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THE
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OPEB Funding in the Southern States

Part of *Balancing the Budget in
the Southern States*

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Balancing the Budget in the Southern States — This six-report series is based on the Volcker Alliance’s Truth and Integrity in Government Finance project results as well as additional research conducted by the Center for State and Local Finance.

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Table of Contents

Introduction	2
Other Postemployment Benefits	
Health Insurance Coverage	2
Funding Methods	3
Assessing Fund Health	4
Accounting Changes	4
The State of OPEB Funding in the South	
Unfunded Liabilities and Funded Ratios	5
Unfunded Liabilities Per Capita	6
States with Prefunding Assets	7
OPEB Reforms	7
Conclusions	8
References	10
About the Author	12
About the Center for State and Local Finance	12

Introduction

In retirement, government employees often receive pension benefits as well as other postemployment benefits (OPEB), primarily health insurance coverage. Pension costs have drawn increasing scrutiny in recent years, but OPEB also represent growing liabilities for many governments. OPEB obligations in many states accompany pensions as multibillion-dollar promises to current and past employees. Prefunding these long-term obligations can reduce the OPEB burden on the state, but this funding method is often challenging because states face budgetary pressure from near-term costs and other long-term liabilities. Unlike pension liabilities, most states do not prefund OPEB, and many states struggle to curb rising OPEB costs.

Based on research gathered for the Volcker Alliance's *Truth and Integrity in Government Finance* project, which evaluates state budgeting and financial management for best practices and the transparent use of funds, this report dives deeper into OPEB funding in the South. Beginning with a background of OPEB funding, the report reviews OPEB liabilities in the southern regions of the United States. Specifically, this report examines OPEB liabilities in the 16 states that form the U.S. Census Bureau's South region: Alabama, Arkansas, Delaware, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia and West Virginia.

Other Postemployment Benefits

While pensions provide a periodic payment in retirement, OPEB typically offer supplementary benefits, such as contributions to health care insurance, life insurance, disability insurance or other services (Governmental Accounting Standards Board 2015). Governments use this array of benefits to attract and retain a skilled workforce (National Institute on Retirement Security 2010). Often, these benefits also offset lower average salaries than those in the private sector. This section looks at several aspects of OPEB, beginning with health insurance coverage—the largest OPEB liability in most states. Next, OPEB funding methods and assessments are discussed, followed by recent changes to OPEB accounting standards.

HEALTH INSURANCE COVERAGE

For most individuals age 65 or older, the federally funded Medicare program serves as the primary health insurer. States often provide supplementary OPEB coverage for these retirees. Across the country, 27 states offer benefits as a percentage of the insurance premium cost, 12 offer fixed-dollar contributions toward the premium cost, nine offer access to insurance plans but do not contribute to costs, and two do not offer anything related to health care insurance (Pew 2016). These differences in health care options have a dramatic effect on the overall OPEB liabilities a state faces. States that tie contributions to the plan premium may see their costs rise as health care costs increase. With a fixed-dollar contribution, the state

is more protected from increases in health care costs. Providing only access to coverage but no additional contribution is the least costly health care coverage option for states.¹

States also may offer health insurance coverage to individuals who retire before the Medicare-eligible age of 65. Unlike the Medicare-eligible population, these retirees require comprehensive health care coverage. While comprehensive coverage is more expensive than supplementary coverage, the under-65 group of retirees is healthier, in general, than the Medicare-eligible population and requires fewer health care services overall.

FUNDING METHODS

Pension and OPEB liabilities have become a top policy concern and are regularly addressed by governors and state legislators (S&P Global, Market Intelligence 2018). At the center of this growing concern are unfunded liabilities, the cost of promised OPEB or pension benefits that the state has not yet covered with savings. State pension plans are prefunded, meaning the state pays, through the annual budget process, the benefit costs it incurs in a given year as well as an additional amount that prefunds the system for future costs. States determine prefunding amounts by projecting total liabilities into the future, typically 25 to 30 years, and projecting assets from investments. Any unfunded difference is then amortized, or distributed, across the time frame.

The legal protections of pension benefits require that promised payments are made to retirees. This annual expenditure necessitates a steady source of funding. In comparison, OPEB plans often lack those same legal protections, and states have long funded annual costs on a pay-as-you-go (pay-go) basis. The states that use a pay-go basis do not build assets, and contributions are subject to revenue volatility.

Although common, pay-go funding raises issues of intergenerational equity because today's taxpayers pay the retirement expenses for employees who may have retired many years prior (Auerbach and Lee 2011). Some states are moving from a pay-go method toward a prefunding method, which can improve the viability of pension and OPEB systems by building assets. Assets can be invested to generate market returns that help pay down the unfunded liability and reduce the annual burden on the state. This mechanism is especially valuable as many states are seeing large numbers of retirees and health costs that outpace inflation (S&P Global 2016).

Although a prefunding method has several benefits over pay-go, prefunding can be difficult. The forecasting of total liabilities requires numerous assumptions, such as future health care service costs, disability claims and mortality rates. Forecasting assets requires other assumptions, including an average rate of return on invested assets. Because of this uncertainty and the substantial size of many states' OPEB and pension liabilities, small changes in any underlying assumptions can have dramatic effects on the total assets and liabilities. In turn, these assumptions can affect the health of OPEB or pension funds,

¹ Employer-sponsored health insurance coverage is separate from the Affordable Care Act's Health Insurance Marketplace. Even without premium contributions, government employers can provide retirees with lower premiums than those on the individual marketplace from negotiated insurance plans. When providing access to coverage only, the state's costs are administrative.

changing the required prefunding contributions or altering the funded ratio, which shows the state's assets projected to cover future OPEB liabilities.

ASSESSING FUND HEALTH

In assessing the strength of an OPEB or pension fund, the overall funded ratio and annual contribution levels can provide some insight. OPEB funds are often less healthy than pension funds because many states fund OPEB using pay-go and do not maintain assets. However, as OPEB liabilities continue to rise across the country, the importance of prefunding OPEB liabilities to curb future costs has become a significant political consideration (S&P Global, Ratings Direct 2017a).

Oregon, for example, prefunds OPEB and has the highest funded ratio in the country at 70.9 percent. Nevertheless, this funded ratio falls short of many targets for retirement funds. S&P Global suggests that a 90 percent or greater funded ratio should be considered healthy (Brainard and Zorn 2012). The Government Finance Officers Association (2016) identifies a 100-percent funded ratio as a best practice for pension and OPEB funds. In this view, even the country's best-funded OPEB fund would fall short of healthy.

The annual contribution levels also can help determine the strength of an OPEB fund and a state's commitment to improving its funded ratio. When prefunding OPEB or pensions, the actuarially required contribution (ARC), or the actuarially determined employer contribution (ADEC), estimates the annual payment a state should make to meet its OPEB costs that are due in a given year as well as any additional prefunding. States that regularly contribute 100 percent of the ARC are striving to fulfill future obligations, ensuring their ability to support the benefits promised. While many states across the country meet the ARC every year for pension funds, few states meet the ARC for OPEB funds. Some states include OPEB prefunding above annual pay-go amounts, but not at the ARC level, which intends to reach a full funded ratio.

ACCOUNTING CHANGES

States are responding to OPEB accounting changes from the Governmental Accounting Standards Board (GASB). GASB Statement Nos. 74 and 75 alter how states calculate OPEB liabilities and how they present the information. The changes standardize some asset and liability assumptions, improving comparability across states. For some states, the new calculations may increase unfunded liabilities because states may have previously used other liability calculation methods or chosen a more optimistic rate of return assumption for their assets.² The GASB statements also require proportional share reporting for certain OPEB plans, which may reduce reported liabilities for the state and require other entities that participate in the plan to report their share of liabilities. A final major change with these statements is that states are no longer required to report the ARC. S&P Global (2017a) notes, "The ability to track state funding

² Under prior GASB rules, total OPEB liabilities could be calculated using one of six actuarial cost methods. Under the new GASB rules, only the entry age normal method is used, where an individual's pension is estimated based on a level percent of payroll from the hire date to an estimated retirement date.

progress against actuarial recommendations could be more difficult with the new standards, due to the elimination of the ARC from OPEB disclosures.”

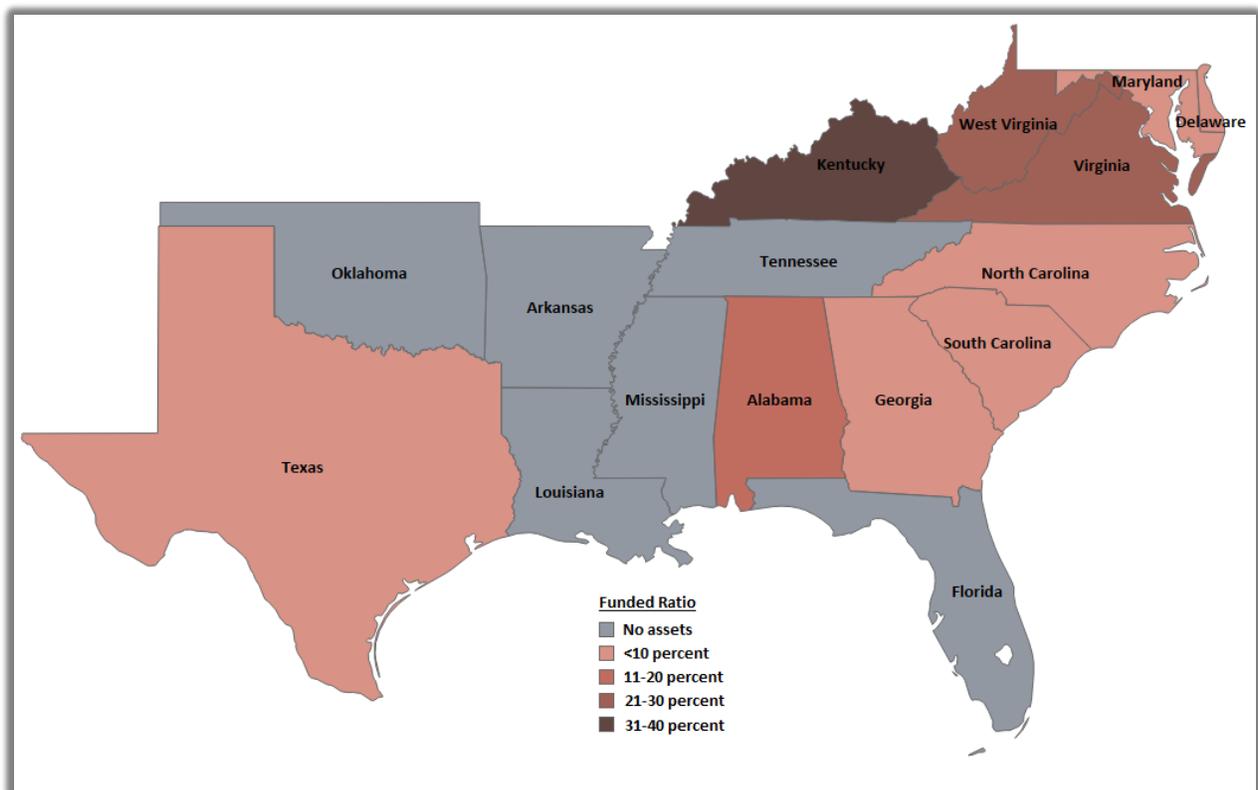
The State of OPEB Funding in the South

An examination of OPEB funding in the South reveals a wide range of unfunded liabilities, annual contribution levels and attempted reforms. This section first looks at unfunded liabilities and funded ratios, followed by a look at southern states with prefunded assets. Finally, this section illustrates reform attempts meant to reduce OPEB liabilities.

UNFUNDED LIABILITIES AND FUNDED RATIOS

Most of the southern states fund OPEB on a pay-go basis, meaning they do not meet the ARC and have few or no assets. If funded ratios and annual contributions provide some insight into the strength of OPEB funds, then funding in the South is weak, mirroring the rest of the country. Figure 1 shows the status of funded ratios in fiscal year (FY) 2016.

Figure 1. Funded Ratios of Southern States, FY 2016



Source: S&P Global; Volcker Alliance data

The average unfunded liability in the southern states—\$13.2 billion in FY 2016—is similar to the national average of \$12.7 billion. The average funded ratio for the southern states is 7 percent but climbs to 12 percent after removing the six states with no assets. Kentucky, Virginia and West Virginia prefund OPEB

costs, but none have funded ratios greater than 32 percent.³ Only Kentucky and Oklahoma met their ARC each year from FY 2015 to FY 2018.⁴ Table 1 provides an overview of the state of southern OPEB funding.

Table 1. OPEB Funding in the South, FY 2016¹

STATE	UNFUNDED LIABILITY (\$M)	UNFUNDED LIABILITY PER CAPITA	FUNDED RATIO	PAY-GO FUNDING	MET ARC FY 2015-18
Alabama	\$9,107	\$1,873	13%	Yes	No
Arkansas	\$2,160	\$723	0%	Yes	No
Delaware	\$7,150	\$7,510	5%	Yes	No
Florida	\$19,099	\$927	0%	Yes	No
Georgia	\$13,663	\$1,325	8%	Yes ²	No
Kentucky	\$4,539	\$1,023	32%	No	Yes
Louisiana	\$5,322	\$1,137	0%	Yes	No
Maryland	\$11,789	\$1,959	3%	Yes	No
Mississippi	\$709	\$237	0%	Yes	No
North Carolina	\$32,467	\$3,200	4%	Yes	No
Oklahoma ³	\$5	\$1	0%	Yes	Yes
South Carolina	\$9,857	\$1,987	9%	Yes	No
Tennessee	\$1,380	\$207	0%	Yes ⁴	No
Texas	\$87,235	\$3,131	1%	Yes	No
Virginia	\$5,297	\$630	24%	No	No
West Virginia	\$2,712	\$1,481	21%	No	No
Southern Average	\$13,281	\$1,747	7%	69% Yes	12.5% Yes
National Average	\$12,736	\$1,797	12% ⁵	N/A	N/A ⁶

Sources: Volcker Alliance; S&P Global; Pew Charitable Trusts

¹ Unfunded liabilities and funded ratios are from S&P Global based on the most recent OPEB valuations, FY 2015/16.

² Georgia made changes to begin prefunding in FY 2015, but the state's FY 2017 Comprehensive Annual Financial Report says that the state continues to use pay-go funding, despite contributions above pay-go levels since FY 2015.

³ Oklahoma does not offer substantial retiree health benefits.

⁴ Tennessee will begin prefunding in FY 2019.

⁵ This figure rises to 20 percent after removing states with no assets.

⁶ National results have not yet been released by the Volcker Alliance.

UNFUNDED LIABILITIES PER CAPITA

Because the states in the South vary widely in unfunded liabilities, examining the liabilities on a per capita basis allows for better comparison across states. The southern average unfunded liability of \$1,747 per

³ In contrast, Oregon and Arizona have the best funded ratios in the country, both higher than 60 percent.

⁴ Oklahoma met ARC over this time period, but its total OPEB liabilities are minimal.

resident is similar to the national average of \$1,797 (S&P Global, Ratings Direct 2017a). Arkansas, Florida, Mississippi, Tennessee and Virginia appear in relatively good shape with liabilities below \$1,000 per capita. Delaware, North Carolina and Texas, in contrast, have OPEB liabilities greater than \$3,000 per capita. Not only do these high per capita liabilities indicate a heavy burden relative to other southern states, but each of these states has few assets, with funded ratios of less than 5 percent. In fact, Delaware has one of the most substantial OPEB liabilities per capita in the country, only below those of Alaska and New Jersey.

STATES WITH PREFUNDING ASSETS

Only three states in the South regularly contribute some amount of prefunding: Kentucky, Virginia and West Virginia. All three states have funded ratios greater than 20 percent. Unlike Kentucky, however, Virginia and West Virginia do not make large enough contributions to reach the ARC level. Although Oklahoma also meets its ARC every year, the state is notable for its small OPEB liabilities—only \$5 million annually—because it does not offer significant retiree health benefits (State of Oklahoma 2017). Oklahoma, therefore, does not have to prefund its OPEB liabilities to meet the ARC.

Two other states have made efforts to begin prefunding OPEB liabilities, as well. In FY 2015, Georgia established an OPEB trust with the intent to prefund OPEB liabilities, and the state has made contributions above pay-go levels since FY 2015. Although the state made voluntary additional contributions of \$462 million in FY 2017, the state's 2017 Comprehensive Annual Financial Report reports that the state still uses pay-go funding for OPEB costs (Georgia Department of Community Health 2016; State of Georgia 2017). Tennessee authorized prefunding beginning in FY 2019 (State of Tennessee 2017).

OPEB REFORMS

With budgetary pressure from current costs and other long-term obligations such as pensions, states struggle to prefund OPEB liabilities. Over the past decade, most of the southern states have attempted OPEB cost-savings measures because of the increased attention on growing long-term liabilities. Overall, reforms either reduce liabilities, primarily by limiting retiree health care benefits for new employees, or increase prefunding to grow assets. In some states, reforms have consisted of removing OPEB entirely for new employees.

West Virginia instituted a series of changes that have helped grow its funded ratio. In 2006, the state created a dedicated OPEB trust fund, and in 2011, the state legislature capped retiree health care expenditures by limiting subsidy increases to no more than 3 percent, which lowered its liabilities by an estimated \$2.6 billion (Pew 2016; State of West Virginia 2018). The state also does not contribute a portion of health insurance premiums for retirees, greatly reducing its total liabilities (Schiff and McGaffey 2016). Finally, in its 2012 session, the West Virginia legislature added additional funding to reduce the state's unfunded OPEB liabilities further. These changes, particularly the decision to prefund, allowed

West Virginia to assume a higher investment rate of return on its assets that reduced estimated unfunded liabilities by 58 percent from 2010 to 2013.⁵

Kentucky also has made concerted efforts to prefund OPEB in recent years. Reforms from 2003 changed retiree benefits to fixed inflation-adjusted subsidies per month of service. Further reforms in 2010 introduced a shared responsibility solution, whereby the state, school districts, and active and retired teachers began prefunding retiree health care benefits (Kentucky Teachers' Retirement System 2010).

Louisiana and Delaware have made changes to the health care benefits they offer. Louisiana has been able to reduce liabilities by \$2 billion by changing the structure of prescription drug benefits by using an Employer Group Waiver Plan as a cost-savings tool (Pew 2016). Delaware has made several reform attempts, also changing prescription drug benefits to an Employer Group Waiver Plan. The state made lump sum contributions in 2002 and 2003 and created an OPEB trust fund in 2007. Despite several other reform attempts, Delaware's unfunded liability has continued to grow in recent years (S&P Global, Ratings Direct 2017b).

Other states have removed OPEB options for future employees to reduce costs. While Tennessee plans to prefund OPEB obligations beginning in FY 2019, the state passed additional laws during the 2015 legislative session that essentially remove retiree health care options for future hires. Both actions will help the state see significant improvements in its OPEB liabilities in the coming years. Likewise, North Carolina has instituted similar changes; beginning in 2021, no new hires will be eligible for retiree health care benefits through the state (State of North Carolina 2017).

Finally, an emerging area for reducing OPEB liability is leveraging the pricing of OPEB benefits. Generally, states provide retirees with access to OPEB plans, but the premiums are subject to annual changes (Pew 2016). Some states have found that raising OPEB premiums causes some retirees to opt for the Affordable Care Act's Health Insurance Marketplace offerings, due to the potential federal premium subsidies, reducing the state's OPEB liability.

Conclusions

Overall, OPEB liabilities in the southern states are mostly unfunded outside of the annual budgeting process. Several states have adopted reforms in recent years, with varying degrees of success. Some states in the South have begun prefunding liabilities, but even the best-funded plans have funded ratios just above 30 percent. However, the importance of addressing long-term liabilities has reached the public eye.

⁵ Without substantial OPEB assets, the discount rate assumption remains similar to a municipal bond index, around 3.5 percent. With prefunding, states can raise the discount rate assumption in line with pensions, 7-8 percent (Herman and Chmielewski 2018). The higher rate assumption helps to reduce the annual contributions of the employer or state.

In recent years, states from Georgia to Michigan have seen protests against retiree health care benefit changes. Health care costs in the United States have been difficult to curb, and reform attempts have been contentious. As the largest component of OPEB, retiree health care costs will continue to impact state budgets without significant reforms to insurance coverage and health care costs. In addition, modifications to pension and OPEB accounting from GASB are making the true liabilities of these benefits more transparent, and for many states, these represent multibillion-dollar obligations. Although some states have begun prefunding OPEB, many in the South still rely on pay-go financing that may present funding challenges in the coming years.

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