The Financial Planning Implications of an Aging Population and Budget Deficits

by William Jahnke

William Jahnke is chairman of Comprehensive Wealth Management in San Francisco, California. His e-mail address is lbforty@aol.com.

When developing a financial plan, the planner should consider the prospects for future market returns and the cost of funding the client's targeted standard of living over the client's planning horizon. Armed with market return expectations, earnings prospects, and asset holdings, financial planners can evaluate the prospect for meeting future consumption goals given alternative savings plans and investment strategies. This article addresses some of the issues that will affect both future investment returns and the cost of living.

The Challenge

Director of the CSIS Global Aging Initiative, Richard Jackson, in his testimony before the House of Representatives' Committee on Ways and Means on May 19, 2005, observed, "The aging of America promises to usher in one of the most fundamental social transformations that our nation has ever experienced. Over the next few decades, it will restructure the economy, reshape the family, and redefine our cultural self-image. Perhaps most fatefully, it will push a growing share of the nation's resources towards an ever larger elderly population whose entitlement to public benefits has come to rest on age alone."

According to the General Accountability Office (GAO), by 2050 there will be one elderly dependent for every three people of working age. A longer and healthier life span is a great societal development, but it also poses a challenge. The process of population aging will affect both the size and composition of government budgets. Greater longevity requires more funding for pensions, health care, and social services for the elderly. According to the GAO, federal spending on Social Security, Medicare, and Medicaid is projected to grow from 8 percent of the economy today to 19 percent by 2045. To pay for these expanding social programs, the government ultimately must, in some combination, raise taxes and reduce benefits.

In the current environment of 3 percent- plus annual growth in gross domestic product, low interest rates and contained inflation, there is little incentive to raise taxes or cut benefits. This is especially so as foreigners have been very willing to finance our budget deficit. Some financial experts see nothing wrong with trading paper claims on the United States for consumer goods. Other experts see the current account deficit, which is running at 6 percent of GDP, as worrisome. The longer the United States runs large deficits in its current account, the larger the national debt held by foreigners as a percentage of GDP and the higher the interest payments to foreigners. At some point foreigners will become less inclined to finance our budget deficits for fear of devaluation or due to the financial demands of their own aging populations. An improvement in the U.S. account deficit accompanies downward pressure on the United States and upward pressure on interest rates. A decline in the dollar will lift the prices of foreign goods and put downward pressure on the growth rate in the standard of living (a combination of growth in the number of hours worked per capita and productivity growth). Anything that reduces the number of hours worked per capita, or reduces the improvement in productivity of those hours, reduces the standard of living. According to GAO projections, the aging population will reduce the number of hours worked per capita by 40 percent by 2050, which places a large burden for improving the standard of living on productivity growth. The good news is that technological advances in information processing, business control systems, telecommunications, medicine, and in other areas are positive factors supporting future productivity gains. But will it be enough?

The Budget Shortfall

The aging population poses a real problem in reining in future budget deficits. One problem is the unfunded liabilities of Social Security and Medicare. Payroll contributions for Social Security and Medicare hospitalization exceed the cash outlays. Taxes collected for these programs are pooled with other taxes collected by the U.S. government to fund not only Social Security and Medicare, but its entire budget. It is this pay-as-you-go system that will break down when cash outlays exceed Social Security and Medicare revenues. While the unfunded liabilities for social programs are amassing, there is no feasible way to pay for future benefits other than future tax increases or the reduction of benefits. Debt creation is not a solution—it merely defers even higher taxes.

Social Security estimates that its collections will shift from being a positive contributor to the U.S. budget to a drain on the U.S budget around 2018. The cash deficit to Social Security is then expected to grow rapidly. While Social Security funding is a serious problem, the funding of Medicare is an even bigger long-term problem. As shown in Table 1 prepared by the GAO, unless government raises taxes or cuts benefits, or both, by 2045 the total spending of the U.S. government will (1) expand from 20 percent to 53 percent of GDP, (2) interest payments on the national debt will rise from 1.5 percent to 24 percent of GDP, (3) the deficit will grow to 35 percent of GDP, and (4) the public debt will grow to 484 percent of GDP! The GAO estimates the present value of the open-ended unfunded liabilities of the U.S. government to be $79 trillion!

Table 1: U.S. Budget Items as a Percent of GDP

Discretionary Spending Grows with GDP and All Expiring Tax Provisions Are Extended

	Social Security	Medicare	Medicaid	Interest	Other Spending	Total Spending	Revenue	Unified Deficit	Public Debt
2005	43	2.4	1.5	1.5	10.5	20.3	17.5	–27	37.7
2015	47	3.3	2.0	2.8	9.9	22.8	17.4	–54	59.4
2025	61	5.0	2.1	5.2	9.9	28.1	17.4	–10.7	109.6
2035	72	6.4	2.5	11.2	9.9	37.3	17.4	–19.9	234.0
2045	87	7.4	3.0	23.6	9.9	52.6	17.4	–35.2	483.9

Source: GAO's August 2005 analysis.

As alarming as the GAO's simulation is, it has been criticized as being overly optimistic. The critics point out that other spending, which includes all of the discretionary items in the budget, will be hard to contain; the projected growth in Medicare appears unrealistically low at 1 percent above GDP growth; the return of the national savings rate to its historical norm appears optimistic; and the rate of inflation and the interest assumption could turn out be underestimated. All of this darkens the picture even further.

End of a 'Free Lunch'

In recent years, the U.S. budget deficit and investment in the United States have been financed by foreigners, resulting in a large and growing account deficit. In 2005, foreigners will trade roughly $2,000 of goods and services for every man, woman, and child in the United States in exchange for a $600 billion investment in U.S. Treasury debt and other claims on U.S. assets. The U.S. government has not put a stop to this mercantilist practice as it serves our short- term interests of funding our deficit, providing investment in the United States where our savings rate is close to zero, flooding the United States with low-priced goods, and keeping interest rates low. The cost is a loss to our manufacturing base and a growing indebtedness to foreigners. Foreign countries support the practice as a means of accelerating their developing economies.

The growing flood of artificially low-priced goods and investment into the United States pushes up the recorded standard of living. When the flood retreats, there will be downward pressure on the standard of living. The large foreign investment in the United States, along with the loose monetary policy of the Fed, have promoted asset bubbles in the U.S. real estate and financial markets. While the current generation of consumers is benefiting, the number of employed in the United States is not keeping up with the growth in the population, real wages are falling behind productivity gains, and the indebtedness to foreigners is growing.

The ability of foreigners to finance our debt will diminish as many of the developed countries and China face even greater demographic challenges. This implies a weakening of the dollar, and upward pressure on prices and interest rates, at the same time the higher tax rates required to fund a ballooning U.S. budget sap the consumer. The end of the "free lunch" will come as a shock to many in the United States who have taken too much for granted and have not provided adequately for their retirement. At some point, instead of being a net importer of goods, the United States will become a net exporter of goods as foreign investors begin enjoying the fruits of their investment in the United States.

Implications for Financial Planning

Clients should be encouraged to clean up their balance sheets, save more and place less reliance on future appreciation of their homes. At this time, a larger-than-usual allocation to short-term bonds and investments that benefit from a weakening U.S. dollar is attractive from a risk/reward perspective. With high current asset valuations, rising short-term interest rates, and a flattened yield curve, the opportunity cost associated with this scenario does not appear to be very large. Stocks, long bonds, and real estate offer modest return expectations with high levels of downside risk.