



SOCIETY OF ACTUARIES

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BREAKING PROMISES

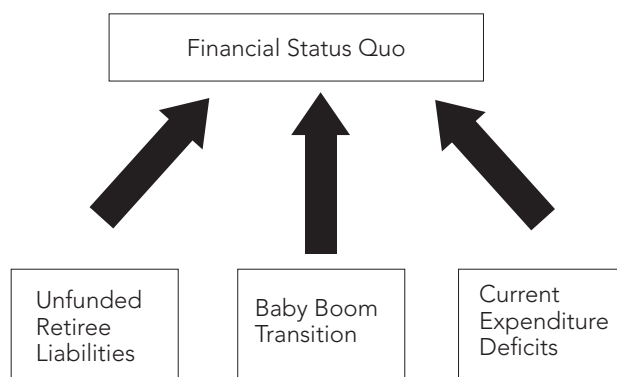
By Tia Goss Sawhney



Tia Goss Sawhney, Dr.P.H., FSA, MAAA, is director of Data, Analytics, and Research at Illinois Department of Healthcare and Family Services, Chicago, Ill. She can be contacted at tia.sawhney@illinois.gov.

Forces of unprecedented strength are set to fracture the financial status quo of our states, nation and the developed world.

At the broadest level these forces are current expenditure deficits, unfunded retiree liabilities, and the transition of the baby boom adults from productive labor years, within which they can contribute to paying governmental debts, to non-productive high health care cost years, during which they draw down (personal and) governmental assets.



Current expenditures and unfunded retiree liabilities have received most of the press. However, the aging of the baby boom generation is just as important and is possibly overlooked, in part, because it is unprecedented. This is the largest generation ever to enter retirement, in terms of both absolute size and also as a percentage of the total population. The baby boom generation is expected to live longer in their retirement years than any other generation has in history. The aging of the baby boom is also very possibly overlooked because of the natural exuberance of its members. Many baby boomers and other members of society incorrectly “wish the problem away” by saying that “they will work forever.” The reality is that bodies and minds degrade with age, and skills become obsolete. As a result, most people will not have lifetime employment. Many members of any aging population will want all available medical technology and services to assist in

their fight against aging, illness, frailty and, ultimately, death.

The relative strength of the individual forces varies somewhat depending upon where one resides geographically in the developed world and from which perspective one considers the problem. From the vantage point of those residing in the United States, we can look at the past decade. The U.S. government has funded two wars, expanded and added various programs, stimulated the economy and decreased taxes. This has resulted in a massive accrual of current expenditure deficits. Public pension and private pension funds have been underfunded for many years. The recent U.S. mortgage and housing market collapse and the concurrent recession have only made matters worse by increasing government deficits and decreasing the value of assets that support pension plans.

We have all read the articles that propose changes to address our various financial challenges such as Medicare, Medicaid, Social Security, federal deficits and state and local deficits as stand-alone problems. Considered separately, the changes necessary to solve each problem are staggering and inevitably elicit cries of protest from entrenched interests. Yet, solving any one of these problems individually is not sufficient. We need solutions that address all of these problems simultaneously.

There are no easy, pain-free technical fixes that will mostly preserve the status quo. A simultaneous solution is going to involve gut-wrenching changes, negotiated in the political arena. Major interests are going to be hurt as the status quo cracks. As a society and sub-societies within, we have overspent for decades and made forward-looking promises without proper consideration of how we will pay for them. The bills for the spending and promises are coming due over the next few years, just when our ability to pay the bills will be diminished by the exit of the baby boomers from the workforce. We are going to need to break promises.

Therefore, as a nation we must make tough political decisions, with full knowledge that some major interests are going to oppose attempts to break down the status quo. The defining question we must answer is how the pain will be shared among the major interests and individual citizens of the United States. So, who are the major interests? In my opinion, there are four major interest groups that can come up with the money that is missing from the financial equations of the next couple of decades:

Major Interests/Funding Sources

Taxpayers	Bondholders
Current and future retirees	Health care, social services, and education recipients

These are the core stakeholders of the status quo. Specific individuals, of course, often fall into multiple interest groups. Society will need to extract funding from the interest groups, in part, by breaking some of today's promises. The key questions are whether we do this in an orderly way that shares the pain or wait for a financial collapse, and whether we place the burden on a subset of the interests or share the burden among many interests.

Note that the interests in the chart above do not include waste, fraud, abuse, or other inefficiencies. Do these exist in government and private systems, and how large of a relative impact might they have? Yes, they exist, but collectively, they are not big enough to be the solution to the problems. In addition, they are not clearly established or easily eliminated. One interest's waste, fraud, abuse, or inefficiencies are often another interest's stream of revenue or services—a stream that they will fight to guard. Improved government efficiency is an admirable and necessary goal, but efficiency efforts are not a panacea for our problems.

Our society is faced with tremendously difficult choices. No one wants to break promises, especially politicians, irrespective of party. It is often much easier simply to do nothing. But delays push us toward the chaos of financial collapse, which will not be pretty. If anyone believes that collapse is impossible, I recommend that they read *This Time Is Different: Eight Centuries of Financial Folly*, by Kenneth S. Rogoff and Carmen M. Reinhart (2010). Devastating economic collapses, much bigger than the recent recession, do happen, and they can happen to us.

No one wants to have a promise that has been made to them broken, especially big, powerful interests. Consider the interests in the context of Illinois, a state flowing in red ink (full disclosure: I am a State of Illinois employee). Last year personal income taxes increased from 3 percent to 5 percent, which is a 67 percent tax rate increase. Another tax increase would not seem acceptable to the citizens of Illinois, especially in an election year. On the other hand, our budget is billions of dollars short and, even if we make our required pension contributions, our pension plans will still be desperately underfunded. Most state, local, and school employees are covered under union contracts that do not support retirement cuts. As I mentioned once, it is an election year, and union employees and retirees make up a large percentage of the voters. Given this apparent impasse, it may seem that the only other choice for the state of Illinois is to renege on promised bond payments. Bondholders, however, are the most influential members of our society, and we need their confidence for future borrowing. Reneging on promises to the bondholders in the form of defaults can only be made as a last resort.

Social services and education are areas where cuts could also occur. Education is not an area that many feel good about reducing; therefore, social services, including health care, would

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CONTINUED ON PAGE 14

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more likely be cut. Many of us might support the concept of cutting government-funded health care and social services with respect to ‘other people,’ but feel the cuts are unacceptable when they are cut with respect to ourselves, someone that we love, or just someone whose face we recognize. We, admirably, don’t have the societal tradition of passively letting people in our communities literally or figuratively die on the street, even if their condition is of their own making. If generosity toward family and fellow man is not sufficient reason to preserve these services, alternatively, consider the economic impact of health care and social service dollars being paid to businesses that very much want to preserve their revenue streams.

We have a huge problem. I believe in this country and in our ability to adapt and change. We must try to accomplish this in an orderly

fashion, rather than as a reaction to financial collapse, and we must start now. First, we must acknowledge that there is no panacea that will fix it all, with little pain for few people. Next, we must recognize that tomorrow will not be what we, individually and collectively, had planned. Finally, we must negotiate via our political processes how we can share the burden of change. Negotiation will require stepping beyond the firm lines often drawn by today’s political parties and politicians and avoiding the tendency to assign blame. We got into this together; we should get out of it together.

Undoubtedly, these changes will be hard, and the choices will be difficult; however, if we get started now, we have a fighting chance to not only avoid financial collapse, but to prosper in the face of adversity. Are we up to the task? 