5th Edition

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OTHER POST-EMPLOYMENT BENEFIT LIABILITIES

THE CONTINUING NEED FOR OPEB REFORM

ALEC American Legislative Exchange Council

LIMITED GOVERNMENT • FREE MARKETS • FEDERALISM

Other Post-Employment Benefit Liabilities, 5th Edition
The Continuing Need for OPEB Reform

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Introduction

Other post-employment benefits (OPEB), also known as the "trillion-dollar acronym," covers all the benefits a retired public employee is eligible to receive in retirement that are not a pension. These benefits include health insurance, life insurance, Medicare Supplement Insurance and other benefits.[1]

This report measures unfunded OPEB liabilities, now totaling over $959 billion (just under $3,000 for every man, woman and child in the United States). While it is difficult to estimate future liabilities because of variables like health care costs and mortality rates, calculating the present value of future liabilities can provide an estimated valuation of those future liabilities today. Unfunded OPEB liabilities are lower than the $966 billion calculation in *Other Post-Employment Benefit Liabilities, 2020*. This is caused by a slight improvement in OPEB funding, although funding levels are still dangerously low. Given that OPEB data lags one year behind pension data, we can reasonably expect OPEB liabilities to increase with the lowering of the risk-free discount rate for FY 2020.[2] What remains to be seen is the magnitude with which OPEB liabilities will increase. OPEB plans across the board have lower funding ratios than pension plans.

This study uses a risk-free discount rate, a percentage that assumes the state's inability to default on promised benefits, that is lower than the discount rates used in many state financial documents by at least two percentage points. The discount rate is the rate used to determine the monetary value today of the amount an OPEB plan must pay retirees in the future, also known as the present value of future OPEB liabilities.[3] Generally, the higher the discount rate, the lower the present value of future OPEB liabilities; and the lower the discount rate, the higher the present value of future OPEB liabilities.

Although the difference may seem miniscule, raising or lowering the discount rate by a percentage point could mean the difference of billions of dollars, or more, in liability valuations for any given OPEB plan. The ALEC discount rates are used to show a more prudent valuation of those liabilities and to more accurately compare liabilities between states. Using a lower discount rate reflects a state's inability to not fulfill a promised benefit. As discussed in previous reports, OPEB benefits often do not have the same legal protections that guarantee public pension benefits.[4] However, we examine OPEB liabilities using the assumption that states must keep their promises.

This year the risk-free discount rate decreased from 2.96% to 2.34%. The risk-free discount rate used to measure pay-as-you-go OPEB plans also decreased from 0.27% to 0.18%. These two decreases have increased the present value of OPEB liabilities. To control for year-over-year changes, this report also uses a 4.5% fixed discount rate.

Across the 50 states, unfunded OPEB liabilities, however, still total $959 billion. Additionally, estimated OPEB plan assets in this report reflect valuations for FY 2019, July 1, 2018, to June 30, 2019 for most states. These calculations are made prior to the unexpected economic downturn and subsequent increase in active members retiring at the end of FY 2020. It is for that reason OPEB reform is especially necessary, as states that have made the necessary reforms to their OPEB plans toward a defined contribution structure are better able to keep OPEB promises solvent during the unexpected economic downturn.

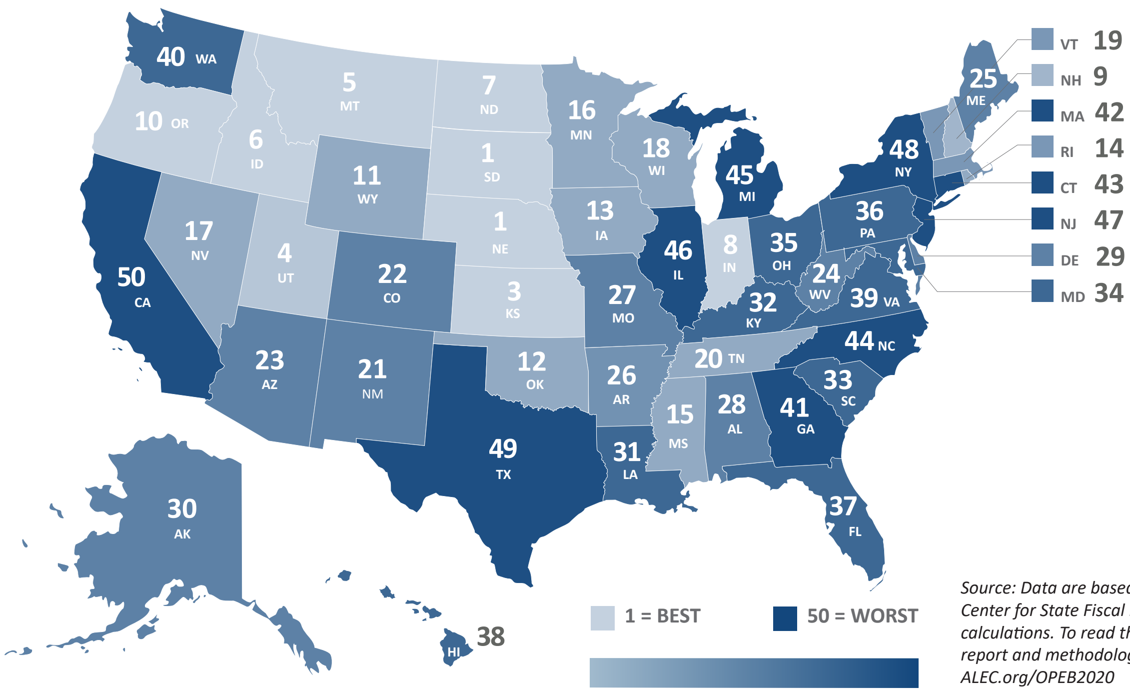
Section 2 further explains how a risk-free discount rate is calculated and why it is used to determine the value of OPEB liabilities. Section 2 also explores the lack of information regarding Actuarially Determined Contributions (ADC). Many states did not provide ADC information for OPEB plans, omitting important information for how the plans were funded. For this reason, the ADC rankings in this edition have been omitted.

State OPEB plans face many of the same problems as public sector pension plans. Without real reforms, defined benefit OPEB plans will place a severe burden on taxpayers and other state spending priorities. By offering a range of defined contribution options as well as implicit subsidies by pooling retirees together with active employees, states can keep the promises made to both public employees and taxpayers.

Section 1: Key Findings

FIGURE 1 TABLE 1
Total Unfunded OPEB Liabilities

This metric shows the total OPEB liabilities in each state. It is important to note that Nebraska and South Dakota implemented defined-contribution healthcare benefits, eliminating unfunded liabilities in these states.



Source: Data are based on ALEC Center for State Fiscal Reform's calculations. To read the full report and methodology, see ALEC.org/OPEB2020

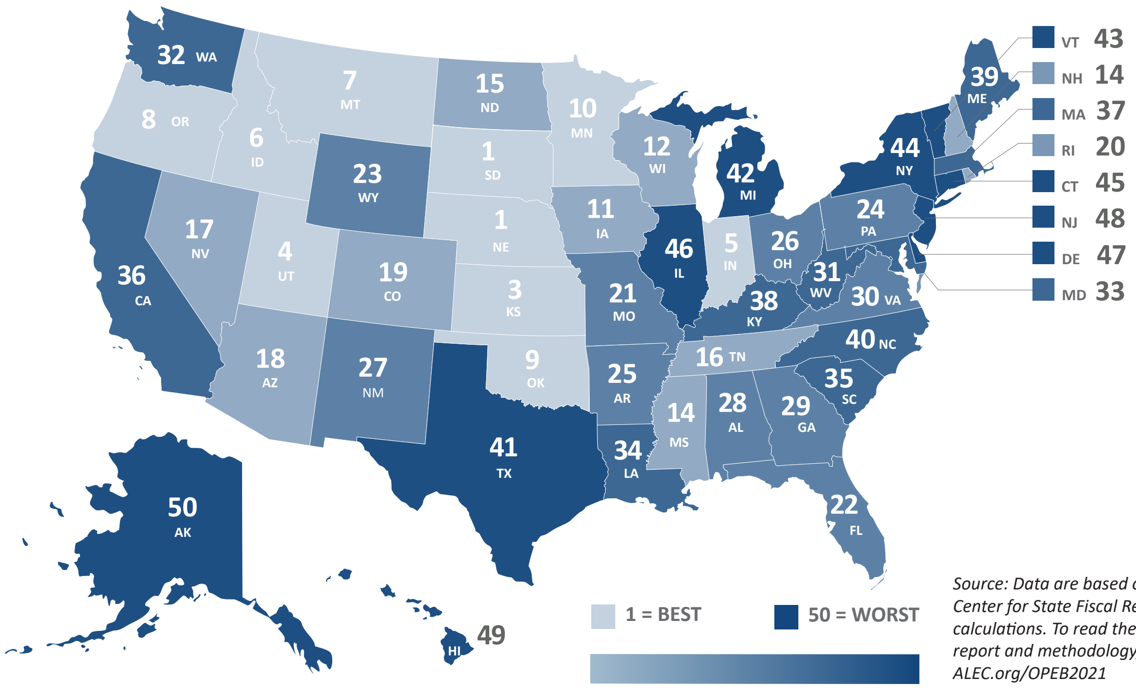
Ranking	State	Total Unfunded Liabilities
1	Nebraska	$0
1	South Dakota	$0
3	Kansas	$138,373
4	Utah	$113,643,864
5	Montana	$138,976,485
6	Idaho	$205,853,795
7	North Dakota	$258,476,535
8	Indiana	$341,007,757
9	New Hampshire	$458,891,967
10	Oregon	$581,630,093
11	Wyoming	$646,931,140
12	Oklahoma	$722,104,169
13	Iowa	$729,528,281
14	Rhode Island	$827,810,898
15	Mississippi	$1,005,027,453
16	Minnesota	$1,159,507,767
17	Nevada	$1,570,901,589
18	Wisconsin	$1,880,522,308
19	Vermont	$2,695,723,726
20	Tennessee	$2,863,852,761
21	New Mexico	$3,558,272,947
22	Colorado	$3,869,181,941
23	Arizona	$3,931,579,071
24	West Virginia	$4,015,619,011
25	Maine	$4,573,899,430
26	Arkansas	$4,706,048,273
27	Missouri	$5,217,611,482
28	Alabama	$9.111,735,649

Ranking	State	Total Unfunded Liabilities
29	Delaware	$9,897,802,620
30	Alaska	$10,465,369,515
31	Louisiana	$13,183,243,653
32	Kentucky	$14,569,561,030
33	South Carolina	$16,058,191,936
34	Maryland	$17,046,087,272
35	Ohio	$18,433,727,397
36	Pennsylvania	$18,443,951,834
37	Florida	$18.617,493,676
38	Hawaii	$18,742,935,751
39	Virginia	$18,996,780,830
40	Washington	$20,750.181.194
41	Georgia	$22,074,513,706
42	Massachusetts	$22,357,822.937
43	Connecticut	$27,596,865,649
44	North Carolina	$37,768,028,088
45	Michigan	$40,870,483,254
46	Illinois	$101,589,984,034
47	New Jersey	$104,340,736,085
48	New York	$111,615,332,033
49	Texas	$116,447,159,333
50	California	$124,608,551,798

Note: Nebraska and South Dakota have defined contribution OPEB. This means that liabilities vary for each account based on the individual retiree's medical needs.

FIGURE 2 TABLE 2
Total Unfunded OPEB Liabilities Per Capita

This metric shows the average OPEB liability per resident in each state, an indicator of potential future tax burdens on residents.



Source: Data are based on ALEC Center for State Fiscal Reform's calculations. To read the full report and methodology, see ALEC.org/OPEB2021

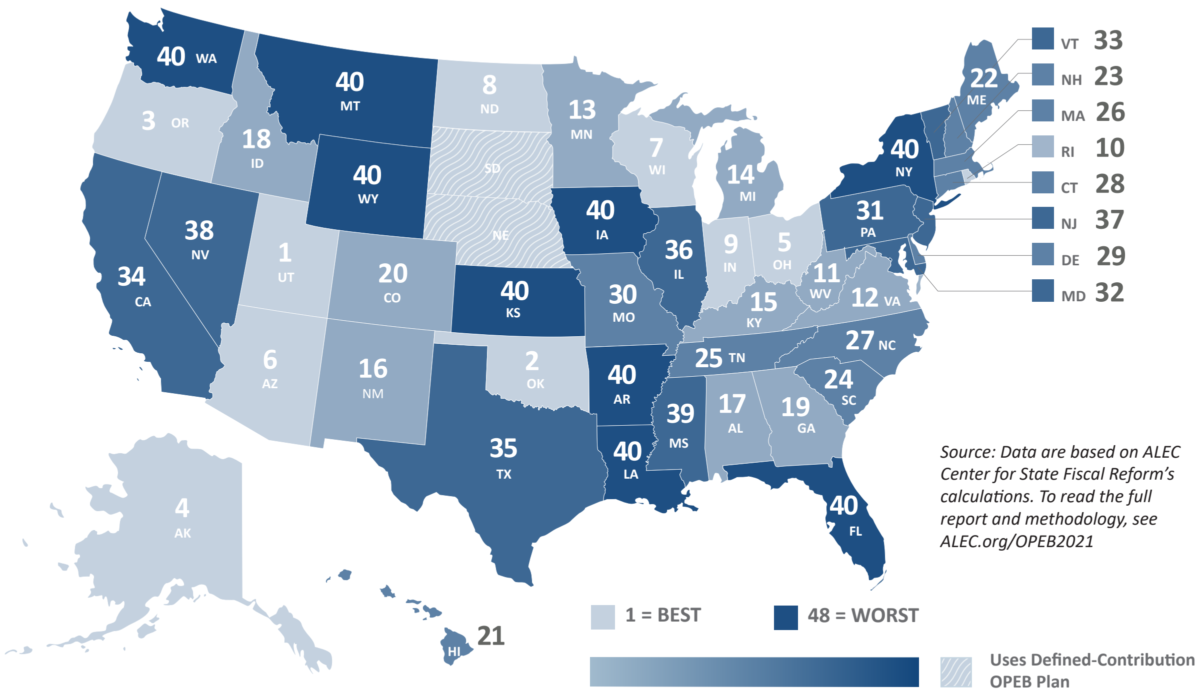
Ranking	State	Total Unfunded Liabilities Per Capita
1	Nebraska	$0.00
1	South Dakota	$0.00
3	Kansas	$0.05
4	Utah	$35.45
5	Indiana	$50.65
6	Idaho	$115.19
7	Montana	$130.03
8	Oregon	$137.90
9	Oklahoma	$182.49
10	Minnesota	$205.66
11	Iowa	$231.22
12	Wisconsin	$322.98
13	New Hampshire	$337.49
14	Mississippi	$337.69
15	North Dakota	$339.18
16	Tennessee	$419.36
17	Nevada	$510.01
18	Arizona	$540.15
19	Colorado	$671.88
20	Rhode Island	$781.42
21	Missouri	$850.13
22	Florida	$866.83
23	Wyoming	$1,117.79
24	Pennsylvania	$1,440.71
25	Arkansas	$1,559.43
26	Ohio	$1,577,00
27	New Mexico	$1,696.98
28	Alabama	$1,858.33

Ranking	State	Total Unfunded Liabilities Per Capita
29	Georgia	$2,079.08
30	Virginia	$2.225.62
31	West Virginia	$2,240.68
32	Washington	$2.724.95
33	Maryland	$2,819.55
34	Louisiana	$2,835.84
35	South Carolina	$3.118.87
36	California	$3.153.67
37	Massacusetts	$3,243.79
38	Kentucky	$3,261.11
39	Maine	$3,402.66
40	North Carolina	$3.601.04
41	Texas	$4,015.99
42	Michigan	$4,092.43
43	Vermont	$4,320.15
44	New York	$5.737.53
45	Connecticut	$7.740.43
46	Illinois	$8,017.00
47	Delaware	$10,164.48
48	New Jersey	$11,747.19
49	Hawaii	$13,237.73
50	Alaska	$14,305.85

Note: Nebraska and South Dakota have defined contribution OPEB. This means that liabilities vary for each account based on the individual retiree's medical needs.

FIGURE 3 TABLE 3
Funding Ratios

This metric shows the ratio of assets to liabilities. A higher funding ratio enables an OPEB plan to better withstand economic shocks.



Source: Data are based on ALEC Center for State Fiscal Reform's calculations. To read the full report and methodology, see ALEC.org/OPEB2021

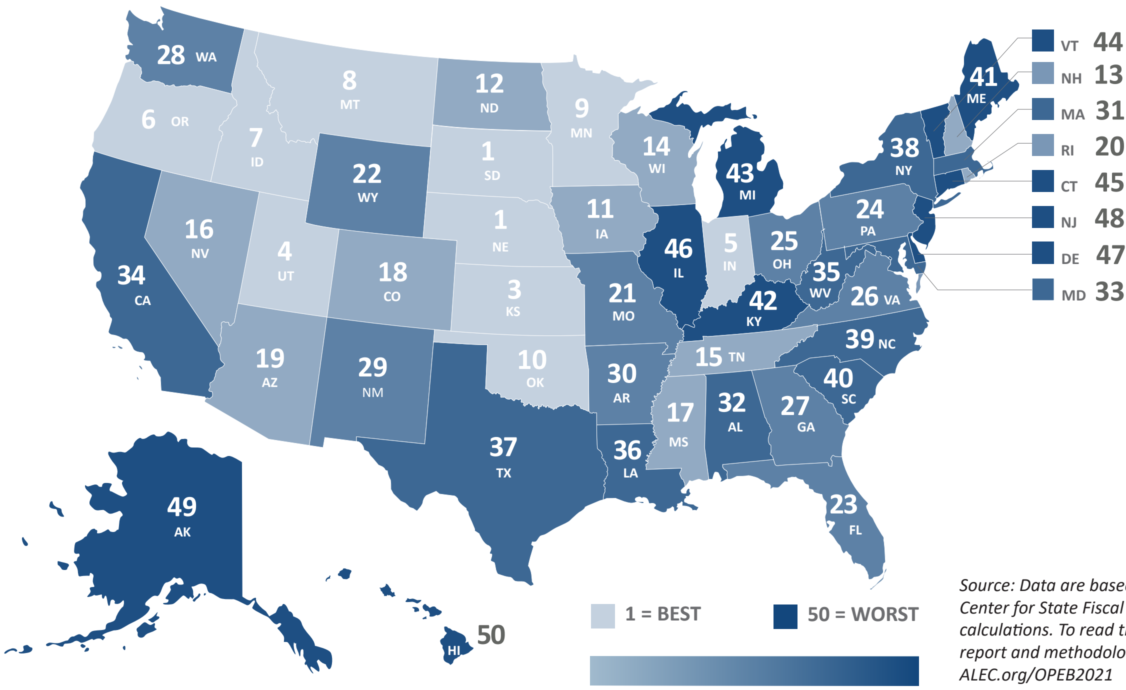
Ranking	State	Funding Ratio
1	Utah	71.69%
1	Oklahoma	54.00%
3	Oregon	52.94%
4	Alaska	50.76%
5	Ohio	47.43%
6	Arizona	38.02%
7	Wisconsin	34.94%
8	North Dakota	34.73%
9	Indiana	33.65%
10	Rhode Island	27.88%
11	West Virginia	21.37%
12	Virginia	20.46%
13	Minnesota	20.10%
14	Michigan	19.36%
15	Kentucky	17.83%
16	New Mexico	17.54%
17	Alabama	15.47%
18	Idaho	14.09%
19	Georgia	13.99%
20	Colorado	10.59%
21	Hawaii	8.36%
22	Maine	7.60%
23	New Hampshire	7.43%
24	South Carolina	7.25%
25	Tennessee	6.94%
26	Massachusetts	5.77%
27	North Carolina	4.62%

Ranking	State	Funding Ratio
28	Connecticut	4.34%
29	Delaware	3.98%
30	Missouri	3.66%
31	Pennsylvania	2.68%
32	Maryland	2.04%
33	Vermont	1.89%
34	California	1.42%
35	Texas	1.15%
36	Illinois	0.14%
37	New Jersey	0.11%
38	Nevada	0.102%
39	Mississippi	0.099%
40	Arkansas	0.00%
40	Florida	0.00%
40	Iowa	0.00%
40	Kansas	0.00%
40	Louisiana	0.00%
40	Montana	0.00%
40	New York	0.00%
40	Washington	0.00%
40	Wyoming	0.00%
N/A	Nebraska	N/A
N/A	South Dakota	N/A

**Note: Nebraska and South Dakota have defined-contribution OPEB. This means that each individual Health Savings Account (HSA) has its own ratio of assets and liabilities depending on employee medical expense needs.*

FIGURE 4 TABLE 4
Unfunded Liabilities as a Percentage of Gross State Product (GSP)*

This metric considers a state's ability to pay off its liabilities.



Source: Data are based on ALEC Center for State Fiscal Reform's calculations. To read the full report and methodology, see ALEC.org/OPEB2021

Rank	State	Unfunded Liabilities as a Percentage of Gross State Product
1	Nebraska	0.00%
1	South Dakota	0.00%
3	Kansas	0.0001%
4	Utah	0.06%
5	Indiana	0.09%
6	Oregon	0.24%
7	Idaho	0.25%
8	Montana	0.27%
9	Minnesota	0.30%
10	Oklahoma	0.35%
11	Iowa	0.38%
12	North Dakota	0.44%
13	New Hampshire	0.52%
14	Wisconsin	0.55%
15	Tennessee	0.76%
16	Nevada	0.86%
17	Mississippi	0.88%
18	Colorado	0.99%
19	Arizona	1.06%
20	Rhode Island	1.35%
21	Missouri	1.57%
22	Wyoming	1.63%
23	Florida	1.67%
24	Pennsylvania	2.31%
25	Ohio	2.66%
26	Virginia	3.43%
27	Georgia	3.46%

Rank	State	Unfunded Liabilities as a Percentage of Gross State Product
28	Washington	3.47%
29	New Mexico	3.49%
30	Arkansas	3.60%
31	Massachusetts	3.77%
32	Alabama	3.94%
33	Maryland	4.04%
34	California	4.08%
35	West Virginia	5.07%
36	Louisiana	5.18%
37	Texas	6.25%
38	New York	6.28%
39	North Carolina	6.34%
40	South Carolina	6.56%
41	Maine	6.68%
42	Kentucky	6.74%
43	Michigan	7.69%
44	Vermont	7.90%
45	Connecticut	9.58%
46	Illinois	11.41%
47	Delaware	12.85%
48	New Jersey	16.32%
49	Alaska	19.19%
50	Hawaii	20.42%

This metric examines a state's ability to pay off its unfunded liabilities. The larger the percentage, the more difficult it becomes for a state to pay off its liabilities by growing its economy. Government debt of all types, unfunded pension and OPEB liabilities and bonded obligations, create a drag on economic growth because future generations must sacrifice their income to pay down the debt through taxes.

Section 2: Key Assumptions

This study examined 140 OPEB plans spanning FY 2013-2019, with key findings focusing on FY 2019. Data are drawn from the most current Comprehensive Annual Financial Reports (CAFR) and Actuarial Valuation Reports available at the time of data collection.

Every OPEB plan examined in this report, save a handful of plans in states that have defined contribution OPEB, is structured as a defined benefit plan in which state governments—and sometimes employees—contribute funds into plans during employment. These plans often work in tandem with federal programs such as Medicare to provide various non-pension benefits for retirees.

OPEB plans can be structured as defined contribution plans as well. Defined contribution is a type of benefit structure where an employee contributes a fixed amount of money, and employers can match employee contributions up to a designated amount. Defined contribution plans, such as a Health Savings Account, stay with employees, even if they change jobs. A defined contribution plan is the best way to ensure responsible OPEB liability funding that provides flexible benefits for retirees and protects taxpayers.

As mentioned in earlier editions of Other Post-Employment Benefit Liabilities, Nebraska and South Dakota are models of reform. In *Other Post-Employment Benefit Liabilities, 2020*, Indiana was also highlighted as a state that made changes to implement a defined contribution system.[5]

It is important to note that South Dakota and Nebraska's defined contribution plans report zero unfunded liabilities as well. South Dakota and Nebraska funding ratio data are represented as "N/A" due to their transition from defined benefit to defined contribution plans as mentioned in Section 1 and further discussed in Section 4.

We'll also return to North Carolina, which closed its OPEB plan to all new hires after January 1, 2021. In addition, New Hampshire, Oregon, Tennessee and Utah have closed their OPEB plans to new hires. Section 3 will explore these different cases and what changes other states can learn from.

Total OPEB Liabilities

Total OPEB Liability for OPEB plans estimates a state's obligation to current and future retirees. State governments have seen increased pressure on their balance sheets from growing OPEB liabilities. This pressure is becoming more apparent with improved financial reporting. No new statements have been issued on OPEB by the Governmental Accounting Standards Board (GASB). The latest GASB statements pertinent to OPEB are No. 74 and 75, which are discussed extensively in *Other Post-Employment Benefit Liabilities, 2019*.[6] GASB 74 and 75 greatly improved financial transparency for OPEB reporting, much like GASB 67 and 68 did for pension reporting, but there is much room for improvement regarding discount rates, asset smoothing, funding requirements and reporting requirements for contributions.

The information required by GASB 74 and 75 is reported in the "Required Supplementary Information" notes section at the end of the state CAFR and can also be found in independent actuarial valuations for each OPEB plan. Each note is numbered and focuses on a specific topic. These notes include asset valuations and Fiduciary Net Position (FNP) for all OPEB plans, how the OPEB plan discount rate is calculated and information about liability valuations.[7] The data quality is discussed later in the subsection on transparency. It is important to note GASB 74 and 75 do not require that an OPEB plan be prefunded.

Health Care Cost Trends, Mortality Rates and Number of Retirees

Most OPEB plans use historical trends to estimate future conditions of assets and liabilities. However, history is not always the best predictor of future performance, and OPEB liabilities are more difficult to estimate than pension liabilities. Variables such as health care cost trends and mortality rates increase the variance between OPEB estimates and true performance. The variance in OPEB estimates and actual costs is greater than the variance calculated with pension forecasts. In this report and in previous editions of *Other Post-Employment Benefit Liabilities*, we did not alter plan assumptions about health care cost trends, mortality rates and the estimated number of public employees retiring each year. Although these variables remain unchanged, these factors deserve some consideration.

Health care cost trend rates are the most difficult to predict. Many factors affect health care costs, such as changes in laws and regulations as well as innovation in medical treatments, making future costs difficult to predict. Mortality rates were not adjusted to account for the COVID-19 pandemic because the data reflects FY 2019. The same can be said for the number of employees retiring each year, which saw an increase in the number of retirees as a share of all public employees in calendar year 2020.[8] If public plans underestimate future health care costs and the number of public employees retiring each year while overestimating the mortality rate, they will underestimate the cost of future liabilities, leaving them unprepared to pay future OPEB promises.

OPEB Funding: Prefunded vs Pay-As-You-Go

TThis report distinguishes two types of OPEB funding strategies: Prefunded and "Pay-As-You-Go." An OPEB plan is prefunded when assets meet these criteria, as stated by GASB Statement No. 75[9]:

1. Contributions from employers and the state to the OPEB plan and earnings on those contributions are irrevocable.
2. OPEB plan assets are dedicated to funding OPEB to retired public employees in accordance with the benefit terms.
3. OPEB plan assets are legally protected from the creditors of employers, the state government and the OPEB plan administrators. In the case of defined benefit OPEB plans, plan assets also are legally protected from creditors of public employees.

If funds do not meet these criteria, the OPEB plan is considered to have no prefunded assets. Unlike public pensions, GASB does not require OPEB funds be prefunded. In the case of prefunded OPEB plans, they are funded in a similar way to pension funds: through employer and employee contributions and investment returns. These funds are reflected in the OPEB plan fiduciary net position (FNP).

A "pay-as-you-go" OPEB plan includes plans without prefunded assets and plans that have less than 1% funding ratios. These plans depend on contributions made by the state government on an annual basis. Of the 140 OPEB plans examined, 49 plans (35%) are "pay-as-you-go" plans. Pay-as-you-go plans allow large unfunded liabilities to accumulate, especially when demographic changes occur.[10]

The Risk-Free Discount Rate

A plan's investment rate of return is based on a prefunded OPEB plan's portfolio of assets and what those investments will earn. How much these investments will earn is subject to many factors, including the interest rate and the risks associated with the assets. The assumed rate of return reflects the level of risk in plan assets.

The discount rate, on the other hand, reflects the level of risk in a plan's liabilities. Last year's report examined different cases involving states adjusting or reforming OPEB liabilities and the results are mixed—some states were able to adjust OPEB benefits while others were locked into paying those benefits.[11] The goal of the risk-free rate is to be able to create a uniform standard of measurement for OPEB plans across the country. In addition, it provides a common basis of measurement to compare with pension liabilities.

This is where this report's risk-free discount rate for prefunded plans comes in. Using a risk-free discount rate leads to a more prudent valuation of liabilities and stands as a contrast to many rosy assumptions used by many state plans. This report used a discount rate from money market fund yields of 0.18% to normalize liabilities for plans that had no assets, also known as pay-as-you-go plans. A full description of the discounting method is available in the Appendix.

This report's risk-free discount rate is based on the average of 10-year and 20-year U.S. Treasury bond yields to create a hypothetical 15-year bond yield for the 15-year midpoint of paying OPEB liabilities, which provides a more prudent discount rate. The discount rate calculated from these bond yields is the best proxy for a risk-free rate. The 15-year midpoint comes from GASB noting on pension "amortization of the total unfunded actuarial accrued liabilities (or funding excess) of the plan over a period not to exceed 30 years."[12] In laymen's terms, GASB recommends that no pension plan take longer than 30 years to fully pay its liabilities, thus 15 years is the midpoint for paying off those liabilities. While GASB is referring to defined benefit pensions, the same logic can be applied to defined benefit OPEB plans. Research has shown that a lump-sum payment in 15 years can be treated as an approximation for the annual benefit liability owed by the plan.[13]

The higher the discount rate, the lower the value of state liabilities. This creates perverse incentives for plan administrators and state policymakers to underreport the value of liabilities. Fortunately, the greater transparency mandated by GASB statements 74 and 75 has shed some light on the true magnitude of OPEB liabilities.

The risk-free discount rate is the standard applied to pensions and utilized in the ALEC pension report *Unaccountable and Unaffordable*. State pension plans often go hand-in-hand with OPEB plans because the same retirees that receive a pension also receive OPEB benefits. In both cases, state governments made a promise to employees to properly fund and manage pension and OPEB benefits. The risk-free discount rate provides a uniform measurement by which to compare both unfunded pension liabilities and unfunded OPEB liabilities. This provides readers with the most accurate picture of unfunded liabilities burden in each state.

State courts have also provided mixed rulings on the issue of whether states can legally default on OPEB liabilities. In addition, GASB has weighed in on the distinction between pensions and OPEB liabilities. In almost all cases, states have what GASB calls a "legal liability" to provide a pension because states are contractually, and in some cases constitutionally, obligated to pay out promised pension benefits. In the case of OPEB, the benefits are not as strongly protected and are referred to as "constructive liability." This "constructive liability," although not bound by strict legal requirements, represents an obligation to pay promised benefits. These benefits are promised but the amount of benefits paid may change over time, due to changes to health care costs, mortality rates, and other changes such as anticipated rates of participation.[15]

Also discussed in last year's report was the decision in Kansas to close the state OPEB plan due to severe fiscal distress from overspending. Now the state provides retirees with an implicit subsidy.[16] The implicit subsidy allows retirees to participate in the state employee health insurance plan, which pools them with state employees, thus giving them the same premiums and coverage as younger, healthier employees.

Even if states can default on their OPEB promises, the risk-free discount rates serve to normalize the variables. Plans within the same state often use different discount rates. Discount rates also vary across states. The risk-free discount rate creates a common scale that can be used to compare liabilities among different plans within a state and liabilities across states.

Actuarially Determined Contributions: An Alarming Change From GASB

Since the implementation of GASB 74 and 75, data on Actuarially Determined Contributions (ADC) has become increasingly difficult to obtain. While ADC payments were difficult to find, many plans reported "deferred inflows/outflows of resources" and "OPEB expenses." A similar discussion of pension plans reporting "deferred inflows/outflows" of resources is discussed in *Unaccountable and Unaffordable, 6th Edition*.[17] Under GASB 67, public pension plans were banned from asset smoothing, where a multiyear average of market values are taken to "smooth out" market fluctuations while masking portfolio volatility. GASB 68, issued alongside GASB 67, allows a form of asset smoothing to continue by allowing plans to defer the recognition of the difference between assumed rate of return and the actual return on investments.[18]

Under GASB 74 and 75, similar to GASB 67 and 68, the GASB Board banned asset smoothing for OPEB plans. The statement reads, "The Board concluded that the use of a smoothed market value would not faithfully represent what the measure of the OPEB plan's fiduciary net position is intended to represent as a component of the net OPEB liability."[19] In a similar fashion to the changes made in public pension accounting, however, states were allowed to report OPEB expenses and "deferred inflows and deferred outflows of resources" in relation to those OPEB expenses. As discussed in *Unaccountable and Unaffordable*, the problem with these "deferred inflows and deferred outflows of resources" is that this reporting allows a form of asset smoothing to persist. This practice allows plan sponsors to gradually incorporate any changes to the market value of the fiduciary net position over a five-year period.[20]

While every plan lists its deferred outflows/inflows of resources and an OPEB expense, it is shocking to note that many CAFRs and actuarial valuations for FY 2019 and FY 2020 did not include Actuarially Determined Contributions for their OPEB plans. State governments are required to list contribution information for their pension plans, but the same information is not included for OPEB plans. This is explained in both GASB 74 and GASB 75. In GASB 74, the board recognizes that Statement 43, which set the previous standards for OPEB reporting, required OPEB plans to present a schedule of employer contributions. This requirement was removed in GASB 74 and GASB

75 because, "the Board has removed the specific link between (a) the accounting measures of the net OPEB liability and (b) the actuarially determined funding-based measures."[21] This link was removed because OPEB liability growth is affected by numerous other factors besides contributions from the state.[22] In an attempt to take a more wholistic approach to understanding liability growth, GASB waived requirements for new ADC payments. They allow states the option to show historical trends for these contributions, but do not require them since the implementation of GASB 74 and 75.

This was a mistake on the part of GASB because it obscures information to policymakers, public employees, and taxpayers. Now these key stakeholders are kept in the dark about how much is being contributed to fund OPEB plans. This is extremely pertinent information for "pay-as-you-go" plans because these plans rely heavily on contributions from the state to remain solvent.

Funding Ratios

The funding ratio is the fiduciary net position (FNP) divided by the Total OPEB Liability expressed as a percent. The FNP is the value of OPEB plan contributions and investment returns that go toward paying the liability and used by an actuary for the purpose of valuation. In previous years, this report has used the term Actuarial Value of Assets (AVA) but, during data collection, the authors found that most plans used the term fiduciary net position. According to GASB 74, the FNP still refers to major categories of assets held, cash and cash equivalents; receivables, investments and capital assets. It also consists of the principal components of receivables, contributions from employers, the state, employees, interest or dividends on investments and investment categories.[23]

Often, many plans have overly optimistic actuarial assumptions regarding assets and liabilities. These include high rates of return on assets, low retirement rates, modest inflation growth, and even modest growth in healthcare costs. These optimistic assumptions lead to overly optimistic funding ratios as well. The funding ratios based on risk-free rates calculated in Section 1 provide a more realistic estimate of each state's funded ratio. If these assumptions were updated, one could reasonably expect OPEB liabilities to increase significantly. States will eventually need to address these rising costs, or radically change the benefits new employees receive.

Iowa

Starting in FY 2018, Iowa switched to an implicit rate subsidy OPEB plan. The implicit rate subsidy refers to the concept that retirees under the age of 65, and thus not eligible for Medicare, generate higher claims on average than active participants. In Iowa's case, the medical plan is self-insured, so premiums are usually determined by analyzing the claims of both active and retired employees and adjusting for administrative costs. The premium is called a blended premium because it blends the claims of active and retired public employees. Since individuals generally have more frequent and expensive claims as they get older, the blended premium paid for retirees is lower than market rates.

It is called an implicit rate subsidy because retirees pay a lower premium thanks to being pooled in with younger active employees. The younger active employees pay a slightly higher premium than the market would provide because they are pooled in with retirees, thus the active employees are "subsidizing" premiums for retirees. With this change, the State of Iowa also requires retirees to pay 100% of the blended premium, thus covering the state's portion of the Actuarially Determined Contribution.

The OPEB plans observed in Iowa (the single employer state OPEB plan and the University OPEB plans) are pay-as-you-go. As discussed in Section 2, pay-as-you-go OPEB plans can be susceptible to large increases in unfunded liabilities. Iowa could follow the lead of Indiana, Nebraska, South Dakota and Utah and improve its OPEB plans by pre-funding the plan and switching new hires into a defined contribution OPEB system.

North Carolina

Other Post-Employment Benefit Liabilities, 2019 highlighted the great work state Treasurer Dale Folwell and the North Carolina Legislature did to reform state OPEB plans.[24] To summarize, North Carolina made two key reforms. First, in 2006, North Carolina raised the number of years required to qualify for retiree health care from 5 to 20 years. Second, in 2017, as part of the state budget, North Carolina lawmakers passed legislation closing the retiree health insurance plan to all new hires after January 1, 2021.[25]

Now that the January 1, 2021 cutoff has come and gone, it is important for North Carolina to stay the course. Critics may point out that unfunded liabilities in North Carolina have increased since the 2020 edition of this report. This increase, however, is primarily caused by the decrease in the risk-free discount rate from 2.96% to 2.34%. When using the fixed discount rate of 4.5% for FY 2018 and FY 2019 and controlling for inflation, North Carolina's unfunded OPEB liabilities decreased by over $780 million.

The benefits of OPEB reform will continue to pay off in North Carolina in future years. As noted by Daniel DiSalvo of the Manhattan Institute, current workers who are eligible for retiree healthcare in North Carolina will retire or leave the public sector but not be replaced. This will dramatically decrease the annual costs of OPEB each year, where DiSalvo estimates that taxpayers are currently saving around $3.6 million per year in annual costs but these savings will increase after 2040.[27] OPEB costs will steadily move closer to zero as current workers quit or retire, with the last group of retirees eligible for the OPEB plan retiring at the end of 2040.

Utah

The State of Utah is another example of sound OPEB reform. While there is still a defined benefit OPEB plan in place, it is closed to employees who do not have sick leave earned prior to January 1, 2006, and to employees of the Utah State Board of Education hired on or after July 1, 2012. Currently, Utah offers Medicare supplemental plans, Health Reimbursement Accounts (HRA), Health Savings Accounts (HSA), and Flex Spending Accounts (FSA) offered through the Utah Public Employees' Health Plan (PEHP).

The unfunded OPEB liabilities in Utah have steadily decreased from FY 2013 through FY 2019. This is because the number of public employees who qualify for the old OPEB system are gradually decreasing over time as more public workers quit or retire. To enroll in any of Utah's Medicare Supplement Plans, retirees must be enrolled in both Medicare Part A and Part B. Retirees pay the full premiums and can be paid either by deducting the premium amount from the monthly pension benefit, paying a monthly bill, deducting the premium amount from the HRA or an automatic bank account withdrawal.[28] The Medicare Supplement plans offered cover 100%, 75%, or 50%

(the 100, 75 and 50 plans, respectively) after what Medicare pays. These options offer retirees the option of determining what Medicare Supplement Plan is most affordable to them.

In addition to Medicare Supplement Plans, retirees can also enroll in an HRA. The HRA is like an HSA, but retirees cannot make a personal contribution to an HRA. The Public Employees' Health Plan issues retirees a "healthcare MasterCard" that is used to pay for medical expenses.[29] Employer contributions to the HRA are made twice per fiscal year, first at the end of July and then at the end of January. Unfortunately, due to IRS rules, retirees who are enrolled in Medicare, HRA or FSA cannot enroll in an HSA.[30] The HSA offered by PEHP works like a normal HSA, where retirees can set aside pre-tax dollars, grow and invest money in an HSA and employers match employee contributions.[31] The Flex Spending Account offered by PEHP, known as PEHP FLEX$, allows employees to set aside a portion of pre-tax salary to pay eligible expenses. There are two FLEX$ accounts, one for medical expenses and another to help with dependent childcare costs. There are two variations of PEHP FLEX$ for medical expenses—some employers offer a $550 rollover, which allows you to move some unused funds into the next plan year. The other option offers a 75-day grace period by which all remaining funds must be used, or they will be lost.[32]

Despite the onerous IRS rules, the state of Utah succeeds by offering their retirees a wide range of options that do not place the burden of large unfunded liabilities on taxpayers.

Do Not Let Problems Grow into Crises: States with the Fastest Growing OPEB Liabilities

The following states had the fastest growing OPEB liabilities in the nation between FY 2018 and FY 2019. Table 5 highlights how rapidly unfunded liabilities can pile up and develop into fiscal crises.

Of these 10 states, Arkansas, Mississippi and Washington have a funding ratio of less than 1% and are listed as pay-as-you-go plans. Arkansas and Washington have no prefunded assets while Mississippi has $1.08 million in assets but over $1 billion in risk-free liabilities, giving the state a 0.12% funding ratio. In addition, Connecticut, Maryland, New Hampshire and Tennessee all have less than 10% risk-free funding ratios. While Connecticut has some prefunded OPEB assets, unfunded liability growth is driven by liability growth outpacing asset growth in the State Employees' OPEB Plan, the largest OPEB plan in Connecticut. All but one plan in Tennessee, the Primary Employee

TABLE 5 | **States with the top 10 fastest growing unfunded OPEB liabilities FY 2018-2019**

State	Percent Growth in Unfunded Liabilities
Virginia	36.96%
Tennessee	29.30%
Wisconsin	25%
Arkansas	18.50%
Maryland	14.84%
Kentucky	11.43%
Washington	7.97%
Mississippi	6.81%
Connecticut	6.20%
California	5.85%

Note: This calculation uses the fixed discount rate of 4.5% to control for changes in discount rates over time and adjusts unfunded liabilities for inflation. Previous reports note changes in risk-free unfunded liabilities.

Group OPEB Plan, have no prefunded assets. The Tennessee Group OPEB plan and the Tennessee State Employees' OPEB Plan were closed to all participating employees hired on or after July 1, 2015.[33] Although these plans have been closed for six years, they still must be properly funded. In California, despite asset growth slightly improving funding ratios, liability growth still outpaced asset growth for the State Substantive OPEB Plan, the largest public OPEB plan in California. This is reflected in the funding ratio of only 1.42% for California.

Virginia saw the largest increase in unfunded OPEB liabilities this year because its largest OPEB plan, the Pre-Medicare Retiree Healthcare plan, has no prefunded assets. By not pre-funding OPEB plans, unfunded liabilities can grow rapidly in the span of a year. Maryland prefunds its primary State OPEB plan, but the MTA OPEB plan has no prefunded assets, contributing to large growth in unfunded liabilities. Among this list, Wisconsin has the highest funding ratio at 34.94% with Kentucky in a distant second at 17.83%. The largest Wisconsin OPEB plan, the State Health Insurance Program, has no prefunded assets but uses an implicit rate subsidy to fund OPEB contributions to the state Health Insurance Program but still has traditional DB OPEB plans such as the Duty Disability Fund, and the Retiree Life Insurance Fund. Kentucky is the only state on this list that prefunds all its OPEB plans, but its funding ratio is dangerously low. This year's ranks show that while prefunding OPEB plans can help, the best way to keep plans solvent and taxpayer burdens low is by making sound OPEB reforms.

Section 4: Policy Recommendations

Transparency is Necessary for Accountable Government

To keep government accountable, taxpayers, public sector employees and other stakeholders must be able to review government operations in an easy and accessible manner. The call for greater transparency in government documents has remained constant throughout the various iterations of the ALEC Center for State Fiscal Reform publications. This call is more important now that many states are lacking information regarding Actuarially Determined Contributions.

As stated in Section 2, GASB no longer requires OPEB plans to disclose ADC payments. The authors of this report urge OPEB plan managers to continue disclosing ADC information. This information is important because it discloses how much the state is spending toward normal costs for the year and paying off unfunded OPEB liabilities from previous years. With this information, key stakeholders can assess what reforms need to be made to keep OPEB costs low for taxpayers and public employees.

Governments should disclose all financial information to the public in accessible and understandable formats in a regular and timely manner. Governments keep stakeholders in the dark when they fail to disclose important information such as the financial status of the system, actuarial assumptions, investment portfolio composition and performance, investment decisions and findings of relevant independent assessments. ALEC Model Policy, "The Open Financial Statement Act," provides information on modernizing government financial reports. The act replaces PDF-formatted audited financial statements of state, county, municipal and special district filings with filings utilizing Interactive eXtensible Business Reporting Language (iXBRL). It also establishes these iXBRL audited financial statements as the only annual financial filing required from public agencies by the state, reducing duplicative reporting and making government more efficient.[34]

It is of utmost importance that states provide consistent and clear information on the health of OPEB plans for both primary government and component units of the state so stakeholders can stay fully informed.

Reform Today, Keep OPEB Solvent Tomorrow

If state policymakers simply maintain the status quo on OPEB, unfunded liabilities will continue to grow. As state debt of all types crowds out state budgets, OPEB benefits may be the first on the chopping block. The best way for states to keep their promises of OPEB benefits to public employees and affordable government services to taxpayers is by making reforms for new hires.

If states follow the examples of Indiana, Nebraska, North Carolina, South Dakota and Utah, the sound OPEB reforms will keep these promises funded for the next generation. Nebraska, South Dakota, and Utah are already seeing the benefits of defined contribution healthcare. These states will continue to see the benefits of OPEB reform as the years continue.

Other states have taken different approaches. Iowa, as mentioned, requires that all retirees pay 100% of the premiums and provide an implicit rate subsidy. In Ohio, the Police & Fire Pension Fund discontinued its OPEB plan and instead provides retirees with a fixed monthly stipend that they may use to purchase private health insurance. As mentioned in Section 2, Tennessee closed its two major OPEB plans and now provides Medicare Supplement Plans for state employees.

Although many states are leaning on Medicare to cover retiree healthcare for public employees, that may not be a sustainable solution. Unfunded Medicare liabilities contribute $77.7 trillion of the $112 trillion 2021-2051 deficits and a major contributor to the growing federal debt.[36]

It is reasonable to expect that Medicare will go through some major reforms to account for rising benefit costs and the resulting interest costs soon. By allowing other defined contribution options aside from Medicare Supplement Insurance paid for by retirees, states can keep OPEB plans solvent and get ahead of the impending challenges of Medicare funding.

Daniel DiSalvo proposes the idea of Retiree Medical Trusts (RMT) as an alternative to OPEB. A RMT is like a Voluntary Employee Beneficiary Association (VEBA) which is an organization created to pay life, sick, accident or similar benefits to members, their dependents or designated beneficiaries.[37] The key feature of both a RMT and a VEBA is that both are voluntarily created by employees and not sponsored by employers. He notes that the key feature of RMTs is that the plans are run by employees and/or their unions instead of the state. GASB 45 allows the creation of legally authorized trusts that are sponsored by the government. The best way for an a RMT replace state OPEB plans is if the RMT is managed privately by the employees and not sponsored by taxpayers.[39,40] While the RMTs allow employees to keep defined benefit OPEB, there must be clear restrictions preventing the state or federal government from bailing out the RMT if the RMT is not properly funded or managed by the employees.

The key success of the reforms in Utah in the early 2000's is their ability to provide a plethora of options to retirees. Whether it's a combination of Medicare Supplement Plan and HRA or an HSA or FSA, employees can pick the best option for them without placing large burdens on taxpayers.

Section 5: Conclusion

Maintaining the status quo is no longer a viable option. Despite the small decrease in unfunded liabilities in this report, unfunded OPEB liabilities are just shy of $1 trillion nationwide. By ignoring the problem, state policymakers are putting promised benefits in jeopardy and saddling taxpayers with hundreds of billions of dollars in debt. The problem is not that states are not growing their economies fast enough or need better investment returns. The problems are structural. By not properly funding OPEB promises, state leaders are saddling future generations with government debt and likely future tax burdens as well.

The time for OPEB reform is now. States can follow the lead of Indiana, Iowa, Nebraska, North Carolina, South Dakota and Utah. By offering affordable options for healthcare through Health Savings Accounts, Flex Spending Accounts and implicit rate subsidies, these states are able to provide quality benefits at affordable costs to public employees and taxpayers. States have made promises to public employees for solvent retirement funds and promises to taxpayers for affordable public services. Making the necessary OPEB reforms now allows state leaders to keep their promises to everyone.

Appendix: Methodology

This report features a complete dataset from FY 2019 and uses each plan's fiduciary net position (FNP) and Total OPEB Liability (TOL) to calculate unfunded liabilities. However, this report makes several assumptions regarding the structure of state liabilities and the quality of the actuarial assumptions to present a different estimate of each state's liabilities than commonly is found in the state financial reports.

In addition, many plans often use the phrase "rate of return" and "discount rate" interchangeably. The rate of return on investments refers to the level of risk in asset portfolios while discount rate should reflect the level of risk in plan liabilities, as explained above.[41] The assumed rate of return reflects the level of risk of OPEB plan assets. The discount rate should reflect the state's inability to default on OPEB liabilities. Legal protections for OPEB are still open to interpretation by state courts. This report assumes that once states have promised OPEB benefits it cannot default on those promises.

Also mentioned in Section II, higher assumed rates of return and discount rates create perverse incentives for policymakers to overvalue the returns on investment, undervalue liabilities and lower contributions. When this occurs, OPEB plans become underfunded while giving the appearance of being well-funded.

For this report, a 15-year midpoint, using a hypothetical 15-year U.S. Treasury Bond yield, is used to derive an estimated risk-free discount rate of 2.34%. This is calculated as the average of the 10-year and 20-year bond yields. The 15-year midpoint comes from the GASB statement 45 recommendation that an OPEB plan take no longer than 30 years to pay off its OPEB liabilities.[42] As noted by Economist Eileen Norcross, "A lump-sum payment 15 years hence can be treated as an approximation of the annual benefit liability owed by the plan."[43] This measurement is also used in the ALEC pension report, *Unaccountable and Unaffordable*.[44] Applying the risk-free rate to both pension and OPEB liabilities allows for more accurate cross-state comparisons than simply comparing liability values as stated in state financial documents. Applying the risk-free rate to OPEB liabilities will also provide a more accurate comparison between pension and OPEB liabilities within a state and between states, although OPEB plan midpoints likely vary more from 15 years than the average pension plan.

Discount rates used for OPEB plans can vary even among different plans within a state. The use of a risk-free discount rate normalizes discount rates across OPEB plans, providing the means to accurately assess present value of liabilities across plans. This provides a basis of comparison for liabilities and funding ratios across the 50 states. Other variables provided by state financial documents such as mortality rates, demographics and health care costs were assumed to be correct and not normalized across plans.

The 2.34% discount rate is a more prudent discount rate than many plans use.[45] The formula for calculating a risk-free present value for a liability requires first finding the future value (FV) of the liability. That is shown in Equation 1 below, in which "i" represents a plan's assumed discount rate:

$$(1)\ FV = TOL \times (1+i)^{15}$$

The second step is to discount the future value to arrive at the present value (PV) of the more reasonably valued liability. That formula is expressed in Equation 2 below, in which "i" represents the risk-free discount rates or fixed discount rate:

$$(2)\ PV = \frac{FV}{(1+i)^{15}}$$

One challenge is that pay-as-you-go plans assume different discount rates. Prefunded plans invest their assets into long-term securities and equities. For pay-as-you-go plans, plans without assets, this study assumes a discount rate equal to the money market for large deposits, 0.18% for FY 2019, as they are not reported but likely close to the assumed return.[46] Since these money market investments offer lower yields, these pay-as-you-go plans should use a lower discount rate, but many plans do not.

This methodology was developed by Dr. Barry Poulson and Dr. Art Hall in the ALEC 2011 "Public Employee 'Other Post-Employment Benefit' Plans" OPEB report and from the ALEC 2012 pension report by Andrew Biggs.[47,48] Using a risk-free discount rate normalizes the liability values across plans and presents a more prudent valuation of liabilities than many state benefits plans with more optimistic assumptions, such as higher discount rates.

Data quality has improved since plans have started implementing GASB requirements, which has yielded improvements for utilizing various discount rates for different types of plans, e.g., single employer, cost-sharing multiple employer, agent multiple employer, single employer pay-as-you-go. As we have noted, reporting requirements for Actuarially Determined Contributions is lacking because GASB no longer requires plans to report ADC payments for OPEB.

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