Unfunded Liabilities: The Inevitable Great Emancipation of the 21st Century

This speech will discuss the counter-party risks of saving for retirement. I will show that groups collectively don't plan and save for retirement any better than individuals, and why they may even be worse. Before I begin I would like to provide the context for, and stress the urgency of, my topic with brief discussions of the past, present and future of public pensions.

First, are two historical questions about the past:

Question #1: What do the following publicly traded companies have in common?

Delta Airlines	Trans World Airlines	United Airlines	US Airways
Bethlehem Steel	LTV Steel	National Steel	Weirton Steel
Delphi Automotive			

Answer: All filed for bankruptcy in the first decade of the 21st century, dumping the unfunded liabilities of their insolvent pension plans onto the Federal Government.

Question #2: What do the following states have in common?

Arkansas	Florida	Indiana	Illinois
Louisiana	Maryland	Michigan	Pennsylvania

Answer: All defaulted on their public debt in the 1840s.

Second is a sample of three stories chronicling the current crisis of unfunded pension liabilities.

[1] Newspaper: *Richmond Times-Dispatch*
Date: March 15th, 2010
Headline: "State Will Dip Into Pension Fund"

Text: Virginia is taking away more than $620 million that would have been paid toward state employee pensions, but the state is leaving an IOU. Beginning in 2013, the state will have to repay the money to the Virginia Retirement System over 10 years. Senator Walter Stosch said "I don't want anybody to feel that their pension is in jeopardy, because it isn't. We're recognizing the unfunded liability and requiring it to be repaid."

Translation: Like teenagers, the Virginia Legislature is ignoring its moral and legal responsibility to save, and instead is grabbing its credit cards and heading to the shopping mall.

[2] Newspaper: *New York Times*
Date: September 19th, 2012
Headline: "Next School Crisis for Chicago: Pension Fund Is Running Dry"

Text: The Chicago Teachers' Pension Fund is paying out more than $1 billion in benefits a year — much more than it has been taking in. That has forced it to sell investments, worth hundreds of millions of dollars, to pay retired teachers. Experts say the fund could collapse within a few years unless something is done. The State Legislature granted the Chicago school district a break from its pension contributions, starting in 1995. Since then, the city has never contributed the required amount; for many years it put in nothing. All the while, the teachers' benefits kept building up. Teachers in Chicago, as in many cities, do not earn Social Security credit. Having skipped its pension contributions for many years, Chicago is supposed to start tripling them in another year under state law. But the school district has drained its reserves.

Translation: The Chicago Teachers pension fund is insolvent, and it's only a matter of time until it files for bankruptcy. The only question that remains is who will be forced to bear the loss: The city taxpayers, the state taxpayers, or the retired teachers.

[3] Newspaper: *New York Times*
Date: May 27th, 2012
Headline: "Public Pensions Faulted for Bets on Rosy Returns"

Text: In New York, the city's chief actuary, Robert North, has proposed lowering the assumed rate of return for the city's five pension funds to 7 percent from 8 percent, which would be one of the sharpest reductions by a public pension fund in the United States. But that change would mean finding an additional $1.9 billion for the pension system every year, a huge amount for a city already depositing more than a tenth of its budget — $7.3 billion a year — into the funds. But to many observers, even 7 percent is too high in today's market conditions. Mayor Bloomberg said, "The actuary is supposedly going to lower the assumed reinvestment rate from an absolutely laughable 8 percent to a totally indefensible 7 or 7.5 percent. If I can give you one piece of financial advice: If somebody offers you a guaranteed 7 percent on your money for the rest of your life, take it and just make sure the guy's name is not Madoff." Edmund J. McMahon, a senior fellow at the Empire Center for New York State Policy, commented, "The continued risk here is that even 7% is too high." And Jeremy Gold, an actuary and economist who has been an outspoken critic of public pension disclosures, said, "If you're using 7% in a 3% world, then you're still continuing to borrow from the pension fund."

Translation: A pension fund valued at an unrealistic 8% return only needs half the assets of one valued at a prudent 3% return. Reports of pension funds that are 80% funded, are actually only 40% funded because most pension funds are currently valued using an 8% rate of return.

Finally, I would like to pose two hypothetical scenarios to you about the future:

Scenario One — In an effort to reduce its unfunded liability, the federal government offers everyone below age 65 the option of exiting the Social Security system and will no longer require them to pay the 15.3% payroll tax — in effect giving them a 15% raise. However, anyone accepting this offer must forfeit all of the payroll taxes they have already paid, along with any benefits they might receive in the future. The first question is: Would you accept this offer given your age and current situation? And conversely, the second question is: How would you react if Congress repealed the Social Security Act (SSA) and forced this decision on you?

Scenario Two — When you turn 21 and become a legal adult, an attorney pays you an unannounced visit and informs you that a distant relative has left you a tax-free trust fund of $10 million dollars. However, you are not allowed to access this trust fund until age 65, or when you have paid off all of your debts — whichever is later. If you found yourself in this situation, how would you live and spend throughout your working life? Would you make sure that you had no debts at age 65 to allow you to access this trust fund as soon as you could? And would you bother to save anything for retirement knowing that you had this enormous amount of money waiting for you?

Now think of the baby boomers in their 50s and 60s you read and hear about, who have saved little or nothing for retirement, many of whom are in debt. They have lived and spent during their adult lives as if they had a financial windfall waiting for them at age 65, when they know they do not. Of course they would not accept the government's offer in scenario one. But as I will explain, they may not have a choice.

My speech, which will run about 45 minutes, is divided into six parts:

- Part I presents the crisis of unfunded pension liabilities as a thought experiment with two unpleasant outcomes
- Part II will explain how the principles of accounting and economics can degrade into the art of science fiction and fantasy when applied to public pensions
- Part III will explain how individuals plan and save for retirement
- Part IV will explain how groups collectively plan and save for retirement
- Part V will discuss the problems of saving for retirement created by regulation
- Part VI concludes that the dilemma presented as a thought experiment in the introduction is a reality that we must inevitably face

Part I — The 21st Century Great Emancipation of Unfunded Liabilities

When markets collapse, as they did in 1929 and 2007, amateur economists attempt to measure the impact in terms of "lost wealth." But if wealth is measured by the things we own, then the calculation is simple: the lost wealth is essentially zero, because all the things we collectively own still exist. The houses that lost value since the market peak in 2006 are still here. The nation's wealth did not change.

What changed was not physical wealth, represented by the nation's stock of housing, but rather the numbers we attached to those houses. Those numbers — the presumed market values — were merely thoughts in people's heads. People were either fooled into believing their houses were worth twice as much in 2006, or they are being fooled into believing their houses are only worth half as much today.

Changing your thoughts from one extreme to another is a trivial matter compared to the extremes of physical reality. When Dresden and Tokyo were firebombed in 1945, the housing stock of those two cities was destroyed, representing a real loss of wealth. The mental realignments of the markets in 1929 and 2007 should be quick and easy, compared to the tragic and painful physical realignments of Germany and Japan in 1945, which took decades.

In addition to wreaking havoc on the housing market, this collective manipulation and deception of thoughts in people's heads also occurred in the arena of social insurance and public pensions.

However, unlike the bull market in stocks of the 1920s, and the housing market of a few years ago (both of which spanned less than a decade), the momentum for the social insurance and pension bubble — collectively referred to as **unfunded liabilities** — has been building for three generations. And the resulting financial consequences will be proportionally more devastating.

The pathology of the unfunded liabilities disease is the same as the housing disease. One group of people — governments and employers — put numbers on pieces of paper that represented promises that could not be fulfilled. While another group of people — citizens and employees — believed those numbers and promises to the point where they willingly offered a significant portion of their earnings in exchange for them.

Citizens and employees, seduced by politicians and employers, fooled themselves into thinking they were wealthy and had their retirement expenses paid for. They believed those numbers and promises to be reality, and proceeded to live and spend as though they were assured of fully-funded pensions when they retired. Since they lacked the desire, discipline or intelligence to save for their old age, they foolishly delegated that task to politicians and bureaucrats, who they never met, and who would never be held accountable.

The first question is: How can such an absurd state of affairs come to define the United States and most Western nations? It's as if there was a worldwide conspiracy that was able to fool (almost) all of the people (almost) all of the time for three generations. The second question is: How to correct this error, and right this wrong, that has permeated most of the Western world? An examination of history reveals that there are two potential solutions to the second question: first is a financial emancipation, and second is a financial collapse.

The first solution holds that the social insurance systems of the United States and the Western World must inevitably endure a monetary Emancipation. Just as the 13th Amendment unilaterally granted slaves their freedom, the debts of the unfunded liabilities of the Western World would be retired once and for all by ceasing all Social Security taxes and benefit payments immediately. The taxpayers and employees would be granted their freedom from the onerous burden of exponentially expanding unfunded liabilities. While the pensioners, who laid claim to the fruits of the labor of succeeding generations, will receive nothing in return.

The second solution attempts to continue to pay benefits to honor all existing social insurance promises by hyper-inflating the currency to infinity — as Germany did in the 1920s or Zimbabwe did recently — rendering money worthless. This would reduce both the value of the taxes paid by the workers, and the monthly payments to the pensioners, to zero.

The advantage of the first option of immediate emancipation is that it frees the younger generation of an exponentially increasing tax burden and confines the suffering to those dependent on government pensions. The disadvantage of the second option of hyperinflation is that it destroys the monetary system — along with the entire economy — wiping everyone out.

Notice that the result of both the Emancipation of slaves in the 19th Century, along with the inevitable Emancipation from Social Security in the 21st Century, the collective wealth of society — represented by the things we own — does not change. Also notice that the combined suffering and social upheaval are the same whether they occur today or 50 years from now. The transition is not physical, it only requires a mental realignment of the thoughts in peoples' heads, reallocating wealth and property to its rightful owners.

Understanding this dilemma, and why it is inevitable, only requires the realization that the laws of economics are like the laws of physics, which hold that for each action, there is an equal and opposite reaction. This is the principle of double-entry accounting.

Part II — Accounting and Economic Fact, Fiction and Fantasy

In the early 1980s, on a television talk show, Isaac Asimov and Harland Ellison discussed the art of science fiction. Both admitted that much of what they wrote should be classified as "science fantasy" as opposed to "science fiction," because it involved scientific impossibilities such as time travel and exceeding the speed of light. They confessed that these fantasies were valuable plot devices which were popular with their readers. Like Asimov and Ellison, accountants, actuaries and politicians continue to perpetuate the fantasies of social insurance schemes, because their audience — the voting public — demands them and is willing to pay for them, despite the mounting irrefutable evidence to the contrary.

To illustrate how society migrates from economic fact to fiction to fantasy — and inevitably to bankruptcy — we need to begin with five fundamental principles of economics:

- First, your **investment** is equivalent someone else's **debt**; and conversely your debt is equivalent someone else's investment. When a bank loans you money to buy a car or house, it is investing in that car or house. Conversely, when you deposit money in a bank, you are loaning money to the bank. And when you invest your money in stocks or bonds, you are loaning money to the corporation or government that issues them.
- Second, loans and investments are **contracts** of value-for-value exchange, that represent **secured** obligations, backed by **assets**, that can be sold to third parties — such as a car, house, or share of stock. **Unsecured** loans are unfunded liabilities backed by nothing. They are only promises by borrowers to repay a sum of money, hence they cannot be sold to third parties. Banks do not make unsecured loans, such as helping out those unable to pay their bills. And you would never trust your savings with one that does.
- Third, nothing stands still. Every asset, be it money, stocks or bonds is always either **appreciating** or **depreciating** in value. While some assets are more stable than others, all assets — from houses and cars, to stocks and bonds, to gold and paper currency — are always at risk and always in a state of flux.
- Fourth, changing one's opinions, accounting methods, or actuarial assumptions has no impact on reality; it only serves to shift the valuation — i.e. the thoughts in peoples' heads — closer to, or further from, reality. Assuming that housing prices will return to the levels at their peak in 2006 may make someone feel better, but it does not change the value of his house.
- Fifth, everyone has to fund his own retirement just as everyone has to fund his own house, car and next meal. Similarly, every pension fund, like every bank and every mutual fund — properly accounted for — is merely the sum of its parts. Depositors and shareholders regularly withdraw their funds in entirety, without impacting any of the other participants.

> An underfunded pension plan is the same as an insolvent bank or fraudulent Ponzi scheme, where shareholders are told they have legal claim to more assets than exist.

A loan is a promise to pay, and we all make countless promises during our lives. Most we keep; but some we break. If people, by nature, kept all their promises and repaid all of their debts, then banks would make a profit on unsecured loans, and would regularly lend money to people with no assets or income.

It can be difficult at times to keep your promises and control your desires. Imagine trying to keep the promises and control the desires of others. Now imagine being legally bound to keep the promises and fulfilling the desires of total strangers who you will never meet, and who you can't hold accountable. You don't have to imagine this because, as I will explain, you already live in this world. And the ugly reality of social insurance schemes and public pensions is a bold attempt to do just that.

Promises and intentions are irrelevant in the physical world. One obvious scientific fact of life is that we don't have to think legally or ethically about the laws of motion and gravity, because the effects of physical actions are immediate and invariable. Force equals Mass times Acceleration ($F = M \times A$), regardless of your personal, legal or ethical framework. Hence both first class and economy passengers share the same fate when a plane crashes.

When individuals reap the rewards or suffer the losses of their actions, economists call this **internalizing** costs and benefits. But if individuals can reap the rewards when they succeed, but are allowed to dump their losses onto others when they fail, this is called **externalizing** costs to innocent third parties.

We all know that if we eat too much, we get fat. And if we drink too much, we get a hangover. Because the laws of science force us to internalize the costs of our physical actions, we generally avoid excessive eating and drinking. You don't worry about your neighbor's drinking, because if he gets drunk, it will be him — not you — who will suffer the hangover.

Let us venture into the realm of science fantasy and create an imaginary universe where legal and ethical considerations of eating and drinking are necessary, because those who eat and drink to excess get to externalize the costs. In this brave new world, the laws of physics still apply, but you can externalize the effects. So when you overeat, someone else gets fat. And when you get drunk, someone else gets a hangover. If you could eat all you wanted and not get fat, and drink all you wanted and not get a hangover, how much would you tend to eat and drink?

While you might be tempted to drink recklessly, your victim will be extremely irate and come after you looking for revenge. To avoid this problem, you need to lessen the pain he feels to the point where it is small enough that it won't get him angry. The way to do this is to **mutualize** the costs of your drinking. Instead of assigning one victim to wake-up suffering from the bottle of vodka you drank last night, you simply pick 100 people at random and have them wake up feeling as though each one only had a tiny sip. Since your victims will barely notice the difference, they won't bother to object to what you have done to them.

Of course this fantasy does not apply to physical objects such as food and drink. However it does apply to money, which is the unit of accounting for pension liabilities. The only difference between the physical world of science and the economic realm of money is — with economics — while you can't change the magnitude of the resulting costs, you can delay, externalize and mutualize their effects onto others.

Part III — Individual Retirement Planning and Saving

As life expectancy approaches 80 years, people understand the necessity of saving a portion of their earnings for retirement, even if they choose not to do so. Thus, the disciplined person, whom we will call Timothy Thither, who diligently saves 10% of every paycheck for his retirement, is seen as a responsible member of society.

Now consider this scenario: assume a devious banker in Boston, decides to steal Timothy's savings instead of depositing it into his account. He sends fraudulent monthly statements to Timothy leading him to believe he is funding his retirement, when in fact he is robbing him blind throughout the four decades of his working life. When Timothy reaches age 65 and wants to retire, instead of a million dollar nest egg sitting in his account, he is stuck holding a bank statement that represents — not tangible he assets owns — but a worthless unfunded liability.

If a banker (or politician or corporation) in Boston steals $1 million from Timothy Thither, he shouldn't be able to force an innocent bystander — such as a plumber in Pittsburgh — to repay him. But perhaps he can. Perhaps he delay, externalize and mutualize the cost of his theft and coerce all the plumbers in Pittsburgh to pitch-in and pay this unfunded liability. And he can even get their willful consent. He does this by convincing them to pay for Timothy's pension, in exchange for a promise that he is funding their pension benefits payable at some date far into the future, when in fact little or nothing is set aside for them.

With respect to your savings, held in the form of Social Security and public pensions, what the bankers have done is not only legal, but actually encouraged by the evolving law and standard actuarial practices. The result is: the sum of the claims of the employees and pensioners greatly exceed the assets available to pay them. They survive undetected because the current flow of funds from new investors into the plan exceeds the flow of funds out of the plan to pensioners. This is how Bernie Madoff operated for decades and what describes the social insurance systems of the Western World. Once the flow of funds is reversed, the scam is uncovered and the result is bankruptcy.

Scientific fantasy is harmless entertainment. But the ultimate effect of the economic fantasy of unfunded liabilities is fraud and theft made possible by what economists call an environment of low **transparency** — where you can't tell what's going on. Like being locked in a dark basement, you can't tell what time it was or whether it's raining outside.

To understand a financial low transparency environment, imagine investing in a company that doesn't know what its assets, liabilities, income and expenses are. And when they do publish financial statements, they are allowed to redefine these terms and rewrite the rules of accounting.

As stated by principle number four, changing one's assumptions, definitions and opinions doesn't change reality.

We've all been victims of low transparency, such as being shocked by outrageous roaming charges on your cell phone bill. Fortunately, items famous for low transparency soon migrate to high transparency when they are exposed to free market forces and customers begin to vote with their feet. Thus, Ponzi scams cannot last very long in competitive markets subject to high levels of transparency.

However, Ponzi scams can persist for decades in low transparency environments, where participation is mandatory, because they are protected by the draconian laws of the Social Security Act (SSA), the Internal Revenue Code (IRC), and the Employee Retirement Income Security Act (ERISA), which prescribe the delay, externalization and mutualization of costs, that fool the majority of the people, a majority of the time, into thinking that they will gain more than they lose. But what people fail to realize, is that while they believe they can delay, externalize and mutualize their retirement costs onto everyone else, everyone else is trying even harder to delay, externalize and mutualize their retirement costs onto them.

Part IV — Collective Retirement Planning and Saving

The history of unfunded pension liabilities, which is less than 100 years old, began as innocent flirtations, by decent people, blissfully ignorant of the laws of economics and human nature.

Let's travel back in time to 1934, and assume a longtime employee of the Packard Motor Company, Mr. Workhorse — who never planned or saved for retirement — finds he can no longer endure the physically demanding work required of him on the assembly line. [1] When Mr. Packard learns of the predicament of his loyal employee — being a decent and honorable man — he decides to continue to pay Mr. Workhorse $2,000 a month until he dies.

When writing the first pension check to Mr. Workhorse, the bookkeeper at Packard Motor must credit cash, and debit … what? The question that must be answered is: What goes on the left side of the ledger? What does Packard Motor receive in return for the payment to Mr. Workhorse after he leaves the company?

Surprisingly, the bookkeeping entry for Mr. Workhorse's pension is the same one retail stores use to account for losses due to shoplifting, because the impact is the same. It must debit shrinkage, or theft. Of course, Mr. Workhorse doesn't consider himself a thief, and neither does Mr. Packard or the rest of the Packard Motor employees. However, all these people are only three steps away from creating a Ponzi scheme of unfunded liabilities.

First, Mr. Workhorse's pension amounts to a hidden tax levied on the other Packard Motor employees. If Mr. Workhorse was self-employed, he wouldn't be able to retire with a pension because, as stated by principle five: everyone must fund their own retirement. Once he quit working, there would be no revenue from which to fund these $2,000 monthly payments. But if Packard Motor has 2,000 employees, then each one — without realizing it — would end up donating $1.00 of his monthly salary to Mr. Workhorse; just as customers — without realizing it — pay higher prices for the goods they buy to make up for losses from shoplifters. This is the delay, externalization and mutualization of costs, in an environment of low transparency. This is not possible in the physical realm of eating and drinking, but is possible — for a time at least — in the realm of financial accounting for public pensions.

Second, Mr. Workhorse's pension is funded on a "pay-as-you-go" basis and paid out of current cash flow, ignoring the discounted present value of the cost to the company. This is a dangerous accounting practice because it conceals the existence and magnitude of this long-term unfunded liability from the shareholders.

Third, the other 2,000 employees will eventually face the same predicament of outliving their useful productive years. They will also proposition Mr. Packard requesting a pension. What began as an exception, will soon become a rule, which will transform this minimal pension benefit paid out of petty cash into an unfunded liability, which becomes an onerous tax on — or theft of — the employees, shareholders and managers of Packard Motor.

Once he recognizes these problems, Mr. Packard decides to create the Packard Motor Pension Plan, which will pay workers 50% of their salary after they retire until they die. Since the mathematics of pensions are highly specialized, Mr. Packard hires an actuary who calculates that, based on the population of Packard employees, the pension plan will cost $400 million. When he hears this, Mr. Packard nearly has a heart attack, because profits in 1934 were zero due to the depression, and historically averaged only $60 million a year. But the actuary tells Mr. Packard that he can amortize the cost of the pension plan — tax-free — by creating a $400 million unfunded liability, costing the company only $20 million a year over the next 30 years. This satisfies Mr. Packard, who now feels he can convince the board to approve it.

Let's stop for a moment to consider how a bank views this financial transaction. As stated by the second principle, when you borrow money to buy a car, the bank receives — in exchange for your commitment — an asset of equal value, in the form of legal title to the car until you repay the loan. But, while the employees of Packard Motor all get a raise — in the form of extended salaries after they retire — Mr. Packard and the shareholders receive nothing in return.

Mr. Packard has placed the shareholders in the same position as the plumbers in Pittsburgh, who must repay the $1 million the banker from Boston stole from Timothy Thither. To avoid admitting this, he can digress into a discussion of either (a) the status of the company's unfunded liability, which represents a serious accounting issue, or (b) the company's worker-to-retiree ratio, which is an admission that it is unwilling and unable to fund the pension plan.

When accountants, actuaries and economists refer to a worker-to-retiree ratio, they are admitting that the sum of the claims exceeds the assets. When banks do this, they are declared insolvent, seized by regulators, and often followed by criminal indictments of the bankers. But when employers do this, they are hailed as responsible corporate citizens. As illustrated by principle number five: Timothy Thither funded and paid for his own retirement. Honestly and properly accounted for, his retirement is not affected by a worker-to-retiree ratio.

Thus the term, “worker-to-retiree ratio” is a polite euphemism for Ponzi scheme. This is why chain-letters never instruct recipients to keep their great wealth producing idea a secret, but instead to pass it along to everyone they know. Because once the scheme stops growing exponentially, the house of cards will collapse.

Banks and mutual funds often have payouts that exceed deposits in their normal business operations. In fact, some of the best mutual funds are closed, and have no influx of funds from new investors. Unlike Bernie Madoff, they are honestly and properly accounted for because they are fully funded by assets that can be sold to third parties, as illustrated by principle number two. However, the workers’ claims on their retirement benefits represent unfunded liabilities that are not backed by assets that can be sold to third parties. They only represent the good will of the company and its promise to eventually pay back an unsecured loan with assets it does not have.

The Packard Motor Pension Plan is not a value-for-value exchange, as specified by principle number two; rather it represents a deferred unfunded liability, externalized and multualized onto the unsuspecting employees, managers and shareholders. In economic terms, this is known as a **wealth transfer** — which is simply the transfer of wealth from party A to party B. When done voluntarily — with no expectation of future reciprocation — this is called a donation or a gift. When done involuntarily, or with expectation of future returns — as with corporate and government pensions — this is called an unsecured loan at best, and theft at worst.

Consider the difference between the case of (a) a $400 million unfunded liability created by the Packard Motor Pension Plan and (b) the chief financial officer (CFO) embezzling $400 million from the company and fleeing the country. In both cases, the company is damaged and burdened by a $400 million loss. And both cases have the same impact on the company’s financial statements. Because the laws of economics and fundamentals of accounting — although they may be ignored, delayed, externalized and mutualized — must, like the laws of gravity, ultimately apply to Packard Motor.

What looks like an enforceable value-for-value exchange, is actually nothing more than a wealth transfer of unsecured obligations that often results in bankruptcy. As with all Ponzi schemes, the winners are the early pensioners, while everyone else is a loser. To find out how and why, let’s walk through the economic calculations. The profits of any business are commonly divided among three competing constituencies:

- **Owners** who demand dividends as a return on their investment,
- **Managers** who need investment capital to maintain and grow the business, and
- **Employees** who want to be rewarded for their hard work and success.

Let’s assume that, of the average annual $60 million in profits of Packard Motor:

- The owners receive $20 million in dividends.
- The managers receive $20 million in investment capital.
- The employees receive $20 million in bonuses and salary increases.

But now, Packard Motor has to increase its operating expenses by $20 million to fund its pension plan, which reduces its annual profits by $20 million. Who among these three competing interests should suffer?

- Should the owners forfeit their dividends? No, otherwise they will sell their stock.
- Should the managers cancel their capital investment projects? No, because this would cripple product development and threaten the company's long-term survival.
- Should the employees forfeit their bonuses and salary increases? Of course not. Once word of this got out, the work force — knowing that ambition, dedication and extra effort would not be rewarded — would begin to leave the company.

Regardless of which group bears the burden of funding the pension plan — or even if the burden is shared among all three — the long-term prospects of Packard Motor are irreparably damaged. When the time comes to fund the pension plan, the illusion of the long-term intergenerational contract on paper is exposed as a wealth transfer of unsecured obligations. The owners, managers and employees will desperately scramble in the corporate game of musical chairs to avoid being left out of the annual distribution of earnings.

The CFO of Packard Motors is placed in the role of the banker from Boston, who needs to disguise this enormous wealth transfer, avoid detection, and save his job. This tragic morality play was nicely described by the late Peter Drucker, and illustrates principle number four, which states that changing assumptions doesn't change reality:

> "We owe the defined-benefit trust to mere accident. When General Motors management proposed the pension fund in 1950, several powerful board members resisted it as a giveaway to the union. The directors relented only when promised that, under a defined benefit plan, the company would have to pay little or nothing. An ever rising stock market, so the argument went, would create the assets needed to pay future pensions. Most private employers follow the GM model, if only because they too deluded themselves into believing that the stock market, rather than the company, would take care of the pension obligation." [2]

Assuming inflated investment returns is the most prevalent disease affecting pension plans today. In the past, the most common defense was to change the definitions and claim the rules did not apply. One standard textbook [3] does both. First, after admitting that the Social Security System is not actuarially sound, it proceeds to redefine actuarial soundness. Then it argues this new definition is legitimate because most actuaries agree that it doesn't apply. Finally it concludes that the Federal government is immune from the laws of economics, and that fully funding the Social Security System is unnecessary.

Part V — Economics of Regulation and Monetary Segregation

Now that the shareholders, managers and employees of Packard Motor are stuck in the trap of delayed, externalized and mutualized unfunded liabilities, in an environment of low transparency, we add the factor of government regulation to make this bad situation worse. The rules and laws that accomplish this are classified as **monetary segregation,** which is segregation of money, income and personal wealth via the SSA, IRC & ERISA. Historical examples of monetary segregation are pension benefits, 401(k)s, tax-exempt municipal bonds, and the home mortgage interest deduction.

Segregation, in any form, is not free; it has a price. Segregating a bag of M&Ms into piles of separate colors takes a modest amount of time and effort, but serves no purpose because all colors taste the same. While segregating violent criminals into prisons away from the rest of society is very expensive, but has benefits that exceed the costs. Segregation is only harmful or wasteful when the costs exceed the benefits, because the items are either indistinguishable — as in the case of M&Ms — or actually have more value when integrated — as in the case of the ingredients for apple pie. Thus segregation doesn't increase the resources available to society, it only redefines and reallocates them.

Obviously there is no value in monetary segregation. The dollar in your wallet is worth as much as the dollar in someone else's wallet. Dollar bills with odd serial numbers are interchangeable with dollars having even serial numbers. Five one dollar bills are worth as much as one five dollar bill. And a dollar printed in April 2007 is interchangeable with one printed in March 2002. In other words, like M&Ms, dollars are indistinguishable and interchangeable.

However, monetary segregation is backed by the force of law and grants one group of dollars more rights than another. When the law arbitrarily grants rights to one group — while denying them to another group — it creates what is known as an **asymmetric relationship**, which arbitrarily and artificially creates privileged and disenfranchised classes.

Again, principle four holds that changing a definition doesn't change reality; it only moves the definition closer to, or further from, reality. Consequently, the asymmetric relationships created by monetary segregation do not change reality; all they do is confuse and distort the thoughts in people's heads. Monetary segregation has four dimensions:

- **Category** — Where can you spend the money? For example, the mortgage interest deduction only applies to the purchase of a house.
- **Time** — When can you spend the money? U. S. Savings bonds, which represent money, cannot be spent until they mature.
- **Control** — Who allocates and invests the assets? Individuals control savings bonds. But employers control retirement savings and decide how they are funded, invested and spent.
- **Ownership** — Who has the legal right to the assets? The 1960 Flemming v. Nestor Supreme Court decision ruled that taxpayers have no rights to Social Security benefits, which are solely at the discretion of the U. S. Congress, and which can be reduced or rescinded at any time. It's as if a bank one day decided that its customers had no rights to their deposits, and that it had no obligation to honor customer requests for withdrawals.

The instruments of monetary segregation and asymmetric relationships are the SSA, IRC and ERISA. They define an infinite combination of categories, timelines, fiduciary responsibilities, and ownership rules, which create privileged classes of income, savings and wealth, taxed at different rates, or not at all. And (almost) all citizens fall for this bait because they've been convinced they have been designated members of a privileged class.

Here's how it works: Consider the decision facing an employer of how to reward its employees. Should it pay an employee another $1.00 as salary, or should it credit $1.00 to that employee's pension? For each additional $1.00 in salary, 15% will go to pay Social Security taxes, 28% will go to pay federal income tax, and perhaps 7% or more will go to pay state and local taxes — leaving the employee with only 50 cents, or half the initial amount, after taxes. But for each $1.00 the employer contributes to the employee's pension — which it controls, manages, and invests — none of these taxes has to be paid.

Essentially, the employer has two options: [1] allocate $1.00 as salary, half of which will be taxed away, or [2] allocate $1.00 to pension benefits, in which case the employee (apparently) gets to keep it all. The ultimate effect of this monetary segregation is that, while a "pension dollar" is nominally worth twice as much as a "salary dollar," its true value is reduced by half because there are artificially twice as many. Consequently, segregating dollar bills doesn't create wealth anymore than segregating the races does. It only creates artificial classes of privileged and disenfranchised dollar bills — in other words, a Jim Crow monetary system.

Notice that the IRC segregates income for pension benefits using three of the four dimensions of monetary segregation:
1. First, the employee's income is segregated into the categories of a privileged class of tax-exempt deferred pension benefits, and a disenfranchised class of taxable current salary.
2. Second, because pension benefits cannot be accessed until employees retire, their income is segregated by time.
3. Third, because the employer allocates and invests their pension assets, employees' have ceded control and fiduciary responsibility to their employer.
4. The SSA adds the fourth element of segregation of ownership rights, as the Flemming v. Nestor Supreme Court decision confirmed. Employer pension plans used to have this element of monetary segregation as well. But the abuses were so prevalent and so devastating, that in 1974 Congress passed into law the "separate but equal" doctrine governing employer pensions known as ERISA, which nominally granted ownership rights to employees. However, history has shown that these ownership rights of pension benefits are often little more than the right to stand in the line with other creditors in bankruptcy court.

Finally, note that none the insidious evils of monetary segregation existed 100 years ago, because there were no income or payroll taxes. Hence there was no basis or need for segregation of the monetary system. In the asymmetric world of reduced transparency and monetary segregation your investment decisions have been distorted like your physical appearance in hall of mirrors.

In the spirit of Alexander Tyler, author of *The Decline and Fall of the Athenian Republic*, this cycle of financial and moral decay can be summarized as follows:
- Regulation (ERISA, IRC & SSA) leads to Asymmetric Relationships
- Asymmetric Relationships lead to Reduced Transparency
- Reduced Transparency leads to Bad Measurement (where pension claims exceed assets)
- Bad Measurement leads to Bad Contracts (i.e. government and employer pensions)
- Bad Contracts lead to Bad Behavior (i.e. unfunded liabilities)
- Bad Behavior leads to Regulation, and of course we already know that
- Regulation leads to Asymmetric Relationships

Fortunately, the remedy — i.e. desegregating the monetary system — is simple because, unlike Dresden and Tokyo in 1945, recovery does not require a physical realignment. It only requires realigning the thoughts in peoples' heads. Yet the resistance to desegregation of the monetary system is greater than the resistance to racial desegregation in the 1950s. Because an established majority of the population — homeowners, pension plan participants, and anyone who owns a tax-exempt investment — has been convinced that they will suffer a loss of status and wealth.

Part VI — Conclusion: The Inevitable 21st Century Great Emancipation

The Founding Fathers, who envisioned the demise of the institution of slavery, lacked the courage to confront the dilemma. Instead of being leading visionaries, they chose to be laggardly cowards by freeing their slaves, but only after they died. In today's popular culture, those who advocate this temporary fix for unfunded social insurance schemes label their position as, "mend it; don't end it." While those who oppose it, call it "kicking the can down the road."

Virtually every pensioner today would sign on to the compromise "mend it; don't end it" solution of dealing with the crisis of unfunded liabilities … after they die. This does not solve the problem, or even ease the pain. It only attempts to pass the problem and the pain on to the next generation. That the masses of pensioners — and soon-to-be pensioners — of so many diverse nations of the Western world are following the example of our Founding Fathers attests to its universally popular appeal.

In science fantasy, you can travel backwards in time and faster than the speed of light, while in economic fantasy everyone can live happily ever after in a world of exponentially increasing unfunded liabilities of social insurance schemes. While it's impossible to rectify the injustices caused by these peculiar institutions, I have attempted to show why it's not possible to save Social Security any more than it was possible to save slavery. Slavery lasted nearly 250 years in the New World; and unless the United States implements a severe austerity program such as what the Greeks, Spaniards and Italians are violently rejecting today, Social Security, born in 1937, won't even last 100.

As you ponder the dilemma I have posed to you of choosing between a 21st century Great Emancipation and a hyperinflation which destroys the monetary system, please take note of two historical facts: first, the United States forcefully implemented one Great Emancipation in the 19th century and survived. And second, take a close look at all the wealth that surrounds us here in the United States. The wealth you see around you is here to stay, regardless of which course we take. Now I would like to hear the thoughts in your heads.

Notes:

[1] The company and the numbers are fictitious and for illustration only

[2] Peter Drucker, "Reckoning With the Pension Fund Revolution," *Harvard Business Review*, March/April 1991

[3] George E. Rejda, *Social Insurance & Economic Security* (1991), Fourth Edition, Prentice-Hall