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A QUICK LOOK INTO IMPORTANT ISSUES OF THE DAY

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Sustaining Health Benefits for Retired Public Employees

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In addition to pensions, most state and local governments offer retired public workers other post-employment benefits (OPEBs). The most important is employer-subsidized health insurance coverage, though other benefits can include life, disability and long-term care insurance—even legal services. States provide starkly different levels of OPEB coverage for their retirees.

Mounting health care costs and new rules governing the accounting and reporting of OPEB liabilities have focused more attention on these key benefits in recent years. Different legal rules govern pension and OPEB promises, giving governments more latitude to adjust commitments and retirees limited recourse to hold states and cities to their original obligations.

States structure their OPEB health benefits in a variety of ways, but three broad plan designs typify what states provide:

- A percentage of the premium, which can be greater or smaller depending on how long a person worked in public service.
- A fixed dollar subsidy.
- An implied subsidy where an insured is responsible for the full premium, but that premium costs less because it is based on risk pooling with younger, healthier, active employees.

Not surprisingly, the first model exposes states to escalating health care costs in a way that the others do not. Notably, some states permit employees to invest their own contributions in a defined contribution account.

Primary health insurance coverage lasts until retirees reach age 65, when Medicare kicks in. Then OPEBs become secondary. In most cases, OPEBs extend to spouses and dependents as well as retired public workers. Sometimes, it's retirement systems, with their often-considerable asset management expertise, that administer OPEBs. Other times, OPEB administration falls to different agencies.

Did You Know?

- Total unfunded retiree health care liabilities for U.S. states fell by 7.3% in fiscal 2018 to $628 billion.
- Retiree health benefits can be especially important for public safety employees (police and firefighters), who may be required to retire before they become eligible for Medicare at age 65.
- Nationwide, only about 7% of retiree health care obligations are currently prefunded, though there is wide variation among states.

OPEB and pension financing differ dramatically. Pensions rely on prefunding. Each year, state and local governments transfer a set amount of earmarked cash into dedicated pension trust funds, which invest that money (along with employee contributions) and then use the earnings amassed over decades to pay out benefits. In contrast, governments have traditionally used a pay-as-you-go method with OPEBs, paying the cost of benefits claimed in a given year out of that year's revenues.

Nationwide, only about 7% of retiree health care obligations are currently prefunded, though there is wide variation among states, and some have made meaningful progress of late. The proliferation of trusts in which government employers are accumulating assets to prefund retiree health care promises is an encouraging trend (though some of these trusts remain conspicuously empty).

Just 13 states—California, Connecticut, Florida, Georgia, Illinois, Massachusetts, Michigan, North Carolina, New Jersey, New York, Ohio, Pennsylvania and Texas—account for over 80% of the total U.S. state-accrued OPEB liability.

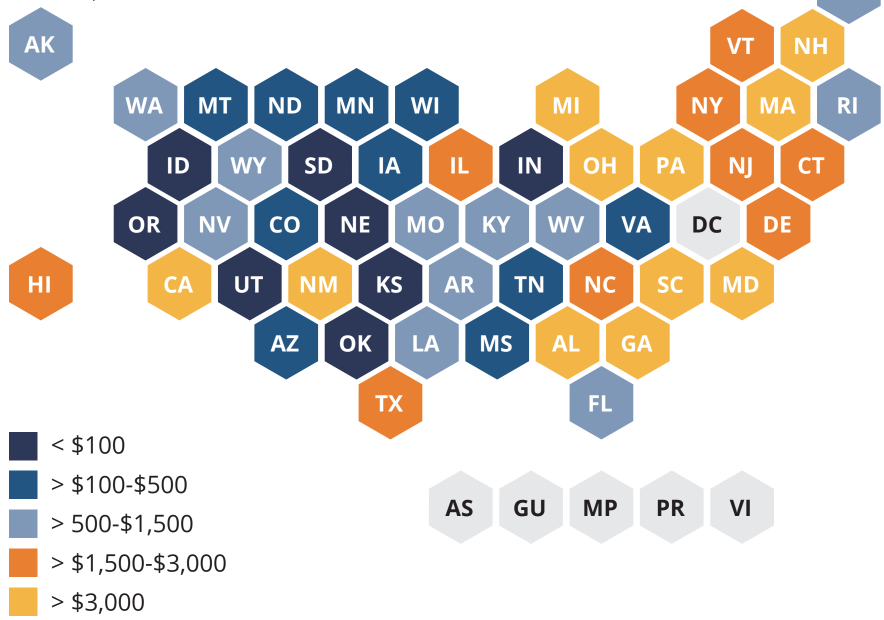
This shortfall poses a serious risk to state balance sheets and credit ratings, according to various analysts. S&P Global Ratings found total unfunded retiree health care liabilities for U.S. states fell by 7.3% in fiscal 2018 to $628 billion. S&P expects unfunded liabilities to escalate in the future, however, absent substantial funding improvements or benefit reductions. It found that combined annual plan contributions do not cover new benefits earned during the year and interest accrued on the unfunded portion of the liability for 45 of 48 states it surveyed.

With an eye toward enhanced transparency, the Governmental Accounting Standards Board (GASB) approved new guidance that applies to OPEB plans and participating governments in 2015. Echoing changes for pensions, Statements No. 74 and 75 shift the financial reporting framework for OPEB plan liabilities and require more extensive disclosures. These include how actual OPEB contributions compare with required ones and the effect of different actuarial assumptions about demographics and economic performance.

For most states, OPEBs currently represent a relatively small percentage of state spending, but this can range from nearly zero to over 5% of expenditures.

Unfunded Liabilities for Other Post-Employment Benefits

Per capita in FY 2017



Source: NASRA/SLGE, U.S. Census Bureau

State Action

Often adopted through rule change, recent retiree health care benefit reforms have introduced new, less generous coverage tiers and eliminated subsidies for some participants altogether. But as some states slash OPEBs, many are taking steps toward prefunding benefits by creating irrevocable retiree health care trusts. By 2015, at least 35 states had created one of these trusts.

Some states, including Kansas, Nebraska and South Dakota, do not offer a retiree health insurance subsidy. Kansas abolished its health care subsidy for non-Medicare-eligible retirees beginning in 2017. New Mexico has tightened OPEB eligibility requirements, while 2017 legislation in North Carolina eliminated retiree medical benefits for employees first hired after Jan. 1, 2021.

Effective in 2019, Ohio discontinued Medicare Part B premium reimbursements for its state teacher retirees and replaced group health insurance coverage with a fixed monthly stipend for its police and fire retirees. Meanwhile, retirees in the Ohio Public Employees Retirement System will shoulder higher costs for health care beginning in 2022, following a vote by the system's board earlier this year.

Importantly, Ohio is one of the few states that has made meaningful headway toward prefunding its OPEB obligations (its funded ratio exceeds 50%). Hawaii also committed to prefunding its OPEB benefits with the passage of Act 268 in 2013. The timing and magnitude of savings that the states could realize will depend on how investments and financial markets perform, as well as trends in health care costs.

Additional Resources

- "State OPEB Plan Designs," National Association of State Retirement Administrators (NASRA)
- "Other Post-Employment Benefits by State," NASRA/SLGE
- "Legal Protections for State Pension and Retiree Health Benefits," The Pew Charitable Trusts
- "Healthcare Promises for Public Employees," Arizona Law Review

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