FACING FACTS QUARTERLY

A Report about Entitlements & the Budget from The Concord Coalition

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The Other New Health Entitlement

With the nation facing record budget deficits as far as the eye can see, this is no time to launch large new entitlement programs. Yet the health-care reform legislation now taking shape in Congress would create not just one, but two. Everybody knows about the first entitlement—the new federal subsidies to help individuals and families without employer coverage purchase health insurance. The second entitlement, which has found its way into both the House and Senate bills without attracting much public debate or scrutiny, is a new long-term care program: the Community Living Assistance Services and Supports program, or CLASS Act.

The CLASS Act would establish a voluntary public long-term care insurance program, ostensibly financed by beneficiary premiums, that would be open to any active worker (in the Senate bill) or any active worker and his nonworking spouse (in the House bill). Cash benefits would be payable after a five-year waiting period to participants with a substantial cognitive impairment or at least two to three ADLs—that is, limitations on activities of daily living such as dressing, bathing, or cooking. The primary purpose of the program is to assist with home-care expenses, but benefits could also be used for institutional care.

With Congress already coming under fire from budget hawks for a health-care reform plan that focuses more on benefit expansion than cost control, one wonders why it would tack on yet another potentially costly entitlement. The answer in large part lies in the surreal rules that govern budget scoring. Because the CLASS Act premiums would be collected immediately but benefits would only be paid with a lag, the program would generate large surpluses over the next ten years—which are the only years that show up in the CBO's budget window. These surpluses thus count as an offset to the cost of health-care reform. Incredibly, Congress is paying for one new entitlement by collecting premiums for another.

To be sure, proponents insist that the CLASS Act will not cost taxpayers a dime. But in fact it is guaranteed to become a large and growing burden on the budget.

To begin with, the self-financing claim relies on the financial alchemy of trust-fund accounting. As with Social Security FICA taxes, the fiction is that CLASS Act premiums that are collected today can be saved to pay for benefits due tomorrow. They can't be. Whatever the cost of the program turns out to be, a large share of that cost will inevitably fall on future taxpayers.

Then there's the CLASS Act's flawed design. Because the program is voluntary and will be prohibited from taking health status into account, it will inevitably attract disproportionate numbers of sicker and more costly participants. This adverse selection will drive up costs and premiums—and as they rise, so will public pressure for a government bailout. Because the program pays for a panoply of desirable home-care benefits, but fails to provide for adequate oversight, it also invites moral hazard. Even as adverse selection drives up costs and premiums, so will induced demand.

The vulnerability of American families to rising long-term care costs is a legitimate policy concern. But the CLASS Act, with its budget gimmickry and dangerously careless design, is not the answer.

ISSUE IN FOCUS
by Neil Howe and Richard Jackson

Budget Gimmickry

Let's start with the gimmickry. Premium collections under the CLASS Act would begin in 2011, but no benefits would be paid until 2016. As of 2019, the end of the ten-year budget window, the CBO projects that annual premiums will still exceed annual benefits by more than two to one. As a result, the program will generate substantial near-term budget savings that can be used to offset the cost of health-care reform. According to the CBO, the Senate version of the CLASS program would generate budget savings of $72 billion between 2010 and 2019 while the House version would generate savings of $102 billion.

Perversely, the larger near-term budget savings of the House version, with its extra benefits for nonworking spouses, is due to its larger long-term cost. The more generous the CLASS program becomes, the higher the premiums have to be set—and (presto!) the more affordable health-care reform becomes.

The same premiums of course cannot be spent twice—once to offset the cost of health-care reform and again to pay for CLASS Act benefits. That's where the alchemy of trust-fund accounting comes in. Even as the premiums are spent, they will be credited to a new government trust fund, where they will accumulate along with interest until, sometime in the mid-2020s, annual benefit payments exceed annual premiums and the trust fund will be tapped.

Proponents of the CLASS Act make a big deal of the fact that the program must, by law, be actuarially balanced—meaning that the present value of benefits cannot exceed the present value of premiums over the next 75 years. But actuarial balance says nothing about fiscal sustainability. A private insurance company can prefund benefits, but the federal government, which operates on a strictly cash-in/cash-out basis, cannot. Just as with Social Security, what's an asset to the CLASS Act trust fund is a liability to the rest of the budget. When the time comes to redeem the fund's Treasury IOUs, taxes will have to be raised, other spending will have to be cut, or the government will have to borrow more from the public.

It makes no difference that the CLASS Act prohibits the use of any "taxpayer funds" to pay for benefits. The program's financing structure inevitably creates a large new unfunded taxpayer liability—even as trust-fund accounting allows proponents to maintain the pretense that the program is self-financing. Congress could have proposed to move the CLASS program entirely out of the budget and invest its premiums in private securities. But genuinely funding the program would of course have eliminated the near-term budget windfall that Congress needs to pay for health-care reform.

A Flawed Design

This kind of budget gimmickry is irresponsible enough, but the CLASS Act's flawed design sets even more alarm bells ringing.

First, there's the danger of adverse selection and runaway premium costs. A responsible plan would seek to minimize this danger in one of two ways. On the one hand, it might require some form of underwriting—that is, it might take people's health status into account in setting their premiums. On the other, it might mandate participation, thereby guaranteeing a large risk pool in which there are always enough low-risk enrollees to cross-subsidize the high-risk ones. The CLASS Act sidesteps these difficult policy choices. There is neither underwriting nor a mandate—a surefire recipe for adverse selection.

Both the American Society of Actuaries and the Center for Medicaid and Medicaid Statistics' Office of the Actuary have warned that the CLASS Act's design may render it unsustainable. As disproportionate numbers of high-risk individuals join, costs and hence premiums will begin to rise. Disproportionate numbers of low-risk individuals will then begin to drop out, further driving up premiums. In insurance parlance, this is called a "death spiral"—and once it begins, the only way for the plan to avoid collapse is for Congress to provide massive subsidies. Congress will certainly be tempted to do this. No legislator will want to be blamed for allowing user "premiums" to be wiped out.

Then there's the danger of moral hazard and the ballooning numbers of benefit claims. If the CLASS program's coverage were limited to institutional care, moral hazard would not be a major concern. Nobody wants to check into a nursing home unless they absolutely have to. But the CLASS program covers a vast range of desirable home-care benefits—not just nurses aids, but counseling, home remodeling, "accessible" transportation, and respite benefits for currently unpaid family caregivers. Since just about anyone who can possibly qualify will want to collect these benefits, there is a large risk of induced demand—or what is sometimes called the "out of the woodwork" phenomenon.

To prevent fraud and keep costs down, benefit claims will have to be carefully reviewed. The problem is that the legislation caps administrative expenses at no more than 5 percent of premiums. According to the American Society of Actuaries, claims review alone often costs more than this in private long-term care insurance plans—and administrative expenses would also have to cover the cost of enrollment, premium collection, and marketing, the last of which is especially important if the CLASS program is to stand any chance of broadening its risk pool and avoiding adverse selection.

Legislative Malpractice

With the budget deep in deficit, new war costs looming, and Congress struggling to find the fiscal resources to pay for the President's core health-care reform agenda, the Concord Coalition does not believe that this is the time to enact a new long-term care entitlement. But if Congress does enact one, at the least it should ensure that it is soundly designed and honestly paid for.

As it stands, the CLASS Act embodies the worst sort of budgetary and actuarial chicanery. It pretends that premiums can be double-counted both as a near-term budget offset and as long-term savings. And it violates the most basic principles of sound insurance design by failing to provide for either underwriting or a mandate and by underfunding the oversight needed to detect fraud. The losers will be today's younger taxpayers, who will have to bear the ultimate cost. Congress' willingness to engage in this kind of legislative malpractice helps to explain why so many Americans believe that government does not have the interests of future generations in mind. ■

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Federal Budget: Debt & Deficits	Bil $	%GDP
Gross Federal Debt: End of November 2009	$12,057	85.3%
Statutory Debt Limit	$12,104	NA
Publicly Held Debt: End of November 2009	$7,712	53.4%
Debt Held by Foreigners: End of September 2009	$3,497	54.5%*
Budget Balance in FY 2009	-$1,417	-10.0%
Budget Balance in FY 2010: CBO Baseline	-$1,381	-9.6%
Budget Balance in FY 2010: Concord Baseline†	-$1,,447	-10.0%
10-yr Budget Balance: CBO Baseline	-$7,137	NA
10-yr Budget Balance: Concord Baseline†	-$14,447	NA
Budget Balance in FY 2019: CBO Baseline	-$722	-3.4%
Budget Balance in FY 2019: Concord Baseline†	-$1,940	-9.2%

Fed. Outlays: FY 2009	Bil $	% Budg
Social Security	$683	19.4%
Medicare	$430	12.2%
Medicaid	$251	7.1%
Other Entitlements	$813	23.1%
Domestic Discretionary	$584	16.6%
Defense	$663	18.8%
Net Interest	$191	5.4%
Offsetting Receipts	-$93	-2.6%
TOTAL OUTLAYS	$3,522	100%
TOTAL REVENUES	$2,105	NA
TOTAL DEFICIT	-$1,417	NA

*Percent of publicly held debt. †Concord's "plausible baseline" assumes that discretionary spending grows with GDP, that operations in Iraq and Afghanistan are gradually scaled back to about one-third of today's level, and that all expiring tax provisions are extended with AMT relief.

GAO's Long-Term Budget Scenario*

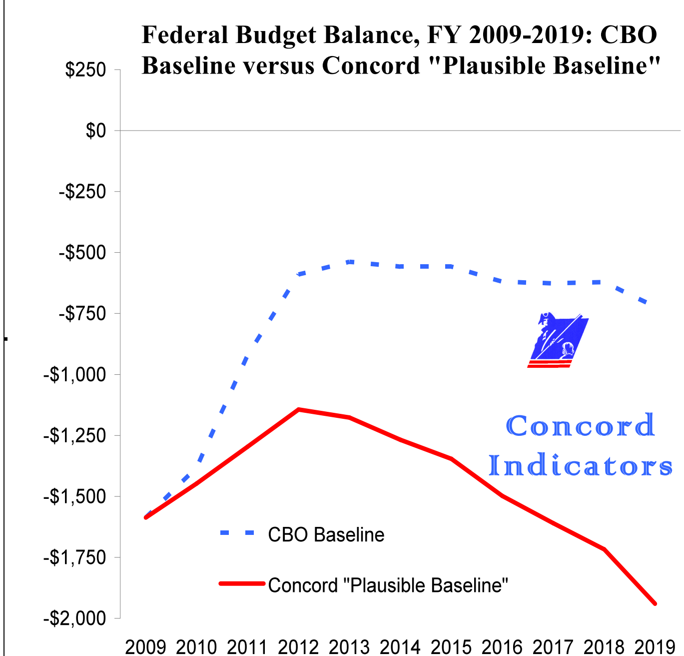
(% GDP)

	1962	1980	2000	2020	2040
Discretionary	12.7%	10.1%	6.3%	8.6%	8.6%
Entitlements*	4.9%	9.6%	9.8%	13.6%	18.6%
Net Interest	1.2%	1.9%	2.3%	5.3%	14.7%
Revenue	17.6%	19.0%	20.9%	17.5%	18.3%
Budget Balance	-1.3%	-2.7%	2.4%	-10.1%	-23.7%
Pub Held Debt	43.7%	26.1%	35.1%	110.5%	300.6%

*GAO March 2009 update. Assumes discretionary spending grows with GDP and all expiring tax provisions are extended; entitlements are net of offsetting receipts.

National Savings (% GDP)	2008	2nd QTR
Personal Savings Rate*	2.7%	4.9%
Net Private Savings	4.6%	6.3%
State & Local Savings	-0.3%	-0.2%
Federal Savings	-4.5%	-9.1%
Net National Savings	-0.2%	-3.0%
Current Account Balance	-4.9%	-2.8%
Intl Investment Position	-24.0%	NA

*Percent of disposable income.



NOTE: Concord's "plausible baseline" assumes that discretionary spending grows with GDP, that operations in Iraq and Afghanistan are gradually scaled back to about one-third of today's level, and that all expiring tax provisions are extended with AMT relief.

Social Security & Medicare*

	Social Security	Medicare HI	Medicare SMI	Social Security & Medicare
Payroll Cost Rate in 2009	12.4%	3.6%	3.0%†	19.0%†
Payroll Cost Rate in 2040	17.0%	7.6%	7.7%†	32.3%†
75-Year Unfunded Liability (PV $)**	$7.7 TRILLION	$13.8 TRILLION	$24.4 TRILLION	$45.9 TRILLION
Infinite-Horizon Unfunded Liability (PV $)**	$17.5 TRILLION	$36.7 TRILLION	$52.5 TRILLION	$106.7 TRILLION
Date of First Cash Deficit	2016	2008	NA	NA
Date of Trust-Fund Insolvency	2037	2017	NA	NA
Cash Deficit in Year of Insolvency (2009 $)	$-338 BILLION	$-63 BILLION	NA	NA

*Data are from 2009 Trustees reports. **Figures are not offset by trust-fund assets. †Figures for Medicare SMI are net of beneficiary premiums. Although SMI is not financed with payroll taxes, net expenditures are shown here as a percent of payroll to facilitate comparison.