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States Need $645 Billion to Pay Full Health-Care Costs.

New accounting guidelines urge local governments to put their full health costs on their balance sheets

When Aurora, Ill., closed its books last December, about $150 million disappeared from the city's bottom line.

The Chicago suburb of 200,000 people hadn't become poorer. Instead, for the first time it recorded on its balance sheet the full cost of health care promised to public employees once they retire.

States and cities around the country will soon book similar losses because of new, widely followed accounting guidelines that apply to most governments starting in fiscal 2018—a shift that could potentially lead to cuts to retiree heath benefits.

The new Governmental Accounting Standards Board principles urge officials to record all health-care liabilities on their balance sheets instead of pushing a portion of the debt to footnotes.

The adjustments will show that U.S. states as a group have promised hundreds of billions more in retiree health benefits than they have saved up. The shortfall amounts to at least $645 billion, according to a new report from the nonprofit Pew Charitable Trusts based on 2015 data. That is in addition to the $1.1 trillion that states need to pay for promised pension benefits, according to Pew.

The new level of transparency around retiree health expenses for public workers could lower municipal-bond prices and force new decisions to reduce or scrap retiree health benefits as a way of coping with ballooning future costs, some analysts and researchers said. "I think the market has understated the concern," said Richard Ciccarone, president and chief executive of Merritt Research Services LLC, a research firm that tracks municipal bonds.

Rising retiree health-care costs are compounding government pressures when many state and local officials are struggling to manage their ballooning pension liabilities and balance their budgets. Waves of baby boomers are already wrapping up their working lives, and expenses are expected to rise in coming years.

"By not dealing with it, we could be setting ourselves up for a very unwelcome surprise," said New York State Comptroller Thomas DiNapoli.

The change will lower bottom lines by tens of billions for some state governments. In New York, the state's health-care liabilities as reported on its balance sheet will jump to $72 billion once the new accounting rules are in place, up from $17 billion. That new total would be 10 times the state's pension liabilities, Mr. DiNapoli's office said.

Mr. DiNapoli said New York has been upfront with bond-rating firms about its retiree health liabilities, but he hopes the new numbers will provide a wake-up call for policy makers. For the last decade, he has helped draft legislation annually that would establish a fund to set money aside for retiree health costs, but he said those bills have stalled.

“If you can put money towards a school or a senior center today, that has a lot more appeal,” Mr. DiNapoli said.

Most states have almost no money saved up for future retiree health-care costs and treat the benefits as an operating expense. States had just $48 billion in assets set aside as of 2015, compared with $693 billion in liabilities, according to Pew.

One state that has been setting aside more is Michigan, where retiree health-care liabilities have dropped by roughly $20 billion since 2012 partly because of added state payments. The state also stopped offering retiree health care to new employees, instead contributing an additional 2% of salary to their defined-contribution plans to limit the state’s exposure to rising health costs.

“It’s transferring the risk for those inflationary items from the state to the employees,” said Kerrie Vanden Bosch, director of Michigan’s Office of Retirement Services.

Even so, states’ retiree health obligations are still much smaller than future pension promises, which are already reported this way. Even if states were to start setting aside money for future costs, annual state spending on retiree health care would still be just 3.4% of expenditures, compared with 1.4% today, according to a study by the National Association of State Retirement Administrators and the Center for State and Local Government Excellence.

States that want to bring their liabilities down will likely face fewer legal hurdles to benefit cuts than they have with public pensions, which enjoy ironclad legal protections in many states. Courts have often upheld employers’ rights to increase health-care costs and reduce coverage unless the benefits are laid out in explicit detail in a collective-bargaining agreement or protected by a state constitution, said University of Minnesota Law School Professor Amy Monahan.

“It’s going to be really hard to prevent those changes,” Ms. Monahan said.

Among more than 80 state and local governments surveyed last year by Segal Consulting, 57% said they were somewhat or very likely to reduce benefits in response to the new accounting standards. The guidelines aren’t mandatory, though they are widely followed and ignoring them can complicate audits.

The American Federation of State, County and Municipal Employees, which represents public-sector workers, opposed the new Governmental Accounting Standards Board guidelines. It said in a comment letter that “implementing new standards during a fragile recovery may lead to hasty and unwarranted decisions about retiree health benefits.”

“If you’re going to tell people that you’re going to give the best years of your life as a firefighter or cop, you have to figure out a way to bridge those people to Medicare,” said Steven Kreisberg, director of research and collective bargaining for the union. “These are manageable expenses, if you want to manage them.”

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