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Session 73 Seminar
Addressing the Financial Risks from Retirement Systems Seminar: Beyond Private Enterprise: Risks in Social Security, Medicare and Government Plans

Track: Pension

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Panelists: STEPHEN C. GOSS
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Summary: Before ERISA and SFAS 87, various provincial Canadian legislation and CICA 3461, there was *little financial regulation of defined benefit (DB) pension plans. An actuary's advice to clients on funding and other aspects of plan financing was based on the costs and risks inherent in the plans themselves. With the passage of ERISA and parallel legislation in Canada, plan funding in most cases became a matter of meeting minimum funding standards without exceeding tax-deductible limits. The advent of SFAS 87 and CICA 3461 set similar but different standards for reporting pension plan liability and expense on the company books. Over the last 30 years the inherent risk plan sponsors face from their pension plans has changed. Thirty years ago, DB plans were relatively smaller in relationship to the plan sponsor's core business or sponsoring government's infrastructure. A graying baby boom population, increased longevity and contraction of old-line industries have combined to increase the cost and financial risk engendered by pension plans. Once small fringe benefits, retirement plans have grown to become substantial financial commitments with the accompanying risk. Many plan sponsors have reacted by terminating or freezing plans and moving to defined contribution (DC) plans. In the meantime, the tight regulatory environment for private plans has led sponsors to lose sight of these changes in the bustle of compliance with myriad*

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NOTE: The chart(s) referred to in the text can be downloaded at:
http://handouts.soa.org/conted/cearchive/neworleans-june05/073_outline.pdf.

complex and obscure rules. Actuaries must help plan sponsors get back to the basics: the costs and risks inherent in DB and DC plans before the accumulated overlay of regulation. From this perspective, it is possible to address more cogently some fundamental questions about DB and DC plans: Is eliminating DB plans the only possible solution? Are DB plans the answer? What can actuaries do to help corporate plan sponsors manage the risk of both of these types of pension plans? How can these risks be balanced to manage needs of sponsors, shareholders, plan participants, taxpayers and guaranty agencies? And what happens to a society where DB plans disappear? Do DB plans still provide other benefits to plan sponsors and overall society to make them worth the risk? Addressing the Financial Risks from Retirement Systems seminar is designed to help actuaries better measure, discuss, manage and mitigate risks that pension plans bring to their sponsoring organizations. This session takes a break from the focus on private plans, and look instead at the risks faced by Social Security, Medicare and government sponsored plans. Many of the risks are the same, such as changing demographic profiles, but the effect on the systems can be quite different. For Social Security and Medicare, we'll consider how the aging of the baby boom and increased longevity have put pressure on these systems, and how those pressures bring into focus the need to change retirement as our parents and grandparents have known it. Our focus on government plans focuses on issues related to taxpayers, including how risks are being shifted to future, smaller generations of taxpayers and the role of assets for government plans.

MR. JOSHUA DAVID BANK: This is a session on public plans, which include government plans, Social Security, Medicare, and we also have New York State Teachers' Retirement System represented.

I'll tell you a little bit about the speakers and then I'll just hand it off. I'm the moderator for this session. I'm going to do some brief introductions now. The order that we're going to speak in is first, Larry Johansen. He'll be speaking about the New York State Teachers' Retirement System. Effective June 1, 2005 Larry, who's an actuary, was appointed by the Retirement Board of the New York State Teachers' Retirement System as a securities investment officer. He's responsible for overseeing the system's 84 billion securities investment portfolio. Prior to this appointment, Larry served for 16 years as a systems actuary. I would say chief actuary, but I think they don't have a chief actuary. We're seeing 255,000 active and 121 retired participants. For another 16 years prior to that, he held a number of other positions with the system after earning his Bachelor of Science degree in math and economics from the University of Buffalo. In addition to serving on several Academy and Governmental Accounting Standards Board (GASB) committees and task forces, he serves as vice president and president. He served as vice president and president of the Academy from 1999 to 2001 and has been on the Academy's Board of Directors since 1996. I think he moves on from there in 2006.

Next we'll have Steve Goss, whom you all know. Steve is currently the chief actuary

at the Social Security Administration. He joined the Office of the Chief Actuary in 1973, same year, after earning bachelor's and master's degrees in math and economics at the University of Pennsylvania and the University of Virginia, respectively. He's written numerous articles and actuarial studies. He has made many presentations to a wide range of audiences including members of the executive branch, members of Congress and their staff, special commissions and private organizations like ours. Mr. Goss is a key member of the National Academy of Social Insurance and active volunteer in various committees of the North American actuarial bodies.

Clare McFarland is an actuary and deputy group director for the Medicare and Medicaid Costs Estimates Group in the Office of the Actuary at the Center for Medicare and Medicaid Services (CMS). But if you can't remember that all, it's DGD/MMCEG/OA/CMS. You'll remember that one. The office is responsible for projecting Medicare spending, for the trustee's report, for the president's budget and for measuring potential impacts of all legislative proposals affecting Medicare and Medicaid. She's been with CMS since 1986. She has a B.A. in biomechanical engineering.

With that, I'll hand it over to Larry. Larry is going to talk about the New York State Teachers' Fund System.

MR. LAWRENCE A. JOHANSEN: Thank you, Josh. While most of my slides and comments will be regarding the New York State Teachers' Retirement System, in many cases what is affecting us is affecting many large and small public plans across the nation with respect to the demographic issues, the financial and investment issues, the inner-generational issues and the political issues. Those are all significant risks that are facing our plan as well as all the plans across the country.

I'll start off with some of the demographic issues. In our plan, one in three members is eligible to retire within the next five years. The baby boom became eligible to retire at 55 in 2001. The leading edge of the baby boom, one in six of our members, is eligible to retire immediately. That, obviously, has a dramatic impact upon not only the staffing of the plan, but also the cash flow of the plan, and we'll talk a little bit about the cash flow later.

Slide 3, page 2 shows how the plan has grown dramatically over the years. In the early years of the plan the retired members were doubling almost every decade. Obviously, as those numbers get bigger, that slows down a little bit, but we still have significant growth in membership. And as retirements increased substantially through the 1990s and 2000, as the leading edge of the baby boom started to become eligible to retire, as well as the state and some of the school districts were having financial issues, there were a number of early retirement incentives that increased dramatically the number of retirements and, obviously, therefore, the payroll.

Slide 1, page 4 shows the more recent periods—2003 was an early retirement incentive that increased the number of retirements substantially. Using the retirement assumptions for the plan, we expect somewhere on average, without extraordinary exogenous things affecting the plan, about 7,000-8,000 retirements a year. The year 2003 with the early retirement incentive was almost 3,000 more than that. That was the record number of retirements in a year. It put a huge pressure on the staff to make sure that all of those retirements received their first check the month following retirement and were finalized within a six-month period. So it's been a substantial strain not only on the staff, for administration, but also on the cash-flow needs of the retirement system, which we'll talk about a little bit later.

Investments have had a dramatic impact on us and everyone else (Slide 2, page 3). We smooth over five years so this is where we were almost two years ago. An average five-year return is 2.2 percent, substantially less than the assumption of 8 percent. When you have two minus numbers in there, almost a –7 and a –6, no matter how good your returns are, you're still going to have some real problems, and that's going to take a while on a five-year basis to work its way through. Almost a year ago, we had a very good return, a little better than 16 percent. However, when you average that over the five years, again, with the –6 and the –7, you've only increased your five-year return to 2.6 from 2.4. Obviously, that has significant upward pressure on the employer contribution rate.

The funding ratio obviously has been affected by the fall-off in the capital markets. In the years 2000 and 2001, it peaked at about 125 percent. Then, as the capital markets started falling off, it fell to just below 100 percent. There's a Governor's Task Force in 2000 that was bipartisan. It included management, labor and other interested constituent groups. It came to the legislature with a recommendation for some substantial benefit improvements in 2000. Part of the fall-off in the funded ratio was the recognition of those benefit improvements as well as the fall-off in the capital markets.

This was translated into real dollars from the taxpayers' and the school districts' perspective. In the fall of 2004, we received our employer contributions in three equal installments: September, October and November. So for the fall of 2004, we received about $300 million in employer contributions. This fall, 2005, we expect about $700 million in employer contributions. The employer contribution rate that will be set by the retirement board next month is expected to generate contributions of about $1 billion. That contribution level is still substantially lower than the new entrant rate. In the fall of 2003, just to put this in perspective, from the school district perspective, we collected about $50 million in employer contributions. Both in absolute terms and, obviously, relative terms, going from $50 million in 2003 to $1 billion in 2006 puts some significant pressure on school districts.

I happen to serve on the Budget Advisory Committee for my school district. It's a very typical suburban school district. Three causes of increasing their budgets (and this is very typical statewide), in order of significance, have been health insurance, retirement costs and salary increases. One of the reasons salary increases is third is because of the number of retirements and typically the way teacher pay scales work in New York. It's really a two-dimensional pay scale. They get salary increases as their tenure increases, but they also get salary increases as their posteducation increases, so they've moved down a diagonal as their salaries are increased. Because of the significant number of retirements, they hire teachers at the lower end of the scale and that's why salaries are not increasing as much as they have been historically.

Slide 1, page 5 dramatically shows a cash flow problem. The darker bars are the benefit payments. The lighter bars are the employer contributions. Back in the 1980s, while the employer contribution rate was in the neighborhood of about 8 percent, we still had positive cash flow. As the capital markets started to take off and the employer contribution rate continued to decline, the number of retirements and the benefit payments increased dramatically. Even if the contribution rate were at a level comparable to the normal rate, for new entrants, of about 12 percent of pay, that lighter bar would still only be about 1.4 billion. So on a payroll to our annuitant population of over $4 billion, even with 1.4 billion you have a significant negative cash flow.

One of the things that we spend a lot of time looking at as part of our annual asset allocation review, in addition to where we are relative to target and range for each of the asset classes, is where the cash flow is coming from so that we don't end up systematically reducing our fixed income portfolio as that generates the significant amount of cash to pay benefits. We need to make sure that we continually rebalance to target so that we have an appropriate asset allocation, yet recognizing in the fiscal 2005 about a $3.5 billion shortfall. In 2006 fiscal year, there is still a $3 billion shortfall in employer contributions versus benefit payments.

Slide 2, page 5 is a recent history of the employer contribution rate. One of the things that I find very interesting in talking with school boards, school superintendents, school business officials and other related parties (the legislative group is always an interesting group to talk to), is they all have very short memories and they remember the contribution rate when it was under 3 percent. None of them remember the contribution rate when it was almost 25 percent. For the longest period of time through the 1970s and most of the 1960s and early 1980s, the contribution rate was north of 20 percent of pay. Nobody remembers that. Nobody wants to remember that. Even when it's pointed out to them, they sort of try to ignore it, but it's not an issue that's easily ignored.

As we talk about going forward, we recognize that while there have been dramatic increases in the contribution rate, should we reach some state of equilibrium, hopefully the contribution rate will stay somewhere between the 10 and 15 percent

level once it gets there if capital markets return to more normal returns.

So where are we going? It's going to continue to increase. The five-year return of less than 8 percent is going to continue for the foreseeable future. It would take extraordinary returns, even more extraordinary than we experienced in the 1990s, to average a –6 and a –7 and still end up over five years greater than 8. Liabilities continue to grow. Members continue to earn service and increase their benefits. The employer contribution rate, which was a concept that has been difficult to accept for many of the constituent groups that we talk with, of 12 percent is not a ceiling on the rate, but that's ultimately where the rate should move around depending upon actual gains and losses, primarily investment gains and losses.

There are other risks that we're facing. One of the significant issues that we're addressing, and there are a variety of proposed solutions to this, with respect to governmental employment postretirement, paid retirement and working in retirement, is there's a substantial shortage of administrators at all levels in New York. Certain hard-to-staff schools are having shortages in certain subject areas; math and science are having shortages. So the state education department and other allegedly creative people are thinking of ways of allowing retired members to come back and teach in those difficult-to-staff areas or jurisdictions.

Part of the problem is that New York State has this public policy that, if you're a retired public employee, you can't go back to public employment and earn any credits, and there are substantial limits on what you can earn in public employment once you're retired. So it harkens back to older times and different demographic issues.

Part of the problem that the baby boom faces as they retire is the issue that many of us are facing—you still have children, even though they're young adults of various stages of adulthood, who, as I affectionately call it, with respect to my two daughters, they're still on the payroll; one's married with a granddaughter, who I'm helping to have a nice lifestyle. My other daughter is a lawyer and I'm sort of weaning her from the payroll. She's doing public law so I'm not sure she's ever going to be well-to-do.

But, as an interesting aside, when the retirement board appointed me to this new position, I sent an e-mail to my two daughters telling them what was happening and told them that it was going to be an interesting and challenging, exciting way for me to conclude my career with the retirement system. They both immediately wrote back and said, "That sounds an awful lot like retirement, dad. What about the money tree and the money well?" And I said, "Well, my time horizon is a number of years or when both of you are off the payroll permanently and completely so you have nothing to worry about."

The baby boom generation has adult children that are in various stages of financial independence and have elderly parents that are in various stages of health or

independence or both. Recently, my mother-in-law moved in with us and that's been an interesting six months. She just had knee replacement surgery so that six months is going to be a lot longer than six months. Everyone is facing that and so retirement is not what it once was. Maybe people are changing careers and there are significant health care issues.

There was a big article in this morning's paper. General Motors (GM) is threatening to just pull its health care with United Automobile Workers (UAW) if they don't sit down and begin to negotiate. GM has advertised that for every car it cost them $1,500 in health care. Health care is a significant issue. Various public entities have a variety of ways of how they do or don't and at what level provide health care and retirement, and many people continue to work so that they have access to health care.

Political risks: those are probably the most difficult risks to assess and begin to address. Increasing employer contributions and employer contribution volatility all have created significant budgetary concerns not just in New York State, but also across the country. It has led to a lot of discussion about replacing DB plans with DC plans in the public sector. Governor Schwarzenegger had a huge initiative that he's at least temporarily backed off from.

We've had initiatives in New York and a whole host of states that the DC replacement for the public DB plan will solve everybody's problems, but ultimately what they don't necessarily recognize is that if you put in a DC plan to put in a similar level of benefits, it will cost you at least as much, if not more because one of the things that a DC plan does is give more money to shorter, younger service employees than the DB plan. So if they're looking to provide a comparable level of benefits, it's not going to be any cheaper and may, in fact, be more expensive.

The last significant political issue that is going to face public employees throughout the country is the impact of the new GASB standard 45 on other postemployment benefits. Depending upon the size of the entity, public employers are going to have to start booking the liability comparable to a Financial Accounting Standard (FAS) 106 liability that publicly traded companies have to book related to the liability on account of the health care benefits that they promised into retirement. So how that ultimately impacts public employee entities with respect to their budgets on the balance sheets is still as yet an unknown, but it's certainly a significant political factor as many of the taxpayers that are supporting these benefits don't themselves have health care in retirement. So it's going to be an interesting political situation.

MR. BANK: Thanks, Larry. We'll go to Steve Goss now to cheer us up with an entirely different picture.

MR. STEPHEN C. GOSS: Great. Well, I'll try, but Larry's remarks make me recall something I heard from the chief actuary of Bulgaria some years ago when he said the only real retirement security is a job. Let's hope that turns out not to be the

case in the future.

Social insurance is really a little bit different. The way we tend to look at social insurance principally, because it's financed in this country on a pay-as-you-go basis, is quite a bit differently from what's been discussed for the last day and a half in this room, which has been extremely interesting. Because it's pay-as-you-go, we really look at it more on sort of an open group financed basis. We look at how the flows will be occurring in the future with new entrants, not so much at a closed group kind of look but in a accrued liability look, so it really is quite a bit different.

As a result, I think we look at risk a little bit differently. We tend to look at risk really more in the aspect of the uncertainty question because the future, new entrants, what's going to happen with the growth in the economy, and everything else really is extremely uncertain. Of course, for the social insurance part we don't have the control that many of your clients do of determining how large their firm is going to be and how many employees they're going to have. We have no such control. Whoever is working in the United States, we get them. We have to deal with this.

The uncertainty is not all bad. You know, we tend to focus when we use the word risk. People tend to think of it as being kind of negative when you look at the down sides of the risk. There are also some up sides. But from the point of the social insurance plan, this kind of variability, whether you think of the risk or not, is really just something that we need to have the ability to adapt to over time.

In the negative sense, I think, therefore, that risk really would be a matter of putting ourselves in a position where we have a plan where we cannot adapt, where it would be impossible to adapt going to the future. Fortunately, with the Social Security system, and I think this is probably true for the Medicare system also, we don't really have liabilities for the future. We call them obligations and that, of course, is because our plan sponsors have the ability at any time to modify the plan and to change things if they turn out to be too costly, or not costly enough for the amount of money that's been allocated.

By way of adaptations in the future, we have many possibilities, one of which would be to change the law so that we had certain additional indexing in the program—for instance, indexing of retirement age to longevity increases. Another possibility would be a schedule in increases in the retirement age going forward, or we just sort of take care of it as we go along and make changes. The preference, clearly, in this day and age, and I think for everybody in this room, would be to either schedule or to index some changes in the retirement age or in the benefit level so that people have a lot of advance notice or advance warning and be able to better plan where they're going in the future.

Frankly, the members of Congress that we talked to tend to be a little bit more inclined towards scheduling increases, specifically on an ad hoc basis in retirement

age than having index increases. They tell us that their constituents say for 40 years old, they want to know what retirement age they're going to face when they retire. Don't tell them this stuff about some actuaries. They're going to look at what the life tables are when we're 60 to tell us what our retirement age will be when we're 62.

The principal uncertainties that we face on these open group valuations and are looking forward into the future are really the demographics, as has been discussed. Mortality has been discussed in these forums. Immigration is another source of our uncertainties for population projections. Really the principal one that is impacting us now and for the foreseeable future is fertility, the thing we talk a little bit less about. And the deal on fertility is that birth rates really made a big drop after the baby boom generation. We all talk about, oh, my gosh, the baby boom is coming, the baby boom is coming. But the real issue is not that the baby boom happened. It's what happened after the baby boom. We baby boomers didn't have enough kids, whatever enough is. We had fewer kids. And the expectation is that there will be fewer kids going into the future. There was a real fundamental shift in the birth rates between 1965, the end of the baby boom generation where on average we were having over three kids per woman through her lifetime and 1972, just seven years later, down to two kids per woman. And it has stayed pretty stable at about that level ever since. Now that's really a fundamental shift for a pay-as-you-go system.

Ultimately, I think for any of the plans if we will collectively put all our private plans together and think of them as a whole, the world isn't really any different. We're working within the same kinds of constraints. A real big shift in the nature of the demographics is going to make it hard to finance any plan in the future whether it's advanced-funded or not.

You can really see on Slide 3, page 7 pictorially what has happened to these birth rates. You can see this big drop that we had since 1970. We recovered a little bit after we went to two children per woman. We're projecting it to be flat in the future. Now this is not as bad as it could be. We could be like Europe or Japan where the number would be about halfway between where you're seeing zero in the future, and that would really be an unfortunate picture. The result of having this big shift in the birth rates is with some delay, you'll see on the next slide, we'll have what we're going to have. There's no uncertainty here; between 2010 and 2030 this ratio of the number of workers per beneficiary, again, sort of on a pay-go point of view, is going to drop, and it's going to drop exactly commensurate with the fact that we've had fewer kids. This worker-to-beneficiary ratio is going to drop from a little bit over three down to two just as the birth rates went from three down to two. And the arithmetic is easy. I'm sure you've all worked it out.

Slides 1 and 2, page 8 show the historical period where we have this big drop in this worker-to-beneficiary ratio. This is just to sort of put a line there to indicate that this was not demographics back then. This was just a matter of a matched ratio of a

program. This program, as most of you are probably aware, sort of taxing pretty much everybody right at the beginning back in 1937. The beneficiaries only gradually came on line because you had to have some years of service after 1937 to get a benefit. Not too many 80-year-olds in 1940 had three years of service. We only gradually brought the beneficiaries in. You have to look after 1975 to see really what the demographic effects have been. And from 1975 to 2010, it's just about flat. There's really almost no change at all in demographics; 2010 to 2030 is the big drop, and you can see a little bit of an edging down after that, and that's what the longevity is about. The longevity counts. There is a rather stable level of our cost as percentage of our tax base, the taxable payroll is going to shift up between 2010 and 2030 again, going up to a significantly higher level because of the shift in the birth rates and, therefore, the change in the worker beneficiary wages. There's a very gentle sort of tendency to continue growing after that. Now that's important. That's the longevity. That's something we could affect by having some sort of small effects on the retirement ages in the future. But the big thing really is this big shift in our relationship between workers and beneficiaries because of the fertility.

Now the implications, the demographics shift. Of course, as was mentioned, I think by Eric Klieber earlier in the day, we're not projecting our trust funds to run out of money until 2041. But by then and, hopefully, much sooner something will be done. And as of 2079, remembering that last chart, the cost chart, we would have to have revenue shifts increased by about half compared to what is scheduled under current law, or the benefits that are scheduled have them dropped by about one-third by 2079. Now less between now and then, but this gives you sort of a sense of the order of magnitude on a sort of a steady state basis after all this fertility has worked its way through.

Unless, now there are some possibilities. Maybe the world is going to change again, a high uncertainty. Fertility could change again. Fertility rates could go back up. With some delay then, we'd be in better financial shape. We're not counting on that obviously. We think we understand why fertility rates dropped and we expect them to stay down. They could go lower though. Look at Europe and Japan where they have birth rates of closer to one child per woman than two. That's a possibility. Again, we think that's relatively unlikely.

Mortality rates could improve considerably faster as some demographers think or they could improve more slowly. We have, fortunately, in this day and age, demographers that are arguing on both sides. They talk about the obesity epidemic and all that discussion.

Immigration also, which is a little bit more under control of the government, could change dramatically. There are legal limits that are fairly soft, but we could control the amount of illegal immigration, but that is also a major component of immigration that comes in and ends up on a legal basis over which we have little sort of direct control. The economic disparities probably have more to say about that.

The economic uncertainties for the social insurance plans; well, under current law, as I mentioned before, we have a pay-as-you-go system and actually the finances and the benefits are reasonably well-aligned. They're better aligned than we are on the demographics. That's because as we have faster wage growth and excessive prices, then our payroll gets bigger and we get more taxes coming in, but our benefits also follow suit with somewhat of a delay. So we get a little bit of a boost out of having faster real wage growth in the future, but it's not really dramatic. Program solvency is relatively insensitive under a pay-as-you-go system to the economic variabilities.

Risk for Social Security is sort of what we were assigned to sort of talk about. I was at least told, and I assume that the other members of this panel also were told, don't go to financial economics. Well, you know, it's been kind of inevitable. We've been there the last day and a half, but I'll still try to stay away from it here as much as possible. Under the current law system we don't have any involvement in equities. We have relatively little involvement in investments, in any case, simply because we do have a roughly pay-as-you-go system. But one of the risks that Social Security faces, certainly, is a decline in public support, and this would be fine as long as the other legs of the stool are there and people are happy with them.

You know, it sort of reminds me of a situation when I was talking to a group of young people, even younger than this crowd, people in their 20s, a few years back. They were employee benefit administrators and plan administrators. You think these people should really know what's going on. They're the human resources (HR) people from a lot of big firms. Social Security pulls these people together every year to talk to them about reporting earnings and everything to Social Security. Well, I got them in there and I saw these really young people so I thought this is going to be a great chance to ask one of our favorite questions.

You all probably are aware there was a survey some years back where people were asked: What do you think you're more likely to see? Social Security benefits or space aliens? And so I said, "So what do you all think? Are you more likely to see space aliens than Social Security benefits in your lifetime?" All the hands went up. Everybody said they're more likely to see space aliens. And I said, "Why? You all are a very knowledgeable smart group and you make pretty good money. So I guess that means that you all must be really saving a lot because you know Social Security is not going to be there for you, right? So everybody, hold up your hand if you're really saving a lot." No hands going up. So I said, "Well, wait, how does this figure? How does this work out?" And after a while, a couple of them raised their hand and said, "We don't really think Social Security is not going to be there. You know, we know there will be something there."

As it turns out, it was sort of like the hula hoop thing. It's kind of popular, I guess, to be cynical about things. But when it came right down to it, after they thought about it for a while, they said they really do think there will be something there, or

at least they used that as an excuse for why they're not saving. It's hard to tell.

Another risk for Social Security is what has driven a lot of the thinking about Social Security reform in recent years: the perception of a very low rate of return on a pay-as-you-go system. We all know when you have slow population growth, as we have with the low fertility rates, you end up with an implicit low internal rate of return on benefits. It's just inherent in the system, under these demographics. Is there really an alternative? Eric Klieber sort of raised the issues earlier about whether or not we can really expect to have higher induced national savings. If you're a life cycle hypothesis guy like Modigliani, you'll probably question it.

Therefore, how effective would advanced funding be for Social Security? Remember, Social Security does not have the luxury of being like a single plan, a single employer and say we can act in a way that will not affect the rest of the economy. If Social Security acts within as being a very, very large player within the economy, the question is: Can we really affect an increase in savings? Eric raised that question, but he didn't really explore it a lot in the last session. We try to do that at a national level, but then you have to remember we can increase saving, but we can only increase saving by doing one thing, and that's less consumption for some period of time.

Of course, we are talking about the United States of America here, the consumer engine of the world. We're really, really good at that. And in encouraging Americans to consume less, to be able to save more and generate real savings in the future is kind of dicy. In our projections where we have either on the last administration formulations that would result in a substantial advanced funding within the trust funds or currently we have many, many proposals we look at, whether it would be advanced funding developed within individual accounts, when we're faced with the issue of will this result in more savings and investment in a nation as a whole, our call has been no. We look at it as being a swap and that there would be a shift in assets and that there would not be really an increase in savings and investment. That's probably a little bit conservative because surely there would be some effect, but that's what we have at this point in our estimates.
Thank you for the opportunity to share this perspective with you.

MR. BANK: Thanks, Steve. Now we'll move to Clare for the portion of the social insurance program that doesn't really get enough attention, but she'll set us straight on that.

MS. CLARE M. MCFARLAND: I have a few more numbers than Steve so, hopefully, you won't find that too overwhelming. We have the same uncertainties, of course, as Social Security as far as the demographic, but our bigger uncertainty is really around the utilization, price increases and intensity of health care services.

But given all that uncertainty, this is what we're projecting for Medicare spending. It's currently 2.6 percent of gross domestic product (GDP) projected to be 5 percent

by 2020, 9.3 in 2050 and 13.6 75 years from now. The expenditures will be double that. We'll see Social Security in 2024 to be double what Social Security is spending at 75 years from now. Beneficiaries are currently increasing at 1.5 percent per year and that will double after 2010 when the baby boom retirement gets into full swing. We're projecting continued growth in volume and intensity of services per beneficiary, and it's higher than it otherwise would have been because now we're also paying for prescription drugs. This projected growth places substantially greater strain on workers and beneficiaries in the form of premiums and co-pays and also on the federal budget.

When we talk about Medicare, we have to talk about the two funds separately because they're financed in a different way. The Part A hospital insurance (HI) is funded like Social Security; mainly through payroll taxes, 1.45 percent each for employer and employee. In 2004, the fund took in less from tax income than it paid out in benefits and we're projecting that to be the case for all future years. The fund is projected to be exhausted in 2020. Tax income at that time should cover 79 percent of the benefit, 41 percent in 2050 and only 27 percent of benefits 75 years from now. If we wanted to balance the HI program for the next 75 years we'd have to immediately cut benefits by 48 percent or increase the tax rate over 100 percent.

Slide 3, page 10 is just a picture of the situation. The income rate is the income over taxable payroll and cost rate. This is spending over taxable payable. The shaded area is just represents the assets and interest being cashed in to pay for benefits. As you can see, there's a big discrepancy between the income rate and the cost rate.

Supplemental medical insurance (SMI) used to be Part B. Now it’s Part B and Part D. They're separate accounts within one fund. The income equals expenditures in all years for Parts B and Part D because the premium and general revenues are set each year to match the expenditures. Part B premiums are 25 percent of the cost and for Part D they're supposed to be 25.5 percent of the Part D costs. The addition of Part D increased aggregate Medicare cost by one-quarter in 2006, and we're expecting it to be one-third in 2020 because the drug prices are projected to go up more quickly than the Part A and B cost.

Per beneficiary costs for Part B and Part D are increasing at least 5 percent a year. Actually, that's sort of unrealistic because what we have in the projection is current law. There’s a system that is used to pay the physician. It's called the sustainable growth rate (SGR) system. The physician payment updates are based on this SGR, and the payment is adjusted each year for physicians based on what their actual spending was, and they have a target. If they exceed the target, then they have to get cuts in prior years. So we're currently projecting that they'll get cuts of about 5 percent for the next six years. And, of course, Congress will probably not let this happen because they haven't let it happen in the last two years. You know, we set the premiums and they come and pay the physicians more so the premiums aren't really sufficient to cover the cost, but we do have to project current law in the

trustee's report. So it's a little bit unrealistic.

The premium and co-pays are going to represent a growing share of the average person's Social Security benefit. When the drug benefit starts in 2006, we're estimating it will be about 35 percent of that benefit; 44 percent in 2020; 65 percent in 2050; and 91 percent of the benefits 75 years from now.

The general revenue financing is projected to increase by 6.5 percent a year representing a growing share of federal income taxes. If taxes stay at their historical average level that they've been for the last 50 years, this general revenue piece would be 50 percent of all federal income taxes by 2080.

Part D starts in 2006. Slide 3, page 11 shows the total picture of how Medicare is being financed. As you can see, it's mostly from the transfers from general revenue. For the HI deficit, there's really no provision in the law to cover those costs so who knows what will happen there, but it's still part of the expenditures.

Possible solutions: not anything that anybody's talking much about these days. I mean it's pretty difficult to cut benefits, but what the administration is trying to do is to get more efficiencies out of current providers and get more quality. There are a lot of initiatives about quality; having hospitals report data for quality and all the other payers and they're doing a lot with pay for performance for physicians and, hopefully, more efficiencies could possibly cut benefits. I suppose you could raise the tax rate for HI. I haven't really seen any proposals with anybody being interested in that. You could increase cost sharing, but, as we saw in an earlier slide, if it's already going to be such a huge portion of the beneficiary's Social Security check, that would have to be done in some kind of income-related way. Increasing the eligibility age is a possibility, but the thing is the 65-year-olds aren't the ones that are using most of the services so you don't get as much from that as you do from Social Security.
Income-related premiums and benefits: there is, starting in 2007, an income-related premium. It's going to be phased in over five years. I think there's a threshold if your income is a 160,000 for a couple, you pay, I think, 35 percent instead of 25 percent, and there are different levels. It ends up having a person paying 80 percent of the premium themselves. I don't think we've exactly projected that to save the system or anything, but it does have some effect, so that's all I have to say.

MR. GOSS: I just want to add one real quick point because Clare brought up this very, very interesting projection about the proportion of the Social Security cash benefit that is going to be eaten up by trying to pay the Part B premiums. One thing you all should understand is, of course, as we all know, the assumptions matter a lot in any projections. We have the same board of trustees that works for both Social Security and Medicare, and the real wage group assumption through the 75-year period is 1.1 percent real. The per capita health care costs grow a lot faster than that by these assumptions. For at least the latter 50 years of it, the per capita

health care costs, I believe, on an age-adjusted basis grow at about 2.8 percent real, so that's sustained through this whole period. Just so we have an understanding why the health care grows so much faster than anything else. I mean if health care had the same level of utilization and health care workers were just going up at 1.1 percent like the average wage, then there wouldn't be any difference. We have another 1.7 percentage points growth rate here in the health area.

FROM THE FLOOR: The question is for Steve. In your presentation, you talked about the rate of return on Social Security. I'm not sure that's what I'm referring to, but that might be a different calculation. In the media for the last couple of years one of the biggest criticisms of Social Security is that the individuals' rate of return has been extremely low. And I think that statistic is easily misunderstood even if calculated correctly. For instance, one of the newspapers in Philadelphia had an editorial on the rate of return saying that, oh, it's 3 percent. Well, anybody can use 3 percent. They didn't recognize the keyword that said is 3 percent real return? It was probably too complicated for them to understand that. So there's definitely a communication issue as to the understanding of that rate.

But I also understand that the way it's typically calculated is to look at the retirement benefits of somebody who's retiring versus their contributions and completely ignores, in most cases, survivor benefits, disability benefits and any other benefits. I wonder if you have an approach to communicate properly what the real answer is and if it's actually an attractive answer.

MR. GOSS: That's a really good question. We do it both ways and actually it doesn't turn out to make a lot of difference. When we calculate an internal rate of return, we look at the benefits paid on a cohort basis versus the taxes that are put in. It turns out that on a pay-go system that your internal rate of return is determined really by the growth in the population, the growth on the tax base. Ultimately, we hit a little less than 2 percent, maybe 1.5 percent real. Real is important, but still, when people compare that to thinking of 4, 4.5 percent real possible yield, then it looks relatively low.

FROM THE FLOOR: I have two questions, one for Clare. With those projections that you put up there, was there any estimate assuming the same type of medical cost increases in the general population what medical care would be as a percentage of GDP for the economy as a whole? I know when FAS 106 came in and we started doing projections for single employer plans on their FAS106 obligations, we did not project the trend to continue unabated, but said if we did so, we would be projecting that, by 100 years from now, medical care in the economy would be more than 100 percent of GDP, and that can't happen. So at some point, there has to be a rationing of some sort or some cost control on medical care. In doing those projections where you're just looking at the Medicare-eligible population and the cost for the Medicare portion, have you looked at what the total cost is of all medical care across the entire economy?

MS. MCFARLAND: Well, we're in the process of doing that right now because the office does project the total national health expenditures for 10 years so we're working on a 75- year model.

FROM THE FLOOR: Because I think that could affect the projections that you're doing for the Medicare piece.

MS. MCFARLAND: Yes.

UNIDENTIFIED PANELIST: But, Clare, might I ask isn't the projection, it goes from 14 to about 43 or something like that of the current projection?

MS. MCFARLAND: For the national health expenditures?

UNIDENTIFIED PANELIST: For the national health expenditures.

MS. MCFARLAND: Yes.

UNIDENTIFIED PANELIST: And then it goes much slower thereafter because the trustees, as of the 76th year, assume that there no longer will be GDP plus fund, but instead GDP only.

FROM THE FLOOR: Larry, have you, as an actuary, started discussing, whether you agree or disagree with the views of financial economics, but at least socializing the issues raised by the financial economists with respect to DB pension plans, investments, intergenerational, risk shifting? Have you started socializing those issues with your trustees and the other parties to the system that you are very heavily involved with? What do you see overall of your responsibility in that regard?

MR. JOHANSEN: We have even when I was the actuary because it has become an issue of substantial import to the DB community. We started at some very, very elementary stages talking about it. Obviously, it's a long conversation. It's a dramatic shift from where most DB plans have been. We also have this year a significant turnover in the board so a lot of those conversations will be postponed until we're probably going to have 40 percent and possibly 60 percent turnover in a 10-member board. So we're going to have to start from basics first and then continue that dialogue. But that is an important dialogue to continue.

MS. ANNA M. RAPPAPORT: I have a first question for Larry and a question for Steve. For Larry, you talked about the whole possibility of DC conversion as one of the ultimate risks facing state systems. What I wanted to ask you is what you can tell us about employee reaction or participant reaction to that in various states and how that helps us to understand what people know about the two kinds of plans that they are affected by.

MR. JOHANSEN: I can speak specifically about New York and California. One of the reasons Governor Schwarzenegger has postponed his agenda to convert the California plans to a DC plan was because of the significant and well-organized reaction of the public employee unions in California. New York has had various proposals floated here, there, and everywhere by various think tanks about conversion and, again, primarily the teacher unions in New York have taken the lead. But the well-organized collective bargaining units, especially in larger, more industrialized states, where the public employee unions are very well organized, they really understand the issue and are not at all ignoring it and are doing a lot of education. There are a lot of national organizations with respect to public employees that are keeping their members informed and alerted to the issue. So the members, by and large, at least the leadership understand the issues and are attempting to keep the members informed and are eager to keep the current structure the way it is.

MS. RAPPAPORT: I have a question for Steve. You talked about risks. One of the things that I have been wondering about is since we have different benefit structure changes, are there risks to participants that they might significantly lose benefits or that benefits might be distributed differently? Is that an issue that you all are looking at, or thinking about?

MR. GOSS: Well, we certainly do and we know there have been many instances in the past where people have different kinds of legislation; things like going to earning sharing possibilities. We saw that in the mid 1970s and the mid 1980s. They've developed sort of a culture where people talk about the winners and the losers, and we looked very specifically at different types of groups, different income levels, different marital statuses, and basically the whole concept of making those changes kind of fell down because after a while the legislators all said, this is a great idea, but let's make sure there are no losers, let's have a hold harmless. With two systems, everybody gets the higher benefit from the two, and that turned out, unfortunately, to be a little bit expensive and so we didn't end up going there. Ultimately, what we do here will be a big question, but people have so much of a sense that we're under financed and need to make changes. It's not clear whether there will be that same kind of sort of pull back.

FROM THE FLOOR: Two brief questions for Larry. Are the teachers covered by Social Security?

MR. JOHANSEN: In New York they are. That's not the case in all states, but in New York they are. By and large, those that were, individually, had the option in the 1950s, and there are still a few teachers who personally elected not to join Social Security, do not have Social Security benefits but, by and large, almost everyone has Social Security.

FROM THE FLOOR: For those left out teachers, will they get a supplemental?

MR. JOHANSEN: No.

FROM THE FLOOR: Not even the employer contribution.

MR. JOHANSEN: No.

FROM THE FLOOR: Secondly, given the well-publicized shortage of teachers in the United States, why do they offer an early retirement incentive?

MR. JOHANSEN: The logic escapes me. In fact, a couple of sessions ago, we were actually meeting with the Senate Finance Committee and the Assembly Ways and Means Committee and they were seriously discussing what they called a start-stop program, which was an early retirement incentive combined with an incentive to keep teachers teaching. The logic is there some place. I just can't understand where it is.

FROM THE FLOOR: In regard to what's going on in California, I think the main reason that Governor Schwarzenegger backed off is there was a lot of outcry from the unions, obviously. But his first proposal was fundamentally flawed in a political way because there was no reference to long-term disability and preretirement death benefits. And I think, ultimately, he viewed that as the political fatal flaw.

Now, meanwhile, I think it's a year or two overdue in support, the California State Association of Counties came out with a fairly remarkable statement of their view on January 24th, which ultimately was a mea culpa. They said, yes, there are excesses in the DB plans in this state, and they actually are on record as advocating four or five different reforms that, in essence, replace the DB structure with a different DB structure, and that's what I've advocated and am hoping it will help carry the day. But as far as a point of information, I think it's the long-term disability (LTD) issue and the preretirement death issue that I believe forced Governor Schwarzenegger to back off just for the time being.

MR. BANK: Thank you very much, everybody. Thanks to our wonderful panel.