Conjuring Magic To Cover States' Debts: Fiscal Reality Sets In

The first warning about the possible bankruptcy of the town of Vallejo, California, was reported by the Associated Press on February 28, 2008, when Councilwoman Stephanie Gomes said, "Our financial situation is getting worse every single day. No city or private person wants to declare bankruptcy, but if you're facing insolvency, you have no choice but to seek protection."

Marci Fritz, vice president of the California Foundation for Fiscal Responsibility, blamed the action on promises made earlier by the council to the city's employees concerning salaries and retirement benefits that the city no longer can afford. According to Fritz, these were promises made during economically flush times, and were due to the city council's unrealistic expectations that those times would continue indefinitely. She said, "It's a nightmare for city governments because they have to continue to pay these benefits that were granted when they had extra money from real estate and sales tax[es]."

Vallejo, a city of 120,000 across the bay from San Francisco, faced a $9 million budget shortfall at the time, owing to soaring payroll costs for its firefighters and police officers whose pay and pension costs make up almost 80 percent of the city's budget. Those pay packages were negotiated with the unions representing those workers, and were necessary, according to spokesmen for the city, to be competitive with surrounding towns.

{modulepos inner_text_ad}

In May of 2008, the council voted 7-0 to declare Chapter 9 bankruptcy to "reorganize its finances," which meant attempting to break the promises it had made earlier to the unions through the bankruptcy court. By this time, the budget shortfall had increased from $9 million to $15 million, despite efforts to cut expenses for museums, public works, senior centers, and libraries. The bankruptcy process allows the judge to void the union contracts, which essentially forces the city workers to accept a pay package that the city can afford, in light of declining tax revenues. But city employees weren't the only ones at risk: The city had sold tax-exempt general obligation bonds whose interest payments would also be reduced or even eliminated. With an annual budget of $80 million, the city owed $53 million to those bondholders, and another $220 million in unfunded pension and retirement health benefits, totaling more than three times the city's annual revenues.

When Judge Michael McManus determined that labor contracts can be broken in the Chapter 9 bankruptcy, union spokesmen said this set a dangerous precedent for other cities and townships in similar trouble to "do a Vallejo." However, because of a binding arbitration clause inserted into the city charter in 1970, unions were able to renegotiate another contract with the city and, starting in July, 2010, police officers are getting a seven-percent pay raise. New Vallejo Councilwoman Marti Brown was appalled: "No one is getting a 7 percent increase, even in cities not in bankruptcy." This raise takes place when the city's budget has decreased from over $80 million in 2008 to just over $63 million in 2010.

The city of Maywood, California, took a different approach to its fiscal difficulties. On July 1, 2010, everyone on the payroll was fired. The *Los Angeles Times* said that by laying off an estimated 100 workers and contracting the remaining essential services such as finance, rec-ords management, parks and recreation, and street maintenance to a nearby town, Maywood would save the city $165,000 a year. On July 1, "We will become a 100 percent contracted city," said interim City Manager Angela Spaccia.

San Diego is considering bankruptcy as a result of a report by the San Diego Grand Jury that "such a step could help the city cut its onerous retirement and health benefits." At present the city has an unfunded pension obligation of $2.2 billion and another unfunded retiree healthcare liability of $1.3 billion. And MoneyNews said that San Diego is the fifth major city in the state to consider such a move, along with Los Angeles.

The recent exposure by the *Los Angeles Times* of the outrageous salary and retirement benefits being provided by Bell City to its City Manager and Chief of Police confirms the attitude of entitlement and disregard for fiscal responsibility that appears to be rampant in cities across the state and the country.

Papering Over Problems

All of this is putting the state of California on the "verge of system failure," warns Jean Ross, executive director of the California Budget Project. With an annual budget of about $125 billion, California faces a $19 billion shortfall this year, and an expected $37 billion gap next year. But that's just the tip of the iceberg. A recent Stanford University study concluded that the state's pension fund is short by roughly $500 billion. The study urged Governor Schwarzenegger "to inject $360 billion into its public benefit systems … [just to] have an 80 percent chance of meeting 80 percent of [the state's] obligations over the next 16 years."

As Agora Financial put it,

> The problem, just like with the subprime [meltdown], is an irrational form of leverage. In essence, municipalities borrow current earnings of public employees in exchange for some of the most favorable retirement plans in the world. That borrowed money is invested aggressively, just like a private-sector employee would in his 401(k).

Except if the fund loses money, which they all have over the last 10 years, pension funds don't adjust payouts. The social and political pressure to maintain the status quo — keeping our public employees comfortably retired — is just too strong. So municipalities kick the can down the road. New employees buy into the funds. Fund managers maintain their projections of endless 8 percent annual returns. Retirees keep taking out the funds they were promised … and no one pays the tab.

And it's not just California. Orin Kramer of New Jersey's pension program estimates a national funding gap among all the states of around $2 trillion. The Center on Budget and Policy Priorities, a Washington research institution, announced that "finances in Arizona, New Jersey, New York and other states show few signs of improvement. Forty-six states face budget shortfalls that add up to $112 billion for the fiscal year ending next June [2011]." The May/June issue of *Chief Executive* magazine published its annual "Best and Worst States for Business 2010" and gave its "booby" prize for worst state to California, with New York, Michigan, New Jersey, and Massachusetts rounding out the bottom five.

Hugo Tassone, a retired Yonkers, New York, policeman, recently received a lot of unwanted attention when it was revealed that when he retired three years ago, at age 44, his pension was $74,000 a year. Now 47, his pension is $101,333 a year. He is just one of over 100 retired Yonkers police officers and firefighters who are collecting more in retirement than they did while they were working. Statewide, more than 3,700 retired public workers are getting pensions of more than $100,000 a year. The problem, according to David Simpson, a spokesman for the Mayor of Yonkers, is that "once you give something, you can't take it away."

This fades into relative insignificance in light of Bell City, California's problems. When City Manager Robert Rizzo's pension kicks in, he will receive "at least $600,000 a year for the rest of his life," according to the *Los Angeles Times*. This would make him the highest-paid retiree in the California Public Employees Retirement System (CalPERS). Third on that list would be Bell City's Police Chief Randy Adams, who will receive more than $400,000 annually.

Bell City's misfortunes will be shared with 140 other cities and districts such as Norco, La Canada, Flintridge, and Goleta because they are in the same pension "liability pool" as Bell. And there appears to be no way out. As the *Times* put it, "Public pensions are difficult to rescind. Courts have repeatedly upheld the [pension benefits] in favor of employees." A slight glimmer of hope was offered by Stephen Silver, a Santa Monica attorney specializing in pension law, who said that "investigators [would have to] show that Bell's high salaries were an unlawful expenditure of public funds."

In June, New York's cash crunch was so severe that Governor David Paterson said the state might have to start paying its bills with I.O.U.s, much like California did last year. The very next day, however, the New York State legislature came up with an ingenious way to kick the can: borrow from itself. By borrowing from the state's own pension fund, the state could help close its current $9 billion budget gap, in exchange for a promise to pay back the loan starting three years from now. But don't call it borrowing. Robert Megna, New York's budget director, said, "We're not borrowing. We would view it more as an extended-payment plan." Lt. Governor Richard Ravitch challenged that characterization: "Call it what you will, it's taking money from future budgets to help solve this year's budget."

Legislators in other states have promoted similar budgetary sleight of hand. One way to "fix" the pension shortfalls has been to take more risks with the invested funds in the hopes of getting higher returns. A *New York Times* article quoted Frederick Rose, former chairman of the Texas Pension Review Board, "In effect, they're going to Las Vegas [to play] 'double up to catch up.'" Naturally, the money managers disagree, saying that such strategies are merely aimed at "diversification," which now includes investing in commodity futures, junk bonds, foreign stocks, and deeply discounted mortgage-backed securities, as well as investing on margin. In addition, some managers are betting on hedge funds to help enhance their returns. According to the *Times*: "The problem now is that bond rates have been low for years, and stocks have been prone to such wild swings that [the usual] 60-40 mixture of stocks and bonds is not paying 8 percent. Many public pension funds have been averaging a little more than 3 percent a year for the last decade, so they have fallen behind where their planning models say they should be." Some states, like New Jersey, "have fallen so far behind they may never catch up again."

Any attempt to lower the estimated or projected rate of return, however, would only exacerbate the problem because it would increase the contributions required to be made by the states. In Colorado, for instance, its $30 billion pension fund requires that the fund earn no less than 8 ½ percent annually. At present, because of much lower real returns, the plan is underfunded by nearly $18 billion. But if that projected return were adjusted downward by just one-half of one percent, the plan's shortfall would jump to more than $21 billion, requiring the state to increase its contribution. But Colorado cannot even make the contribution currently required and has fallen several billion dollars behind, despite reducing current retirees' cost-of-living adjustment down to 2 percent from the previous 3 ½ percent. And employees' unions are threatening to sue to have that downward adjustment reversed.

Exacerbating the Problems

California's problem isn't just fiscal. *Chief Executive* magazine's recent survey quoted one CEO: "Texas is pro-business with reasonable regulations, while California is anti-business with anti-business regulations." Another respondent agreed: "California is terrible. Even when we've paid their high taxes in full, they still treat every conversation as adversarial. It's the most difficult state in the nation. We have actually walked away from business rather than deal with the government in Sacramento." A third complained, "The leadership of California has done everything in its power to kill manufacturing jobs in this state. As I stated at our annual meeting, if we could grow our crops in Reno, we'd move our plants [there] tomorrow."

Texas, on the other hand, is where 70 percent of all new U.S. jobs have been created since 2008, and has gained nearly a million new residents over the last 10 years. By comparison, California lost 1½ million residents, and New York lost even more than California. New Jersey lost so many residents that it has dropped from 10th to 11th place in population. Part of the attractiveness of the top states in the *Chief Executive* survey is that their budgets are relatively under control. For example, Montana Governor Brian Schweitzer said recently, "It gives us a great deal of pride that when 48 states zigged, we zagged. We were certainly not visionaries, but when times were good, we put money aside to get through the current downturn. Do we have enough money set aside to get us through this? I don't know. I think so. I hope so, but I know this: We did a better job than 48 other states."

Forbes magazine did a "Political Litmus Test" and discovered that the states in the worst financial condition were also heavily Democratic. Said *Forbes*: "The five states in the worst financial condition — Illinois, New York, Connecticut, California and New Jersey — are all among the bluest of blue states [while three of] the five most fiscally fit states — Utah, Nebraska and Texas — boast Republican majorities." Kent Redfield, former professor at the University of Illinois, concluded that the difference "comes down to stronger unions and a larger appetite for public programs. Unions in general have more influence in Democratic-controlled states. This isn't to say that unions are bad, but where they're strong you have bigger demands for social services and coalitions with construction companies, road builders and others that push up debt." Utah, according to Forbes, is the most fiscally responsible state in the union, with just $442 of debt per resident and unfunded pension obligations of $7,272 per resident. It is also the reddest state in the Union, with a 21 percentage point advantage for Republicans. And it boasts a triple-A credit rating from Moody's. By contrast, Illinois, a blue state, has a per resident debt of $1,877 and unfunded pension liabilities of $17,230. Moody's rates its general obligation debt second lowest in the country, just ahead of California.

Added together, 46 states face budget shortfalls this year of more than $110 billion. Dean Banker of the

Center for Economic and Policy Research concludes that the states have few options: "States are going to have to cut back spending and raise taxes, the same way Greece and Spain are." Former New Jersey Governor Christine Todd Whitman was more direct: "States don't have a choice anymore. These problems are going to require major surgery."

Not if the politicians themselves can avoid facing the music, however. Illinois Governor Pat Quinn recently signed legislation that would slash retirement benefits for state workers, saying, "We can't afford to deny reality or delay action any longer." But the *New York Times* exposed Quinn's deceit: "That vaunted $300 million in immediate savings? [Quinn] produced it by giving [Illinois] credit [today] for the much smaller checks it will send to retirees many years in the future — people who *must first be hired* and then, for full benefits, work until age 67." (Emphasis added.) In other words, through the magic of accounting and obfuscation, Quinn's savings are coming from workers who haven't even been hired yet!

Not Saying No to Constituents

The creativity of politicians trying to stay in office and avoid making hard decisions is something to behold. The city of Wichita, Kansas, will soon begin imposing a "false alarm fee" that applies to residents whose security alarms go off by accident. San Francisco has decided to charge a euthanasia tax of $25 per pet, and another $20 if residents want the city to dispose of the newly deceased pet. Residents in Washington, D.C., are now charged $51 a month to keep the streetlights on at night. Las Vegas will start taxing amateur sports, and fees will double for all youth and adult sports leagues and summer camps. Smokers in New York get to pay an additional $1.60 per pack of cigarettes, while Baltimore just passed a "beverage tax" of 2 cents per bottle, which includes water as well as soda. Probably the most notorious was New York State's "borrowing from itself" but not calling it borrowing, just "smoothing" out the revenue stream. New Hampshire was recently ordered by the courts to "put back $110 million that it took from a medical malpractice pool [in order to] balance its budget," according to the *New York Times*. Connecticut tried to revise its accounting rules to reduce the impact of its budget shortfall. Hawaii has already initiated a four-day school week. California accelerated its corporate income tax this year, making companies pay 70 percent of their 2010 taxes by April 15. And many states have attempted to balance their budgets using federal healthcare dollars *that Congress has not yet even appropriated*. Colorado tried unsuccessfully to raid that state's worker's compensation program in the amount of $500 million.

The audacity is breathtaking. According to MoneyNews, seven states that are in financial trouble continue to hire new workers. Joshua Rauh, a finance professor at Northwestern University, released a study showing that Illinois, Connecticut, Indiana, New Jersey, Hawaii, Louisiana, and Oklahoma have hired 9,700 new workers during the Great Recession. Says Bloomberg columnist Joe Mysak, "Politicians have talked a lot about layoffs during this recession. In most cases, that talk is … empty." Politicians have an "attitude of entitlement and arrogance," he adds.

Pension Fairies

Some despair that politicians and pensioners will continue to believe in "the pension fairy," as Gary North put it recently. He says that "voters are poorly informed but [they are] not stupid. They know that some future group of voters will simply stop funding the pension program[s]. They know that when things get tough there will be a new Legislature, and there will be a new Governor, and these faithful politicians will do whatever is necessary to get themselves re-elected." North compares the states' situations to that of General Motors before the government takeover. The company's debt was restructured [read: defaulted] which “stiffed all of the pensioners [and] stiffed all of the bondholders…. What happened to General Motors is going to happen to most pension funds in most municipal governments and most state governments … one by one, they are going to go belly up.”

Others are making “zero-sum” recommendations, such as selling digital ads on state-issued license plates; selling off state-owned properties, as was proposed in Minnesota when they suggested selling the Minneapolis-St. Paul International Airport to private businesses; or offering statewide, private vouchers for education, as was recently tried in the District of Columbia, generating some savings. Writing for the *Los Angeles Times*, columnist Michael Hiltzik complained about all the “corporate welfare” in which California engages. He referred to the “Hollywood” subsidy, currently $100 million annually in tax credits and “enterprise zones,” which costs the state upwards of $500 million. He further complains that “California is the only major oil-producing state that doesn’t levy a severance tax on oil taken from the ground, even though such a tax could yield billions of dollars a year.”

But all of these “raids” and “adjustments” and sleight-of-hand accounting tricks are simply nibbling at the edges of the problem. Joshua Rauh, quoted earlier, recently recalculated the pension obligations of all the states using the rules followed by bond issuers. The states’ unfunded liability is $3.23 trillion (with a T).

The reality is that with politicians’ interest in kicking the can down the road, the vested “entitlement” interests of the retirees, and belief in the “pension fairy,” bankruptcies will continue to claim victims. States are already looking to the federal government for “assistance.” If General Motors is too big to fail, what about California? And if California, why not New York? If New York, why not Illinois? The irony is, as always, the federal government has no money of its own. It’s already past the “tipping point,” and is taking on water faster every day. The future appears to many to be grim indeed.