THE WISCONSIN
TAXPAYER

Vol. 86, Number 5 | May 2018

Promises to Keep

Unfunded liabilities improve but still pose challenge for many cities

While Wisconsin's largest cities still face sizable unfunded liabilities for retiree health care, progress has been made to close the gap. Between 2013 and 2016, all but a handful of the state's 25 largest cities saw their unfunded commitments decrease. Nevertheless, those cities still hold liabilities of more than $2 billion, with some of them facing obligations of hundreds—or even thousands—of dollars per resident.

Over the past several decades, many cities in Wisconsin made a seemingly modest commitment to their workers, agreeing to pay some or even all of their health insurance costs in retirement.

As the cost of health care has shot upward, so has the size of this liability for local governments. But data on these post-employment benefits have remained out of reach for most citizens and elected leaders. Since 2007, national accounting standards have required the disclosure of these liabilities in financial reports. These numbers, however, do not show up in the budget documents that get the most attention from elected officials and the media.

To shine light on the issue, we reviewed reports from Wisconsin's 25 largest cities from 2013 and 2016. At the end of 2016—the last year for which complete reports are available—these cities were looking at total unfunded liabilities valued at $2.25 billion.

The commitments are known as "Other Post-Employment Benefits," or OPEB, and the vast majority of them concern health care for retirees. These liabilities aren't fixed or definitive. They are complex actuarial forecasts that rise or fall from year to year for reasons that we explain later. Some cities, for instance, are cutting their obligations by controlling their overall health care costs or by reducing the benefits offered to future retirees.

Almost no communities, however, are setting aside any money to cover the commitments that remain—cities are simply paying those expenses out of their regular annual budgets. In 2016, these 25 cities covered the health care costs of their existing retirees, but those payments amounted to less than half of the annual amount needed to pay down their liabilities over the next generation.

MIXED PROGRESS

Over the three-year period, most communities made progress

Also in this issue:

WISCONSIN POLICY FORUM

in reducing their unfunded commitments to retirees. However, the projected costs in two cities—Milwaukee and Racine—rose so dramatically that they erased the combined gains in all the other cities.

Between 2013 and 2016, the expected cost of these post-retirement health care benefits in Milwaukee and Racine rose by a total of $228.1 million. (See Figure 1.) That easily cancelled out the net $120.1 million decrease in those years in the expected benefit costs for the other 23 largest cities in Wisconsin and led to an overall increase of $108 million in retiree health care liability across the entire group. In one piece of good news, however, Racine officials say their projected liability will see a substantial drop in 2017 because of changes they have made to their benefits.

Where to Find Data on Retiree Liabilities

These obligations are disclosed by local governments in their Comprehensive Annual Financial Report (CAFR). This audited financial document is typically posted on the web page for the city's finance department, budget office, or comptroller. Here is what to look for:

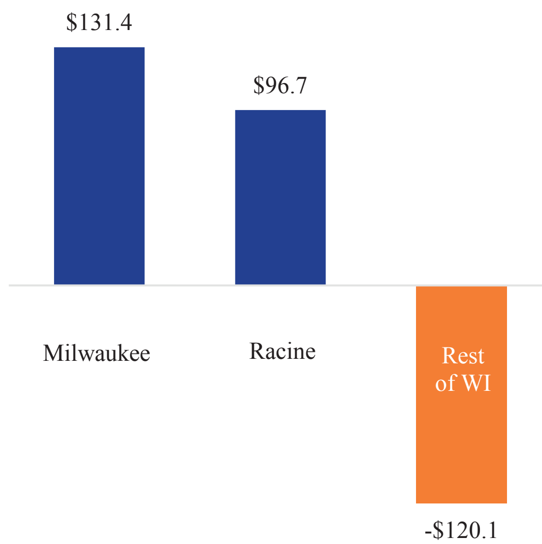
Other Post-Employment Benefits (OPEB) are any benefits offered to retired employees except their pension. For local governments, these are almost always for retiree health coverage though they may include some other benefits such as life insurance.

Actuarial Accrued Liability (AAL) is a complex projection that represents the present value of the benefits earned by retirees and active employees. It does not include benefits that might be earned or provided in the future.

Unfunded Actuarial Accrued Liability (UAAL) represents the AAL minus the value of any assets set aside to cover it. It is calculated over a 30-year time frame. Since local governments often have nothing set aside to pay for retiree health care, it is common for the AAL and the UAAL to be the same number.

Annual required contribution (ARC) is the annual amount that local governments should set aside to fund their retirees' health care for the year, cover the cost of the benefits earned by employees over the period, and pay down their UAAL. Typically, local governments choose the "pay as you go" approach and do not cover the full ARC, paying only for the health care used by their retirees that year, so their liability can grow.

Figure 1: Milwaukee, Racine Liabilities Rise
2013 vs. 2016, in $Millions



These challenges are not entirely a big city problem. Madison—the state's second largest city—has a relatively modest liability for retiree benefits while much smaller cities such as West Allis and Beloit have substantial obligations. (See Table 1, page 3.)

Given that municipal property taxes remain under state-imposed caps, the added expenses for retirees may make it harder for cities to maintain services such as parks, police, and fire protection. Local and state leaders can take a series of additional steps to help control these costs moving forward. But they

THE WISCONSIN
TAXPAYER

May 2018 Vol. 86 Number 5
Publication Number USPS 688-800
Periodical postage paid at Madison, Wisconsin

Subscription Price:
$17.97 per year
Published each month, except July, by the Wisconsin Policy Forum, 401 North Lawn Avenue, Madison, Wisconsin 53704-5033

Postmaster:
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Table 1: Unfunded OPEB Liabilities Decline in Most Cities
Unfunded Liabilities 2013 vs. 2016, % change

Municipality	2013 Unfunded Liability	2016 Unfunded Liability	Percent Change
Milwaukee	$888,982,700	$1,020,383,400	15%
Racine	$406,575,691	$503,249,686	24%
West Allis	$139,828,532	$140,942,518	1%
Beloit	$136,395,684	$102,502,429	-25%
Eau Claire	$69,237,469	$66,633,160	-4%
La Crosse	$76,663,426	$66,389,645	-13%
Madison	$55,710,752	$62,775,317	13%
Kenosha	$84,200,933	$61,778,167	-27%
Wauwatosa	$62,732,743	$46,237,093	-26%
Oak Creek	$57,307,289	$44,983,388	-22%
Janesville	$46,210,811	$41,473,664	-10%
Waukesha	$27,901,608	$27,015,611	-3%
Greenfield	$23,003,450	$21,053,259	-8%
West Bend	$14,334,314	$10,431,059	-27%
Brookfield	$8,199,722	$8,681,373	6%
New Berlin	$6,503,239	$5,547,355	-15%
Oshkosh	$11,550,920	$5,088,022	-56%
Sheboygan	$4,231,036	$4,955,334	17%
Appleton	$2,984,470	$3,593,900	20%
Fond du Lac	$6,332,156	$1,809,030	-71%
Franklin	$5,784,933	$1,278,029	-78%
Wausau	$1,483,204	$721,537	-51%
Manitowoc	$3,185,366	$652,054	-80%
Green Bay	$1,361,621	$512,561	-62%
Sun Prairie	$125,486	$112,192	-11%
Total	**$2,140,827,555**	**$2,248,799,783**	**5%**

have to balance these options with their need to keep and attract good public employees at a time of low unemployment.

UNFUNDED COMMITMENTS

Local governments in Wisconsin have offered retiree health care benefits dating back to at least the early 1970s. At that time of relatively low health care inflation, elected officials in some communities extended medical coverage to retirees to hold down salary increases or enhance overall compensation for workers. Since then, increases in health care costs have accelerated and more baby boomers have begun to retire. The bill is now coming due.

It is important to keep retiree costs for cities in context. Wisconsin, for instance, has a stable and fully funded pension system that covers nearly all state and local government employees. The main exceptions are workers for the city of Milwaukee and Milwaukee County, which each maintain their own pension systems. State workers can use the value of their unused sick leave to pay their health insurance after retirement; though those costs are substantial, the state has set aside assets to cover them. Those two factors put taxpayers and government budgets here in a much better position than in many other states.

Conversely, OPEB liabilities are largely a local government challenge and it is not entirely clear why some cities still have this problem and others do not. Take, for example, the neighboring cities of Franklin and Oak Creek, which have almost the same number of residents. The most recent projection puts Oak Creek's unfunded liability for retiree health care at $45 million, an amount that is more than 35 times larger than what Franklin expects to pay.

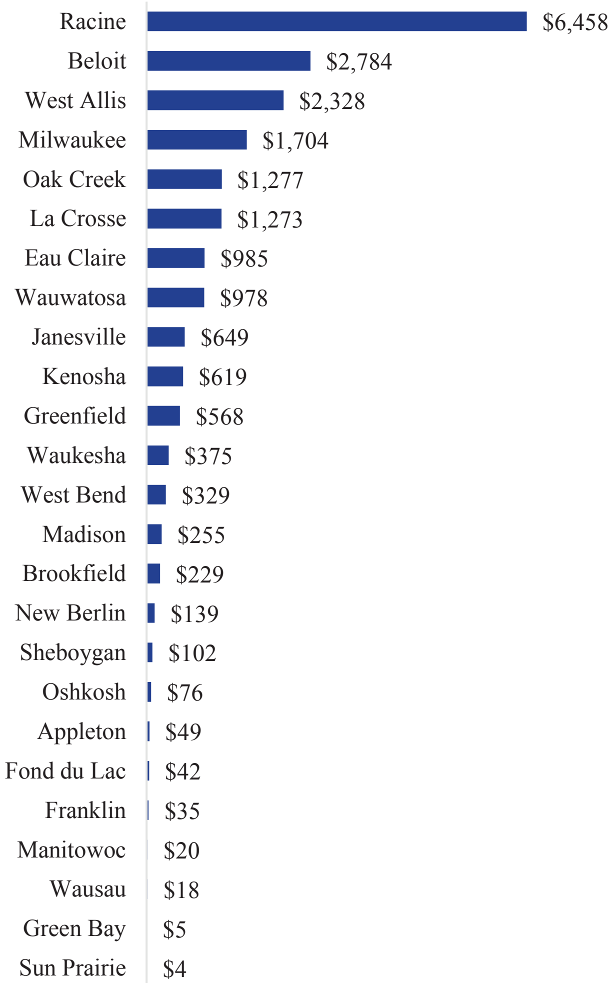
Oak Creek's liability adds up to $1,277 for every resident of the city. (See Figure 2, page 4.) The obligation is just larger than the sum the city spent on capital projects and debt refinancing in 2016. Franklin, on the other hand, has an unfunded liability of only $35 per person. The good news is that Oak Creek's liability fell 22% between 2013 and 2016.

Oak Creek has been paying the expenses on retiree benefits as they have been incurred. The city reported paying just under $2 million in 2016, up 5% from 2013. The city's finance director says Oak Creek has held down increases in recent years by making changes to its benefits and anticipates continuing to do so. Over the last several years, the city has ended guaranteed retiree health care benefits for all new hires. In the case of newly hired police officers and firefighters, Oak Creek has replaced the benefit with a contribution that is made every pay period to various retirement accounts for these employees.

IOUs to Employees

Cities took on these liabilities by handing out IOUs of $200,000 or even more in health care benefits to individual retirees. For instance, in La Crosse, a rank and file police officer hired in 2012 could potentially work for 20 years and then retire

Fig. 2: Liability Varies Among Major Cities
$ Per Capita, 2016



at age 53 with the same health benefits and same monthly premium as an active employee. Along with his or her spouse, the retired officer could then draw benefits until he or she was 65 and qualified for federal Medicare coverage.

It currently costs La Crosse $18,800 a year to provide family coverage to rank and file officers, with a net cost of $16,400 a year to the city once the officer pays his or her share of the premium. Even without accounting for inflation, it would cost the city about $197,000 for the 12 years of coverage needed to take this officer from retirement to Medicare eligibility. (See Figure 3.) So far the city has not put aside money to pay for its commitments.

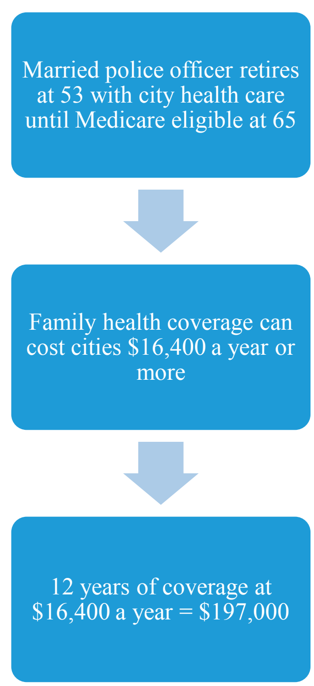
Ideally, local governments would have dealt with such costs by steadily setting aside money to cover the benefit as their workers were earning it. Instead, elected officials in some cities now face substantial liabilities that may force them to make difficult decisions on staffing and services to deal with the expenses.

Many cities have been slowly addressing the challenge. As the Wisconsin Policy Forum detailed in an April report, the city of Racine once covered all of the health care premiums for life for qualified long-serving employees who retired before 2007. Several years ago the city cut off the lifetime benefit for most employees hired after 2007 and reduced its share of premiums to between 90% and 95% for most workers retiring after that same date.

Still, current employees and even new hires who meet the requirements can have most of their premiums paid by the city between their retirement and age 65. Many employees will be able to retire with this benefit at age 55 if they have built up 20 years of service.

Estimating OPEB liabilities can be complex. Actuaries try to forecast variables such as what will happen with health care costs far into the future, how often workers will switch jobs, how long retirees will live, and how much health care they will need. In doing so, they estimate the present day value of all the benefits earned by an employer's current retirees and workers.

Figure 3: How Unfunded Liabilities Pile Up
Take this Case of a Retired Police Officer:



Law Gives Cities Options

Local governments have little or no control over some factors that impact OPEB liabilities, such as the cost increases in health care services over time. But in other respects, state law gives leaders more options for managing costs for retiree health coverage than it does for pensions or other retiree benefits such as accumulated sick leave.

For instance, local officials can manage expenses by reducing their overall health care costs. Health benefits for retired workers tend to be based on those provided to current employees. So typically, the obligation will go down if the local government helps participants get healthier, lowers the cost of its current plan, or asks active employees to contribute more through increased co-pays or deductibles.

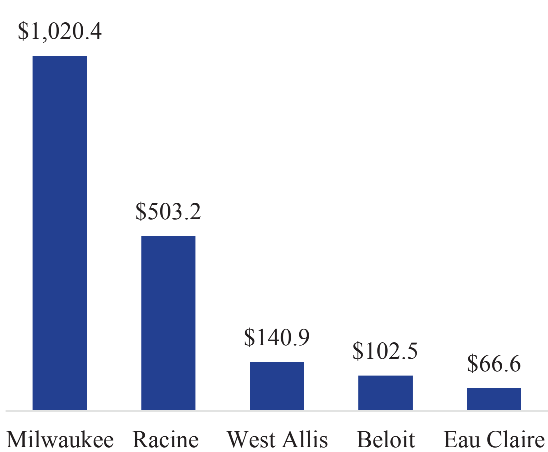
In some circumstances, officials can also choose to raise eligibility requirements for the benefit or end it altogether. Their ability to do so depends on the specific language of each employer's existing policy and union contracts; furthermore, they cannot change the fundamental nature of the benefit for former workers who have retired and are already receiving coverage. But they can change or end the benefit for new employees and, in some cases, for a portion of their current ones.

In 2008, the Wisconsin Supreme Court ruled unanimously in *Loth v. City of Milwaukee* that the city was allowed to reduce the plaintiff's retiree health benefit. Previously, Milwaukee had paid the full health care premiums for workers who retired at age 60 or older with at least 15 years of service. But the city changed its policy to require that part of the premium be paid by qualifying workers who retired after Jan. 1, 2004.

In a unanimous 2008 decision, the Wisconsin Supreme Court found that Milwaukee could reduce an employee's future retiree health benefit because the worker had not yet retired.

The plaintiff in the case had reached 15 years of service prior to the change in Milwaukee's policy and he argued that entitled him to receive the full benefit even though he retired in April 2005. The court disagreed, ruling that the language of Milwaukee's specific policy required the plaintiff also turn 60 and actually retire before he was entitled to keep this benefit. Until all three conditions of Milwaukee's policy were met, the city could change the benefit, the justices found.

Figure 4: Liability Concentrated in a Few Cities
2016 Liability in $Millions



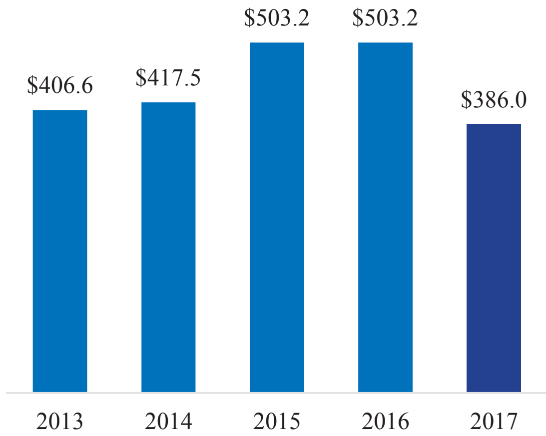
Reducing Costs

For more than a decade, local governments have made some use of this flexibility. The city of La Crosse, for example, has made a series of changes to raise eligibility standards going back to 2004. The city then phased out retiree coverage entirely for employees who were hired after January 2014. This statewide trend intensified after the passage of 2011 Wisconsin Act 10, which greatly restricted collective bargaining for public employees other than police and firefighters.

Over the past several years, La Crosse has seen the projected liability for its retiree health benefits fall by $10.3 million, a decrease of 13%, from $76.7 million in 2013 to $66.4 million in 2016. Of the 25 cities reviewed, 18 saw their unfunded promises to retirees decline over the three-year period. The biggest drop in dollars came in Beloit, where the expected obligation fell $33.9 million, or 25%, from $136.4 million in 2013 to $102.5 million in 2016. (See Figures 4, this page, and Figure 6, page 6.)

Liabilities increased in seven of the 25 cities over that period, with three communities seeing a substantial rise: Madison, Milwaukee, and Racine. Madison had a $7.1 million increase in its liability, but the overall obligation of $62.8 million remained relatively modest for a city of its size, working out to $255 per capita.

Figure 5: City of Racine Liability Declines in 2017
2013-2016 (Light Blue) vs. 2017 (Dark Blue) in $Millions



Milwaukee saw the largest dollar increase, with its projected liability rising $131.4 million, or 15%, from $889 million in 2013 to $1.02 billion in 2016. (See Figure 6.) Even if Milwaukee's actual costs turn out to be only half as large as estimated, they would still represent a considerable challenge. For instance, the current yearly budget for the city of Milwaukee's general fund, or main account, amounts to only 61% of the present value of its total retiree health care obligation over the next three decades.

Beloit has budgeted $19.1 million this year for capital needs such as street construction and maintenance, economic development subsidies, building repairs, and new equipment. If instead the city took that money and invested it to pay for the retiree health care promises for current and former employees, Beloit still would have less than half of the estimated $39.7 million needed to cover these projected costs over the next 30 years.

Racine had the largest challenges for a city of its size. Its total retiree health care obligation grew $96.7 million, or 24%, between 2013 and 2016 to $503.2 million. The good news, city officials say, is that a forthcoming study is expected to show the liability dropped to $386 million in 2017. (See Figure 5.) They said that was due to a variety of factors, including a decision to shift some retirees to a Medicare Advantage plan for prescriptions. Still, Racine's 2017 projection for its obligation amounts to $4,953 per person.

That was almost three times more than Milwaukee's substantial liability of more than $1,700 per resident in 2016 and 2017. Milwaukee will report in the coming weeks that its unfunded liability rose 4.1% in 2017 to $1.06 billion.

BUDGET IMPACT

Currently, cities in Wisconsin are paying the cost of retiree health care as they incur it each year. In doing so, they are not setting aside money for future expenses. In 2016, these cities made $76.8 million in payments on these benefits, with essentially all of that going to pay for health care for current retirees. But if local leaders wanted to also start providing the necessary funding for their remaining obligations over the next 30 years, they would have needed to budget and invest $98 million more in 2016. (See Figure 7, page 7.)

Figure 6: Five Largest Decreases and Increases
Change in Retiree Health Care Liability, 2013 vs. 2016, in $Millions

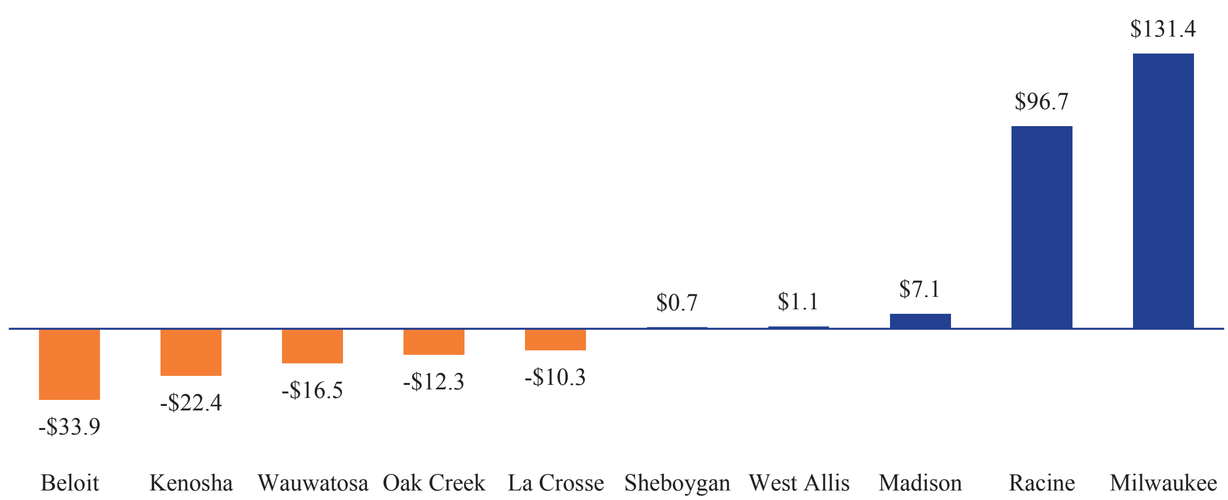
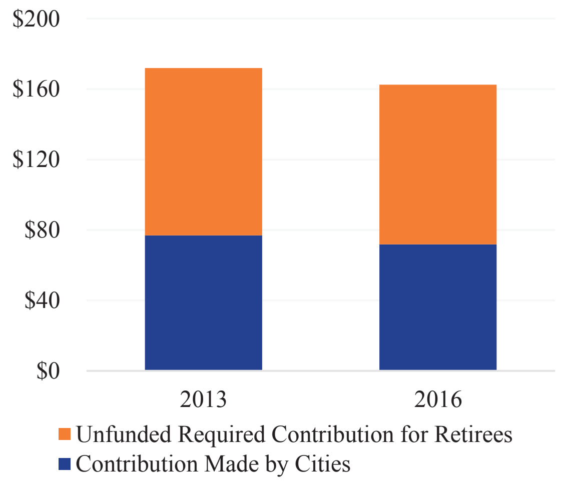


Figure 7: Cities Only Partly Funding Liabilities
Contribution Made Versus Needed, 2013-2016 in $Millions



When cities do not make these contributions, their unfunded liability may continue to grow.

To address these obligations, city officials will have to consider the realities not only of their budgets but also of their local labor markets. The benefits have been part of the total compensation package that cities have offered to police officers, firefighters, and other public workers. In some cases, the benefits were granted in lieu of pay increases.

With the state unemployment rate hovering at or near record lows, cities must compete with other employers to attract and retain good workers. If leaders drop the benefits for future retirees or make all workers cover more of their health care premiums or copays, some workers may decide to change jobs or retire more quickly.

Options for City Officials

In past years, many OPEB benefits were awarded through collective bargaining with public employee unions. In the wake of Act 10, local officials can change almost all future health benefits on their own. They still have to bargain with police and firefighter unions before changing the share of the premiums paid by those workers, which in some cases also affects the share paid by retirees.

In many recent cases, elected officials simply exercised their ability under state law and their own policies to reduce retiree benefits, and they could continue to do so. If a city still covers retiree health care for some new employees, then it could choose to drop those benefits moving forward. Many cities, however, have already taken that step. With these simple changes now made, local leaders may face greater resistance in attempting others.

One measure to lower costs would be to reduce health care benefits or increase copays for existing employees, since in many cases that also would reduce retirees' benefits. Another option would be to reduce or eliminate the benefit for existing employees who have not fully earned it under the terms of the current local policy.

If cities fear the effect on their current employees, they could cushion the blow by raising their wages or contributing to a deferred compensation account for their employees' retirement. The city of Oak Creek, for example, recently took a similar step for new hires.

In deciding their path, local leaders and voters will have to consider factors such as how fast their tax base and revenues are growing, how much debt they are carrying, and what their other long-term spending needs may be.

In addition, the state could offer incentives to entice communities to take these steps or simply require them to do so. Legislators could also consider whether local governments should be prefunding some or all of their retiree health care liabilities, as currently happens with the state of Wisconsin, city of Milwaukee and Milwaukee County pension systems.

In deciding their path, local leaders and voters will have to consider factors such as how fast their tax base and revenues are growing, how much debt they are carrying, and what their other long-term spending needs may be. Some city budgets may tolerate higher retiree health care costs than others. A community with booming development and modern infrastructure may find it easier to pay these expenses than a city with stagnant tax revenues, high debt, and aging infrastructure.

Whatever route is chosen, many local leaders will have challenging budgets in the coming years. State-imposed limits on their property tax levies and stagnant state aids may constrain the growth in their revenues and bring difficult decisions. Officials will have to consider how to pay retiree benefits while controlling the growth in property taxes and offering the services their citizens expect.

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POLICY NOTES

■ **Parents Claim Child Sales Tax Rebates.** As of June 20, 467,430 claims had been made by Wisconsin taxpayers for $100 per child sales tax rebates. Parents had until July 2 to make their claim and will receive their checks or automatic deposits over the summer.

The one-time rebate is for dependent children who are Wisconsin residents, U.S. citizens, and younger than 18 as of Dec. 31, 2017. The state estimated that about 671,000 families with 1.22 million children would be able to claim the rebate at a cost to the state of $122 million. The per child payments are worth noting both because of the savings they pass along to taxpayers and for the effect they will have in lowering the state's budget balance.

Most parents will not have to report the rebate payments as income on the state tax returns that they will file in the first part of next year. However, taxpayers should seek guidance on whether to include the payments on their federal taxes.

■ **UW Fees to Rise**. The University of Wisconsin System Board of Regents has approved increases in student fees and the cost of room and board. The System's $6.34 billion budget for the 2018-19 academic year includes an average increase of $33 per year in student fees at four-year schools and an average increase of $118 in room and board. The 2017-19 state budget also keeps in place a freeze on UW tuition for in-state students that began in 2013.

■ **Clarification on March edition of Taxpayer.** In our March edition of Taxpayer, some of the numbers on page 5 did not correspond to those in Figure 6 on the following page. Here are the correct numbers:

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During 2012-2017, only 14 of 72 counties experienced annual new construction rates of 1.25% or more. Many of the counties with new construction rates averaging 1% to 1.25% bordered these 14 counties.

■ **Order MunicipalFacts17.** Get the best tool for comparing the finances of Wisconsin's largest 245 municipalities: our annual reference guide is filled with figures on revenues, spending, and tax base. Go to https://wistax.org/publications/municipal-facts, send an email to gstaskal@wispolicyforum.org or call 608-241-9789 ext. 26.

In FOCUS . . . recently in our biweekly newsletter

- Is municipal debt rising too fast? (#8-18)
- New CBO report raises concerns for deficit, federal aid (#9-18)
- Local governments turn to "wheel taxes" as other revenues lag (#10-18)
- How should local governments respond to declining transit ridership? (#11-18)
- Municipal Street Quality: A Bumpier Ride? (#12-18)

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