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Chapter 3
Is Retiree Health Insurance Crowding Out Retiree Cash Benefits?

Deborah J. Chollet

Employer payments for health insurance in the United States have surpassed payments for any other employee benefit. In 1990, employers paid an estimated $174.2 billion in contributions for health insurance, equal to 5.3 percent of total compensation.[1] Employer payments to health insurance now represent nearly one third of aggregate employer payments for all benefits combined, including voluntary benefits and social insurance (U.S. Department of Commerce 1992). Obviously, since not all firms offer health insurance to current workers or to retirees, these relative measures understate the burden assumed by firms that do offer them.

Most employer payments for health insurance benefits finance coverage for active workers. However, employer promises to continue benefits after retirement, often made as an inducement for workers to take early retirement, have changed the balance of cost for many employers during the last decade. Some older manufacturing companies, with a long history of collectively bargained contracts, now count more retirees and retiree dependents in their health plans than active workers and their dependents. In 1988, 7.8 million retirees aged 55 or older received health insurance as a retiree benefit in their own name. These people represented 42 percent of all retirees aged 55 or older who were not currently employed (Zedlewski 1993).[2]

As of December 15, 1992, most private employers that are obligated to pay health insurance benefits for current or future retirees must report the present value of that obligation as a liability against corporate assets and income. The present value of corporate liabilities for retiree health

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insurance, estimated by the U.S. General Accounting Office (GAO), approached $300 billion in 1989—as much as one half of aggregate spending for health care in the United States and approximately twice the level of all employer payments for current health insurance benefits in that year.[3]

This chapter is an overview of issues and evidence related to the burden of funding retiree health insurance liabilities and is organized as follows: first, the nature of employer obligations to recognize the present value of unfunded liabilities on their balance sheets, as well as evidence about employer responses to date are reviewed. Second, employer options for funding liability for retiree health benefits are summarized. Drawing on simple economic theory to suggest the likely distribution of burden, the incidence of increases in the cost of retiree health benefits related to funding future obligations is then discussed. Finally, the current relationship between health insurance benefits and pension benefits is described, together with inferential evidence about how that relationship may change for future retirees.

Employer Responses to the Recognition of Retiree Health Liabilities

Financial Accounting Standard (FAS) 106 requires corporations to "book" the actuarial present value of retiree health insurance benefits attributable to the accrual period, net of plan assets, as of December 15, 1992. Compliance with FAS 106 requires firms to amortize accumulated obligations for retiree health insurance benefits for active workers and retirees alike, and to fund future benefits as workers earn them, rather than as they are received.

Issued in 1990, FAS 106 had been anticipated for a decade before the statement's actual effective date for compliance.[4] A series of preliminary conclusions issued by the Financial Accounting Standards Board (FASB) that accrual accounting was appropriate for post-retirement benefits other than pensions had resulted in FASB taking two steps in 1984: establishing a major project to explore issues related to the recognition and measurement of liability, and issuing an interim statement (FAS 81) in November 1984 that required disclosure of the current cost of these benefits to the extent possible.[5] It is noteworthy that in the years immediately following FAS 81, many firms were unable to identify and, thus, to report the current cost of health insurance benefits for retirees.[6]

In addition to clear signals from FASB that accrual accounting standards for retiree health insurance liabilities were virtually inevitable, employers also received strong signals from both the courts and Congress that corporate retiree obligations were taken seriously. Litigation that

tested employer rights to modify or terminate retiree health insurance benefits increased markedly during the 1980s.[7] Persistent increases in the cost of health benefits as well as the acceleration of merger and acquisition activity led many corporations to seek ways to cut the cost of current and prospective benefits. Retirees, in turn, sued for reinstatement of benefits that had been modified or terminated. These cases ultimately confirmed the contractual nature of employer promises related to retiree health insurance and served to alert employers to the importance of language used in plan documents and personnel interviews to describe the nature and durability of retiree health insurance benefits.

In 1985 and again in 1988, Congress passed legislation affecting the rights of retirees to continued coverage in employer-sponsored health insurance plans. In 1985 (and as subsequently amended), the Consolidated Omnibus Budget Reconciliation Act (COBRA) required employers to offer retiring and other terminating workers and their dependents the opportunity to continue health insurance benefits for a period of 18 to 36 months following termination of employment.[8] A special bankruptcy provision enacted in 1986, moreover, requires that in the event of Chapter XI bankruptcy reorganization, retirees be offered indefinite continuation of coverage—that is, until the retiree dies or regains group coverage as a consequence of re-employment or marriage.

Although COBRA allows employers to charge as much as 102 percent of average plan cost for such continuation, employer experience suggests that adverse selection is a substantial problem (Charles D. Spencer and Associates 1992). As a result, employers' obligation to offer continued coverage to retirees at approximately average plan cost represents in effect an obligation to offer a contribution for continued coverage. In 1988, approximately 244,000 retirees reported having coverage from a past employer that would continue for not longer than 18 months; such coverage is presumed to represent COBRA continuation (Zedlewski 1993).

In 1988, the Retiree Benefits Bankruptcy Act again addressed the matter of retiree health insurance benefit continuation in cases of sponsor bankruptcy. That legislation prohibits companies filing for Chapter XI bankruptcy from modifying or terminating retiree health benefits unless they are able to prove in court that they must do so to avoid liquidation. Although various proposals to improve tax incentives for the funding of future liabilities have been discussed at length, none of these has been considered seriously in light of the significant potential for federal revenue loss.

These consistent signals from FASB, the courts, and Congress over the last decade or more have given employers both reason and opportunity to reconsider the nature of their retiree health benefits that they promise to current workers. Preliminary evidence from the U.S. Department of

Labor (DOL) suggests that employers have in fact modified their obligations to current workers in ways that would reduce the current cost of retiree health benefits, as well as liability for future cost.

In 1991, 42 percent of workers in private firms with 100 employees or more had health insurance plans that would continue coverage after early retirement; 40 percent had plans that continued coverage after normal retirement (see Table 3.1). These counts represent a decline in reported coverage from two years earlier and contrast with an expansion of retiree coverage promises to workers in large firms between 1981 and 1986. Clark et al. (1992) report that the decline in coverage promised to both early and normal retirees between 1988 and 1989 was most dramatic among firms in wholesale trade.

TABLE 3.1 Percent of Employees in Larger Establishments with Health Insurance Benefits that Continue After Retirement[a,b]

Year	*Retirement before Age 65*	*Retirement at Age 65 or Older*
1981	61	55
1985	64	59
1986	82	68
1988[c]	45	37
1989[c]	40	35
1991[c]	42	40

[a] *Source:* Tabulations of survey data from the United States Department of Labor, Bureau of Labor Statistics, various years.
[b] Data include only benefits to which the employer will contribute and that continue for one month or more after retirement.
[c] Data are based on a sample of firms with 100 or more employees; prior years' data are based on a sample of firms with 250 employees or more.

Funding Employer Liability for Retiree Health Benefits

For many firms, the obligation to fund accrued liability for the health benefits promised to current and future retirees represents a substantial increase in current spending for those benefits—by one estimate, five to ten times annual pay-as-you-go costs (Cotter 1993). The burden of funding these benefits on an accrual basis is further magnified by restrictions on recognized funding that are imposed by FASB, as well as restrictions on allowable funding imposed by the federal tax code.

FAS 106 recognizes funding as an offset to liability for retiree health benefits only if the funds are held exclusively for that purpose. Funds held in a trust that is usable for funding welfare benefits other than retiree health insurance (for example, a 501(c)(9) trust) would not qualify as an offset to liability under FAS 106; the trust must be designated spe-

cifically and exclusively for the purpose of funding retiree health benefits.

Employers may make tax-preferred contributions to fund current and future retiree health benefits under various sections of the federal tax code. Of those summarized here, the most generally useful funding options available to employers are 501(c)(9) plans and 401(h) plans.

501(c)(9) Plans

Also called Voluntary Employee Benefit Associations (or VEBAs), these plans can be used to hold and invest assets against retiree health obligations. However, the federal tax code tightly limits both the amount of the contribution (by disallowing contributions against future inflation, regardless of how reasonable the assumptions used) and the effective rate of return on assets held in a VEBA for the particular purpose of funding retiree health insurance benefits. Earnings against such assets are subject to tax as unrelated business income. Note that these provisions affect only single-employer plans; 501(c)(9) trusts established under collective bargaining agreements are subject to neither the zero-inflation restriction nor the tax on earnings.

401(h) Plans

Federal law also allows the use of 401(h) medical accounts for the purpose of funding retiree health benefits but restricts contributions to such plans to 25 percent of the employer's contribution to the pension plan. That is, while employer contributions to a 401(h) trust are tax deductible and earnings in the trust accumulate tax free, use of the 401(h) plan requires that the employer be able to make a pension contribution within the plan's full funding limit. A revision of the "incidental" rule governing 401(h) plans has been discussed, allowing 401(h) contributions against the accrual of employer pension liabilities regardless of the pension plan's funding status. As with other proposals that might ease funding of retiree health liabilities, however, these discussions have foundered on the issue of potential federal revenue loss.

Employers with money purchase pension plans may also use 401(h) plans for the purpose of funding retiree health liabilities. In this case, the pension plan in effect never reaches a full funding limit, so that a tax-qualified contribution to the 401(h) trust is always allowable. Even in this case, however, the 25-percent limit on such contributions may bear no relationship to the employer's actual accrued liability for retiree health benefits.

Transferring Excess Pension Assets to a 401(h) Plan

The Omnibus Budget Reconciliation Act of 1990 created Internal Revenue Code (IRC) Section 420. Section 420 addresses the effective prohibition on employers from using 401(h) plans if their pension plan has reached the full funding limit. Section 420 allows for a limited transfer of excess pension assets into 401(h) plans to fund current-period retiree health benefits. Section 420 does not allow this transfer to fund liability for *future* benefits; therefore, it helps to amortize neither past-accrued liability nor current-period accrual of liability for future benefits.

The use of Section 420 transfers is also restricted in other ways:

- All current pension plan participants must be fully vested in all accrued benefits at the time of the transfer.[9]
- Employers that make a Section 420 transfer cannot reduce per-retiree health care spending for five years following the transfer. This means that employers whose cost experience improves may actually need to enhance retiree health benefits to maintain cost.
- Employers can transfer only those amounts that exceed 125 percent of the amount needed to cover current pension liabilities.
- Transfers to the 401(h) trust can be made only once per year through 1995.
- Transferred funds not used to pay health benefits must be transferred back to the pension plan account and are subject to the excise tax on asset reversions.
- No transfer can be made to pay benefits for key employees.

These restrictions are such that few employers are likely to use Section 420 transfers. Indeed, one employer has done so only with the expectation of terminating its retiree health benefit altogether in 1997 (Mintz 1993). Millholland (1992) notes that Section 420 transfers are useful primarily to employers with substantially overfunded pension plans and immediate cash-flow needs. However, the transfer reduces the employer's current tax deduction for medical benefits and hastens the time when the employer must begin making tax-deductible contributions to the pension plan.

Designated Qualified Retirement Plans

Employers may also use conventional qualified profit-sharing or stock bonus plans to fund retiree health liability. As with 501(c)(9) and 401(h) plans, assets held in these plans offset the employer's FAS 106 liability if the plans are designated exclusively for the purpose of funding retiree

health benefits. This degree of segregation may be prohibited under the rules governing qualified retirement plans (Hutchison 1991), although professional opinion on this point appears to be divided.

The use of a designated qualified plan allows the employer to make tax-deductible contributions within the current-law limits governing contributions to such plans for the purpose of retirement saving, and earnings accumulate tax free. Retirees may use plan distributions to pay their share of the cost of health benefits at the time of receipt. Although both contributions and earnings to the plan are tax deferred, distributions are taxable income to retirees. Millholland (1992) suggests that the qualified plan itself may purchase a health insurance plan, which then may provide tax-exempt medical benefits to retirees.[10]

Corporate-Owned Life Insurance (COLI)

Although COLIs may not be counted toward an employer's FAS 106 liability, they may help employers manage cash-flow needs associated with retiree health benefits. Employers may purchase a COLI on part or all of their active work force; as deaths occur, the company collects the life insurance distributions tax free. The company may also borrow against the cash value of the policy to create cash flow to meet all or part of its current costs for retiree health benefits. Interest on loans under $50,000 is tax deductible.

Employers also may combine a COLI with a 501(c)(9) plan (or VEBA) to provide additional tax benefits. Such plans, called *trust-owned life insurance (TOLI)*, allow employers to deduct the life insurance premium and to accumulate earnings as inside-buildup (and, therefore, not subject to tax as unrelated business income). Unlike a COLI, the cash value of a TOLI does count against the employer's FAS 106 liability.

Both COLIs and TOLIs carry some potential disadvantages. Both require that the employer transfer risk to an insurance company, including the risk of asset performance. Employers also may have to comply with some states' insurable interest laws and may need employee consent to structure retiree health plan funding in this way. Finally, in the near term, neither COLIs nor TOLIs may have sufficient asset value to fund accrued retiree health liability for current retirees or for workers near retirement.

Despite the variety of funding options available to employers, none necessarily offers employers the ability to fund accrued retiree health benefit obligations with the same tax advantages that apply to funding pension obligations. Depending on the firm's particular circumstances, there may be no option that would allow full funding of the true present value of liability for retiree health benefits with fully deductible contributions and exemption of plan earnings. Arrangements that are most like

conventional defined-contribution pension plans in their tax implications may be unable to provide the tax-exempt benefit after retirement that is normally associated with an employer-sponsored health plan. Although TOLIs may come closest to replicating the tax advantages allowed employer pension funding, their usefulness depends critically on the demographics of the covered work force. The difficulty of configuring adequate funding against employer liabilities for retiree health benefits under current law may prove to be among the most important factors in an ongoing decline of these benefits.

The potential difficulty of designing an adequate, tax-preferred funding arrangement for employer contributions, however, does not mean that employers would not sponsor group coverage for retirees without a contribution. Various conventional defined-contribution pension plans may be used to accumulate employee contributions to finance future participation in a group retiree health plan. Such arrangements help offset employer reductions in plan benefits or in their obligation to contribute to benefits and may enable employers to redesign their liability as a defined contribution.

Various surveys indicate that many employers have in fact redesigned their retiree health plans in ways that increase retiree costs to participate in the plan and limit employer liability either absolutely or relative to total plan cost. Plan reports tabulated by Clark et al. (1992) suggest that retiree contributions for coverage became much more common even between 1988 and 1989. In 1989, fewer than one half of workers (45 to 47 percent) with a health benefit that would continue after retirement either before or after age 65 would have the benefit wholly paid by their employer, although this proportion varies widely among industry groups

TABLE 3.2 Workers with Wholly Employer-Paid Retiree Health Benefits as a Percent of All Workers with Retiree Health Benefits: Establishments with 100 Workers or More, 1989 [a]

Industry group	*Retirees Under Age 65*	*Retirees Aged 65 or Older*
Mining	28	30
Construction	58	67
Manufacturing	46	44
Transportation, communications, and utilities	73	75
Wholesale trade	75	70
Retail trade	10	10
Finance, insurance, and real estate	32	37
Services	29	40

[a] *Source:* Clark RL, Headen Jr. AE, Shumaker L. *Retiree Health Insurance Benefits and the Retirement Decision.* Final Report, HHS Grant No. 90-ASPE-231A (June 1992), Table III-6. Washington, DC: Department of Health and Human Services, 1992.

(see Table 3.2). A survey conducted by Hewitt Associates (1990) indicated that more than one third of the nearly 300 surveyed employers with retiree health benefits had made changes in either 1988 or 1989 that increased retiree contributions for single or family coverage or raised the deductibles or coinsurance provisions of the plan. Of these, approximately one third had provided offsetting increases in other benefits such as pensions.[11]

The Incidence of Increases in the Cost of Retiree Health Benefits

Some simple economics of employer responses to the increased current cost of health benefits are described in this section. The expected increase in employer cost, both now and over the foreseeable future, comes from a number of sources.

Before 1993, most employers that sponsored retiree health benefits neither recognized nor funded any accrual of liability.[12] By forcing balance-sheet recognition of the present value of employer promises to provide retiree health benefits, FAS 106 has forced plan sponsors to increase current spending for health benefits greatly, to avoid significant loss of financial net value. This cost can be taken as a one-time "hit" to the corporate balance sheet; however, FAS 106 allows employers to amortize past accruals over as many as 20 years.[13]

The cost of health benefits, both for retirees and current workers, has exceeded growth in any other sector of the economy and probably will continue to do so for some time. As a result, the relative cost of health benefits compared to wages, other benefits, capital, and corporate gross income will continue to grow for many if not most employers. Thus, even if plan sponsors were to continue pay-as-you-go financing of retiree health benefits, the relative cost of these benefits would continue to rise.

Employers' limited ability to fund against retiree health obligations in a tax-effective way magnifies the cost of retiree health liabilities relative to other retirement benefits that the employer might offer. If employers are more willing to fund pension benefits than health benefits, the effect of increasing retiree health costs on retiree cash benefits—the central question of this Chapter—may be less than if funding options for both were equally tax-advantaged.

The discussion that follows distinguishes between the cost of funding accrued retiree health benefits and the cost of funding current benefit accruals. Although this distinction is conventional in a discussion of pension liability, where standards for vesting and accruals are established in law, with respect to retiree health insurance benefits the distinction is relatively novel.

Funding benefits pay-as-you-go, most employers have eschewed the

notion of pre-retirement vesting for retiree health benefits. Typically, employers have in effect cliff-vested workers at the point they became eligible to receive pension benefits.[14] However, FAS 106 is premised on FASB's determination that terminal accrual of liability (that is, accrual at retirement) is inappropriate (FASB 1990). Instead, FAS 106 requires employers to recognize benefit accruals using a benefits/years of service approach that attributes the expected benefit obligation to each year of service in the attribution period.[15] Thus, FAS 106 requires employers to fund liabilities for current workers during their working years, even if the employer retains terminal vesting for the benefit. It is this provision of FAS 106 that makes the question of incidence especially interesting.

Anticipating new accounting rules and seeking to control the cost of funding for short-service workers, some employers have established explicit, graduated benefits schedules for retiree health benefits. In general, such schedules provide for greater employer payment for coverage after retirement (in either dollar terms or as a percentage of plan cost) for workers with longer service, and less or no payment after retirement for short-service workers (for example, workers with fewer than ten years of service at retirement). Such graduated schedules for retiree health benefits may become more common as employers begin to adjust to the new accounting rules.

Funding Past Accruals

In the simplest scenario, the cost of funding past-accrued liability (either for retiree benefits that already are in pay status or for benefits that are fully obligated to current workers) has no bearing on current production decisions. Even if the firm is able to alter its contractual obligation to pay these benefits, to the extent that the firm retains liability related to past service, funding that liability raises the firm's fixed cost: the cost of funding the liability cannot be altered by changing any short-term production decision. Thus, the firm suffers reduced profit but will make no adjustment in the level of production or the price of its product, unless reduced profit affects the firm's cost of obtaining capital.[16] An increase in the cost of capital may cause the firm to scale back production and employment, and, as a result, the product price may rise. Obviously, even firms with relatively little need for external capital can be forced out of business if their fixed costs for past accruals are sufficiently high, perhaps affecting market prices for labor, capital, and their product more widely.

In any case, the magnitude of the potential effect on product price depends on the structure and regulation of product markets. Reduced output could raise product prices in markets with relatively few competitors. Regulated monopolies, such as public utilities, may be especially

successful in shifting the cost of funding past accruals forward to consumers, as rate increases are administratively determined and generally gauged to maintain a fixed margin of profit for the firm. In fact, firms in transportation, communications, and public utilities (TCU) may bear the greatest liability for health benefits related to current retirees;[17] together with firms in finance, insurance, and real estate, TCU firms are the most likely to offer retiree health benefits to current workers. In more competitive industries, where firms have limited ability to raise prices independently, plan sponsors and, in turn, shareholders would bear the cost of funding past accruals.

To the extent that employers fail to fund past accruals as they are recognized, past research on pension funding suggests that the firm's share prices may adjust quite accurately to the magnitude of unfunded liability for benefits (Feldstein and Seligman 1981; Landesman 1986). It seems likely that most firms with very large accrued liability for retiree health benefits will avail themselves of the 20-year amortization period that FAS 106 allows for past accruals. As a result, the impact of past accruals on employers' financial statements is likely to be gradual and cumulative, whether funded or otherwise. Nevertheless, it is noteworthy that equity markets apparently have not been sensitive to retiree health liabilities since FAS 81 required disclosure.[18]

Finally, if the firm is able to alter its obligations to current retirees, how the employer handles health benefits for current retirees may affect the employer's credibility in negotiating compensation for current workers. That is, the funding of past accruals may affect the incidence of the cost of funding current accruals. The value to the employer of sending the "right" signal to current workers may be so significant that employers who would reduce substantially or terminate benefits for current retirees must do the same for current workers, even if the employer believes that a retiree health plan is critical in attracting and retaining good workers. This effect is discussed next.

Funding Current Accruals

The accrual of liability for retiree health benefits stretches the attribution period for benefits over the worker's career.[19] As a result, the employer's recognition of liability becomes a current cost of labor and production decisions, rather than a fixed cost of retiring the worker. This adjustment in employers' (and perhaps employees') view of retiree health benefits may have implications for wages and other benefits, short-run and long-run production decisions, and employment.

Figure 3.1 offers a simple graphical exposition of the hypothetical tradeoff between retiree health benefits and other forms of labor compensa-

tion. We assume that employers are interested only in total compensation, not necessarily the relative components of the compensation package. After Smith and Ehrenberg (1983), the firm's "isoprofit" curve—a curve along which any combination of benefits and cash compensation yields equals profits to the firm—is depicted as YY′. In effect, this is the firm's offer curve to workers in negotiating compensation.

In this case, we consider retiree health benefits separately from wages and all other benefits. For simplicity, one may assume that employer contributions to pensions and benefits other than retiree health are monotonically (and positively) related to wages. If employee productivity does not change systematically with the mix of retiree health benefits and other compensation, then the firm's isoprofit curve is a straight line. YY′ can easily be nonlinear (convex or concave) if the presence of retiree health benefits enhances employee work effort by reducing turnover or, conversely, if retiree health benefits are structured so as to be independent

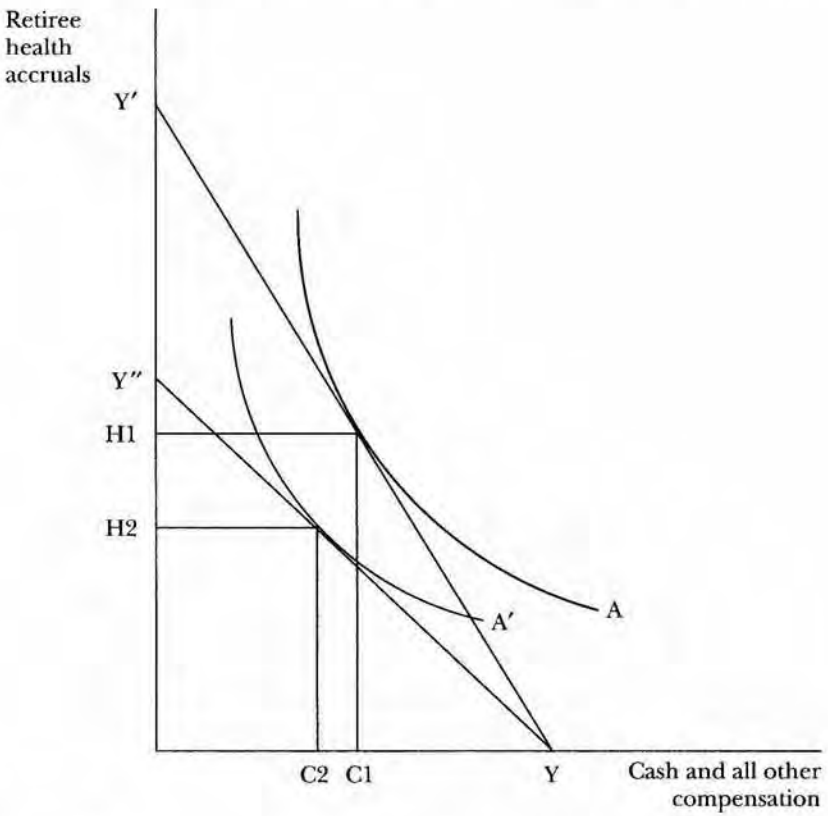

Figure 3.1 Retiree health benefits versus other forms of labor compensation.

of work effort and, therefore encourage absenteeism (Lazear 1990). However, the essential results of the analysis are the same for our purposes.

Adopting standard convexity assumptions, employee demand for retiree health benefits relative to wages and other benefits is depicted as indifference curve A. Employees with different preferences for retiree health benefits versus cash or other benefits will have indifference curves situated at different tangencies to the firm's offer curve. Each worker's utility is maximized at a tangency point; the differences among workers' preferences and their resulting tangency points define a range of compensation offers that the firm will make to employees (at a given target profit) and the resulting mix of wages and benefits in employee compensation. A uniform increase in the cost of funding retiree health benefits produces a downward swing of the firm's offer curve and a reduction in the worker's utility maximizing level of retiree health benefits relative to wages and other benefits. Whether wages and/or other benefits fall in equilibrium depends on employees' relative preferences for retiree health benefits and, therefore, the relative income and substitution effects of the new funding requirement.

The incidence of the cost of funding current accruals has to do with the willingness of employees to tolerate a reduction in wages and other benefits to sustain retiree health benefits. Worker tolerance for reduced wages and other benefits, in turn, depends on their relative preferences for retiree health benefits, their ability to find a preferred mix of compensation in alternative employment, and the degree to which they believe that their retiree health benefit is guaranteed.

Figure 3.2 depicts the market demand for and supply of labor for comparable workers. Required new funding for retiree health benefit accruals represents a downward shift in employer-sponsors' demand for labor by the full cost of funding. Guaranteeing the benefit to workers, in turn, shifts their supply curve outward by an amount equal to their valuation of the benefit. If the value of retiree health benefits to workers equals the cost of funding the benefit, then the supply of labor shifts outward to S′, and the cost of funding is offset fully by a reduction in current compensation (to C3). Given time for market adjustment, plan sponsors would bear none of the cost of funding accruals.[20]

Workers who have little confidence that they ultimately will receive a health benefit in retirement will place a lower value on retiree health benefits than workers who are more confident of receiving the benefit, and they will be less tolerant of a reduction in current compensation to fund the benefits. The supply curve for these workers will shift outward less (to S″), and their current compensation in equilibrium will fall only to C2. The employer burden of funding retiree health benefits will be

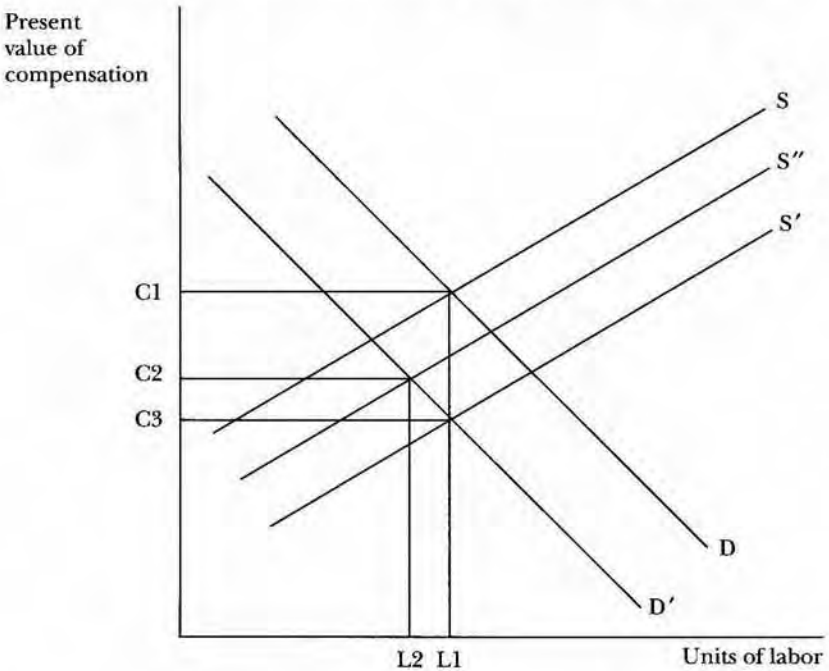

Figure 3.2 Market demand for and supply of labor in response to required new funding for retiree health benefit accruals.

greater (by the distance C2 - C3) than if these workers placed a higher probability on receiving the benefit.

It is this difference in the incidence of the cost of funding that may drive employers to adopt explicit (contractual) graduated benefit schedules, despite the absence of any requirement in law that employers establish vesting for retiree health benefits comparable to that required for pensions. By contractually guaranteeing partial benefits to workers, even if they terminate employment before retirement, the plan sponsor may be able to bargain much more effectively to fund accruals by reducing other forms of current compensation. Failure to convince workers of the current value of retiree benefits, conversely, places the burden of funding entirely on the plan sponsor, with little likelihood of obtaining any offset in other forms of compensation.

Furthermore, employers that retain the right to modify or terminate retiree benefits at will (and demonstrate that right with respect to benefits in payment to current retirees) may seriously diminish workers' confidence that they ultimately will receive the benefit, regardless of the agreement struck with current workers. As a result, these employers reduce

the likelihood of obtaining wage concessions to offset the cost of funding current accruals.[21]

Although the relatively simple scenario described above captures the essence of the problem of incidence, the level of retiree health insurance benefits likely to emerge in the marketplace may be affected greatly by the idiosyncracies of the tax rules that govern funding of these benefits. For example, at present, the rules governing 501(c)(9) plans limit the level of tax-deductible contributions well below the full current value future benefits by disallowing any inflation assumption. Similarly, funding in a 401(h) plan is limited by the firm's pension funding status. Obviously, funding options that do not protect the plan sponsor from taxation of earnings on assets reduce the value to the employer of a dollar spent to fund retiree health benefits relative to a dollar spent on benefits that are relatively tax preferred, such as pensions or current insurance.

Although the second matter—taxation of earnings at all levels of funding—is important, analysis of its effect is qualitatively the same as that already presented. That is, the cost of funding retiree health benefits is simply higher, at every level of the benefit, than it would be were earnings in the plan tax deferred or tax exempt, and employers are correspondingly less willing to offer retiree health benefits at any level.

The presence of effective limits on tax-deductible contributions, however, may produce a qualitatively different result by producing a "kink" in the employer's compensation offer curve. Such a case is depicted in Figure 3.3.

YY″ in Figure 3.3 represents the firm's isoprofit curve, reflecting the current cost of funding retiree health benefit accruals with full deductibility of employer funding. A limit on deductible funding at H1 produces a new, kinked isoprofit curve, YY‴. In the limit, the equal-profit level of retiree health benefit funding becomes Y‴, where

$$Y''' = Y''(1 - t)$$

and t is defined as the marginal tax rate on employer contributions above the deductible limit.

For workers with relatively strong preferences for retiree health benefits, such as that depicted by A′ in Figure 3.3, the limit on tax-deductible employer funding of the benefit will have the effect of further reducing worker utility from compensation (relative to the no-limit case) and also fixing worker demand for retiree health benefits nearer (or at) H1. That is, although the equilibrium level of retiree health benefits (at a given level of profit) is likely to drop for all workers as employers begin to fund retiree benefits, it will drop most for workers who prefer relatively extensive retiree health benefits and, as a result, represent funding that ex-

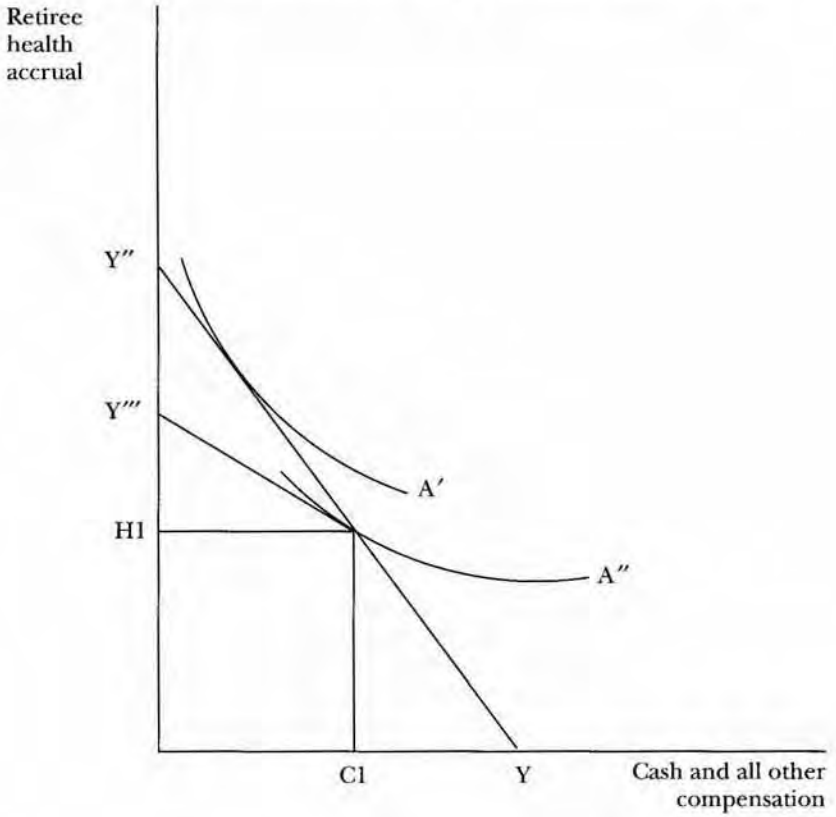

Figure 3.3 Effects of limits on tax-deductible contributions, or the so-called "kink" in the employer's compensation offer curve.

ceeds the tax-deductible limit. For such workers especially, employers may seek to improve employee satisfaction with total compensation (at the same level of profit) by redesigning the retiree health plan—for example, by using a conventional qualified plan to fund defined employer contributions as well as employee contributions to the benefit.

One reason why employees may have strong preferences for retiree health benefits relative to pension benefits, in particular, may relate to historically high rates of health care cost inflation. That is, if employees perceive that the discounted present value of retiree health benefits exceeds the discounted present value of equal employer contributions to a pension plan, they may prefer greater funding of retiree health benefits to maintenance of the pension benefit. By trading retiree health benefits for pension benefits, employees would, in effect, buy inflation protection with respect to a major expense item—health care. For workers antici-

pating retirement before Medicare eligibility, this may be especially attractive. This scenario might lead one to expect that pension coverage and benefits might deteriorate in favor of retiree health benefits.

Such preferences for retiree health benefits in lieu of pension benefits seem unlikely for several reasons. First, workers likely to value retiree benefits most also are likely to be near retirement. Such workers would have the most to lose from significant reductions in the pension formula in order to gain inflation protection for relatively few years. They may be more willing to delay retirement instead. Second, recent changes to Medicare (in particular, limiting physician balance billing) lessen the value of inflation protection after age 65. Finally, employers would seem unlikely to favor such a trade, accepting the open-ended liability of a retiree health benefit in lieu of the close-ended liability of a pension benefit.

Implications of Health Benefit Cost Increases for Retirement Benefits

The simple analysis already offered suggests that the impact of employer funding for retiree health benefits may be limited substantially by the relative tax disadvantages of funding these benefits. There are good reasons to expect employers to respond to FAS 106 by redesigning retiree health benefits to reduce or eliminate liability. Conversely, few scenarios would suggest that employers simply would commence funding an unaltered obligation unless otherwise constrained to do so. And, to the point of this chapter, there is little reason to believe that retiree health benefits would flourish at the expense of retirement cash benefits.

The intuition that employers would be reluctant to retain generous retiree health benefits is consistent with the recent erosion of retiree plans in general and the erosion of retiree plans that are fully employer-paid in particular. These patterns were described earlier in the section about employers' initial responses to the required recognition of accrued liability for retiree health benefits. Because the shortness of available time-series data supports (at best) only preliminary conclusions about trends toward scarcer and less generous retiree benefits, the issue clearly bears watching.

The funding of retiree health benefits, however, may affect pension benefits in other ways. Under IRC Section 420, employers may transfer excess pension assets for the purpose of funding current retiree health benefits. Because no available data describe the funding status of pension plans sponsored by firms that also provide retiree health benefits, the potential impact of Section 420 can be inferred only very generally from funding reports on all plans. Examination of Form 5500 reports on defined benefit pension plans, in particular, indicates that firms in indus-

tries that are the most likely to offer a concurrent retiree health benefit (in finance, insurance, and real estate) are also the most likely to have very high pension asset ratios.

A second way that retiree health benefit funding may affect pension plans is also an artifact of tax code restrictions on allowable retiree health plan funding. That is, employers who wish to use a 401(h) trust to fund retiree health benefits may contribute to the 401(h) plan only an amount that is not more than 25 percent of their contribution to the pension plan. As a result, consideration of retiree health obligations may force significant change in employers' pension funding strategies, encouraging greater contributions within the plan's full funding limit. These points are developed in greater detail in the following section.

Tabulation of the U.S. Department of Labor (DOL) employee benefit survey data indicates that about 40 percent of all establishments that sponsor a defined-benefit pension plan also sponsor retiree health benefits (see Table 3.3). Conversely, few firms (16 percent in 1989) offer a retiree health benefit, but no pension (Clark et al. 1992).

TABLE 3.3 Percent of Defined Benefit Pension Sponsors that Offer Retiree Health Benefits, by Age of Retiree Eligibility, 1989 [a]

	Retirees Under Age 65	*Retirees Aged 65 or Older*
Total, all establishments	44	40
Industry Group:		
Mining	56	43
Construction	24	36
Manufacturing	48	44
Transportation, communications, and utilities	58	46
Wholesale trade	29	22
Retail trade	42	29
Finance, insurance, and real estate	57	61
Service	21	17
Establishment Size:		
250 - 499	41	28
500 - 999	38	33
1000 - 2499	46	39
2500+	68	62

[a] *Source:* Calculations based on: Clark RL, Headen, Jr. AE, and Shumaker L. *Retiree Health Insurance Benefits and the Retirement Decision.* Final Report, HHS Grant No. 90-ASPE-231A (June 1992), Tables III-11 and III-12. Washington, DC: Department of Health and Human Services, 1992.

The contingent probability of a retiree health benefit, given the presence of a defined benefit plan, is highest in firms that have 2500 or more

TABLE 3.4 Distribution of Defined Benefit Pension Plans by Funding Status, 1990[a]

	Number of Plans	Participants (in millions)	Plan Assets as a Percent of Current Liability: Less than 50%	50–99%	100–124%	125–149%	150% or more
			Percent of Plans				
Total, all plans	15,561	33.21	3.2	16.7	22.4	20.7	36.8
Industry Group:							
Agriculture, mining, and construction	1100	1.86	1.9	17.0	32.7	25.0	23.4
Manufacturing	7835	14.27	4.3	22.2	24.4	19.4	29.8
Transportation, communications, and utilities	811	4.45	2.7	14.3	15.5	21.9	45.5
Wholesale and retail trade	1203	3.27	2.7	12.6	23.4	20.7	40.6
Finance, insurance, and real estate	1405	3.32	1.6	5.3	12.6	22.1	58.4
Service	3165	6.01	2.2	10.4	19.8	21.6	45.9
Missing	42	0.03	11.9	19.0	19.0	16.7	33.3
Number of Employees:							
< 100	233	0.04	3.4	16.7	24.5	19.3	36.1
100 - 499	3044	0.75	2.5	9.1	17.0	23.2	48.3
500 - 999	1321	0.75	3.2	11.0	17.9	20.5	47.5
1000 - 2499	1408	1.70	2.2	9.9	17.0	23.8	47.2
2500 or more	1992	12.52	2.0	8.7	18.5	22.3	48.5
Missing	7563	17.44	4.1	24.2	27.4	18.8	25.5

[a] *Source:* Form 5500 reports.

employees; in 1989, 68 percent of firms that offered a defined benefit pension plan also offered a health benefit to early retirees, and 62 percent offered a health benefit to retirees aged 65 or older. The contingent probability of retiree health benefits is the highest among firms in finance, insurance, and real estate (FIRE) and among TCU firms. In 1989, 57 percent of FIRE firms that sponsored a defined-benefit pension plan also provided health benefits for early retirees; 61 percent provided health benefits for retirees aged 65 or older. Among TCU firms, 58 percent of firms that sponsored a defined-benefit pension plan also provided health benefits for early retirees, but only 46 percent provided health benefits for retirees at age 65. This latter rate is not substantially different from that reported by firms in manufacturing or mining.

Tabulations of Form 5500 reports for defined benefit pension plans indicate that most plans are well funded. In 1990, nearly 58 percent of defined benefit pension plans reported asset ratios that exceeded 125 percent, and in that respect would qualify for use of Section 420 transfers (*see* Table 3.4). Among plans in FIRE—and most likely to have a concurrent retiree health benefit—82 percent reported funding ratios that exceeded 125 percent; 58 percent reported funding ratios that exceeded 150 percent. In no other industry group were pension plans so likely to be substantially overfunded. Pension plans sponsored by TCU firms also were likely to be substantially overfunded relative to the average among industries: two thirds reported a funding ratio in excess of 125 percent, and 45 percent reported a funding ratio in excess of 150 percent.

A multiple regression analysis of the determinants of pension funding

TABLE 3.5 Determinants of Pension Plan Asset Ratios in 1990: Multiple Regression Results [a]

Variable Name	*Estimated Coefficient*
Intercept	1.3954 [b]
Industry Variables (omitted=manufacturing):	
Agriculture	-0.0510
Mining and construction	0.3770
Trade	0.0493
Transportation, communications, public utilities	0.1766 [b]
Finance, insurance, real estate	0.2516 [b]
Services	0.1735 [b]
Number of Employees	0.0113
1988 Asset ratio	0.0002
Equation F-value = 4.542; Adjusted r^2 = 68%	

[a] Dependent = 1990 Assets as a percent of current liability; n=4138.
[b] Significant at 0.99 (two-tailed).

status among plans that reported both in 1990 and in 1988 confirms the industry variation in pension funding status already described. These results are reported in Table 3.5. Furthermore, it demonstrates that pension funding status in 1990 did not vary significantly with firm size, suggesting that very large firms are not necessarily better positioned to use Section 420 to finance current retiree health benefits than are smaller firms. Nor was pension overfunding in 1990 significantly related to funding status two years earlier. This latter result, indicating apparent volatility of asset ratios over a relatively short period of time among firms that could be matched to an earlier report, was somewhat surprising. Employers that have experienced such volatility may be especially unwilling to use Section 420 transfers to fund current retiree benefits.

The accumulation of substantial excess assets in a defined contribution plan may offer a limited opportunity to use Section 420 transfers to fund current retiree benefits, but this opportunity is of no use to firms that have few retirees and a relatively large number of workers with past and current accruals. In contrast, 401(h) plans can be used to fund accruals as well as current benefits. Their use is limited, however, by the

TABLE 3.6 Average Contribution per Participant to Defined Benefit Pension Plans, 1990 [a]

	Total Number of Plans	*Percent of Plans with a Contribution*	*Average Contribution per Participant* [b]
Total, all plans [c]	15,561	63.4%	$1123
Industry Group:			
Mining and construction	993	80.4	1336
Manufacturing	7835	62.4	737
Transportation, communications, and utilities	811	57.7	4447
Wholesale and retail trade	1203	59.6	995
Finance, insurance, and real estate	1405	50.4	1817
Service	3165	69.5	981
Missing	42	68.9	1273
Number of Employees:			
<100	233	52.7	2076
100 - 499	3044	59.2	1010
500 - 999	1321	61.1	929
1000 - 2499	1408	59.2	860
2500 or more	1992	54.8	832
Missing	7563	68.9	1273

[a] *Source:* Form 5500 reports.
[b] Includes only plans with nonzero contributions in 1990.
[c] Includes plans in agriculture not included in industry detail.

employer's current contribution to the pension plan. Consequently, current pension contributions are of as much interest as the plan's funding status as a gauge of employers' opportunity to fund retiree health liabilities with the same tax advantages as apply to pension funding.

In 1990, fewer than two thirds of defined benefit plans reported any current-year contribution to the plan (see Table 3.6). Pension plans in FIRE and TCU were less likely than the average plan to report a current-year contribution. Although the variance in current contributions (among plans with non-zero contributions) was substantial, the average contribution per participant was approximately $1100.

On average, these contributions were markedly lower than the levels that might provide an opportunity to fund retiree health benefits adequately. As reported in one survey, the median level of funding required to fund accrued retiree health liabilities for current retirees alone in compliance with FAS 106 was estimated to exceed $9000 per year in 1990—although again the variance among firms was substantial (ranging from $0 to more than $30000) (Hewitt Associates 1990).

Finally, a Tobit analysis of employer contribution levels in 1990 among plans that also reported in 1988 indicates that the plans' reported funding ratio in 1990 had no significant bearing on the level of pension contributions that year. The absence of a statistical relationship between funding status and current contributions appears to demonstrate the flexibility with which employers make pension contributions to achieve current-year financial and tax objectives. The coefficient estimates reported in Table 3.7, however, indicate that firms in industry groups and firm sizes most likely to have retiree health benefits (firms in FIRE and firms with more than 2500 employees) were also significantly less inclined to

TABLE 3.7 Determinants of Defined Benefit Pension Contributions in 1990: Tobit Results [a]

Variable Name	*Estimated Coefficient*
Intercept	187.3158 [b]
Industry Variables (omitted=manufacturing):	
Agriculture	107.2888
Mining and construction	39.8286
Transportation, communications, and utilities	41.3764
Trade	-145.7760 [c]
Finance, insurance, real estate	-271.1919 [b]
Services	81.5744
Number of Employees	-53.3406 [b]
1990 Asset ratio	0.0988
Normal scale parameter	1570.5663
Log likelihood = -39602.93	

[a] Dependent = Contributions per participant; noncensored n = 4266; left-censored n=3148.
[b] Significant at 0.99 (two-tailed).
[c] Significant at 0.95 (two-tailed).

make greater pension contributions in 1990. For such firms, use of a 401(h) trust to fund retiree health liabilities would appear to require a significant departure from past pension funding strategies.

Conclusion

The need for employers to fund their retiree health obligations is driving re-evaluation of these benefits by both employers and employees. Some employers, anticipating unsustainable cost for these benefits, have altered their retiree health plans significantly or terminated them altogether for current employees. Data sufficient to indicate the prevalence of this behavior are unlikely to accumulate for some time. One recent survey indicated that only about one third of 306 employers with retiree health plans had completed their analysis of the initial impact of FAS 106 at the time of the survey (Hay Group 1993).

It seems unlikely that employers' need to fund retiree health benefit liabilities would significantly jeopardize pension benefits. Indeed, the analysis presented in this chapter suggests that significant reductions in retiree health benefits are much more likely than any reduction in pension benefits. The relative tax disadvantage of funding retiree health benefits adequately may be among the most important factors in employers' reluctance to adjust pension formulas in favor of greater funding for retiree health benefits. Furthermore, the analysis presented in this chapter indicates that pension funding ratios may be volatile, even in the short term. As a result, firms may be unwilling to use Section 420 transfers to pay retirees' current health benefits and, in turn, provide cash flow to fund past and current accruals.

Finally, although funding retiree health benefits through a 401(h) plan offers the greatest tax advantages, full funding limits on pension plans may not offer employers sufficient latitude to fund large retiree health obligations. Firms' pension contributions apparently are gauged to serve corporate financial and tax needs; at the margin, these considerations appear to outweigh consideration of the plan's current funding status. For many firms, use of a 401(h) plan to fund retiree health liabilities would seem to force a significant reconfiguration of their pension-funding strategy.

In general, FAS 106 has come at a difficult time. Uncontrolled inflation in health care costs is driving national re-evaluation of our entire system of financing health care and paying health care providers. Medicare Part A, which pays most of retirees' hospital costs, is in serious financial trouble: the program's projected insolvency date has been moved forward to 1999 under intermediate economic assumptions, and to 1998

under more pessimistic assumptions. In such an environment, the future of employer-sponsored retiree health benefits seems far less certain than the future of pensions.

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Notes

1. By comparison, employer contributions to pension and profit-sharing plans in 1990 were less than one third this amount, or $52.5 billion (U.S. Department of Commerce 1992).

2. These counts exclude persons covered as a dependent of a retiree with benefits in his or her own name, as well as employed retirees whose coverage is provided by a past employer. Including these persons (but also individuals who may have coverage only as COBRA continuation), the 1987 National Medical Expenditures Survey (NMES) counted 10 million retirees with coverage from a past employer (Monheit and Schur 1989).

3. Other national estimates based on different empirical methods have produced similar estimates (Chollet 1989). Based on a sample of 1989 corporate statements, estimates produced by Warshawsky (1992) suggest that accrued liability for retiree health benefits may be somewhat higher. The difference among these estimates is related primarily to differences in assumptions about the long-term rate of inflation in health care costs.

4. FASB first commented in 1979 on disclosure of nonpension benefit liabilities in *Disclosure of Pension and Other Post-Retirement Benefit Information* (July 12, 1979). Five subsequent papers were issued related to accounting for retiree health benefits between 1981 and 1984, culminating in *Statement 81* (November 1984).

5. *FAS 81* required corporations to (1) describe the benefits and employee groups that are covered; (2) describe the accounting and funding policies related to these benefits; and (3) report as a footnote the current cost of the benefit (if distinguishable from the cost of benefits for active workers and dependents) or the combined current cost of the benefit for active and retired workers (if the firm was unable to distinguish costs for each).

6. A survey of 100 corporate annual reports for 1987 indicated that 10 percent were unable to disclose costs at all; 18 percent did not distinguish between costs for retirees and for employees (Charles D. Spencer and Associates 1988).

7. A discussion of various key cases related to retiree rights to continued benefits is provided in Chollet (1989) and in Warshawsky (1992).

8. COBRA requires employers to offer retiring workers the option to continue coverage for 18 months following retirement, or 29 months for disability retirement. Spouses and dependent children must be offered the option to continue

employer coverage for as long as 36 months, if they lose coverage as a result of an employee's eligibility for Medicare, or a retiree loses coverage as the result of sponsor bankruptcy (EBRI 1990).

9. This provision includes former active workers who separate within one year of the transfer.

10. The Internal Revenue Service also has allowed the creation of an "HSOP;" that is, an ESOP that qualifies as a money purchase pension plan and is combined with a 401(h) plan dedicated to funding retiree health benefits. Such a plan provides tax-free benefits to retirees, with allocated assets counted toward the firm's FAS 106 liability. Since approving such a plan created by Procter & Gamble, the IRS has subsequently declined to issue determination letters on other HSOPs.

11. Among current retirees with health benefits from a past employer, 33 percent paid part of the cost of benefits; 19 percent paid the full cost of coverage, with no employer contribution (Zedlewski 1993).

12. Of 2215 firms selected for study, Warshawsky (1992) discovered only 49 firms that used some form of accrual accounting for retiree health benefits; only 19 firms had any prefunding of benefits.

13. Warshawsky's (1992) estimates indicate that some firms' accrued liability for retiree health insurance is very large, averaging 31 percent of net worth and 17 percent of the market value of equity among 676 large firms in 1989. Furthermore, the variance in liability for retiree benefits relative either to net worth or to market value of equity was substantial: in that sample, employer liability for retiree health benefits ranged from zero to 38.5 times the market value of equity.

14. In 1988, only about 12 percent of retirees with health benefits (3.7 percent of all retirees aged 55 or older) reported not receiving a pension benefit as well (Clark et al. 1992).

15. FASB also determined that the relevant attribution period for retiree health (and other retiree welfare benefits) concludes at the employee's date of eligibility for benefits, rather than at the employee's expected retirement date. As a result, the accrual period for retiree health benefits may be shorter than that which the employer uses to fund pension benefits.

16. Statements made by Standard & Poor (in 1989) and by Moody (in 1990) suggest that neither believes that recognition and accounting for retiree health benefits will affect firms' credit ratings. Moody's stated position is that the credit market had already internalized these obligations, so that no further adjustment was likely.

17. In 1988, 62.5 percent of retirees aged 55 or older who had retired from a transportation, communications, or public utility firm reported receipt of retiree health benefits. This compares to 58 percent of retirees from mining firms and 30 percent of retirees overall (Clark et al. 1992).

18. Mittelstaedt and Warshawsky (1993) found that the market apparently undervalued firms' unfunded liabilities for retiree health benefits in 1986, 1987, and 1988, and, in fact, appeared to do worse in each successive year during that period. They attribute the market's failure to evaluate liabilities appropriately to the historic vagueness of firms' obligations for retiree health benefits as well as anticipation of the enactment of the since repealed Medicare Catastrophic Coverage Act which was presumed to reduce the employer cost of health benefits for Medicare- eligible retirees.

19. The attribution for retiree health insurance benefits, as required by FAS 106, terminates when the employee becomes eligible for benefits. This is shorter than the attribution period (terminating at retirement) that is allowed for recognition of pension liabilities.

20. Despite the intuition of this result, researchers generally have failed to produce consistent evidence or measures of compensating wage differentials with respect to pension benefits. This problem generally is attributed to inadequate data (Smith and Ehrenberg 1983; Schiller and Weiss 1980).

21. Employers' failure to obtain an offset in wages or other forms of compensation would in most cases induce them to reduce output and employment, all else being equal. Depending on the size of the firm or the prevalence of this behavior among firms, this result could depress wages marketwide. In this case, workers who are not directly involved in bargaining for retiree health benefits would also bear the incidence of the increased cost of current funding. I am indebted to Mark Pauly for this insight.

Commentary: Olivia S. Mitchell

Supply of and Demand for Retiree Health Insurance in the Labor Market

Voluntarily provided employee benefits are only observed in the labor market when both workers and employers desire them. A micro-economic framework suggests that employees will desire a company-sponsored benefit when (1) the price of the benefit is low, compared to other forms of compensation, and (2) workers have strong preferences for the insurance benefit as compared to earnings.

In the special case of retiree health insurance benefits, all workers may not necessarily want and/or be able to afford employer-provided, post-employment health coverage. For example, employees' desires for retiree health coverage are expected to be highest among those more likely to need the benefit, those who are most risk averse, and those who face lower prices for nonwage benefits versus cash—perhaps for tax reasons.[1]

The determination of who receives retiree benefits must also consider the employer side—who chooses to sponsor retiree health insurance plans. Compensation specialists sometimes suggest that companies offer retiree health insurance to attract and retain employees. Although this is undoubtedly true, the explanation does not tell us why some firms do not sponsor these plans. Drawing from the literature on other benefits, theory tells us that an employer will gain from offering retiree benefits if, by doing so, (1) the firm can elicit certain desirable behaviors from its workers, and (2) the advantages of providing the benefits exceed their costs (Gustman et al. 1993).

Recent studies on private pensions show that companies offer deferred compensation to induce workers to be more productive, to reduce employee turnover, and to elicit optimal retirement patterns (Gustman et

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al. 1993). Companies that do not offer these benefits tend to be those where monitoring technology permits ready assessment of worker output, where younger workers are readily and cheaply available, where training and turnover costs are low, and/or where the production process does not require long-term workers.[2] Extending this argument to the retiree health insurance arena suggests that companies that offer these benefits do so because of their expected effects on employee behavior. Specifically, the particular level of deferred benefits should be determined by their relative price and by employees' willingness to exchange benefits for other forms of compensation.

It is difficult to disentangle the factors that affect employee demand for retiree health benefits from factors that influence companies to provide them. This is because analysts observe both sides of the labor market, working simultaneously. This simultaneity also makes it difficult to judge whether "too many" or "too few" Americans are covered, or how seriously public policymakers should respond to falling retiree health coverage rates reported over the last decade (EBRI 1988, 1991). In another benefits area—the pension field—researchers have only begun to unravel this simultaneity problem. It appears that roughly half of the last decade's downward trend in defined benefit pension coverage may be attributable to industrial employment shifts (Bloom and Freeman 1992). Whether recent retiree health insurance coverage changes also can be attributed to these overall employment shifts or whether other factors are more important is unclear, but the issue demands an urgent look in future research.

Policy Changes and Retiree Health Insurance Coverage

The simultaneity just mentioned also makes it difficult to evaluate how innovations in the policy environment can affect retiree health benefit offerings. This is especially true when the change affects employer *and* employee valuations of the benefit. This point is clarified by discussing two recent changes in the retiree health environment.

FASB Accounting for Retiree Health Insurance

Consider the recent change in retiree health benefit accounting required by the Financial Accounting Standards Board (FASB) ruling No. 106. As Chollet describes clearly in Chapter Three, this rule requires corporations offering retiree health insurance coverage to recognize the benefit promises on their balance sheets and, in addition, requires that employers accrue retiree health liabilities even before the workers covered by

the plans attain vested status. An important policy question is whether these FASB rules have discouraged employers from providing retiree health benefits, because these promises are almost completely underfunded and represent an important claim against future profitability.

One strand of research measuring the FAS 106 effect takes the position that these rules will have only a small impact on the availability of retiree health insurance and on the labor market in general. In particular, if the health insurance liability had been fully recognized and allocated previously, no impact of the FASB rulings would be anticipated. Support for this position is offered by studies showing that retiree health liabilities were partially reflected in share prices of corporations that offer these plans, even before FAS 106 (Warshawsky 1992). The fact of partial capitalization suggests that further exploration of this matter is required. In particular, it is possible that other stakeholders should be considered as well, and prime candidates include the covered workers themselves. In the pension arena, for instance, workers who hold underfunded pension promises appear to be compensated partly by higher earnings (Gustman et al. 1993), and a similar pattern might be expected in the retiree health arena.[3]

The policy concern, of course, is that at least some of the recent changes in the retiree health insurance scene probably are attributable to factors other than the FASB accounting innovations and must be taken into account if we are to obtain a clear picture of the rule change on its own. These other factors are numerous, and Chollet (1994) points to many of them, including unexpectedly high medical cost inflation, cutbacks in Medicare, increasingly expensive and high-tech medical advances, and changes in laws that enhance retirees' health care claims in bankruptcy. The common element to all these changes is that they have altered the nature of the insured risk, in large part by raising the projected costs of retiree health insurance and by making it more variable. As yet, few analysts examining changes in retiree health offerings have had access to information on costs of quality-adjusted insurance benefit packages. These other factors must be taken into account when evaluating the impact of FASB changes on retiree health insurance coverage.

A different factor that may explain cutbacks in retiree offerings is the elimination of mandatory retirement in the private sector—a factor that has been underrated to say the least. A series of recent papers indicates that employers who used mandatory retirement while it was still permissible also were more likely to adopt early-out retirement incentives when mandatory retirement was outlawed (Luzadis and Mitchell 1991; Mitchell and Luzadis 1988). It appears that these firms had paid workers according to a deferred compensation profile and required retirement when

earnings began to exceed productivity at the end of the contract (Lazear 1983). A compensation system like this can reduce turnover throughout the worklife, but it will not be profitable unless it also carries with it a prespecified termination-of-contract retirement date enforced by mandatory retirement. After legislation rendered mandatory retirement unenforceable, some employers used alternative human resource tools such as pensions to achieve the same departure patterns (Fields and Mitchell 1984; Mitchell 1992). In fact, early pension offerings were increased the most by employers who previously required mandatory retirement (Luzadis and Mitchell 1991). In other cases, employers might have sought to renegotiate the long-term contract by lowering older workers' pay, to retain them profitably after the now illegal mandatory retirement age.

To the extent that retiree health promises were part of a long-term contract, it follows that reducing or eliminating retiree health insurance promises can be seen as a method to reduce compensation that exceeded workers' productivity at the end of their worklives. This practice probably was concentrated among companies that had paid older workers above their market rates and, hence, had relied most heavily on mandatory retirement when it was still legal.

Of course, the FASB accounting rule changes did not occur in isolation; they were part of a larger change in the environment for older workers. Among the changes were rules that restricted the use of age in early retirement windows, Consolidated Omnibus Budget Reconciliation Act (COBRA) regulations that required continuation of benefits after retirement at relatively premium rates, and laws that protected jobs of disabled workers. Taken as a whole, these policies have limited employers' ability to manage turnover among older workers flexibly and may explain why employer commitment to retiree health benefits has suffered recently.

Several explanations are plausible for why retiree health insurance offerings have been curtailed lately. Demonstrating which of these explanations is more nearly correct will require a longitudinal study of employer pay and benefit options that covers enough workers and firms and that extends for a long enough time to offer real variability for measuring the behaviors of interest. These data are not currently available and obtaining them should be a high priority for the future (Gustman and Mitchell 1992). In the interim, it is Chollet (1994) who appears to be accurate when stating that changes in retiree health insurance promises did not occur solely because of accounting rule developments, although FAS 106 "has come at a difficult time" (p. 39).

Price Sensitivity of Retiree Health Insurance

Another area of substantial policy interest is the price sensitivity of retiree health insurance offerings, with particular reference to the benefits' tax

status. The general economic principle is that workers' interests in obtaining retiree health care coverage and employers' willingness to provide these benefits depend in part on their price. Tax law, in turn, affects the extent to which benefit dollars are shielded from income and payroll taxes. Current regulations on tax-qualified prefunding of retiree health insurance are nicely summarized by Chollet (1994), who uses inferential data to conclude that regulatory limitations on 501(c)(9) and 401(h) plans have prevented tax-preferred prefunding of retiree health offerings over the last decade. In contrast, pension contributions still can be offered at tax-favored rates, so that for many employers a dollar devoted to a pension plan goes farther than a dollar set aside for post-employment health care. Public policy discussions actively debate the merits of allowing retiree health coverage to be granted tax-qualified status, but the huge size of the tax loss anticipated—$37 billion per year—ensures that the proposal meets fervent political opposition (EBRI 1991).

Despite fiscal politics, the fact remains that we do not know the price sensitivity of supply and demand for benefits in general, and for retiree health coverage in particular. This information is difficult to discover because the price of retiree health care depends in complex ways on employer-side and worker-side behavior; hence, price changes for retiree coverage can elicit unexpected outcomes.

An example of this complexity may be instructive. Consider an older worker who must chose between no health care insurance on the current job and coverage from one of two plans, one of which is a prepaid plan with little choice over physicians and the other, a fee-for-service plan that requires high costsharing for active workers. The sponsoring employer specifies that the plan option chosen during the worklife must be identical to the option carried into retirement—a rule often used to reduce adverse selection. In this example, if the worker opts for no active employee health plan (perhaps because other health insurance coverage was available through a spouse's program), then the employee would not be permitted to select retiree health care coverage if the spouse were to die. If the employee selects the prepaid plan while employed, then any choice of a fee-for-service plan after retirement would be eliminated. The point, of course, is that health care insurance purchases during the worklife can feed into prices and availability of insurance after retirement in complex ways not often well-measured by researchers. It should be noted that workers may not fully understand how retiree health consequences flow from their health care plan choice while employed, and this too is a high priority research agenda item.[4]

The issue becomes more complex if the older worker can obtain extended coverage for 18 months after retirement under COBRA legislation, by paying up to 102% of the regular premium. Because the full cost

of continued health insurance probably is far greater than the premium charged under COBRA (Chollet 1994), this permits retirees to obtain a substantial amount of subsidized health care coverage. In addition, COBRA benefits are offered through tax-qualified health insurance plans.[5] It would be interesting to investigate who takes up COBRA coverage and to what extent the tax subsidy enhances the program's appeal. To date, however, no such analysis has been undertaken by researchers.

What this means is that evaluating the demand for retiree benefits, as well as the supply of such offerings, is made complex by an intricate menu of prices, some of which are determined endogenously and some of which are affected by tax preferences in unexpected ways. As a result, researchers do not know how price sensitive workers' desires are for retiree health insurance and, hence, how much retiree coverage would increase if plans could be pre-funded in a tax-favored way. This should receive high priority in future studies on why some firms and workers have retiree health coverage while others do not.

Conclusions

Labor market researchers seek economic explanations for observed differences in older workers' compensation patterns, as expressed in their earnings profiles as well as in their pension and retiree health insurance plan structures. This discussion highlights the need to understand better the relative importance of retiree health insurance options in the overall menu of retirement incentives available to older employees. It would also be useful to "nail down" the role of retiree health insurance in encouraging older workers to leave the workforce early, or to defer retirement from earlier to later dates.[6] Finally, research should examine differences in health care insurance options across different types of employees (e.g., depending on income, occupation, age, and service), and across different types of employers (e.g., by firm size, by technological level, and by industry). Such an investigation is required to determine how retiree health insurance plans influence employee behavior and, in turn, contribute to modern human resource policy.

Several data needs must be met if such research is to be carried out. Surveys are needed with information about the retiree health care and pension options that confront workers when they make job changes and retirement decisions. Some gaps will be filled with the new Health and Retirement Survey (HRS) funded by the National Institute on Aging, which is collecting information on pay and benefits packages as people near the end of their worklives. Such worker-side surveys are invaluable for understanding what individual retiree coverage actually is and what workers believe their coverage to be. Previous studies that have focused

on pension plan features find that employees have extraordinarily imprecise notions of their retiree benefit coverage (Mitchell 1988), and it may be that knowledge of health care insurance coverage is worse than their pension knowledge. It would be informative to find out whether employee misinformation about retiree health care plans is widespread, and what "incorrect" retirement decisions are made, as a result.[7]

In addition to the worker-side data, new employer-side surveys must be developed to understand better who offers what types of retiree benefits and how these benefit strategies influence and, in turn, are influenced by sponsoring companies' economic status. Currently, few data sources exist to meet this need. One benefits information source known as the Employee Benefit Survey (EBS), devised by the United States Bureau of Labor Statistics, offers many useful insights into retiree benefit offerings, with data provided by a wide range of firms. Unfortunately, the survey omits employers who sponsor plans but who do not contribute a portion of the premium. This causes problems for analysis, since one reason employers sponsor benefit plans is to provide employees risk pooling not readily obtained by individual purchase (Gustman and Mitchell 1992). As a result, the EBS cannot be used to explore the valuable role of the employer as a risk-pooling agent.

Another important reason to collect better employer-side information is that existing sources do not link compensation and benefits data to information on profitability and other important employer-side outcomes. It has been difficult to pinpoint which specific pension and retiree health care designs improve productivity and, in turn, which corporate environments produce benefits systems with specific features. This point probably has been underrecognized in the retiree health insurance area, although it has been made in the pension context (Gustman et al. 1993). Improved and linked data sets can help establish, for example, why many employers are moving to a defined dollar retiree health care plan and how this change, in turn, affects earnings profiles, other benefits, turnover and retirement outcomes, and a host of other labor market outcomes. Data such as these also are invaluable if we are to evaluate properly the impact of changes in the regulatory environment on employer benefits offerings. For instance, proposed increases in payroll and other benefits taxes to pay for national health insurance certainly will have potent effects on earnings, employment, and the availability of employer-sponsored benefits. Better employer-side surveys collected now will allow improved evaluations of the effects of regulatory changes on health insurance plans and will provide better explanations of overall labor force trends in the future.

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Notes

1. Other reasons for cross-sectional differences in the demand for retiree health insurance include differential bequest motives, differential forecasts of life expectancy and medical care needs, and, perhaps, different needs for self control. For a related discussion in the pension context see Gustman et al. (1993).

2. Principal/agent theory suggests that defined benefit pensions can also be used to impose additional risk on workers who otherwise might maximize short-term returns at the expense of shareholders. There is considerable debate about this theory, as summarized by Gustman et al. (1993).

3. This suggests that requiring employees to recognize accruing retiree health insurance promises before retirement will have little effect, even though vesting

in retiree health care coverage does not generally occur until the firm's early retirement age. This is because in a well-informed labor market, the option value of vesting in a retiree health plan should be reflected incrementally in earnings as the promise accrues. As a result, requiring employers to recognize the future liability in a formal manner should not be expected to change materially the worker's or the shareholder's view of the future claim, unless one or both parties was misinformed about the liability.

4. Research on employees' knowledge about pensions reveals some systematic myopia (Mitchell 1988).

5. The limited duration of COBRA benefits restricts the extent of the subsidy, but the existence of these tax-qualified and subsidized benefits should not be ignored in evaluating which workers will want retiree health insurance.

6. Recent studies have come to very different conclusions, with Gustman and Steinmeier (1993) finding that retiree health influences retirement patterns only very modestly and Clark et al. (1992) arguing for a more potent role. Both studies suffer from data problems, however, and the jury must be said to be still out.

7. Alongside the individual HRS survey will be an employer survey of health care insurance and pension offerings.

Commentary: Diana L. Murray

Dr. Deborah J. Chollet takes the position that Financial Accounting Standard (FAS) 106 and a lack of good tax preferential funding arrangements have combined to make it difficult for employers to provide retiree benefits in the same manner as in the past, and that employers will not provide retiree health benefits at the expense of retiree cash benefits. Overall, this commentary supports Dr. Chollet's basic thesis. It also is noteworthy to consider, however, that in shifting the focus of benefit cost from the benefit budget to the employer's bottom line, FAS 106 has merely accelerated the trend of controlling cost through reallocation of benefit dollars that began in the early 1980s. To illustrate this point, the comments that follow begin with an historical perspective of benefits planning during the 1980s, describe the initial reaction of employers to FAS 106, and conclude with a discussion of the current benefit issues that employers are addressing as they seek to determine the most efficient use of their benefit dollars.

Historical Perspective of Benefit Planning

During the 1970s, there was little benefit planning. Most medical plans were insured, and the birth of the Employee Retirement Income Security Act (ERISA) was just starting to have an impact. In fact, because the main function of the benefit office was primarily enrollment and bill paying, the accounting department of many companies assumed responsibility for benefit planning.

In the early 1980s, employers were hit hard by rapidly escalating health care costs and an explosion of government regulations. Benefit managers were no longer just paying bills but were forced to control health care costs at the same time that they were interpreting and implementing the changes required by TEFRA, DEFRA, ADEA, TRA '87, COBRA, OBRA, and the infamous, short-lived Section '89. Since most benefit departments were paper driven, it became extremely expensive to provide the

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newly required reporting data. Unfortunately, benefit dollars now had to be allocated to cover data systems, actuaries, consultants, and attorneys at the same time that medical costs were escalating.

In addition, rapid changes in the business world impacted on traditional corporate culture. The 1980s became an era of divestitures, acquisitions, closures, downsizing, globalization, decreasing numbers of unskilled manufacturing jobs, and increasing numbers of skilled technical positions. Employers and employees no longer were certain of their business future. Companies were worried about staying in business, and employees were worried about having jobs. Responding to this state of uncertainty, many employers considered replacing their current management philosophy of lifetime guaranteed benefits with a management philosophy of flexible benefit planning that could be adjusted to changing business needs. Rising medical costs, proliferating government benefit regulations in conjunction with detailed reporting requirements, and an unstable business economy forced benefit managers to review the allocation of benefit dollars. No longer were many companies willing to take the total financial risk of providing benefits.

Massive changes were underway in benefit design, with many employers making annual changes to their benefit plans. Basic/major medical plans were replaced by comprehensive plans with cost-sharing deductibles and coinsurance; insured plans were replaced by self-insured plans; utilization management, health maintenance organizations (HMOs), and preferred provider organizations (PPOs) were introduced; employees were asked to share in plan cost through monthly contributions; and most importantly, companies now reserved the right to amend or terminate their benefit plans.

Retiree cash benefits were also affected by this shift in benefit philosophy. Many employers introduced employee stock ownership plans, savings plans, and 401(k) plans. Some employers actually replaced their defined benefit plans with defined contribution plans to limit their company's financial risk. In the 1980s, benefit planning became a dynamic, everchanging process as employers assumed that benefit cost could be controlled through effective, efficient plan design.

Impact of Financial Accounting 106

In the 1980s, the responsibility for benefit planning and cost control was delegated to a company's benefit department. With the introduction of FAS 106, the high cost of providing retiree health benefits would now be highlighted as a booked expense on the company's income statement. Many employers became worried that public exposure of this escalating liability would reduce stockholder confidence in the strength of their

companies. Now the command, "Do something to control cost!", came from the executive level down. Benefit planning had evolved to strategic business planning.

Determining the extent of FAS 106 liability was not easy for employers. Like the case in the 1980s, much of the data required for FAS 106 liability were unavailable. Most pre-65 retiree plans were identical to the active employee plans, and the claims data for actives and retirees were not separated. In addition, many companies administered their retiree medical plans locally at the different plant locations. Employee contributions often were collected sporadically or waived at will for particular retirees under special circumstances. Even more difficult was the task for companies with unions. Many companies had multiple union retiree medical plans, all varying in benefits and contributions based on the contract year of an employee's retirement.

At the same time that the employer, consultant, and actuary were calculating the FAS 106 liability, the employer's attorney was reviewing the summary plan descriptions and plan documents of current retirees. Many older plans implemented before the mid-1980s often expressly stated or implied that health benefits were guaranteed for life. Employers weighed the savings from amending or terminating their old retiree medical plans against the cost of potential litigation and/or adverse publicity.

Many employers have decided not to risk changing their older retiree health plans but have been reassessing benefit provisions for future retirees. In the last few years, many employers have limited coverage to pre-age 65, established employee service requirements, capped employer financial exposure, offered flexible plan choice, and implemented managed care. A few employers have terminated all future retiree health benefits and have implemented employee/employer matched savings plans to assist employees with their future retiree health expenses.

Some employers are currently amending or terminating old retiree health plans. These employers have calculated the risk and cost of changing guaranteed benefits and have determined that the cost of their FAS 106 liability is much greater than that of potential litigation. Many cases are now pending in the courts.

Allocation of Benefit Dollars: Current Issues

As stated earlier, the issuance of FAS 106 has merely focused wider attention on the cost of health benefits and accelerated a trend of cost control through benefit dollar reallocation that was begun in the 1980s. Although employers in the 1980s concentrated on the impact of federal legislation and attempted to control cost within the parameters of benefit plan struc-

ture, employers today are viewing benefits as a strategic element in the cost of doing business. Employees and their needs (i.e., "benefits") are no longer ancillary to the business; they are essential to business success. As employers look to "Workforce 2000," they are determining what is needed to maintain their "human capital," that is, to attract and retain skilled, productive employees.

Like any other business decision, cost and benefit analyses are being done to determine the most efficient allocation of employer benefit resources. Employers are reviewing their current human capital needs, assessing how well their current benefit programs address those needs, and projecting the needs of their future workforce. Employers realize that all kinds of costs are attached to doing business. Each employer must determine the correct cost/benefit balance (including the cost of retiree health) that supports business growth strategically. Listed next are a few cost factors that illustrate each employer's uniqueness in that decision-making process.

Type of Business

Employers look at what benefits their competition may be providing. Depending on the type of business and its needs, that competition could be across the street, across the country, or across the ocean. Employers who need to attract and retain specialized, highly skilled employees may have to provide a specific benefit package. On the one hand, the cost of providing special benefits may be less than the cost of a potentially volatile workforce. On the other hand, if needed workers are in large supply, then employers may decide to spend their benefit dollars elsewhere.

Business Strength

Employers are looking at their company's anticipated growth or loss in today's sluggish economy. Benefit planning that may seem strategic when the company is growing may not be prudent if the business is facing a loss. If an employer is planning a benefit strategy in isolation of current business status, then the employer may find that the strategy remains but the company does not.

Unique Business Needs

Employers make many different decisions based on the unique needs of their companies. In nonunion companies, an employer may offer a generous benefit package to discourage unionization. The rationale is that the cost of doing business in a unionized environment is more expensive

than the cost of offering a benefit package larger than the company's unionized competitors.

Another important factor is public image. Many goods are sold because the buyer feels that if a company treats its employees well, the company's product must then be good. This is particularly true with businesses in small communities, where everyone knows everyone or with companies that sell brandname products. Providing good benefits becomes a cost of goods sold.

As employers begin to feel the impact of "Workforce 2000," the traditional allocation of benefit dollars may be diluted by the pressing needs of a more diverse workforce. Day care, elder care, long-term care, or flex time all may compete for a piece of the benefit pie. Given the projected workforce demographics, benefit planning may require a more individualized approach to maintain the business' human capital and to ensure its productivity.

Management Philosophy

As stated earlier, management philosophy is very important in determining the direction of benefit planning. Management philosophy ranges along a continuum, from the paternalistic company that takes care of its own to the cash-driven employer who relegates risk and costsharing to the employee. Management philosophy toward benefit planning can shift with the profitability of the business or with a change in company leadership. Seldom does an employer's management philosophy remain constant along the continuum, but, rather, management philosophy swings dynamically, in reaction to the current economic and political environments.

Administrative Ease and Cost

Administrative ease and cost are important in benefit planning. In the 1980s, employers learned that benefit administration could be extremely expensive. As benefit planning and government regulations became more entangled, administration complexity, reporting requirements, and penalties for violations likewise escalated. Benefit consultants, actuaries, and attorneys thrived at the expense of the benefit budget.

FAS 106 also increased the cost that employers must spend on benefit administration. Many employers do not want to put themselves at further risk by using the Section 420 transfer or a 401(k) plan to pay for retiree benefits. Not only do the current restrictions make these methods of paying for retiree benefits unappealing to most employers, but, perhaps more importantly, given the government's propensity for increasing its

regulations and reporting requirements, many employers do not want to put themselves into a potentially vulnerable position.

Future Benefit Planning Issues

Employers are becoming increasingly unwilling to make major benefit changes, other than cutbacks, because of the uncertainty of future health benefit requirements. State legislators and members of Congress are shaking the foundations of the ERISA tree. ERISA pre-emption, which has upheld the right of self-insured employers to plan their own health benefit package, is being attacked on all sides as being discriminatory. Individual states want to regulate benefit provisions and costsharing for all health benefit plans, including those of the self-insured. The recent Americans with Disabilities Act (ADA) is raising further questions about discriminatory intent or cause in benefit design. Perhaps the most unsettling thought for employers is the future state of national health care. Most employers foresee a benefit future that is inundated with complex regulations, reporting requirements, discrimination testing, and penalties.

FAS 106 uprooted employer-provided retiree health benefits, but national health care reform may destroy it. When asked who should be responsible for providing medical coverage to retirees, many employers shake their heads and say, "Let the government do it!"

Conclusion

Are health care benefits crowding out retiree cash benefits? The issue is not so much that retiree health care benefits may or may not be crowding out retiree cash benefits but how employers will incorporate benefit planning into their companies' strategic business plans, to ensure that they stay competitive and productive in today's changing global economy.