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# VALUE IN NORTHEAST OHIO

June 2010

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## Age of Entitlement

As most of you know we have federal deficit problems that sprawls out as far as the eye can see. The deficits for this year and next are largely a function of the recession. As we move out in time, the projected deficits are caused by ever increasing entitlement spending, primarily Social Security and Medicare.

The question is what can be done about them? Generally there are two answers; tax more or spend less.

First I want to look at taxing more. Clearly increasing taxes will put a drag on economic growth, particularly when they are initially implemented. Given the tax proposals included in the Healthcare Bill and the expiration of the Bush tax cuts, the tax burden on the highest income earners will rise dramatically as it is. Additional taxes to fund ever increasing entitlements will further impede growth.

I personally don't mind the expiration of the Bush cuts as they did not provide the stimulus promised, but did contribute to the expanding Federal deficit. But like many things a little may be good, but a lot may not be better. I believe that overburdening even those that can afford to pay more taxes will have adverse consequences for the economy as a whole through lower savings and spending in the private sector.

On the spending side of the budget there are many ways to adjust it, but I would like to focus on two general methods. The first is reducing benefits to current recipients and the second is reducing benefits to future recipients.

By and large cutting current recipients is both difficult politically and practically. Politically it is impossible because senior citizens have very high turnout rates. It is often said that Social Security is the third rail of politics. It is offensive to many people, including myself, because current recipients are poorly positioned to respond economically. Most cannot go back into the workforce.

There have been adjustments made in the past. Social Security benefits were not taxable until 1984. Once benefits started being taxed there was a de facto means test put in place. There have also been proposals to adjust how cost of living increases are computed as it has been argued that the current formulas exaggerate the true inflation rate and result in excessive adjustments.

The problem with means testing is that it moves the Social Security program further from being some sort of pension and closer to being a conventional welfare program. Since most people think they have



## Age of Entitlement, Continued

contributed toward their benefits, as opposed to just paying another form of tax, this would be a difficult sell to the public. Curtailing cost of living adjustments may be more possible if it were presented properly, but would also be very difficult politically.

Reducing benefits to future recipients may be the easiest to do. The method that I prefer is to increase the age at which one qualifies for a level of benefits. If is gradually phased in, most people affected by the change will be able to economically adjust to the new reality.

For example on December 31, 2011 people would have to wait an additional month to collect full benefits for each month until they qualify for full benefits up to a maximum of 5 years. People who were planning to retire in January 2012 would have to wait until February 2012. Those people would most likely work the additional month. Those turning 65 in December 2016 would have the most difficult pill to swallow. As birthdays move forward from 1952 the

ability to adjust increases.

The effect this would have is to flatten out the rate of benefit expansion and increase the amount of taxes collected from people working longer. The burden of the change is spread out over a very large population in a fashion that puts fewer people in financial jeopardy and would help expand the labor force which would help mute inflation. I would have Medicare benefits similarly affected.

There is no simple painless solution to the fiscal box we are in. The sad thing is that this has been apparent for decades. What could have been relatively painless solutions 20 years ago are now much more difficult. Continued inaction by Congress and the President is only making the ultimate resolution more traumatic for those whose shoulders it falls upon.

Voters should press Congressional candidates for how they propose respond to the situation and not accept evasive answers alluding to commissions, blue ribbon panels or study groups.



## European Entitlement

World financial markets are being roiled by fiscal crises that are largely caused by European retirement systems.

The average age for retirement in Greece is currently 61 years of age. Their austerity plan will raise that to 63.

Germany increased their retirement age to 67 from 65.

In France 57% of people polled oppose increasing the retirement age from 60 to 62 and strikes are threatened, but this is the main priority of the Sarkozy regime.



## European Entitlement, Continued



PriceWaterhouseCoopers did a study for the United Kingdom and concluded that the retirement age there needs to increase to 70 years in order for pension benefits to be linked with earnings. Otherwise there will be increased usage of means testing and/or rising tax burdens to pay for the system. The current proposal of increasing the retirement age from 65 to 66 by 2020, 67 by 2036, and 68 by 2046 did not go far enough.

The Spanish are increasing their retirement age from 65 to 67 with phases starting in 2013 and becoming fully effective in 2025. Spanish demographers projected that the population of people over 64 years old will double in the next 40 years and that workers

will be a little over half of the population with the remainder being minors and retirees.

Italy requires that men attain the age of 60 and contributed to *Previdenza Sociale* for 35 years and women attain the age of 57 and contributed for 35 years. Recently enacted reform measures will have this rise in stages to age 61 and 36 years of contributions by January 1, 2013.

The debt crisis is causing significant anxiety, but it is also spurring reform that seems only possible to achieve in a crisis situation.

## Government Employee Retirements

Although the European nations are beginning to show a loss of confidence in their debt due to the unsustainable nature of their retirement systems, in this country our public employees receive benefits that are even more generous and thus less sustainable.



The Federal Employee Retirement System (FERS) covers civilian employees. For the Basic Benefit employees pay 0.80% of their gross pay. After 30 years of service an employee can receive benefits of approximately 30% of their pay (its actually a more complicated formula but I don't want to get into boring details.) This is in addition to being part of Social Security.

Let's look at the benefits. Assuming a \$100,000 salary, having reached 62 years of age, 30 years service and a 1/1/11 retirement date the Social Security benefit will be

\$1,594 per month. The FERS benefit will be \$2,500 per month.

I performed a calculation assuming 5% average annual salary increases (which includes both cost of living and promotions), a 6% rate of return on pension investments, and working 30 years, and 25 years of retirement benefits and not even indexing those benefits for inflation. The conclusion I came up with is that it would take 10.2% of the employees salary to fund the pension under FERS of which the employee contributes 0.8%, the other 9.4% comes from Uncle Sam. There are few private employers that treat their employees so well.

The military pension program also is extremely generous.. Basically a person can get 2.5% of the average of the highest 3

## Government Employee Retirements

years of pay multiplied by the number of years of service. There isn't any retirement age requirement. According to Military.com a person can start drawing a pension as early as age 37.

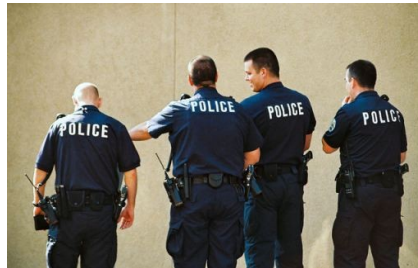
It's not just the Federal government that has very generous retirement plans. Ohio gives 2.2% of "final average salary" times the number of years service for the first 30 years plus 2.5% for each year beyond 30 for regular employees. Law enforcement gets 2.5% per year of service and can retire at age 48. The employee currently pays in 10% of their wages and the employer pays 14%. Unfortunately it is becoming apparent that this funding formula is as inadequate as the Greeks'.

Many California law enforcement agencies have a 3% @50 plan where a worker gets 3% times the years of service and can retire starting at the age of 50..

In New York retirement starts at 55 with 2% for each year of service.

Each of these states has a large budget deficit and are currently enjoying bailouts from the Federal Government. Those bailouts will be as unacceptable in short time to the rest of the U. S. as the EU's bailout of Greece is to the Germans. It's unlikely that taxes rates can be raised because Ohio and California are already losing population, and New York, California and Ohio are among the highest taxing states in the country.

The hard fiscal medicine that has begun to take place in Europe will need to come stateside pretty soon.



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