Fiscal Time Bomb
Guest: Scott Beaulier
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BEAULIER: Hey, Tom. How are you?

WOODS: Great. I'm doing much better than the pension systems. That's a pretty awkward segue. But this is a very important fiscal issue on the federal level and at the state level, and you seem like a good guy to help guide us. Let's start out with the federal government, which always seems to be in the worst shape of all. What's going on with the pension programs at the federal level in terms of their sustainability?

BEAULIER: I think that's a good place to start. They're broke. If you look at total debt in the United States we have about $17 trillion of debt, but we have unfunded liabilities that some economists believe are closer to about $100 trillion to $200 trillion, somewhere in that range. And what we mean by that are all of the promises that have been made to current retirees, current workers, and future generations that have to be paid out. And of this massive liability, somewhere between $100 trillion and $200 trillion, we have Social Security, which is a federal program that is now beyond pay-as-you-go. It's not even that all the money coming in is covering all of the people demanding it. It's currently a drain, and it's projected to get much worse in the future.

WOODS: So that's the federal situation, but aren't there promises that have been made to federal employees specifically? At the state level we see a lot of generous packages that have been given over the years to state employees. I think I know why they do that, by the way. It's to keep taxes at bay in the short run, and yet keep the public employees happy in the short run. Then in the long run, when it comes due, the people will be out of office, and they won't have to deal with the tax revolt. What's going on the federal level?

BEAULIER: That's indeed correct. It's happening at the federal level, too. Now what's interesting about the federal level, and we might want to come back to this, is they have done a little bit more than many of the states in terms of putting pension funding for a lot of government workers and the military on firmer footing. So go figure: they actually want to assure that their employees have a sustainable retirement. The states are much worse in this area. Back in the mid-1980s the federal government shifted a lot of workers from just a straight defined-benefit program, which means you're guaranteed a certain set of payments based on how much you made, to a defined-contribution program, which allows for greater worker control over their retirement. They did it in the mid 1980s, and states are lagging way behind. I personally am a member of the defined benefit program here in Alabama. It's pretty bad in terms of just how tied your hands are and how many promises have been made to retirees, too.

WOODS: Let's talk about the states. We'll talk about Michigan and Detroit specifically in a little while, but first, where in the country is the pension system in the worst shape? If you had to list the top three or five states that are facing the biggest crisis in the immediate future what would those be?

BEAULIER: Without question, Illinois. Illinois is running as fast as it can towards pension insolvency. They're not taking enough steps to deal with it. In fact, a couple of years ago lawmakers were able to get through the state house and senate approval for pension bonds which were borrowing to firm up the finances of their pension system. They took the money and used it elsewhere for other state efforts. So even when they were trying to improve one particular area that's in dire need of improvement, they grabbed it and used it on other pet projects instead. So Illinois is hands down the worst.

After that it gets a little bit trickier to compare, but Pennsylvania is in particularly bad shape. They haven't made the required payments in nearly ten years now, which is an actuarial point that I don't want to dig too deeply into. But they're not even making what's required, which is like not making your mortgage payment. If you miss that again and again, it just gets to be a bigger and bigger problem, thanks to interest on it as well. After Pennsylvania, New Jersey is particularly bad, and you go down the list from there, and it gets harder. There are about ten states that are just really bad. Alabama's in that top ten, probably.

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WOODS: Is the bad condition of these programs in some of these states due to one or both of the following factors? One would be that they've promised benefits that are simply unreasonable, especially when compared with what people are getting in the private sector? Is it also that especially in the wake of the financial crisis returns are too low? There's no way these funds are going to earn an 8 percent return or whatever it is they need to make good on all their promises. So is it one or both of those factors, and if it's both which one is the larger?

BEAULIER: It is both, but the first is far more important. Just the politics of the system and the promising benefits that simply cannot be paid out over time, and just putting faith that somehow it'll get taken care of in the long run. And like you mentioned earlier, it's a problem that gets kicked to the next pension administrator, who's a public official. It's a problem that gets kicked to future senators and house members of different states, which is an issue that they don't have to worry about as well. What you see in New Jersey, for example, is that when the market return really cranked up in the 1990s, lawmakers couldn't resist passing additional benefits off on retirees, so New Jersey engaged in what's called pension spiking. They gave all of their current retirees basically a 10 percent cost-of-living adjustment, and what does that do for the lawmakers who did it? It assures they get voted back in and remain very popular. What does it do to the system long term? It's probably why New Jersey is the third worst in the country right now. The stock market crisis of 2008 is in some larger sense a blip. Yes, these pensions are invested aggressively, but anyone who understands finance from a long-run perspective understands that you're going to have variation like that, and in the long run, the rate of return is pretty good if you're in the market.

WOODS: What can you say about private pensions as compared to public? Are they in better shape simply because they're making their decisions on the size and scope of their benefit packages on the basis of some kind of market-influenced consideration whereas the public pensions are based on political considerations? Am I oversimplifying that?

BEAULIER: I think that's right, and one big difference is that the private sector's just been much more nimble in response to changes in the actual economic environment. So while most public pensions haven't really shifted at all in the last 30 years, the private sector's experienced massive change. Thirty years ago you probably would have been in a defined-benefit program if you were in a Fortune 500 employer. Today you're almost certainly in a defined-contribution program, which means you get 10 percent of your income that goes into, say, a Vanguard fund, and you have to make decisions over how to finance it. If you leave the

company, you take that with you. And what it's allowing the Fortune 500 companies to do is have great amounts of certainty about how much they're going to have to pay their workers in retirement. Public pension systems around the country have been very slow to make this change. There have been a couple. Utah, the state of Michigan, and Alaska have actually gone the defined- contribution route, but its slim pickings when you look at the actual public-sector response.

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WOODS: I realize that it's hard to give a specific number here, but when we say things like it's impossible for them to make good on all these promises and to make all these payments, we could mean that in the sense that they can make only 98 percent of what they promised, but I assume we're talking about something rather more severe than that. If we had to say, in the worst states, if we had to give some kind of percentage, roughly where would we be? If they had to make payments to everybody, and let's say there was some rule that said everybody will have to take a haircut proportionately based on how much we can afford to pay out, what percentage can they afford to pay out of what they've promised? Can we say something at least roughly about that?

BEAULIER: Yeah, you can for each state, and it varies quite a bit. Take a state like Illinois. If you want to truly make all of your pensioners whole and get out of the business of the model that has been in place in Illinois, you're looking at a massive tax increase. I want to say it's something like a 50 percent tax increase on state income. Illinois already has very highly taxed individuals. They have been entertaining passing millionaire taxes. It's a very progressive state. You have to take all of those up to about 50 percent higher than current levels.

WOODS: In other words, that just can't be done. Even the people of Illinois would say there's no way we're going to do this. You're just going to have to renege on some of the pensions.

BEAULIER: That's exactly right. Scott Walker would probably be, again, welcoming residents from Illinois to Wisconsin, which he did already once in response to higher business tax. They simply can't do it. But the idea of cutting pension benefits is something that is sacred. You should never, ever do that, and there's a lot of constitutional backing that makes it very difficult for any kind of change to the current retirees or current workers.

WOODS: I think it makes sense at this point to talk about what's going on in Detroit, because how that turns out will have a substantial influence on how a lot of the cases around the country at the municipal level and elsewhere are going to deal with this problem. Tell us what's going on in Detroit, and what's the legal status of the pension obligations? Is there any way for Detroit to get out from underneath that burden?

BEAULIER: It's a great question. For those of us interested in the public pension crisis we're seeing around the country, Detroit, and what's happening in the courts in Detroit, is kind of like the shot heard round the world. Up until now, we've seen other cities and counties go bankrupt. And when bankruptcy happens, it seems like what you should do is consider all of your liabilities, including pension liabilities to municipal workers. But the courts have consistently ruled that you can't touch those in bankruptcy. So city officials' hands are tied. They can only focus on reforming their city budget with a debt that isn't related to pensions.

What's happened in Detroit is Judge Steve Rhodes has ruled that, in fact, pension debt is no different than any other debt, and city officials have put together a blueprint for Detroit to emerge from bankruptcy that includes massive cuts to the pensions. If, in fact, it goes unchallenged it would be a 34 percent cut to current retiree benefits if you're just a standard city worker, a 10 percent cut if you're a police or fire officer. So these are huge. The reason why Detroit is something we have to pay attention to is that this notion of guaranteed benefits has just been basically tossed up into the air. We'll see if it actually sticks. That's the real question: will his ruling be upheld? It's probably going to end up at the Supreme Court.

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WOODS: Is this a situation where there's some—not necessarily easy or painless—way out, some plan devised by some think-tank somewhere that could somehow navigate these states out of this predicament, or is this just going to be a case in which they have made their bed over the years, and now they're going to be forced to sleep in it?

BEAULIER: It's a problem that if they don't deal with it sooner rather than later, it's definitely going to be a case of having made their bed and sleeping in it. Will some of the states that are kind of on the bubble make some kind of turn in the direction of positive reform soon enough is the question that we're asking in this literature right now, and there are some states that have done it. Utah had $3 billion of annually accruing liabilities from their pension program. They shifted to defined contribution, and they're in a much more solid financial footing as a state than they were before. There are examples of states that do it before it gets really dire. There are others, like Illinois, where no matter how bad it gets you just don't see any real positive signs of reform.

WOODS: Are you familiar at all with the situation in California? Does California have a problem along these lines?

BEAULIER: They do. Cities particularly have problems in California. CalPERS is pretty strong in terms of its financing as a whole, but the problem with the California system is that a place like Stockton, California, for example, goes bankrupt, and it gets backed and essentially is too big to fail thanks to CalPERS. So if major cities in California were to go down, it's going to be a real strain on the overall public pension program for the state.

WOODS: These constitutional obstacles that you say stand in the way of in some cases being able to make real progress on the pension issue by being able to reduce the benefit payouts, these are state constitutions that have enshrined this principle?

BEAULIER: More or less, yes. It's often in state constitutions. If it's not there, it's protected in the courts as well. If it's not written into the constitution, it's written into previous precedents in the courts. Because a state worker is protected by all resources and assets of the state, the state can rely on more or less anything, any resource that it needs, to make sure that the retiree's benefits are untouched. When we try to discount these things we typically treat them as guaranteed income, and that's what, if you're putting a really low discount rate on it, causes the pension liabilities to blow up as well. The actual pension liabilities across the U.S. are around $7 trillion from all the states instead of the about $5 trillion that official estimates suggest.

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WOODS: This is going to be an absolute nightmare to figure out what to do unless there is some constitutional reform that's made. In other words, you've got an impossible fiscal task that these governments and states are being presented with, because the major budget-busting aspect of it is untouchable, so what in the world are they supposed to do? I could imagine…you know what? I can't imagine. I can't imagine that the people could actually get going with some type of a referendum amending the constitution to allow for this, because you would get six months of TV commercials about my starving kids who aren't going to be able to survive, because I'm a loyal public worker and you're taking my money away. It seems like a political impossibility.

BEAULIER: It does, and everywhere you see it getting really bad. What you just described is exactly what happens. For example, this fall: the city of Cincinnati has its own defined benefit program that's separate from the state of Ohio programs. It's broke, and it really needs reform. Cincinnati put on the ballot a referendum that was considering pension reforms that are along the lines of what we've been talking

about. Just firming up the program, changing some of the payment requirements, and lo and behold it got shot down in just a landslide vote. Because the people who turned out were the people who claimed they would starve with any kind of reform. People who are well organized. And most people are totally confused about what a pension liability is. This conversation we're having is going to go over the heads of 99 percent of people. That's the problem: you're trying to convey this is a really big deal, and the only people who are entrenched on it are the ones who are benefiting from the program.

WOODS: Scott, you're talking to a very sympathetic audience, so let me shift gears completely toward the end here and ask you to tell people a little bit about the economics department at Troy University. I don't know if you're in the business cchool or in the liberal arts division or what, but I know that the economists there are very free- market sympathetic, and I have a lot of young listeners who are thinking about where they should pursue their four-year degrees. Why don't you make your pitch?

BEAULIER: I have one of the best jobs in the world. I get to go to work every day with eight other free-enterprise scholars in one of the largest free-market departments in the country. Other than George Mason, I think we're probably second in the United States for what we're offering and just the size and number of faculty that we have in one place. We're in the Sorrell College of Business at Troy University. We have an economics major that's both an arts and sciences major and a business major. I'm taking to our state commission in two weeks a proposal for a master's program in economics at Troy University. That program will have Austrian economics in it. It'll have history of economic thought. It'll have Public Choice and constitutional economics, so really important courses that can help a person bridge between their undergraduate experience and, say, a Ph.D. program at a place like George Mason. It's a really exciting place. Any listener who hears my pitch should certainly just reach out and get in touch with me.