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Intelligent Money

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Special Notes of Interest:

- Medicare pays for less than 1% of the costs of long-term health care
- By the year 2025, the Urban Institute projects that Medicare beneficiaries will spend 28.6% of their income on uncovered medical expenses.

Current thinking from Haven Financial Advisors

Retirement in the Shadow of Medicare Reform

There has been a lot of legislative posturing in Washington regarding Medicare since the last presidential election. Both major presidential candidates endorsed some general form of prescription drug benefit. Last year, The House of Representatives passed the Medicare Modernization and Prescription Drug Act of 2002 (H.R. 4954), with limited Medicare reform provisions. The Senate, however, did not enact any reform legislation.

Prescription drug coverage is one of the biggest gaps in Medicare. It also promises to be one of the largest cost centers to tomorrow's senior citizens. The rate of increase in the cost of prescription drugs is far outpacing inflation – 10.1% annually. Of course, most of these costs will be concentrated among seniors. By 2012, Senior citizens will be paying nearly $500 every month for medicines not covered by Medicare under the current arrangement. The table below, prepared by the Congressional Budget Office last year, illustrates the problem.

As a financial planner, I have become progressively more aware of the financial liability that prescription drugs will impose in retirement. The self-employed have an unfortunate tendency to discount medical expenses under the mistaken assumption that they will be underwritten by Medicare. Many prospective retirees of larger companies anticipate that retiree medical benefits will offset this cost - a dangerous assumption. Unlike pension benefits, retiree medical benefits are not vested. In fact, the trend in Corporate America is to downsize medical subsidies for both active and retired employees.

This year employees are likely to pay 25 % of their health insurance premiums offered as an employment benefit according to UBS Warburg. Employees only paid 17.5% of premiums in 2001! Employer financial support will shrink to less than 10 % of total retiree medical expense by the year 2031 under plan provisions already adopted by many employers according to the consulting firm Watson Wyatt. These same plans in place today typically pay more than 50

	Spending per Medicare Beneficiary (Dollars)		Average Annual
	2003	2012	Change
Outpatient Prescription Drugs[a]	2,439	5,816	10.1%
Medicare Benefits[b]	6,775	10,794	5.3%
GDP per Capita	37,900	55,800	4.4%

a) Total spending per beneficiary on outpatient prescription drugs not currently covered under Medicare , regardless of payer
b) Benefits and administrative costs per beneficiary under the Hospital Insurance and Supplementary Medical Insurance programs.

Medicare Reform (continued)

percent of total retiree medical expenses!

The need for prescription drugs is not uniform among seniors. A large share of that spending pays for the treatment of chronic conditions, such as hypertension, cardiovascular disease, and diabetes. A comparatively small cohort bear a disproportionate burden. There is now a political consensus to underwrite the cost of these medicines. The devil is in the details, though.

Philosophically, the Republican Party has promoted the notion of government subsidies to seniors requiring prescription drugs. The Democrat opposition has focused its reform on an expansion of Medicare to include outpatient medicines. Pharmaceutical companies fear price controls under the Democrat plan. Either innovation would be expensive to underwrite.

Most recently, President Bush proposed a prescription drug benefit that would be conditioned on patient participation in a managed care program rather than Medicare's traditional fee-for-service arrangement. Congressional reaction has been unenthusiastic. There is strong sentiment to preserve seniors' right to choose their own doctors. Given the success of Republican candidates in the mid-term election in November, the pendulum has probably shifted in favor of the overall Republican preference for subsidies rather than price controls. If a bill is to pass both houses of congress, it is likely to offer the subsidies preferred by Republicans but will not force patients into HMOs to obtain these benefits.

The price tag for a prescription drug benefit would be enormous. The moribund H.R. 4054 passed in the Republican house last year would have cost $350 billion over the next 10 years. The Democrat opposition wanted a program costing $600 billion. With a war in Iraq looming, legislation involving huge increases in domestic expenditures may be relegated to the back burner.

The bottom line here is not to count on government subsidies. It is imperative that you provision for significant medical outlays in retirement. Let's run some numbers. Today, Medicare pays for about 53% of the medical expenses of seniors. That means $6000 in annual expenses are *not* covered. However, those expenses are most heavily concentrated in the area of prescription drugs and long-term health care. The cost of the former is increasing about 7% faster than inflation while the latter is increasing about 3% faster. Taken together, these health care liabilities will grow faster than any reasonably diversified investment portfolio.

The cost of health care is akin to the cost of a 4 year education at an elite private university. In other words, the best way and perhaps the only way to provide for your health care is to start early.

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"Today, Medicare pays for only about 53% of the medical expenses of seniors"

Other Legislative Developments

The President surprised a lot of people with his proposed overhaul of our pension system this month. While dividends garnered most of the attention, Bush's budget proposal included a sweeping overhaul of the alphabet soup of retirement savings plans. They all would have been replaced by 3 powerful savings vehicles.

Unfortunately, he did not consult with congressional leaders prior to its public release. Many were caught by surprise and the retirement savings package is probably dead on arrival. Too bad. Saving for retirement might have become more widespread if it were simplified.

Congress still seems committed to some measure of pension reform. It looks like the scheduled increase in contributory limits to IRAs and 401(k)s will be accelerated. For example, allowable contributions to IRAs may ratchet up to $5000 this year and 401(k) deferral limits may similarly be increased to $15,000.