Pre-Funded Retiree Medical Savings Account Would Help Employees Meet Escalating Retiree Health Care Costs

New Alternatives Needed in How Americans Save for Retirement Health Care Needs; Account Provides Alternative to Dwindling Employer-Provided Retiree Health Benefits

A critical element of retirement security is ensuring that individuals have sufficient health insurance coverage in retirement or adequate resources to purchase it. In the past, many employers provided retirement health benefits to their post-65 retirees to supplement Medicare's benefits and bridge coverage to their early retirees until they were eligible for Medicare. However, health care cost increases and accounting rule changes have caused employers to reduce or eliminate retiree coverage, and as a result this number has dropped sharply in recent years. Because health care costs will continue to consume an ever-expanding share of retirees' income, new mechanisms are needed to enable employees to save more during their working years. In its monograph, *The Future of Retirement Security*, HR Policy Association has recommended the establishment of a prefunded retiree health account that would enable employees to save additional sums to meet these costs.

Cost Increases and Accounting Changes Are Causing Employers to Eliminate Retiree Health Benefits The simplest explanations for why many employers have dropped their retiree health insurance benefit are increasing costs and regulatory uncertainty. There are two sources of retiree health care cost increases. The first is the increasing cost of providing a health care benefit. The second is the indirect cost of accounting for promised future health care benefits on the company balance sheet. Specifically, accounting rule changes proposed earlier this year by the Financial Accounting Standards Board (FASB) would move promised future benefits onto the balance sheet as liabilities. As health care costs continue to rise and interest rate remain relatively low, these future liabilities will become significant and give employers a strong incentive to drop the benefit altogether. According to the Employee Benefit Research Institute (EBRI), in 2002, 13 percent of private-sector employers offered retiree health benefits to early retirees and 13 percent offered benefits to post-65 retirees, down from 22 percent and 20 percent, respectively, in 1997.

Erie County Decision Creates Substantial Uncertainty Over Pre-65 Coverage

Another factor causing employers to reduce or eliminate coverage is the *Erie County* decision—that providing lesser health benefits to Medicare-eligible retirees while providing better ones to pre-65 retirees violates the Age Discrimination in Employment Act (ADEA). Many employers have historically offered their early retirees a bridge health care benefit until the retiree reaches Medicare eligibility at age 65. If the *Erie County* decision is allowed to stand, employers would be required either to drop subsidized retiree health coverage or provide equal subsides to pre- and post-65 retirees. Since equalizing pre- and post-65 medical plan benefits would cost employers about $1,500 per Medicare-eligible retiree, or $12.6 billion a year, it is far more likely that employers will choose to eliminate or cap their retiree medical liabilities than divert resources from their active employees to non-productive former employees. The Equal

Employment Opportunity Commission rules that would clarify that the ADEA would permit bridge coverage were challenged by AARP and are currently in litigation.

Reduction in Employer-Provided Retiree Health Puts More Pressure on Other Sources Retirees have four resources that they can use to pay their health care expenses: the federal Medicare and Medicaid programs, an employer-sponsored health care plan, individually purchased private health care plans, and personal savings. EBRI estimates that a 65-year-old couple that retires without an employer-sponsored health benefit will need to have saved at least $200,000 if they live to 85 and $778,000 if they live to age 100. As demonstrated below, a prefunded retiree health account will give employees the best chance to save the necessary amount and obtain coverage.

Few Attractive Options for Increasing Retiree Health Benefits Through Publicly Funded Programs The primary options for meeting projected health care needs without increasing greater personal savings involve increasing benefits from Medicare and Medicaid. The government could increase the Medicare payroll tax to shore up the program's finances and perhaps augment benefits. An immediate increase of the Medicare payroll tax to 5.99 percent, up from its current 2.9 percent, would improve solvency for most of the program. However, this rate represents a 107 percent increase, which will not be attractive to employers or employees, and the increased taxes would make saving for retirement more difficult for the active labor force. Means testing Medicaid recipients would enable the government to concentrate retiree health benefits on those in the greatest need. Shifting to a means tested benefit, however, requires a major philosophical shift in the program design, from that of an entitlement to a safety net.

A Near-Term Solution: Develop a Prefunded Retiree Health Account Recognizing the limitations of federal entitlement programs, HR Policy has recommended the creation of a defined contribution-based pre-funded retiree health savings plan to allow employees to save more for health needs later in life. Employers may find the plan attractive because its defined contribution structure eliminates the specter of runaway legacy costs. Employers are not required to make any contributions, but if an employer chooses to contribute, there is no further obligation once the contribution is made. From the employee's perspective, rather than presuming that an employer will be financially able to provide benefits at retirement, a prefunded account is much more stable and is more likely than traditional retiree health plans to deliver on its promises in the long-term. Modifying the existing Health Savings Account (HSA) structure offers the simplest way to create a pre-funded retiree health savings account since it would require few substantive changes to the existing HSA legal structure. To be effective, however, the annual contribution would need to exceed current HSA limits. Thus, this option would require a change in the law to increase the amount that could be contributed annually. Employers that already have a pay-as-you-go retiree medical plan would find pre-funding expensive because the employer will be burdened with the cost of paying benefits that are currently due and the cost of allocating funds for future benefits. However, employers that do not currently have a retiree health plan or are in the process of transitioning away from such a plan may find the pre-funding option attractive.