The Research Bureau

Other Post-Employment Benefits (OPEB)

Holding Government Liable

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Research in the Public Interest

Worcester Regional Research Bureau, Inc.
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Worcester's Unfunded OPEB Liability 2016-2017:

$860,873,100

Upon retirement, Massachusetts state and municipal employees may be eligible for both pension and other post-employment benefits (OPEB), such as health care. Each year, Massachusetts governmental entities must determine current costs (pension and benefits provided to existing retirees) and future costs (pension and benefits to be provided during retirement of current employees, as determined by actuaries) to determine total liability.

The City of Worcester, like most municipalities, has struggled with outstanding pension and OPEB liabilities. In 1992, the Commonwealth of Massachusetts offered grant funding to cities and towns that committed to a schedule to eliminate unfunded pension liability. The City of Worcester accepted the offer, committing itself to full pension funding by 2028. In 2010, in light of the financial downturn, the Commonwealth offered cities and towns a waiver on the original plans, allowing Worcester to extend its schedule to 2032. As of June 30, 2016, the City had funded approximately 62% of its pension obligation based on the actuarial value of assets.

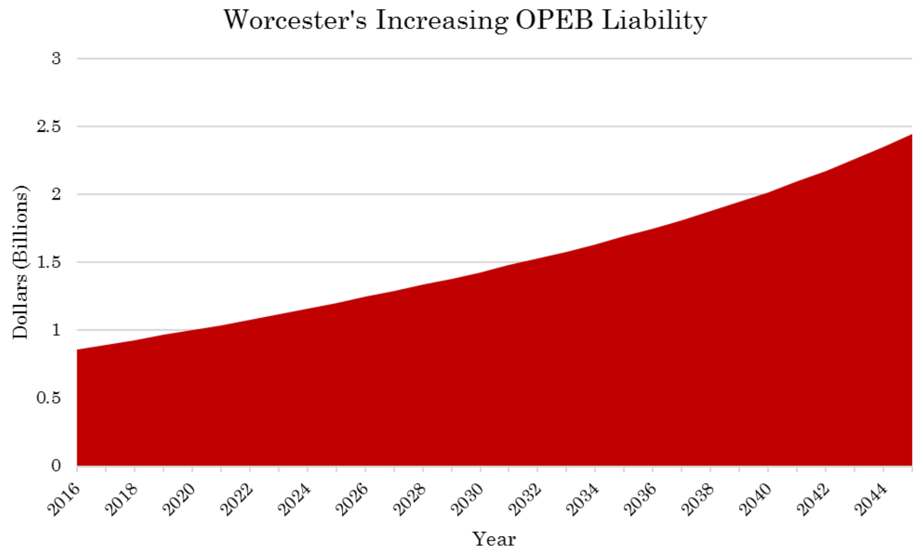
As a result of its failure to systematically address OPEB, the City of Worcester is currently $281,267,948 in arrears on a 30-year program to retire its OPEB liability.

Unlike pension obligations, Massachusetts does not mandate that municipalities address OPEB liabilities. Yet it does compel localities to follow the procedures and protocols disseminated by the Government Accounting Standards Board (GASB). GASB Statement 45 requires that municipalities calculate and report current OPEB liability and determine an annual payment (the "Annual Required Contribution" or "ARC") for fully funding OPEB over 30 years. While municipalities must disclose the obligation, Massachusetts cities and towns are not required to make ARC payments or any other payment toward OPEB liability. The City of Worcester's current OPEB liability—$860 million—is essentially unfunded, with $8,896,391 (or 1% of total liability) in assets as of June 30, 2016. This liability is generated by the City's 4,146 active employees potentially eligible for future benefits and the 5,083 retired employees or their survivors currently receiving benefits.

The City functions on a pay-as-you-go system, with OPEB payments to retirees allocated annually within the City budget. The City's Five Point Financial Plan lays out the City's OPEB liability funding policy which commits 30% of free cash—surplus funds remaining after the end of the fiscal year—for deposit in an OPEB account. If free cash is not available, funds are generally not contributed. In FY2017, the City did take the unusual and commendable step of budgeting $500,000 directly for the OPEB Trust. To comply with the ARC, however, the City would have needed to set aside an additional $51,209,189.

Worcester's OPEB liability increases annually as new employees vest and become eligible for post-employment benefits, current retirees live longer, and health insurance costs rise. With no new efforts to reduce OPEB obligations, the City's liability will reach more than $2.5 billion in 30 years (Figure 1).

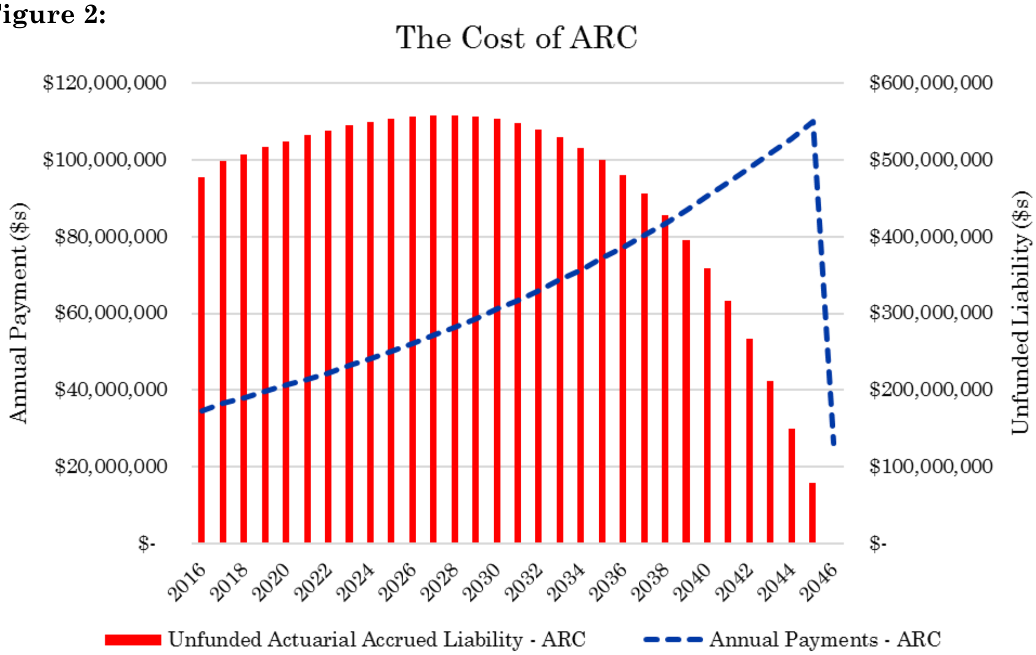
Figure 1:



Source: KMS Actuaries, LLC, *City of Worcester Other Postemployment Benefits Program, Actuarial Valuation,* July 1, 2015.

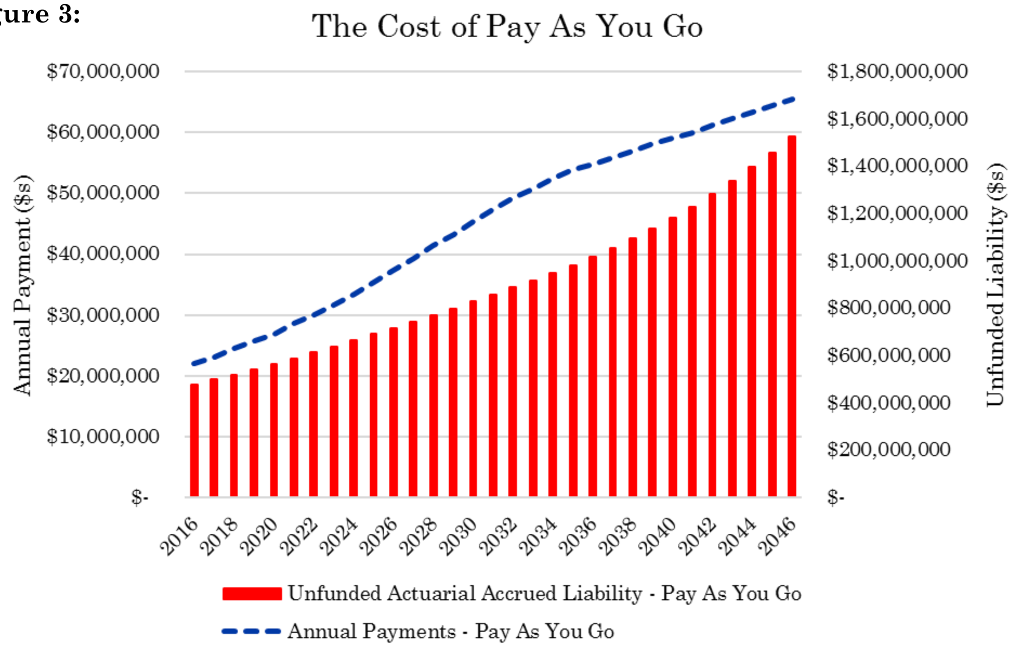
When dealing with such significant dollar figures, GASB Statement 45's ARC is admittedly not a simple solution to the OPEB liability dilemma. A commitment to full ARC payments over 30 years would still require a $38 million contribution in FY2018, which would rise to over $110 million in the final few years of payment. Without the ARC, however, the City's unfunded liability continues to grow unchecked. If the ARC were implemented, unfunded liability would continue to rise for about a decade before falling to $0 over the following 20 years. Thereafter, the City would only be responsible for paying the "normal cost" on an annual basis, or the liability generated by that year's current employees—an estimated $24 million at that time. Without the ARC, the City is responsible for paying the actual benefit payments for retirees on an annual basis—an estimated $66 million at that same time (Figures 2 & 3).

Figure 2:



Source: KMS Actuaries, LLC, *City of Worcester Other Postemployment Benefits Program, Actuarial Valuation,* July 1, 2015.

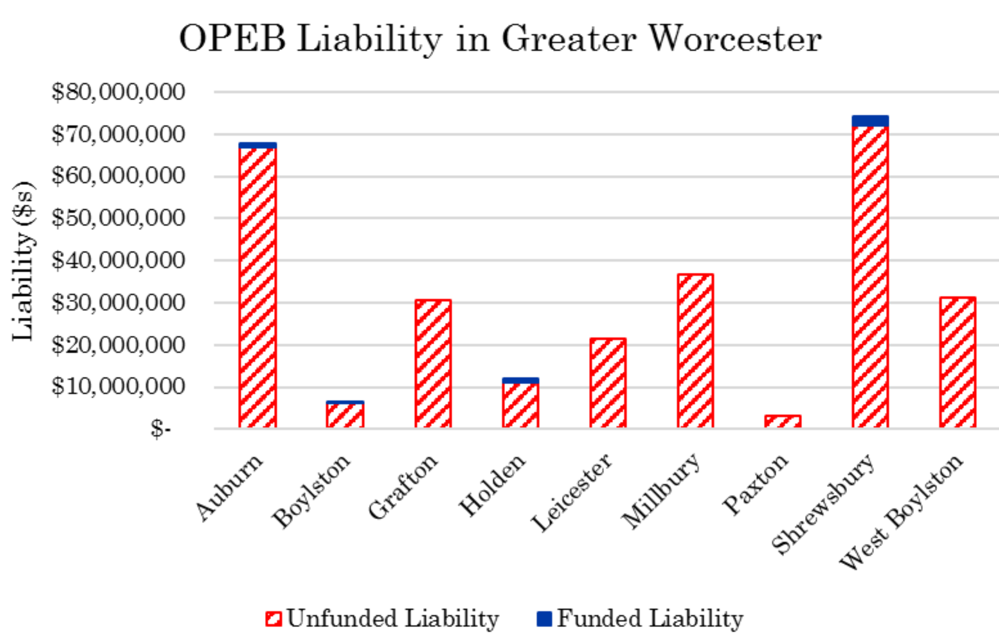
Figure 3:



Source: KMS Actuaries, LLC, *City of Worcester Other Postemployment Benefits Program, Actuarial Valuation,* July 1, 2015.

Worcester is not alone in its OPEB challenges. While the scale of OPEB liability differs significantly in Greater Worcester communities, no neighboring community has funded its liability obligations by more than 10%. Holden, with an overall liability of $11.2 million, has made the most progress, but with only 6.5% coverage (Figure 4). When comparing unfunded OPEB liability to each community's total assessed property value—the tax base that will ultimately be burdened with paying for any liabilities—Holden also does better than its peers (Table 1).

Figure 4:



Source: Public Employee Retirement Administration Commission, *OPEB Summary Report*, September 2016. (PERAC)

Table 1:

Municipality	Unfunded OPEB Liability as a % of Total Assessed Property Value (FY16)
Worcester	6.5%
West Boylston	3.6%
Auburn	3.5%
Millbury	2.6%
Leicester	2.4%
Grafton	1.4%
Shrewsbury	1.4%
Boylston	1.0%
Paxton	0.7%
Holden	0.6%

Sources: PERAC and Massachusetts Department of Revenue

The Bureau's View

While cities and towns are not legally required to fund OPEB liability, the ever-increasing cost of annual post-employment benefit payments has the potential to impact future municipal solvency. OPEB is currently an unsustainable pay-as-you-go system that may ultimately force municipalities to reduce staffing, reduce services, and increase taxes to cover annual retiree costs. The problem only grows with time. According to a study by the Kaiser Family Foundation (KFF), while 66% of large employers offered retiree health coverage in 1988, only 23% did so in 2015.* It is simply too costly.

Worcester and its neighboring communities should lay out plans and take steps to intentionally and strategically 1) reduce the current liability, 2) fund the overall liability, 3) reduce the future number of eligible individuals, and 4) eliminate the ongoing obligation of retiree health care.

1. Municipalities can reduce current OPEB liability by expanding cost-sharing requirements. Increases in the contribution rates on premiums and new plans with higher co-payments could lower the outstanding liability. Massachusetts municipalities have the authority to modify retiree contribution rates to 50% without engaging in collective bargaining; Worcester's retirees currently contribute 25% of the premium cost.** To mitigate the impact of an increase, communities should call on the Commonwealth to transform OPEB into a means-tested system, whereby retiree contributions are increased on a sliding-scale based on income. Currently, municipalities contribute the same amount toward individual retiree health care whether the retiree receives a $10,000 or $100,000 pension. A sliding-scale could reduce cost increases on those with limited incomes and likely create a more equitable system than currently exists.
2. Municipalities can begin funding the overall liability first by establishing an irrevocable OPEB Liability Trust Fund in accordance with Massachusetts General Laws Chapter 32B, Section 20. While Worcester maintains an OPEB Trust account, it does not meet the standards of Section 20. As in the City of Worcester's FY17 Budget, OPEB Trust contributions should be funded through the annual budget as well as free cash. While challenging, municipalities should craft a schedule to phase in full funding for the ARC, capitalizing on savings as outstanding pension obligations become fully funded. In the near term, communities could commit to funding the normal cost of new hires, laying the groundwork for full funding for all staff in the future.

*2015 Employer Health Benefits Survey, Kaiser Family Foundation, September 2015. **Retirees age 65 and older pay 100% of the premium in 40% of health plans and 0% of the premium in 14% of health plans. The average retiree share of the premium among the 46% of plans in which employers and retirees split costs is 38%. Frank McArdle with Tricia Neumann and Jennifer Huang, *Retiree Health Benefits at the Crossroads*, Kaiser Family Foundation, April 2014.

3. Municipalities can reduce the number of retirees by identifying opportunities to outsource or privatize certain municipal functions—reducing the number of staff and therefore retirees eligible for pension and health care benefits. While a number of municipal operations are unique to cities and towns, some universal administrative or operational activities such as human resources or legal support might be supplemented by private contract. While likely requiring state approval, extending the period before an employee vests (currently ten years from date of hire) or increasing the number of weekly work hours required for eligibility (currently 20 hours, excluding teachers) would also reduce the number of OPEB-eligible retirees.
4. Working with the Commonwealth, municipalities must develop a comprehensive plan to eliminate OPEB. While not yet forcing immediate action, GASB Statement 45 highlights the significant danger that post-employment programs like OPEB pose for future municipal budgets. The public sector must embrace a defined contribution—rather than a defined benefit—approach to retirement. Respecting the interests of current and imminent retirees reliant on the post-employment health care benefit to make household finances work, Worcester and its neighboring communities should look at creative ways to transition from an employer-sponsored retiree health care system. Admittedly, it is likely a long-term approach. Eliminating OPEB for new employees is a start, but it could require six or more decades to phase out current employees. A buyout might tempt some current retirees to exchange up-front payments for long-term health care assistance. As an alternative to OPEB, municipalities should explore retiree medical savings accounts, which can be used for premiums, and health savings accounts, which can be used for qualified health expenses.

Worcester faces an OPEB liability significantly larger the City's entire annual budget. It is unsustainable. Local governments, like all governments, must adopt systems whereby costs are paid as they are incurred and not deferred to future generations. A defined contribution post-employment system rather than a defined benefit system is needed. The OPEB liability will be a difficult challenge for Greater Worcester communities for decades to come. It requires intentional and strategic action today, or it will one day prove insurmountable.

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The Research Bureau serves the public interest of Greater Worcester by conducting independent, non-partisan research and analysis of public policy issues to promote informed public debate and decision-making.

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