



## Solving the REAL Debt Crisis

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Now that the debt ceiling impasse (circus) has been resolved, it's time to address this country's real debt crises. Our leaders need to conquer the far more daunting entitlement issues we face. Our choice is simple – either reduce costs and face austerity, or raise taxes. Those alternatives need not be as painful as you or they might think, as I will demonstrate.

Here are some key terms for the discussion.

**Entitlements** – Simply those services which are owed or felt to be owed — good if you can get them and primarily paid for by others. Many entitlements have become too expensive in their present forms. People's expectations and demands about what they should receive, however, haven't changed. Is this generational narcissism, ignorance or the only way the beneficiaries can survive?

**Austerity** – A tightening of one's fiscal belt — spending less and requiring less. There are real, perceived and social limits to belt tightening. And if one agrees with the adage "It takes money to make money," then austerity poses risks to future economic growth.

**Taxes** – Ideologically, the costs we incur for a civilized society: the revenues that pay for entitlements and more. Studies, such as those by former Obama adviser Christina Romer, have shown that higher taxes contain risks to future economic growth.

If both austerity and taxes contain risks to future economic growth, then the most appropriate action is to "needs balance" entitlements. Needs balancing imposes higher costs (caps or contributions) and/or lower benefits (older eligibility and means-testing) on entitlement recipients.

Without economic growth, funding entitlement will become an enormous, if not intractable, handicap. Promoting higher productive capacity in our country is far more preferable.

The present value estimates on our unfunded entitlement liabilities vary greatly depending on the analyst's party affiliation and underlying assumptions. Growth estimates, years discounted and the year in which the estimate was done can all influence results. It is difficult to be certain just how deep a hole we're in, but we should consider the classic admonition: "When you're in a hole, stop digging."



Here is how we might fix our two biggest entitlement holes and our public pension problem without imposing undue hardship on any of our citizens.

### **Social Security: An unfunded liability between \$8 and \$20 trillion**

Let's begin with a little perspective. Nobel Laureate Paul Samuelson, at a 2006 conference sponsored by the Boston Federal Reserve, called Social Security "a system – of which I was in on – formulated deliberately in Depression times to intentionally discourage savings and coax job 'hoppers' into retirement." How about *that* shovel? Social Security was signed in 1935 as an insurance program to prevent the elderly from lacking a minimum level of income.

Aside from add-on features over the years, this was an insurance system – making payments to those in need. Today, the average person receives 100% of what he or she paid in within 60 months after reaching full retirement age (FRA). This could be considered a premium refund from an insurance perspective. A 65-year-old today has a life expectancy of roughly 83 years, while the actual *insurance* payments would be expected to last for roughly 13 years.

The question is: how much insurance is needed, not wanted? According to the Social Security Administration, Social Security represents more than 90% of income for 34.2% of Americans over age 65. And for 63.9%, it represents at least 50% of their income. There is clear need for this insurance, and the need for it varies across socioeconomic status.

Once everyone receives the refund of their insurance premia, they should be means-tested (with an eventual phase out of benefits) based on their monthly income capability. This capability should be based on an aggregate asset yield (IRA assets, taxable assets, home equity, etc.). The phase-out should be based on the amount their monthly income capabilities and Social Security benefits exceed the poverty threshold. And, for those who die prior to receiving their entire premium refund, the unpaid balance should be returned as a death benefit to the insured's survivors.

The execution of this phase-out would be complex but possible. Here's an example of what it could look like.

- If the monthly income capability plus Social Security is between three and four times the poverty threshold, then Social Security is cut 20%.
- These cuts continue in 20% increments with each multiple of the poverty threshold until one reaches seven times the threshold, at which point Social Security is completely phased-out

Payment reductions, which would impact higher wage earners disproportionately, would significantly benefit the system's solvency, since higher wage earners also tend to live the



longest. These earners, who have the least need for insurance, are stressing the system the most. Those with genuine need, however, would be spared any cuts.

The trade-off for these same high-wage earners would be a reduction (or cap) in the program's tax load as a result of the program's much-improved solvency. Any reduction in taxation would provide additional discretionary income (an indirect privatization) over the length of their working careers. Cost of living adjustments (COLAs) do not need to change, but taxation of benefits should discontinue. In addition, a back-end loaded benefit should also be considered for all earners who phase out of the system. This benefit would restart monthly payments beginning, for example, at age 85, in the guise of an advanced-life-delayed annuity (longevity insurance).

Separately, the system's FRA retirement ages need to age themselves. And early retirement availability, even at reduced payment levels, should stop. Any aging changes need to be thoughtful. Age 65 in the 1930s is roughly equivalent to age 72 today. While the age at which benefits begin needs to increase toward 72 or at least 70, this needs to be job sensitive. White-collar workers can easily work until age 70, given the reduced physical demands of their jobs compared to those of blue-collar workers. Having an FRA that is job-sensitive makes sense. This would not engender gaming of the system by those wanting to retire earlier, because younger eligibility would require a minimum number of years in that job classification (e.g., seven out of the last 10) to qualify.

Maintaining an insurance perspective can be helpful. Consider the following:

- Insurance is best suited to cover infrequent but significant risks
- When insurance becomes too expensive, it no longer makes sense. For example, when your homeowner's insurance costs \$1,000 per year it makes perfect sense, but it would no longer make sense if it cost \$25,000 per year.
- And accepting insurance payments without need is considered fraud.

### **Medicare: An unfunded liability between \$23 and \$80 trillion**

To help cure Medicare's ills, we must start by getting its future recipients to be responsible for their health. The by-product would be that as the program's costs become untenable, its recipients will be healthier.

As a result, this section is constructed to fix all health insurance issues. Medicare-specific fixes are denoted by an asterisk (\*).

What if all healthcare policies...

1. Were individually owned, beginning at an early age such as 18 or even at birth? This would directly connect the user with the payer, unlike today. Healthcare policies would be personal, without any pre-existing exclusions or portability issues.



If ownership begins at a certain age, such as 18, the purchase could be tied to something like a driver's license, so citizens must buy insurance to receive a license. And individuals could shop around for the right insurance plan over the course of their lives.

2. Were accepted by any and all physicians and hospitals without limits for non-elective procedures? Elective procedures by definition shouldn't be covered by insurance. A benefit cap\* should come into usage at older ages such as 75. Expenses beyond the cap – when incurred – would not be covered by the insurance policy. Spending \$1 million on a 12-year-old is not equivalent to spending the same on a 75-year old in terms of expected future productive capacity.
3. Rationalized the costs and affordability as they relate to common usage? All policies would be standardized catastrophic policies with annual out-of-pocket (OOP) limits and attached health-savings account (HSA) features. These policies are the most affordable and do the best job of connecting personal responsibility with the insured. With a catastrophic policy, the first "x" expenses (OOP) are the responsibility of the insured, and any other expenses are then the responsibility of the insurance company. The HSA is a conduit to pay for the OOP with tax deductible funds. For example, the OOP maximum could be \$5,000 for those under age 40 and \$3,000 for those older. And, the HSA limit should be \$10,000 per Social Security's FRA\* individuals.
4. Had all costs (premiums, prescriptions, etc.) borne by tax-deductible and tax-sheltered HSA accounts? To avoid tax-shelter abuse but allow solid funding, an HSA's balance should be limited to a multiple of three-times (or more at older ages) the OOP limit. The investments, of course, should be short-term and ultra-conservative, and would be directed by the insured. Perhaps are government might be interested in a new market for short-term Treasury securities?
5. Had marginally increasing premiums over time to cover higher costs but offered discounts (incentives) to help control those higher costs? Discounts would be based on the relative stability or improvement in the insured's risk-markers. Risk-markers could include body-mass index (BMI), blood pressure, cholesterol and tobacco use and reflect risky behaviors such as skydiving. Routine care such as physicals and risk-marker measurements would be a requirement of coverage and come without costs. If one doesn't get examined periodically (e.g., every two to four years), then coverage – not the policy – would become inactive until the next exam. People have to be responsible to help reduce the moral hazards we have today. Discounts earned could persist for a guaranteed period of two years, even in the event of a negative risk-marker change. This system will yield benefits from earlier detection of problems as well as from the longitudinal benchmarking of individual health.
6. Required (but revocable) end-of-life statements\* to determine whether one remains on life support? This would likely lower the industry's enormous costs in the final months of life. It is estimated that the final year of Medicare coverage represents 25-30% of Medicare's total spending. And beyond a certain age (75), all expenses above a set amount become the responsibility of the person or family\*.



Healthcare policies could also benefit from these necessary changes.

- **Real tort reform:** A decrease in malpractice litigation or its costs would benefit every part of the system – with the exception of the attorneys. The purchase of pharmaceutical patent extensions should be outlawed.
- **Contributions by the insured's employer:** Corporations could still offer a health-insurance benefit via contributions to their employees' individually owned HSA accounts. Corporate America would benefit from the savings of not being responsible for coverage, and this might lead to improved employment opportunities.
- **Improved and/or expanded access to health professionals:** We need to incentivize more individuals to pursue the healthcare profession (tort and insurance reform would likely help). How about something like the GI Bill, focused on medical training? In addition, how about having nurses handle classic yet basic doctor-patient interactions and making nurses more accessible (in or by all pharmacies).
- **Enhanced development of electronic records and information sharing:** This is needed to facilitate my second recommendation for Medicare, in which any patient can use any doctor or hospital. This would also lead to significant cost savings.

Health care is a right at a given threshold and a privilege above that threshold. Regardless of where the breakpoint lies, we must be mindful that studies on healthcare spending in the U.S. show that our comparative health outcomes do not support our high per-capita spending.

### **Pensions: Unfunded liability estimates over \$3 trillion**

Fixing underfunded public pension plans needs to begin with the following three basic understandings.

1. The pool needs to be protected.
2. Retirement benefits are only for those retired.
3. Monthly income benefits are provided only monthly.

Individuals covered by these plans may have counted on the promises made to them. In addition, a reasonable (but not recommended) behavioral response for those covered by pensions would be to not save. Fixes to these plans can have severely negative impacts on individuals. However, a bit of austerity is necessary.

1. Benefits promised and accrued (earned) should not be guaranteed. Benefit amounts that lead to replacement rates – when combined with Social Security – of greater than a threshold (i.e., 70% or 80%) of pre-retirement income should no longer be provided. We shouldn't be paying people to retire, because doing so poses risks to future economic growth.



2. All funding calculations for defined benefit plans should be done with one accounting approach, FASB, rather than with the more kind and forgiving GASB.
3. Minimum funding requirements should begin at the 93% funded level, and all new benefit accruals should be discontinued until the funding level is above 97%. This would be an automated and hopefully temporary freezing of benefits. In addition, COLAs should be temporarily discontinued, and new entrants should not be allowed into the plan. Promises cannot be made or continued without proper funding. Any and all benefit improvements should be prohibited unless the plan is at least 105% funded.
4. Retirement benefits should not be paid until Social Security's FRA is reached. Early retirement is fine, but the first benefit should not be paid out until achieving one's FRA. Also, COLAs should only be allowed to the extent that they are in line with the SSA's definition.
5. The definition of compensation should require income to be averaged over a minimum of the prior 10 years. Final salary plans should be prohibited — no more last minute boosting of benefits.
6. Lump sum payouts should be prohibited. And joint and survivor benefits should have a survivor's age threshold limited to 10 years less than the retired employee's age.
7. Pension bond sales (carry investments) should be prohibited as a form of funding. Enough with risky investment behavior to fund or help finance plan deficits. Furthermore, hedge fund allocations should be limited or eliminated, as they are not necessarily less risky than equity allocations. (For example, many long/short managers attempt to take advantage of offsetting positive and negative (short) betas, but individual security risks are idiosyncratic and may not offset. The result is two distinct sources of alpha – positive and negative – versus what is commonly believed to be a single net source.)
8. And, in the case of pensioner politics, the public pensioners should be allotted paid TV time to ask the public for more contributions (higher taxes) because they were promised, have earned and deserve this benefit. Only the public can help, via telethon-styled pension fundraisers, in the case of potential benefit cuts. If not enough funds are pledged or promised through a referendum vote, then the pension benefits should be cut until the minimum 93% funding level is attained. This system is democratic, public, escapes politics and helps to avoid conflicts. Most importantly, it allows politics to leave the building. If taxes support the benefit, then take the case directly to the people paying those taxes.

Of course, many private plans face fiscal difficulty even though they have protocols in place to deal with underfunding. The Pension Benefit Guarantee Corporation (PBGC) already caps benefits for the plans it takes over and has the ability to refuse a plan. But not surprisingly, PBGC is underfunded and could ultimately require taxpayer dollars. This taxpayer liability is still less than with public plans. Nonetheless, some of the concepts above would help private plans.



## **In closing**

We should all pursue a thoughtful re-examination of our needs and objectives. My goal is to generate conversations, not vitriolic shouting matches. Through an open exchange of ideas and contributions from topic experts, perhaps we can improve our entitlement impasse soon. The importance of this cannot be understated – our fiscal health depends on it.

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