Discussion of How Do Retiree Health Benefit Promises Affect Municipal Financing? by Betermire, Holland, and Wilkoff

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Disclaimers

- The analysis and conclusions set forth here are those of the discussant and do not indicate concurrence by other members of the Federal Reserve Board research staff or by the Board of Governors.

Lots to Like

- Question: Do liabilities for OPEB influence muni bond yields
- Important question given magnitude of liabilities $> \$1$ trillion
  - Approx. $\frac{1}{2}$ of state and local gov. own source revenue
  - Largely unfunded
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- Very surprising this is first paper to examine question
- Empirical methods are sounds
  - Panel data approach is sensible
  - Variation in effect on yields – e.g. difference by type of gov. contribution – increases confindence in results
  - Solid evidence against pension obligations explaining the results

More discussion of *why* OPEB should affect yields

- OPEB benefits lack strong legal protection
  - Govs. have broad latitude to make changes
- State and localities have been pairing back benefits
  - Reducing/eliminating subsidies, closing to new hires, eliminating completely, etc. (Munnell, Aubry, Crawford 2016; NASRA 2019)
- If a government is under sufficient stress to be unable to make debt payments, is it likely to continue to pay OPEB benefits?
  - If not, how much should liabilities affect yields?

More discussion of *why* OPEB should affect yields (cont.)

- Paper would benefit from discussion of this
  - E.g. What has happened to OPEB benefits in recent muni banckruptices?
- There are good reasons why OPEB benefits might affect yields
  - Not all governments could eliminate payments
  - Costs to dropping OPEB even if permissible

Why Do Health Care Costs Matter?

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- But why does market care if size of liabilites arises from costs vs. generosity of benefits?
- Result reflects the price of *risk* - needs more discussion
- Future rise in cost of OPEB mostly due to rising health care costs (Lutz & Sheiner 2014)
  - Higher costs today likely implies greater risk from rising health care costs
- More explicit discussion of this

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- IV result for funding ratio effect on spreads, -3.35, is an order of magnitude larger than the standard estimate, -0.35
- IV results seem implausibly large given sample mean yield spread of 0.25

Empirical Suggestions: OPEB Measures

- Two key explanatory variables explored: liabilities and funding ratio
- Regressions run separately for each of these variables
- But they capture different aspects of OPEB obligations
  - E.g. large liability implies risk even if "fully funded"
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  - Accounting rules allow for using risky rate of return
- Implication: Include both in single specification
- If there is a desire to use a single measure $--->$ unfunded liability

Empirical Suggestions: Exploration of Heterogeneity

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- But the estimates often appear to not be different in statistical sense

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- Different estimates are taken as evidence of heterogenity in the OPEB effect
- But the estimates often appear to not be different in statistical sense
- Use a single regression and include interaction and main terms

$$spread_{i,s,t,m} =$$
$$\alpha + \beta_1 * OPEB_{s,t} + \beta_2 * cont\_method_{s,t} + \beta_3 * OPEB_{s,t} * cont\_method_{s,t} + ...$$

- Estimate of β_3 indicates if effect meaingfully differs by contribution status

Empirical Suggestions: Instrumental Variables

- Health care cost factors as instruments for OBEP variables
- Instrumental variables approach requires instruments affect bond spreads *only* through influence on OPEB obligatons
  - E.g. role of nurse practioners must affect state finances only via OPEB
- More needs to be done to establish this
- Does nurse practioner status affect Medicaid outlays?