

The \$2 Trillion Hole

By JONATHAN R. LAING

Promised pensions benefits for public-sector employees represent a massive overhang that threatens the financial future of many cities and states.

LIKE A CALIFORNIA WILDFIRE, populist rage burns over bloated executive compensation and unrepentant avarice on Wall Street.

Deserving as these targets may or may not be, most Americans have ignored at their own peril a far bigger pocket of privilege -- the lush pensions that the 23 million active and retired state and local public employees, from cops and garbage collectors to city managers and teachers, have wangled from taxpayers.

Some 80% of these public employees are beneficiaries of defined-benefit plans under which monthly pension payments are guaranteed, no matter how stocks and other volatile assets backing the retirement plans perform. In contrast, most of the taxpayers footing the bill for these public-employee benefits (participants' contributions to these plans are typically modest) have been pushed by their employers into far less munificent defined-contribution plans and suffered the additional indignity of seeing their 401(k) accounts shrivel in the recent bear market in stocks.

And defined-contribution plans, unlike public pensions, have no protection against inflation. It's just too bad: Maybe some seniors will have to switch from filet mignon to dog food.



James Bennett

Sweet retirement for public servants could lead to severe cuts in basic services.

Most public employees, if they hang around to retirement, can count on pensions equal to 75% to 90% of their pay in their highest-earning years. And many public employees earn even more in retirement than their best year's base compensation as a result of "spiking" their last year's income

by working ferocious amounts of overtime and rolling in years of unused sick and vacation days into their final-year pay computation.

A survey by the watchdog group California Foundation for Fiscal Responsibility found that some 15,000 Golden State public employees are knocking down \$100,000 or more, while some 200, mostly police and fire chiefs and school administrators, are members of the \$200,000-a-year-and-up club.

THE PROSPECTS ARE BLEAK for many state and local governments as a result of all this. According to a survey last month by the Pew Center on the States, a nonpartisan research group, eight states -- Connecticut, Illinois, Kansas, Kentucky, Massachusetts, Oklahoma, Rhode Island and West Virginia -- lack funding for more than a third of their pension liabilities. Thirteen others are less than 80% funded.

Governments could fill that gap by raising property, sales and income taxes, but most are wrestling with huge revenue shortfalls in trying to balance their budgets.

The more likely outcome is dramatic cuts in essential services, such as police and fire protection, health spending, education and infrastructure improvements, in order to cover ballooning pension payments. State and municipalities, after all, must do something: Most have a legal obligation to pay out earned pension benefits. And some don't even have the courage to switch new teachers, bureaucrats and police to a defined-contribution system, to prevent the funding problem from worsening as time rolls on.

THUS, MORE DEBT DEFAULTS and bankruptcy filings probably lie ahead, unsettling the \$2.7 trillion municipal-bond market. The possibility of taxpayer revolts and likely insolvencies has shaken some investors' confidence in general-obligation bonds -- those backed by the "full faith and credit" of the states or localities. Once the gold standard for munis, GOs are under a cloud in financially troubled areas.

The size of the legacy-pension hole is a matter of debate. The Pew report puts it at \$452 billion. But the survey captured only about 85% of the universe and relied mostly on midyear 2008 numbers, missing much of the impact of the vicious bear market of 2008 and early 2009. That lopped about \$1 trillion from public pension-fund asset values, driving down their total holdings to around \$2.7 trillion.

Other observers think the eventual bill due on state pension funds will be multiples of the Pew number. Hedge-fund manager Orin Kramer, who is also chairman of the badly underfunded New

Jersey retirement system, insists the gap is at least \$2 trillion, if assets were recorded at market value and other pension-accounting practices common in Corporate America were adopted.

Finance professors Robert Novy-Marx at the University of Chicago and Joshua Rauh of Northwestern University asserted in a recent paper that the funding gap for state pension plans alone might exceed \$3 trillion, in part because state funds are using an unrealistic long-term annual investment return of 8% to compute the present value of future payments to retirees, as is permitted in government standards for pension-fund accounting.

This establishes a "false equivalence" between pension liabilities and the likely investment outcomes of state investment portfolios, which are increasingly taking on more risk by beefing up their exposure to stocks, private-equity deals, hedge funds and real estate. Using a much lower expected return -- say, one at least partially based on the riskless rate of return on government securities -- would both properly and dramatically boost the present value of the pensions' liabilities while decreasing their likely ability to meet them. The academic pair, using modern portfolio theory, claim that state funds, as currently configured, have only a one-in-20 chance of meeting their obligations 15 years out.

MAKING THE STATE AND local pension problem all the more trying is that government entities can do little to wriggle out of their exposure, even if spending on essential services is threatened. The constitutions of nine states, including beleaguered California and Illinois, guarantee public-pension payments. And most other states have strong statutory or case-law protections for these obligations. "One shouldn't be surprised by this, since state legislators, state and local judges and the state attorneys general are beneficiaries of the self-same public pension funds that they've done so much to promote and protect," Orin Kramer notes wryly.

True, a dozen or so states, including New York, Nevada, Nebraska, Rhode Island and New Jersey, are attempting reforms such as raising retirement ages, cutting pension-benefit formulas, boosting employee contributions, curbing income "spiking" and partially switching employees to less costly defined-contribution plans. But these changes affect almost exclusively new employees and do little to solve the existing funding gap.

The municipal-bond market, for one, seems vulnerable to the growing public pension mess. Warren Buffett, in his 2007 Berkshire Hathaway annual report, inveighed against the "woefully inadequate" funding in many public pension funds to meet "huge" promised payments to retirees. True to his word, Buffett has sold precious little municipal-bond insurance in a Berkshire Hathaway unit he set up for that purpose in 2008.

Jim Spiotto, a muni-bond restructuring expert at the Chicago law firm Chapman & Cutler, argues the pension crisis is quickly reaching a tipping point after being ignored for years.

Hall of Shame

Here are the states ranked worst to first in percentage of pension liabilities that are funded. Some states that do OK here, such as California and New York, are struggling with other fiscal woes. The bond ratings reflect states' overall strength.

State	Unfunded Liability (bil)	% Funded	RATING		
			S&P	Moody's	Fitch
Illinois	\$54.4	54%	A+	A2	A
Kansas	8.3	59	AA+	Aa1	AA-
Oklahoma	13.2	61	AA+	Aa3	AA
Rhode Island	4.4	61	AA	Aa3	AA-
Connecticut	15.9	62	AA	Aa3	AA
Massachusetts	21.8	63	AA	Aa2	AA
Kentucky	12.3	64	AA-	Aa2	AA-
West Virginia	5.0	64	AA	Aa3	AA-
New Hampshire	2.5	68	AA	Aa2	AA
Hawaii	5.2	69	AA	Aa2	AA
Colorado	16.8	70	AA	Aa2	F1+
Louisiana	11.7	70	AA-	A1	AA-
South Carolina	12.1	70	AA+	Aaa	AAA
Indiana	9.8	72	AAA	Aa1	AA
Mississippi	8.0	73	AA	Aa3	AA
New Jersey	34.4	73	AA	Aa3	AA-
Alaska	3.5	76	AA+	Aa2	AA
Nevada	7.3	76	AA+	Aa2	AA
Alabama	9.2	77	AA	Aa2	AA
Maryland	10.9	78	AAA	Aaa	AAA
Wyoming	1.4	79	AA+	NR	F1+
Arizona	7.9	80	AA-	A1	NR
Maine	2.8	80	AA	Aa3	AA
Oregon	10.7	80	AA	Aa2	AA
Minnesota	10.8	81	AAA	Aa1	AAA
Missouri	\$9.0	83%	AAA	Aaa	AAA
New Mexico	4.5	83	AA+	Aa1	NR
Michigan	11.5	84	AA-	Aa3	A+
Montana	1.5	84	AA	Aa2	AA
Utah	3.6	84	AAA	Aaa	AAA
Virginia	10.7	84	AAA	Aaa	AAA
Arkansas	2.8	87	AA	Aa2	NR
California	59.5	87	A-	Baa1	BBB
North Dakota	0.5	87	AA+	Aa2	NR
Ohio	19.5	87	AA+	Aa2	AA
Pennsylvania	13.7	87	AA	Aa2	AA
Vermont	0.5	88	AA+	Aaa	AA+
Iowa	2.7	89	AAA	Aa1	AA+
Texas	13.8	91	AA+	Aa1	AA+
Georgia	6.4	92	AAA	Aaa	AAA
Nebraska	0.8	92	AA+	NR	NR
Idaho	0.8	93	AA	Aa2	AA-
Tennessee	1.6	95	AA+	Aa2	AA+
South Dakota	0.2	97	AA	NR	AA-
Delaware	0.1	98	AAA	Aaa	AAA
North Carolina	0.5	99	AAA	Aaa	AAA
Washington	(0.2)	100	AA+	Aa1	AA
Wisconsin	0.3	100	AA	Aa3	AA-
Florida	(1.8)	101	AAA	Aa1	AA+
New York	(10.4)	107	AA	Aa3	AA-

NR=Not rated

Sources: Pew Center on the States; Standard & Poor's; Moody's, Fitch

"I just can't believe that any bond issuer would be willing to suffer the stigma of defaulting on their general-obligation debt as a result of having to fund future pension obligations, but such a situation is no longer beyond the realm of possibility," he observes.

For proof, look no further than the San Francisco Bay city of Vallejo, which filed for Chapter 9 bankruptcy in 2008 as a result of insolvency.

The California municipality, which has 120,000 residents, is proposing a three-year moratorium on all interest and principal payments on the \$53 million of municipal debt that is backed by its general fund. But it is keeping fully intact its \$84 million in pension-fund obligations.

SOVEREIGN DEFAULT IS A hot topic these days. With Greece tottering and other European countries in fiscal distress, some have even voiced the possibility that a U.S. state -- also considered a sovereign entity -- could suffer a general-obligation debt default.

Says Todd Zywicki, a law professor at George Mason University: "In many ways, some of our states are like General Motors before its bankruptcy, suffering from falling revenue, borrowing money to cover operating expenses and operating under crushing legacy health and pension liabilities. It's entirely possible, given the gigantic size of the pension liabilities, that some states might do what was once the unthinkable at GM and default."

Such assessments might be alarmist. A rebound in the U.S. economy and a continued rally in stocks would do a world of good for ailing public pension funds. And only one state -- Arkansas in 1934 -- has defaulted on its GO bonds in the past century with their holders suffering losses. Arkansas, however, was a special case. In addition to the Great Depression, it was ailing from large local debts it had assumed as a result of catastrophic floods in the 1920s.

But what if the stock-market rally falters, the economy doesn't return to full health, jobs remain scarce and tax revenues remain depressed?

According to muni-bond expert Spiotto, most defaults at the municipal level have come as a result of shortfalls in the revenue generated by quasi-public projects, such as hospital additions, sports facilities, housing-development infrastructure, giant garbage incinerators and the like, rather than systemic financial failures of major localities like Vallejo. And even after New York City's debt default in 1975, municipal-debt holders were ultimately made whole.

NONETHELESS, SOME MAJOR BOND investors are altering their strategies in light of the impending pension crisis.

John Cummings, the executive vice president in charge of the \$27 billion muni portfolio at giant fixed-income house Pimco, says it is underweighting the GOs of the "poster boys" of debt problems and pension under-funding -- California, Illinois, New Jersey and Rhode Island. Revenue bonds -- those backed by the money generated by a specific source -- have become more attractive to Pimco, particularly if they're backed by essential services like water authorities, sewer systems or school districts and have dedicated, stable revenue streams that can't be diverted to other uses. Revenue bonds funding new projects could be considerably more risky.

Says Cummings: "We want to stay as far away as possible from bonds that depend on the politicians and general funds of financially shaky states and smaller issuers unless the price is

right. You ask California Treasurer Bill Lockyer, one of the greatest bond salesman ever, about the state's pension situation and all you get back is a thousand-yard stare and a quick change of subject. That's concerning."

A spokesman for Lockyer told *Barron's* that the treasurer "realizes that the pension-underfunding problem is serious, unsustainable and therefore needs to be fixed. He wants to ensure that any reform is fair to all stakeholders, including the state, public employees and taxpayers."

No one, of course, would dispute that public servants deserve adequate retirements, particularly the 25% to 30% that lack Social Security coverage. But the old saw that rich retirement packages are a necessary inducement to attract good employees to public payrolls because of below-average pay scales no longer is true.

According to the latest compensation survey by the Bureau of Labor Statistics, the average state and local employee *outearns* his counterpart in the private economy with an hourly wage of \$26.11, versus \$19.41. That's before benefits (pensions, health care, paid vacations and sick days and leaves) drive the disparity even higher, to \$39.60 an hour for public employees and \$27.42 for private workers.

Even if one looks at pay received by so-called management and professional employees in each realm, fat benefits in the public sector drive the total compensation received by state and local managers to almost dead-even with private-sector managers -- \$48.15 versus \$48.17.

THE CURRENT STATE AND local pension crisis has many fathers. State and local governments have been under-funding their pension systems for a decade or more, under the misapprehension that the stock-market boom of the 1990s would continue and bail out any shortfalls. The underfunding has continued with a vengeance over the past two years as budgets were slashed to eliminate deficits.

For example, last year New Jersey, under Gov. Jon Corzine -- a financially savvy former Goldman Sachs chief -- contributed only \$105 million, instead of an actuarially determined \$2.3 billion. In all, states and localities kicked in \$72 billion in fiscal 2008, far short of adequate funding levels of \$108 billion, according to the recent Pew study.

Such behavior is only encouraged by the fact that state and local governments are allowed as much as 30 years to close funding gaps. So it's easy for politicians to kick the can forward, avoiding the pain of boosting taxes and making hard spending decisions. The 30-year amortization periods

have an evergreen nature, being renewed and invoked almost every year as the compounding of pension obligations works relentlessly against units of government.

Then, too, pension funds are being hit by baby-boomer retirements. A report from the National Association of State Retirement Administrators underlines this impact: It found that in 2008, for every state retiree collecting benefits, only 2.02 current workers were contributing to pension systems, compared with 2.45 in 2001.

Besides the politicians, the primary culprits are the public-employee unions, which have used their growing power to dramatically enhance pension benefits. They curry favor with sympathetic politicians, lavishing them with large donations and manning campaign phone banks. They also engage in full-court-press lobbying at all levels of state and local government.

One would think legislators or managers in state, county and local governments would protect the taxpayer by bargaining hard. But they clearly don't, because of inherent conflicts of interest.

Nearly all public employers, regardless of their position, benefit from the very same pension programs, either directly or indirectly. Legislators in the main receive the same pension benefits that they lavish on other public employees. And administrators, though subject to independently negotiated contracts, use enriched union pension plans as a valuable bargaining wedge. So there's little incentive to fight the unions with much vigor.

In fact, bad behavior abounds on both sides of the table when it comes to pensions. *Plunder!*, a recently published book by California journalist Steven Greenhut, details a number of ploys that both workers and management employ to goose their retirement checks. A favorite, he asserts, is income spiking. In the year before they retire, California police, firefighters and prison guards typically start notching hours and hours of overtime that has been reserved for them by less senior colleagues. Whatever they make in that final year is used in the formula that determines the monthly retirement check. Golden State, indeed.

OTHER ABUSES DETAILED in the book include widespread "double-dipping." Public employees can start collecting their full pensions while returning to their old job as consultants. Alternatively, they can take another public-sector job to earn credit toward yet another pension.

Stories are rife around the country of various pension hijinks by public employees. A Contra Costa Times article bemoaned the artistry of a retired local fire chief in San Ramon, Calif., who boosted his annual pension from \$221,000 a year to \$284,000 by getting credit in his final earnings for unused vacation and sick leave.

In Illinois, veteran police with more than 12 years of service receive annual longevity pay boosts of 4% to 5% in addition to other salary increases. In some local departments, these boosts are all awarded as a 20% bump-up in the first couple months of the year, rather than prorated evenly throughout the year. This, of course, helps police in those jurisdictions get a 20% jump in their presumed compensation -- and, therefore, their pensions -- if they time their retirement date properly.

VALLEJO, CALIF., HAD NO CHOICE but to file a Chapter 9 bankruptcy in 2008 after property-tax revenue collapsed in the housing bust and a major employer -- the U.S. government's Mare Island Ship-yard -- closed. With the tax base hammered, rich public-employee contracts granted in better times were devouring more than 90% of the city's budget.

Though Vallejo is still months away from getting a court decision on whether it can go ahead with its debt-adjustment plan, it has succeeded through contract renegotiations and major layoffs in cutting its employee costs by nearly a quarter.

But the fallout has been brutal. Employee health-care benefits have been decimated. Holders of the city's municipal bonds are unlikely to get all their money back. And violent crime rates have shot up dramatically as a result of reductions in its police force from 158 to 104 officers.

The only thing that will be left untouched? The very thing that tipped the California city into Chapter 9 -- its \$84 billion in future pension obligations.