Allegheny County's Port Authority contributes 7.8 percent of its budget for its ATU plan alone, and 9 percent of its budget for its three OPEB plans.

C. What share of city revenues will be devoted to OPEB in ten and twenty years?

Table 5 shows that OPEB expenditures relative to general fund revenues will rise significantly over ten and twenty years. To perform these calculations, we made the following assumptions:

- Benefits grow as projected by actuaries. If no projections are provided, we assume 8 percent growth through 2025 and 5 percent growth 2025–2035. Projected contribution levels based on these assumptions are shown in italics.
- Cities continue advance funding out of government resources at today's real dollar levels, growing by 2 percent per year inflation. To the extent that employees contribute to OPEB funds (notably San Francisco City and County and San Antonio Fire and Police), their contributions also grow at the same rate from today's levels.
- General revenues grow at 2 percent inflation each year.
- Fund assets return 3 percent per year, i.e., Consumer Price Index plus 1 percent.

We draw two main conclusions from this analysis.

First, in the absence of major changes that reduce government costs for retiree health care, the share of state and local budgets that will be necessary just to pay current OPEB benefits will continue to grow for almost all the plans. For example, by 2035, San Francisco will need 11.3 percent of its general revenues to pay benefits for its city and county OPEB plan. Boston will require 8.2 percent for its primary plan, and the Metro Council of Minneapolis and St. Paul will require 11.4 percent. Among the separate entities, the OPEB plans of the Port Authority of Allegheny County and the Boston MBTA will require over 20 percent of their respective operating revenues. In only a small number of the municipal OPEB plans we study could it be said that the costs are rising relatively slowly.

Second, if cities that prefund continue to prefund at the same real dollar level as in the latest fiscal year, only two OPEB funds will by 2035 have relatively enough assets on hand to pay for even ten years of benefits: the San Francisco BART Retiree Medical OPEB and the Minneapolis Metro Council OPEB. Others—such as the Boston plans, the Minneapolis public schools, and the San Antonio Water System—will have between five and ten years of benefits on hand. The remaining plans will have fewer than five years of assets on hand, if they fund at all.

Table 5: Projected Budget Impacts (\$000s)

	2025 Benefits			2035 Benefits			2025 OPEB Fund			2035 OPEB Fund		
	Level	% Gen Rev	% Op Rev	Level	% Gen Rev	% Op Rev	Level	Years Ben	Level	Years Ben	Level	Years Ben
San Francisco Area												
1.1	City and County	392632	8.4%	639556	11.3%	466687	1.2	1076522	1.7			
1.2	SF Unified School District	52325	6.8%	85231	9.1%	0	0	0	0			
1.3.1	BART - Retiree Medical	34897	6.1%	56844	8.1%	430501	12.3	744662	13.1			
1.3.2	BART - Additional OPEB	1332	0.2%	2006	0.3%	0	0	0	0			
Boston Area												
2.1.2	Public Schools and All Other	212808	6.2%	346643	8.2%	910476	4.3	1844907	5.3			
2.1.2	Public Health Commission	7183	0.2%	11700	0.3%	42239	5.9	91714	7.8			
2.2	MBTA Transport Authority	137000	17.1%	223159	22.9%	0	0	0	0			
Minneapolis Area												
3.1	Postemployment Benefits Plan	11933	2.1%	19438	2.8%	0	0	0	0			
3.2	Public Schools	7581	1.2%	12349	1.6%	20653	2.7	91714	7.4			
3.3	Metropolitan Council	18716	6.2%	30486	8.2%	339945	18.2	520821	17.1			
Tampa Area												
4.1	Health Care Benefits Plan	6091	1.7%	9922	2.3%	0	0	0	0			
4.2	SDHC	9834	0.5%	16019	0.7%	0	0	0	0			
4.3	Hillsborough County OPEB	13554	1.7%	22078	2.2%	30392	2.2	47912	2.2			
4.4	Tampa Bay Water	113	0.1%	184	0.1%	0	0	0	0			
4.5	Hillsborough County Aviation	557	0.2%	908	0.3%	0	0	0	0			
San Antonio Area												
5.1.1	City	17700	1.1%	28164	1.4%	0	0	0	0			
5.1.2	Fire and Police	62139	3.9%	119333	6.1%	565136	9.1	963997	8.1			
5.2	Water System SAWS	19049	3.0%	31030	4.1%							
Pittsburgh Area												
6.1	Municipal OPEB	34463	6.7%	39640	6.3%	43731	1.3	97602	2.5			
6.2	School District	25578	3.8%	41664	5.1%	0	0	0	0			
6.3	Allegheny County	4012	0.5%	6535	0.6%	0	0	0	0			
6.4	Pittsburgh Parking Authority	74	6.0%	121	8.0%	0	0	0	0			
6.5	Allegheny County Airport	387	0.2%	631	0.3%	0	0	0	0			
6.6.1	Port Authority - ATU	74813	14.5%	121862	19.4%	0	0	0	0			
6.6.2	Port Authority - IBEW	1924	0.4%	3133	0.5%	0	0	0	0			
6.6.3	Port Authority - Nonrep	10080	2.0%	16419	2.6%	0	0	0	0			

Assumptions: Contributions of employers and employees grow at an inflation rate of 2 percent. Asset returns are 3 percent. *Italicized benefit levels are projections based on 8 percent growth 2015–2025 and 5 percent growth 2025–2035.*

Some entities in our sample already have plans to ramp up the prefunding of OPEB benefits. For example, San Francisco (according to propositions B and C) plans to provide increasing contributions as a percentage of payroll until the plan is 100 percent funded. However, as the funding sources for these plans are not fully established, those intentions to fund are not reflected in this table. The goal of the table is to present the projections of OPEB under the assumption that the fiscal burden of prefunding does not increase relative to its levels today. If cities are to prefund beyond today's real amounts, that will raise the level of funds but will represent an increased burden on taxpayers in the intervening years and hence a higher percentage of the budget that would have to be dedicated to OPEB.

Part 3

Recent Triggers for Actions

As explained in Part 2, unfunded OPEB liabilities threaten the long-term financial viability of all the cities we study, especially Boston, Pittsburgh, and San Francisco. To mitigate this threat, most cities should start soon to adopt measures that will gradually reduce these OPEB liabilities. Yet how will current city officials become motivated to adopt such politically difficult reforms, which will not provide significant financial relief for years?

In this Part 3, we will delineate four recent developments that could catalyze the near-term adoption of OPEB reforms by many cities.

1. In 2017, the new GASB accounting rules for reporting OPEB liabilities will become effective for all large cities.¹³ These new rules will not only increase the reported OPEB liabilities of most cities, but will also focus public attention on these liabilities by displaying them on city balance sheets.
2. In 2015, the US Supreme Court established the principle that employer promises to pay retiree health care benefits end at the same time as the collective bargaining agreement—unless expressly guaranteed for life by that agreement.¹⁴ So most cities will be able to renegotiate these benefits within the next decade.
3. Over the last few years, courts have treated health care plans of retirees as unsecured creditors of cities that declared bankruptcy. Therefore, to the extent that these plans are unfunded, they will probably be wiped out in city bankruptcies, as happened in Detroit¹⁵ and Stockton.¹⁶
4. In 2020, retiree health care plans will become subject to the so-called Cadillac tax: a 40 percent excise tax on very expensive plans. Without significant reforms of their

current plans, which are quite expensive, most cities will be required to pay a large Cadillac tax.¹⁷

Below, we examine each of these factors in depth.

New Accounting Rules

As mentioned previously, GASB has adopted new accounting standards for reporting OPEB liabilities of governmental entities, which become fully effective in fiscal years starting in 2017.¹⁸ These new accounting rules should focus more voter attention on the unfunded liabilities of the cities where voters reside. Hence voters should realize that the funding of OPEB deficits will begin to crowd out other budget priorities such as police and schools.

To begin with, the unfunded liabilities of cities will appear on their balance sheets, rather than in the footnotes to their financial statements.¹⁹ Of course, analysts of municipal bonds and rating agencies have been reading these footnotes in the past. But ordinary citizens are more likely to be aware of these unfunded liabilities if they appear more prominently on the city's balance sheet than in obscure footnotes. Perhaps this prominence will lead local journalists to write about a city's unfunded OPEB liabilities.

At the same time, the OPEB deficits reported by most cities on their balance sheets will be substantially higher under the new GASB than previously reported in the footnotes. Under the prior rules, cities were allowed considerable leeway in setting the discount rate for determining the present value of their future OPEB obligations.²⁰ As table 2 shows, the six cities in this study used discount rates ranging from 3 percent to 7.75 percent.

By contrast, the new GASB rules require all cities to use a uniform discount rate when calculating the unfunded portion of their OPEB liabilities. In specific, for unfunded liabilities, cities must use the interest rate on an average municipal bond with an AA rating and the appropriate duration—usually around twelve years. In today's economic environment, this means a discount rate of at most 3 percent.²¹ As shown in table 3, a 3 percent discount rate would result in substantially higher unfunded OPEB liabilities for cities or related units currently using higher discount rates.

However, there is a big loophole in the GASB rules for prefunded OPEB liabilities: where the city has made contributions to a qualifying trust designed to pay future OPEB liabilities, rather than current benefit payments. The new GASB rules allow cities to choose their own discount rate for the prefunded portion of their OPEB liabilities if the trust meets certain conditions—most importantly, that the assets are held in an irrevocable trust dedicated to paying future OPEB benefits and that the trust's assets will not be exhausted during the relevant period.²²



Both of these conditions can easily be met by cities. A city can readily establish an irrevocable trust whose assets are dedicated solely to the future payment of OPEB liabilities. Nevertheless, two authorities in our study—the Minneapolis-St. Paul Council and the Tampa Port Authority—have decided to retain financial flexibility by using revocable trusts whose assets could be used for non-OPEB purposes.

A city may meet the second condition for choosing a higher discount rate simply by announcing that it intends to continue making contributions to an irrevocable OPEB trust, even though such intentions are not legally binding. For example, Boston has begun to contribute \$40 million per year to an irrevocable OPEB trust and says that it will continue making such a \$40 million contribution in future years. In fact, as the cost of OPEB benefits rises, it will become more and more difficult for Boston to devote such a large portion of its budget to paying current OPEB benefits and making this additional \$40 million contribution. Yet Boston gets the advantage of using a higher discount rate merely by announcing its intention to make this additional contribution because, under this assumption, the assets in the OPEB trust will never be exhausted.²³

In short, the new GASB rules will give cities an incentive to prefund OPEB liabilities, as every dollar they contribute to a qualifying OPEB trust has the potential to lower the amount of OPEB liabilities they report by more than one dollar. However, the use of a high discount rate based on a nonbinding intention to make future contributions will mislead the city's residents about the true size of its OPEB liabilities.

Supreme Court Decision

As the new GASB rules become effective in 2017, taxpayers will become more aware of OPEB liabilities as they become displayed on the balance sheets of their cities and states. In quite a few cases, taxpayers—or journalists from local newspapers—will see much larger OPEB liabilities than previously reported because of the lower discount rate required by the new GASB rules for unfunded retiree health care obligations. But how can these taxpayers induce local governments to adopt measures reducing these OPEB liabilities in the future?

Legally, retiree health care plans are much easier to change than future commitments to pension plans. For years, the constitutions of many states have specifically protected against any reduction in pension benefits promised to public employees at the time of their employment. By contrast, no state constitution expressly protects retiree health care benefits, although the Illinois Supreme Court has expansively interpreted the state's constitutional protection for pension benefits to cover retiree health care plans.²⁴

In 2015, the US Supreme Court unanimously approved principles for interpreting collective bargaining agreements, which will help many local governments scale back their retiree

health care benefits. Although the case involved a collective bargaining agreement between a private company and its union, the judicial principles articulated in the case should apply to such agreements in the public sector.²⁵

In *MG Polymers v. Tackett*, the Supreme Court was faced with a union challenge to a company proposal for retirees to share the premiums for their health care plan. The collective bargaining agreement provided retired workers with a full company contribution toward their health care benefits “for the duration of [the] Agreement.”²⁶

Since this agreement was subject to renegotiation after a few years, the critical legal question was whether the retiree health care benefits continued after the expiration of the agreement.

The Sixth Circuit had agreed with the union-plaintiff, which had argued that the collective bargaining agreement vested these health care benefits for life. The Sixth Circuit had based its conclusion primarily on inferences it had made from the terms and context of the agreement despite its ambiguity. But the Supreme Court reversed on the grounds that such inferences by the lower court were improper. Instead, the Supreme Court declared that, given the ambiguous contract, the plaintiff must supply “affirmative evidentiary support” that both parties to the agreement intended to provide these retirees with free lifetime health care.²⁷

In deciding this case, the Supreme Court reinforced two general principles of contract interpretation, which should apply to any agreement where the duration of retiree health care benefits is unclear. First is the traditional principle that “courts should not construe ambiguous writings to create lifetime promises.”²⁸ Second is the traditional principle that “contracted obligations will cease, in the ordinary course, upon termination of the collective bargaining agreement.”²⁹

These two principles should be very relevant to retiree health care plans in the public sector. For example, courts in California and Michigan have held that, when the collective bargaining agreement is silent on the duration of retiree medical benefits, these benefits expire at the end of such agreement.³⁰ On the other hand, when the New York courts are faced with ambiguous contract language on retiree medical benefits, they tend to favor an interpretation that such benefits are vested for life.³¹

Many collective bargaining agreements do not expressly bind the city or state to provide a specific package of health care benefits for the whole life of all retirees. These agreements for retiree health care plans were often made quietly by elected officials, who would no longer be in office when local taxpayers realized the significant burden of these generous plans on local budgets.



So when these collective bargaining agreements come up for renewal, as they do every three to ten years, there is likely to be a heated negotiation on retiree health care benefits. While elected officials may attempt to reduce the cost of these plans, public unions will demand that any long-term promises be expressly written into the new agreement. However, elected officials will now be constrained by the new GASB reporting rules, which will display the OPEB liabilities on the balance sheets of cities and states.³² As a result, elected officials will be less likely to expressly promise generous health care benefits to their retirees, because local taxpayers will soon be informed about the adverse impact such promises would have on future budgets and property tax assessments.

Threat of Municipal Bankruptcy

As explained above, the Supreme Court's recent guidance on contract interpretation should lead city officials and unions to renegotiate the package of retiree health care benefits when the collective bargaining agreement comes to an end. In these negotiations, both sides should keep in mind the possibility that a city with serious financial troubles might file under Chapter 9 of the federal bankruptcy code. Cities cannot file under Chapter 9 without the approval of the relevant state—twelve states allow cities to make such a filing without conditions; another twelve permit cities to make such a filing subject to certain conditions.³³

When a city files for bankruptcy under Chapter 9, pension benefits generally get treated much better than retiree health care benefits. Although Chapter 9 filings have been rare historically, there have been three larger filings since 2012: Detroit, Michigan; Stockton, California; and San Bernardino, California.³⁴

In all three cases, the plan approved by the bankruptcy trustee preserved most of the pension benefits for city workers, but virtually wiped out all health care benefits for city retirees.³⁵

Why? The funding of most retiree health care plans is very low—in most cities, less than 2 percent of their long-term OPEB liabilities.³⁶ To the extent that health care benefits of retirees are not backed by securities held in an irrevocable trust dedicated to paying future OPEB liabilities, these retirees are unsecured creditors of the bankrupt city. As unsecured creditors, they are low in the pecking order of claimants on the city's limited assets.

Therefore, in cities with financial troubles, it may be in the interest of public unions to trade off a lesser package of health care benefits in exchange for a city's commitment to contribute substantial assets to an irrevocable trust dedicated to paying OPEB benefits. To the extent that the health care benefits of retirees are backed by earmarked assets in

an irrevocable trust, they will probably be considered secured creditors of the bankrupt city—entitled to have those assets used to pay future OPEB obligations.

Moreover, as mentioned before, pension benefits are frequently protected by specific provisions in state constitutions, while health care promises do not enjoy such strong legal protections. On the other hand, if promised health care benefits are eliminated by a bankruptcy trustee, those retirees will be able to obtain some form of health care through Medicaid, Medicare, or the ACA connector for the relevant state. Although the premiums for the policies available from the ACA connector may be substantially higher than those in the promised health care plan, retirees with annual incomes below certain levels will be eligible to receive federal premium subsidies, as discussed in Part 4.

Threat of Cadillac Tax

Like the threat of municipal bankruptcy, the threat of the Cadillac tax may motivate city officials to reduce the cost of their retiree health care plans. The Cadillac tax is a 40 percent excise tax on any health care plan whose total costs exceed specified annual limits—originally, \$27,500 per family and \$10,200 per individual in 2018. Total costs encompass premiums paid by employers and employees, including pretax contributions to flexible health care plans.³⁷

Congress recently delayed the effective date of the Cadillac tax from 2018 until 2020, when the relevant limits will be increased to reflect inflation. Congress raised the limit for the Cadillac tax as applied to high-risk professions such as firefighters and police officers in cities. Congress also lowered the burden of the Cadillac tax on businesses by changing it from a nondeductible to a deductible tax.³⁸

The Cadillac tax does apply to health care plans of local governments as well as plans of small and large businesses. These plans of local governments are usually more expensive than those in the private sector. In 2014, for instance, government health care plans were 17.5 percent more expensive than the average citizen's plan, according to United Benefit Advisors.³⁹

Here are two examples of health care plans—for big and small cities—that would be subject to the Cadillac tax. In a 2013 letter, the deputy mayor of New York City estimated that the Cadillac tax would cost the city \$22 million in 2018, rising to \$549 million in 2022.⁴⁰ Similarly, the Association of Washington State Cities estimated that the Cadillac tax would cost its members \$76 million over the decade starting in 2018.⁴¹

If city retirees have their own health care plan, the costs will be particularly high because retirees are older and experience more illnesses than current city workers. If city retirees are part of the same plan as current city workers, the relatively high cost of retiree health care



will increase the premiums of current workers. This is effectively an implicit health care subsidy to retirees.

The threat of the Cadillac tax has already led some cities to pare back their health care plans. For example, in 2015 Boston reportedly negotiated changes to its labor contracts in part to avoid the Cadillac tax.⁴² But the pressure exerted by the Cadillac tax may have diminished when its effective date was delayed from 2018 to 2020.

Some commentators believe this delay is the precursor to the repeal of the Cadillac tax. They point out that the delay received bipartisan support.⁴³ Others argue that the delay was passed to give employers more time to get under the relevant limits.⁴⁴ They emphasize that repeal of the Cadillac tax would create a serious financing problem, since the Congressional Budget Office estimated it would raise \$87 billion through 2025.⁴⁵

In short, the fate of the Cadillac tax is unclear. Nevertheless, this uncertainty creates downward pressure on health care costs at local governments, since adoption and implementation of major reform measures would take several years.

Part 4

Menu of Options

This part will cover two main subjects. It will begin by evaluating a very different approach for cities: switching retirees from OPEB plans to hold policies under the ACA connector in the relevant state. Then it will outline a series of specific measures, within the current structure of OPEB plans, that would substantially reduce the cost of retiree health care plans.

A. Impact of requiring retirees to get health care from connector

Some cities like Chicago have considered phasing out locally funded retiree health care coverage, instead asking retirees to purchase health care policies on the state exchange. This strategy could substantially reduce the health care costs of the city, but would shift great costs onto the federal government.⁴⁶

City employees and retirees with relatively low incomes could receive federal premium subsidies if they obtained their health insurance on a state exchange. In addition, cities could provide supplemental payments to defray any incremental costs of switching from their current health care plans to Gold Plan policies on an exchange.

But the economic calculus is very different for switching city employees versus city retirees. If a city does not offer qualifying health care policies to its employees, it will have to pay substantial penalties, as would a firm in the private sector. By contrast, these penalties

would *not* apply to a city that relied entirely on the state exchange to provide health care insurance to its retirees. That's because these penalties apply only to an employer with respect to its current employees, not its retirees.

Similarly, if a city provided supplemental payments to defray its incremental costs in switching from a city health care plan to a Gold Plan policy on a state exchange, these payments would be taxable income to those employees under the IRS rules. By contrast, if a city provided such supplemental payments to its retirees to ease their transition to a Gold policy, those supplemental payments would *not* be taxable income to these retirees. That's because the IRS rules apply only to such payments by employers to their employees, not to their retirees.⁴⁷

Thus, a recent article estimated that, if state and local governments (SLGs) switched their employees from their existing health care plans to equivalent policies on state exchanges, this switch would cost SLGs significantly more than the status quo. This result is driven mainly by the penalties that would be incurred by the SLGs.⁴⁸

By contrast, if SLGs made a similar switch only for their retirees, this switch would produce savings of \$18 billion to \$21 billion over ten years. Most of these savings to SLGs result because many of their retirees would receive federal premium subsidies and other forms of cost-sharing available for certain buyers of policies on state exchanges.⁴⁹

Let's consider an example to illustrate the savings from switching city retirees from their current health care plans to a Gold policy on a state exchange. Suppose a city currently paid 100 percent of the \$2,000 monthly cost of a health care plan for a retired worker who is age fifty with a family of four and annual income of \$50,000. That worker could obtain a Gold policy on the exchange for roughly \$1,300 per month with a premium subsidy of \$700 per month. The city would come out way ahead even if it paid the worker \$600 per month to cover the remaining premium, plus another \$200 per month to cover deductibles and co-insurance.

Despite these big advantages to the city, however, switching from a retiree health care plan to a state exchange raises significant concerns from both local and national perspectives. On a local level, the union for the city workers will likely object to the switch.

As discussed above, the Gold policy on the state exchange is probably not as generous as the existing city plan for retirees. Moreover, the city's plan may offer a broader choice of providers than the Gold policies. In Boston, for example, the retiree health care plan offers coverage from Harvard Pilgrim and Blue Cross. But there are few, if any, Gold policies offered by these two providers on the Massachusetts exchange.



On a national level, if a city switches from its existing plan to a Gold policy for retirees, the federal government subsidizes the health care costs of the city by providing premium subsidies and cost-sharing to low-income retirees. The cities with the most incentive to make this switch are those with expensive retiree health care plans and minimal advance funding of such plans. Thus, the switching strategy effectively rewards cities that have done a poor job of managing the health care costs of their retirees. These perverse incentives will be highly objectionable to those local governments that have done a good job of managing the health care costs of their retirees.

B. Measures to Reduce Cost within Current Structure of OPEB Plans

Within the current structure of OPEB plans, cities could adopt various measures that would substantially reduce their long-term liabilities for retiree health care. While these measures could be applied just to new city hires, these would produce relatively modest savings that would take years to materialize. On the other hand, cities would confront severe political resistance if these measures were applied to employees at ages fifty and older. An intermediate approach might be to apply these new measures to all new hires and gradually to employees under age fifty.

Here is an illustrative list of possible OPEB reforms that have been adopted by at least a few cities.

1. Eligibility for OPEB Benefits Massachusetts allows city employees to obtain full OPEB benefits after only ten years of employment for a local city. In certain cases, full OPEB benefits can be obtained with only ten years of part-time work for a city. In Tampa, former employees and beneficiaries of the city satisfy retirement eligibility if they commence retirement benefits immediately upon termination and have at least six years of service.⁵⁰

Retiree health care benefits should be a reward for long-term employees with a commitment to a career in public service. Thus, full OPEB benefits could be linked to those with twenty-five to thirty years of city employment.

Alternatively, a city could follow the model of San Antonio, which charges different levels of premiums for OPEB benefits to retirees based on their number of years of public service. For example, OPEB premiums for retirees would decrease from thirty to twenty-five years of service, from twenty-five to twenty years of service, etc.⁵¹

2. Level of City's Premium Contribution In certain OPEB plans of cities like Boston and San Francisco, the local government pays all of the health care premiums of OPEB retirees. By contrast, other cities like Minneapolis and Tampa ask their retirees to make some contribution to the premiums of their OPEB policies. Retirees in Tampa, in particular, must pay substantial premiums, amounting to at least \$571 per month for individual coverage

and \$1,347 per month for family coverage, which pays for around 75 percent of the city's total current costs.⁵²

Even cities like Boston and San Francisco require their retirees to help pay the premiums for the health care of their dependents.

As a matter of policy, the level of premium contributions by OPEB retirees could be based on the number of their family members who otherwise would not have health care coverage. In some instances, the spouses of retirees may hold jobs with health care coverage, or retirees may get a post-retirement job with health care coverage. In either case, the OPEB premiums paid by the city might be reduced to an appropriate extent.

3. Deductibles and Out-of-Pocket Maximums Some cities, such as Tampa and Minneapolis, do have annual deductibles that must be met before retirees can obtain reimbursement for health care costs. These deductibles are typically higher for families than for individuals.

In other cities, such as Boston and San Francisco, the majority of the offered plans do not have annual deductibles for families or individuals with OPEB coverage. Thus, these cities lack an important incentive for their retirees to constrain their health care expenditures each year.

Another important incentive is the out-of-pocket (OOP) expenditure maximum. A higher OOP maximum provides employees with a greater incentive to control costs, as they will owe co-pays at higher health expenditure levels. Most cities put a maximum on OOP payments made by retirees under their OPEB policies. Like deductibles, there are typically higher maximum OOPs for families than for individuals, and these maximums vary widely among OPEB plans of cities. Many of the plans in San Francisco have OOP maximums of \$3,000 or \$4,000 for a family, while Pittsburgh's OPEB plans have OOP maximums of over \$13,000.

4. Co-payments for Medical Service Co-payments are the amounts paid by retirees whenever they seek medical treatment—for doctors' visits, inpatient hospitalization, and brand-name drugs. Reasonable co-payments provide incentives for retirees to avoid unnecessary medical visits.

Co-payments have become more prevalent as cities grapple with rising health care costs, especially for brand-name drugs. Nevertheless, a few cities do not require co-payments for certain types of medical events.

Moreover, cities could become proactive in managing costs by linking different levels of co-payments to different charges for similar treatments. For example, there might be a \$20



co-payment for a knee MRI costing \$400 at one hospital and a \$60 co-payment for a knee MRI costing \$800 at a second nearby hospital.

5. Ancillary Medical Services Most high-quality health care plans, such as those offered by research universities, have separate charges for eyeglasses and dental coverage. These coverages are usually optional add-ons, which may or may not be accepted by participants in these plans.

Although most OPEB plans do impose extra charges for eyeglasses and dental work, a few do not. In these instances, such as some OPEB plans in Boston, routine vision or dental services are offered at no cost to retirees. These services are part of the standard health care policy offered to retirees, who may or may not make substantial contributions to the premiums for this policy.

Similarly, private health care plans of the HMO type have generally narrowed the available network of eligible doctors and hospitals to constrain costs. Plan participants incur significant additional charges for using out-of-network providers. But some OPEB plans continue to offer a broad network of doctors and hospitals so that out-of-network charges are infrequent.

6. Transition to Medicare The primary rationale of OPEB plans was historically to cover the gap between retirement from public service and Medicare. As a result, most OPEB plans now require retirees to join all parts of Medicare: medical treatment, hospitalization, and drugs.

Yet half of the cities in our study still pay all or (in one case) two-thirds of the Medicare premiums for OPEB participants. This is not a question of financial need: the standard annual premiums for Medicare are quite modest for low- and middle-income families. These premiums increase for Medicare Parts B and D only when annual income exceeds \$170,000 for married couples or \$107,000 for a single tax filer.

Similarly, several cities pay the annual premiums of their retirees for Medigap, a supplemental insurance policy offered by AARP and others. Medigap covers those charges not absorbed by Medicare, such as deductibles and co-pays. By paying the Medigap premiums for their retirees, cities undermine the cost-control functions of these deductibles and co-pays.

Conclusion

1. All the cities studied had multiple OPEB plans for the city and related governmental units, such as school districts, utilities, and transportation authorities (see table 1). Yet each of these multiple OPEB plans for the same city had significant differences in

benefit packages and unfunded liabilities. Additionally, the OPEB plans of the related units were typically financed by operating revenues, rather than the general fund revenues used to finance the city's OPEB plan.

2. The cities studied reported a broad range of aggregate unfunded OPEB liabilities for the city and related governmental units. For example, San Francisco and Boston reported aggregate unfunded OPEB liabilities around \$4 billion each, while Minneapolis and Tampa reported aggregate unfunded OPEB liabilities of less than \$400 million each (see table 2). These significant differences show that some cities manage their OPEB liabilities much better than others.
3. However, most of the reports published by the cities studied significantly understated their unfunded OPEB liabilities because many used unrealistically high discount rates between 4 percent and 7.5 percent. Using a 3 percent discount rate, we calculated that the unfunded OPEB liabilities of these cities (without related utility or transportation authorities) were at least 50 percent higher than those in the city's own OPEB reports (see table 3).
4. We then calculated the percentage of each city's general tax revenues needed to pay current benefits for the city's primary OPEB plan. Again we saw a broad range of results—4 percent to 5 percent for Boston, San Francisco, and Pittsburgh, versus 1 percent to 2 percent for Minneapolis, San Antonio, and Tampa (see table 4). We also found that most cities were not putting aside enough advance funding of OPEB benefits to cover these benefit obligations for many years in the future.
5. Based on reasonable assumptions, we then projected the OPEB benefits relative to general fund revenues for the cities studied over ten and twenty years (see table 5). We found that, absent major policy changes on retiree health care benefits, such benefits would consume an increasing percentage of general fund revenues—in twenty years, between 7.4 percent and 11.3 percent for Boston, San Francisco, and Pittsburgh. As a result, the payment of OPEB obligations would crowd out spending on other important city functions like schools and police.
6. On the other hand, we identified two major sets of rule changes that will likely lead to more public focus on the challenges presented by OPEB benefits and more potential for renegotiation of current OPEB benefit packages.
 - a. New GASB rules will require most cities to use a lower discount rate in computing their unfunded OPEB liabilities. For example, the discount rate for many cities will be in the range of 3 percent—the current interest rate on AA municipal bonds with a twelve-year duration. Thus, the new rules will increase the unfunded OPEB liabilities of most cities, which will then have to display these liabilities on their published balance sheets.



- b. The Supreme Court recently held, as a principle of contract interpretation, that OPEB benefits in collective bargaining agreements end with the agreement, absent an express lifetime guarantee. Since such agreements are typically not so clear about the duration of OPEB benefits, many cities will have a chance to renegotiate OPEB benefits in the next three to ten years, as their current collective bargaining agreements come to an end.

- 7. We also identified two potential threats to cities, which may lead them to constrain the growth of their OPEB costs.
 - a. Since 2012, there have been three municipal bankruptcies; in all three, the OPEB plans of retirees were treated as unsecured creditors and wiped out by the court-approved bankruptcy plan. In contrast, the pension plans of city employees were generally protected in these bankruptcy plans. These cases may lead public unions to push for the status of secured creditors for city retirees through advance funding of OPEB benefits, perhaps in exchange for less generous OPEB benefits.
 - b. The Cadillac tax is a 40 percent excise tax on the health care plan of any employer (including a city) if its total costs exceed specified annual limits for families and individuals. Because of their expensive OPEB plans, many cities would have been required to pay the Cadillac tax in 2018. Although the effective date of the Cadillac tax has been delayed from 2018 to 2020, the threat of this tax may lead some cities to reduce the costs of their health care plans for their retirees.

- 8. Some cities have considered requiring retirees to purchase health care policies on the relevant state ACA exchange, an action which would entail a major restructuring of a city's retiree health care program.
 - a. Many retirees will be eligible for federal subsidies for policies purchased on the state exchange, so the city can realize large savings on its premiums for OPEB benefits. Moreover, since retirees are no longer the city's employees, the city will not incur ACA penalties if it gives vouchers to its retirees to defray the cost of their policies purchased on an exchange. And these vouchers will not count as income to the city's retirees.
 - b. However, this strategy of shifting OPEB benefits from cities to state exchanges is likely to be strongly opposed as a matter of national policy. This strategy effectively subsidizes cities that have done a poor job of constraining their OPEB costs at the expense of cities that have worked hard to manage their OPEB costs to a reasonable level.

- 9. Within the current structure of OPEB plans, cities may reduce their OPEB costs by adopting one or more of several measures. These include:
 - a. more years of public service to qualify for OPEB benefits
 - b. higher retiree contributions to health care, especially if a retiree or spouse gets a job after public retirement

- c. higher annual deductibles and maximum out-of-pocket expenditures
- d. differential co-payments for treatment at high-cost health care providers
- e. narrower networks and higher charges for out-of-network services
- f. an end to city subsidies for retirees after they become eligible for Medicare

In short, underfunding of OPEB benefits is a serious and growing challenge in many cities. Without major OPEB reforms, these cities will have to devote more tax revenues to OPEB benefits and less to essential functions like schools and police. There is a broad variety of reasonable measures that cities could adopt to materially reduce their long-term OPEB liabilities. While some cities have risen to the challenge, others have made only minor adjustments to their OPEB obligations.

NOTES

- 1 Government Accounting Standards Board, "Summary of Statement No. 45," June 2004.
- 2 GASB, "GASB Publishes New Standards for Reporting Health Insurance and Other Retiree Benefits," news release, June 29, 2015.
- 3 See Martin Z. Braun, "State Pension Funding Levels in U.S. Improve for a Second Year," Bloomberg, October 13, 2015. For most plans, the pension standards assume asset returns of over 7 percent per year.
- 4 The Pew Charitable Trusts, "Cities Squeezed by Pension and Retiree Health Care Shortfalls," March 8, 2013, 4; Standard and Poor's, "Diverging Trends Underlie Stable Overall U.S. OPEB Liability," November 17, 2014, 10–11.
- 5 Pew, "Cities Squeezed," 1.
- 6 Standard and Poor's, "Diverging Trends," 11.
- 7 Pew, "Cities Squeezed."
- 8 Robert Pozen and Joshua Rauh, "Relief for Cities' Budget-Busting Health-Care Costs," *Wall Street Journal*, July 26, 2015.
- 9 GASB, "New Standards."
- 10 Pozen and Rauh, "Relief."
- 11 Robert Novy-Marx and Joshua Rauh, "Funding Soft Liabilities," Working Paper, 2014.
- 12 As of January 1, 2015, the Minneapolis Public Housing Authority's retiree health care is no longer included under the City of Minneapolis. These figures do not yet reflect that change.
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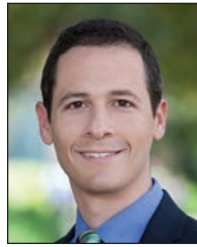
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Synopsis

The growing costs of health care benefits for retired public employees—known as OPEB (other post-employment benefits)—pose a serious challenge to many city governments. In this paper, we analyze the retiree health care systems of six American cities: Boston, Minneapolis, Pittsburgh, San Francisco, San Antonio, and Tampa, Florida. Without major reforms, most of these cities will have to devote a much larger share of tax revenues to OPEB benefits and consequently less to essential functions like schools and police. We outline a broad variety of reasonable measures that cities could adopt to materially reduce their long-term OPEB liabilities.

