Those Pesky Pensions

By Manuel A. Rodriguez

In a sign that the looming pension battles continue unabated, the New York Times reported recently that the Securities and Exchange Commission accused the State of New Jersey of securities fraud and claimed that it had not been properly funding public worker's pensions, while claiming it had. The SEC settled its suit with New Jersey by issuing a cease-and-desist order, and no penalties were imposed.

The SEC claimed that from 2001 to 2007, New Jersey claimed to have set aside funds to pay for pension benefits, when no such funds had been made available or earmarked. According to the SEC, New Jersey engaged in an accounting fiction to make it appear that the funds existed. The SEC also claims that this accounting illusion allowed New Jersey to sell $26 billion worth of state bonds to unsuspecting investors, who were never made aware of the magnitude of the state's pension troubles.

New Jersey's public pension fund is one of the largest in the country, and its chronic underfunding can potentially undermine future budgets by requiring significant redistributions from the operating budget to service its pension obligations. According to the SEC, the state treasurer repeatedly certified that the pensions were being funded according to the plan, which was never true. Interestingly, though, the SEC chose not to pursue charges against the treasurers who certified the misstatements or other professionals and auditors who reviewed them.

In another recent article, the Times reports that future pension obligations will likely create "class wars" and highlights how divisive this issue may ultimately become. The article again points to the pension study from the Pew Center from the States that was released early this year, which concluded that a $1 trillion funding gap exists between the promises made to current and future retirees and the funds currently available to pay for these obligations.

This unfunded pension liability, or gap, will presage a sharp division between retirees and current workers in deciding whether or how this liability should be funded. Ultimately, citizens will either be asked to fund these gaps, through taxes, or states will be forced to break their promises and the pension obligations to their retirees. It is difficult to envision a scenario where taxpayers will agree to fund ever-increasing pension obligations to generations of retired workers, but it is even more difficult to envision the legal mechanism through which the states will break those promises. Looming legal battles, state or municipal bankruptcies, or a combination of both, are likely, and the risk of financial default by one or more states increases, too.

Public pensions were thought to be sound fiscal and public policy at their inceptions. Generous pension promises acted as countervailing forces against the higher salaries and greater vertical mobility of workers in the private sector, who also earned generous pensions. This was set against the backdrop of economic ascendancy in America, where defined benefit plans were the norm, not the exception, and IBM and GM still ruled their territories. Public pensions preserved the ability of public institutions and governments to attract and keep their best workers, and municipal governments distributed their pension “gifts” abundantly, ignorant of the fact that future generations would be required to fund these mandates.

Most of these promises were made to a relatively young workforce, throughout a period of rising stock markets, and underpinned by a growing taxpayer base. These factors are no longer true. Sharply reduced tax revenue, coupled with the demographic change inspired by an aging workforce has made these promises nearly impossible to keep. Deep public anger and resentment has begun to brew, as most current workers have seen their pension plans terminated, and many have only 401(k) plans as poor “substitutes” for defined benefit plans. Americans are facing uncertain futures in retirement, as the safety net of social security looks increasingly imperiled.

Balancing the competing demands of retirees against current workers will ultimately become a political tightrope, one that could foment social and civil unrest. As Americans increasingly face the prospect of uncertain retirements, they will grow increasingly resentful of their neighbors’ 100% pension plans. How state and local governments balance these demands will ultimately determine their future, as the courts may be asked to intervene and impose their will on a political class brought to its knees by its union supporters on one side and its voting constituency on the other.

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