<u>**BACKGROUND BRIEF:**</u>

HELPING PUBLIC EMPLOYERS AND EMPLOYEES MANAGE ESCALATING HEALTH CARE COSTS

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for the
Subcommittee on Disability and Retiree Health Care

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Introduction

Appointed by the State Administration, Public Retirement Systems, and Veterans' Affairs Interim Committee, the Subcommittee on Disability and Retiree Health Care has been asked to examine "options for addressing the cost of postretirement health insurance and other medical care for public retirees". (See House Bill No. 79, section 63(3)(a), from the 1999 Session). This staff paper briefly:

- summarizes the issue;
- outlines last interim's legislative activities on the issue; and
- discusses options so far examined.

The issue: Retirement income is fast falling behind ever-increasing health care costs

A key concern among many analysts of health care costs for retirees is that retirement income will not keep pace with the faster increase in health insurance premiums and other medical expenses incurred by retirees. What are some of the indicators analysts are looking at? For starters, our country's 76 million baby boomers are turning 50 years old now at a rate of one every 7.7 seconds. And, when these baby boomers hit retirement sometime in the next decade, the population of people over the age of 65 will likely double.

The effect of America's aging will be particularly profound in western states. According to census data and analyst estimates of demographic changes between 1995 and 2025, Montana is in the midst of experiencing an expected 140% increase in the number of people age 65 or older. And, if these numbers fail to get your attention, consider this: Although many admit that the financial health of retirees is relatively good now, at least compared to previous generations, in 1988 (nearly 10 years ago) the 33% of all health care expenditures were for the elderly.

Health care costs are consuming a larger share of income

For many retirees, trying to make ends meet, the added financial strain of rising medical costs could quickly overwhelm fixed retirement incomes. According to research collected by the Congressional Budget Office, in 1987, about 94% of people age 65 and older incurred average medical expenses (not including long-term care) of $4,600 annually. And, since then, health care costs have risen at a rate of about 10% annually. The good news is that baby boomers have also experienced a strong growth in real wages, will reap higher Social Security benefits, and government programs will cover a large portion of medical expenses.

The bad news is that Medicare (the primary health care program for virtually everyone over the age of 65) still only covers 48% of average medical expenses, leaving more than half of a retirees health care expenses to be paid from other sources (i.e., a combination of Social Security, personal savings, pensions, and other income). But baby boomers have saved less, are predicted to retire earlier, and will live longer. Further analysis of the numbers indicate that, while in 1987 more than 20% of a person's postretirement medical expenses had to be paid out-of-pocket, that number has been steadily increasing. Particularly stressed financially in retirement will be those who are single, who have not worked immediately before reaching normal retirement age, have less than a high school education, belong to low-income families, and are women.

Investment returns are not keeping pace with increased reliance on pension plans

How does investment for retirement figure into the picture? Baby boomers seemed to have relied mostly on capital gains on housing as a substitute for financial income in retirement and to be anticipating higher than probable income from employer-sponsored pension plans. Hence, many baby boomers have underestimated the importance of personal savings. Of those who have personally invested in the stock market for their retirement years, long-term yields have averaged about 8% (compared to the 10% inflation of health care costs).

Finally, for purposes of this paper, it is also important to note one additional bit of information regarding retirement investments. While retirees are having to rely more and more on income provided through employer-sponsored pension plans to help pay postretirement health care costs, the share of income for those 65 and older provided through government-employee pensions has remained stagnant compared to private pension plans. In other words, there has, over the last three decades, been an increase in the amount of money paid to retirees through private employer-sponsored pension plans, while the share of income to retirees from government-employee pensions has been a flat line.

Conclusion: A collision at the intersection of public pensions, health care, and public assistance

Montana's aging population, obligations and costs as the largest employer in Montana, and increasing health care costs for retirees translates into a significant strain on government resources from all sides, but a potentially explosive political issue for state lawmakers. Making the maximum use of available resources, therefore, becomes a critical objective.

Last interim: The tip of the iceberg

Last interim, the legislature began to see the tip of the iceberg when the Committee on Public Employee Retirement Systems (CPERS) commissioned numerous focus groups across Montana (though not looking at health care issues). The focus groups consisted of a large cross-section of employees and employers who participate in the largest of Montana's public employee retirement systems, PERS. A common theme heard by CPERS was the increasing concern among retirees and employees alike about the escalating cost of health care insurance and other medical expenses after retirement.

A review of the situation of PERS employers, employees, and retirees may assist the Subcommittee in getting a handle on the articulated concern:

- Montana's PERS consists of about 500 different public employers (the state, the university system, counties, cities, school districts, and other agencies), more than 28,000 employees, and over 12,000 retirees.

- The average benefit payment to a PERS retiree is less than $600 a month.

- State law (section 2-18-704, MCA) provides that a person who retires from active service with at least 5 years of service (and depending on employer eligibility rules) may stay on the employer's group health insurance plan after retirement (i.e., until the member becomes eligible for medicare at age 65 or the member joins another group plan with the same or greater benefits at equivalent cost).

- State law also provides that the group plan member who stays on the employer's group health insurance plan pays the full premium for that coverage. (Employer contributions will increase from $270 a month to $295 a month by January 2001.)

- Although a significant benefit to public retirees is that they are charged the same rate as active employees even though they are a higher-risk group, the cost of staying on group health insurance plans is significant and increasing.

In response to its findings and based on consultant reports and recommendations, CPERS last interim began to initially explore options for helping PERS employees save for postretirement health care costs. Three options discussed were:

- establishing a VEBA (Voluntary Employees' Beneficiary Association) outside of PERS as a vehicle for financing costs by pooling employer and employee contributions to pay specified health care cost for members of the VEBA and thus mitigating the financial strain caused by growing welfare benefit (in the generic

sense) liabilities;

- establishing a 401(h) as a separate account under PERS that can be used to pay certain health care costs after an employee's retirement; and

- requiring 457 plan (deferred compensation) vendors to provide for some type of postretirement health care plan (such as a VEBA) for plan members.

CPERS's consultants recommended the establishment of a VEBA to cover PERS members and presented a plan that would have involved having 2% of PERS contributions diverted into the VEBA. However, before this scenario was further discussed , the Department of Administration articulated concern that IRC regulations governing VEBAs seemed unclear. Focus then shifted to the 401(h) option. However, though IRS regulations governing 401(h) seemed more defined, the potential for the 401(h) to compromise the qualified (tax-exempt) status of PERS became a new concern. CPERS gave no attention to the third option involving 457 plan vendors. And, with time during the interim running out, events quickly overtook further examination of postretirement health care issues.

Summary of the VEBA and 401(h) options

Attachment A is a chart prepared by consultants to outline for CPERS the basic features of a VEBA and a 401(h). Both of these options provide a way of pre-funding medical expenses that would otherwise have to be paid on a pay-as-you-go basis and of covering certain medical expenses at a lower cost than paying premiums to stay on a more comprehensive group health insurance plan (e.g., the state's group insurance plan).

Voluntary Employee Beneficiary Associations (VEBA)

Governed under IRC Section 501(c)(9), a VEBA is a trust account that VEBA members can use to pay certain medical expenses for themselves, their dependents, and their beneficiaries. A VEBA trust fund is completely separately from a pension trust fund and is either controlled by VEBA members or by an independent board of trustees. Provided that the VEBA is qualified (through an IRS determination letter), employer contributions to the VEBA are tax exempt. Employee contributions must be after-tax. The medical benefits paid from a VEBA are not taxable. However, the tax treatment of employee contributions made after a one-time election to join the VEBA is made under a contract for employment remains a gray area in IRC. In other words, it may be that employee contribution can be "picked up" and counted as employer contributions and therefore not taxable. Or, it may be that employee contributions must be taxable.

A 401(h) account

Under IRC Section 401(h) a pension plan may establish a separate account within its trust fund to pay benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses, and their dependents. Employer contributions to the 401(h) are tax exempt. Employee contributions are after-tax. Benefits are not taxable,

but may only be used after retirement. Furthermore, 401(h) accounts must be subordinate to pension
trust fund obligations (that is, the obligation to pay retirement benefits comes first) and the health benefits may be reduced.

Advantages and disadvantages

Each option had a different mix of advantages and disadvantages. The following is an initial (i.e., the short-list) of the most evident advantages of one option over the other.

VEBA advantages over the 401(h)

- assets may be invested with more latitude to gain potentially higher rates of return than otherwise;
- not subject to IRC contribution limits imposed on pension plans;
- provides benefit payments to active and retired employees;
- benefits are not subordinate to pension plan obligations.

401(h) advantages over the VEBA

- administration may be easier because it can be done within existing pension plan operational structure;
- IRC laws are more well-defined.

Questions to be resolved before the Subcommittee can move forward

Many questions remain to be asked and answered. However, before the Subcommittee can move forward, at least a few questions must be asked and answered:

- Should discussions consider only PERS members, or should it focus more broadly on all public employees?
- Should discussions consider only the state employer, or the university and local government employers?
- If one or the other option is offered, what will be the impact of "adverse selection" on the employer-sponsored health plan?
- Assuming current contributions to an employee's retirement plan are diverted to fund health care benefits through either type of account, do the potential advantages outweigh the reduction of contributions to the retirement plan? If not,

should additional employer and/or employee contributions be considered?

Again, unless or until Subcommittee members first address these (and perhaps other) basic questions, it will be difficult to move forward. Therefore, Subcommittee discussions should be focused to accomplish the following objectives:

- Get Subcommittee consensus or take a vote to determine if the Subcommittee wishes to further examine VEBAs or 401(h) accounts?

- If further examination of VEBAs or 401(h) accounts is warranted then what further research and/or testimony do Subcommittee members need and for what group(s) of employees and for what group(s) of employers?