USA: Unfunded Benefits Dig States' $3 Trillion Hole

Commentary by Orin S. Kramer

Jan. 20 (Bloomberg) -- Everyone seems to know the current path of federal fiscal policy is a deathtrap over the long term. What's peculiar is the relative inattention to the balance sheets of state and local governments.

Hidden behind accounting fictions, the politically unspeakable reality is that public employee pension systems are under-funded by more than $2 trillion. Add more than $1 trillion in unfunded health-care benefits for retired public employees, and state governments face protracted structural deficits ranging from challenging to insurmountable.

Unfunded promises are the equivalent of government debt. The burden of promises made by state governments to their employees -- effectively an invisible wealth transfer from future taxpayers to current and prospective public-sector employees -- amounts to about one quarter of U.S. gross domestic product. The strength and durability of the current economic recovery are unknowable; that state and local governments, which employ one in nine workers, will be a drag on that recovery is certain.

Ultimately, mathematically unsustainable trends must reverse. As with New York City in the late 1970s, eventually the federal government may get involved in redefining the services state and local governments provide, the benefits paid to public employees and the burdens on taxpayers. States cannot kick the can down the road ad infinitum.

Accounting Fictions

The starting point for addressing the long-term policy challenge is recognizing the math. Government accounting standards make a series of benign assumptions about the future and ignore the actual market values of pension investment portfolios. By those standards, public pension plans are 88 percent funded. Unfortunately, government accounting rules create economic fictions.

If we tweak one variable and use estimated real market values of pension investment portfolios for Dec. 31, 2009, pensions are about 75 percent funded. Using the more conservative standards imposed on every corporate pension plan, state plans are only about 60 percent funded, which translates into a shortfall of more than $2 trillion relative to the funding that should exist today.

The severity of the problem and the short-term focus of the interested parties create powerful incentives for elected officials and others to avoid doing the math. In New Jersey, some of us for years publicly and repeatedly suggested that the real shortfalls were multiples of official government actuarial figures. Over time, those draconian assessments regrettably proved to be correct. But leading local newspapers showed zero curiosity about the limits of government accounting and refused even to publish the warnings on the grounds that readers would be confused.

Managing Political Risk

In theory, exceptional investment returns could cover any funding gap. But beyond the improbability of sustained returns above historic norms, a skeptic might argue public pensions frequently tend toward an investment process heavily geared toward reputational risk control -- which means averting political criticism -- under the nominal guise of prudent investment management. Although it may be counterintuitive, systems geared toward perceived safety and political risk avoidance may in fact increase investment risk.

My impression is that too many fiduciaries think they can play it safe professionally by mimicking the investment decisions of their peers in other states. Consultants, in turn, tend to be too sensitive to the herding instincts of their clients, reinforcing the trend to invest in ways that are only perceived to be safe.

Herding Effect

The investment risk is a perpetual pattern of arriving late in the game to asset classes. Late arrivals create adverse crowding effects that dilute returns. But individual managers avoid what they believe is the greatest risk: failing in isolation. The perception of safety is strongest for investment strategies that have produced recent success and enjoy widespread institutional support. In fact, investment risk is often lowest when perceived risk is highest.

The herding effect is powerfully reinforced by how we interpret our legal responsibilities asfiduciaries. We are held to a prudent man standard. At any point in time, many of us might differ as to what constitutes a prudently positioned portfolio.

But the law in effect creates a safe harbor for fiduciaries imitating the most common strategies of other fiduciaries. The fiduciary at legal risk is the one pursuing an unconventional strategy. So we have an anomaly. Investment success arises from purchasing assets that are cheap because they are undervalued by the crowd. But the only unassailable defense against legal exposure is pursuit of the crowd.

Three Lessons

In looking at the pension problem, I would draw three broad inferences.

First, there is a correlation in government between the creation of long-term liabilities and the propensity to rely on fantasy math.

Second, the parties to the arrangement suffer to the extent they fail to understand the math.

Third, there is an inverse correlation between the magnitude of a shortfall and the visibility of the issue. Precisely because the size of the problem precludes easy answers, it lies beneath the surface of the public dialogue.

(Orin S. Kramer is chairman of New Jersey's State Investment Council and manager of Boston Provident Partners, a hedge fund. The opinions expressed are his own.)

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To contact the writer of this column: Orin Kramer atoskramer@bprov.com

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