

From 'ticking time bomb' to 'manageable challenge'

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Los Angeles Unified School District, the second-largest school district in the United States, estimates that its unfunded liability for retiree health care is \$5 billion—a figure that is roughly 80% of its entire annual budget.

The city of Duluth, Minn., population 90,000, calculates that the cost of its pledge to provide free lifetime health benefits to its retirees is \$178 million—more than double the city's current budget.

Maryland computes its unfunded retiree health care liabilities at \$23 billion. To cover the costs, the state would have to cut into current programs and services to increase its annual payments for retiree health care from \$300 million to \$1.9 billion.

The ticking time bomb of promises made to retirees is close to detonating.

Beginning in December, the Governmental Accounting Standards Board Statement No. 45 requires most large public employers to reflect the future cost of health care for retirees on their current balance sheets.

Factors converge

A convergence of factors—the huge baby boomer population closing in on retirement age, retirees living longer and end-of-life health care becoming more expensive—is driving up those costs even as state and local governments are being forced to bring them out into the light of day. One expert, quoted in the "2006 Rockefeller Institute Reports on State and Local Government Finances," estimates that the total tab for public employers' retiree health care could approach \$1 trillion.

As state and local governments struggle to cope with the new reality, their decisionmaking is complicated by the quicksand of solutions that appear attractive on the surface but carry hidden dangers. The best example: the decision on how to handle Medicare Part D.

Under Medicare Part D, one of the largest rising health care costs—prescription drugs—is subsidized by the federal government. But to encourage employers already offering this benefit to retirees to continue their coverage, the federal government provides a 28% retiree drug subsidy. In the corporate world, many businesses quickly took the subsidy in the first year of the program. But now they are finding that the subsidy comes with expensive strings attached, including the cost of annual actuarial studies, administrative burdens and federal audit compliance.

State and local governments face not only the drawbacks that corporations are discovering, but two others as well.

First, recently issued GASB rules require the subsidy to be reflected as current income rather than an offset for future liability. That means that while the huge cost of meeting retiree health care commitments is compounded into the future, the federal government funding that would cover more than one-quarter of the costs for prescription drug coverage won't be reflected.

Second, part of the value of the subsidy to corporations is that it is tax-free. For a business paying 35% in taxes, that increases the value of a \$600 subsidy to more than \$900. State and local governments receive no similar bump up in value because they don't pay taxes.

As a result, what looks like a simple decision—taking the 28% subsidy—is not always the best answer. In order to make the best decision, state and local government risk managers should familiarize themselves with all possible courses of action. In addition to applying for the federal subsidy, public sector employers may decide to do nothing. By choosing this path, organizations do not disrupt current benefits to retirees and avoid the cost of applying for the federal subsidy. On the other hand, doing nothing fully exposes the employer to the GASB problem of future costs reported as current liabilities.

Government entities can also apply for a federal waiver that allows them to become a Medicare D prescription drug plan themselves. While this decision enables employers to design their own benefit packages and share the risk with the federal government, it also carries several additional burdens. These include a complicated filing process, exposure to federal audits and the administrative burden of tracking employees who sign up for Medicare Part D independently.

Lastly, states, counties and municipalities can contract with a prescription drug plan to outsource the administration of Medicare Part D. While this makes them ineligible for the federal subsidy and requires that they educate their retiree population about the plan they are sponsoring, the advantages include shifting the risk to the prescription drug plan and the federal government, and avoiding GASB 45 implications—thereby protecting credit ratings and the ability to sell bonds.

GASB 45 is having a dramatic impact on how public employers look at retiree health benefits. Medicare Part D adds a layer of complexity to the decisions that must be made about meeting the unfunded liability that threatens to overwhelm state and local government budgets. By understanding the nuances of GASB 45 and the Medicare Part D subsidy, public employers can make a smart decision that will turn a looming crisis into a manageable *challenge*.

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