COMMENTARY *By Gerard Smedinghoff*

First, Let's Fire All the Actuaries

There are some members of Congress who would like us to imagine a world with a flat tax rate: no deductions, no exclusions. It's idyllic, it's simple, and six out of every eight insurance actuaries are out of a job.

A quick check of the actuarial directory reveals that there are roughly seven times as many life and health actuaries as there are property and casualty (P/C) actuaries. Outside of commercial insurance (most of which is P/C), most people have four basic insurance needs: home, auto (both P/C), life, and health. One might think that life and health insurance needs (and demand for actuaries) should be approximately equal to property and casualty needs.

So why, instead of a one-to-one ratio of life and health to P/C actuaries, is there a grossly distorted seven-to-one ratio? The public doesn't buy seven times as many life and health policies as home and auto. The complexity of the mathematics involved is similar. Both groups of products are sold through the same distribution systems. And given the fact that most annuity, life, and health policies are sold on a group basis, the economics of scale should reduce the resources needed on this side of the insurance spectrum.

The answer to this distortion in the allocation of actuarial talent is that both annuities and life and health insurance can exploit the inequities of the U.S. tax code, while home and auto insurance cannot. Property/casualty insurance policies are the product of pure actuarial calculations, unrelated to the shifting winds of the Internal Revenue Code (IRC). The premiums are not tax deductible, there is no deferral or tax-exempt inside buildup of income, and these policies cannot be used to avoid inheritance taxes.

The demand for annuities and for life and health insurance is unnaturally and unnecessarily inflated by the unfair tax advantages these products enjoy. Annuity, life, and health premiums are not taxed up to specified levels. Annuity and life insurance deposits are allowed to grow without being taxed, and they are commonly used as a means of avoiding inheritance taxes. Anyone whose vision is not disoriented by the perversions of the IRC can plainly see that the demand for annuities and for life and health insurance (and actuaries) is greatly inflated at the expense of other sectors of the economy and society as a whole.

To see how this happens and to measure the effects—or damage done—to the economy, examine the process of earning and spending a dollar. For each dollar earned as income:

- 15% is lost in the black hole of the Social Security system
- 28% or more goes to the U.S. Treasury
- at least 7% is taken in the form of state and local income taxes, unemployment insurance, and workers compensation.

After running this gauntlet of government molestation, the average Jane or Joe is lucky to be left with 50¢.

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What the government effectively does is make an unbalanced offer to the U.S. citizenry. It holds up each dollar of income and says, "We'll let you have half of this to spend as you like, or you can have all of it—provided you purchase an annuity, life insurance, or health insurance." For most people, this is an offer they can't refuse.

The Good Life for Actuaries

In fact, the higher the effective tax rate, the better it is for life and health actuaries. At a 50% rate, the IRC gives actuaries the power to design products that can double the value of a dollar to an insurance-purchasing citizen. At a 67% rate, this leverage doubles to two-to-one. At a 91% tax rate, actuaries can multiply a portion of someone's wealth by a factor of ten. Taxation at such dizzying altitudes can turn an actuary from a mere mortal into a Midas with a golden touch. Conversely, if the tax rate were only 1% or 2%, employing accountants and actuaries to avoid such trivial taxes wouldn't be worth the cost.

Not only do life and health actuaries benefit from the eagerness of the IRS to do the dirty work of inflating the demand for their services (and the salaries they command); they benefit as well from the exponentially increasing complexity of the IRC. People who can't understand the tax code find that they can increase their wealth by hiring someone else to explain it to them and negotiate their earnings and savings past the clutches of the IRS with minimal shrinkage.

In addition to feeding at the trough of higher tax rates and a highly complex tax code, life and health actuaries also derive financial advantages from the continual churning of the IRC. When last year's insurance product loses its tax-exempt status, there is an artificial demand for accountants and actuaries to design new ones and close out and transfer the funds from the old ones.

Most structural shifts in the tax code are like wars: Some of the winners are better off, and the losers are worse off, but the total wealth of society is unquestionably reduced. The reduction of wealth and the waste of economic resources are the result of two basic flaws in the minds of the voting public: (1) voters favor higher taxes on everyone but themselves—a state of affairs that can only exist in a dictatorship—and (2) voters believe they are smarter than average and can avoid paying the taxes that apply to everyone else—a statistical *reductio ad absurdum.*

The bulk of the efforts of annuity, life, and health actuaries (perhaps six-sevenths) represents economic waste in the form of unnecessary transaction costs entailed in safely transferring the income from one's employer through the IRC minefield to one's personal accounts. Citizens must inevitably pay either the transaction costs or associated taxes with the following four categories of personal savings:

- separating retirement savings [IRAs and 401(k)s] from the remainder of their discretionary savings
- separating medical and dependent care expenses (flexible spending accounts) from the remainder of their disposable income
- separating life and health insurance costs from the remainder of their insurance needs
- avoiding the "top-heavy" status of a pension plan and needlessly manipulating the forms of compensation to "highly compensated employees."

While all of these efforts provide a comfortable living to many people employed in the insurance industry, and are included in the nation's gross national product, they result in a reduction of the overall wealth of society. It's like a public works project that employs people to dig ditches in the morning, only to fill them back up again after lunch.

And, given their warped sense of Orwellian humor, actuaries have gone so far as to label these categories of personal savings as "flexible compensation." Actuaries can be so isolated from reality and the rest of society that they are totally unaware that the English language already has a word for flexible compensation: It's called "cash." You can spend it wherever, whenever, and on whatever you please. The proper term for these artificial types of savings is "*in*flexible compensation."

Dreaming a Better World

Imagine if Congress modified the IRC such that, to cancel your vacation plans to pay for unexpected home repairs, you have to hire a tax accountant, file several IRS forms to declare a financial hardship, pay a 20% vacation "early withdrawal" tax, and be legally prohibited from taking another vacation till the year 2004. As absurd as this sounds, if there is no cost entailed in diverting your vacation spending to home repair bills, why should you have to pay to divert your long-term savings or health care expenses to spending on vacations or home repairs?

Now imagine a world where there are no income or inheritance taxes (actually, you don't have to imagine this: Just study U.S. history prior to World War I) or a world with a flat tax rate with no deductions or exclusions, such as that proposed by Rep. Dick Armey (R-Texas).

Overnight, every savings account becomes a 401(k) account—or vice versa. Every flexible savings account becomes a regular savings account, a Medicare savings account, and a 401(k) account. The transaction costs of shifting one's savings around in the event of a financial hardship are driven down to zero. And life and health actuaries—just like border guards at the Berlin Wall—find the demand for their services is dramatically reduced.

Life insurance would be purchased only to insure against the loss of the discounted future economic value of one's earnings. Annuities would be purchased only to insure against outliving one's savings. And health insurance would only be purchased to pay for unforeseeable, unbudgetable health care expenses.

In this scenario, people are left to spend their time and money on other more important things than tax-avoiding, transaction-burdened annuity, life, and health insurance products. Six out of seven life and health insurance actuaries will be thus liberated to apply their talents in pursuing other lines of work. Perhaps, then, they'll earn an honest living, creating real economic value instead of squandering their most productive years collecting funds from unnecessary and counterproductive toll barriers erected by Congress and staffed by the IRS. □

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