Mitchell's Musings 3-11-13: What Someone Forgot to Mention

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Let's think about pensions. I'm talking about traditional defined-benefit pensions, the kinds that are disappearing in the private sector and are the subject of controversy in state and local government. And let's start in southern California. Below is an excerpt from an item (in *italics*) from the February 27 Orange County Register:

COSTA MESA – An outside expert on public employee pensions told the City Council Tuesday that it should take "drastic" actions to lower its retirement fund debt, which he said was slightly worse than neighboring cities. Joe Nation, a Stanford University professor and former state assemblyman, offered a bleak picture of some Orange County governments' pension finances. While some California cities have declared bankruptcy or slashed public safety spending as retirement costs rose, nothing of the sort is imminent in Costa Mesa. But Nation told officials they should be more realistic about future risks.

***"If you don't deal with this, you won't have anything that you care about,"** said Nation, a professor of public policy...*[1]

In Nation's report, the city with the highest unfunded liability – the difference between what it has promised current and future retirees and what it has set aside to pay them – is Newport Beach, when calculated on a per capita basis. It owes nearly $3,000 per resident, while Costa Mesa comes in second at just under $2,000...

Nation is actually what is called Professor of the Practice of Public Policy, what at many universities would be called an adjunct position. Such positions are often occupied by someone – in the case of public policy – who comes from a political background (as opposed to a tenure-track faculty member). But that background doesn't mean Professor Nation has the wrong numbers. In fact, let us assume he is right about the $3,000 and $2,000 estimates, figures which apparently scared the civic authorities in Costa Mesa.

Nation in the past has gone along with the idea that since public pension obligations are legally ironclad, you should use the riskless long-term Treasury rate as a discount factor in calculating liability. In the past when such claims were made, the long-term rate was around 4%/annum but now it is around 3%. I don't know for sure which rate was used to calculate the $3,000 and $2,000 figures. But it won't matter much for our purposes.

Typically, unfunded pension liabilities are not paid off at once but over an extended amortization period. That is, the one thing that certainly won't happen is that the city council of Costa Mesa will send a bill to each household of $2,000 per resident. Let's suppose the pay-off period is 20 years. And let's then figure out what the annual payment would be if the

[1] http://www.ocregister.com/news/nation-497464-mesa-cities.html

residents were charged a level *nominal* amount for 20 years. Turns out that for Newport Beach, the figure would be under $215/year whether we assume a discount factor of 3% or 4%. For Costa Mesa, the amount would be under $145/year. Both municipalities are above-average income cities so it is not quite accurate to say that they won't have anything left that they care about.

For the average Newport Beach resident, we are talking about something like 0.3% of annual personal income to begin, an amount that would presumably decline as the flat nominal dollar amount was eroded by inflation. Costa Mesa is not so well off as Newport Beach, but its liability is less. So we are talking about something like 0.5% of personal income to start in that city.

These estimates do not mean that either jurisdiction should administer its pension obligations poorly. But they do provide a bit of perspective which someone forgot to mention, both at the city council and in the Orange County Register article.

Let's move from local pensions to pensions at the national level. Below is another excerpt from a news article. I spotted this one in the Los Angeles Daily News – also on February 27 - although it appeared in various other newspapers around the country.[2]

Vast Majority Wants a U.S. Pension

NEW YORK (The Street) -- Here's an intriguing concept: Every American should have a pension. Far-fetched? Maybe not. A study shows the vast majority of U.S. adults (especially millennials, the generation of U.S. adults born after 1976) say the current retirement system is in major disrepair and needs an overhaul. To many Americans, a national pension plan is the way to go. Certainly, Americans are anxious yet underachieving toward their own retirements. A recent report out from HSBC (HBC) says Americans will spend 21 years in retirement but have enough only savings to get through 14 years. Thus, (there is a) relatively quiet but firm push for some sort of national pension plan.

According to the Washington, D.C-based National Institute on Retirement Security, 84% of Americans say they are in favor of a pension "for all Americans" and that Congress should act on the problem...

85% of Americans say they are "highly anxious" about their retirement prospects.

95% of millennials say the current retirement system is "under stress and needs repair."

[2] http://business-news.thestreet.com/daily-news/story/vast-majority-wants-a-us-pension/11853378

90% of Americans support "a new pension plan that is available to all Americans, is portable from job to job and provides a monthly check throughout retirement for those who contribute."

67% of Americans say "it is a mistake to cut government spending in such a way as to reduce Social Security benefits for current retirees." ...

For younger Americans, the preference is for the retirements of their grandparents and definitely not of their parents, which appears to millennials to be in disarray, if not jeopardy...

So let's see. Folks want a *national* pension plan. They want it to be available for *all Americans*. And they want it to be *portable* from job to job. I thought we already had such a plan and it was called Social Security, the very plan respondents don't want to see cut. Social Security <u>is</u> a national defined-benefit pension plan for virtually all Americans. Indeed, what poll respondents seem to be saying is that they want Social Security to be enhanced, not just exempted from cuts. However, the article doesn't make that (obvious?) point. We seem to have found yet another implication that someone forgot to mention.