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A Missing Opportunity to Fix Government Finances.

Most places focus on pensions for cost-cutting. But a new study argues it would be easier for governments to reduce the collective $1 trillion they owe in retiree health care.

Pension liabilities have been a high-profile issue in recent years, and they remain a major budget burden for state and local governments. States and cities have tried to rein in expenses by issuing less bond debt, and they've tried to mitigate further increases in their pension liabilities.

But a new study released Thursday says governments are missing a key opportunity to reclaim billions in annual revenue by not making severe cuts to retiree health care, commonly referred to as other post-employment benefits, or OPEB.

"There continues to be a lot of emphasis on pensions, and rightly so," said Stephen Eide, a co-author of the report produced by the Manhattan Institute. "But we wrote this report to say it might make more sense to focus more on OPEB reform than pensions — the simple reason being, legally speaking, you're more likely to get further in bringing down OPEB costs than pension costs."

In other words, states have more flexibility in restructuring retiree health-care benefits, and doing so could save hundreds of billions of dollars.

Eide and co-author Daniel DiSalvo argue that retiree health-care costs are just as big a culprit for crowding out other government priorities as pension costs have been, although the latter has received much more of the blame.

For instance, New York City's unfunded OPEB liability is more than $85 billion, more than four times the amount of the city's entire housing authority maintenance backlog. A 2013 study of California school districts found that rising health-care costs were in part offset by transferring money from other government funds that had been earmarked for kids with special needs and for remedial education.

A big reason retiree health care has flown somewhat under the radar is that most governments just appropriate money every year for their annual OPEB bill. While they report their annual liability — which is a collective $1 trillion — there are no long-term projections about how much their annual bill will increase over time, as there are with pensions. By not pre-funding OPEB in a way similar to pensions, it keeps the view on costs in the short term.

In general, retiree health-care costs aren't as ironclad as pension benefits. That's led some people to adopt a somewhat dismissive attitude about total liability numbers: Governments can always reduce their OPEB costs, the thinking goes, so that bottom-line number doesn't count for much.

Moody's Investors Service, which has taken a more critical view of pension debt, issued a report last year saying it doesn't view retiree health-care liabilities in the same light. Instead it focuses on OPEB more as a current budgetary expense — which averages about 1.5 percent of operating costs — when evaluating government fiscal health.

But those costs are expected to rise, thanks to health-care cost inflation and a growing retiree population. The Manhattan Institute report points to New York City, which paid $3.1 billion for retiree health care in 2015 alone — a 244 percent increase from what the city paid 10 years ago. Meanwhile the city's actual budget increased just 48 percent in comparison.

Given the trajectory, Eide and DiSalvo argue that governments should act now on health care before costs get out of control. Pointing to the trouble many governments have had in fully funding their pensions, the authors say governments should scrap the idea of prefunding OPEB and simply phase out the benefits.

How exactly that phase-out would work depends on the government, as OPEB benefits vary widely, as do the state-by-state legal requirements. But for states looking to cut costs, one area of focus may be on government retirees who are younger than 65 and therefore don't yet qualify for federal medical coverage under Medicare. People in this group keep their health-care coverage even after they retire and their former government employer continues to pay part — or in some cases, all — of their premiums.

The study notes that the Affordable Care Act, which set up health-care exchanges so that the nation's uninsured could access group health-care coverage, provides an opportunity for governments to phase out their own long-term health-care benefits. The authors point to Chicago as a test case, where Mayor Rahm Emanuel began phasing out the city's health-care program for retirees in 2014. At the time, Chicago had more than $800 million in unfunded OPEB liabilities. The Illinois Supreme Court, however, recently struck down that attempt by Chicago. The ruling was issued after the Manhattan Institute paper was completed.

The costs don't end once retirees qualify for Medicare, however. Many state and local government plans supplement federal medical coverage by paying for part of those retirees' out-of-pocket payments like copays and deductibles.

"The whole rationale [today] for having retiree health care seems to be much weaker versus when these programs were originally enacted," said DiSalvo. "California's OPEB started before there was even Medicare. Now there's Medicare, the Obama exchanges, you can get insurance under your [working] spouse if you retire early. That takes away a significant amount of need for this."

Still, some say that retiree health-care costs can be controlled without dismantling the whole system.

Josh Franzel, vice president of research for the Center for State and Local Government Excellence, notes that governments have been shifting more and more health-care costs onto their employees and retirees in recent years.

"Of course every dollar is scarce and there's competition for them," said Franzel, who had not yet seen the report. "But if you're going to try and retain individuals and have certain job types [like firefighters] that have higher physical requirements, enabling these folks to retire before being Medicare eligible is important."

But DiSalvo said some governments, such as New York City, have health-care liabilities so big that passing on more costs to employees and retirees wouldn't make a big enough dent. Additionally, he said, current employees tend to bear more of the brunt of those costs.

"In places where you're really backloading benefits, it's not only bad for … transparency, it's bad for workers themselves because you have to be a long term employee to really reap the benefits," he said. "Instead, you could put some of the [health-care] savings back into government salaries."

**This story has been updated to reflect a ruling by the Illinois Supreme Court.*

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