States' Pension, Health Plans Increasingly Vastly Underfunded

The numbers being reported by pension fund managers are so out of touch with reality that Representative Devin Nunes (R-Calif.) has proposed legislation to correct them. Said Nunes: "It has been clear for years that many cities and states are critically underfunding their pension programs and hiding the fiscal holes with accounting tricks. When these pension funds go insolvent, they will create problems so disastrous that the fund officials assume the federal government will have to bail them out."

According to Joshua Rauh, a senior fellow at the Hoover Institute, the amount of underfunding is *three times larger* than that being officially reported. The Detroit bankruptcy in 2013, driven in part by underfunded pension and health plans, cost banks, insurance companies, creditors, and beneficiaries an estimated $7 billion. And that's for a city of just 700,000 population.

Other cities such as Chicago and Austin, Texas, along with states such as California, Illinois, and New Jersey are likely to follow Detroit, according to Rauh. The solution, according to the author of the study done exclusively for the *Financial Times,* is for cities and states to increase drastically the amount they are putting away to meet those future obligations. At present they are contributing about seven percent of their budgets; they would need to increase contributions to between 17 and 20 percent to stave off bankruptcy.

Even Connecticut, the country's richest state by per capita income, is in trouble. According to the *Wall Street Journal*, it has roughly half of what it needs to make future promised payments to its workers when they retire. Thanks to severe underfunding by the state, poor investment performance, and longer life spans of those retiring, Connecticut's unfunded pension liabilities have more than doubled in just the last 10 years and, unless something drastic is done, according to State Senator Scott Frantz, "Connecticut will end up as another Detroit."

Part of Connecticut's problem is that because it is so rich relative to the rest of the country, everyone has assumed that it will always have the money. As expressed so eloquently by Fredrena deFraggenreaidt, a 61-year-old state retiree from East Hartford, "Everyone sees us as this very wealthy state and yet our pension isn't 100% funded? How is that possible?"

Here's how: A combination of political decisions and economic reality has joined to put Connecticut on the same path as Detroit. Although it is the country's richest state, it ranks just 48th in the funding of its pension obligations. For decades the state legislature failed to make adequate contributions to the state's pension and healthcare plans for reasons that seemed plausible at the time. The immediately urgent needs overtook the more prudently important. Poor investment returns and retirees living longer than projected added to the increasing shortfall. Fund managers underperformed in comparison to their peers since 2000 and then, in an attempt to boost sagging returns, turned part of the investments over to hedge fund managers who then proceeded to disappoint with *their* results.

Despite cutting benefits, raising taxes, laying off state workers, and making promises, Connecticut appears to be in a death spiral so severe that the three credit rating agencies — Standard & Poor's, Fitch Ratings, and Moody's Investors Service — have been forced to cut the state's credit ratings and put it on "negative" watch for possible further downgrades.

The real problem, however, lies in the assumptions pension plan managers use to determine how much government entities should put away. The higher the assumed rate of return, the lower the obligation (and the perceived, reported total future liability). At present most pension managers assume invested funds will earn between seven and eight percent annually, which, compounded over years and decades, adds significantly to the theoretical pile of funds waiting to be distributed to beneficiaries.

But what if they don't? What if pension managers aren't able to meet the performance assumptions? What happens then? It's simple: It's compound interest only in reverse. In Connecticut, for instance, despite tax increases, benefit cuts, and more aggressive investment strategies, the pension and healthcare program liabilities are continuing to run away from the state's ability ever to fund them completely.

Add to that the outlook by John Bogle, the legendary founder of the Vanguard Group of mutual funds, that stocks will return just four percent on the average over the next decade, and Connecticut and other states and cities are facing an irresistible force that will absorb so much of their budgets that bankruptcy will ultimately be the only alternative. When pressed on the matter, Bogle told Morningstar's personal finance editor Christine Benz that even a balanced portfolio — roughly half stocks and half bonds — will return even less: around 3.5 percent for the next decade. That's half the assumed returns.

And when adjusted for inflation, expected returns in the real world will diminish further.

Some suggest that guaranteed benefit ("defined" benefit) plans should be replaced with "defined contribution" plans instead, thus shifting the responsibility from government entities and managers to the beneficiaries themselves. But where will they invest that would do any better?

It's a massive conundrum facing those reliant on governments to keep their promises. Optimists look at the impending implosion and see a time when individuals will once again be forced to become more self-reliant, discovering the limits to government and the inability and unwillingness of politicians to keep their promises.

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