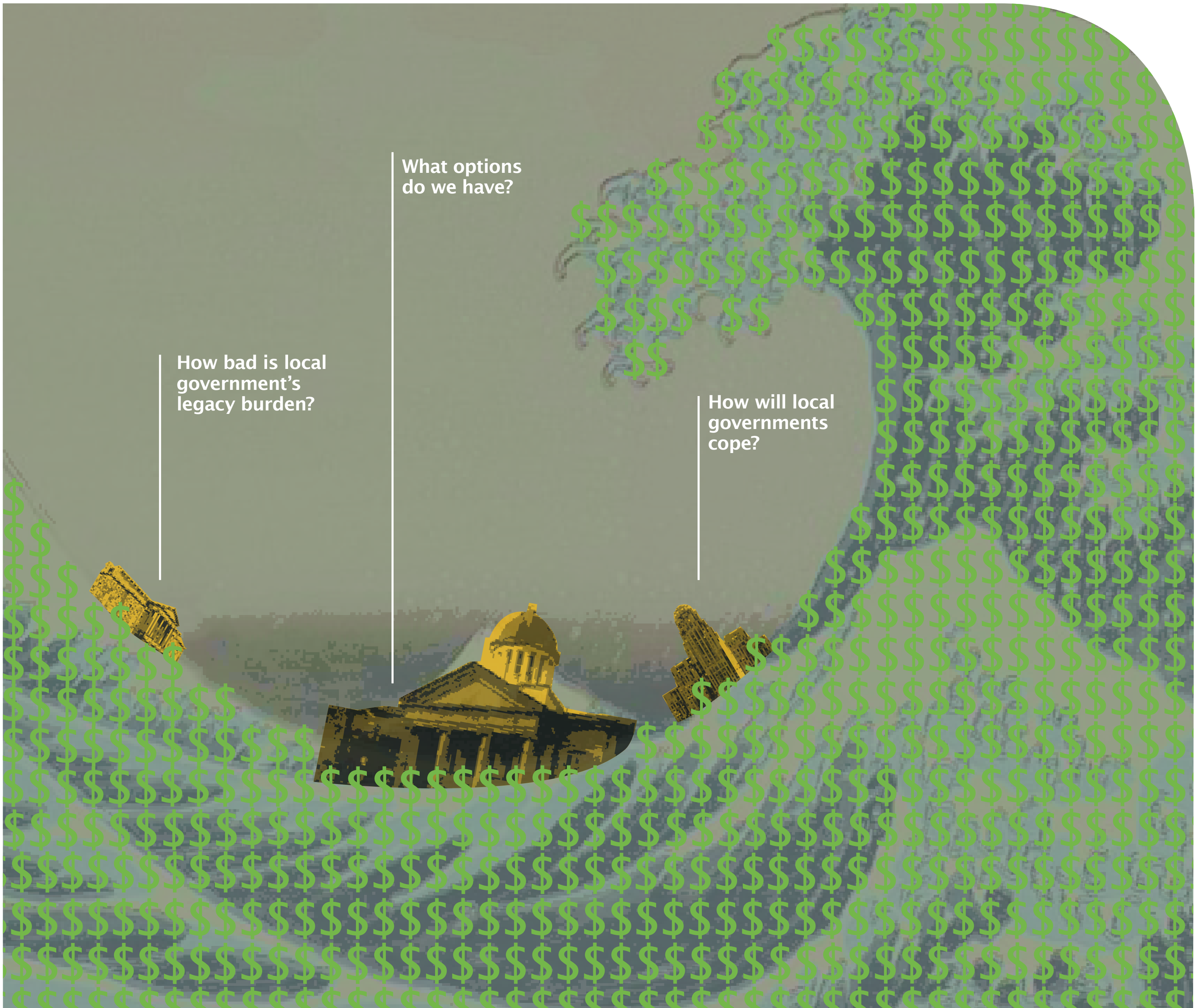


The End of Local Government As We Know It?

As local governments deal with budget fallout from the current recession, a long-term budget debacle looms. An examination of the non-pension retirement liabilities of Western New York's nine largest local governments reveals a combined $3.7 billion in unfunded obligations over the next 30 years. Hard choices must be made to proactively deal with this problem—choices that could fundamentally change the face of local government.

How bad is local government's legacy burden?

Existence has its price. For people and places alike, the passage of time brings deteriorating infrastructure and escalating repair bills. Hips fracture, water mains rupture, and repercussions from long-ago decisions accumulate. In communities grappling with aging facilities and growing ranks of public sector retirees, the toll of existence is mounting.

Retiree health care and other non-pension benefits will create potentially catastrophic strains as leaders struggle to cover long-standing commitments to increasingly long-lived workers while reinvesting in critical assets and services. Whether ignored or addressed, this challenge could fundamentally change local government as we know it.

The challenge is felt nationwide, with legacy costs escalating year by year as baby boomers retire and health care costs balloon. Credit Suisse estimates a $1.5 trillion unfunded liability in the U.S. public sector for non-pension retiree benefits. New York State has an estimated unfunded liability of $50 billion for state workers alone (over $2,600 per resident), the highest of any state.

For many counties, cities, towns, villages and school districts, the problem is especially acute, given their limited capacity for raising revenue and relatively older workforces. In 2007, the average local government employee in metro Buffalo was 47.5 years old, compared to 43.5 years for state workers in the region and 39.8 years for those in the private sector.

If data reported in 2007-2008 financial statements of the region's largest local governments are any indication of the long-term liabilities faced by local governments in general, trouble lies ahead. For the nine largest local governments in Western New York (by revenue) examined in this brief, the estimated 30-year value of unfunded non-pension benefits that have been or will be earned by retired and current employees is nearly $3.7 billion. Analysis of these statements reveals the following:

> ***Long-term unfunded liabilities vary widely, reflecting diverse approaches to employee compensation.***
> Among these nine governments, the estimated 30-year unfunded liability for non-pension benefits range from $1.04 million for the Williamsville Central School District (or $16 per capita) to $1.08 billion for Buffalo City Schools (or $3,968 per capita). All but two of these governments have per-capita liabilities greater than $500. These estimates are tied directly to the degree that deferred compensation—such as retiree health care—is used as a means of attracting and retaining employees without raising personnel costs in the short-term. A variety of economic, social and political factors can motivate this practice, including fiscal distress and compensation for difficult working conditions.

> ***Governments are allocating less than half of what they should, every year, to meet their long-term liabilities.***
> Along with estimating their 30-year unfunded liabilities, governments also calculate their Annual Required Contribution (or ARC)—an actuarially determined amount likely to provide sufficient resources to pay benefits as they come due. The ARC represents a combination of dollars to cover current-year retiree costs, as well as dollars set aside for future years. Currently, these nine governments are not meeting their ARC. At 39 percent of ARC, the Buffalo School District's payment in 2007-2008 came closest to meeting this standard, while Erie County and Cattaraugus County lagged at 23 percent of ARC. These figures reflect the widespread "pay-as-you-go" practice of covering current-year non-pension retiree costs and nothing more.

> ***If property taxes alone had been used to close the gap between payments made and the annual required contributions in 2007-2008, tax rates would have increased sharply in many places.***
> Given the funding levels allotted to non-pension benefits in their 2007-2008 financial statements and their estimated ARC levels, each of these governments would have had to sharply increase their retiree health care allotment to achieve the ARC. If these increases had been made with funding derived entirely through the local property tax levy, tax rates would have ascended by double digit percentages in all but two of these jurisdictions. The largest tax increases would have come in the City of Buffalo. A city taxpayer would have seen a 46.5 percent spike in the city's tax levy and a 92.5 percent increase in the school district's levy. For a house assessed at $100,000, these increases would have translated into a $1,445 combined property tax increase—not counting the increase to the Erie County tax bill.

An Emerging Picture

The Governmental Accounting Standards Board (GASB) is implementing new guidelines requiring state and local governments that follow GASB rules to report on "other post-employment benefits," or OPEB, in their annual financial statements. These include all non-pension retiree benefits, led by health care.

Unlike some states, New York does not require local governments to estimate or publicly report their non-pension retiree liabilities. As a result, the new GASB policies—which affect most school districts and large local governments in New York—will provide the first real glimpse of the long-term non-pension liabilities faced by local governments. WNY's largest governments—including the nine examined here—are the first to be affected by the new rules.

Public Entity (ordered by Unfunded Liability)	30-year Unfunded Liability	Per Capita Liability	Annual Revenue	What is the ANNUAL REQUIRED CONTRIBUTION	What was PAID IN 07-08	TAX INCREASE	On a $100,000 Home
Buffalo City SCHOOL DISTRICT	$1,081,714,000	$3,968	$808,605,000	$105,805,000	$40,736,000	92.5%	$855
Buffalo CITY	$945,598,800	$3,468	$571,261,000	$57,158,000	$21,834,000	46.5%	$590
Erie COUNTY	$736,191,567	$806	$1,573,783,000	$76,799,332	$17,484,977	22.7%	$117
Niagara COUNTY	$351,231,633	$1,635	$354,927,076	$24,433,894	$8,619,575	20.4%	$163
Niagara Falls City SCHOOL DISTRICT	$263,898,804	$4,818	$144,277,097	$17,865,713	$6,242,640	46.4%	$98
Amherst TOWN	$133,824,359	$1,158	$141,040,975	$11,070,362	$3,181,327	21.7%	$104
Cattaraugus COUNTY	$124,631,500	$1,556	$158,821,000	$11,784,720	$2,753,366	21.6%	$249
Chautauqua COUNTY	$25,282,000	$189	$334,007,000	$3,084,000	$1,087,000	3.6%	$31
Williamsville Central SCHOOL DISTRICT	$1,039,623	$16	$158,399,000	$122,535	$31,123	0.1%	$1

What **should have been allocated** in 2007-2008?
What **was allocated** in 2007-2008?

If funding to meet the Annual Required Contribution had been paid entirely through **property taxes, how much would taxes have risen?**

30-year Unfunded Liability:
The value of unfunded non-pension retirement benefits already earned by retired and current employees, estimated actuarially for a 30-year period.

Annual Required Contribution (ARC):
The annual payment necessary to retire non-pension retirement liabilities in the long-term.

What options do we have?

PAY-AS-YOU-GO

MUNICIPALITIES
Buffalo
Amherst

SCHOOL DISTRICTS
Buffalo (City)
Niagara Falls (City)
Williamsville Central

COUNTIES
Cattaraugus
Erie
Niagara

Maintain the present course...

The pay-as-you-go approach allocates funding to cover the current-year cost of non-pension retiree benefits.

These payments can escalate rapidly as retirees grow in number and health care costs inflate, requiring larger and larger percentages of municipal revenue over time.

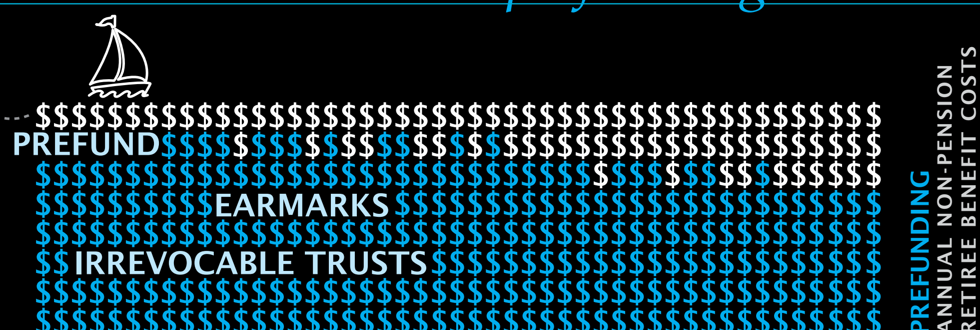
SAVINGS from health care cost containment:

Entering cooperative benefit plans

Raising premiums, deductibles and co-pays

Initiating employee wellness programs

...or adjust course through cost containment *and prefunding.*



The prefunding approach allocates funding at or near the Annual Required Contribution (ARC) level, covering current-year costs and setting aside funding for future liabilities through budget earmarks or irrevocable trusts.

Prefunding establishes a pattern of predictable yearly payments enabled by investment income and compound interest.

PREFUNDING

COUNTIES
Chautauqua

Doing nothing is the easiest option—and the riskiest. As years pass, spiraling costs can inundate local governments to a point of insolvency, leaving them incapable of meeting obligations to taxpayers and municipal retirees. Avoiding this dire scenario is by no means simple, especially for governments facing the largest unfunded liabilities. For many governments, a combination of health care cost containment and prefunding will be needed to reduce and ultimately retire their long-term liabilities.

Several steps can be taken to stabilize or lower costs. Entering into cooperative health care plans with other governments can save by enhancing the collective's ability to negotiate lower rates. The Labor Management Health Care Fund in Erie County, currently with eight participating entities, is a local example of this approach. Elsewhere in New York, health consortiums are being implemented or studied in several places with the help of shared services grants from the state. Employee wellness initiatives are also emerging in more and more places, with the goal of reducing costs by creating healthier workers and smarter health care consumers.

Another cost-side approach involves adjusting employee contributions (by raising premiums, deductibles and co-pays) or making the switch from a defined-benefit system to a defined-contribution system. While substantial cost-savings can accrue from these changes, they can be difficult to achieve, often requiring a collective bargaining process. Incremental changes that affect only new employees are often easier to negotiate than more sweeping changes, though the clear prospect of insolvency may alter the bargaining positions of administrators and unions.

Even if costs can be stabilized or reduced, the remaining costs still need to be funded. Prefunding these liabilities, either fully (by reaching the Annual Required Contribution) or partially, is costlier in the short-term than the pay-as-you-go approach, but produces income to help cover expenses in future years. Because borrowing to prefund is not allowed by state law, funding must be drawn from existing budget items or raised through higher taxes. Painful as these choices are, failing to prefund can lead to lower credit ratings and a spike in borrowing costs.

Currently, municipalities in New York can prefund their liabilities by earmarking a portion of their fund balance. For these earmarks to count against the liability, the new accounting standards require the establishment of an irrevocable trust where assets are legally protected from creditors and devoted exclusively to non-pension retiree payments. New York law does not expressly authorize these trusts, but a bill in the legislature may soon change this, allowing the state to create a trust for itself and participating local governments, and allowing municipalities to create their own trusts.

Chautauqua County's Approach

With its relatively low unfunded liability ($25.3 million, or $189 per capita), Chautauqua County has taken several steps to control expenditures on retiree health care and prefund its liabilities.

Cost Containment **Health care options for retirees are basic. When county workers retire, they have the option of receiving a lump sum payment for accumulated sick days or using their sick days to purchase health insurance. If they choose the latter, every five sick days are converted into one month of health insurance, with the employee responsible for 15% of the premium. If the employee has served the county for at least 15 years, then each year of service is also converted into one month of health care. As a result, the average qualifying retiree receives three to four years of health insurance through the county before switching to Medicare or private coverage.**

The county has also taken incremental steps to contain retiree health costs. In the latest round of labor negotiations, the county and its bargaining units agreed to benefit plan changes. New flex, Medicare advantage and prescription drug plans will result in cost savings for the county while maintaining benefit levels for retirees.

Prefunding **To help cover the long-term liabilities posed by sick day accruals, the county designated a portion of its fund balance to that purpose. Originating in the early 1990s, the fund balance has accumulated nearly $12 million from regular budget earmarks and investment earnings. From an accounting standpoint, however, these earmarks do not qualify as prefunding and cannot be counted against the county's long-term liability. Until the county creates an irrevocable trust—pending explicit authorization by the state—the funds may be used for other purposes. Due to the current economic and fiscal environment, the county recently reduced its annual earmark to the fund balance and may reduce or eliminate the earmark next year.**

The promise of a lifetime…

For municipalities with the largest retiree liabilities, the promise of lifetime health care for workers (and sometimes their spouses) is a major contributor. These promises were often made decades ago, when workforces were young, life expectancies were lower and the cost of health care was more stable.

Today, these governments are caught in a bind similar to many older companies with unsustainable obligations. While companies such as Bethlehem Steel have declared bankruptcy to absolve themselves of these liabilities, municipal bankruptcy is a more complicated and far less traveled route. Striking a workable balance that treats employees and retirees fairly while doing the same for taxpayers is ideal. But if a balance cannot be reached, radical measures—bankruptcy, consolidation, or some other substantial restructuring—may be inevitable.

How will local governments cope?

Knowledge is power. Governments that have calculated their non-pension retiree commitments now have the information and responsibility to address the promises they have made. And those that have not should do so.

However, the current global financial crisis has precipitated a fiscal crisis, and New York State and local government budgets have been hit hard. Revenues have stagnated or declined and will likely decline further while expenditures continue their higher-than-inflation increases. The same governments saddled with non-pension retiree liabilities and a short-term fiscal crisis also face long-term demographic, socioeconomic and fiscal pressures that negatively affect their fiscal capacity. Shrinking populations, aging infrastructure and rising debt burdens will drain local government treasuries further.

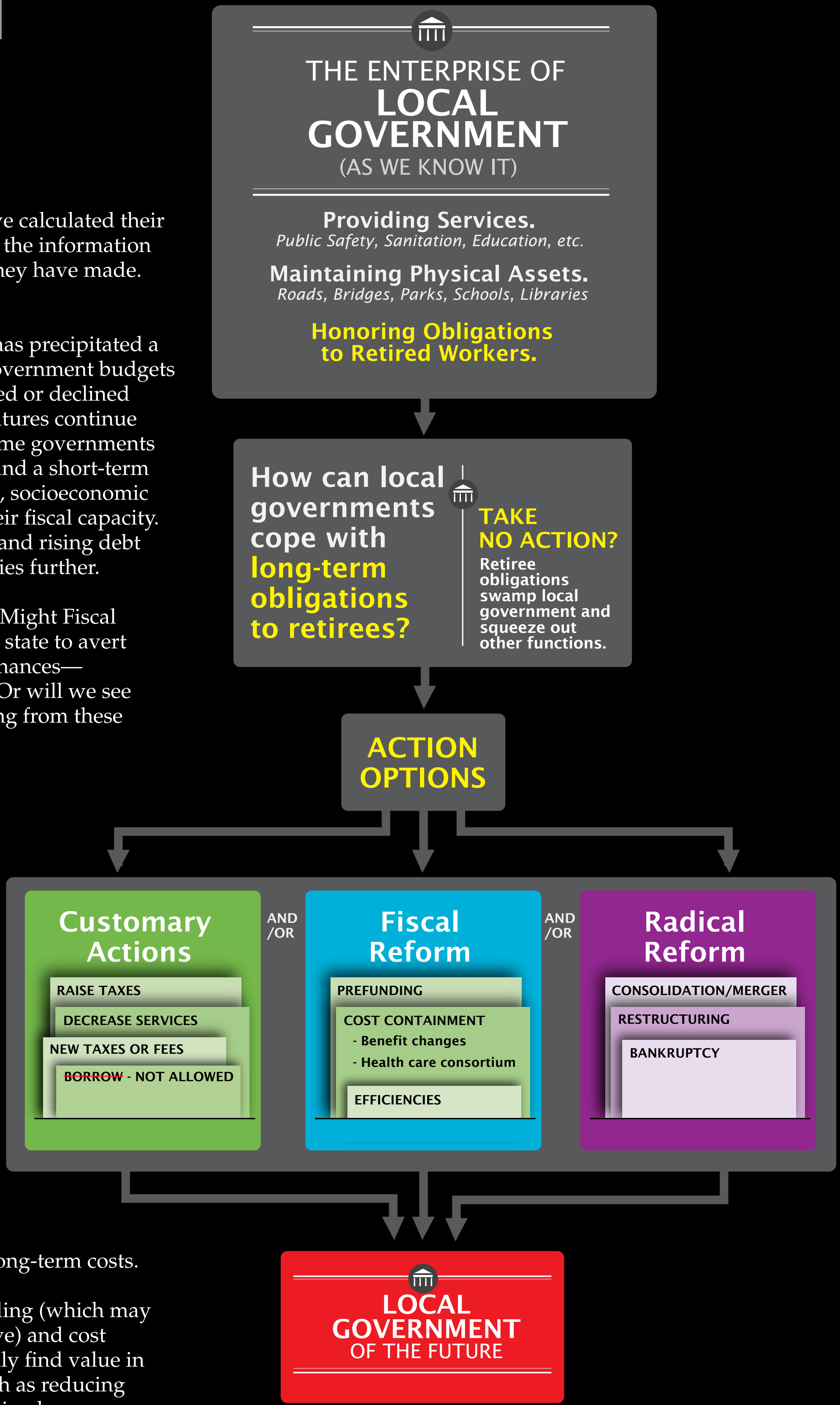
How can local governments possibly cope? Might Fiscal Stability Authorities—entities created by the state to avert insolvency and stabilize local government finances—proliferate throughout Western New York? Or will we see new approaches to local government evolving from these short- and long-term crises?

Despite uncertainties and fiscal stress, each local government will be charting a course for the future, willingly or not. Doing nothing, which would turn some governments into unrecognizable entities devoted simply to paying out retiree benefits, is not sustainable. Instead, three general paths can be pursued in either a planned and purposeful way, or in a hasty attempt to avert disaster.

The first path invokes customary means of plugging budget holes—raising taxes, decreasing services, or implementing new taxes or fees. These options may be preferred by many governments with relatively low liabilities. For others, these tools may be impractical or even insufficient to cover long-term costs.

Fiscal reform is another path, led by prefunding (which may require tax increases or service cuts to achieve) and cost containment. All governments can potentially find value in one or more cost containment measures, such as reducing benefit levels. As costs are reduced, prefunding becomes more and more affordable.

Drastic change is also an option for any government, especially those with liabilities that cannot be addressed by less radical means. These changes may take the form of consolidations with other governments, fundamental restructuring and, as a last resort, bankruptcy.



If none of these paths is taken intentionally, radical reform may become a forced option. And whichever path is taken, local government as we know it will change.

Data Notes

Unfunded non-pension liabilities, annual required contributions and 2007-2008 non-pension retiree payments for the primary government activities of the nine governments examined in this brief (Erie and Niagara counties include respective community college liabilities) come from 2007-2008 financial statements issued by those entities. Revenue figures are drawn from the same financial statements; revenue reported for the City of Buffalo comes from the 2006-2007 financial statement due to the unavailability of certain 2007-2008 data at time of publication. Per capita figures were generated using 2005 population estimates for the Niagara Falls and Williamsville School Districts and 2007 population estimates for the remaining jurisdictions.

Estimated impacts on property tax levies and tax and equalization rates were developed using data from the New York State Office of Real Property Tax Services' MuniPro System. These estimations assume that the funding necessary to make the Annual Required Contribution (ARC) is derived entirely from the property tax, holding all else constant.

For More Information

National Resources

Government Accounting Standards Board, Project Pages – Other Postemployment Benefits, online at http://www.gasb.org

National Government Finance Officers Association, online at http://www.gfoa.org

Center for State & Local Government Excellence, online at http://www.slge.org

National Association of State Retirement Administrators, Analysis of OPEB Rules, online at http://www.nasra.org/resources/medical.htm

U.S. Government Accountability Office, online at http://www.gao.gov

"You Dropped a Bomb on Me, GASB." March 2007. Credit Suisse Equity Research, online at http://online.wsj.com/public/resources/documents/DroppedB.pdf

New York State and Local Resources

Office of the New York State Comptroller GASB 45 & OPEB Frequently Asked Questions, online at http://osc.state.ny.us/localgov/pubs/opeb45faqs.htm

"GASB 45: Reporting the True Cost of Other Post-Employment Benefits." May 2008. New York State Office of the Comptroller, online at http://www.osc.state.ny.us/localgov/pubs/research/opeb_policyreport.pdf

Broome County GASB 45 Citizen's Task Force, online at http://www.gobroomecounty.com/legis/gasb45

The State Comptroller's Office, the Office of General Services, BOCES districts, the Government Finance Officers Association and respective county, city, town, village and school district associations all provide services for, and expertise on, addressing OPEB liabilities. The Office of General Services has approved and made accessible three statewide contracts for actuarial OPEB valuation services. In addition, BOCES units have also entered into joint purchasing agreements for actuarial services with member school districts.

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