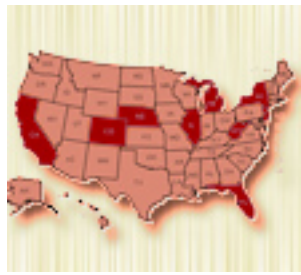


JUNE 13, 2005

SPECIAL REPORT -- PUBLIC PENSIONS**Sinkhole!**

How public pension promises are draining state and city budgets

[Interactive Map >>](#)

The public schools in Jenison, Mich., are real gems: Test scores are well above the national average, its autism and special-education program is recognized around the country, and the music program has been honored by the group that hands out the Grammy Awards. The 4,800-student district averages close to 100% attendance at parent-teacher conferences, and on Friday nights in the fall families crowd the high school stadium's bleachers to watch football. Parents have moved to this idyll on the west side of the state from as far away as Kentucky, Texas, and New Jersey just to get their kids enrolled. Over 500 students from nearby districts attend Jenison by choice.

But underneath all that success is a looming fiscal crisis. In the past three years, Superintendent Thomas M. TenBrink has surgically cut \$4.2 million out of his \$39 million budget in a quest to keep Jenison the fiscally responsible district it has long been. He has instituted fees for participating in after-school sports and field trips. He eliminated 30 teaching spots, leaving the district with 287. He hasn't bought a new textbook in three years. He saved \$550,000 by turning an elementary school into a self-financing preschool and day-care center. But TenBrink is running out of options. "It's getting to the point where it will start affecting the children," says Lauralee Ryan, the parent of a first-grader and an active supporter of the schools.

Jenison is caught in a financial vise. School funds from the state are capped by law at \$6,700 per student, a figure that has been frozen for the past three years, but costs are zooming. The fastest-growing outlay of all: contributions to pensions and retiree health care. This year the bill is \$1 million. Next year it will jump to \$1.5 million. An expense that for years hovered at 12.99% of payroll is now eating up 14.87% of it, and state finance experts predict it will hit 20% within three years. "That is just draining our budgets," TenBrink says.

TenBrink's daily struggle to provide vital community services while meeting retirement promises mirrors

the battle playing out across Michigan and the entire country. It's not just school districts that are being squeezed. State and local governments, hard hit by the economic downturn of 2001, find themselves in a financial bind. While sharp anti-tax sentiment constrains revenue and governments face new outlays for everything from homeland security to No Child Left Behind, there's a growing feeling that the retirement promises made to everyone from office workers and state patrols to firefighters and legislators may simply be unbearable. For some of the worst-off states, like Illinois, there is a long history of failure to fund pensions, which have snowballed into multibillion-dollar shortfall. For others, the depth of the problem is new, the result of poor investment returns and overly generous promises made when funds were flush in the late '90s.

The result: Essential services like education are being squeezed. States have only slowly recovered from the economic recession and revenue drops of as much as 40% in 2001 and 2002. Nicholas W. Jenny, a senior policy analyst at the Nelson A. Rockefeller Institute of Government, says that while taxes have begun to rise slightly, hikes have been more modest than they were in previous downturns, including the early 1990s, something he attributes to a political climate that's "very tax-increase averse." Recent anecdotal evidence shows that many towns and cities have bumped up taxes over the past few years as state and federal governments have pushed unfunded requirements like No Child Left Behind and other costs down the ladder.

How long that can continue without voter backlash is unclear, however. Meanwhile the cost of retirement has continued its steady climb. According to the U.S. Census Bureau, major public pension plans paid out \$78.5 billion in the 12 months ended Sept. 30, 2000. By the comparable period in 2004, that had grown to \$117.8 billion, a 50% climb in five years. Beyond hiking taxes and cutting costs, governments have few ways to meet this bill. One option that many fiscal conservatives find troubling is pension obligation bonds. They are, essentially, an arbitrage bet in which governments borrow at relatively low municipal rates, invest the money, and hope they make enough to cover pension payments and earn a bit on the top. But they can lose money if the market goes south, a situation that New Jersey, which issued \$2.7 billion in bonds in 1997, now finds itself in. Over the past decade state and local governments have borrowed approximately \$30 billion this way.

Don't expect that flood of debt to slow, because there's little relief in sight. Excluding federal workers, more than 14 million public servants and 6 million retirees are owed \$2.37 trillion by more than 2,000 different states, cities, and agencies, according to recent studies. In 2003 alone, states and municipalities poured some \$46.2 billion into these plans, according to the National Association of State Retirement Administrators, a 19% jump from the year before. Excluding federally funded programs, pensions went from 2.15% of all state and local spending in 2002 to approximately 2.44% in 2003. But the largest state and city funds were still short \$278 billion in 2003 -- approximately 20% of state and municipal revenue excluding federal funds. That's twice the \$123 billion pension hole Wilshire Associates found at the companies in the Standard & Poor's (MHP) 500-stock index that year.

As much as states are throwing into pensions, they may owe even more. Despite a 2004 stock market rise that should narrow some of the gap, pension experts at Barclays Global Investors (BCS) say that if public plans calculated their obligations using the more conservative math that private funds do, they would not be \$278 billion under, but more than \$700 billion in the red. "It's just ruining the financial picture for states and municipalities," says Matthew H. Scanlan, managing director of Barclays, one of the largest managers of pension-fund investments. "You're looking at a taxpayer bailout of this pension

crisis at some point."

There's more bad news. One major category of cost isn't disclosed at all: how much retiree health care has been promised to public retirees. No one can estimate how much these promises will add up to, but they're sure to be in the tens of billions, and only some states seem to have put aside reserves for them, according to bond analysts. That's chilling, given how quickly medical costs are rising. After a pitched battle, the Governmental Accounting Standards Board (GASB), the independent accounting standards-setter for state and local governments, has finally begun to require states to disclose these liabilities. Numerous unions and state government representatives objected to the change, says GASB member Cynthia B. Green, "not because [unions and states] didn't think these were important, but because they thought once the governments did their studies and found what the price tag was, they would be concerned or, if not concerned, staggered." The requirement will be phased in beginning in late 2006.

If these costs aren't brought under control, rising taxes could prove unavoidable -- and a competitive problem for the states in the worst shape as well as for the country. Stephen D'Arcy, a professor at the University of Illinois at Urbana-Champaign's College of Business who has studied public pensions, worries that if states like Illinois have to sharply hike taxes to pay for benefits earned decades ago, companies -- and even citizens -- could end up moving to states in better fiscal shape. "You could see it turning into an economic desert in certain states," he warns. Combined with the national retirement issues surrounding Social Security, these plans contribute to a depressing outlook for U.S. competitiveness overall.

RUDE AWAKENING

Even states with well-funded plans are struggling to meet their current obligations. For years, New York State enjoyed low pension payments, thanks to strong investment returns and fully funded plans, but in 2004 cities and counties across the state got a rude awakening. Pension contributions jumped as much as 248% in one year. "It was the equivalent of what I call a fiscal atom bomb," says Richard A. Bucci, mayor of Binghamton, a city in the center of the state, with a metro-area population of 250,000. In 2004, Bucci's pension bill jumped from \$1.6 million to \$4.2 million, forcing him to both cut back services and raise taxes. Homeowners saw property taxes jump 7% last year, half of which went to pensions, and another 7% hike is coming this year for the same reason.

Just a few years ago funds across the country were in much better shape. "Five years ago we were starting to feel pretty good about pension funds not being a credit issue," says Parry Young, a pension expert at S&P, "but now they're back on the plate." In 2000, Wilshire Associates found the largest state funds were overfunded -- boasting assets equal to 109% of liabilities. By last year that had dropped to 83%

One reason for the drop was unavoidable: The impact of the bear market of 2000-2002 on the value of these fund investments was severe. The other reason was just foolishness: a lathering on of billions of dollars worth of new promises to workers in flush days. It was a familiar mistake: Public-pension provisions are determined by elected officials, and civil servants vote. Legislators have a long history of making such expensive upgrades to already generous plans.

Some of these giveaways are truly spectacular. In 1998 the city of Houston instituted a deferred-retirement option plan, or DROP, that would allow workers to in effect take their retirement when they

became eligible for it but continue to work at their salary. The retirement income was put in a side account where it earned an attractive rate of return, and the employee could later have his pension adjusted upward to a higher level. The DROP, along with other pension improvements, drove the city's pension plan down from 91%-funded in 2000 to just 60% two years later. Houston had gone from contributing 9.5% of payroll toward pensions to more than 32%. Joseph Esuchanko, a Michigan actuary brought in to study the problem, discovered that things would only get worse. According to his calculations, it was possible for employees to become millionaires thanks to the system. Under one scenario, a lifelong city employee retiring with a salary of \$92,000 could get \$420,000 a year in pension benefits. The citizens of Houston agreed with Esuchanko's conclusion that the system was a "win-win for the employee and a lose-lose for the employer." Last May they voted to end the benefits.

Little wonder, since even bare-bones guaranteed retirements are increasingly rare in the rest of the economy. According to the Census Bureau, 90% of state and local workers have a defined-benefit pension with a guaranteed payout. But only 24% of people employed in the private sector have such plans. (Most public-sector employees contribute along with employers to their pensions, unlike private-sector workers.) And more of the companies that once offered these benefits -- places like Motorola (**MOT**), IBM (**IBM**), and Delta Air Lines (**DAL**) -- are dropping them for new workers in favor of 401(k)s. Health-care coverage for retirees, a costly perk that companies have been shedding at lightning speed, also remains common in the public realm.

It has long been accepted as truth that government workers get good benefits and job security in lieu of high salaries, but over the years the gap between public and private employee paychecks seems to have narrowed. It's hard to come by perfect comparisons, since government numbers for the private sector include lower-wage industries like retailing, which pull down the averages, but overall, public-sector workers look to be getting a pretty good deal. In 2004 average salary for a public worker was \$49,275 compared with \$34,461 for everyone else, according to the Employee Benefit Research Institute (EBRI).

Even white-collar workers are better off in the public sphere. According to the U.S. Labor Dept., state and local government managers and professional staff earned \$42.87 an hour last year, while their private-sector counterparts earned \$41.52. One big reason: government workers get \$2.62 an hour in retirement benefits; everyone else gets \$1.63.

States pay more for public retirees too. According to the EBRI, the average public-plan retiree got \$16,188 a year in 2003, far more than the \$7,200 their private company counterparts could expect. One reason for that big split is that some public retirees do not get Social Security. But that too is changing. Since 1983 most public workers have been part of that system too, so in the future the disparity could well widen. All in all, EBRI concludes, state and local government wage and salary costs are 40% higher than the private sector's; its employee benefit costs are 60% higher.

Workers naturally fight any changes hard, and they can be a very sympathetic group. In California, Governor Arnold Schwarzenegger came up against the political challenges of taking on public pensions this spring after he declared his support for a radical solution: ending the state's traditional pensions for new hires instituting a 401(k)-style system instead. (The norm in the private sector, such defined-contribution plans are rare in government.) Schwarzenegger spent February and March campaigning for a resolution to be put on the ballot possibly this coming fall. He collected signatures personally. He raised money for a series of radio ads. But by Apr. 8, the "Governator" had been felled

by public campaigns arguing his plan would cut survivor benefits for police and firefighters. "What we really need is a discussion about what kind of society we want to be," says J.J. Jelincic, president of the 140,000-member California State Employees Assn. "What does it take to get there and how do we fund it."

EXTREME BENEFITS

To Jelincic, the answer is to raise taxes, but though Schwarzenegger lost the first round he hasn't warmed to that idea and has vowed he won't give up. The state's pensions hit the news last year with revelations of a crippling \$1.4 billion deficit in San Diego's municipal pension fund. The city's mayor, Richard Murphy, announced on Apr. 25 he would resign on July 15 after facing a continuing debate over how to solve the problem and probes by the Securities & Exchange Commission, FBI, and the U.S. Attorney for the Southern District of California's office into securities fraud and public corruption in connection with the fund.

But San Diego is only the beginning. Citizens of Salinas, Calif., where pension costs are up and revenue is down, are facing the possibility that their public libraries will close this year. Orange County, Los Angeles County, and many other California counties have significant pension deficits. The state itself will pay \$3.5 billion into pension and health benefits for retirees this year, almost triple what it paid just three years ago. And California's Legislative Analyst's Office (LAO) expects that to climb another \$1.1 billion over the next five years.

Moving all new California employees to a 401(k)-style plan wouldn't eliminate the bill already due, but it would slow the pace at which the pension deficit grows. Although there would still be a cost to this plan, it would be more predictable and lower than what the state is currently paying. Over many decades, California's pension costs would shrink as high-cost employees are replaced.

California's pension benefits are extreme. In 1999 and again in 2001, a time when the pension plans were flush with strong investment gains and state contributions were low, the state legislature upped the benefits to levels far beyond even the most generous public plans. A recent analysis by the LAO notes that for longer-term and some local employees, it's quite possible to receive more annual income in retirement than when a worker was employed.

This tendency to dole out goodies in fat times is the core moral hazard of public-pension plans. Politicians like to reward voters when they can, and public workers vote. It wasn't only in California that benefits crept up during the end of the bull market. Public employees saw benefit enhancements in New York, Colorado, Illinois, New Jersey, and many other states. "That was the mirage of cost-free benefits," says S&P's Young. "Nobody pays, nobody gets hurt." Not all of California's sudden pension bill is due to this; much comes from falling stock prices. But the LAO calculates that \$600 million, or almost 25%, of the \$2.6 billion contributed to state pensions in 2004-2005 resulted from these benefit increases. And unlike the investment performance, there is no hope for relief from this new, more expensive set of pension promises.

A plan's downturn can be tough to predict. Just five years ago, the city of New York was expecting its fiscal 2004 pension bill to total \$650 million. Instead, it came in at four times that much, \$2.46 billion, or 8% of the city's \$29.7 billion budget. Half of that \$1.8 billion surprise came from benefit improvements, including \$251 million in cost-of-living adjustments. By fiscal 2007, the Independent Budget Office of the City of New York projects pension contributions to hit \$4.9 billion, 12% of the \$40.5 billion budget.

REVERSE COMPOUNDING

But states have also voluntarily heightened their own exposure to this risk. Rosalind M. Hewsenian, managing director of Wilshire Associates, says the biggest cause of the sharp drop in funding levels at public plans over the past few years was a drop in employer funding and a reliance instead on investment gains to make up the difference.

Take Illinois. The fifth-wealthiest state in total income, Illinois nevertheless has a 30-year history of shirking its pension promises. According to an analysis by the Civic Federation, a Chicago research group sponsored by the business community, since 1970 Illinois has not once paid its annual pension bill in full. Over the next 40 years the state will have to contribute \$275.1 billion if it is to reach its goal of 90% funding -- and that's presuming no benefit changes are made. Through bull markets, bear markets, and sideways markets, the state has consistently lagged, and over time those delays have become more and more expensive. The culprit: reverse compounding. A pension plan's obligations are determined in part by the expected investment return on its assets. In the case of Illinois, that is 8%. So for every dollar not added to assets in time, the state is effectively borrowing from the pension plan at 8% interest. That's a high price in today's market, where municipal bonds typically pay closer to 6%. Illinois Governor Rod R. Blagojevich says that if the state follows its current spending plan, it will have paid \$220 billion in interest before it fills the hole.

After 30 years of the state's procrastination, the pension burden has grown backbreaking. Illinois' five pension funds are \$35 billion in the red, a serious shortfall for a state with a general operating budget of \$43 billion this year. Illinois owes \$2.6 billion this year, and within five years that will reach \$4 billion annually. By comparison the state will spend \$5.9 billion total on kindergarten through 12th-grade education next year. "If we were a business we wouldn't be in Chapter 11, we'd be in Chapter 13," says Ralph M. Martire, executive director of the Center for Tax & Budget Accountability, a Chicago-based nonprofit think tank. "We'd have to liquidate." Illinois is not a fast-growing state that can hope that future population and tax growth will bail it out. D'Arcy of the University of Illinois calculates that Illinois should be 97%-funded based on the rate of its income growth. Instead, retirement funds are 62%-funded.

The challenge to fixing the state's pension mess is, again, politics. Right now the halls of the state legislature in Springfield are a lobbying battleground between proponents of a plan proposed by the governor to cut benefits for new workers and union-led forces opposed to such a two-tier system. In many ways, the union argument is quite persuasive: State workers in Illinois have perks that are generally in line with or even a bit below those of other state's civil servants. Workers have consistently made their contributions to the pensions -- it's the state that has failed to pay its share. And Illinois has an antiquated tax system that probably is holding revenue down.

Over the years, even as the state failed to pay for existing pension promises, the Springfield politicians have added more. In the past 10 years benefit sweeteners have added \$5.8 billion in new benefits, largely through early retirement inducements. And there has been a general creep up in the level of promises made. Today, one-third of Illinois state employees get hazard rates of pension payments originally intended only for state police, according to the governor.

Elected officials are hesitant to ask the rest of their voters to pay for these promises through higher taxes. One primary reason: Outside of government workers, very few employees have these kinds of

deals anymore. "Our people at 55 years of age can get 75% to 80% of their salary [as pension], and it's a pretty nice salary," says Illinois State Representative Robert S. Molaro, a member of a commission convened by the governor to make recommendations for fixing the pension system. "It will be hard for us to go to the taxpayers and ask them to pay for our pensions with benefits you in the private sector couldn't even dream of."

FREE FROM SCRUTINY

Given this divide, it's reasonable to wonder why there hasn't been more debate about these plans already. They've been protected from scrutiny for a number of reasons. The public-pension systems lack the regulatory system governing corporate pension plans. Corporations have to disclose timely, detailed information about their pensions to investors and the SEC. Rating agencies focus on them, too. In combination, these groups can pressure companies to be more conservative in their fund management. Devereaux A. Clifford, managing director of pension consultants Greenwich Associates, says it was pressure from these watchdogs that forced corporations to lower unrealistic investment return assumptions, from 8.9% in 2002 to 8.3% in 2004.

The public world has far less scrutiny. Nor do these plans have an equivalent to the Pension Benefit Guaranty Corp., the government-sponsored insurer of corporate plans. They have to conform to the funding requirements or accounting demands of the Employee Retirement Income Security Act, the federal law passed in 1974 to monitor private pensions. And public fund reporting lags corporate reporting by at least six months. Important factors like the performance and cost of bonds issued to cover pension obligations are even harder to suss out.

That's bad news. Understanding the depth of these retiree problems seems especially important for state and local governments because of their limited financial options. Unlike the federal government, which can always print money, and private companies, which might sell more widgets and make more profits to fund their pensions, and whose pensions are guaranteed by a government-backed insurer, local government basically has only one way of meeting those promises: your taxes. Public-pension experts note that these obligations must be paid. Public-sector retirement benefits are generally guaranteed by state constitution. Even in the throes of New York City's fiscal meltdown in the 1970s, while services were being cut and emergency bonds were being issued to keep the city afloat, cutting existing pensions was never even discussed.

Don't expect much help from the stock market, either. Much of what fueled big gains in state assets in the '80s and '90s was a shift from investing primarily in bonds to higher-returning equities. Meredith Williams, executive director of Colorado's public employee retirement system, says that by 2000, his funds were 90%-invested in equities and real estate investment trusts. The bear market took Colorado's plan from 105%-funded to only 76%. That prompted Williams to cut stocks to something closer to 60% of total holdings. "You live by that sword, you die by that sword," he says. Neither would it be smart for state and local governments to continue borrowing to pay down pension liabilities, a move that not only can backfire if investments are weak but also saddles future generations with debt.

The more likely answer is the most painful: Taxes will keep going up and benefits will be cut for future public employees. Both are unpopular. The debate is just starting to be heard.

By Nanette Byrnes, with Christopher Palmeri in Los Angeles

JUNE 13, 2005

SPECIAL REPORT -- PUBLIC PENSIONS**Online Extra: San Diego's Widening Pension Woes**

A fund shortfall has prompted the mayor's exit, felony charges against pension-fund board members, and talk of bankruptcy

Despite the cool ocean breezes, the political climate in San Diego just keeps getting hotter. On July 26, the city will hold a special election to replace Mayor Richard Murphy, who's stepping down after a scandal involving the city pension fund. He had won reelection last year, following a narrow and hotly contested three-way race. Subsequently, Murphy had a public spat with City Attorney Michael J. Aguirre and was named by *Time* magazine as one of the nation's three worst mayors.

The unlikely source of Murphy's woes: San Diego's municipal pension fund, which is about \$1.4 billion short of the money it needs to pay city retirees over time. Murphy's office had acknowledged that the Securities & Exchange Commission, the FBI, and the U.S. Attorney's office were investigating allegations of securities fraud and public corruption in connection with the fund. Some civic agitators have even called for America's seventh-largest city to declare bankruptcy to help it get out of its financial bind.

STRETCHING PAYMENTS. How did a wealthy city of 1.3 million people get in such a mess? The problem's roots trace back to 1996. During the term of Murphy's predecessor, Susan Golding, the city council voted a big hike in retirement benefits for municipal workers. Rather than increase the city's contributions to the plan, however, the council opted to stretch the contributions out over time. Four years later, as the stock market began to fall and fund assets declined, the city once again looked to limit its contributions.

To do that, the council had to win the permission of a pension-fund board composed largely of labor representatives. The council got permission -- after agreeing to additional benefit hikes. "What we're witnessing is the growing power of labor unions in city affairs," says Steven Erie, a professor of political science at the University of California, San Diego. "They're becoming big players. It's a very serious financial problem."

According to reports produced by Aguirre, the combined cost of the two benefit hikes increased city employee retirement pay by as much as 66%. As of the last fiscal year, the San Diego City Employee Retirement System had \$4 billion in liabilities vs. \$2.6 billion in assets, a funding ratio of just 65% -- well below a national average of 91%.

TOUGH TALK. Murphy had taken steps to fix the problem. Last November, voters supported his proposal to reconstitute the pension-fund board. Seven of the 13 board members are now independent, with no ties to city employees. In its previous incarnation, just four were independent.

To close the gap in funding, Murphy had hoped to sell hundreds of millions in pension obligation bonds, backed by the city. And he was getting tougher in labor negotiations -- looking to freeze salary and benefit increases, hike employee pension contributions, and reduce benefits for new hires.

The prospect of bankruptcy is remote. Nearby Orange County, Calif., which declared itself insolvent in 1994, remains the most prominent example of such an event. Although other cities, most notably Bridgeport, Conn., and Pittsburgh, have threatened such action.

SIX CHARGED. "It's mainly a way to throw gasoline on the fire and get everyone to deal with the problems," says Carl Jacobs, a director of municipal-bond ratings at Standard & Poors, which suspended its San Diego rating last year, pending completion of an outside audit of the city's finances.

Meantime, the fallout from the pension scandal continues. On May 17, the San Diego County District Attorney Bonnie M. Dumanis charged six current or former pension-fund board members with felony charges. Dumanis claimed they violated state laws by voting to limit city contributions to the fund at the same time they were personally benefiting by increasing their own pensions.

"As a former judge," says Murphy, "I believe people should not rush to judgment."

Editor's note: This updates a BusinessWeek Online story that originally appeared on Apr. 26, 2005

By [Christopher Palmeri](#) in Los Angeles

EDITED BY Edited by Patricia O'Connell

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JUNE 13, 2005

SPECIAL REPORT -- PUBLIC PENSIONS

Online Extra: How the Garden State Dug a Hole

Borrowing aimed at boosting the assets of New Jersey's pension plans went way awry. It's a lesson to governments everywhere

It must have seemed like a good idea at the time. Back in 1997, New Jersey borrowed \$2.7 billion in pension obligation bonds to fill a gap in its plan funding. These bonds — sometimes called POBs — are general obligation debt much like any other municipal borrowing, but they're issued in order to put the proceeds into the pension funds, not the general government coffers. The issuing city, county, or state bets that the borrowed money can be invested to earn more than the interest rate that the bonds must pay.

In recent years, these bonds have become a common tool for filling holes in city, county, and state pensions. According to bond-rating agency Standard & Poor's, the Garden State's 1997 deal was part of some \$30 billion that has been raised in this manner over the past decade. New Jersey's was the first state POB, and because it was issued only a few years before a big drop in the stock market, it has now become a cautionary tale of how wrong that bet can go.

THEN THE BUST. For a few years, New Jersey's gamble paid off. Along with the rest of the state's pension assets, the bond money was invested heavily in equities and rose in value as the stock market boomed in the late 1990s. The pension accounts climbed at a double-digit annual rate for several years, well above the 7.6% the Garden State promised in interest on the bonds.

Then came the market bust in 2000, followed by two years of depressing returns that turned what once looked like a winning strategy into a dud. Since 1997, New Jersey's POBs have averaged an annual return well below the 7.6% they owe in interest, according to State Treasurer John E. McCormac. And that's before factoring in whatever the state paid its investment bankers to get the deal done.

Worse, the borrowing, which was intended to boost the plan's assets, has instead become a painful multiplier of the state's existing pension problems. Currently facing a pension deficit of at least \$25 billion, the state will have to contribute more than \$1 billion to its pension fund next year, up from \$100 million this year.

RISING BILLS. At the same time, the interest payments on its pension obligation debt are escalating -- a structure built into the bonds from the start. Now about \$170 million a year, that bill is steadily rising and will hit \$500 million annually by the end of the issue's 30-year life.

"The decision looked good for a couple of years and has not looked good at all the past couple years," says McCormac, who wasn't treasurer in 1997. He's trying to improve investment returns by diversifying the pension portfolio in private equity and other asset classes. But that's unlikely to be

enough.

He believes the state will also have to chip in to help halt what he calls a "crisis" at the pension funds. To do so, the legislature, which created the POBs eight years ago, would likely have to either make spending cuts, increase taxes, or both. "Without a doubt states should look at all these experiences, recognize all the risk, and go in eyes wide open to a transaction like this," McCormac warns.

"A BAD IDEA." Critics of POBs say those risks rarely if ever make the move worth it. Jeremy Gold, a pension consultant based in New York, argues that POBs are always a bad deal, no matter how the investments perform.

First, they're expensive. In addition to underwriting costs that can easily reach the millions of dollars for larger deals, there's the fact that the pension fund could more cheaply borrow money using other mechanisms, including swap transactions, that would hold a far shorter term than a 30-year bond.

Gold also objects to fixing a current budget problem by pushing off payments onto future generations. "This is a bad idea that keeps on giving," he says. "It lowers the burden for the current government, usually at the expense of some future taxpayer either in the form of risk or losses."

DOUBLED DEBT. In addition to pushing the bill off to future generations, it also makes these deficits a fixed general obligation of the state or municipality that issues the POB.

S&P credit analyst Parry Young notes that pension shortfalls are somewhat flexible. Though they must be made up at some point, as long as current pensioners are getting their check, it's possible for employers to time their payments to suit their other financial needs.

By issuing POBs, a state or municipality takes an off-balance-sheet and somewhat flexible obligation and makes it a fixed general obligation of the government. When Illinois issued a \$10 billion POB in 2003 at the favorable interest rate of 5%, its debt instantly doubled.

PRICEY SWEETENERS. The pension bonds weren't New Jersey's only misstep. It probably should have put more into its plans over the years and not relied so heavily on a strong stock market. The Garden State's elected legislators also gave away expensive pension sweeteners that just deepened the hole.

Many states made similar mistakes. Now they're searching for ways to fund their pension shortfalls. New Jersey's experience is a cautionary tale about how dangerous such borrowing can be.

By [Nanette Byrnes](#) in New York

EDITED BY Edited by Patricia O'Connell

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