An Analysis of Policy Issues

concerning the

Funding of Future Liabilities for Health Insurance for Retired Employees (OPEB) of the Town of Lexington

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Background

The Town of Lexington is required by State law to provide health benefits to retired employees[1] that are comparable to those provided for active employees. Much of the cost of retiree health insurance is borne by Medicare, but the Town must provide supplementary coverage and coverage for retired employees not on Medicare. Since the Town is obligated to provide this benefit on an ongoing basis, the cost that will be incurred over the lifetimes of the current and future retirees represents a liability. The actuarial value of this liability must be included in the Town's financial statements. It is calculated by estimating the present value of the costs that will be borne by the Town over the lifetimes of all employees who have, at the time of the evaluation, earned the right to receive benefits in retirement, and is, at present, in the hundreds of millions of dollars. In this article, I discuss policy issues regarding management of these future liabilities.

Possible Strategies for Meeting Future Liabilities

Like in all previous years, in FY 2013 the Town will meet its obligation to pay its yearly share, approximately $6,000,000 on this occasion, of the costs of the health insurance for retired employees. The funds to do this were appropriated in the Shared Expenses part of the operating budget and will be raised from current revenues (the property tax levy, etc.).

A second way of funding the obligation for the next fiscal year is to use part of the income from a trust fund with a large balance. The Town has taken modest steps toward building a trust fund that is intended to be used for this purpose in the distant future. A Post Employment Insurance Liability (PEIL) Fund was created in 2007, and, in each of the last four years (FY2009-2012), Town Meeting has approved an appropriation into the Fund. In FYs 2009, 2010, and 2011 the appropriation involved a portion of free cash that approximated the previous year's reimbursement from the federal government for the prescription drug coverage the Town provides to retirees in lieu of Medicare Part D coverage. These reimbursements go into the general fund and become part of the following year's free cash balance. In FY2012, the appropriation was rounded up to $500,000. The balance in the PEIL Fund is now about $2,034,000. The Town received approximately $395,000 in Medicare Part D reimbursements in FY2011. The Board of Selectmen has recently decided to request, under Article 18, the

[1] Since these benefits are in addition to pension benefits, they and other non-pension benefits are sometimes known as "other post-employment benefits" or "OPEB".

appropriation of $1,000,000 from the tax levy and/or free cash and to add the full amount to the PEIL Fund[2].

In short, there are two possible strategies for meeting future OPEB liabilities. They are 1) the use of current revenue to pay current year expenses, and 2) the use of investment income from a trust fund with a balance that was built using tax revenues over many years. Of course, current year obligations may also be met by any combination of the two funding methods.

Is the Town Obligated to Fund the Future Liabilities?

As stated above, the Town has, for many years, met its current obligations with current revenue. There is no legal mandate or any other reason, to my knowledge, that compels the Town to change this practice. The only relevant mandate is to disclose the liability for future expenses in the Town's financial statements.

Should the Town Fund the Future Liabilities?

Even if the Town is not legally obligated to fund the future OPEB liabilities, it is important to consider whether the Town should fund the liabilities. There are reasons in favor of funding and there are also reasons against funding, but even if one accepts that funding is in the Town's interest, it is critical to carefully review the policy implications of different funding schedules and to adopt a schedule in line with the desired effects. The advantages of funding the liabilities are as follows:

Advantage 1) The investment income from a trust fund replaces, to the extent that the income exceeds the amount needed to keep the fund at the 100% funding level, the need for current revenue. In the real world, the investment income will fluctuate from year to year, and the 100% funding level can only be approximated over a number of years. See the footnote to the next paragraph for additional comments on the fluctuations in the fund income.

Advantage 2) In the years after the balance in a trust fund, i.e., the PEIL Fund in Lexington's case, reaches the fully-funded level, it is expected that the Town will raise the monies needed to cover the new OPEB liabilities that are incurred in a particular year from revenues raised that year, i.e., from the tax payers who are actually receiving services in that year. Ideally, this would maintain the trust fund at a fully-funded level[3].

Advantage 3) A fund that has a balance equal to the current actuarial liability provides assurance to bond rating agencies, bond holders, and employees that the Town will be able to meet its future obligations. A comment regarding this advantage is in order here. It makes sense to compel organizations that do not have virtually guaranteed income streams, e.g., companies and other business enterprises, to fully fund their future benefits liabilities because there is substantial risk that before many years any such organization will go out of business or otherwise lose its ability to meet such obligations from current income. The Town has the power to raise tax revenue and there is at most a very minute risk that it will go out of business in the foreseeable future. The

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[2] At a "summit meeting" held on April 11, 2012, the Board voted to use part of the funds that became unallocated upon moving to a GIC-based health insurance program to increase its request under Article 18 from $500,000 to $1,000,000.

[3] In the real world, the value of a trust fund, like all investments, will fluctuate as its stock and bond investments change in value. This, in addition to the uncertainties in the future costs of health care, makes it rather difficult to estimate the level needed for 100% funding. The fluctuations can be managed to some degree by averaging the estimates of full funding and also the annual contributions to the fund over, for example, 5-year intervals.

application of a policy designed to protect employees from the vagaries of private businesses is not particularly relevant to institutions like the Town or the Commonwealth of Massachusetts.

Advantage 4) A fund could be used as a reserve, e.g., to fund present retiree health costs in a particularly challenging fiscal year.

The disadvantage of building a fund is:

Disadvantage 1) A very substantial fund must be built up over many decades by using tax revenues and the investment income on the previously invested tax revenues. This increases the need for tax revenues in the years that the fund is being built. The taxpayers that paid the taxes that go into the fund in its early years are unlikely to ever benefit from the fund because of the long time needed to build the fund to a level where tax revenue is no longer needed for its sustenance. Furthermore, monies invested in the fund are unavailable for other uses and this represents opportunity costs to the Town. One may ask whether funding future liabilities should take priority over other liabilities such as the anticipated costs of maintaining or replacing roads and buildings in a timely manner. Choosing the latter might generate significant future savings and represent a better use of the funds.

To summarize the question somewhat crassly, the argument is whether the Town should take monies out of taxpayers pockets and invest them so as to generate investment income that will not be spent until many years in the future. One can argue that the taxpayers should have the opportunity to invest the monies instead. I will not make this argument at the present time; rather in this article I will argue that the best strategy at present is to build a fund over a long rather than short interval[4]. I make this statement even though I do not have a clear vision of how to achieve a fair balance between the impacts on present and on future taxpayers. In any case I believe that the Town's boards, committees, and staff should wrestle with these issues and somehow attempt to come to a consensus regarding the funding schedule.

Funding Schedule Considerations

The two primary factors that come into play in discussions of funding schedules are 1) the average (or typical) amount of tax revenue that will be put into the OPEB trust fund each year, and 2) the time needed to achieve full funding of the liability. Clearly, these two factors are closely related. A number of subsidiary issues also come into play.

As noted above, the building of a balance in a trust fund involves both the use of tax revenues and the accumulation of investment income. Short schedules to achieve full funding will result in the accumulation of relatively little investment income during the building of the fund and will require that the fund be built mostly from contributions from taxpayers. Furthermore, the short schedule implies that the yearly contributions must be large. Thus, a short full-funding schedule impacts in two ways the amounts taxpayers must pay. On the other hand, once full funding is achieved, taxpayers will benefit from the income generated by the fund. A long schedule impacts taxpayers much less each year while the trust fund is being built, but the advantages of full funding do not begin until farther in the future. A long schedule also may allow the Town to fund higher priority needs, such as important capital investments, in parallel with building up the trust fund. It is critical to understand these tradeoffs when deciding upon a funding schedule.

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[4] We do not have good estimates of plausible times needed to achieve full funding, but I will guess that a short interval may be, e.g., 30 to 50 years, while a long interval may be 50 to 80 years.

It is not clear what the limits might be on the length of the funding schedule that would affect the degree of assurance held by bond rating agencies and employees in regard to protection against default. Even quite long funding schedules would likely be satisfactory.

We, meant broadly, need better information on the policy implications of different funding schedules and their dependence upon important assumptions. It must be emphasized that even the very careful evaluations of actuarial companies depend on a set of highly speculative assumptions concerning inflation in general, the escalation of health care costs over time, and the future performance of investments in the fund, and therefore should be viewed as a set of exercises that illustrate the general properties of various choices, rather than as semiaccurate projections.

We do not have a good vetted number that represents the amount the Town would need to contribute to the PEIL Fund each year to keep the current liability from growing. Indeed, it is not even clear whether the baseline for purposes of comparison and discussion should be the amount needed 1) to keep the current liability from growing, 2) to keep the current liability from growing faster than inflation, 3) to fund all new liability including the portion that is replacing recently retired liability[5], or 4) to satisfy some other criterion.

The overall picture of the Town's future liabilities should be considered when deciding upon a funding schedule for the OPEB trust fund. Pension liabilities and capital renewal needs as well as OPEB liabilities should be taken into account. In the FY 2013 budget, approximately $1,500,000 was appropriated under Article 4 for building up the Retirement Trust Fund[6], and $1,000,000 is presently proposed to be put into the PEIL Fund. I will not attempt to determine the value of the appropriations made this spring for capital investments – while the total is very substantial, the near-term capital investment needs of the Town are also very substantial, i.e., likely in the range of $50,000,000 to $100,000,000. Given the magnitude of the present capital investment needs, it is not clear that it is wise to divert as much as $3,000,000[7] more or less from capital project appropriations in FY 2013. Indeed, past discussions have pointed out that it may make sense to leave the OPEB contributions at low levels until the Retirement Trust Fund is fully funded, at which point the annual OPEB contributions would be raised to, e.g., a level of about $2,000,000 per year.

Other Policy Considerations

Funding the future OPEB liabilities is not a substitute for thinking about the management of the expense side of the Town's liabilities, i.e., it does not obviate the need to control or minimize future obligations.

Conclusions

At present Town officials have not had a full discussion of the issues involving the funding of OPEB liabilities. Assertions that the Town has the responsibility to fully fund the liability appear to have no basis for justification – the Town must meet its obligations but can do so in at least two ways. Furthermore, such assertions do not provide a basis for choosing a funding schedule. Even if all involved decide that it is desirable to continue to build the PEIL Fund, there has not

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[5] This is the "normal cost" reported in the actuarial evaluation of the Town's OPEB liabilities.

[6] Line 2110 of the operating budget (Contributory Retirement) includes amounts for pension costs in FY 2013 as well as for building up the balance in the Retirement Fund. I do not have a specific breakdown of the two components.

[7] This figure includes the $1,500,000 for the Retirement Fund, $1,000,000 for the PEIL Fund, and $400,000 to offset the exempt debt tax rate.

been an informed discussion of the issues surrounding a funding schedule, and thus there is no clear basis at present for making a rational decision about the funding schedule. Any decision about the funding schedule should take competing needs for funds, such as those for capital investments, into account.

I favor a rather long funding schedule, because I believe it is unfair to unduly burden present taxpayers in order to reduce the tax burden on the taxpayers many decades from now. It is also worth pointing out that we don't know which set of taxpayers have the greatest need for assistance; perhaps the best choice would be to subsidize current taxpayers at the expense of future taxpayers by continuing to fund current year liabilities from current year tax revenues. I cannot specify either a specific length or a target amount to be put into the fund annually without further detailed analysis that is probably best done on a joint basis with Town staff and relevant boards and committees.