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Our Cities Need Preventive Care Too:

How Pre-Funding and Policy Changes Can Help California's 20 Largest Cities Manage Growing Retiree Benefit Costs

Adam Tatum

Executive Summary

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Together, California's 20 largest cities (by budget) currently have already promised $16 billion in non-pension benefits to their current and future retirees, and $12 billion of that remains unfunded. These non-pension benefits, or Other Post-Employment Benefits (OPEBs), largely consist of retiree health care.

As Baby Boomers have begun to reach their 60's, we have seen an upswing in the number of retirees accompanied by both longer predicted life spans for those retirees and an overall increase in health costs. In short, more people are earning benefits for longer periods of time at higher costs.

In general, these cities are not doing enough to address and plan for these rising long-term costs. Only nine of the studied cities are currently setting aside money for future payments, or "pre-funding." The other eleven work under "pay-as-you-go" systems, meaning they pay benefits from their operational budgets and do not accumulate assets for future payments. Should these eleven cities do nothing to address them, the growing OPEB costs could eventually crowd out crucial programs in their annual budgets.

Our analysis of the 20 cities' OPEB obligations found the following:

- **9 pre-funding cities.** Los Angeles, San Jose, San Diego, Anaheim, Roseville, Palo Alto, Bakersfield, Burbank, and Santa Clara all pre-fund their future retiree health care benefits to some extent. Los Angeles has set aside the largest portion (59%) of what it has promised retirees, followed by Anaheim, which has set aside (30%) of what it has promised.

- **11 pay-as-you-go cities.** San Francisco, Oakland, Sacramento, Redding, Santa Ana, Long Beach, Glendale, Fresno, Riverside, Pasadena, and Santa Monica have no funds set aside to pay for future retiree health care. If those 11 cities start paying their OPEB contributions as determined by CalPERS and continue to do so annually, they will collectively save an esti¬mated $2.2 billion in payments for benefits earned before 2011.

- **Benefit costs on the rise.** Average benefit costs among these cities have increased an average of 36% between 2008 and 2011. This figure hides substantial variation: while some cities have seen moderate growth over the period of less than 20% (Sacramento, Pasadena), others have seen their benefit costs jump more than 50% in three years (San Jose, Bakersfield).

- **San Francisco currently has the largest unfunded liability ($4.4 billion).** Though it still has no assets set aside to finance its future obligations, the City took initial steps to address this issue in 2008.

- **San Jose has the largest unfunded liability as a "percentage of covered payroll" (465%).** The city is slowly phasing in a full pre-funding plan, but given the scale of its obligations, it should consider altering its benefit structure.

Because pre-funding is dictated by the simple idea that the costs of a benefit (such as pensions) should be recognized as they are earned, it discourages irresponsible political behavior that defers costs to future generations that may not be able to bear them. Further, pre-funding accumulates secure assets towards paying future costs and supplements them with invest¬ment profits. Absent significant cost containment measures within the health care system, the cost of OPEB to California's cities will continue to increase in the coming years. To deal with this strain on their operational budgets, they can either restructure the way they pay for these long-term benefits or restructure the benefit plans themselves.

Options for restructuring their funding policy include committing to either fully or partially paying required contributions to pre-fund the benefit plans. Options for restructuring benefit plans include restricting eligibility for full benefits based on time worked, lowering maximum premiums covered, transitioning from defined benefit to defined contribution plans, and intro¬ducing cost sharing plans with active employees. But even as they consider changes to their benefit plans, pre-funding still offers them the opportunity to both reduce their future out-of-pocket costs and secure funding for their current and future retirees' health benefits.