STORIES CITY LIGHTS NEWS

Broke Cities (including this one)

By Don Bauder | Published Wednesday, April 7, 2010

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AVERAGE COMPENSATION 2009
Dollars Per Hour Worked

	State and Local Government	Private Sector
Wages & Salaries	$26.01	$19.39
Benefits	$13.65	$8.02
Total Compensation	$39.66	$27.41

SOURCE: U.S. BUREAU OF LABOR STATISTICS, JUNE 2009

Those euro-zone countries get everything backward — working to live instead of living to work. That's what we smug Americans think. Take Greece. It has promised too much too soon to its pensioners, whose average retirement age is 61. And there's excessive generosity in other financially ailing European countries known by the snotty acronym PIIGS, standing for Portugal, Italy, Ireland, Greece, and Spain. Actually, even the so-called stable countries of Europe, such as France, are too indulgent.

But let's not get too overconfident in our own country, as the *New York Times* pointed out in a March 12 story. Jagadeesh Gokhale, economist with the Cato Institute, noted in that story that officially Greece's debt is 113 percent of its total annual economic output. But if its pension obligations were included, Greece's debt would be 875 percent of output. Bad, huh? Yes. But the comparable ratio for France would be 549 percent and Germany 418 percent. The United States? About 500 percent, says Gokhale, who includes Medicare, Medicaid, and Social Security obligations in his figures.

The Pew Center on the States says there is a $1 trillion gap between what the 50 states have promised workers in retirement benefits and what they have set aside. Some economists say phew to Pew. As noted in the March 15 cover story of *Barron's*, finance professors Robert Novy-Marx at the University of Chicago and Joshua Rauh of Northwestern say that the funding gap for state pension plans alone might be more than $3 trillion. Take a deep breath: these professors say that state pension funds as presently set up have only a 1 in 20 chance of paying their obligations 15 years from now, according to *Barron's*.

In California, State Treasurer Bill Lockyer says that past pension guarantees are legally cast in cement. The City of Vallejo, in the Bay Area, filed for Chapter 9 bankruptcy two years ago because its employees' pay and pensions ate up a staggering 90 percent of its budget, according to *Barron's*. Vallejo has slashed employment. There have been so many cuts in police that the crime rate has risen sharply. But the root problem — excessive pension promises — has not been touched.

Over the last several decades, government pay and fringes have soared while private sector remuneration sagged. Economist Chris Edwards of the Cato Institute, using figures from the U.S. Bureau of Labor Statistics, points out that the average salary of state and local government workers is $26.01 per hour, compared with $19.39 in the private sector. And there is a yawning gap in benefits: state and local government workers get $13.65 an hour, private sector workers $8.02. If you have been keeping track of this on your calculators, you see that total compensation (wages plus benefits) is $39.66 an hour for state and local government workers and $27.41 in the private sector.

Of those benefits, government workers get $4.34 an hour in health insurance, more than double the $1.99 of folks in the private sector. Government workers rake in $2.85 an hour in defined benefit pensions versus a mere 41 cents in the private sector. (In a defined benefit plan, retirees get a set amount each month, no matter what happens to the fund's investments. In a defined contribution plan, employees plunk money in monthly, but their pots go up and down with the markets.)

Here's the punch line: a whopping 80 percent of government workers get that guaranteed defined benefit pension. Only 21 percent of workers in the private sector have defined benefit plans, according to the Bureau of Labor Statistics.

The stark truth is that, increasingly, governments know they can't meet future obligations. But fearing that they can't break pension promises, they punish the citizenry by raising taxes and fees and slashing services, maintenance, and urgently necessary infrastructural spending. Sound familiar, San Diegans?

To play catch-up, public sector pension funds are putting money into gamy things such as hedge funds, venture capital, private equity funds, junk bonds, commodities, and the like. Also, they are not slashing the high percentage of their portfolios that they had in stocks in the fat years. Back in 2006, both public and private sector funds had about 60 percent of their assets in stocks, according to the National Institute on Retirement Security.

Now, despite all the mayhem in the stock market, public funds still have 57 percent in stocks. But private sector funds are down to 38 percent equities as they put more into conservative bonds. Some of that is no doubt due to caution, and some relates to a change in the law. The Pension Protection Act of 2006 requires companies with underfunded plans to plunk in more money and write off the shortfalls over a short number of years, explains Brian White, head of the San Diego County Employees Retirement Association. “There is nothing comparable for the public sector,” says White. “We have a longer investment horizon.”

The speculation can backfire. White’s County fund at one time had as much as 20 percent of its portfolio in hedge funds. One of them was Amaranth Advisors. That fund lost $6.5 billion of its $9 billion on futures market speculation, finally closing down. The County’s fund lost $175 million initially and got $90 million back. It expected to recover the rest in a fraud lawsuit against Amaranth, but in mid-March a New York court threw out the suit. The County’s fund is appealing. The chief investment officer resigned under duress as a result of his aggressive strategy. Now, hedge funds are down to 6 to 8 percent of the portfolio.

In some ways, the County’s fund is conservative: stocks are just 43.5 percent of the portfolio, with bonds at 30.8 percent. But junk bonds are 7.7 percent of the total pot, and emerging market debt is 4 percent. Private equity funds (capital pools looking for opportunistic investments) are 4.8 percent of the County’s portfolio. They represent 5 percent of the City’s pension fund, San Diego City Employees’ Retirement System. The City’s fund has 5 percent of the pot in so-called market-neutral strategies that often take both long and short positions, similar to hedge funds. Also, the City’s fund is 53 percent invested in stocks — gamier than the County’s — versus only 26 percent in bonds.

Both funds, along with others all over the country, vastly overstate their expected long-term returns. The City’s fund claims it will make 7.75 percent a year; the County ups the ante to 8.25. But the City’s fund has only chalked up a performance of minus 1.84 percent over three years, 3.3 over five years, and 5.1 over ten. The County’s performance has also badly lagged its bogey.

A government’s annual contribution to its fund is based on these unrealistic expected rates of return. Many scholars suggest using a “risk-free rate of return,” which would be about 5 percent. At a meeting last month, one of the officials of the City fund said that if the expected rate of return were cut to 5 percent, the unfunded actuarial liability would double or triple to $5 billion or $6 billion. Whew! Chief of staff Rebecca Wilson says board members aren’t quite so pessimistic: they think the unfunded liability would double and the required annual contribution rise by 50 percent.

But a 50 percent boost in the City’s required contribution would be backbreaking. So maybe going to 5 percent would lead to reform: the City of San Diego would be forced into bankruptcy, and a judge might challenge the notion that excessive benefits are embedded in the law.

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