DANGER, DANGER, DANGER
Michael S. Williams

"He who keeps danger in mind will rest safely in his seat; he who keeps ruin in mind will preserve his interest secure; he who sets the dangers of disorder before himself will maintain a state of order."

- Confucius
551 – 479 B.C.

It is difficult to avoid news from around the world of what happens when real economic trouble strikes. In today's instant news - on demand society - it does not take much to cause a crisis. Even the perception of a problem can quickly become an emergency.

Many economic experts think our most urgent need is to aggressively address the profound problem of public employee defined benefit pension plans. There is no denying that they threaten the financial solvency of many local and state governments.

The current economic situation is complex and has been a long-time coming. It should not be a surprise to anyone. The reality is we can no longer defer costs or assume an insurance company or bankruptcy court will make our public debts go away. The day of accountability is here and it is shaping up to be a brutal experience.

The *nonpartisan* Pew Center for the States reported, "The combined pension and health costs are both a cause for serious concerns." California's public retirement system's combined obligations are in excess of $112 billion over their 2010 assets creating an unfunded liability of $77 billion."

CalPERS reports that current pension costs in California is $3 billion a year. On a larger scale, it is widely reported that the aggregated pension shortfall in the United States is potentially as high as $3 trillion. These deficits are rapidly growing as fewer people are working and paying into the system. This is compounded further by meager interest rate and the growing number of "Baby Boomers" who are retiring.

The January 2012 report from US Senator Orrin Hatch, "State and Local Government Defined Benefit Pension Plans: The Pension Debt Crisis that Threatens America" suggests that "aggregate underfunding of state and local defined benefit pension plans may be closer to $4 trillion."

The $4 Trillion figure is based on a report by Northwestern University, Kellogg School of Management's Josh Rauch, "Shortfall for State and Local Pension Systems Today: Over $4 Trillion." By comparison, the aggregate municipal bond debt total is $2.9 trillion.

Senator Hatch's report continues, "Although the debt associated with underfunded pension plans is not as transparent to the public as municipal bond debt, it represents the greater portion of aggregate municipal debt. This crushing debt load is ravaging state and local government

budgets, and there are few options available to them for addressing this crisis – cuts in services, reductions in benefits, higher taxes, or some combination of the three."

Rauch's report says "Based on September 2009 asset values, if state pension fund asset returns have an average return of 8 percent going forward (the state's typical assumptions), states in aggregate will run out of funds in 2028. If average returns are 10 percent through 2045, the funds aggregate will be roughly sufficient to cover liabilities to existing workers under the states' actuarial assumptions. If average returns are only 6 percent, state funds in aggregate will run out in 2024."

The report further suggests that even with an 8 percent assumed rate of return for the pension funds in the states of Illinois, Connecticut, Indiana, New Jersey, Hawaii, Louisiana and Oklahoma will be broke before 2020.

In truth, many of these funds may crash much sooner because of their inflated assumed rates of return. The real interest rates have been well below the overly optimistic 8 percent estimate.

The Orange County Register's 2009 article, "Bad data, unfounded fears fueled pension crisis" asked and answered the question, "How did California get in the pension mess? Experts say it was one part good intentions, one part bad luck, and one part public safety lobbying gone awry."

Senator Hatch's report pulls no punches as he addresses the question: "There are several reasons for the current crisis. Some states and local governments have lacked fiscal discipline, some have promised overly generous benefits, and many have failed to make the annual contributions necessary to maintain an actuarially sound pension plan."

Here are some other startling points from the Senators report:

- "Unfunded pension liabilities of state and local governments also affect the Federal government's credit rating, and municipal insolvency or default threatens to place significant additional burdens on the federal government, which already spends trillions on anti-poverty programs."

- "A crisis at the state level – or in a large municipal setting – could worsen an economic downturn in the rest of the nation."

- "A federal bailout of the states must be avoided at all costs. Responsible states that have prudently managed their pension plans and pose no risk of financial contagion to their neighbors, and the American taxpayer, cannot be asked to bailout states that have underfunded pension liabilities for public employees."

- "The public pension crisis also presents the risk that retirees and employees will not receive the full pensions they have been promised."

- "In some cases, it is possible that the individuals affected will not even have social security retirement to fall back on, because 27.5 percent of state and local workers are not covered by social security."

- "Additional demands will be placed on the resources of Federal programs such as Medicaid, The Emergency Food Assistance Program ("TEFAP"), the Supplemental Nutritional Assistance program ("SNAP" or Food Stamps) and the HUD Public Housing Assistance Program, just to name a few."

The September 8th issue of *Capitol Weekly* reported on the recent California pension reform legislation AB 304 noting, "the legislation does not cover a quarter of California cities, 121 of 482 that operate under their own charters rather than general law. Among them are several with well-publicized pension problems: Los Angeles, Oakland, San Diego and San Jose."

Municipal bankruptcies have already started with many more on the way. *Human Events* recent article, "Bankruptcy, No Panacea for California Pension Mess" said, "Municipal bonds have long been among the safest investments, but a coming wave of municipal bankruptcies in California – and disturbing way one of those cities is stiffing its bondholders – could change perceptions about the wisdom of lending money to cities." Keep in mind that pension systems often invest heavily in municipal bonds too which exasperates the growing problem.

The Chapter 9 municipal bankruptcy process has recently taken an interesting turn in Stockton and San Bernardino. It seems not all bond holders and insurance companies are willing to just roll over and take the loss on behalf of bankrupt governments. They are fighting back over how well protected are public pension plans at their expense. Who do you think is going to win - bond holders and investors or pension plans?

What does this mean to you? No matter what, we are all going to be paying more for less. There is no point in assessing blame because we are all to blame. Inattention, lack of accountability, poor judgment, unrealistic expectations, intimidation, Moral Hazard, conflicts of interest, greed, voter apathy, and an indifferent business community all contributed.

Some questions to ponder: What do you suppose is going to happen when millions of entitled get cut off from public benefits? What do you think retirees are going to do when some, if not all, of their retirement benefits evaporate? What type of litigation can government pension programs anticipate and who is going to pay for that? What are we going to do when taxes and inflation eat up most of our income?

Senator Hatch concludes that "Regardless of the cause of the crisis, the current public defined benefit pension system is not sustainable for taxpayers or retirees." Ironically, the ultimate victims of this disaster may well be the public employees themselves.

The late Steve Irwin, better known as the Crocodile Hunter, was known for his poisonous snakes, large lizards, crocodiles, alligators and his famous line, “danger, danger, danger.” Indeed we are confronted by profound danger. Someone has to pay and that someone is us.