United States General Accounting Office

# GAO Testimony

For Release
on Delivery
Expected at
1:00 p.m. EST
November 5, 1991

# Significant Reductions in Corporate Retiree Health Liabilities Projected If Medicare Eligibility Age Lowered to 60

Statement of
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Before the
Subcommittee on Health,
Committee on Ways and Means
House of Representatives

GAO/T-HRD-92-7

052873 / 145248

**Significant Reductions in Corporate Retiree Health Liabilities Projected if Medicare Eligibility Age Lowered to 60**

Summary of Statement by Lawrence H. Thompson
Assistant Comptroller General
U.S. General Accounting Office

Many companies, especially larger ones, provide health benefits to their retirees, and often to their retirees' spouses and dependents as well. About 9 million private sector retirees rely on these benefits.

Companies are becoming increasingly concerned about the cost of providing retiree health benefits as the workforce ages and health care costs in general continue to rise sharply. Furthermore, a new accounting rule adopted by the Financial Accounting Standards Board (FASB) will hit some companies very hard--and some much harder than their competitors--by compelling them to acknowledge substantial unfunded retiree health liabilities.

Several legislative proposals, including the "Health Insurance Coverage and Cost Containment Act of 1991" (H.R. 3205), would lower the age of Medicare eligibility from 65 to 60. This change would increase the security of retiree health benefits for early retirees and make health insurance available to more retirees.

This change in eligibility also would provide considerable financial relief to companies by substantially reducing their pay-as-you-go (PAYG) costs, accrued liabilities, and prefunding costs for retiree health benefits. Companies and industries with many retirees under age 65, older workforces, and generous benefit packages (e.g., the auto and steel industries) would likely experience the greatest reductions in costs and liabilities. However, the change in eligibility entails a substantial expansion of Medicare program costs, which would be borne in part by all employers and their employees through higher taxes.

We estimate that companies' 1991 PAYG costs of $11.4 billion would have decreased 35 percent, or $4 billion, if the age of Medicare eligibility had been lowered to 60, effective January 1, 1991. Companies' 1991 accrued retiree health liabilities, which we estimate at $335 billion, would have dropped about 30 percent, or $99 billion, due to the change in eligibility.

If companies were to prefund retiree health benefits, they would make annual contributions for benefits accrued during the year and for the amortization of any existing unfunded accrued liabilities. Companies' 1991 prefunding costs, calculated as if companies had started prefunding in 1991, would have dropped about 17 percent, from $42 billion to $35 billion, if the age of Medicare eligibility had been lowered to 60.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss company-sponsored retiree health benefits. Many companies, especially larger ones, provide health benefits to their retirees, and often to their retirees' spouses and dependents as well. About 9 million private sector retirees rely on these benefits. Company-sponsored retiree health coverage is especially important to retirees under age 65 who are not yet eligible for Medicare, because they tend to have fewer options than active workers to regain health coverage if a company reduces or terminates benefits.

Companies are becoming increasingly concerned about the cost of providing retiree health benefits as the workforce ages and health care costs in general continue to rise sharply. Furthermore, a new accounting rule adopted by the Financial Accounting Standards Board (FASB) will hit some companies very hard by compelling them to acknowledge substantial unfunded retiree health liabilities.[1] Most companies finance and account for retiree health expenses on a pay-as-you-go (PAYG) basis out of current revenue. Financial Accounting Standards No. 106 (FAS 106) will require them to adopt an accrual accounting system for

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[1]Financial Accounting Standards No. 106 requires companies to record their unfunded retiree health liabilities on their financial statements, effective for fiscal years beginning after December 15, 1992.

retiree health benefits, in which benefit costs are recognized as expenses as companies accrue them for workers.

In mandating that companies' financial statements reflect their retiree health benefit obligations, FAS 106 will conform accounting practice to the view that retiree health benefits a form of deferred compensation. This is a laudable objective, in our view. The accounting change will prompt all companies that offer retiree health benefits to report higher expenses for these benefits. However, companies with an older workforce or a richer benefits package, for example, will report disproportionately higher retiree health liabilities than their competitors.

Several legislative proposals, including the "Health Insurance Coverage and Cost Containment Act of 1991" (H.R. 3205), contain a provision that would lower the age of Medicare eligibility from 65 to 60. This provision would shift some retiree health liabilities from companies to Medicare by making retiree health plans secondary payers at an earlier retiree age. You asked us to estimate what effect this would have on companies' retiree health costs and liabilities.

Lowering the age of Medicare eligibility would provide several benefits to both retirees and companies. It would (1) increase the security of retiree health benefits for early retirees (those who retire prior to age 65) by making Medicare the primary insurer, (2) make health insurance available to more retirees by extending Medicare coverage to early retirees of companies that do not currently offer retiree health benefits, (3) substantially reduce companies' PAYG costs, accrued liabilities, and prefunding costs for retiree health benefits,[2] and (4) spread the retiree health care burden among companies by helping those with older workforces and high retiree health costs become more competitive, both domestically and internationally, with companies with younger workforces. While the change in eligibility age would benefit retirees and companies, it entails a substantial expansion of Medicare program costs, which would be borne in part by all employers and their employees through higher taxes.

Lowering the age of Medicare eligibility would reduce companies' health costs for early retirees because Medicare would pay a substantial portion of these retirees' costs. Companies' health costs for retirees covered by Medicare are on average about 70 percent lower than their costs for retirees not covered by Medicare, by our analysis.

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[2]PAYG costs affect cash flows, whereas accrued liabilities and prefunding costs constitute accounting costs. PAYG costs represent payments a company makes for health benefits provided to current retirees. Accrued liabilities are the retiree health costs a company records in its financial statements to reflect the benefits it accrues for workers. Prefunding costs represent the annual contributions a company would have to make in order to begin advance funding its accrued liabilities.

My testimony presents our estimates of the reductions in companies' (1) PAYG costs, (2) liabilities, and (3) prefunding costs due to the change in Medicare eligibility. Some of these reductions are dramatic. We produced these estimates by using the retiree health model we developed for our 1989 report on companies' retiree health liabilities.[3] My testimony also discusses how the effect of the change in eligibility would likely vary among companies and industries.

## PAY-AS-YOU-GO COSTS

About 63 percent of companies' current PAYG costs are for early retirees. Most early retirees are between ages 60 and 64; PAYG costs for this group account for nearly half of companies' total estimated 1991 PAYG costs of $11.4 billion. If the Medicare eligibility age had been lowered to 60 this year, companies' 1991 PAYG costs would have decreased 35 percent, or $4 billion.[4]

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[3] Employee Benefits: Companies' Retiree Health Liabilities Large, Advance Funding Costly (GAO/HRD-89-51, June 14, 1989), describes the methodology and assumptions used in our retiree health model.

[4] Our estimates do not take into account any phase-in of the change in eligibility; they are calculated as if the change in eligibility had become effective January 1, 1991.

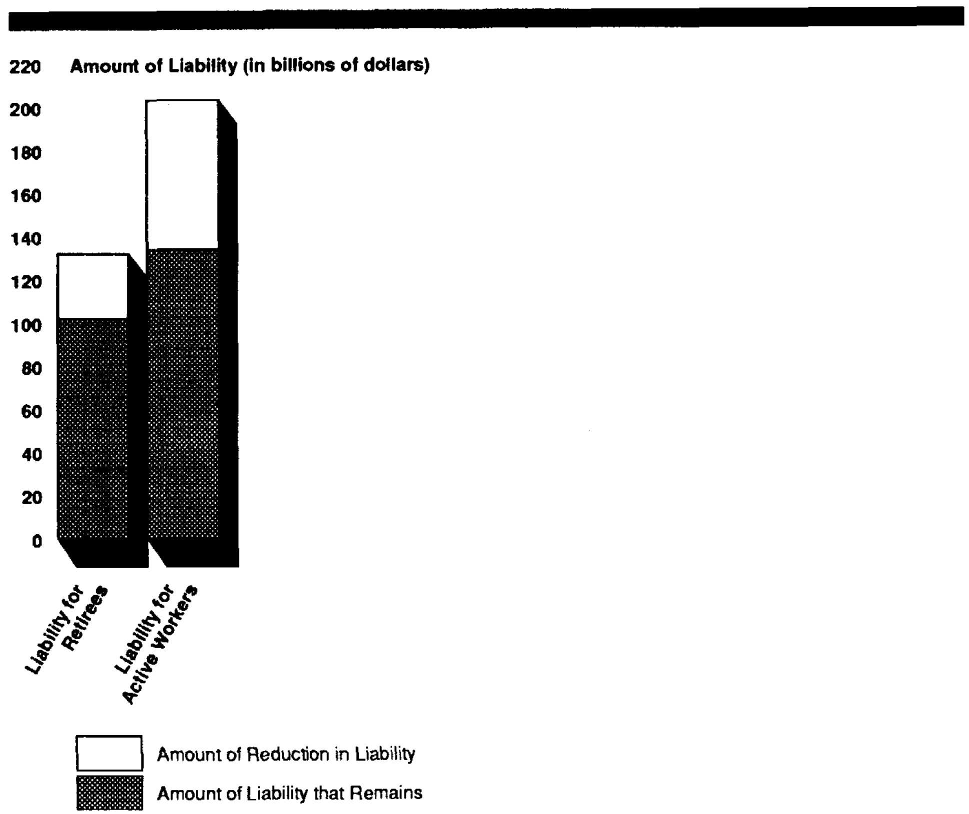
## CURRENT LIABILITIES

The liabilities of U.S. corporations for retiree health benefits, which we estimate at $335 billion in 1991, would have dropped about 30 percent, or $99 billion, if the age of Medicare eligibility had been lowered to 60. These liabilities represent companies' transition obligation under FAS 106. Companies may book the entire amount of their transition obligation, as some already have, or amortize the amount over 20 years.

The accrued liability figure represents the present value of (1) benefits currently owed to retirees and (2) accrued benefits for active workers who will retire with these benefits. The portion of companies' accrued liabilities that is for retirees, which we estimate at $132 billion in 1991, would have decreased approximately 23 percent, to $102 billion (see figure 1). For current retirees under age 65, companies' costs would decrease as a result of the change in Medicare eligibility, thereby lowering their liabilities. For retirees aged 65 and older, companies' costs would remain the same.

The portion of companies' accrued liabilities that is for active workers, which we estimate at $203 billion in 1991, would have decreased about 34 percent, to $134 billion, as figure 1 shows. The decrease is attributable to lower company health costs for active workers who will retire before age 65. Most workers

Figure 1: Reduction in U.S. Companies' 1991 Accrued Retiree Health Liabilities If Medicare Eligibility Age Had Been Lowered to 60 in 1991



retire between 60 and 65 at an average retirement age of about 62. Companies in which workers retire on average at age 62 would experience an average of 3 years of lower health costs for each retiree. In contrast, companies in which workers tend to retire before age 60 would have on average 5 years of reduced health costs per worker. (In app. I, we examine a company's projected costs for two hypothetical workers to illustrate the effect of these reduced costs on companies' liabilities.)

Companies will continue to accrue retiree health costs for active workers each year. If the age of Medicare eligibility had been lowered to 60, the reduction in active workers' future accruals would follow the same pattern as the reduction in their current accruals.

PREFUNDING COSTS

If companies were to prefund retiree health benefits, they would make annual contributions for benefits accrued during the year and for the amortization of any existing unfunded accrued liabilities. Few companies prefund their retiree health benefits and FAS 106 does not require companies to prefund benefits. Prefunding costs for retiree health benefits, calculated as if all companies had begun prefunding in 1991, would have dropped about 17 percent, from $42 billion to $35 billion, if the age of

Medicare eligibility had been lowered to 60.[5] This prefunding amount represents what companies would have to report on their income statement.

DISTRIBUTIONAL EFFECTS

Our analysis shows that the change in Medicare eligibility would provide significant financial relief for companies by substantially reducing their PAYG costs and accrued liabilities for retiree health benefits. The reductions in accrued liabilities would lower the amounts companies would have to report under FAS 106.

However, the amount of reductions experienced by particular companies would vary depending on the characteristics of a company's workforce and benefits package. Companies with a lower average retirement age, more retirees under age 65, a richer benefits package, or an older workforce, for example, tend to have higher PAYG costs and retiree health liabilities than other companies, everything else being equal. They would benefit most by the change in Medicare eligibility because they would experience greater reductions in their PAYG costs and liabilities than other companies. Companies in the auto and steel industries, for instance, would likely experience considerable reductions in their costs and liabilities since

[5]Our estimates assume a 25-year amortization period.

they tend to have many early retirees and provide generous benefits.

This concludes my testimony, Mr. Chairman. I would be happy to answer any questions.

Effect of a Change in Medicare Eligibility on a Company's Retiree Health Liability for Two Hypothetical Workers

A discussion of how the change in Medicare eligibility might affect a company's retiree health liability for two hypothetical workers will illustrate how a few years of anticipated reduced costs for some retirees can significantly lower companies' liabilities. Consider the case of a 60-year-old worker who retires in 1991 and is expected to live to age 78. From assumptions about company health costs and medical inflation, we can project two benefit streams: one under the current system (stream A) and the other calculated as if the lowered Medicare eligibility had taken effect in 1991 (stream B). Each benefit stream represents the company's estimated annual retiree health costs for the worker.

Except for the 5 years from age 60-64, the benefit streams are identical; costs are 70 percent lower in stream B for these years. The present value of the benefit streams is obtained by discounting[6] the annual costs and summing the results. Stream B's present value ($21,129) is 36 percent lower than stream A's present value ($33,114) (see fig. 2).

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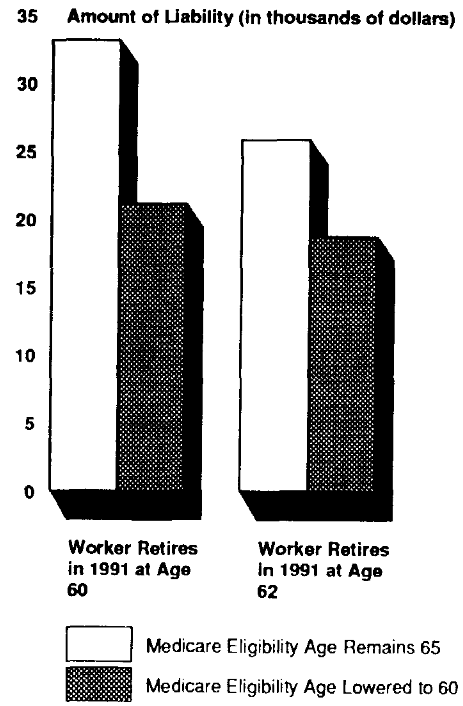
[6]Future costs are discounted (reduced in value) to reflect the time value of money. A $1,000 payment due in ten years, for example, has a present value of $508 if funds can be invested at 7 percent interest.

**Figure 2: A Company's Retiree Health Liability For Two Early Retirees**



Now consider a worker who retires in 1991 at age 62 rather than 60. The worker's retiree health benefit streams (A* and B*) would be identical except for the 3 years from age 62-64. In this case, stream B*'s present value ($18,725) is 27 percent lower than stream A*'s present value ($25,816), as figure 2 shows.

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