Seeking Alpha α

Pension Fund Conundrum

by: David Merkel

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My piece on bank reform will have to delay until Monday evening. I am still working on it. This piece is on entitlements and pensions globally and locally.

I asked recently if anyone had data on other countries of the world to analyze where other countries were in terms of debt plus unfunded liabilities as a percentage of GDP. I got a few good suggestions, but then I stumbled across this article in the New York Times that provided the graph below right.

The article is about Greece, but the graph covers all of Europe and the US. I am not sure where the author got the 5x GDP estimate for the US, but I have e-mailed him. My own estimate was 4x GDP.

Either way the U.S. and the EU are more comparable than different by this measure. They are both in the 4-5x GDP zone. But the EU contains some real basket cases such as Poland, Greece, Slovakia, Slovenia, and Latvia. Oddly, Spain looks good on this measure, and Ireland and Italy are better than the EU average.

Now, recognize that these figures are from 2004, so they could be worse by now — they are unlikely to be better. Here is the original article from Jagadeesh Gokhale, the fellow who calculated the European figures at the Cato Institute. Quoting from his paper:

> No EU government has made the necessary investment. As an alternative, the next-best option is for these countries immediately to gradually but significantly increase saving and investment. In particular, the average EU country could fund its projected budget shortfall through the middle of this century if it put aside 8.3 percent of its GDP each and every year. Despite this adjustment, a budget shortfall is likely to emerge after 2050, requiring additional fiscal reforms.
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> What will happen if EU countries do not set aside these funds? Unless they reform their health and social welfare programs, they will have to meet these unfunded obligations by increasing tax burdens as the larger benefit obligations come due. Although spending averages 40 percent of GDP today:
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> - By 2020, the average EU country will need to raise the tax rate to 55 percent of national income to pay promised benefits.
> - By 2035, a tax rate of 57 percent will be required.
> - By 2050, the average EU country will need more than 60 percent of its GDP to fulfill its obligations.

Later, he continues:

> In comparison, the United States' shortfall for Social Security and Medicare alone has been somewhat smaller than the EU average, at 6.5 percent of future GDP. But as a result of the expansion of the Medicare program to cover prescription drugs, the U.S. fiscal imbalance is now 8.2 percent of future GDP. Putting this in perspective, to close its fiscal imbalance:
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> - The United States would need to save and invest an amount equal to 8.2 percent of its GDP beginning now and continuing every year forever to pay expected future benefits without future tax increases.
> - This could be accomplished by more than doubling the current 15.3 percent payroll tax on employers and employees, immediately and forever.
> - Alternatively, the federal government could immediately stop spending nearly four out of every five dollars on programs other than Social Security and Medicare — eliminating most discretionary spending on such programs as education, national defense, environmental protection and welfare — forever.

> Each year that the United States does not take action to reduce the projected shortfall, it grows by more than $1.5 trillion, after adjusting for inflation.

If you are a wonk on these matters, I recommend that you read the paper. But the article from the New York Times motivated the issue in other ways. A hairdresser in Greece retires at age 50? In the US, aside from the military, the only people I know of that retire with a full pension at age 50 are oil wildcatters, and those that similarly punishing hard work. Also, it is backward for women to retire earlier than men; they live a lot longer.

Promises, Promises

Already struggling with existing debts, governments across Europe face daunting pension obligations that are likely to require major changes in retirement programs.

Government debt versus future obligations as a share of gross domestic product

Euro currency zone members	CURRENT DEBT	CURRENT AND FUTURE OBLIGATIONS
Italy	116.3%	364.1%
Greece	**113.2**	**875.2**
Belgium	98.5	296.5
Hungary	78.4	N.A.
Euro zone	**77.4**	n.a.
France	75.8	549.2
Portugal	73.7	491.9
E.U. 25*	**72.3**	**434.2**
Germany	71.9	418.2
Malta	68.9	467.5
Cyprus	68.6	N.A.
Austria	67.6	409.8
Britain	63.4	442.1
Ireland	62.2	405.2
Netherlands	61.5	522.8
Poland	50.5	1,550.4
Spain	49.7	244.3
Sweden	40.3	430.7
Denmark	40.0	382.5
Finland	39.6	539.3
Slovenia	35.6	758.5
Czech Rep.	34.8	590.8
Slovakia	34.7	1,149.1
Latvia	32.8	619.1
Lithuania	25.4	497.2
Romania	21.7	N.A.
Luxembourg	14.9	376.7
Bulgaria	14.2	N.A.
Estonia	6.2	455.6

There is no way that we are going to get governments to run 8% of GDP surpluses per year to deal with these crises. I hate to say this, but if some of the profligate European governments want to deal with this situation, they will need to change their constitutions or laws that guarantee pension payments at a certain level and age, and extend the age and drop the benefits. Political suicide, I know. But do you care if the Eurozone fails? Do you care if your nation fails? I'm not saying that one group has to bear pain while another does not, but aside from those that work at physically demanding jobs, there is no reason why everyone can't work until age 75. Yes, 75, leaving aside disability. Retirement should be the last 10 years of life on average, not the last 20, much less 35.

When someone stops working, the rest must pick up the slack. Is there any way for a culture to work where those who work must support 2+ people excluding themselves? Many Western governments are staring at cultural failure, and can't see the forest for the trees. They see the short run funding difficulty, but do not see the long-term problem that is lurking to begin to bite in the next decade. The sad thing is — it's too late. Aside from cutting benefits, or raising benefit ages, there is no way out.

The Divided States

The Barron's cover article dealt with high state and municipal pensions. Though I wrote a piece on this recently, talking about the Pew report study, among other things, this article makes the valid point that the state and municipal discount rates on pension liabilities are likely too high, averaging 8% or so. The nominal GDP growth rate of the economy of the whole is probably the best estimate of where discount rates should be — what shall we say? 4-5%/year? In this low rate environment, earning 8% forever is ludicrous. But at 4-5%/year we are talking about a deficit of ~$3 trillion, not $1 trillion.

As the article points out, workers in the public sector earn more on average than those in the private sector. The need to have high pensions to attract workers is no longer valid.

Also, the states and municipalities are taking above average risks to try to earn their target rate, even though doing so is highly unlikely. As it says in the article:

> 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.
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> 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.

As I said above with countries, so it might be with states. Some states will have to repeal statutory or constitutional guarantees on pensions in order to survive. I don't like saying this, but I don't think there is any choice eventually. Do you want your state or municipality to survive or not? Even Chapter 9 and/or ERISA should be amended to allow for adjustment of pension obligations in municipal bankruptcy. States also should be able to use Chapter 9, or, a new Chapter of the Bankruptcy code for States.

That is why bond investors are getting skittish over General Obligation bonds, and moving to Revenue bonds, if the revenues are stable enough, and protected for bondholders. They don't trust the states and municipalities.

Now, this comes after years of underfunding the pension funds. Few truly were farsighted, and set aside the assets, rather than having more current spending, or deceasing taxes.

Where does this leave us? In no good place. Is there a solution? Yes, but only that of shared pain. We have to decide whether we take structured pain now, through benefit cuts and higher taxes, or, take unstructured pain when the riots arrive, time to be determined. Cultural failure is a real possibility; civilization is more veneer than solid when everyone argues for their self interest, and few argue for the good of the whole.

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