tax and financial ISSUES

January 2017 | Interest rate suppression policies by the Federal Reserve and mismanagement at the state and local level have created a government pension problem that won't go away.

When assuming a ladder won't work. Time for a reality check on pensions.

Q: What do you do when you're stuck in a hole?
A: Stop digging.

An engineer and an economist were walking through the forest when they fell into a deep pit in the ground. It had vertical sides, and they could not climb out.

"This is hopeless," said the engineer. "We'll never be able to get out. No one knows we are here. We will die before we are found."

"Not so," said the economist. "There is no problem."

"What do you mean? How could that be so?" replied the engineer.

"It's simple," said the economist. "First, assume a ladder."

Background

The ability of defined benefit pension plans to function lies at the intersection of several factors.

- Adequate contributions by employers and employees over employees' working careers
- Fairness in the awarding of benefits (reasonableness in comparison to career earnings)
- Returns on invested assets being adequate to fund future benefits.

A pension plan isn't capable of paying future benefits by meeting one of two of these requirements. This is like a stool with three legs. It won't work unless it has all three.

Problem #1: Not making adequate contributions

1) Governments always face competing needs for money.

- Infrastructure spending
- Spending on employee wages at the expense of funding pensions
- Paying for Medicaid expansion
- Trying to bring the Olympics to your city

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The list is endless, but what happens is pure human nature. Unfunded pension obligations are on the distant horizon, and other needs are more immediate and take priority.

In 2003 the State of Illinois borrowed $10 billion to pay down the unfunded liabilities of the state's pension system. Then in 2004 and 2005 under Governor Rod Blagojevich the state skipped making contributions out of general revenue. The money got spent on other things.

2) Not reacting to poor investment performance
Poor investment returns in a single year are viewed as an aberration. The assumption is that the ups and downs of investment returns will balance out to approximate historical long-term investment results.

It's never pleasant to react to poor investment performance by jacking up contributions, but at some time if the performance is insufficient to fund benefits, contributions must be stepped up. Human nature dictates that the timing is always too late.

3) An aversion to raising taxes
Politicians are all about getting reelected, and raising taxes is a great way to get retired from public office. The result is that borrowing bridges the gap between tax revenue and expenditures.

Politicians have learned that not paying bills is a form of borrowing. The State of Illinois has made an art form of this, with unpaid bills expected to reach $14 billion in 2017 according to Moody's Investors Service. A stack of unpaid bills is an obstacle for adequately funding pensions.

4) An inability to pay
This happens when the most productive segments of the population depart, leaving state and municipal workforces to be supported by a smaller tax base. Think about Chicago, Detroit, and Philadelphia.

5) Simply ignoring the existence of unfunded liabilities
Acknowledging the existence of large unfunded pension obligations might scare away taxpayers and businesses. Retirees can move to other states. Businesses can choose to do locate elsewhere.

It's similar to the tree that falls in the forest but no one hears it. If no one talks about a pension liability does it exist? Perhaps not... until benefits can't be paid. The 1997 Illinois pension ramp under Governor Jim Edgar was one of these acts of denial. It was designed to achieve full funding over a 40-year period, much of it back ended.

6) Being deluded into thinking that good investment results will continue indefinitely.
Here is where the Federal Reserve earns a triple dunce cap. For the past eight years they have suppressed interest rates in order to elevate asset values, create a wealth effect, and stimulate economic activity.

The basic problem with this strategy is that the gains related to a decrease in the level of interest rates are not recurring. If bonds increase in value because of a decline in interest rates, once the capital gain is harvested all that is left is reinvestment at lower rates.

John Hussman has commented on this extensively in his Weekly Market Comment.

> "QE has effectively front-loaded realized past returns, while destroying the future returns prospect of conventional portfolios, at least as measured from current valuations. As a result, the coming years are likely

> to see a major pension crisis across both corporation and municipalities because the illusory front-loading of return has encouraged profound underfunding."
>
> "The Fed has done enormous violence to the public and the underlying stability of the financial markets... by creating an environment where scarce resources have been increasingly diverted to speculative activities, and where pensions have been encouraged to underfund their obligations in the belief that past realized returns are indicative of future outcomes."
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> (The Coming Fed-Induced Pension Bust, May 23, 2016)

All the variants of interest rate suppression (Quantitative Easing, Zero Interest Rate Policy (ZIRP), etc.) are a one trick pony. They delude governments on two fronts. They temporarily mask the pension underfunding problem, and they mess up priorities. Cheap credit becomes a substitute for income (tax revenue), and spending increases beyond what tax revenue is capable of supporting.

Problem #2: When benefits are not based on lifetime earnings

1) Manipulation of the earnings base
Social Security benefits are based on an employee's lifetime earnings history. The highest 35 years of covered earnings (those up to the FICA limit) are indexed by the change in average urban wages to present value, and the result is used to compute the benefit. It's impossible for an individual to manipulate a 35 year earnings history.

This is not the case with defined benefit pension plans. The measurement period is shorter. For example, Illinois uses a formula that applies the years of service against the highest four years of service in the 10 years prior to retirement.

Benefit formulas vary by state and government entity, and have led to a variety of benefit maximization strategies.
- Maximizing overtime during the peak four years
- Maximizing the teaching load during the peak four years
- Cashing in accumulated sick days during the peak four years
- Union contracts that maximize pay for teachers approaching retirement

This presents problems for employers that make contributions as a percentage of compensation. An increase in compensation over the peak four years results in under contributions for the earlier years, and a windfall for the employee. This phenomenon is called pension spiking.

2) Inflation escalators
The idea of inflation escalators is not particular wacky. In a world where there are market interest rates, the rate of return on financial assets should include an inflation factor. The idea is that some of the inflation related return on assets should be passed along to beneficiaries in the form of higher benefits.

Then there is the State of Illinois. It has had an automatic 3% increase in benefits which is independent of the actual rate of inflation. In periods when the inflation rate is low there is no way that investment returns can keep up with benefit increases. In comparison, Social Security benefits have an inflation escalator which has averaged 1.2% over the past seven years.

3) Allowing payment of pension benefits to start before full retirement age
When Social Security was enacted, the retirement age was 65 and average life expectancy was 67. The system collected taxes for 40 years and paid benefit for two years on average.

With Social Security allows benefit to commence at that earliest at age 62. For retirees who have Full Retirement Age of 66, commencing benefit at 62 results in a 25% benefit reduction.

The Illinois Policy Institute determined that 58% of Illinois state retirees begin collecting benefits in their 50s. Life expectancy is now far greater. Now the deal is you work for 30 years and collect benefits for 30 years.

4) Giving employees a windfall by changing the benefit formula
After the enacting the Illinois pension ramp in 1997, Governor Jim Edgar put the icing on the cake by presiding over a benefit formula increase in the following year. Pennsylvania Republican Governor Tom Ridge did the same in 2000.

5) No takeaways
Illinois is one of those states where the payment of public pensions is guaranteed under the state constitution... regardless of whether they couldn't be afforded in the first place.

Changes to Illinois pensions were invalidated by the Illinois Supreme Court in 2015 (2015 IL 118585). Now the Illinois constitution has to be amended to deal with the problems.

Problem #3: Interest rate suppression policies of the Federal Reserve leave investment returns far below actuarial assumptions

Defined benefit pension plans do funding calculations. The future benefits that employees have earned are discounted back to present value to determine the asset level required to fund those future benefits.

In a well-behaved world, the return on invested assets approximates the discount rate applied to future benefits. Reality is a lot messier. Starting in the early 1990s, a standard tool of the Federal Reserve has been to suppress interest rates during periods of economic weakness. While this promoted borrowing, it has been an unmitigated disaster for pensions.

- It reduces the investment income that pension assets can earn.
- It decreases the discount rate applied to future benefits in calculating the present value of future obligations, increasing the present value dramatically.

The interaction of these two factors has led to a ballooning of unfunded pension obligations as evidenced by the following headlines.

> "Stanford study reveals California Pensions underfunded by $1 trillion or $93,000 per household." (Stanford Institute for Governance and Public Policy)
>
> "Illinois Pension Funding Ratio Sinks to 37.6% As Unfunded Liabilities Surge to $130 Billion" (Special Pension Briefing, Illinois Commission on Government Forecasting and Accountability)

You can see the future

- *In Dallas*
  There has been a lump sum distribution run on Dallas Police and Fire Pension System. ("Dallas Police and Fire Pension Board ends run on the bank, stops $154M in withdrawals", Dallas Daily News, Tristan Hallman, 12/8/2016)

  > "On Wednesday, the city officials unveiled its plan to save the fund. The biggest target was the lump-sum program officially called the Deferred Retirement Option Plan, or DROP.
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  > That plan, originally intended as a retention perk for veterans, made hundreds of officer, firefighters, and retirees into millionaires. DROP allows them to retire on paper, continue working and meanwhile defer their pension benefit checks into a separate account. Once they actually retired, they could remain in DROP and continue deferring their checks.
  >
  > For years, DROP guaranteed at least 8% interest on the money. That hurt the entire fund when investment returns couldn't keep up."

  Episodes like this expose these underfunded retirement plans for what they are... Ponzi schemes. The contributions made on behalf of younger participants are effectively diverted to pay the benefits of retirees.

  The Ponzi nature of the Dallas plan could not be hidden because beneficiaries were able to request lump sum distributions, depleting the assets available to pay retirees taking annuity payouts and the assets available to pay future retirees. Other Ponzi arrangements can be perpetuated for longer when the lump sum option is not available.

- *And with the Central States Pension Fund*
  This is an example of a critically underfunded multi-employer pension plan looking for a deep pocket.

  Most of the fund's participants are truckers. The key problem for the fund started when trucking deregulated in the 1980s, resulting in fewer employers and fewer unionized drivers contributing to the plan. It is projected that without outside funding the plan will be bankrupt in 10 years. This is what happens when a Ponzi scheme breaks down when there aren't enough contributors.

  The trustees submitted a plan of reorganization that was found wanting by the Treasury Department. As reported in the New York Times . . . .

  > "The proposal was based on flawed assumptions and did not demonstrate it would successfully rescue the plan.
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  > The proposed reorganization counted on an assumption about future investment returns that federal regulators found unrealistic – even though that assumption is widely used by state and municipal pension plans, which are not subject to federal regulation. The Central States trustees said the reorganization would succeed if the fund's investment averaged 7.5% annual returns."
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  > (Treasury Department Rejects Plan to Cut Pension Benefits for Teamsters, Mary Williams Walsh, New York Times, May 6, 2016)

The first step in passing the hat is to go to the Pension Benefit Guarantee Corp., but its resources are limited. It's the deep pocket that isn't deep enough.

> "Because Central States is so big, its failure could wipe out the federal insurance program for pensions of its type, stranding tens of thousands of other retirees who were never members of the Teamsters."

There are no easy answers here. If the plan fails, there will be dramatic benefit cuts.

One thing can't be overemphasized. The 7.5% rate of return assumption is "widely used by state and municipal pension plans," and result in pensions understating the present value of their unfunded liabilities. If that's the case, how many other pension time bombs are out there? The only thing keeping those plans functioning is the prospect of dragooning taxpayers into bailouts.

Trustees have acted like the economist at the start of the article, assuming a 7.5% ladder to get out of the hole. It's time for Plan B.

Steps that need to be taken
Earlier we mentioned that a functioning pension is like a three-legged stool. The underfunding situation won't be turned around until problems with each of the legs are corrected.

1) Contributions have to be made that are reasonable in relation to the benefits being promised.

- Rate of return assumptions must be conservative so as to preclude understating the level of contributions that are needed.
- State and local governments must be subject to the same full funding requirement as the private sector.
- If eager to be elected politicians want to increase benefits, then the underfunding that results should be remedied immediately. The benefit increases should be contingent on the funding. No funding, no benefit increase.
- Governmental entities should be precluded from having defined benefit plans unless sound management can be demonstrated. The alternative is to have a mandatory conversion to a defined contribution plan.
- Full retirement age should be increased in line with increased life expectancy.

2) Beneficiary windfalls should be rescinded.

- Unrealistic inflation escalators
- Full benefits with early retirement
- Years of service qualifying for multiple pensions
- Pension spiking should be eliminated by basing benefits over more than a short period of years.

3) The Federal Reserve's policy of subsidizing borrowers at the expenses of savers should cease.

- Federal Reserve officials should be held to account for their role in pension problems.
- There should be a frank and open debate on the merits of interest rate suppression policies rather than delegating policy making to a handful of appointed officials.