

# Wrestling the Alligator

Final

March 5, 2009

By Jon Snyder, Tisbury Finance and Advisory Committee

**Tisbury has a warrant article for the annual town meeting** to see whether the town will appropriate \$1,566,000 to start setting aside money to pay for retirement benefits for town employees. We have been funding our pension plan, but we have not been funding promised health insurance and other benefits.

These future benefits have become a huge, twenty-foot alligator. We didn't mean for this to happen – it's just that for many years we did nothing to prevent it. Our alligator started out as a baby, not at all alarming, but it has grown to around \$20 million, and it's growing bigger every year.



Island-wide, the problem is about \$90 million (see table below.) Most other towns in Massachusetts have a similar problem, and it is likely that most towns and cities in the country do, too.

## Why should we start putting money aside now?

**Fairness:** If we don't fund this liability, we push the expense onto the next generation. We employ people today and promise them benefits when they retire. When they retire and collect benefits, they are no longer working for the town. Those benefits are part of the cost of today's employment, so, by not paying for them now, we push today's cost onto future citizens.

**Good financial planning:** A little pain now helps avoid a lot of pain later. It's like saving for college – saving some now means not having to come up with ALL of the cost when it comes due.

**Lower borrowing costs:** Having such a fund should improve the town's credit rating, resulting in a lower borrowing cost for future bond issues. It shows that the town has acted prudently to manage these future expenses.

**How as the town been paying for retirees' health insurance?** Tisbury has been paying retirees' health insurance every year on a pay-as-you-go basis: as each year's insurance premium bill comes in, the town pays it. Tisbury is now paying \$582,000 a year for these pay-as-you-go benefits for retirees and their families.

**How can we estimate how much we will have to pay in the future?** For a given employee, we can guess when he or she will retire and how long he or she will live. So for a given year in the future, say, 2020, we can estimate what our health insurance cost will be for that one person.

Add that up for all our employees and retirees, and we can estimate our total cost in 2020 – which turns out to be about \$1,640,000 for that one year. We don't want to put away that much money now, because over the next eleven years, that money would earn interest and grow.

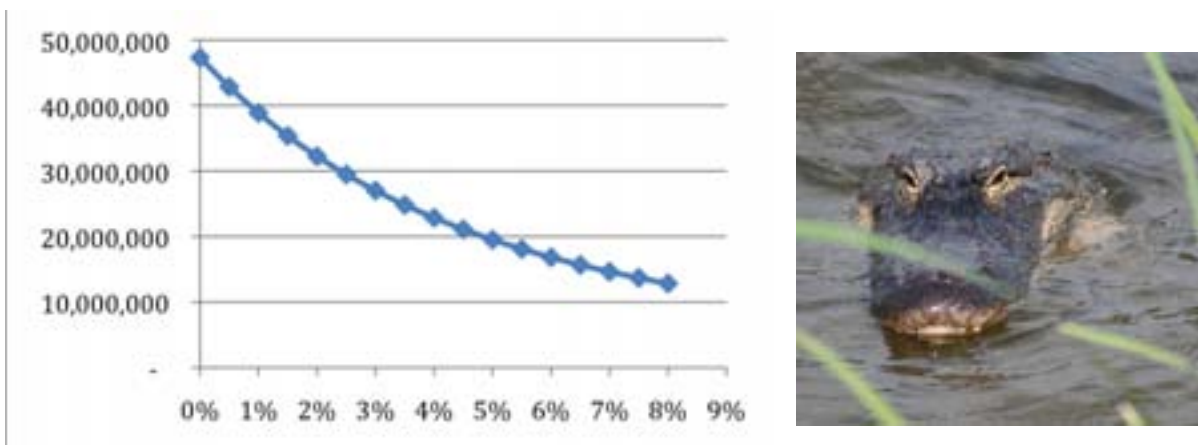
## How much money do we need to put away?

- **The farther in the future the expense, the less you need to put away today.** If we need to pay \$100 a year from today, and if my investments earn 5% a year, we need only put away  $(\$100/1.05)$  or \$95.24 today. Or, if we need to pay \$100 two years from today, we could set aside  $(\$95.24/1.05)$  or \$90.70 today. In a year, it would grow to \$95.24, and in two years it would be \$100, just when we need it.
- **Also, the more interest we earn, the less we have to put away today.** If we could earn 8%, we'd only have to put away \$86 or so. On the other hand, if we earn only 3.5%, we'd have to put away \$93.35. (Don't even talk to me about investment losses.)

Do the same math for our 2020 cost of \$1,640,000 – if our savings earn 5% every year, we could put away **\$959,000** today, and then we only have to wait. We can do the same number for 2019, and for 2018, and for all the years between now and any time in the future.

We hired consultants to do just that, analyzing a number of moving parts – how many people we employ, when those employees retire, the cost of benefits each year, and so on. The consultants tell us that the present value of the benefits we have promised to our current and retired employees adds up to between \$13 million and \$26 million over the next 30 years.

The single variable between those two numbers is the interest rate that we assume we can make on our savings. The \$13 million assumes a very optimistic return of 8%, while the \$26 million assumes a return of 3.5%.



Whatever interest rate you pick, it's a lot of money, but we don't have to pay it all today. When you buy a house, you don't put up all the money right away. Instead, you make payments every year.

**What interest rate should we use?** Realistically, where can we safely earn 8% on our savings? We have to ask ourselves, "What return can the town earn on money it puts into a trust fund?"

- Over the long term, the stock market return is about 9.5% a year, but we can't invest this money in stocks and risk the kind of catastrophe we've seen over the past year.
- US Treasuries are presently returning around 3.5% for longer maturities, but rates are below 2% on the shorter maturities.
- For the rest of this report, let's assume a 5% return – rates are very low now, but they won't stay that low for 30 years.

The more realistic 5% interest rate gives us a liability estimate of \$19,500,000.

For that \$19.5 million, if we put away **\$1,209,000** every year for thirty years, some of that money would earn interest for thirty years, some for twenty-nine, some for twenty-eight, and so on, and eventually, when we add up all the deposits and all the interest over thirty years, we will have paid off that liability.



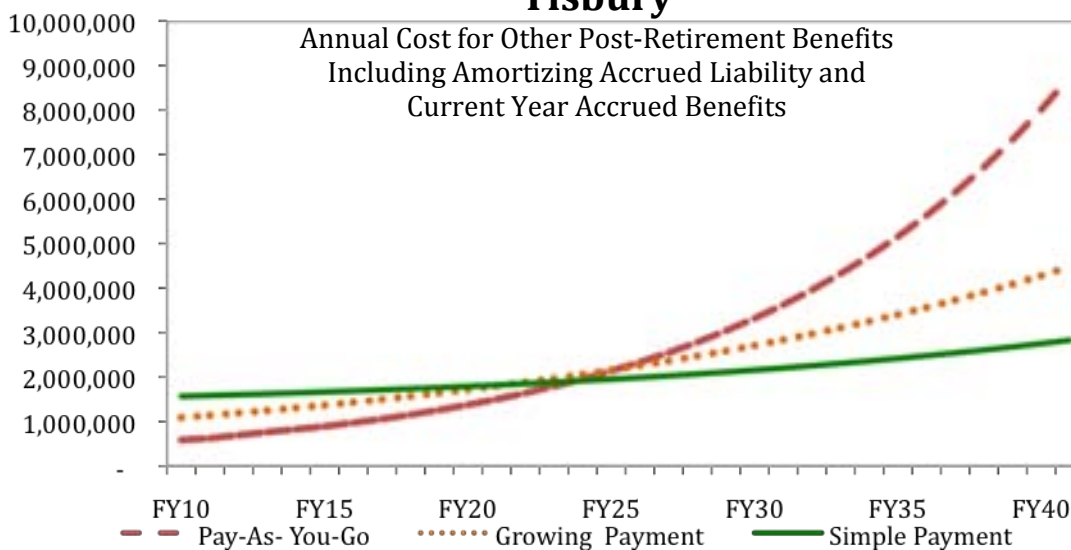
**That's not all.** These flat payments will only pay down the liability we have already accumulated – it does not include anything to cover the additional liability we accumulate every year. This year, we should put away another \$357,000 to pay for this year's increase in future benefits earned by current employees, so that we don't add to the liability that we're trying to pay down. That makes this year's payment **\$1,566,000**.

**What are our choices? Do we *have* to save \$1,566,000 every year?** What if we did something like an adjustable rate mortgage, where the initial payments are lower than normal, and they increase every year? We could start with a low payment of \$731,000 and increase it by 4.5% every year. Add in this year's increase of \$357,000, and this year's payment would be **\$1,088,000**. The payment would grow every year: \$1,140,000 next year, \$1,192,000 the year after that, and so on.

In time, the growing payment will be considerably larger than that starting value, eventually topping \$4,000,000 a year.

**What happens if we stay on the pay-as-you-go plan?** When we pay only the insurance premium for our retirees each year, it will cost the town \$583,000 this year and an estimated \$621,000 next year. The problem is that cost keeps growing faster and faster, until at the end of the 30-year period, the town would be paying **over \$8 million** a year. The town will not have a much larger tax base in ten or twenty or thirty years, and I don't know how many people could afford the real estate taxes at that point.

## Tisbury



**What is the impact on the problem if we put way \$50,000 or \$100,000 this year?** If we have an alligator that is growing by several hundred thousand dollars every year, then every little bit we put away helps slow its growth, but that alligator is still growing.

**What is the impact on the average taxpayer?** The current tax rate for residential properties is 5.98 mils per thousand. For a \$500,000 property, the tax impact would be:

	To Pay Down Liability	Plus Current Year	Equals Total Payment	Add'l Millage	Add'l Tax on \$500,000 Home
Pay-As-You-Go	-	-	-		-
Growing Payment	731,000	357,000	1,088,000	0.42	\$ 210
Flat amortization	1,209,000	357,000	1,566,000	0.60	\$ 302

- **Pay-As-You-Go:** Far cheaper now, this approach will come back to bite us by ramping up payments every year until the town will have to pay over \$8 million a year at the end of the 30 years. This year's insurance payment is already in the town budget, so there is no additional tax impact.
- **Growing Payment:** Starting with \$1,088,000 this year eases the pain now, but it will hurt more over time – rising to over \$2 million after 15 years and over \$4 million for the last four years of the 30 year term.
- **Flat Amortization:** Paying \$1,566,000 every year starting now is a bite right now, but it will pay down the liability over 30 years and provide the funds to keep the alligator from growing larger.

**Beginning to fund the liability now does not commit us to making the same payment every year from now on.** If economic conditions improve, we may be able to earn more than 5% on our savings, and we could reduce the annual appropriation. We will have the consultants re-evaluate the future liability every two years, and we will adjust the annual appropriation if their estimates change – for example, if we have more, or fewer, employees, or if the cost of insurance changes faster or slower than currently estimated.

Whatever the future brings, we will have to pay these benefits, and we must choose how to fund them. The town needs to make this decision with its eyes open, understanding our choices, and knowing that there is a very real cost to taking the easy, low-price, pay-as-you-go road.

See you at town meeting.



**Final note:** The situation is actually worse than this report suggests.

First, the consultant's report and all the numbers in this article are based on estimates as of July 1, 2007, so we are already two years behind, and Tisbury's unfunded liability is already at least \$300,000 larger.

Second, once Tisbury addresses its own unfunded liability, the town still shares in some of the regional entities' unfunded liabilities (see footnote below.)

Buck Consultants estimated the unfunded liability for "Other Post-Employment Benefits" for the following island entities as follows, using the optimistic 8% return. My estimates based on 5% are in the right-hand column. (All numbers rounded to the nearest \$10,000.)

	<u>optimistic 8%</u>	<u>estimate at 5%</u>
County of Dukes County	\$ 5,570,000	\$ 8,460,000
MV Commission	550,000	830,000
MV Land Bank	290,000	450,000
MV Refuse District	750,000	1,140,000
MV Reg. High School District	10,630,000	16,150,000
MV RTA (VTA)	90,000	130,000
OB Water District	420,000	640,000
Up-Island Reg. School District	4,360,000	6,630,000
Town of Aquinnah	1,260,000	1,910,000
Town of Chilmark	1,950,000	2,970,000
Town of Edgartown	9,550,000	14,510,000
Town of Gosnold	930,000	1,420,000
Town of Oak Bluffs	7,120,000	10,820,000
Town of Tisbury	12,840,000	19,520,000
Town of West Tisbury	2,340,000	3,560,000
Total	<u>\$ 58,660,000</u>	<u>\$ 89,150,000</u>