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February, 2008

Dear Friends and Partners:

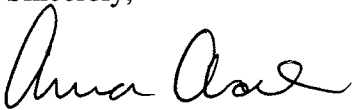
It's here: the latest edition of *In The Ring!*

The Michigan Suburbs Alliance's premiere publication zeroes in on retiree healthcare—and its strain on the already tight budgets of city governments. Not only do we give you a solid grounding in the issue, we offer innovative solutions, case studies and resources. Our mayors and managers have made it clear that cities don't always have to choose between stabilizing their budgets and offering meaningful benefits to their longtime employees. We invite you to share our vision of competitive cities that are nationally recognized for their healthcare leadership.

This edition of *In The Ring* isn't the only new presence here at the Suburbs Alliance: it wasn't too long ago that I first came in the doors myself. I'm pleased to be the new Communications Coordinator at a nonprofit that fuses vision and action. In a reversal of the ubiquitous "brain drain" rhetoric we've been hearing about in Michigan, I chose to return to my home state after spending three years as an expatriate in Boston, MA. As a writer and a community advocate, I've found the Suburbs Alliance to be the perfect place to bring my passions and skills together—online, in print, and, most importantly, face-to-face. As we enhance our communications offerings to you, I am eager to get your comments, criticisms and bright ideas.

If you have any questions, or would just like to say hello, I'd be happy to hear from you. You can reach me at [anna@suburbsalliance.org](mailto:anna@suburbsalliance.org) or at the office in person or by phone.

Sincerely,



Anna Clark

# THE HEALTHCARE CHALLENGE

The cost of providing healthcare to retirees is stressing employer budgets in nearly every sector of the economy, but mature local governments are feeling more pain than most. With shrinking revenues, new accounting standards, a significantly larger pool of retirees to support, and various other historical and emerging issues in the mix, older cities face a daunting situation. What follows is an overview of the primary factors shaping the retiree healthcare challenges of mature local governments.

## Healthcare Inflation

Over the past five years, the average annual cost of providing healthcare for a 65-year-old retired couple has risen 34 percent, and city budgets are certainly not immune to this type of change.<sup>2</sup> In the past several years, communities like Eastpointe and Southfield have seen their annual expenditures on retiree healthcare climb hundreds of thousands of dollars.<sup>3</sup> In other cities, the pain is even more extreme. Ypsilanti's annual post-employment healthcare expenditures, for example, have jumped 38 percent and Lincoln Park's have more than tripled since 2002.<sup>4</sup> The reasons for healthcare's ballooning cost are numerous and complex, and include increased provider, hospital, technological and pharmaceutical costs.

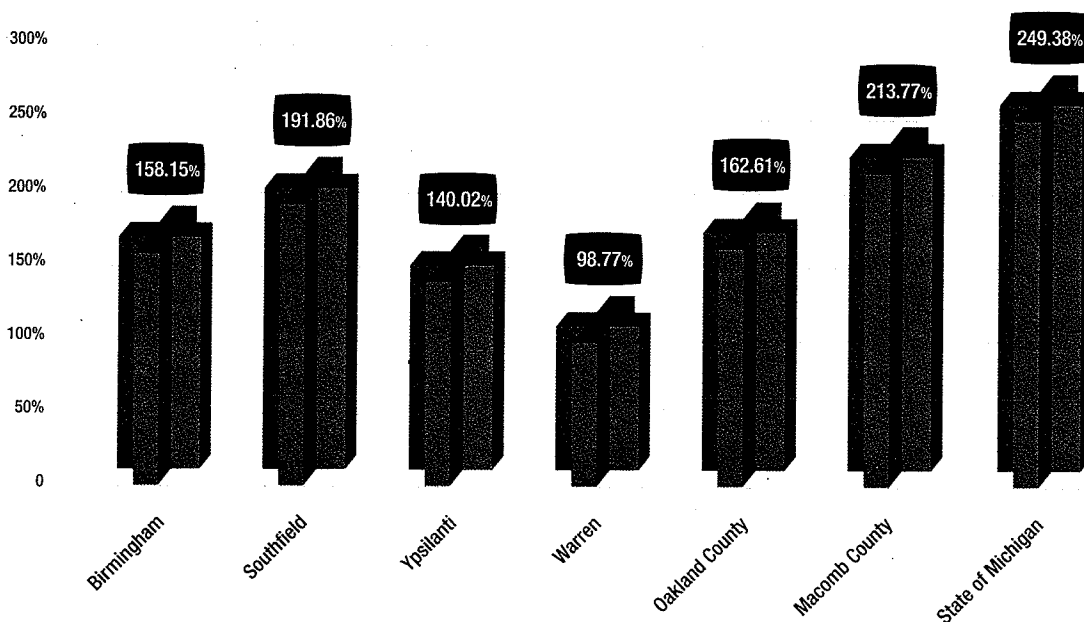
While there is relatively little local government leaders can do to alleviate the growing cost of healthcare, there is one area in which they can make an impact—unhealthy lifestyles. The American Medical Association recently determined that at least 25 cents of every healthcare dollar is spent on the treatment of diseases or disabilities that result from potentially changeable behaviors. Costs related to obesity now total more than \$27 billion per year.<sup>5</sup> Whether the cause is poor diet, lack of exercise, smoking, alcohol abuse, failure to use seat-belts or overexposure to sun, preventable healthcare costs intensify Michigan cities' already arduous fiscal challenges. Fortunately, the institution of wellness programs with financial incentives for employees has been shown to produce a three to five dollar return on every dollar invested by the employer.<sup>6</sup> By offering programs that produce quality care, encourage wellness and prevent disease, cities can realize significant savings while improving the health of their employees and residents.

## New Accounting Standards

Rising costs are compounded by recent changes in government accounting standards. In June 2004, the Government Accounting Standards Board (GASB) issued Statement 45, which requires local and state governments to report other post-employment benefits (OPEB) during employees' working years. The most significant of these

**FIGURE 1: Unfunded Accrued Liabilities as a Percent of 2007 General Funds**

This graph shows the magnitude of unfunded retiree healthcare costs for a select few units of government in Michigan. This challenge is pervasive across various types of government and affects both wealthy and working-class communities.



Sources: Cities of Birmingham, Dearborn, Detroit, Southfield, Warren, and Ypsilanti; Counties of Oakland and Macomb; State of Michigan

expenses is healthcare. Until now, most retiree healthcare plans have been financed during the retirement period with the financial reporting occurring as the benefits are paid, commonly referred to as a “pay as you go” approach. With the introduction of GASB 45, these future expenses must be reported as liabilities, which can adversely affect a city’s bond rating and potentially inhibit various public projects and improvements.

While GASB 45 reporting does not require governmental units to pay these liabilities as they are accrued, it does identify an “annual required contribution,” or ARC, that if made, would satisfy the annual accrued liability for retiree healthcare. Unfortunately, with the cost of healthcare growing so rapidly, few cities are able to pay this amount, further damaging their fiscal reputations. A 2007 report from investment bankers Credit Suisse estimates Michigan’s state-local liability to be in the top ten of a \$1.5 trillion nation-wide unfunded retiree healthcare balance, and many experts believe that without action, non-pension retiree benefits could claim nearly 20 percent of payroll in the near future.<sup>7</sup>

Large governmental units must begin reporting in their first fiscal year beginning after December 15, 2006, with smaller units making the transition over the next two years. More than likely, a vast number of these governments will find their retiree healthcare plans significantly underfunded. To resolve these ominous fiscal challenges, cities will need to engage creative, aggressive strategies for financing the benefits they have promised.

### Legal Issues & Political Ramifications

In many communities, decisive action is needed to stem the tide of rising retiree healthcare costs and bring them back in line with revenue projections. However, legal uncertainties and political constraints often make aggressive reforms nearly impossible, even when communities recognize the need. For example, conflicting court decisions have left many unsure of what modifications are allowed under existing contracts. In some cases, labor agreements prohibit cities from altering the negotiated contract, even if they are providing comparable benefits at a lower cost. Lastly, Public Act 312 arbitration decisions often deny communities the changes requested during negotiations to implement cost savings ideas.

City officials are often squeezed between competing interests. While employee unions are suspicious of altering benefits, southeast Michigan’s stagnant economy has many residents concerned about the cost of government and anxious for reform. In other words, residents are likely to be critical of healthcare-related proposals and would probably favor cuts. These pressures are heightened because healthcare is not just a public policy issue but intensely personal as well. The wrong reforms could severely distress hardworking employees and their families or undercut city services. Thus, local officials need solutions that balance the need for caution with the need for reform.

## COST MANAGEMENT STRATEGIES

While the complexity of the healthcare challenge is intimidating, there are a number of innovative tools and strategies local governments can employ to address this growing liability. To see how some of these strategies are successfully functioning in Michigan and other states, consult the case studies and resources on the following pages.

**Age and Service Requirements:** Achieve substantial savings and greater equity by decreasing the rate at which employees earn retirement benefits, i.e. spread the annual accrual of healthcare benefits over a greater number of years.

**Generic Rx Incentive Plans:** Encourage the use of generic drugs and significantly drive down plan sponsor costs with low or zero-dollar co-pay plans for generics.

**Retiree Drug Subsidy Program:** Eligible plan sponsors can receive a federal government subsidy equaling 28 percent of allowable retiree prescription drug costs for each qualifying covered retiree without disrupting current coverage.

**Key-Person Life Insurance:** Carry life insurance policies on top administrative officials to partially indemnify your city for the loss sustained upon the death of the key person; revenue received may then be used to pay outstanding retiree healthcare obligations.

**Alternatives to Defined Healthcare Benefits:** Establish “retiree medical savings accounts” for employees to access at retirement to cover healthcare costs. These plans promise members annual contributions during their working years, rather than make uncapped promises to pay for healthcare benefits through a retiree’s lifetime.

**Voluntary Employees’ Beneficiary Association (VEBA) Trust:** Create a funding vehicle that satisfies the “separate and apart” requirements under GASB 45. VEBAs already have IRS approval as a tax-exempt trust and allow for multiple funding scenarios and plan design options using individual accounts for each employee or aggregate investment accounts.

**Section 115 Governmental Trust:** Provide medical benefits to retirees through this free-form alternative with non-taxable employer and after-tax employee contributions.

**Healthcare Savings Plan:** Enable employees to pay for current health expenses while saving for future qualified medical and retiree health expenses on a tax-free basis.

**Wellness Program:** Reduce costs by promoting healthy lifestyles and disease prevention through an incentive-based initiative.

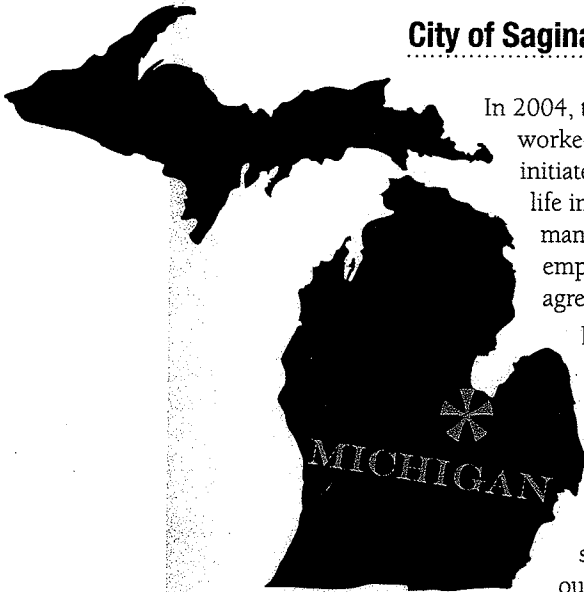
## CASE STUDIES

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The post-employment healthcare challenge facing our local governments is severe. Fortunately, there are many innovative strategies in practice that have already proven to be successful. These case studies will lend insight and creativity to our efforts as we craft our own plans for ensuring healthy cities and public employees.

### City of Saginaw, Michigan

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In 2004, the City of Saginaw worked with AXA Financial to initiate a voluntary key-person life insurance program for management and supervisory employees.<sup>8</sup> Under this type of agreement, the city owns the policy, pays the premiums and is the beneficiary. The funds received upon a covered employee's death are invested toward the city's retiree healthcare costs and cover a significant fraction of those outlays.<sup>9</sup> While the morbidity

of a city benefiting from an employee's or former employee's death is often enough to discourage even the most innocent inquiry into the use of life insurance as a funding vehicle, an extensive education campaign about the program's purpose and similar programs' common use in the private sector can instill honor in those who would be insured and pride throughout the community in the city's innovative approach to fiscal stability. Largely because of this challenge, key-person life insurance programs have not been widely tested in the municipal realm, but nonetheless present an innovative, viable opportunity for addressing healthcare legacy costs.

### University of Michigan

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Despite projections that prescription drug costs would increase by 13.4 percent in 2003, the rate of increase at the University of Michigan was only 2.8 percent due to a new prescription drug program. By consolidating prescription drug coverage under one plan, the university was able to set its own premium rates and save significantly. The increased use of generics and more cost-effective brands, the availability

of a mail-order pharmacy and an increase in drugs available over the counter helped boost savings to \$8.6 million in its first full year of operation. Much of these savings are realized by minimizing drug expenditures of retirees, who often consume newer and costlier medicines at higher quantities. The university's reduction in total cost will help mitigate the impact of future premium increases for it and its plan participants.<sup>10</sup>

## King County, Washington

More than 1,200 King County, Washington employees are exercising and eating their way to good health, competing in teams for points they earn for eating smart and moving more. The countywide Live Well Challenge is part of King County's Health Reform Initiative, an innovative response to rising healthcare costs. By improving quality of care in the region and focusing on preventing chronic disease in its employees, the County plans to cut its escalating healthcare costs by \$40 million by 2009. The Health Reform Initiative includes a new benefit plan that rewards participation in wellness activities and provides case management, disease management, and outreach and education for more than 13,000

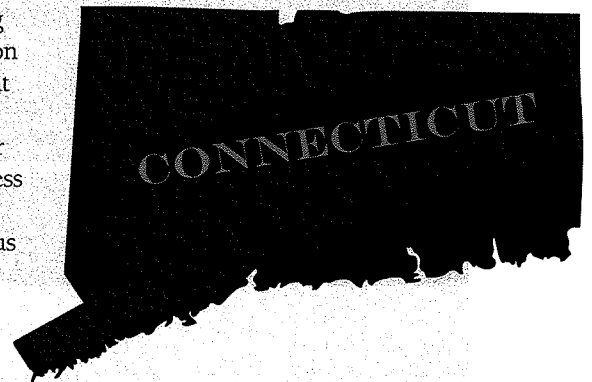
employees and their spouses or domestic partners. Early efforts to control county employee benefit costs have already produced dramatic results, and the region's top corporations, healthcare providers and governments have joined an alliance chaired by County Executive Ron Sims that is working to control costs while increasing quality of healthcare.<sup>11</sup>



## State of Connecticut

The State of Connecticut offers account-based programs and Medicare-approved health plans run by third parties. The options ensure retirees will continue to have access to comprehensive medical insurance while allowing the State to reduce administrative burdens and potentially stem healthcare benefit costs. Connecticut offers health savings accounts, which allow retirees to choose a plan that is right for them and make the State's costs more predictable. Combining these with Medicare Advantage plans enables eligible recipients to choose alternatives to traditional Medicare plans while incorporating a drug benefit.<sup>12</sup> In 2006, the average premium for Medicare Advantage

plans administered by third parties was \$312 per year—nearly \$3,000 less than the average employer-sponsored plan for Medicare retirees.<sup>13</sup> Carriers have established pricing for 2007 that generate on average 20 to 40 percent savings against existing plans.<sup>14</sup> As public sector groups prepare to address GASB 45, this savings could have a tremendous impact in reducing a group's OPEB liability.



## CRAFTING A HEALTHCARE STRATEGY

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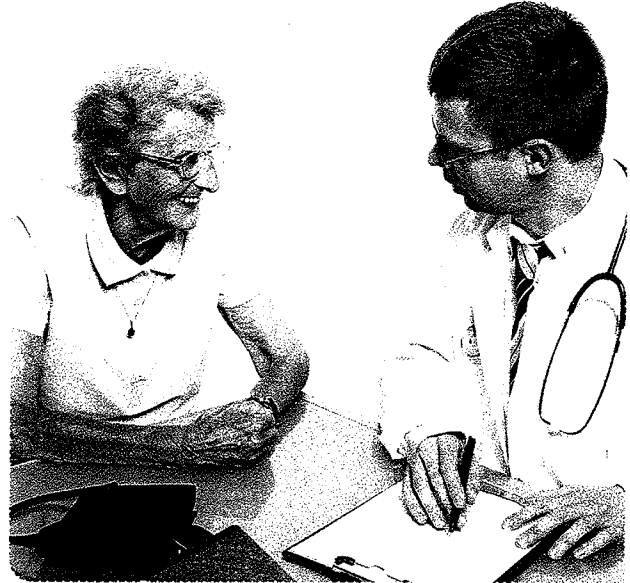
Approaching the retiree healthcare challenge is undoubtedly complex. Many competing factors must be considered, all of them important to ensuring healthy communities. Our cities' and legislators' approach to change should incorporate the following values:

### Ensure Middle Class Lifestyle

Leading the labor movement, Michigan residents set the standard for better wages and working conditions, decreased working hours and generous health and retirement benefits. We built the American middle class, and we need to make sure our healthcare plans continue to embrace that standard. Our cities' strategies for healthcare retiree costs must stay true to the mantra of a middle class lifestyle and give employees confidence that they'll be adequately taken care of once their years of service to the city are over.

### Cost Efficiency & Manageability

While providing a well-rounded healthcare retirement plan is essential, our local governments must be able to afford it. More than just affordability is at stake, however. A truly successful healthcare strategy will be cost effective and easily managed by cities. In this way, local governments will be able to remain the lean and innovative entities that they are without compromising the wellness of retirees or the peace of mind of community residents.



### Attracting Top-Quality Employees

In order to build attractive, top-quality communities, local governments must be able to recruit creative, visionary people to drive them. Public sector compensation packages often make competing with private firms for top-quality candidates a losing battle. With the right mix of generosity and innovation, however, our cities will be able to draw leaders who are both capable and committed to the future of our communities.

### Flexible, Innovative Solutions

While many municipalities are struggling with healthcare legacy costs, not every one faces the same challenges. Older cities, for example, have more retirees, some of whom never contributed to Social Security or Medicare. At the same time, smaller cities have limited provider choices and lack leverage to reduce costs. Finding solutions that are flexible and innovative enough to support the wide variety of local governments facing the ubiquitous healthcare challenge will be essential to stabilizing their fiscal futures.

Healthcare legacy costs threaten the fiscal stability of governments across Michigan, and resolving this challenge will take serious cooperation from local, state and even federal leaders as well as healthcare providers. With a little bit of creativity, we can create the right prescription for fiscally healthy, competitive communities.

## Coordinate Efforts at Multiple Levels of Government

### Principles

Many of our leaders right here in Michigan possess a great deal of healthcare expertise. Sharing knowledge about cost saving models and innovative practices will enable each community to maximize its return on investment and deal with the complex challenges presented by the shifting healthcare landscape. Governments can also collaborate to share the cost burden of facilities by pooling their resources.

### Actions:

- Local governments should establish regional partnerships with community-based public health organizations to educate citizens and policymakers about the healthcare challenges local governments face and potential solutions.
- The Michigan Department of Community Health should create a technical and legal assistance resource to help local officials deal with healthcare costs. This assistance should include model plans, contract language, cost analysis and information about available solutions.
- PA 106 of 2007 allows municipalities to form self-insurance pools for healthcare. Cities should consider partnering with neighboring governments or school districts to aggregate their buying power.
- Counties or regional groups of local governments should negotiate with groups of physicians and pharmacies to lower costs for their employees and citizens.
- Local governments should share health facilities and resources across employee groups as well as political boundaries.

## Manage Costs Creatively

### Principles

While the healthcare costs continue to grow, cities can take proactive steps to stem them. Many of these actions will have far greater returns in the long run by addressing the underlying causes of rising costs, so local leaders should not view them through the lens of short-term savings. The burden of action does not fall only on the shoulders of local leaders; state and federal leaders as well as healthcare providers can help by encouraging prevention and reducing prescription drug prices.

### Actions:

- Local governments should implement appropriate cost management strategies (see Cost Management Strategies and Investment Vehicles on page three).
- Local governments should create environments and implement policies and benefit plans that encourage and reward healthy lifestyles
- Insurance providers should expand wellness programming eligibility to include retirees and a greater number of benefit plans.
- The United States Congress and Michigan Legislature should consider legislation that facilitates lower prescription drug prices and greater access to healthcare for all Michiganders. Local leaders should support such legislation.

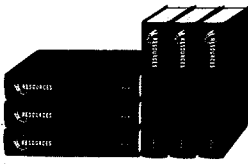
## Tap Into Alternative Revenue

### Principles

Local governments have shouldered much of the burden of increased retiree healthcare costs, but these benefits do not need to be financed exclusively by general operating funds. Local governments can alter their internal practices to generate additional revenue. They can also work with the federal and state government to obtain assistance.

### Actions:

- Local governments should utilize appropriate investment vehicles to manage costs while generating a reliable revenue stream (see Cost Management Strategies and Investment Vehicles on page three).
- Local governments should take advantage of federal funds through the Medicare Advantage and Retiree Drug Subsidy programs.
- The Michigan Legislature should consider legislation that allows municipalities to issue bonds to cover the cost of retiree healthcare. Such legislation should include language that prevents any severe deleterious effects on Medicaid calculations.
- The State of Michigan should provide municipalities seed money through a revolving, low-interest loan fund to implement innovative solutions that require significant initial investments (see Cost Management Strategies and Investment Vehicles on page three).



## RESOURCES

Want to learn more about the healthcare legacy cost challenge and ways cities can address it? Whether you're a city official, state policymaker or concerned resident, the organizations below are worthy of further investigation.

AXA Financial is one of the world's premier financial services organizations and frequently works with southeast Michigan cities.

[www.axa-financial.com](http://www.axa-financial.com)

Blue Care Network of Michigan is an HMO backed by Blue Cross Blue Shield of Michigan. Through its Healthy Blue Living product, members who make a commitment to a healthy lifestyle pay lower out-of-pocket costs.

[www.mibcn.com](http://www.mibcn.com)

[www.mibcn.com/home/healthy\\_blue\\_living](http://www.mibcn.com/home/healthy_blue_living)

Cornerstone Group — specifically, its Municipal Advisory Group — develops strategic benefit plan solutions for public-sector organizations, assisting them in identifying trends, analyzing alternatives, implementing and communicating change, and continually monitoring performance within the evolving legislative and political landscape.

[www.cornerstonebenefits.com](http://www.cornerstonebenefits.com)

Institute for Health Policy Solutions is an independent, nonprofit organization whose mission is to develop transformative solutions to health system problems.

[www.ihps.org](http://www.ihps.org)

Municipal Employees' Retirement System, or MERS, is a statewide retirement plan and tax-qualified trust that municipalities may adopt for their employees. MERS offers defined benefit, defined contribution and hybrid plans, as well as group insurance products.

[www.mersofmich.com](http://www.mersofmich.com)

University of Michigan Health Management Research Center is a worldwide leader in studying how health choices influence total health and productivity, quality of life, vitality and healthcare economics throughout a lifetime.

[www.hmrc.umich.edu](http://www.hmrc.umich.edu)

U.S. Department of Health & Human Services is the U.S. government's principal agency for protecting the health of all Americans and providing essential human services, including health and social science research and Centers for Medicare & Medicaid Services.

[www.hhs.gov](http://www.hhs.gov)

[www.cms.hhs.gov](http://www.cms.hhs.gov)

### CREDITS

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