

GRIDLOCK IN AMERICAN GOVERNMENT – A CHALLENGE FOR FUNDING OPEB

I'm pleased to have this opportunity to speak at the Bond Buyers' Third Annual Conference. I hope you will find my speech interesting and at least modestly enlightening.

[In the way of background, I am a strategy consultant working with both the private and the public sectors. My education includes a Masters degree in Actuarial Science (Georgia State University) and a Masters Degree in Statistics and Operations Research (The Wharton School, University of Pennsylvania). Over the last twenty years, I have written over 50 articles, essays, letters to editors, and speeches on the subject of fiscal malfeasance at all levels of American government.]

Nikita Krushchev, the Premier of the old U.S.S.R. in the 1950s and the 1960s, once said America will destroy itself from within. My talk today centers around the current gridlock and pending bankruptcy of government at all levels – Federal, state, and local – and will document that America is on a course to fulfill Mr. Krushchev's prediction.

Over the next few minutes, I hope to explain how the ratcheting up of debt by our elected leaders has set America on a course for Third-World status.

The current cash funding for government at all levels is 34.8 % of Gross Domestic Product. Despite record levels of taxation, Government at all levels is broke and has the attitude that your income should be reduced by whatever the government bureaucrats claim is needed to run our ever-expanding governments. And, as I will show, the Government's locked-in need for cash will consume a minimum of 58% of this country's Gross Domestic Product.

A little history :

The U.S. exported its inflation from the end of WW II until the mid 1970s....

- After WW II, 98% + of world's car and major-appliance production – set selling prices
- Only major purchaser of raw materials – set buying prices
- Quality was not an issue, since U.S. was the only source of goods
- Profits could grow, wages could grow, and government could grow – and boy did our government grow !
- But, the rest of the world was learning to compete with little, if any, fat in their economies

In today's global economy, the U.S must compete with countries that never enjoyed world domination and did not accumulate all the fat, legacy costs, and inefficiencies that accrued from world domination. Most U.S. corporations are busy trimming the fat. However, Federal Government and most of the 52,500 state and local governments are busy raising or planning to raise taxes and implementing "stealth" taxes in the form of unfunded liabilities, fines, fees and forfeitures.

America today is facing a challenge as big as the Cold War, and it will force the American people to make very difficult decisions. Our choices are :

1. We can sink into the economic abyss :
 - The state of Michigan is a fine example with \$51.5 billion in unfunded pension and health care liabilities (for just state employees – including the state’s k-12 public-school employees) -- \$39.3 billion for OPEB and \$12.2 billion for pensions.
 - The City of Detroit is another fine example with \$8.3 billion in unfunded liabilities -- \$8.0 for OPEB and \$0.3 for pensions (after funding \$1.4 billion in pension liabilities with trust certificates of participation) – for 22,500 employees and 15,000 retirees --\$221,200 in unfunded liabilities per participant.
 - The state of Illinois is yet another example with \$88.7 billion in unfunded liabilities -- \$48.0 billion for OPEB and \$40.7 billion for pensions.;
2. We can have an intergenerational war (future generations will not pay 70%+ of their income to the tax man);
3. We can start looking for stand-up tough-as-nails political leaders who are willing to fight the horrific battles necessary to get us back to economic viability; or
4. We can migrate through some increasingly-difficult combination of the first three choices.

To better understand the inevitability of one of these four scenarios, let’s look at the cost of government – at all levels -- in the U.S. since 1950.

(Note Assumption re : Growth of GDP ≈ Growth of UALs)

J. L. Boyle International

Government Spending / Cost of Government *
(\$ Billions)

	Year						
	1950	1970	1990	2000	2006	2007	2008 (Est.)
Federal Government Spending	\$ 44.8	\$ 195.6	\$ 1,253.1	\$ 1,789.2	\$ 2,655.4	\$ 2,730.2	\$ 2,931.2
Less: Transfers	(2.4)	(21.9)	(121.2)	(291.9)	(464.6)	(492.8)	(523.0)
Net Federal Spending	\$ 42.4	\$ 173.7	\$ 1,131.9	\$ 1,497.3	\$ 2,190.8	\$ 2,237.4	\$ 2,408.2
State and Local Spending	27.9	148.1	972.7	1,742.9	2,474.2	2,585.6	2,702.2
Total Government Spending Before Amortizing Unfunded Liabilities ("Cash" Cost)	\$ 70.3	\$ 321.8	\$ 2,104.6	\$ 3,240.2	\$ 4,665.0	\$ 4,823.0	\$ 5,110.4
Cost of Amortizing Unfunded Liabilities Over 75 Years **	N/A	N/A	N/A	N/A	\$ 2,898.7	\$ 3,050.6	\$ 3,210.0
Total Cost of Government ("True" Cost)	N/A	N/A	N/A	N/A	\$ 7,563.7	\$ 7,873.6	\$ 8,320.4
Gross Domestic Product ("GDP")	\$ 292.5	\$ 1,035.6	\$ 5,803.0	\$ 9,817.0	\$ 13,247.0	\$ 13,843.0	\$ 14,311.0
Cost of Govt. as a % of GDP							
w/o Amortizing Unfunded Liab.	24.0%	31.1%	36.3%	33.0%	35.2%	34.8%	35.7%
w Amortizing Unfunded Liab.	N/A	N/A	N/A	N/A	57.1%	56.9%	58.1%
Memo: Health Care as a % of GDP	N/A	7.2%	12.3%	13.7%	16.0%	16.6%	N/A
Pvt Health Care as a % of GDP	N/A	N/A	N/A	N/A	12.1%	12.6%	N/A

* Sources: Statistical Abstracts of the U.S. for 1950 through 2008, Budget for the U.S. for 2008, Social Security and Medicare Annual Reports, Financial Reports of the U.S. Govt., The Concord Coalition, Christopher Chantrell, and J.L. Boyle International

** Unfunded Liabilities (\$ Billion)	1950	1970	1990	2000	2006	2007	2008 (Est.)
Social Security	N/A	N/A	N/A	N/A	\$ 6,400.0	\$ 6,800.0	\$ 7,225.0
Medicare	N/A	N/A	N/A	N/A	32,400.0	34,200.0	36,100.0
Fed'l Employees and Veterans	N/A	N/A	N/A	N/A	4,500.0	4,800.0	5,120.0
State and Local Benefits	N/A	N/A	N/A	N/A	4,400.0	4,400.0	4,400.0
Total					\$ 47,700.0	\$ 50,200.0	\$ 52,845.0

As you can see, the “cash” cost of government has increased from 24 % of Gross Domestic Product (“GDP”) in 1950 to 31% of GDP in 1970 to 35% over the last two years. This tax burden, even as it stands today, may not be supportable in an increasingly competitive world.

The United States has literally become a beggar nation. Much of its life-sustaining “debt” – required to support our budget and trade deficits – comes from Japan, the Mideast, and countries that America had once considered “Third World” – most notably, China and India.

The private sector in America is trying to compete with a millstone around its neck – a millstone in the form of taxes, hidden taxes (unfunded liabilities, fees, fines, and forfeitures), tens of thousands of laws, and mandated paperwork requirements imposed by bloated and increasingly-needy out-of-control federal, state, and local governments. **And** the cost of government in America is getting ready to skyrocket.

The biggest problem is the unfunded liabilities. Although the “cash” cost of government has been relatively stable over the last 30 years, the “true” cost of government has been increasing at many times the rate of increase in GDP. This increase manifests itself in the form of unfunded liabilities for Social Security, Medicare, and for pensions and retiree-medical benefits for federal, state, and local government employees. As shown in the chart, today, these unfunded liabilities total \$50.2 trillion (\$6.8 trillion for Social Security, \$34.2 trillion for Medicare, \$4.8 trillion for Federal employees’ benefits, and \$4.4 trillion for state and local government employees’ benefits). These unfunded liabilities represent the debt that David Walker (the former Comptroller General of the U.S.), in recent cross-country tours, says will destroy America.

To put this into perspective, this \$50.2 trillion in unfunded liabilities is equivalent to almost 11X total annual government receipts. (Note : Total government receipts for 2007 equal approximately \$4,651 billion after deducting the estimated \$172 billion federal deficit from total government spending.)

Now, let’s assume this \$50.2 trillion of debt is amortized over 75 years at a borrowing rate of 6%. The resulting payment would add a whopping \$3.1 trillion per year to the cost of government – reflecting the “true” cost of government and adding 63% to the “cash” cost of government.

We now can look at the “true” cost of government. Once we include the \$3.1 trillion per year required to amortize government’s unfunded liabilities, the “true” cost of government in 2007 skyrockets from 34.8% of GDP to 56.9% of GDP. This “cost of government” will virtually destroy any chance America has to compete in the world – and will turn America into a financial pariah.

If we want to compare our “true” cost of government to the cost of government for Canada and Western Europe (where health costs are covered by government), we must add the cost of non-government-provided medical care. The total cost of medical care in 2007 in America was about 16.6% of GDP. An estimated 24% of medical costs are covered by government – leaving 76% to be covered by the private/individual sector. Thus, 12.6% of GDP would have to be added to current government expenditures to compare U.S. cost of government (including health care) to the cost of government for Canada and Western Europe – which brings America’s comparable “cash” tax take to a whopping 47.4% of GDP and “total” tax take to 69.5% of GDP.

It also is worthwhile to distinguish between the “haves” and “have nots”. While Social Security and Medicare are the largest unfunded government liabilities, the average monthly Social Security payment (for 53 million recipients) is only \$1,044 and the age at which unreduced benefits currently are available is 65 and 8 months.

By comparison, the average government employee is eligible for unreduced retirement benefits (defined-benefit pensions) well before age 55 – many with pension benefits of \$3,000 to \$15,000 per month. Many, if not most, government employees can obtain full retirement by their early 50s (“25 and out”), and some, with full retirement available after 20 years of service (e.g., Federal judges; military personnel; and employees of Tampa FL, Wayne County MI, and Taylor, MI), can retire with unreduced benefits while still in their 30s or early 40s. And the vast majority of these retirements for government employees are accompanied by gold-plated lifetime retiree-medical

benefits for employees, spouses, and dependents. A large percentage of these individual retirement packages are worth more than \$2 million at the commencement of retirement. As a matter of fact, if you are 45 and do not have \$2.5 million in the bank, you should have been a firefighter for the City of Ann Arbor, Michigan – because that’s the value of an Ann-Arbor firefighter’s pension and retirement-medical benefits after 25 years of service.

It is worth noting that the age-old argument that government workers are entitled to gold-plated benefit packages because their salaries are lower than the private sector no longer holds water. According to the Bureau of Labor Statistics (2005), state and municipal government employees enjoy wages equal to 142% of private sector wages (\$24.52 per hour vs. \$17.23 per hour) and Federal Government employees enjoy wages equal to 179% of private-sector wages (\$30.85 per hour vs. \$17.23 per hour). They also enjoy job security, gold-plated health insurance benefits, and early and well-funded pension and comprehensive retiree health care benefits. Such benefit packages are available nowhere in the private sector. These benefits result in an average benefit cost for local and state employees equal to 164% of average private-sector benefit cost (\$11.64 per hour vs.\$7.11 per hour) and a benefit cost for federal employees equal to 196% of private-sector benefit cost (\$13.97 per hour vs. \$7.11 per hour). This taxpayer-provided largesse is what has led to the unaffordable unfunded liabilities for state and local governments – and they are not sustainable.

The bottom line is that most government employees have the option of spending most of their adult lives in taxpayer-provided retirement enjoying retirement benefits vastly exceeding those available in the private sector. Again, these benefit levels are not sustainable – and the underfunding of pension and OPEB will wreak havoc on many states and municipalities long before the more widely discussed bankruptcy of Social Security and Medicare.

“We [Americans] used to say the system is broken because it won’t respond until there is a crisis,” said David Rothkopf, author of “Running the World.” Now, the system is so broken, it “can’t even respond to a crisis !”

When the unfunded liabilities for OPEB are identified and combined with the underfunding for pensions, the numbers will be staggering. Many states and local municipal entities will be forced to significantly raise taxes, significantly reduce services, restructure, enter into receivership -- or some combination of the four.

The need to reduce the government debt load in America to a level that will not lead to an intergenerational war will require that we elect tough and brave leaders who will :

- Challenge the Baby Boomers’ belief that it’s acceptable for their taxpayer-provided retirement benefits to be paid by future generations of taxpayers (who did not get to vote on the debt they will be forced to pay);
- Challenge the AARP’s (American Association of Retired People) belief that retirement age should remain constant despite increases in life expectancy (from 61 in 1936 when Social Security was enacted to 78 today);
- Challenge the government-employee unions’ belief that taxpayers should provide government employees with wages and gold-plated benefits that are not affordable in the private sector;
- Challenge the entrenched bureaucrats who occupy State Houses, City Halls, and school-district offices across America who believe that their fiefdoms must be sustained at all cost; and finally
- Fight for solutions that actually will reunite future generations of taxpayers with some semblance of hope for economic prosperity.

Absent the willingness to fight these battles, funding OPEB will be an insurmountable cause but then so will salvaging America’s economic future.

John Boyle, Principal
J.L. Boyle International
Ann Arbor, MI
734.665.9514 x220
March 17, 2008