

City of Newton

Retiree Benefits

A Primer

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I. EXECUTIVE SUMMARY AND INTRODUCTION

On June 20, 1928, seventeen years before the statewide uniform public employee contributory retirement law was enacted, the Board of Aldermen established a pension plan for its municipal employees, the City of Newton Contributory Retirement System.¹ On September 4, 1951, Newton's Board of Aldermen accepted the provisions of the statewide public employee retirement pension law.² Unfortunately, the City of Newton has not set aside sufficient reserves in a trust fund to meet its pension obligations. In addition, prior to 2010, the City had not set aside *any* reserves for its obligations to retirees' healthcare insurance. The City of Newton now has a combined pension and retiree health insurance unfunded liability of \$846 million. This is the difference between the present value of what we expect to owe retirees and what we have set aside to pay them.³ Current residents and future generations of the City of Newton are now faced with this dilemma.

DEFINING THE PROBLEM

City of Newton employees, like some private industry employees, earn two types of compensation—current and deferred. Salaries and other forms of current compensation reflected in paychecks are received by employees during their employment. Deferred compensation is received after the employee retires and only when vesting and age requirements have been met.

There are two major categories of deferred compensation for City of Newton employees. First are pensions, monthly payments to a retiree from an investment fund to which both the person and the City of Newton have contributed. Notably, public employees in Massachusetts, including employees of the City of Newton, are not covered by, and therefore do not receive, Social Security benefits. The second category is non-pension post-employment benefits – retiree healthcare insurance and life insurance. These are known as “Other Post-Employment Benefits” or OPEB.⁴

Pensions

Pensions for municipal retirees in Massachusetts— both eligibility and the amount —are prescribed by the Commonwealth's laws.

¹ Acts, 1928, c. 355.

² M.G.L. c. 32, § 1-28

³ A government entity such as the City of Newton has an obligation to pay deferred compensation benefits in the future once they have been earned. The dollar value of this is known as the *total pension and retiree health care insurance (OPEB) liability*. When the total pension and/or OPEB liability exceeds the pension or OPEB plan's net assets (referred to as the plan's “net position”) available for paying benefits, there is a *net liability*. This is often referred to as an unfunded liability. The combined unfunded liability for pension and retiree healthcare insurance benefits, \$846 million, should be used with caution. Because retiree healthcare insurance benefits are different in nature than pension benefits, adding the two together can be misleading. Retiree healthcare benefits are not guaranteed in the same way that pensions are. They are also a function of future health care costs which are uncertain. The state can also make changes to the provisions or rules regarding these benefits. Pension costs are a function of past salaries which are known and future projected salaries which are uncertain.

⁴ This report often uses retiree healthcare insurance when referring to Other Post-Employment Benefits, a category that includes one other non-pension benefit, life insurance. Retiree healthcare insurance, however, constitutes over 99% of the costs for Other Post-Employment Benefits.

State law requires cities and towns to pre-fund pension obligations for current employees. Both the City and the employees set aside money now to pay for the pension benefits later. Current state law also requires cities and towns to fully fund previous, accumulated pension obligations by 2040. The City of Newton's funding plan has mid-2037 as its target for full funding.

Newton has a \$244 million pension unfunded liability as of January 1, 2013. We have enough money in a fund to cover 52.3% of our pension obligations, assuming the future return on assets averages 7.75%.

Wide disparities exist in how well prepared comparable cities and towns are to fulfill their pension obligations. Lexington is in the best position with 78% of its pension obligations funded. At the other end of the spectrum, Arlington is more poorly funded than Newton with a 48% funding level for pensions.⁵

Retiree Healthcare Insurance or OPEB

In addition to our pension obligations, Newton provides healthcare insurance to retirees. The Commonwealth prescribes the minimum percentage that a city or town must contribute towards retiree healthcare insurance and the minimum level of benefits. The City of Newton provides more than the minimum level of contributions and benefits.

In contrast to pensions, the state does not require pre-funding for retiree healthcare and life insurance benefits. The City of Newton has just begun to pre-fund these benefits. As of June 30, 2013, Newton has \$602 million (in present value) more in OPEB obligations than we have reserved to cover these retiree healthcare insurance benefits. Newton has set aside enough money to cover less than 1% of retiree healthcare insurance benefits.

Instead of pre-funding, most municipalities use a policy of pay-as-you-go for retiree healthcare insurance benefits. In other words, the city or town pays the cost of healthcare insurance benefits for retirees from current operating revenues as those benefits come due. While Newton has just begun to set aside a small amount of funding through pre-funding, the city's policy is primarily pay-as-you-go. This is problematic. Financial experts note that this policy transfers costs to future Newton tax payers, costs that are appropriately borne by the current ones. The year in which residents receive services from employees is the year the employer should set aside funds to pay for the compensation the employees will receive in their retirement. Moreover, the pay-as-you-go approach fails to take advantage of the power of compounding of investment assets that pre-funding permits.

Cities and towns that Newton uses as benchmarks have more in common when it comes to gaps in funding for retiree healthcare insurance and other non-pension benefits. In our comparison group, the majority of cities and towns have set aside little or nothing to meet these OPEB obligations. Three communities have set aside meaningful sums: Wellesley (17% funded), Needham (11% funded), and Brookline (6% funded).⁶

⁵ As discussed in the report, cities and towns calculate their unfunded liabilities using different assumptions so apple to apple comparisons can be difficult.

⁶ The Massachusetts Taxpayers Foundation in October 2013 detailed the level of unfunded pension and retiree health care insurance obligations for the State and local governments. The Commonwealth's pension system is 75% funded, the teachers' 61% and the average of all municipalities is 57%. Both the Commonwealth's and municipal retiree healthcare insurance systems are less than 1% funded. The combined unfunded liability of the Commonwealth's and municipal pension and OPEB totals \$83 billion. (Massachusetts Taxpayers Foundation, "Crippling State and Local Retiree Liabilities," October 10, 2013.)

THE CHALLENGE FOR NEWTON

These funding gaps matter. Newton's employees, like all Massachusetts public employees, do not pay into, nor do they receive, Social Security in their retirement. Police, firefighters, and other Newton employees depend on these benefits for income and for healthcare insurance in their retirement.

The funding gaps also matter because if a greater portion of Newton's budget is needed to fund commitments to retirees that were made years ago, funds available for current services may be impacted. The challenge lies in proactively managing tax revenues, operating expenditures, capital investments and retiree benefit expenses while maintaining an Aaa credit rating.

The magnitude of the pension and retiree healthcare liabilities and the complexity of the issue as well as changes in accounting requirements led Ruthanne Fuller, with substantial input from a group of knowledgeable Newton residents, to write this primer. We used information – sometimes verbatim – from many sources. The sources range from the City of Newton, the Commonwealth of Massachusetts, professional associations, various Commissions and Centers, and credit rating agencies to articles from newspapers and magazines.

The goal is to explain the current status of the pension and retiree health insurance systems, and the underlying formulas and assumptions. Understanding the various figures and calculations can be surprisingly difficult. The cost of the benefits provided to employees – and the costs of those benefits that have been promised but not funded – is calculated using a complicated range of assumptions. The terminology that accountants use to describe pensions and retiree healthcare insurance is often hard to understand.

V. CONCLUSION: MOVING FORWARD

Pension and retiree healthcare insurance systems must be simultaneously secure for retirees and sustainable for taxpayers. The current funding levels and the projections for the City of Newton's pension and retiree healthcare insurance systems indicate that, like those of many other municipalities, they will not be providing sufficiently either security of benefits for employees or financial sustainability for taxpayers.

Funding for pensions and retiree healthcare insurance is done in the context of Newton's other priorities. Newton continues to need to increase spending on capital infrastructure, including school buildings, roads and sidewalks, and water, sewer and storm water systems. Enrollment in the Newton Public Schools continues to grow, creating the need to invest in additional teachers and space. Many services need to be bolstered, including those for senior citizens. The Rainy Day Stabilization Fund has grown substantially but still requires additional funding.

We may be tempted to postpone decisions about retirement benefits. But, the unfunded liabilities for pensions and retiree healthcare costs are already uncomfortably high. The liabilities will continue to rise if we do not set aside enough money ahead of time to pay for these future obligations.

The City of Newton has options. Most likely, there will be no one, single solution. We expect instead a multi-pronged, multi-decade solution. Over these decades and their unknown economic cycles, we will have to find the right balance between expenditures on City services and pre-funding/paying retiree benefits, taxes, and benefit levels. We look forward to the discussion on what approaches to take to ensure security and sustainability for the City of Newton's retiree benefit system.