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Iceberg Ahead

The Hidden Cost of Public-Sector Retiree Health Benefits in New York

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EXECUTIVE SUMMARY

New York taxpayers spend billions of dollars a year on health insurance coverage for retired state and local government employees, many of whom are too young to be eligible for Medicare. But the mounting "pay-as-you-go" bill for retiree healthcare is just the tip of a much larger iceberg.

Thanks to a new government accounting standard, the true cost of this long-term entitlement is finally emerging from the depths of state and local finances. Based on a review of financial reports for the state and its largest local governments, school districts and public authorities, this report estimates that New York's total unfunded liability for public-sector retiree health insurance comes to nearly **$250 billion**.

This figure represents a mammoth potential transfer of wealth from future taxpayers to current government employees and retirees—for a type of benefit that is not available to the vast majority of private-sector workers.

The burden of retiree health care is clearly unsustainable and unaffordable. This report, designed as a primer on the issue for taxpayers and government officials, recommends a four-step plan for curbing retiree health care costs before it is too late.

About the Author

E.J. McMahon is a senior fellow of the Manhattan Institute for Policy Research and its Empire Center for New York State Policy. His recent work has focused on state budget issues, tax policy, public pension reform, collective bargaining, competitive contracting of public services and the fiscal record of the Pataki and Spitzer-Paterson administrations. McMahon's professional background includes more than 25 years as a senior policy maker and analyst of New York government. Prior to joining the Manhattan Institute in 2000, he served as Deputy Commissioner for Tax Policy Analysis and Counselor to the Commissioner in the state Department of Taxation and Finance; Director of Minority Staff for the state Assembly Ways and Means Committee; vice chancellor for external relations at the State University of New York; and Director of Research for The Business Council's research arm, the Public Policy Institute. He is a regular opinion columnist for *Newsday*, and his articles also have appeared in the *New York Post*, the *Wall Street Journal*, Barron's, the *Public Interest*, The *New York Times*, the *New York Daily News* and the *New York Sun*, among other publications.

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INTRODUCTION

New York taxpayers spend billions of dollars a year on health insurance coverage for retired state and local government employees, many of whom are too young to be eligible for Medicare.[1] Classified by accountants as Other Post-Employment Benefits, or OPEB, retiree health insurance is rarely offered by private sector employers—but it's among the fastest-growing components of public-sector employee compensation at every level of government. OPEB accounts for nearly 40 percent of annual employee health benefit costs at the state level, and for more than one-third of the annual total in New York City. Buffalo, the state's second largest city, already spends more every year on retiree health insurance than on coverage for active workers.

But the annual "pay-go" expense of health insurance for retired employees is just the tip of a very large iceberg. Under current laws and contracts, most of New York's 1.3 million state and local government employees can look forward to receiving taxpayer-subsidized health coverage for the rest of their lives. This amounts to a mammoth wealth transfer from future taxpayers to current employees.

Thanks to a new government accounting standard, the true cost of this long-term entitlement is finally emerging from the murky depths of state and local finances. The unfunded retiree health care liability for New York's 89 largest state and local government employers totals at least **$210 billion**, according to their most recent financial reports.[2] These estimates suggest the total unfunded liability for all of New York's state and local employers comes to nearly **$250 billion**, as shown below.

Table 1. Summary of Unfunded Retiree Health Care Liabilities in New York State

	($000's)
New York State	73,181,000
New York City	83,900,000
Largest local governments other than New York City	
Counties	17,188,141
Cities	5,527,969
School Districts	7,427,685
Towns	2,925,874
Villages	819,394
Largest public authorities	19,093,138
Subtotal: Officially reported liabilities	**$210,063,201**
All other local governments and school districts (estimate)	39,720,688
	$249,783,889

Sources: Unfunded Actuarial Accrued Liabilities as reported in most recent official statements and financial disclosure reports posted by Electronic Municipal Market Access website of the Municipal Securities Rulemaking Board, emma.msrb.org. New York State estimate for April 1, 2010. Estimates for "all others" are extrapolated from data in reports for largest employers, assuming OPEB liabilities of other employers are distributed in proportion to total medical benefits and personal service expenditures as reported to the Office of the State Comptroller, adjusted to reflect the percentage of employers in each category offering retiree health coverage.

In other words, New York's state and local governments have promised about one-quarter of a trillion dollars in post-retirement health care coverage that they have set aside no money to pay for. Thanks to its relatively large government payrolls and generous benefits, New York represents an outsized chunk of a nationwide state and local unfunded OPEB liability estimated at between $1 trillion and $1.5 trillion.[3]

New York's largest cities and counties all have massive unfunded liabilities for retiree health care. New York City leads the pack with a net OPEB liability of nearly $84 billion as of June 30, 2011. In fact, since the new accounting standard first took effect in 2007, the state of California has been the only government employer in the country to report a larger unfunded retiree healthcare liability than New York City's.[4] New York's state government OPEB liability, which stood at $73 billion as of April 1, 2010, has been third largest among the nation's public employers. The state's 20 largest counties have combined OPEB liabilities exceeding $17 billion, and the Metropolitan Transportation Authority (MTA) alone has promised nearly $18 billion in future retiree health benefits.

Potential for change

Unlike pension benefits—which pose a growing financial problem of their own—the OPEB promises of New York's public employers are not collectively pooled and partially pre-funded out of a few large multi-employer trust funds. Each of the literally thousands of local government units, special districts and public authorities in New York State is fully and solely responsible for its own retiree health care promises.

Because these liabilities are now beginning to count against government balance sheets, OPEB poses a more direct threat to their solvency than rising pension costs. The economic decline of upstate cities such as Buffalo will only accelerate if they continue to pile a growing OPEB burden onto their shrinking tax bases. Even in more affluent suburban areas, the rising cost of health insurance for retirees and their dependents threatens to consume more and more scarce resources needed to fund basic services.

Unfunded liabilities for retiree health coverage are starting to erode the balance sheets of state and local governments, undermining their fiscal solvency to an even greater degree than rising pension costs.

The good news for New York taxpayers is that public-sector retiree health benefits, unlike pensions, are not guaranteed by the state Constitution. Elected officials can still change course on retiree health care by restructuring benefits for both current retirees and active employees.

As reviewed in this report, a few elected officials around the state have tried to get a grip on the problem. Most, however, are steaming full-speed ahead on a collision course with financial reality. It certainly doesn't help that current New York State law restricts the ability of public employers to sequester money in trust funds to pay for future retiree health costs. Efforts to curb retiree health care costs also are hindered by the Tier 5 pension "reform" law, which has locked an estimated $38 billion of long-term OPEB liabilities into school district collective bargaining agreements.

Unions representing other types of local government employees have been lobbying for similar "protection."

In fact, the vast majority of New York taxpayers work for private firms that do not offer *any* retiree health coverage. Even compared with the shrinking number of private employers that still offer such a benefit, retiree health coverage in New York's public sector is significantly more generous; for retirees of New York City and an untallied number of local governments, retiree health care is free of charge.

Charting a new course

This report — updating one issued by the Empire Center in September 2010 — is intended as a guide to the OPEB funding issue for elected officials, the news media, and the general public in New York. The first section summarizes the current array of benefits available to the state's retired public employees. The second section explains how the new accounting rule works, and highlights estimated health care liabilities for the state and its largest public employers. The third and final section presents four steps to retiree health care reform, designed to fairly balance the interests of government workers and their ultimate employers—New York's heavily burdened taxpayers.

Those steps can be summarized as follows:

1. Preserve health benefits for employees who have already retired, but require them to pay a larger share of their own premiums.

2. Reserve the greatest benefit to those who have worked the longest.

3. Establish trust funds to cover adjusted OPEB liabilities, but calculate required contributions to these funds based on assumed returns from conservative, low-risk investment strategies.

4. Eliminate retiree health insurance coverage for all new hires and for employees who have been on the payroll for less than 10 years, and shift these workers into a retirement medical trust. Government workers would make tax-free contributions to accounts managed by their unions, which would pool and invest the money to cover medical expenses.

The state government's OPEB reform strategy can serve as a model for other levels of government, linked to other statutory changes establishing minimum health insurance premium contributions for all employees and prohibiting collective bargaining of retiree benefits.

As summed up by the legal boilerplate in many government financial statements: "These [OPEB] costs may be expected to rise substantially in the future." Governments need to act sooner rather than later to chart a new course for retiree benefits that will avoid potential fiscal shipwrecks in the future.

1. CURRENT RETIREE COVERAGE

Public-sector workers in New York are generally entitled to much more generous fringe benefits than their counterparts in the private sector. These include constitutionally guaranteed pensions, which provide a stream of post-retirement income to all employees who achieve a minimum vesting period.

In addition to pensions, the vast majority of state and local government employees in New York are eligible for other post-employment benefits (OPEB).[5] These benefits consist principally of employer-sponsored health insurance coverage—often including prescription drugs as well as hospitalization and major medical care. (Throughout this report, "OPEB" and "retiree health benefits" will be used interchangeably.)

Pensions are based on length of service, with the biggest benefits flowing to those who have worked the longest. However, as explained below, most of New York's state and local governments offer the same full employee health coverage to all vested retirees, regardless of years of service. Early retirees, who have not reached the Medicare eligibility age of 65, comprise a disproportionately large share of public-sector retiree health costs.

Like pensions, health coverage in retirement is a form of deferred compensation – earned now, paid later. Yet, for decades, the entire bill for current retiree health care promises in New York has been routinely shifted to future taxpayers.

State & local government benefits

While there is no comprehensive source of information on retirement health benefits offered by New York's 3,200 government employers, survey data and financial statements indicate most state and local workers belong to health plans sharing at least these elements:

- Members of a public-sector employee health insurance plan can remain in that plan if they are eligible to begin collecting a public pension and belong to a public employer health plan when they retire, after putting in a minimum of five to 15 years of government service.

- Health insurance premiums for retirees, including those for supplemental Medicare coverage, are heavily subsidized if not fully paid for by employers.

- Retiree health insurance is budgeted as a current expense and financed on a pay-as-you-go basis, usually combined with health insurance for active workers in the general budget category of employee benefits.

The leading source of retiree benefits for government workers in New York is the New York State Health Insurance Program (NYSHIP), administered by the state Department of Civil Service. NYSHIP consists of a broad indemnity program known as the Empire Plan, plus an array of managed-care options offered by HMOs on a regional basis. NYSHIP, the sole source of health insurance for state employees, is also open to local governments and public authorities.

NYSHIP provides benefits to over 1.2 million state and local government retirees and their dependents. Nearly one-third of NYSHIP's members are current or retired employees of state government agencies, including the State University of New York. The rest are current or retired employees of the more than 800 local governments and other participating agencies also offering Empire Plan benefits. (Another 2,400 entities—roughly two-thirds of the state's government employers--are covered by different plans whose costs and benefits have not been centrally tallied by the state.)

When NYSHIP was first created in 1957, the employer share of the premium was 50 percent for individual coverage and 35 percent for additional dependent coverage. The employer share grew over time; for employees hired prior to 1983, the state pays 100 percent of the premium for individual coverage. From 1983 to 2011, the employer share has been set at 90 percent for individual coverage and 75 percent of additional dependent coverage. Under contracts negotiated by the state government's largest unions in 2011, those percentages were decreased to a range of 84 to 88 percent and 69 to 73 percent, respectively, with higher-salaried workers paying the biggest increases in premiums. The minimum employer contribution for local agencies participating in NYSHIP is still set at the original levels of 35 to 50 percent, but can go as high as 100 percent.

There is no central source of information on employee contribution rates at the local level, but many of the largest plans are similar to the state plan, which yields an average employer premium share of at least 78 percent for active workers. To remain eligible as a retiree for continuing subsidized health insurance on the same basis as an active employee, a state worker must have spent at least 10 years on the state payroll and must have reached the minimum retirement age, which is 55 for the vast majority of current employees other than police and corrections officers. (The minimum retirement age is 62 for non-police and fire employees hired between Jan. 1, 2010 and March 31, 2012, 63 for workers hired after April 1, 2012.)

State employees can apply their unused sick time to offset health insurance premiums once they retire. This reduces the retiree share of premiums by 6%, on average.

State employees can apply the value of up to 200 unused sick days to further reduce their share of NYSHIP health insurance premiums once they retire. Since most civil servants are entitled to at least eight sick days a year, and since few need to use all those days, this generates significant additional savings for many retirees. The average sick leave credit claimed by fiscal 2007 state retirees amounted to $110 a month--enough to pay the full employee share of an individual premium in the Empire Plan, or fully half the employee share for family coverage. Sick leave credits offset six percent of the premium cost for retiree health insurance, leaving retirees to pay nine percent of the premium, according to the Department of Civil Service.

NYSHIP charges the same premium for all plan members, active and retired. This means that active workers subsidize premiums for retirees, whose health care costs are generally higher. In addition, as noted, retirees can further defray their own contributions with sick leave benefits. If NYSHIP premiums for family coverage reflected claims experience, early retirees would be paying 45 percent more, and active employees would be paying 5 percent less.[6]

Big Apple benefits

New York State's largest public employer, the City of New York, sponsors its own self-insured employee health insurance coverage. Like NYSHIP, the New York City Health Benefits Program consists of both a comprehensive indemnity program and a variety of managed-care options. Prescription drug, dental, eye care and other benefits are provided by union-run "welfare funds" subsidized by the city. The city government is even more generous than the state--covering 100 percent of both individual and family premiums for basic coverage.

Eligibility guidelines for the city plans are similar to those on the state level: employees qualify for continuing health coverage if they are eligible for a pension and retire after at least 10 years on the city payroll (or 15 years in the case of newly hired teachers starting in 2009.) Employees hired before Dec. 28, 2001, can qualify for a lifetime of free health benefits after just five years of working more than 20 hours a week for the city.

Both the state and city health care plans have an important additional caveat: continuing coverage is available only to employees who are members or "vestees" of the health plans at the time of their retirement. In other words, former city or state workers who otherwise qualify for a public pension cannot receive health coverage if they retire from another place of employment. As will be noted later, this creates a significant incentive for former state and city workers who have already attained the minimum 5- or 10-year service period to get back on a government payroll before reaching the minimum government retirement age, as a way of qualifying for subsidized health benefits.

Medicare interaction

The federal Medicare program offers health insurance coverage to all Americans 65 or older. Under the original two-part Medicare program, Part A provides insurance that can help pay for inpatient hospital care, inpatient care in a skilled nursing facility, home health care, and hospice care. Part B covers medically necessary physicians' services, outpatient hospital services, home health services and a number of other medical services and supplies that are not covered by the hospital insurance part of Medicare. The Part D program, effective in 2006, covers prescription drugs.

Under both the New York State and New York City employee insurance plans, Medicare is treated as "primary" insurance for all retired employees aged 65 or older; in other words, the state and city will pay for no cost that is already covered by Medicare.

With Medicare in place as the primary payer for most over-65 government retirees in New York, why does health coverage for retired workers cost so much? The answers:

- Since Medicare Parts A and B include substantial co-pays and deductibles for hospital and physician care, along with limits on hospital and nursing home stays, those two parts of the program leave uncovered a substantial share of health care costs of the elderly. The New York State and New York City employee health insurance plans make up the difference, providing what amounts to supplemental "Medigap" coverage for their retired members.

- While Medicare Part A is financed through a payroll tax, roughly 25 percent of Medicare Part B costs are financed by premiums charged to beneficiaries. Both New York State and New York City, as well as many local employers, also cover the entire Part B premium for their retired workers. As of 2012, the premium was set at $99.90 a month.

- Most state and local government workers retire years before they are eligible for Medicare. As noted, members of the state and city pension systems can retire as young as 55. Police officers and firefighters can retire when still in their 40s after as few as 20 years of work. For this reason, retiree health care costs tend to be highest for cities and counties, which employ the highest concentration of public safety officers. Early retirees were barely one-third of all retirees in NYSHIP'S statewide Empire Plan but accounted for more than half of the Empire Plan's gross claims in 2005.[7]

The legal status of OPEB

Article V, Section 7 of New York's state constitution treats pension income as a contractual entitlement that cannot be "diminished or impaired." However, the state's highest court has ruled that this provision does not apply to retiree health insurance.[8] The legal status of retiree health benefits varies by employer, as determined in a series of other state court decisions over the past 30 years. This much is clear:

1. Under the state Taylor Law, employee health insurance is a mandatory subject of collective bargaining between government employers and public employee unions.[9]

2. Unions do not represent retired employees, but unions can bargain with government employers over the benefits that active employees will receive after they retire.

3. In cases where retiree health benefits have been stipulated in a union contract, they can only be changed through collective bargaining.

4. If retiree health benefits are not stipulated in a union contract, they can be restructured, reduced or eliminated by an employer unilaterally, without collective bargaining.

In many local jurisdictions across the state, retiree health benefits for public employees were granted by laws or resolutions but have *not* been enshrined in union contracts. In other cases, only a portion of the benefits can be considered contractual.

For example, New York's collective bargaining agreements with its largest state employee unions, the Civil Service Employees Association (CSEA) and Public Employee Federation (PEF), give employees covered by NYSHIP plans "the right to retain health insurance after retirement upon completion of ten years of service." The contracts also create the entitlement to "a sick leave credit to be used to defray any employee contribution toward the cost of the premium."

Crucially, however, these contracts do not stipulate that retirees are entitled to the *same* coverage under the *same* terms as active employees. Benefit levels for retired state workers, including premium shares and reimbursement for Medicare Part B premiums, are determined by a combination of state law, NYSHIP plan design, and other regulations. This means the governor and the Legislature retain considerable leeway to unilaterally reduce the state's massive OPEB liability by restructuring benefits for retirees. In fact, both Governor David Paterson and Governor Andrew Cuomo have attempted do to just that (see "False Starts, Sidesteps and Baby Steps in Albany" on p. 20).

Public school retirees are an exception to this rule, however. Under a temporary law first enacted in 1994 and regularly extended thereafter, the governing boards of school districts outside New York City have been barred from making any change in retiree health benefits unless the same change is collectively bargained for active employees, regardless of whether those benefits were contractual to begin with. This restriction was made permanent as part of a pension "reform" law passed with Governor Paterson's support in late 2009.

The bottom line

Given the constitutional prohibition on diminishment or impairment of pensions, changes in pension benefits, such as the newly enacted Tier 6 plan, have only applied to newly hired employees. As a result, these changes take many years to produce significant savings.

Unlike pensions, however, retiree health benefits for government employees can be restructured in ways that produce bigger savings sooner. This is especially true in situations where the benefits were established by local law or custom. Even in school districts and localities where retiree health benefits are contractually created, change is at least possible – if employers are sufficiently determined to make it an issue at the bargaining table.

Retiree health coverage, unlike public pensions, can be reformed and restructured for current beneficiaries, subject to contractual constraints that vary by employer.

It's critically important for taxpayers and their elected representatives to understand the difference in both legal and financial status between pensions and retiree health benefits. As noted, while pensions are largely pre-funded, the prevailing method of funding and accounting for retiree health insurance means the cost of current compensation is being both obscured and shifted to future taxpayers.

Benefit comparisons

Health benefits for retirees are increasingly uncommon in the private sector. Only 28 percent of firms with more than 200 employees, and 3 percent of smaller firms, offered health benefits to any retirees as of 2010.[10] Even among larger firms offering such coverage, retired employees are asked to share more of the cost burden than their government counterparts. For example, only 8 percent of the largest employers replicate New York City's practice of insuring early retires completely free of charge, according to a recent survey. New York State covers an average of 91 percent of premiums for all retirees; in the private sector, by contrast, early retirees in large employer plans must pay an average of 51 percent of their medical costs.[11]

One of the reasons for the drop in retiree health coverage among private firms was the implementation in the early 1990s of an accounting rule requiring corporations to begin measuring the long-term liabilities associated with their OPEB costs. As those liabilities began hitting corporate balance sheets, many firms responded by reducing benefits or eliminating them altogether. (The private sector OPEB accounting rule was the inspiration for the similar standard adopted more recently in the public-sector, as explained in the next section.)

In some significant respects, state and local retiree health benefits in New York are more generous than those available to federal employees. For example, the federal government covers only 72 percent of the health insurance premium—and, notably, not Medicare Part B premiums—for its retired employees. On the other hand, federal employees can qualify for continuing health coverage if they retire after only five years, which is half the vesting period for New York State employees and city workers hired since 2001.

Most state and local government employees are entitled to a package of generous retirement benefits that their private sector counterparts can only dream of.

New York's state and local retiree health benefit packages also are more generous in key areas than those offered in many other states. Only five states, other than New York, reimburse the Medicare Part B premium for all retired employees.[12]

Combined with guaranteed pensions, health benefits give retired public employees a deferred compensation package that most of their private sector counterparts can only dream of. For example, a $60,000-a-year Tier 3 or 4 retirement system member (hired since 1976 but before 2010) who retires at age 55 after 30 years on the state government payroll is entitled to a $36,000-a-year pension – the equivalent of a job paying nearly $40,000, since pension income is exempt from both payroll taxes and state income tax. On top of that, she can retain NYSHIP health insurance currently priced at roughly $14,000 a year for family coverage, while contributing little or nothing to the premium. In 10 more years, when she becomes a Medicare enrollee at 65, her Part B premium will be fully reimbursed and the NYSHIP plan will cover the holes in Medicare.

Free or steeply discounted health insurance starting in early retirement is not a bad deal, to say the least. But it's also a very costly one for taxpayers.

2. GASPING AT GASB

State and local government finances typically command the public spotlight at budget-making time, when elected officials decide how to raise and spend the taxpayers' money. But government budget documents can be both superficial and misleading. They typically understate both the current costs and long-term obligations associated with employment compensation, in particular. A balanced budget does not mean a government is financially sound in the long run.

For a more comprehensive view of a government's financial condition, credit analysts and potential bond buyers turn to the information in annual financial reports and bond offering statements. Subject to uniform standards, these documents don't simply list annual revenues and expenditures. They also include balance sheets tallying up the value of assets (such as property, equipment, and accounts receivable) and liabilities (such as accounts payable and outstanding debt). Accompanying these tables are narrative "notes" providing essential additional background and explanation for the numbers. Because they also serve as disclosure documents, subject to federal anti-fraud statutes, they are held to a fairly high standard of accuracy.

The main elements of public sector financial reports are effectively mandated by an independent rule-making body, the Government Accounting Standards Board (GASB), which determines the Generally Accepted Accounting Principles (GAAP) used in financial statements by state and local governments.[13] A GASB rule, first effective in 2007, now forces government officials to begin reckoning with the true costs of the promises they have been making to their workers.

What's in a liability?

Like most of their counterparts across the country, New York and its local governments pay for current retiree benefits out of their annual budgets, a practice also known as "pay-as-you-go," or simply "pay-go." They also typically lump health insurance premiums for both retirees and active employees into a single category of current expenditures. The cost of the retiree health insurance coverage promised to current workers has been ignored in part because the current cost has been obscured. Table 2 breaks out these costs for New York State and New York City.

Table 2. Actual and Projected Annual Health-Related Benefit Costs

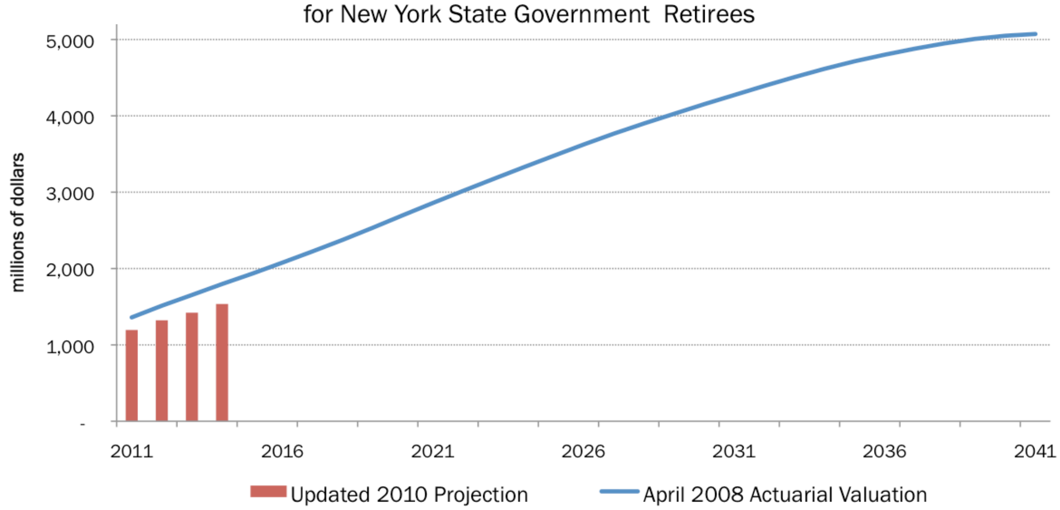
(in millions of dollars)

	New York State			New York City		
FY Ending	Active Employees	Retired Employees	Total	Active Employees	Retired Employees	Total
2006	1,331	885	2,216	2,580	1,200	3,780
2007	1,518	913	2,431	2,730	1,430	4,160
2008	1,390	1,182	2,572	2,940	1,450	4,390
2009	1,639	1,068	2,707	3,170	1,510	4,680
2010	1,542	1,139	2,681	3,450	1,680	5,130
2011	1,826	1,195	3,021	3,650	1,730	5,380
2012	2,052	1,223	3,275	3,920	1,890	5,810
2013	1,987	1,215	3,202	4,160	2,070	6,230
2014	2,132	1,279	3,411	4,430	2,260	6,690
2015	2,294	1,376	3,670	4,800	2,460	7,260
2016	2,469	1,482	3,951	5,190	2,680	7,870

Source: NYS Division of the Budget; NYC Comptroller; NYC Office of Management and Budget. July 2012 forecasts.

These annual outlays—a continual shift of past liabilities into the present—are steadily rising and are projected to continue rising in the future. Figure 1 illustrates the projected annual retiree health care cost trend for the state government.

Figure 1. The Shape of Things to Come?
Projected Annual "Pay-Go" Cost of Health Coverage
for New York State Government Retirees



Source: Buck Consultants, New York State/SUNY GASB 45 Postemployment Healthcare Benefits, April 2008 Actuarial Valuation. Updated actual and projected outlays from state Division of the Budget.

As shown, as of 2010, the state's annual expenditure on health insurance for retirees was expected to nearly double (from $1.4 billion to $2.7 billion) by the end of this decade, and to triple by 2026.[14] While the same detailed data are not readily available for other government employers, the slope of future payments is likely to be similar for entities with plans like the state's.

What's wrong with "pay-as-you-go"? An analysis by the Federal Reserve Bank of Boston put it this way:

> Because this accounting method provided no incentive to set aside current funds to meet the growing demands of these benefits, it quietly shifted the true burden of payment to future generations. This burden would rest not only with future employees, who might see reduced benefits, but also with communities, which could see services cut or taxes increased to cover growing benefit payments. Allowing tomorrow's citizens to pay for the retirement of today's workers is inconsistent with the … concept of inter-period, or inter-generational, equity.[15]

The long-standing method of funding OPEB benefits, like all financial arrangements that shift current costs into the future, can also be viewed as a form of borrowing. Today's government employees earn a valuable benefit, while tomorrow's taxpayers are left to foot the bill. And until recently, there wasn't even an honest accounting of what that bill will be. This stands in stark contrast to the treatment of pensions, which are at least partially pre-funded through employer-sponsored trust funds.

When it came to obfuscating OPEB, private-sector companies used to be as guilty as most government employers. But this began to change in the early 1990s, when the Financial Accounting Standards Board (also known as FASB, the non-governmental counterpart to GASB) issued a rule requiring corporations to recognize their retiree health insurance promises as a long-term liability with real financial consequences.

FASB's Statement 106, issued in 1990, prompted many private employers to reduce benefits, to share more costs with employees, or to eliminate OPEB altogether rather than promise benefits they could not truly afford to fund as a long-term liability.

GASB followed the private-sector accounting precedent with the issuance in 2004 of a rule known as Statement 45, or GASB 45.[16] Like the FASB standard, GASB 45 is rooted in the idea that retiree benefits are a form of deferred compensation whose costs should be recorded when earned, not when paid. GASB 45 was phased in starting in fiscal 2007 for the largest governments (those with revenues above $100 million), and became fully effective in 2009 fiscal year for government entities of all sizes that produce GAAP-based financial statements.

The rule does not require states and local governments to immediately begin spending any more money. It does, however, require them to take these steps:

- Calculate the present value of future retirement benefits that have been promised to and earned by current employees and retirees. The resulting number is called the "actuarially accrued liability," or AAL.

- If any funds have been put aside to support the health plan's future benefit payment, deduct the value of any fund assets from the AAL to produce a second figure, the "unfunded actuarially approved liability," or UAAL. This must be reported in notes to government financial statements.

- Determine the "annual required contribution," or ARC, which combines the UAAL with the present value of health benefits earned during the past year, including the "pay-go" amount. Employers can spread (or "amortize) the UAAL amount over 30 years. Even with this adjustment, however, the ARC typically is three times as large as the existing annual payment for retiree health coverage. To the extent an employer fails to meet its ARC target, the shortfall is added to its total liabilities.

Again, GASB 45 does not actually require governments to make their "required" payments to begin paying off OPEB liabilities. However, as GASB's guide to the issue points out, "the more of its annual OPEB cost that a government chooses to defer, the higher will be (a) its unfunded actuarial accrued liability and (b) the cash flow demands on the government and its tax or rate payers in future years."[17]

Governments that ignore the issue will experience a rapid deterioration in their balance sheets, due to the compounded growth in the liability represented by their annual required contribution. Wall Street rating agencies have indicated that they will take OPEB funding into account in evaluating a government's creditworthiness for the public finance markets—which directly affects borrowing costs.

Table 3 on pages 14 and 15 presents a breakdown of the unfunded retiree health care liabilities for 89 of New York's largest public employers based on data gleaned from their most recent annual financial reports and disclosure statements.

First blush estimates

As shown in Table 3 beginning on page 14, the unfunded retiree health care obligations reported by these 89 entities add up to more than $210 billion. Based on this sample, it can be estimated that OPEB obligations for all other public employers total nearly $39 billion, three-quarters of which could be attributed to school districts. That would bring the estimated unfunded OPEB liabilities for all levels of government in New York to nearly $250 billion.

OPEB liabilities reflect the total present value of retiree health insurance coverage that the state, its local governments and largest public authorities have promised to provide in the future to currently active and retired employees. The benefits in question have been "accrued," or earned, under current laws and collective bargaining agreements, but won't actually be collected for years or even decades to come.

These figures are enormous in any context. New York City's unfunded liability of nearly $84 billion is the second largest of any state or local government employer in the nation. It easily exceeds the city's own total bonded indebtedness as of 2012. New York State's unfunded liability of $73 billion, second only to California among state governments, also exceeds its $63 billion in outstanding debt. The estimated liability of $250 billion for all public employers in New York equates to roughly 85 percent of New York's state and local government bonded indebtedness as of 2009.

The liabilities are also growing rapidly. Between the end of fiscal 2008 and the start of fiscal 2010, New York State's unfunded OPEB liability increased by $23 billion, or nearly 50 percent. Between fiscal 2006 and fiscal 2008, New York City's OPEB liability increased by $32 billion, or 62 percent, in part because of updated actuarial assumptions reflecting increased life expectancy of city retirees and the expected impact of federal health care reform law. As of the end of August 2012, the most recently reported OPEB liabilities for all government entities in New York totaled $45 billion more than those reported as of August 2010.

Comparing OPEB burdens

Table 3 also translates unfunded liabilities of counties and municipalities into per-household values, to allow for comparisons among different jurisdictions and to underscore the exclusive responsibility of residents in each community for the liabilities incurred by the local governments to which they pay taxes.

Some key findings:

- With unfunded liabilities of roughly $4.6 billion and $4.4 billion respectively, Nassau and Suffolk have built up the largest OPEB burdens among counties in both absolute and per-household terms. The next largest per-household liabilities were reported by Rockland and Westchester counties.

- Cheektowaga in Erie County, Clarkstown in Rockland County, and Greenburgh in Westchester County have the largest OPEB burdens among towns, while Brookhaven, Greece, North Hempstead and Babylon are much lower.

Table 3. Unfunded Liabilities (UAAL) for Other Post-Employment Benefits

		UAAL $000	Households	Per Household
New York State		**$73,181,000**		
State government		59,668,000	**7,317,755**	**$10,000**
SUNY and CUNY		13,513,000		
New York City		**$83,900,000**	**3,109,784**	**$26,979**
Most Populous Counties Outside New York City				
	Region	UAAL $000	Households	Per Household
Albany County	Capital	533,884	126,251	4,229
Broome County	Southern Tier	186,715	82,167	2,272
Chautauqua County	Western	49,392	54,244	911
Dutchess County	Mid-Hudson	293,500	107,965	2,718
Erie County	Western	934,228	383,164	2,438
Jefferson County	Northern	268,837	43,451	6,187
Monroe County	Western	629,654	300,422	2,096
Nassau County	Long Island	4,618,696	448,528	10,297
Niagara County	Western	277,116	90,556	3,060
Oneida County	Central	59,604	93,028	641
Onondaga County	Central	837,800	187,686	4,464
Orange County	Mid-Hudson	451,661	125,925	3,587
Oswego County	Central	107,245	46,400	2,311
Rensselaer County	Capital	59,758	64,702	924
Rockland County	Mid-Hudson	665,369	99,242	6,705
Saratoga County	Capital	85,268	88,296	966
Schenectady County	Capital	212,874	62,886	3,385
Suffolk County	Long Island	4,414,160	499,922	8,830
Ulster County	Mid-Hudson	148,050	71,049	2,084
Westchester County	Mid-Hudson	2,354,330	347,232	6,780
		$17,188,141	**3,323,116**	**$5,172**
Most Populous Cities Outside New York City (Municipal Only)				
	County	UAAL $000	Households	Per Household
Albany	Albany	270,264	41,157	6,567
Binghamton	Broome	130,998	21,150	6,194
Buffalo	Erie	1,637,159	112,536	14,548
Long Beach	Nassau	78,623	14,809	5,309
Mount Vernon	Westchester	98,540	26,260	3,752
New Rochelle	Westchester	189,690	27,953	6,786
Niagara Falls	Niagara	195,003	22,603	8,627
Rochester	Monroe	564,241	87,027	6,484
Rome	Oneida	111,635	13,526	8,253
Schenectady	Schenectady	191,522	26,633	7,191
Syracuse	Onondaga	911,000	57,355	15,884
Troy	Rensselaer	139,617	20,505	6,809
Utica	Oneida	57,458	24,905	2,307
White Plains	Westchester	254,920	22,910	11,127
Yonkers	Westchester	697,300	74,550	9,353
		$5,527,969	**593,879**	**$ 9,308**
Most Populous Towns				
	County	UAAL $000	Households	Per Household
Amherst	Erie	145,069	48,894	2,967
Babylon	Suffolk	119,897	70,894	1,691
Brookhaven	Suffolk	281,400	162,884	1,728
Cheektowaga	Erie	145,424	39,325	3,698
Clarkstown	Rockland	157,100	29,234	5,374
Colonie	Albany	49,045	33,088	1,482
Greece	Monroe	49,571	39,407	1,258
Greenburgh	Westchester	167,231	33,495	4,993
Hempstead	Nassau	679,236	246,456	2,756
Huntington	Suffolk	190,444	69,311	2,748
Islip	Suffolk	204,981	103,631	1,978

Continued on next page

Most Populous Towns (continued)				
	County	UAAL $000	Households	Per Household
North Hempstead	Nassau	133,271	227,058	519
Oyster Bay	Nassau	328,057	302,564	1,039
Ramapo	Rockland	121,749	115,885	761
Smithtown	Suffolk	153,400	121,817	1,099
		$ 2,925,874	**1,643,943**	**$1,780**
Selected Large Villages				
	County	UAAL $000	Households	Per Household
Garden City	Nassau	92,989	7,366	12,624
Harrison*	Westchester	188,219	8,375	22,474
Hempstead	Nassau	130,268	15,234	8,551
Lynbrook	Nassau	27,867	7,513	3,709
Mineola	Nassau	33,900	7,396	4,584
Ossining	Westchester	64,400	8,344	7,718
Port Chester	Westchester	53,920	9,240	5,835
Rockville Centre	Nassau	66,403	9,258	7,172
Scarsdale	Westchester	68,871	5,418	12,712
Spring Valley	Rockland	47,247	8,755	5,397
Valley Stream	Nassau	45,311	12,189	3,717
		$819,394	**99,088**	**$8,269**
School Districts				
	County	UAAL $000	Households	Per Household
Albany City	Albany	296,157	41,149	7,197
Brentwood	Suffolk	408,400	20,369	20,050
Buffalo City	Erie	1,681,374	112,536	14,941
East Ramapo	Rockland	311,318	29,381	10,596
Great Neck	Nassau	97,210	16,272	5,974
Greece	Monroe	62,246	34,324	1,813
Half Hollow Hills	Suffolk	274,808	15,761	17,436
Haverstraw-Stony Point	Rockland	248,515	15,933	15,597
Longwood	Suffolk	263,188	24,465	10,758
Middle Country	Suffolk	54,600	20,429	2,673
Mount Vernon	Westchester	141,305	26,260	5,381
New Rochelle	Westchester	105,277	27,953	3,766
Newburgh	Orange	299,454	23,055	12,989
Rochester	Monroe	475,729	87,042	5,466
Sachem	Suffolk	352,336	28,039	12,566
Smithtown	Suffolk	224,443	19,294	11,633
Syracuse	Onondaga	934,000	57,391	16,274
White Plains	Westchester	128,325	22,910	5,601
William Floyd	Suffolk	93,700	15,737	5,954
Yonkers	Westchester	975,300	74,550	13,082
		$7,427,685	**712,850**	**$10,420**
Largest State Public Authorities				
		UAAL $000	Covered Payroll	% of Payroll
Bridge Authority		44,607	10,788	383%
Dormitory Authority		208,499	48,319	324%
Metropolitan Transportation Authority		17,764,000	4,600,000	386%
Thruway Authority		1,021,000	167,067	588%
Urban Development Corp.		54,064	34,100	153%
		$19,092,170	**4,860,274**	**393%**
Subtotal: Major public employers		**$210,063,201**		
All others (estimated)		**$39,720,688**		
	GRAND TOTAL	**$249,783,890**		

Sources: UAALs as reported in latest available comprehensive annual financial reports, or in official statements and financial disclosure reports posted as of Aug. 31, 2012 by Electronic Municipal Market Access website of the Municipal Securities Rulemaking Board, emma.msrb.org. Estimates for "all others" are extrapolated from data in reports for largest employers, assuming OPEB liabilities of other employers are distributed in proportion to total medical benefits and personal service expenditures as reported to the Office of the State Comptroller, adjusted to reflect the percentage of employers in each category offering retiree health coverage. Household counts from 2010 U.S. Census and American Community Survey.

* Harrison is a combined town and village

- The estimated value of healthcare promised to retirees by the Westchester County town and village of Harrison — an unfunded OPEB liability of more than $20,000 per household — far exceeds the norm for all cities, towns or villages in New York State.

- The OPEB liability in the Brentwood School District on Long Island is double the per-household average. At the other end of the spectrum, the per-household OPEB liabilities of the Greece, Middle Country and New Rochelle school districts equate to less than half the average.

- The MTA's $17.8 billion unfunded liability is the third largest among all New York public employers, exceeded only by the long-term OPEB number of the state government and New York City. Expressed as a ratio of payroll, however, the Thruway Authority's liability is almost 50 percent larger.

Differences in relative OPEB burdens within the same class of government may be explained, in part, by the actuarial assumptions and methods used to produce their liability estimates,[18] and in part by differences in the size and composition of their payrolls. Nassau and Suffolk, for example, employ large county police forces, whose members retire early with generous health benefits; this also explains why the OPEB values for most large Long Island towns, cities and villages are relatively low, since these municipalities do not need extensive police forces of their own (although some employ their own police nonetheless).

Long liability tails

New Yorkers live in multiple jurisdictions and are responsible for a share of the unfunded OPEB cost of every level of government to which they pay taxes. To provide a fuller picture of the OPEB burden on residents of New York's largest cities, Table 4 presents combined unfunded liabilities for overlapping municipal governments and school districts.

Table 4. Combined Municipal and School OPEB Liabilities for Selected Cities*

	$000				
	Municipal	School	Combined	Households	Per Household
Albany	270,264	296,157	566,421	41,157	13,762
Binghamton	130,998	89,212	220,210	21,150	10,412
Buffalo	1,637,159	1,681,374	3,318,533	112,536	29,489
Mount Vernon	98,540	141,305	239,845	26,260	9,133
New Rochelle	189,690	105,277	294,967	27,953	10,552
New York City			83,900,000	3,109,784	26,979
Niagara Falls	195,003	131,056	326,059	22,603	14,425
Rochester	564,241	360,956	925,197	87,027	10,631
Schenectady	191,522	144,790	336,312	26,633	12,628
Syracuse	911,000	934,000	1,845,000	57,355	32,168
Utica	57,458	196,636	254,094	24,905	10,203
White Plains	254,920	145,126	400,046	22,910	17,462
Yonkers	697,300	906,400	1,603,700	74,550	21,512
			$93,994,484	**3,654,823**	**$25,718**

* List represents most populous cities that overlap with city school districts. New York City reports a single OPEB liability for all municipal and school operations. A very small portion of the Binghamton School District is in a neighboring town.

Syracuse leads all New York cities with a combined-municipal OPEB liability of $32,168 per household, based on a total unfunded liability of $1.8 billion for the municipal government and school district combined. Buffalo's combined unfunded OPEB liability of $3.3 billion was the largest in absolute terms for cities other than New York City.

Buffalo's municipal government also has reached a fateful tipping point: as of fiscal 2010-11, it is spending more on health coverage for retirees ($35 million) than for active employees ($30 million).[19] The nearby city and school district of Niagara Falls, which has experienced many of the same fiscal and economic problems on a smaller scale, has an even larger per-capita OBEP burden than Buffalo.

Syracuse, Buffalo, Niagara Falls and other fiscal struggling upstate cities are facing the same kind of retiree legacy cost that became a crippling financial drag on General Motors before its bankruptcy and takeover by the federal government in 2009.

False Starts, Sidesteps and Baby Steps in Albany

New York's enormous OPEB iceberg was first spotted by state officials at least as far back as 1995, when newly elected Governor George Pataki's first contract with the Civil Service Employees Association (CSEA) added these two sentences to a provision entitling union members to retiree health coverage:

> "However, in recognition of the forthcoming changes to the Government Accounting Standards Board (GASB) requirements, both the State and CSEA recognize the need to address the inequity of providing employees who serve the minimum amount of time necessary for health insurance in retirement with the same benefits as career employees. Prior to the expiration of this contract CSEA and the State shall, through the Joint Committee process, develop a proposal to modify the manner in which employer contributions to retiree premiums are calculated."[a]

No such proposal was developed, however, and the passage did not reappear in post-1999 CSEA contracts. Prior to 2011, the state's contracts with its second largest union, the Public Employees Federation (PEF), featured a similar provision.[b]

Consistent with the goals of the PEF language, Governor David Paterson's 2009-10 Executive Budget would have created a sliding scale of retiree health insurance coverage, reserving full coverage only for those with 30 years or more of active service.[c] The proposal sank without a trace in subsequent budget negotiations with the Legislature, even though Paterson had estimated it would have saved $8 million in 2009-10 and $17 million in 2010-11—figures that undoubtedly would have increased in subsequent years.

A December 2009 law[d] creating a new "tier" of pension benefits for state and local employees also made permanent a temporary measure, dating back to 1994, that prohibited school districts from making any change in retiree health coverage that was not first negotiated with unions representing active employees. Earlier in 2009, Paterson had become the third consecutive governor to veto a union-backed measure extending the same "protection" to other types of employees at every level of government. To placate its supporters, however, he formed a temporary Task Force on Retiree Health Insurance, which reported in 2010 that it could not reach a consensus on whether to support legislation that would limit the ability of employers to alter retiree benefits. This effectively punted the issue to the next governor.[e]

Paterson and the Legislature did take one very small step towards curbing another element of retiree health insurance: the Medicare Part B premium for retirees over age 65, which New York is one of only six state governments in the nation to reimburse. Under the 2010-11 state budget, Medicare Part B premium costs will be "blended" into the entire rate base for NYSHIP's Empire Plan and HMO coverage, effectively requiring active and retired employees to cover the same 10-25 percent share of Medicare premiums. The change will save the state $30 million a year, or about 2.3 percent of projected retiree health care outlays for 2011-12.

Governor Andrew Cuomo has taken a different approach, sidestepping the Legislature while unilaterally imposing an increase of two percentage points in the share of insurance premiums paid by retirees. The governor's action, which came after he successfully negotiated increases in employee health insurance contributions with CSEA and PEF, has been challenged in federal court by the state's major labor unions.[f]

a. See, for example, Section 9.20 of CSEA Administrative Services Unit contract for 1995-99, posted at http://www.goer.state.ny.us/Labor_Relations/Contracts/1995to1999/cseaasu/02art09.html.
b. Article 9.13(b) of 2007-11 PEF Contract at http://www.goer.state.ny.us/Labor_Relations/Contracts/Current/pefpst/index.cfm.
c. 2009-10 Public Protection and General Government Article VII Memorandum posted at http://www.budget.state.ny.us/pubs/0910_budgetPublicationsAll.html.
d. Chapter 504 of the Laws of 2009.
e. http://www.ny.gov/governor/reports/pdf/HealthCareRetiree.html
f. See, for example, http://www.nyscopba.org/files/news_articles/111228_joint_hi_increase_litigation.pdf

3. STEPS TO REFORM

GASB 45 doesn't just force public employers to disclose the true cost of their long-term retiree health care promises; it also creates an avenue for catching up with these unfunded liabilities.

Nearly all of the New York state and local governments affected by GASB 45 have chosen to calculate and report how much they would need to pay, with interest, to fully fund their OPEB liability over a 30-year period. The resulting number, known as the annual required contribution, or ARC, typically is much higher than the current pay-as-you go amount. For example, New York State's ARC of $3.3 billion is fully three times its current annual expenditure on retiree health care.

As explained in Section 2, payment of the ARC is not actually "required." However, the difference between the ARC and the annual pay-go expenditure must now be counted as a "net liability" on the employer's balance sheet. Thus, for example, in the two years since GASB 45 took effect, the state of New York has amassed $8 billion of unfunded liabilities for OPEB due to its failure to pay the full ARC. The longer the state fails to pay the ARC, the larger those liabilities will grow. At this rate, within 10 years, the state's total liabilities will exceed its total assets, a condition accountants call "balance sheet insolvency."

Thanks largely to its unfunded OPEB liability, New York City is technically "balance sheet insolvent." Investors apparently assume these retiree benefits will not actually be paid.

New York City has already arrived at that point. Unlike other major state and local governments with unfunded retiree health care liabilities, it did not amortize its liability over 30 years for accounting purposes. Instead, even before GASB 45 took effect in 2008, the city booked the *entire* OPEB liability all at once. The result: as of the end of fiscal 2011, New York had negative net assets of $118 billion.[20] The city is still financially liquid; it has a broad and deep tax base, and its cash flow will cover its bills for the foreseeable future. However, the amount the city owes to retirees and to more traditional creditors in the long term is at least $118 billion more than the value of everything it owns—including land, buildings, equipment and infrastructure.

A private corporation in a similar situation would be viewed as financially troubled, to say the least. New York City, however, has a relatively high credit rating and strong markets for its bonds. Investors must assume that the municipal OPEB obligation is not really binding in the same sense as general obligation debt.

If that's the case, someone needs to break the news to municipal labor unions, whose members *do* assume they will receive lifetime health coverage if they retire from the city payroll. Other public employees around the state no doubt assume the same thing. Meanwhile, as these employees continue to accrue benefits, the cost is being shifted to future generations. This is why it is essential for elected officials to begin confronting the full financial implications of their retiree health care promises.

To fund or not to fund?

GASB does not recommend any particular policy approach to dealing with OPEB, but Statement 45 nudges governments toward emulating the long-established method of financing public pensions: create off-budget trust funds and invest in a diverse portfolio of financial assets, including corporate stocks. Under this scenario, governments would be allowed to assume that compounded investment returns can help cover the rising cost of future benefits.

As of 2009, however, only 18 states had set aside any assets to pay OPEB liability, according to a U.S. Governmental Accountability Office (GAO) study.[21] A separate report by the Pew Center for the States found that only six states were on track to have fully funded OPEB obligations during the next 30 years, and only three (Wisconsin, Arizona and Alaska) had pre-funded more than 50 percent of the retiree health care liability. At least two states, Ohio and Vermont, were pre-funding a portion of their OPEB liability through sub-accounts in their existing pension funds. [22]

New York's annual required contribution for catching up to its unfunded retiree health care liability is the largest of any state's.

Most states and local governments, like New York, are still financing retiree health coverage strictly on a pay-as-you go basis. As of 2008, according to the Pew report, most of the nation's OPEB obligation was concentrated in the northeast, among New York and its neighboring states. The same report said New York's annual required contribution for retiree health care was the largest of any state—although, as noted, New York City has an even larger total OPEB liability than any state but California.

There are two problems with the OPEB trust fund approach. First, according to State Comptroller Thomas DiNapoli, New York State law does not explicitly authorize the kind of trust funds encouraged by GASB 45. DiNapoli has sought to remedy this by proposing legislation that would allow localities the option of creating their own trust funds in the comptroller's custody.[23] Notwithstanding the state comptroller's legal opinion, New York City created its own Retiree Health Benefits Trust (RHBT) in 2006. Over the next two years, the City contributed $2.5 billion in surplus funds to the RHBT, which had grown to over $3 billion by 2009. Money deposited in the trust cannot be spent on any purpose other than retiree health care. However, since the city's annual pay-go bill is so large—$1.8 billion as of fiscal 2011—this has not prevented Mayor Michael Bloomberg from planning to withdraw $1.1 billion from the RHBT over a three-year period to help balance the city's operating budget, which will have the effect of raising future OPEB liabilities.[24]

The larger problem with the trust fund approach is that it would replicate a serious flaw in GASB's own public pension accounting rules. The flaw involves the interest "discount rate" used to calculate the present value of future obligations. This is a crucial determinant of a system's necessary funding levels: the higher the rate, the lower the contributions required to maintain "fully funded" status.

Private pension plans must discount their liabilities based on a market rate—typically, a AA-rated corporate bond rate—which is often much lower than the plans' targeted rate of return on investments. Public funds, however, are allowed under GASB standards to discount their long-term liabilities based on the target rate—which, for most public funds, is pegged at an optimistic 8 percent or higher. In other words, the risk premium in the investment target is compounded in the liability estimate. By discounting liabilities based on optimistic rate-of-return assumptions, pension funds have substantially under-estimated the money they will need to pay out to beneficiaries over the next several decades, a growing number of independent financial and actuarial analysts believe.[25]

The initial estimate of New York State's unfunded OPEB liability was based on a discount rate of 4.155 percent, but a qualified OPEB trust fund would be permitted under GASB guidelines to discount its future liabilities based on a higher assumed investment return rate, now set at 7.5 percent for the state pension fund. As if by magic, this would make nearly half the liability disappear; for example, the comptroller's office estimated in 2008 that committing to pre-fund retiree health care over 30 years would have reduced the initial estimate of the state government's OPEB liability from $50 billion to $28 billion.[26] The ARC would also be reduced significantly.

GASB rules for retiree health care trusts would replicate a flaw in the accounting standards for public pension funds, allowing governments to recalculate obligations based on assumed returns from risky investments.

"The benefit that comes from putting money in a trust is that it starts to earn interest and, over time, that interest becomes another funding source for the benefits, replacing some of the contribution that would otherwise come from taxpayers," the Pew study said. However, even if it created such a trust fund for currently promised retiree health benefits, New York's annual outlay for retiree health care would still be roughly twice as high as the current level.[27] The mathematics of full funding under these circumstances would be similar for the state's local governments and authorities. Faced with a sluggish economic recovery and skyrocketing costs for pensions and benefits for active employees, state and local governments obviously cannot afford to fully prefund current retiree health care obligations under *any* circumstances.

Cost saving opportunities

GASB 45 was intended to generate more of the information necessary "to assess the cost of public services and to analyze the financial position and long-run financial health of a government."[28] If the emerging OPEB numbers tell us anything, it's that the cost of retiree health care is much higher than anyone had previously recognized. These liabilities threaten to undermine the long-run financial health of New York's state and local governments, which are already having difficulty balancing competing priorities for scarce resources in the wake of a severe recession.

As explained above, establishing trust funds alone will not reduce the current cost of retiree health benefits. State and local governments need to begin restructuring and reducing the cost of these benefits.

A temporary Task Force on Retiree Health Insurance created by Governor David Paterson in 2009 was presented with several options for reducing retiree health costs, including increases in retiree premiums, elimination or reduction of Part B premium reimbursements, creation of a sliding scale of benefits based on years of service, and establishment of a fixed-dollar contribution.[29]

Similar options have been implemented or are under active consideration in several states, according to the Pew study; other studies find that many large employers still offering retiree health care have made or are considering such changes in their plans. However, in its June 2010 final report, the Task Force limited its recommendations to a series of changes in financial and benefit design changes without recommending any steps to significantly reduce the unfunded OPEB liability.[30]

Meanwhile, some public employers below the state level have begun to take matters into their own hands. Potentially the most significant large-scale changes occurred in Erie County, where former County Executive Chris Collins negotiated a series of agreements with smaller county employees unions that will reduce or eliminate retiree health coverage for members hired since a previous round of contracts expired

The Federal Wild Card

The federal Affordable Care Act signed into law by President Back Obama in March 2010 will bring significant changes to health insurance markets. One of the law's more obscure provisions also cracked open a door to federal involvement in the financing of retiree health care.

Health and Human Services (HHS) Secretary Kathleen Sibelius recently announced that 2,000 employers throughout the country had applied for a piece of a $5 billion "Early Retirement Reinsurance Program" set up under the new federal health care law to subsidize employer-sponsored health insurance for retirees who haven't yet reached the Medicare eligibility age of 65.[a] Specifically, the plan will reimburse 80 percent of claim costs between $15,000 and $90,000 for early retirees.

Of the 156 New York employers applying for subsidies from the reinsurance fund, 66 were government entities, including counties, municipalities, school districts and public authorities. Another 33 were unions or union trust funds, including several representing government employees. Of the remaining 57 applicants, only 33 were for-profit businesses.

By far the biggest New York employer on the applicant list was the New York State Health Insurance Plan (NYSHIP), which said it expects to receive $346 million—fully seven percent of the entire nationwide trust fund. Civil Service Commissioner Nancy Groenwegen said the money would be used to reduce premiums for "all participants" in the plan, including both active employees and retirees.[b]

On a NYSHIP premium base estimated by DCS at $12 billion over the next two years, $346 million works out to a little less than 3 percent. So, from the state government's standpoint, a projected 19 percent increase in health insurance premiums over the next two years will be shaved down to about 16 percent. That works out to a two-year savings of about $180 million–not all that much, really, in the context of a two-year budget gap of at least $20 billion.

What happens after the reinsurance program expires in two years? The HHS press release said the fund was "created … as a bridge to the new health insurance Exchanges in 2014," a reference to the federally subsidized insurance plans that will become available then under the health care law.

Is the Obama administration inviting or expecting states and local governments to dump $1.5 trillion in unfunded retiree health care liabilities into Washington's lap? Stay tuned.

a. "Nearly 2,000 employers and unions approved into new program," August 31, 2010 news release at http://www.hhs.gov/news/press/2010pres/08/20100831a.html
b. DCS TK

in 2006. In May 2010, Collins reached a tentative agreement including similar changes with the county's largest union, which could have significantly reduced the county's $909 million unfunded OPEB liability. However, the contract was rejected by union members.[31]

The White Plains City Council took a different approach to the problem, voting in May 2010 to end free retiree coverage and require a 15 percent contribution to health insurance premiums for city employees hired before 1995 who retired with at least 20 years of service. Unions for police and firefighters immediately sued, winning a pair of temporary restraining orders blocking the change. [32]

Four steps to retiree health care reform

On the state level, as noted in Section 1, the Legislature and Governor have broad leeway to craft changes in retiree health benefits outside of collective bargaining. Pursuing the following strategy would allow them to strike a politically appealing balance between the competing interests of employees and taxpayers:

1. Preserve health benefits for workers who have already retired, but stop reimbursing Medicare Part B premiums for those over 65, and require early retirees to pay a larger share of their own premiums.

2. Reserve the greatest benefit to those who have worked the longest, along the lines initially proposed by Governor Paterson in his 2009-10 budget.

3. Clarify existing law to allow trust funds to cover adjusted OPEB liabilities, but mandate that required contributions to the fund are based on returns from conservative, low-risk investment strategies.

4. Eliminate retiree health insurance coverage for all new hires and employees on the payroll for less than 10 years, and shift these workers into a "retirement medical trust." Government workers would make tax-free contributions to accounts managed by their unions, which would pool and invest the money to cover medical expenses after they retire.

The proposed retirement medical accounts for new hires and less senior employees would be based on a plan adopted by the state of New Hampshire in 2010 after being pioneered by local governments in California, Oregon, Washington, and elsewhere.[33] This model would give employees and their unions a stake in managing health costs, with the added advantage of removing liability for their benefits from the state's balance sheet.

Adoption of this four-part strategy would immediately save the state more than $300 million a year, assuming early retirees were immediately required to pay one-third of premium costs now covered by state government (lowering the average employer share to 61 percent).[34] These changes also would significantly reduce the state's unfunded OPEB liability.

The state government's OPEB reform strategy can serve as other levels of government, but should be linked to these statutory changes:

- repeal the 2009 state law restricting the ability of school districts to alter retiree health benefits;
- require all active and retired public employees in New York to contribute at least 10 percent to individual coverage and 25 percent to family coverage premiums (the same level as state workers), as recommended in 2008 by the state Commission on Local Government Efficiency and Competitiveness;[35]
- amend the Taylor Law to flatly prohibit future collective bargaining of retiree health benefits in New York's public sector.[36]

Elected officials who feel their hands are now tied by collective bargaining agreements need to seize on the opportunity created by GASB 45 to acquaint their taxpayers and employees with the hard fact that these promises are simply unsustainable in the long run. In the short term, budgets already stressed by the economic downturn will be squeezed harder by rising pension bills as well as health insurance costs over the next few years. Something has got to give on this front—and soon.

ENDNOTES

[1] While there is no precise tally of annual state and local government expenditures on retiree health insurance, New York State and New York City will spend about $3 billion for this purposes in fiscal 2011. School districts outside the city spend roughly $1.2 billion on retiree health care, assuming one-third of their reported medical insurance costs are for that purpose. A safe estimate would be that the annual pay-go cost for retiree health care at every level of government in New York comes to at least $5 billion.
[2] Since many of the reports date back to 2008 fiscal years, the total has almost certainly grown since then.
[3] The $1 trillion estimate first reported in a 2005 New York Times article ("The Next Retirement Time Bomb,"Dec. 11, 2005). An October 2006 analysis by the Cato Institute put the figure at $1.4 trillion (Chris Edwards and Jagadeesh Gokhale "Unfunded State and Local Health Costs: $1.4 Trillion," Cato Tax and Budget Bulletin, No. 40. In a 2007 analysis, Credit Suisse estimated the total at $1.5 trillion ("You Dropped a Bomb on Me, GASB," Equity Research, Accounting & Tax Note, March 22, 2007).
[4] Since the GASB 45 reporting requirement first took effect, only the State of California, including its university system, has consistently reported a larger unfunded OPEB liability than New York City. As of June 30, 2010, the last period for which comparable estimates are available, California's total unfunded liability was $78 billion and New York City's was about $75 billion.
[5] Retiree health coverage is offered by 98 percent of New York's school districts and 67 percent of its other local governments, according to surveys compiled by the Governor's Task Force on Retiree Health Benefits. The state's largest public employer, New York City, offers retiree health coverage to all of its employees, as does the state government.
[6] This is derived from a table entitled "Reconfigured 2009 Monthly Premium - Based on Cost Differential of Each Group," which was prepared by the Department of Civil Service (DCS) for the governor's Task Force on Retiree Health Care. All members of NYSHIP paid a blended monthly premium of $1,132.44 for family coverage in 2009, but the DCS calculated that if premiums were reconfigured to reflect cost differentials in 2008, the premium for active employees would be reduced to $1,071.96, the premium for retired members with NYSHIP as their primary plan (i.e., early retirees) would increase to $1,642.59 and the premium for retirees with Medicare as their primary plan (i.e., those over 65) would increase to $1,190.99.
[7] Buck Consultants, "New York State/SUNY GASB 45 Postemployment Healthcare Benefits, April 1, 2006 Actuarial Valuation."
[8] *Lippman vs. Board of Education of the Sewanhaka Central High School District*, 66 N.Y. 2d 313 (1985).
[9] Article 14 of the Civil Service Law.
[10] Kaiser Family Foundation, *Employer Health Benefits, 2010 Annual Survey*, p. 162.
[11] Towers Perrin, 2009 Health Care Cost Survey: 20th Annual Results Report, p. 8.
[12] Citizens Budget Commission, "The Case for Redesigning Retirement Benefits for New York's Public Employees," April 29, 2005.
[13] Government entities ignore GASB standards at their peril; a financial report that does not conform to GASB standards will be noted on an independent audit and potentially lead to a credit rating downgrade.
[14] The cost of future payments will be reduced to some extent if Cuomo prevails in his attempt to impose a higher insurance premium share on retirees, as discussed on page 18.
[15] Federal Reserve Bank of Boston, New England Public Policy Center, "GASB 45 and other post-employment benefit promises: the fog is clearing," *Policy Brief* 07-7, September 2007.
[16] Government Accounting Standards Board, *Summary of Statement 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (Issued 6/04)*, at http://www.gasb.org/st/summary/gstsm45.html.
[17] Government Accounting Standards Board, *Guide to Implementation of GASB Statements 43 and 45 on Other Postemployment Benefits*.
[18] Employers are allowed by GASB to use several different actuarial methods, as well as slightly different discount rates for calculating the "present value" of promised future obligations. Most of the financial statements reviewed for this report used the projected unit credit (PUC) actuarial method and a discount rate of 4 to 4.5 percent.
[19] City of Buffalo, General Fund, 2010-11 Adopted Budget, Section II: General City Charges, at http://www.city-buffalo.com/files/1_2_1/Mayor/2010-2011AdoptedBudget/Section_II_GF_General_City_Charges.pdf.
[20] City of New York., *Comprehensive Annual Financial Report of the Comptroller for the Fiscal Year Ended June 30, 2009*, Statement of Net Assets, p. 34.
[21] U.S. Government Accountability Office, "State and Local Government Retiree Health Benefits: Liabilties Are Largely Unfunded, But Some Governments Are Taking Action," GAO-10-61, November 2009.
[22] Pew Center on the States, *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform*, December 2007.
[23] Office of the State Comptroller, Local Government Issues in Focus, "GASB 45: Reporting the True Cost of Other Post-Employment Benefits,"Vo. 4, No. 1, May 2008. The comptroller's bill, A.11038, did not move out of committee during the Legislature's 2009-10 session.
[24] Office of the State Comptroller, "Review of the Financial Plan of the City of New York," July 2011, Report 4-2011, p. 34.
[25] Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State- Sponsored Pension Plans," *Journal of Economic Perspectives*, Vol. 23, No. 4, Fall 2009, pp 191–210.
[26] At the time, the pension fund rate of return of 8 percent was assumed.
[27] *Op. cit*, Office of the State Comptroller, Local Government Issues in Focus, "GASB 45: Reporting the True Cost of Other Post-Employment Benefits."
[28] Government Accounting Standards Board, *Other Postemployment Benefits: A Plain-Language Summary of GASB Statements 43 and 45*, at http://www.gasb.org/project_pages/opeb_summary.pdf.

[29] Meeting Minutes and the Final Report of the Task Force are posted at http://www.state.ny.us/governor/reports/pdf/HealthCareRetiree.html.
[30] The 15 Task Force recommendations included encouragement of municipal cooperative health plans, prescription drug carve-out plans, and adjusted co-pays to encourage primary and preventative care.
[31] *Buffalo News*, "CSEA rejects proposed contract," June 12, 2010.
[32] *Journal News*, "Federal judges put brakes on White Plains retiree health costs," July 9, 2010.
[33] Pew Center on the States, "In New Hampshire, a new way on retiree health costs," May 12, 2010, http://www.stateline.org/live/details/story?contentId=484070.
[34] Empire Center for New York State Policy, "Blueprint for a Better Budget: A Plan of Action for New York State," estimated workforce savings on p. 26.
[35] New York State Commission on Local Government Efficiency and Competitiveness, Final Report, p. 53. Posted at http://www.nyslocalgov.org/report_page.asp.
[36] Civil Service Law Article 14, Section 201.4.