Putting State and Local Retiree Health Costs in Perspective

March 23, 2016

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Liabilities are large, but several factors limit their potential drain on resources.

In **a recent study**, the Center estimated the aggregate unfunded liabilities for state and local governments' other post-employment benefits (OPEBs), the largest of which relate to retiree health insurance. These unfunded liabilities are $862 billion, equivalent to 28 percent of unfunded pension liabilities – when pension liabilities are calculated with an interest rate comparable to OPEBs.

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.   These factors include policy 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.

Privacy - Terms

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. 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 for some time, so the pace is incremental. 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.

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 them 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.

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. 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.

The final issue is the question of funding. States and localities are criticized for not having prefunded their OPEB plans. In fact, accrual accounting and prefunding were not an issue before the release of GASB 45 in 2004, and private sector firms *still* do not prefund. 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.

In short, while OPEB liabilities are large, several factors limit their potential drain on state and local resources.