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Federal, State and Local Debt and Liabilities, the problem….

A series on what this means to the citizens of West Chester…their livelihood, their families, their retirement and their taxes.

Part 1

The BIG Picture….Debt and unfunded liabilities.

Debts of our state, local and federal governments are identified as bonds, notes and bills that are issued and outstanding. These securities provide the government the ability to borrow money from its citizens and from nations abroad. The government pays interest on this debt by imposing taxes on its citizens.

When you buy a car, or rent an apartment or office building with a long term lease, that obligation is also a debt. Unless you plan to break the lease or contract after several months and renege on your commitments, you are obligated by law to make the monthly payments according to the terms of the contract. These same types of contractual agreements between government and its citizens in the form of promised future benefits are called "Unfunded Liabilities", if no assets are actually set aside. They are either real or a bag of broken promises. The future will tell the truth.

Checking the National Debt clock at http://usdebtclock.org/index.html , one will see that the total outstanding federal debt, securities issued by the US Treasury in the form of notes, bonds and bills, recently passed $13.5 Trillion. This represents 92 % of GDP (Gross Domestic Product). GDP is the monetary valuation of all US citizens' efforts and production from working hard every day, to earn a livelihood and to take care of themselves, their families and charitable inclinations. The total of all goods and services produced in America.

When adding in unfunded liabilities, promises to American citizens in the form of retirement (social security) and health care (Medicare and prescription drugs), the number grows by $110 Trillion to a total of $124.5 Trillion , or over eight times larger than all the hard working citizens can produce in a year, GDP.

The state coffers are not in much better shape. In the March 16, 2010 Wall Street Journal, an article titled "States Hope for a Rich Uncle" cited that 17 states had projected budget deficits of 10% or higher. The debt clock shows an additional state debt mounting to $1.1 Trillion and local debt scaling another $2.0 Trillion. All this debt needs to be repaid eventually or taxpayers will be relegated to a "foreverness" of paying interest. Do you think interest rates will stay at 2% for long? 4% of $13.5 Trillion is $540 Billion, or larger than the projected budget spending on Medicare for 2011 of $491 Billion.

A critical issue is that the Federal Government, through the Federal Reserve, can print money to keep paying their bills, a short term decision that may relieve the pain, but encourages the disease to grow faster. As presented by Fed Chairman Ben Bernanke and the Federal Reserve, as recently as September 21, 2010 in the Board's prepared statement at the conclusion of the FMOC meeting, the Fed Reserve will do what it takes to avert deflation, thus an openness of "Quantitative Easing" (QEII), printing money. This solves short term deficit problems, but creates new potential long term economic ramifications such as hyper-inflation. State and local municipalities cannot print money. States can only solve their problems the old fashioned way: raising taxes and/or reductions in government spending.

One of the "unfunded liabilities" for state and local governments is the state pensions. And like the Federal Government, their unfunded liabilities only add to the outstanding debt as reported by the states and municipalities. Bloomberg reported on September 15, 2010 that "less than half of the states had pension plans that were funded to the 80% level of future obligations". In other words, they are short of what they should have by 20% or more. The state of Illinois is funded to 50.6%. Some pension actuaries place the 80% funding level as a minimum threshold as viable funding towards future benefits to be paid.

The Kellogg School of Management at Northwestern University posted a review in March 2010, of a study by Joshua Rauh and Robert Novy-Marx, discussing the status of state pension plans. They cited a 5% chance that state pensions will be able to meet their obligations to retirees in 15 years. Reportedly there are $2.0 Trillion of assets in state plans and $1.0 Trillion in unfunded liabilities. Rauh and Novy-Marx estimate the unfunded liabilities could be as high as $3.2 Trillion, "due to government accounting standards… that severely understate their defined-benefit pension liabilities."

The main issue in their research is the assumptions these plans make in how fast the assets will grow to fund the future liabilities. On September 18, 2010, the Wall Street Journal article headlined "Pension Gaps Loom Larger…Funds stick to unrealistic return assumptions." As reported by both the WSJ and Rauh and Novy-Marx, most state plans assume a rate of return of 8-8.5%, average annualized returns. Not bad if you can get it. By doubling the return assumptions, you cut in half the funding requirements. When Rauh and Novy-Marx used rates of returns equivalent to municipal debt interest rates of approximately 4% or 10 year Treasury Notes around 3%, to demonstrate conservative rate of return assumptions, they found the "unfunded liabilities" doubled or tripled.

The same WSJ article showed that the median return for state pension plans over the last five and ten years have been around 4-4.5%. To understand how important those real lower rates are, consider having $100,000 in your own Individual Retirement Account (IRA), and you plan to retire in ten years. If you plan using an average, annualized return of 8%, in ten years your IRA would be $215,892, a gain of $115,000. If in actuality you earned 4%, your retirement assets would be $148,024, a gain of $48,000, and only 41% of the gain under the 8% planning, less than half. That would not be very good for your retirement and a little too late to make up the difference.

If, due to the slow economy, which is projected to grow at 1.5%-2.0% over the next couple of years, your investment grew at only 4% for the first five years, you would need to grow the next five years at 12% to make up the difference. It makes intuitive sense. But when you are funding assuming an average annualized rate of return of 8% and you have averaged 4-4.5%, your funding problems more than double or you need to stretch for higher returns with higher associated risk. Not necessarily what you want your employer to do with your retirement assets.

The amount of debt outstanding in this country is mind boggling, both on an absolute basis as well as a relative basis to our GDP. Deficits on a Federal and state level are precariously over 10% of budget. But, unfunded liabilities dwarf the outstanding debt problem and may be understated by a multiplier of 2-3, based upon a simple common sense approach to reasonable rate of return assumptions. You see this is not a problem that can just be covered up and deferred. Eventually everyone will be impacted. Either through higher taxes or even worse, a retirement which was being counted on and is not there.

By Ernest Chisena

In Part 2, "How safe is your retirement", we will further examine the unfunded liability issue in regards to state pension plans and the impact the "timing of returns" can have on a plan.