U.S. Pension Fund Collapse Isn't a Distant Prospect. It Could Come in 5 Years.

Kicking the can down the road won't work for much longer.

By **Aaron Brown** April 18, 2018, 6:00 AM EDT Bloomberg View

Warnings about looming public pension disasters have regularly cropped up since the 1950s, pointing to problems 25 years or more down the line. To politicians and union leaders, [1] the troubles were someone else's predicament. Then crisis fatigue set in as the big problem remained down the road.

Today, the hard stop is five to 10 years away, [2] within the career plans of current officials. [3] In the next decade, and probably within five years, some large states are going to face insolvency [4] due to pensions, absent major changes. [5]

There are some reassuring facts. [6] Many states are in pretty good shape, and many others still have time and resources to fix things. [7] There is no serious chance of retirees being impoverished. What's in doubt is whether states will pay promised benefits to retirees with large pensions or significant outside income or assets. [8] Also, although most of the problem is created by politicians and union leaders cutting deals to promise future unfunded benefits to keep voters [9] happy, there are also plenty of stories of politicians and union leaders risking their careers to stand up for honest pensions. [10]

It's important to distinguish between actuarial problems (the present value of projected future benefit payments exceeds the funds set aside to pay them plus projected future contributions) and cash problems (not having the money to send out this month's checks). Actuarial problems are always debatable and usually involve the distant future. Cash shortfalls are undeniable and immediate.

New Jersey [11] has $78 billion in its state pension fund, which is supposed to cover future payments with a present value of $280 billion. But that latter number is a projection. [12] You can ignore it if you wish, [13] or hope that soaring investment returns or a pandemic among retired workers will fix it. A more certain figure is that the $78 billion represents less than seven years of required cash payments.

If we extrapolate from the past, rather than use promises in the state budget, current employees plus the state will contribute about $25 billion over those seven years, which could provide another few years before the till is empty. But it will also add around $60 billion of future liabilities to current employees. The system probably breaks down before the pension fund gets to zero, for example if assets were to fall below $30 billion while projected future liabilities exceeded $300 billion. Even the most optimistic people would have to admit the situation is unsustainable. This could happen in three years in a bad stock market, or perhaps 10 with good stock returns. But fund assets are so low relative to payouts that good returns aren't that helpful.

The next phase of public pension reform will likely be touched off by a stock market decline [14] that creates the real possibility of at least one state fund running out of cash within a couple of years. The math says that tax increases and spending cuts cannot do much. For one thing, as we learned from Detroit, at a certain point high taxes and poor services force people and businesses out. The numbers are just too big in some states to come out of the budgets. For another, voters won't stand for it. The voters in these states have refused for decades to pay the full costs of the services they were already enjoying; they're not going to have sudden conversions to paying full costs, plus the accumulated costs from the past. State constitutions will be amended if necessary and big legal battles will be fought. I cannot see any plausible scenario in which full promised benefits are paid.

I hope that the problems of the least responsible states will shock the rest of the country into more rational reforms. Actuarial problems 25 years in the future can be solved with only moderate pain today. Cash flow problems three years in the future require chainsaws, not pens. But history does not inspire confidence that warnings will be heeded.

Footnotes (Refer to numbers in the article.)

1. *Remember that they were elected by taxpayers and workers who could have voted for more responsible policies.*
2. *In 2016, state pension funds took in $37 billion from employees plus $93 billion from employers and paid out $214 billion in benefits. This does not factor in the additional benefits that employees earned and that are promised to be paid in the future. Total state pension assets could last for almost 20 years without investment earnings at that rate, but individual states are in much worse positions than average. The trouble is that an average state with a 20-year cushion can reasonably count of significant positive investment returns. A state with a seven-year cushion is more vulnerable to a market decline, and doesn't hold enough assets to benefit significantly from good returns.*
3. *The last decade has seen almost 100 municipal bankruptcy filings, and about an equal number of cities were placed under control of emergency managers. In all cases there were multiple sources of trouble: Municipal pensions were sometimes a minor and sometimes a major contributor.*
4. *The current federal bankruptcy code does not allow states to declare bankruptcy. So either some new process will be invented, or states will repudiate promises using legislation, non-bankruptcy legal proceedings and possibly changes to constitutions.*

5. *The federal government has problems that are much bigger than any state's, but can be probably be finessed for another 20 or 25 years. In addition, the federal government has much greater resources and flexibility to deal with problems. Entitlement reform is still an important issue, but if ignored will not cause immediate problems.*
6. *Pensions are sometimes debated between two camps: those who claim the end of the world is nigh, and the other that denies any problem.*
7. *Also, health care is the big problem and costs may not increase as fast as they have in the past. Perhaps they will even fall as technology improves. Moreover, there's no serious chance of any retirees being denied minimally decent health care coverage, just whether high-quality coverage will be available, or any coverage for middle- or upper-income retirees.*
8. *Or states could pay the benefits, and then tax almost all of them back.*
9. *Voters who knew, or could have known, exactly what they were voting for.*
10. *Roger Lowenstein's excellent book "While America Aged" tells the good, the bad and the ugly of this story.*
11. *Michigan, Pennsylvania, Florida, Ohio, Oregon, Colorado, Kentucky and Rhode Island are in similar shape. These are not the states with the biggest actuarial problems, but those likely to run out of cash first. California has almost as big a funding gap as New Jersey, but its plan is five times as big. Connecticut and Illinois are not much better funded than New Jersey, but they have longer before cash flow problems kick in.*
12. *Unfortunately, this is a conservative projection. The actual present value is probably considerably higher.*
13. *That's not entirely true. It affects the interest rate New Jersey must pay on borrowings, and the state's ability to attract workers -- especially teachers -- and property values and decisions of people to move into or out of the state.*
14. *You can hope for a stock market boom, but that doesn't help much because (a) the pension fund assets are low relative to required payouts so even a high return on those assets doesn't extend the solvency period much, and (b) the troubled states have been quick to give away gains from above-average investment returns.*