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EMPLOYEE BENEFITS: Companies' Retiree Health Liabilities Large, Even With Medicare Catastrophic Insurance Savings

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Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to review with you our analysis of U.S companies' liabilities for their retiree health plans, including the potential effects on liabilities of the Medicare Catastrophic Coverage Act of 1988.

For decades, the Congress has been concerned about the need to provide access to affordable health care. Among other steps, it has provided some tax subsidies to encourage employer-sponsored health insurance plans, both for active workers and for retirees. Such plans are important for the welfare of covered retirees. Generally, the cost of health insurance is lower through these group plans than if retirees purchased insurance individually. In addition, companies often assume a portion--sometimes all--of the costs of their retirees' health insurance. The benefits provided through company plans are especially important to retirees under the age of 65, who generally are not eligible for Medicare.

Increasingly, however, companies are rethinking their commitment to the provision of health benefits provided to their retirees. One reason is that they are experiencing rapid increases in the cost of providing health benefits and are looking for places to cut back. Also, the Financial Accounting Standards Board (FASB) recently proposed that companies report on their financial statements the amount of the future liability implied by their current retiree health benefit plans. This has focused the attention of corporate managers on the high cost of providing these benefits in the future. Some companies already have taken action to reduce their current costs and limit their obligation to provide and pay for retiree health care benefits.

Many people are now asking the Congress to alter the tax code to make advance funding of retiree health benefits more appealing. Advance funding would allow firms to set aside the assets needed to cover the future liabilities for these benefits, thus solving the difficulty that the FASB rule otherwise would present. The necessary changes in the tax code would increase the federal budget deficit, but without them, some companies otherwise willing to continue to offer these benefits may not be willing to do so. Thus, the challenge facing the Congress is to strike the proper balance among the goals of: (1) promoting access to affordable health care among retirees, (2) encouraging honest financial accounting practices, and (3) addressing responsibly the federal budget deficit problem.

In earlier testimony before this committee,[1] we reported on our estimate of aggregate corporate liabilities for retiree health benefits. Our earlier estimate did not take into account the effect of the Medicare Catastrophic Coverage Act of 1988. Some of the provisions in that act will overlap with provisions in company-sponsored retiree health plans. As a result, companies with

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[1]Future Security of Retirees' Health Benefits in Question (GAO/T-HRD-88-30, Sept. 15 1988).

overlapping provisions will realize some savings and their retiree health liabilities will be reduced.

Today, we will present our revised estimates of companies' retiree health liabilities as of 1988, taking into account the Medicare Catastrophic insurance. In addition, we will describe how some companies are coping with their rising retiree health costs and review possible congressional action to make retiree health benefits more secure.

BACKGROUND

We estimate that the number of retirees receiving health care through company plans will increase from under 7 million retirees in 1988 to over 10 million in 20 years. About half of these retirees have spouses or dependents who are also covered by these plans. We estimate that companies paid about $9 billion of the cost of retiree health benefits in 1988.

Most companies currently finance health benefits for their retirees in the same way they finance health benefits for active workers--on a pay-as-you-go basis. The Financial Accounting Standards Board has proposed requiring companies to report accrued liabilities for future retiree health benefits on their financial statements. Their proposal envisions phasing the requirement in during a transition period that begins in 1992.

Since most of these liabilities are not funded, companies and others have expressed concern that their disclosure could adversely affect business operations, including companies' ability to obtain capital financing. This could prompt some companies to either terminate their health care plans or require retirees to pay more of the plans' cost. It also could encourage companies to start prefunding the costs.

To encourage companies to advance-fund, some employers have suggested that current favorable tax treatment provisions be expanded. These suggestions include (1) allowing the use of excess pension plan assets to help pay retiree health costs, (2) reducing or eliminating the limit on the amount of contributions that can be claimed as a tax deduction for advance funding, and (3) no longer taxing part of the income on invested contributions. If tax breaks are expanded, however, the potential tax revenue loss would impair the Congress' efforts to reduce the budget deficit.

Given the current situation, the Congress is faced with deciding whether the federal government should get more involved in these retiree health issues and, if so, how and when?

Mr. Chairman, to help in understanding the dollar magnitude of this issue, you and other Members of the House of Representatives asked us to (1) estimate companies' retiree health liabilities, (2) adjust our initial cost estimate for savings companies could realize from the Medicare Catastrophic insurance; and (3) describe changes some companies are making in their retiree health plans.

Today's testimony first focuses on these topics. Our concluding observations will address the range of possible congressional actions.

LIABILITIES AND ANNUAL CONTRIBUTIONS TO ADVANCE-FUND EXISTING RETIREE HEALTH BENEFITS ARE LARGE

In the report[2] we are releasing today, we estimate that as of 1988 the nation's private employers had accrued liabilities, or "earned" accruals, of $227 billion for retiree health benefits. This is the portion of their retiree health liabilities that retirees and workers have earned in their past years of employment.

Actuaries would use the accrued liabilities as the basis for calculating the amount of contributions needed if retiree health liabilities are to be prefunded. Also, it is this amount that companies would eventually report on their financial statements if FASB's proposal takes effect.

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[2]Companies' Liabilities for Retiree Health Large, Advance Funding Costly (GAO/HRD-89-51, June 1989).

Our initial estimate of retiree health liabilities did not take into consideration employers' savings resulting from passage of the Medicare Catastrophic Coverage Act of 1988. Recently, using calculations by the Congressional Budget Office and other information from benefit consulting firms, we have estimated companies' likely savings from this legislation and adjusted our liability estimates accordingly.

Medicare Catastrophic Savings

The Medicare Catastrophic legislation contains three types of new or amended insurance provisions that go into effect beginning in 1989. These are hospital, supplementary medical, and catastrophic drug insurance. Some provisions take effect in 1989, others in subsequent years through 1992. We estimated employers' future annual savings and reduced their projected benefits accordingly. We do not make any adjustments to our estimate for the maintenance-of-effort requirements contained in Section 421 of the Medicare Catastrophic legislation, as amended by Section 608 of the Family Support Act of 1988.[3]

We estimate that Medicare Catastrophic insurance will reduce companies' costs for retirees age 65 and over by 5 percent in

[3]Section 421 requires employers to enhance benefits or pay workers in cash the value of specified savings they realize.

1989, by 15 percent in 1990, and by 19 percent when fully phased in. Costs for retirees not yet age 65 obviously are not affected.

After incorporating savings from the Medicare Catastrophic legislation, our estimate of companies' accrued retiree health liabilities falls to $197 billion, a 13-percent decrease. If the nation's employers had started advance-funding these accrued liabilities in 1988, their first-year funding costs would have been $28 billion.[4] This is about 3 times their 1988 pay-as-you-go costs of $9 billion.

Companies' accrued retiree health liabilities and the annual contributions that would be needed to advance fund them are significant, even with savings from the Medicare Catastrophic legislation. For instance, our estimate of accrued liabilities of $197 billion represents one-sixteenth of the value of the stocks of American corporations ($3.1 trillion) at the end of 1988. First-year funding contributions of $28 billion would be about one-eleventh of pretax profits of American corporations and just over 1 percent of total compensation paid by American businesses in 1988. While some companies will find themselves better able to handle the added burdens than will others, these liabilities should not overwhelm most companies' ability to pay.

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[4]This amount consists of a normal cost of over $12 billion and an amortization amount of under $16 billion.

COMPANY ACTIONS TO LIMIT RETIREE HEALTH COSTS

In our previous testimony before this committee, we discussed company actions to limit retiree health costs.[5] We met with officials and reviewed the retiree health plans of 29 companies in the Chicago area to determine whether they had reduced or terminated benefits since 1984. Officials at all 29 companies told us that they believe their companies have the right to modify or terminate health benefits for active workers and retirees. The plans of 27 of the 29 companies contained explicit language reserving the companies' right to modify or terminate the plans.

All 29 companies changed their health plans during the 4-year period 1984-88. These changes consisted of (1) adding cost-containment measures, (2) increasing medical service deductibles and coinsurance amounts, and (3) raising the amount plan participants pay for coverage. None of these changes affected only retirees. Instead, the changes affected either the benefits of both active workers and retirees, or the benefits of active workers only. Officials at many companies said they were considering additional changes to their health plan structures.

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[5]For further information, see our report, Employer Benefits: Company Actions to Limit Retiree Health Costs (GAO/HRD-89-31BR, Feb. 1989).

During the last two weeks, we called the 29 companies back to find out if they are continuing to restructure their retiree health plans. We also asked company officials what role FASB's proposed standards and Medicare Catastrophic Coverage Act of 1988 requirements had in these changes. We found that 21 of the 29 companies made additional changes in the last year. Many of these changes were similar to those made in previous years.

However, a few of these companies have made even more significant changes specifically to help limit retiree health costs. For example, one company has decided to phase out retiree health coverage altogether. Current employees and retirees will not be affected; new employees will not receive health benefits upon retirement. Another company will begin giving retirees a fixed dollar amount for health benefits in 1991. A third company eliminated dental benefits for retirees.

Some company officials are continuing to take a "wait and see" approach before making more significant changes. Officials at 21 companies said they are considering additional changes to their retiree health plan structures. For example, at 10 of these companies officials said they are studying the impact of FASB's proposed regulations before making changes. None of the companies has made plan changes as a result of the Medicare Catastrophic Coverage Act. Officials at four companies plan to reimburse retirees for the costs they will save; five companies are still studying the impact of the legislation on their retiree health costs.

CONCLUDING OBSERVATIONS

Even with the estimated savings from the Medicare Catastrophic insurance, companies' retiree health liabilities are large. The FASB's proposed standards are forcing companies to face these large costs. As a result, some companies may reduce the benefits they provide or cancel their plans entirely.

If the Congress wants to preserve retiree health coverage through company plans, it may have to take explicit legislative action. At one end of the range of possible actions, the Congress could require companies with health plans to allow their pre-65 retirees to purchase coverage at group rates. At the other end of the range, it could impose a complete set of requirements similar to those now applicable to defined benefit pensions. "ERISAfication," as some term it, would probably require additional tax preferences in exchange for requiring companies to prefund their retiree health liabilities and to guarantee (vest) these benefits to covered workers.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) provided some health care protection for workers whose employment is terminated, including those who terminate employment by retiring. COBRA requires companies to allow terminated employees, at their own expense, the opportunity to continue to participate in the company's group health care plan, generally for 18 months. Under the minimum option, this requirement could be extended to cover all retirees under age 65. In this case, retirees would bear the full insurance cost of retiree health benefits, but access to coverage at group rates would be maintained. The main disadvantage is that some retirees will have to pay more for their health benefits.

Under a more comprehensive option, the Congress could broaden tax preferences for advance funding retiree health liabilities and require companies to adopt such rules as vesting. This would make health benefits of current and future retirees more secure during their retirement years. But this option could be costly to companies and could cause taxes from corporate profits to fall.

If all the companies that currently provide retiree health benefits had started advance-funding them in 1988, taking into account Medicare Catastrophic savings, their contributions of $28 billion in 1988 would have been about 3 times pay-as-you-go costs. Contributions would eventually fall below pay-as-you-go costs after about 30 years.

Over time, Members of the Congress have recognized the importance of company-sponsored retiree health benefits in a number of ways and have acted to provide security to retirees. For example, the Congress has granted tax preferences for prefunding retiree health benefits in the past. It also acted to ensure that retirees from corporations filing bankruptcy petitions continue to receive health benefits. In this session of the Congress, several Members have introduced legislation designed to better secure retiree health benefits in the future. Such legislation would support companies that maintain retiree health plans and foster a partnership with the federal government to provide health care for elderly citizens.

The FASB's proposal that companies recognize retiree health liabilities on their financial statements has provided a catalyst for serious consideration of these benefits by the Congress, companies, and others. Because of the financial implications for companies and the federal budget, and the significant potential for adverse impact on many current and future retirees, the Congress should consider the various options and provide the leadership only it can in striking the proper balance among (1) promoting access to affordable health care for retirees, (2) supporting honest financial reporting, and (3) addressing the federal deficit.

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Mr. Chairman, this concludes my statement. I would be happy to answer any questions at this time.