

Employee Benefit ■ Plan Review

Retiree Healthcare Benefits in State and Local Governments: Challenges and Opportunities

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Over the past decade, the private sector has seen substantial changes in the types and extent of coverage for retired workers due to the implementation of FASB 106, the Financial Accounting Standards Board statement that directs how retiree medical benefits are treated for financial reporting purposes. The percentage of large (over 200 workers) employers providing retiree health care in the private sector dropped from 66 percent in 1988 to 34 percent in 2002. Among small private firms (three to 199 workers), only 5 percent provided coverage for retirees in 2002. Only recently has this issue begun to emerge as a major concern for the public sector, in light of recent changes proposed by the Governmental Accounting Standards Board, the governmental counterpart of FASB.

This article provides a framework for examining the retiree healthcare programs offered by state and local governments (referred to generically as governments in the balance of this article), review the implications of the proposed GASB statement, and point to the anticipated issues that will be need to be addressed. It remains to be seen whether the

changes that have taken place in the private sector augur the same for the governmental sector as well.

COST OF RETIREE HEALTHCARE TO EMPLOYERS

The cost of retiree healthcare benefits has been increasing dramatically, and there is no consensus as to when double digit inflation in healthcare costs and health insurance premiums may end. Particularly problematic is the increase in prescription drug costs and the employee health insurance programs that may include these costs.

Prior to Age 65

Retirees who have employer-provided healthcare coverage prior to age 65 are covered either with active employees or as part of a separate pool of retirees. Due to the higher cost of covering older workers separately (and in the interest of having as large a covered group as possible), most employers include retirees with their pool of active employees. While this pooling definitely lowers the cost for retiree health premiums, the premium for active employee coverage is higher as a result. Most governmental employers (hereafter referred to as employers) have not focused on this implicit subsidy of retiree coverage to date, but are more likely to do so as the GASB

statement on Other Post Employment Benefits becomes effective. Rates for retirees under age 65 will vary depending on coverage, deductibles, and region of the country, plan experience, and other factors. The employer may pay for retiree coverage in full or in part, or the employer may require the retiree to pay the employer for the cost of the coverage.

Age 65 and Older

Most employers providing retiree health benefits to those over age 65 integrate their coverage with Medicare and treat Medicare as the primary payer for these benefits.

Most public sector employees will automatically be eligible for Medicare Part A (hospital insurance) at age 65.

SPECIAL ISSUES FOR PUBLIC SAFETY (AND SOME OTHER) EMPLOYEES

Public safety employees tend to retire at ages that are lower than the balance of the governmental workforce. Depending on the local jurisdiction, the public safety employee may be able to retire as early as the attainment of twenty years of service, although this is uncommonly generous. Far more common is a combination of age and years of service, such as age fifty with twenty

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years of service. These retirees then have a substantial length of time before they are eligible for Medicare.

Employees hired prior to April 1, 1986 in jurisdictions not covered by FICA are not eligible for Medicare Part A except through a spouse's eligibility. Based on this date of hire, there are large numbers of public sector employees retiring currently who are not covered by Medicare, including, for example, all state and local government employees in Massachusetts and police and fire employees in other local jurisdictions. For these retirees, employer-provided retiree health coverage does not supplement Medicare but provides more complete coverage.

WHO PAYS FOR HEALTHCARE COVERAGE IN STATE AND LOCAL GOVERNMENTS?

Nationally, about 75 percent of state governments and 60 percent of local government employers provide coverage for retiree health care for those under age 65, with slightly less (74 and 57 percent respectively) continuing coverage after age 65. Tables 1 and 2 summarize local government provision of retiree health care. Many local governments have a length of service requirement that is tied to eligibility for benefits or percentage of premium paid.

TYPES OF RETIREE HEALTHCARE PROGRAMS

Just as with public sector pension plans, retiree health care benefit programs come in two basic types: defined benefit (by far the most frequent form of benefit) and defined contribution. With defined benefit plans, the employer provides a benefit at retirement, normally either as a percentage of the employer's health care premium cost or as a flat dollar amount on a monthly basis. Defined contribution programs (also referred to as consumer-driven health care programs) provide individual retirees with accounts out of which the employee may pay for eligible medical expenses, which may include

premium cost, deductibles, co-pays, prescription drugs, etc. Employers may provide one or both of these types of plans to retirees.

Of increasing interest to both employers and employees are hybrid plans that have a basic design as defined benefit or defined contribution but include features of the other. For example, a "target benefit" plan could be established, with individual accounts determining the assets available for retiree healthcare spending and actuarial determinations of annual contributions designed to provide a given account balance at retirement. Thus, the plan is a defined contribution plan with a funding formula that aims for but does not guarantee a given benefit level.

PAY-AS-YOU-GO VERSUS PREFUNDING FOR RETIREE HEALTHCARE

The vast majority of governmental employers pay for retiree health care as a budgeted expenditure for the current year's costs. This pay-as-you-go approach does not reflect the true costs of employer liability for promised defined benefits as will be required by the proposed GASB accounting standard. The standard will force employers to compute this liability and report on funding progress toward reaching full funding for accruing costs. Relatively few employers have calculated these future costs and fewer still have segregated funds dedicated to this obligation. Of those employers who have earmarked funds for retiree health care, very few have actually established and funded a dedicated trust that will be necessary if the assets are to be counted towards the OPEB liability.

THE PROBLEM FROM THE GOVERNMENTAL EMPLOYER'S PERSPECTIVE

Currently, the rising cost of health insurance premiums has been perceived to be a critical issue for employers. Double-digit premium increases are the norm in times when budgets are strained and enhanced

revenue sources are dwindling. This problem represents only the tip of the iceberg for public employers.

The Governmental Accounting Standards Board has determined that post-employment benefits other than pensions (Other Post Employment Benefits or "OPEB") are an accruing cost, similar to pensions, that should be reflected in the governmental unit's financial statements. The exposure draft for OPEB was issued by GASB in February 2003 and is slated to become effective for large governmental units (greater than \$100M in revenue) with financial statements for years beginning after June 15, 2006. Medium-sized employers (between \$10M and \$100M in revenue) will be required to report for years beginning after June 15, 2007, and the following year the requirement will include the smallest employers. Employers will no longer be able to fund only the current year's cost for retiree coverage without having a negative effect on the financial statements of the reporting entity.

For defined contribution plans, the reporting will be relatively straightforward; the employer funds the annual required contribution, which is the annual OPEB cost. Additional information will also be required, including a description of the retiree health savings program.

Employers with defined benefit retiree health plans covering over 200 employees will be required to perform actuarial studies to determine liabilities every two years; employers with 100 to 200 employees every three years; and employers under 100 employees are provided a simplified approach. The financial statements for defined benefit plans will be required to report each year the current year's actuarially calculated OPEB cost consisting of:

1. The accrued cost earned by employees in the current year plus; and
2. The cost for amortization of accrued liabilities.

Additionally, the reporting entity

TABLE 1. STATE GOVERNMENT PROVISION OF RETIREE HEALTH CARE	
No coverage	25%
100% employer-paid	37%
Employees contributing some or all of cost	38%

TABLE 2. LOCAL GOVERNMENT PROVISION OF RETIREE HEALTH CARE	
No coverage	40%
100% employer-paid	20%
100% employee-paid	20%
Costs shared between employer and employee	20%

will have to report the net OPEB obligation (sum of required costs for all years starting with first reporting year, less the contributions made to a trust reserved for retiree health expenses). Thus, for each year that the employer doesn't fully fund the current year's OPEB cost (including the amortized portion of the pre-enactment accrued liability), there will be an increase in the unfunded liability for OPEB benefits. Bond rating agencies have already indicated that attention will be paid to the mismatch between liabilities and assets. This comes at a time when many local governments are experiencing difficulty in retaining their ratings because of problems with revenue sources.

For employers who have both active employees and retirees covered in the same insurance program, the true cost of the retiree premium is in part borne by the active employees and the employer, even if the retiree pays 100 percent of the cost. This "implied subsidy" is considered part of the annual OPEB cost by GASB, and the final OPEB statement, due out late this year, may require the employer to recognize the implicit subsidy cost in its financial statements. Most employers have not calculated the actual value of this subsidy.

Assets accumulated for funding future retiree health costs in defined benefit contribution plans will only be counted as OPEB assets if they are in a segregated trust fund available only for that purpose. Few

employers have calculated their OPEB costs, and the annual required contribution might be catastrophic to already strained budgets. For example, one authority with payroll of \$60M pays 80 percent of the cost of retiree health care. The current year's budget cost for retiree premiums is an "affordable" \$1.1M. The first year's required contribution (to fund current year's accruing benefits and amortizing accrued unfunded costs over 30 years) is estimated at \$11M, almost 20 percent of current payroll costs. A county with 200 employees three years ago calculated its fully funded cost as \$5.1M and set these funds aside. A current update by the actuary indicates that another \$1.9M is needed to bring the asset level to full funding, largely because of the rapid inflation in the cost of retiree health premiums.

Employers who do not provide any retiree health coverage may experience none of the financial difficulties outline below, but frequently employees will be job-locked and unable to retire because of the immediate necessity to cover the expenses of retiree healthcare. Early retirement incentives for employers seeking to trim their workforces may be enhanced by the provision of some level of continuing coverage.

PREFUNDING RETIREE HEALTH BENEFITS

For both employers and employees, prefunding of retiree health ben-

efits will become critical in the future. Employers will be forced by the GASB OPEB standard to pre-fund a dedicated trust if they provide any retiree health benefits and perhaps any implied subsidies. Employees planning for retirement will need to consider the level of assets required to cover their share of healthcare costs in retirement.

NEW DEVELOPMENTS IN PREFUNDING MECHANISMS

There are two relatively new developments in the area of retiree healthcare benefit prefunding: Health Reimbursement Arrangement and, available only in the tax-exempt/public sector area, the Integral Part Trust.

The IRS in June of 2002 issued a Notice and Ruling on Health Reimbursement Arrangements, sometimes called Section 105 accounts (after Internal Revenue Code section 105, which provides for tax-free treatment of employer provided healthcare benefits). HRAs are designed to allow for employer funding of accounts for individual healthcare reimbursement, normally in conjunction with a high deductible insurance program. The funds in the HRA are available during the plan year for reimbursement of eligible expenses, and the account balance at the end of the year is carried forward into the following year, unlike the flexible spending account with its "use or lose" feature. HRAs may not provide for any salary

