

Retiree Health Plans in the Public Sector

Is There a Funding Crisis?



Robert L. Clark
Melinda Sandler Morrill

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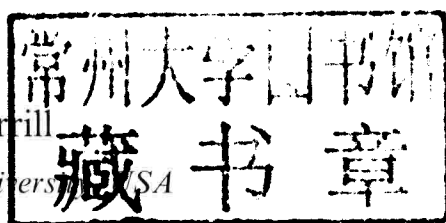
Robert L. Clark

North Carolina State University, USA

and

Melinda Sandler Morrill

North Carolina State University, USA



Edward Elgar

Cheltenham, UK • Northampton, MA, USA

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Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2010925968



ISBN 978 1 84844 758 5

Printed and bound by MPG Books Group, UK

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Acknowledgements

The authors gratefully acknowledge the support of the Center for State and Local Government Excellence for two research grants that provided the impetus for our examination of retiree health plans in the public sector. We especially thank Elizabeth Kellar, Executive Director, and Joshua Franzel, Vice President for Research, of the Center for their support and encouragement for our research examining state and local retiree health plans. Our North Carolina State University colleagues, Richard Kearney and Jerrell Coggburn also were principal investigators on these grants from the Center. We worked closely with them on the development of this research. Christina Robinson provided excellent research assistance on both of the Center grants. In addition, Ms Robinson conducted the web searches, accessed all of the information on state plans, and prepared the state summaries that are reported in Chapter 3. We would also like to thank Jennifer Maki for her research assistance on Chapter 2.

Abbreviations

AAL	actuarial accrued liabilities
ARC	annual required contribution
ASRS	Arizona State Retirement System
BLS	Bureau of Labour Statistics
CAFR	<i>Comprehensive Annual Financial Report</i>
CalPERS	California Public Employees' Retirement System
CalSTRS	California State Teachers' Retirement System
COBRA	Consolidated Omnibus Budget Reconciliation Act (1985)
DB	defined benefit
DC	defined contribution
EPO	Exclusive Provider Organization
FASB	Financial Accounting Standards Board
FY	financial year
GASB	Government Accounting Standards Board
GDP	gross domestic product
HDHP	High Deductible Health Plan
HMO	Health Maintenance Organization
HRA	Health Reimbursement Account
HSA	Health Saving Account
MCO	Managed Care Organization
OAP	Open Access Plan
OGB	Office of Group Benefits
OPEB	other post-employment benefits
PERA	Public Employee Retiree Association
PERS	Public Employees' Retirement System
POE	Point of Entry
POS	Point of Service
PPO	Preferred Provider Organization
RHI	retiree health insurance
S&P	Standard & Poor's
SEHIP	state employee health insurance plan
SLIP	Sick Leave Insurance Program
SUNY	State University of New York
UAAL	unfunded actuarial accrued liabilities
US GAO	United States General Accounting Office

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1. Retirement benefits in the public sector: the role of retiree health plans

State and local governments must attract and retain quality employees if they are to provide the infrastructure, services, and educational programs that their citizens desire. Attracting capable individuals into public sector jobs requires competitive salaries and benefits. Historically, public employment often was associated with lower annual salaries but more generous employee benefits compared with similar jobs in the private sector. Among the most important benefits offered to public employees and teachers are health insurance and retirement benefits. In general, a larger proportion of public employees are in jobs that offer health insurance for active employees, health insurance for retirees, and pension benefits than are workers in the private sector of the economy. Virtually all full-time state and local workers have access to these important benefits (Bureau of Labor Statistics (BLS), 2009).

These benefits often provide a more generous retirement income to workers who remain with their government employer for a full career. Employees who remain in their government jobs for 20 or 30 years are rewarded with relatively large pension benefits, often representing 35 to 75 percent of their final pay, and are typically covered by employer-provided health insurance in retirement. These plans are central to the human resource and compensation strategy for public sector employers. Retirement and health benefits play a major role in enabling state and local governments to attract high quality employees. These benefits increase in value with longer job tenure and help state and local employers to retain these workers. Lower turnover rates reduce turnover costs and enhance productivity. Finally, these same benefits provide strong incentives for many employees to retire at relatively young ages. Munnell, Haverstick, and Soto (2007) provide a detailed discussion of the differences in public and private sector labor markets and the role of pension plans in influencing career choices.

Retiree health insurance (RHI) and pension plans can be viewed as a promise to provide future income in exchange for work today. The

promises are key elements in the compensation to public employees but also represent a significant cost to the employer and tax payers. Public sector pensions have a long history in the United States. Clark, Craig, and Wilson (2003) describe the development of public retirement plans until 1920 and Clark, Craig, and Ahmed (2009) examine the more recent evolution of state pension plans in the twentieth century. Relatively early, public pension plans established trust funds which are used to pay pension benefits. As a result, public pension plans are, to a large extent, prefunded. Annual contributions to these funds are related to the liabilities associated with the annual accrual of future benefits. The relationship between fund assets and liabilities is carefully reported each year. A standard measure of the financial status of pension plans is the funding ratio. Funding ratios are calculated by dividing plan assets by the present value of liabilities of the promised pension benefits earned to date. Prior to the economic crisis of 2008 and 2009, 56 percent of state pension plans had funding ratios of between 80 and 100 percent and 37 percent had funding ratios of between 60 and 79 percent (Center for State and Local Government Excellence, 2008).

In contrast, retiree health plans are a more recent employee benefit, with most plans being established since 1960.¹ Until recently, the cost and liabilities associated with retiree health plans have received much less attention compared with the concerns expressed over the public sector pension plans. As a result, the cost and liabilities of these plans were rarely recognized and few state and local governments established trust funds for these benefit programs. Thus, most of the plans used pay-as-you-go financing and did not produce actuarial reports indicating the liabilities of promised benefits. Changes in the accounting rules in 2004 have brought the cost of providing health insurance to retired state and local workers onto the front pages of the financial press. Articles have indicated that liabilities for retiree health plans managed by state and local governments exceed one trillion dollars (Goldman Sachs, 2007; Pew Center on the States, 2007; Standard & Poor's, 2007b; US General Accounting Office (US GAO), 2009). In response to this newly publicized information, policy makers in many states are reviewing these plans and considering a wide range of options to reduce their current and future costs.

The promise by an employer to allow employees to remain in the employer-provided health plan after they retire is a valuable employee benefit that helps employers attract and retain quality employees. These plans can also be an important component for a successful retirement for qualified employees. Depending on the provisions of retiree health plans, the annual premium for medical insurance can range from around \$5,000 for a retiree to over \$10,000 per year for a retired couple. For

example, the Kaiser Family Foundation (2009) reports the average annual cost of employer-provided health insurance for family coverage in 2009 was \$13,375, with \$9,860 paid by the employer and \$3,515 paid by the employee.

The promise of health insurance in retirement is an important component of the compensation for state and local employees throughout the United States. Many public employees and teachers begin their careers immediately after completing their college degrees in their early 20s. If they remain in the public sector, they will complete 30 years of service in their mid-50s and be eligible for full retirement benefits in most states, including coverage by state health insurance in retirement.

Retiring prior to age 65, and not yet being eligible for Medicare, means that individuals must be concerned about obtaining health insurance and its cost. To be able to retain coverage in an employer-provided medical plan is an important benefit. If the employer pays some, or all, of the health insurance premium, the retiree will have more income for other forms of consumption. The offer of retiree medical coverage is a strong inducement for employees to remain on the job until they qualify for coverage, and once fully qualified for these benefits, retiree health insurance together with a generous pension encourages older public employees to retire. Together with pension plans, retiree health plans provide the resources that allow many public employees to retire in their 50s.

This book assesses the widespread coverage of retiree health insurance for public employees, presents data from the latest actuarial reports covering civil servants and public school teachers indicating the liabilities facing government employers from these programs, and speculates on likely changes in these plans due to the new accounting requirements associated with the Government Accounting Standards Board Statement No. 45 (GASB 45). The variation across the states in retiree health plans is striking and shows that some states face a major financial challenge in order to continue providing this important benefit while other states can more easily manage the cost of their programs in the coming years. As states and local governments consider modifying the terms of these policies, it is important that they understand how changes will influence not only their budgets and debt but also their ability to recruit the workers needed to provide the services demanded by their citizens.

I. WHAT IS RETIREE HEALTH INSURANCE?

Employer-provided retiree health plans allow retired workers to remain in the employer's health insurance plan. For persons leaving their career

public sector job prior to age 65, access to these plans means that the retiree does not have to search for health insurance but can remain in the plan that covered her while she was employed. Participation in these employer plans typically requires some specified years of service. Often the number of years of service required is the same as that to be eligible to receive a pension benefit. Access to and the lower cost of employer-provided health insurance may be a valuable benefit to public sector employees.

Some state and local plans merely provide access to their health plan and require the retiree to pay the full premium for the health insurance. However, the full premium is typically based on the risk pool of both active and retired participants. Thus, the premium charged to retirees is generally lower than they would be able to purchase outside of this plan where the annual premium would be based only on persons their own age. On the other hand, many public employers pay the entire premium for retirees. Similar to health insurance plans for active employees, the individual usually must pay for deductibles and co-payments when they incur health expenses.

Key parameters of these plans include the years of service required to become eligible for the plan, the proportion of the premium paid by the state, and the relationship between the plans and Medicare. Many plans allow retirees to remain in the plan for life but others end coverage at age 65 when the individual becomes eligible for Medicare. Plans that provide post-65 coverage almost always require the retiree to enroll in Medicare. By federal law, Medicare is the primary payer of health care for retirees and employer-provided plans are the secondary payer. As one would expect, states that pay a higher proportion of the premium are facing greater future costs of these plans, as are governments that cover retirees with fewer years of service and those that do not terminate participation in the health insurance plan at age 65.

The variation in retiree health plans across the states is significant especially when compared with differences in state pension plans. Most state retirement plans are defined benefit pension plans that provide a retirement benefit of between 1.6 and 2.2 percent of final average pay per year of service. Much of the differences across these plans is explained by the fact that some states remain outside the Social Security system and thus provide higher retirement benefits from the employer pension plans than those state plans where workers are also covered by Social Security (Clark and Craig, 2010, forthcoming; Clark, Craig, and Ahmed, 2009). In contrast, the retiree health plans range from the state paying all of the premium in some states to none of the premium in other states. The determinants of these differences across the states are examined in detail in subsequent chapters.

II. A BRIEF HISTORY OF RETIREE HEALTH PLANS

After the passage of Medicare in 1965, many large companies, especially those that were covered by collective bargaining agreements, adopted retiree health plans. State and local governments also began offering health insurance to their retirees in the 1960s and 1970s. Initially, these plans were used to facilitate early retirement for older workers (Blau and Gilleskie, 2001; Marton and Woodbury, 2006; Robinson, 2009). Combining generous pension plans with subsidized early retirement provisions along with the promise of continuing health coverage in retirement, employers provided significant retirement incentives to career employees in their 50s and early 60s. Since retiree medical plans tended to be linked to Medicare, the cost to the employer of providing such coverage was dramatically lower after Medicare was established. Thus, many employers found retiree medical plans to be an effective human resource tool while the labor force was growing rapidly during the 1970s and 1980s (Clark, Ghent, and Headen, 1994). However, since 1990 retiree health insurance plans have been disappearing as an employee benefit in the private sector of the US economy. The rapid decline in coverage by these plans is due to several factors including the ever rising cost of medical insurance, the aging of the workforce, the increase in the ratio of active workers to retirees, reductions in Medicare, and the change in financial accounting standards. The cost of retiree health plans in the automobile and certain other industries has been highlighted in recent years as a major factor affecting cost and competitiveness.

When first introduced, the cost of retiree health plans in both the public and private sectors was typically reported as an annual cost to the employer and there was no recognition of the accrued liability associated with promising health insurance to retirees in the future. In 1989, the Financial Accounting Standard Board (FASB) required private employers to report accrued liabilities associated with the promise of retiree medical plans (FASB, 1989). Subsequent statements based on the new FASB requirements revealed that the promises of medical coverage to retirees represented billion dollar commitments in many large companies.

After the change in the accounting rules, there was a sharp decline in the proportion of private sector employers offering retiree health plans. The Kaiser Family Foundation and Health Research and Educational Trust (2006) reports that in 1988 before the adoption of the FASB standards, 66 percent of employers with 20 or more employees offered retiree health plans. After the standards were issued, the proportion of private employers offering such plans dropped to 46 percent in 1991 and further to 36 percent in 1993. In the twenty-first century, there has been a continued movement away from these plans in industries where the legacy costs of retiree

medical plans were large, for example in the automobile industry. Fronstin (2005) reports that the proportion of private sector establishments that offered retiree health insurance to early retirees declined from 22 percent in 1997 to 13 percent in 2002. Fronstin (2010) presents data showing that the decline in coverage by retiree health plans in the private sector is continuing as an increasing number of large firms are terminating their plans.

The 1989 FASB accounting standards did not affect public sector employers and therefore retiree health insurance coverage for public employees did not experience similar changes during this period. In contrast to the sharp decline in coverage in the private sector, most public sector employers continue to offer retiree medical coverage to their retirees and most public school teachers are covered by retiree medical plans. For example, Fronstin (2005) finds that 92 percent of states offered retiree medical plans for their retirees under age 65, an increase from 76 percent in 1997.

Medical expenses tend to be relatively large for older persons and can account for a high proportion of household expenditures if retirees are not covered by some type of employer-provided medical insurance. Thus, retiree health insurance is an important component of the compensation of public employees. As such, retiree health insurance should help state and local governments attract and retain quality employees. These plans, along with the defined benefit pension plans that cover most public school teachers, also provide significant incentives for these employees to retire in their 50s and early 60s.

III. GASB 45: NEW ACCOUNTING RULES FOR RETIREE HEALTH PLANS AND IMPACTS ON PUBLIC SECTOR EMPLOYERS

On June 16, 2004, the Government Accounting Standards Board approved Statement No. 45. This statement requires public employers to produce an actuarial statement assessing the financial status of these programs using generally accepted accounting standards as set forth by GASB.² The new standards brought accounting for accrued liabilities for health insurance by state and local governments in line with the treatment of these plans in the private sector. In general, GASB 45 requires states to report the present discounted value of the future liability of health care promises to current workers as these benefits are accrued, along with the present value of these promises to current retirees.³

Until recently, the cost of retiree medical programs was treated as an annual expense for public employers and attracted relatively little attention and scrutiny. However, GASB 45 changed the accounting standards

for public employers and subsequent reports by the states have revealed the real cost of the programs. Governments are now required to report the liabilities associated with these programs in actuarial statements in the same manner as private employers. The GASB 45 actuarial reports that have been released over the past three years reveal that some states have large and growing unfunded liabilities and the annual cost of providing health care to retirees is growing rapidly (Clark, 2009). In some states, the majority of the state's unfunded liability for these programs is due to the promise of health insurance to retired teachers. The large, unfunded liabilities reported by some states have created concern among policy makers and analysts concerning the ability of states and local governments to continue to provide generous medical coverage to their retirees (Goldman Sachs, 2007; Zion and Varshney, 2007).

Key concepts reported in the states include actuarial accrued liabilities (AAL), the unfunded actuarial accrued liabilities (UAAL), and the annual required contribution (ARC). The UAAL is the difference between the AAL and any assets that the employer has set aside in an irrevocable trust. If the plan is completely pay-as-you-go, the UAAL is equal to the AAL because there are no assets. The UAALs for many states are large in absolute value and relative to total state expenditures, debt, and per capita income of the citizens of each state (Pew Center on the States, 2007; US GAO, 2009). The ARC is the normal cost as calculated by the actuary plus the amount needed to amortize the existing unfunded liability over a 30 year period. The normal cost is the portion of the present value of benefits that is allocated to the current fiscal year of active employees. ARCs and UAALs have been growing over time in most states and are now a major public policy issue for many states.

GASB 45 outlines the appropriate methodology that public employers should follow in the reporting of their retiree health liabilities. Consulting actuaries based accrued liabilities on the accumulation of credits toward future receipt of the health insurance. Standard assumptions are adopted to project the future labor force and the number of retirees. Assumptions concerning health care costs are important in projecting future annual costs of the insurance for retirees. The value of future liabilities is then discounted using an approved discount rate which is related to the methods used to fund the insurance plan.

The values for each of these aspects of the liability calculations are very important in the determination of the total liabilities associated with the retiree health plans. Most state actuarial reports estimate future costs of these plans by acknowledging that current per person costs are rising at a rate of approximately 10 to 14 percent per year. However, these calculations also assume that future cost increases will fall to only 5 percent

within 10 years. If this rapid decline does not occur, projected liabilities reported in the actuarial statements will be significant underestimates of realized costs of these programs.

Determinants of the cost of retiree health plans include the generosity of the plans, eligibility conditions for coverage, the size of the public sector in the states, and the assumptions used to calculate the future cost of providing health care to retirees. These programs vary widely in their provisions, degree of subsidization, cost to the state government, and method of funding. Some states require retirees to pay the full cost of participating in the plan while others offer health insurance that does not require any premium payment by the retiree.

Typically, the 'full cost' of a retiree health plan paid by retirees is the average cost of all participants in the state's health plan for active workers and retirees. Due to age-related differences in the cost of health insurance, allowing retirees to pay the same premium for participating in the plan as active employees involves an implicit subsidy. The new GASB standards require public employers to measure and report this subsidy to retirees. In most states, civil servants and teachers are covered by the same statewide medical plans, while in other states, retiree teachers participate in separate health insurance plans that do not include general state employees. In a few states, retiree medical plans for teachers are provided by local school districts.

GASB 45 does not require states to move toward prefunding these plans or even to establish trust funds for retiree health plans. Thus, states are free to continue pay-as-you-go financing. However, several states recently have enacted trust fund legislation for their retiree medical plans. In part, the movement to establish irrevocable trusts has been in response to GASB 45 and the public disclosure of these liabilities. Some states have maintained trust funds for their retiree benefit plans for several decades. Ohio, with approximately \$12 billion in assets, has the largest trust fund among the states. Data provided in the state actuarial reports indicate that six states have assets in existing funds.⁴

IV. IS THERE A FUNDING CRISIS FACING THE STATES?

The primary objectives of this book are as follows. First, we describe retiree health plans in the public sector. We assess the importance of these plans in human resource management and explore issues such as the role of retirement benefits in attracting, retaining, and retiring workers. Then we report the current financial status of state retiree health plans for state