
INSIDE THE PENSION CRISIS**Adam C. Tosh, CFA**

No crisis is real until it's too late. This means no wake-up call until the accounts run dry. That seems to be the shared mindset of many state and local governments towards their vine-withered pension funds. Sadly for many current pension participants, as well as the workforce counting on a funded future, many will be very upset and disappointed if their checks fail to arrive as promised.

The simple truth is that many governments have been steadily diverting their employer contributions (often hundreds of millions of dollars a year) to other governmental programs over decades – and the bill is finally coming due. While funding erosion causes also include the “Baby-Boomer” demographic wave, generous benefits relative to the private sector, and investment allocations pressured to be more aggressive to make up the government's unfunded gap; these cross-currents have worked to undermine the government's ability to satisfy the obligation to deliver to retirees as promised.

Unfortunately, there is no silver bullet. State and local governments cannot realistically expect that higher-risk investment strategies alone will plug their pension's negative cash flows to balance the burgeoning retirement payments. Greater investment returns, plan efficiencies, and cost cutting will only go so far to cover the shortfalls. It's a shame, because the employees of these governments have been holding up their end of the agreement, paying their contributions as required.

But many governments haven't held up their end of the deal, even if that deal wasn't responsible policy to begin with. Often politicians and trustees have taken

the path of least resistance, unwilling to say no to their constituents. It appears that they figured the benefits promised would be someone else's problem 20 years from now. Well, “20 years from now” is now.

Like the recent misassumptions with housing, many officials assumed pension investment returns would always be in double digits. The strong returns of the 90s meant that politicians could horse-trade to divert pension contributions, using the money for sports stadium-level projects. Ultimately, the burden falls on taxpayers for not minding the store, at a sizable cost.

The result of state and local governments short-changing these pensions, whether defined benefit (DB) or defined contribution (DC) plans, is a new reality that impacts everyone. State and local governments across the country are facing severe budget deficits. That means they are likely contributing even less to pensions, widening the huge unfunded liability gap. Like bad mortgage and credit card borrowing, the debt keeps mounting to eventually curtail or cut off state and local government's ability to borrow money at reasonable rates for elementary/higher education or bridges and roads.

Pensioners are still pinning their hopes on an irrevocable contract and the attendant promises made by politicians. This is both naïve and unwise. A setup for major retirement derailment when the courts are ultimately forced to alleviate the burden of these pension contracts from the back of government. What court is going to give the order to turn off fire, police, and sanitation services to pay the pensioners instead? Those who continue the practice of “kicking the can

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down the road” are relying on an endgame that will harm everyone.

Career officials should stop playing the blame game, deflecting attention and pointing fingers. Because it’s not the pensions that are the problem. It’s the chronic lack of funding for pension plans which cannot make them grow when they don’t have the seeds to sow. Politicians need to demonstrate leadership to formulate a plan for digging out of this mess.

Under the theory that you get what you pay for, governments and taxpayers need to be very cautious. Seeking a quick fix by renegeing on the promises made to hardworking public servants sends a poor signal and will likely affect recruitment, retention, and service. And you think getting your driver’s license renewed now is difficult! The morale and opportunity costs of the broken pension promise may launch its own toxic cycle.

The equation is not that complicated: the laws of math and balanced budgets haven’t been repealed. Contributions plus investments (gains) must still exceed retirement payouts or there’s a problem brewing. Investments alone will not overcome the existing underfunding. And taxpayers not paying attention or gullible in the face of politically expedient accounting gimmicks and actuarial sleight-of-hand will be in for an even more costly awakening. It is the classic battle between spending now versus growing money for the future – at this point the future appears to have lost. The Center for Cultural Studies & Analysis, a think-tank that studies decision making over human history, confirms that “people are very good at thinking and acting in the short-term, and equally bad about projecting those consequences into the future.”

Real leadership is required: compromises and tough decisions are going to have to be made. But one thing is certain, no one involved (pension members, politicians, or taxpayers) is going to be happy in the end. Concessions must be made, because less of something trumps all of nothing. This means pension members must be reasonably willing to accept higher retirement ages, contribute more, or expect fewer benefits. Though promised in the past, the reality is that these pensions are unsustainable going forward.

Politicians and trustees must make the tough and unpopular decisions that leadership requires. Meanwhile, governments must cut wasteful patronage spending to assure some portion goes to make the required pension contributions. Further steps should be taken to prevent strapping future generations with paying for unfunded benefits, including automating and suspending cost-of-living-adjustments (COLAs) when there is no inflation. Finally, taxpayers have to pay attention and vote accordingly, demanding better leadership to ensure reasonable corrective action to uphold the promises made and prevent state and local government from digging the fiscal hole deeper.

The time to act rationally is today, while there is still a chance. Failure to stop the gamesmanship and a refusal to make concessions to shore up the pension funds now will cost every taxpayer much, much more later. The tanks aren’t dry just yet, but the indicator light is blinking – Fuel Low. The pension crisis is not over the hill, but already within the headlights.

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