ECONOMIC ASPECTS OF THE PENSION PROBLEM

As It Appears Sixty Years Later

Part One: Euthanasia of the Pension Funds

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Sixty years ago. in 1950, Ludwig von Mises published an article with the above title. He pointed to inflation as the greatest threat to pension rights. Today an additional threat is looming large on the horizon: the threat of deflation, and a new examination of the pension problem is timely.

Deliberate Dollar Debasement

In 1950 Mises looked at the pension problem from the point of view of the shrinking purchasing power of the dollar, a consequence of what he called the deliberate policy of currency debasement by the U.S. government. In 1950 a pension of $100 per month was a substantial allowance, he noted. Shelter could be rented for a month for less than $30 in most parts of the country. (In 2010, $100 hardly buys one night's stay at a decent hotel.) In 1950 the Welfare Commissioner of the City of New York reported that 52 cents would buy all the food a person needed to meet his daily caloric and protein requirements. (In 2010, $100 barely buys a cup of coffee and a muffin for every day of the month.)

Of course, currency debasement does far more damage than simply eroding the purchasing power of pensions. As Mises observed, it also leads to the insufficiency of capital accumulation. Companies report phantom profits that mask losses, since depreciation quotas understate the wear and tear of productive equipment. Savings are hardly adequate to pay for capital maintenance, let alone new capital or technological improvements in production — the only source from which pensions to an increasing labor force can be paid. When young workers who now join the labor force are ready to retire, the necessary funds to pay their pensions will simply not be available.

Capital destruction due to declining interest rates

I have written extensively about the proposition, one that mainstream economists doggedly refuse to discuss, that a falling interest-rate structure has a deleterious effect on accumulated capital. Capital is destroyed across the board simultaneously and stealthily. By the time the damage is discovered, it is too late to do anything about it and firms go bankrupt in droves. The falling trend of interest rates is the unrecognized cause of the depression that is presently devastating the world economy — just as it also was 80 years ago. Nowhere is the erosion of capital caused by falling interest rates is more obvious than in the case of the capital of the pension funds. They must earn adequate return on their investments, but a falling rate of interest frustrates this effort. At the lower rate the original schedule of capital accumulation cannot be met.

Those who disagree argue that if the present value of a future stream of payments is lower when discounted at a higher rate, then it must be higher when discounted at a lower rate. Thus the steady future receipts of a pension fund from payroll contributions will have a higher value under a regime of falling interest rates. There is no need to argue this point. It is clear that the fund must be around to be able to collect future contributions enhanced by a fall in interest rates. Many of them won't be, as they will have succumbed to capital squeeze caused by the very fall of the interest rate that is supposed to be their savior. At any rate, rules of sound accounting do not allow pension funds to treat expected future payroll contributions as if they were cash payments in the process of clearing.

My correspondent Bruce Brafman of *Prophet without Profit* comments that pension law requires the use of the *lowest* interest rate whenever an employee cashes out in a lump, as a lot of them in corporate America do. This is devastating for the pension fund because it inflates the size of the lump sum payment. The fund is relieved from the obligation to pay the pension, the present value of which has increased by virtue of a decrease in the rate of interest. The law wants the pensioner to benefit from the lower interest rate, rather than the fund. This is reasonable and justified when the interest-rate structure is stable, but will kill the pension funds under the present zero-interest policy of the Fed.

The repercussions for society are devastating. Just as the aging segment of population in the industrialized countries becomes vitally dependent on its pension income, the falling rate of interest undermines the pension plans. In many cases the money to pay out pensions won't be there. For the rest, payout reductions will be inevitable. Defined-benefit pension plans will have to be discontinued. Of course, the problem is even more acute in the case of unfunded pension plans such as Social Security, the pension plan of the military, or that of the civil service of the federal, state, and municipal governments. Under many of these plans contributions of the active members directly pay the pensions of the retired ones. Such plans exhaust the definition of a Ponzi scheme. The moment the civil service is forced to retrench, its pension plan becomes insolvent.

The Great Milch-Cow

When a large segment of the population is facing a drastic cut in income, and since most retired people have no alternative and cannot augment their diminished pension with income from other sources, consumption falls back and lower demand will have further deflationary consequences on the economy. Yet this problem, just as the kindred problem of the erosion of the capital of productive enterprise, is ignored by the profession of economists and that of the accountants. They apparently believe that the Great Milch-Cow, the government, will always be there and able to cover any shortfall.

My correspondent Bruce Brafman points out that companies may be hit with the cost of covering the shortfall. In that case there is a "doom loop": mandatory increases in pension contributions from the employer will reduce company earnings, which will reduce the stock price, and that will exacerbate the pension funding crisis as equity investments decline. This could also encourage potentially fatal excessive risk-taking behavior. The bottom line is that the zero-interest policy of Bernanke is, to put it mildly, counter-productive; to put it a little more strongly, it is insane.

The decades-long slide of interest rates is far from over. As I argued in my other articles, large-scale monetization of government debt in the wake of every new bail-out plan and stimulus-package is going to impart a falling (rather than a rising) trend to the interest rate structure, due to the opportunity it creates for risk-free profits. Bond speculators ambush the Federal Reserve on its periodic trips to the bond market to make its regular open market purchases of government bonds in order to increase the money supply. They buy the bonds beforehand in order to dump them into the lap of the Federal Reserve afterwards at the enhanced price. They pocket the difference. These risk-free profits explain a large part of the present deflation: rising bond prices as well as falling commodity, real estate and stock prices. The new money that the Federal Reserve has created through its open market purchases will not flow to the commodity, real estate, or equity markets as hoped by the policy-makers. It will stay in the bond market where risks are the smallest, and will be financing further bullish bond speculation. The ultimate result will be a further fall in the rate of interest, exposing the pension funds to even greater dangers.

Note that these dangers are in addition to the threat to the *value* of pensions undermined by past inflation, about which Mises was warning sixty years ago. It could be further undermined in case the reckless increase in government debt scared bond speculators and other investors, including foreign holders of the debt of the U.S., for example, the Chinese government. Should they start a stampede out of bonds, they would push interest rates and commodity prices to much higher levels.

Pensions are doomed whatever the government does. Whether interest rates go up or whether they go further down, the pensions are at risk. In the case of rising interest rates their value will be decimated. In the case of falling interest rates pension contributions will not be able to earn a return necessary to accumulate the capital needed in order to pay defined-benefit pensions in the future.

The relevance of the gold standard to the pension problem

As we can see, at the heart of the problem is the destabilization of the rate of interest due, first, to sabotaging and, then, to destroying the gold standard by the government. *There is no known way to stabilize interest rates but by defining the value of the unit of currency as a fixed quantity and fineness of gold.* In this way the amount owing on deferred payments will be fixed. Any breach of promise of deferred payments will be immediately obvious as soon as it occurs. The difference is this, and a very important difference it is: a promise to make future payments in irredeemable currency is a meaningless promise, because breaching it can be — and will be — camouflaged in many different ways. This spells catastrophe. The retired segment of the population will be plunged into penury. The only way to avoid this is to stabilize the rate of interest through the rehabilitation of the gold standard with all deliberate speed.

A fall in the rate of interest has a direct effect of decreasing the return to capital of the pension funds. This decrease should be compensated for by increasing payroll deductions. It is clear that *this is never done*. What is not clear is whether the reason for this omission is ignorance on the part of the economists' and the accountants' profession, or whether it is due to a political decision. Is it possible that the government, motivated by the dictum "let the sleeping dog lie", secretly ordered the accountants not to probe too deeply into the question of solvency of the pension funds? Certainly the government does not want to alarm the people and put wind into the sails of the budding movement demanding the immediate return to a gold standard – even if this is the only way to stabilize interest rates thus making pension plans solvent again.

The last vestiges of the gold standard were unilaterally discarded by the government of the United States in 1971. This event was coincident with the onset of the greatest gyration in the rate of interest on a world-wide scale. In a decade interest rates shot up to two-digit figures in the high teens. Then a slow decline started in the 1980's pushing interest rates relentlessly towards zero. The first move (rising interest rates) was accompanied with a great surge of inflation, wiping out a large part of the value of pension rights. The second move (falling interest rates) which is still continuing has brought deflation. It has not yet fully manifested its corrosive effect on the pension funds as yet. Even so, the forces that drive the rate of interest to zero are squarely responsible for the erosion or destruction of all capital, including the accumulated capital of the pension funds, as well as capital they are in the process of accumulating as a stream of payments through payroll deductions.

Although historians do not advertise the fact, a lot of pension funds went bankrupt in the 1930's, and the remaining ones had to scale back the amounts they had contracted to pay to their pensioners. Economists failed to offer an explanation for this universal phenomenon. Yet the explanation is clear: the accumulated capital of the pension funds was badly impaired (in some cases completely wiped out) by the falling interest rate structure. At the same time the accumulation of new capital was rendered impossible by the absurdly low prevailing interest rate. The pension funds were hit twice: first, their capital was decimated; second, their ability to make repairs was frustrated. Exactly the same causes are operating right now, and exactly the same effects will follow. The only difference is the larger scale of capital destruction in the present episode.

Indexed pensions or Ponzi pensions?

In recent years the pension problem has been swept under the rug. During the past sixty years "experts" have invented indexing as the "cure" for the erosion of pension rights. Indexing means that pensioners can be compensated for the erosion of their pensions due to inflation by making yearly adjustments upwards tied to some index numbers allegedly measuring inflation. This means that the powers that be are aware of the pension problem. They are willing to treat the symptoms, but they still refuse to treat the real cause of the disease. Their outlook on inflation as being "nature given", beyond the power of man to address, is hypocritical and devious.

The basic idea of indexing pensions is that redistributive society will always have the wherewithal to validate all pension rights, since the government can borrow and tax without limit. Funding pensions is anathema to Keynesian economics. The "modern" way of financing pension rights is to make them "pay-as-you-go", a euphemism for Ponzi pensions whereby workers are made to pay pensions payable to members already retired. They are promised that they will be compensated after their retirement by the contributions of members then active.

This is clearly fraudulent as it makes a hypothetical third party bear the full brunt of the arrangement. People are brought into the compact without their concurrence. Some of the members who will pay the pension of the now active workers may not have been born yet! The key point is: contributions are not capitalized upon receipt but are instantly dissipated. Pension contributions must be capitalized in order to make them a meaningful source of future pensions. Current workers' pension rights could be subject to veto by tomorrow's workers, should they find this arrangement unfair. Only fully-funded pensions are secure and it is only under a gold standard that such security can exist. Any other arrangement could unravel if victims of the redistributive society woke up and revolted.

John Maynard Keynes, in a bout of sincerity, blurted out a phrase that only now has revealed its true meaning: *the euthanasia of the rentier*. It gives away the "shabby little secret" of the redistributive society: robbing the pensioners who can no longer take "strike action", and with the loot throwing dust into the eyes of the rest of the society.

Deflation and the pension problem in Japan

The United States is following Japan down the garden path to zero interest. Therefore it is instructive to look at deflation and the pension problem in Japan in order to see the shape of things to come. Consider the plight of JAL, Japan Airlines. The economic slowdown hit travel and cargo traffic hard. Saddled with the equivalent of $15 billion in debt in addition to a massive pension fund deficit, the airline was forced to apply for "mediated debt restructuring" — euphemism for Chapter 11 bankruptcy. Asia's largest carrier by revenue said in its Annual Report that there was a great deal of uncertainty about its ability to continue as a going concern. It has applied for help to the Enterprise Turnaround Initiative Corp., a government-backed fund. However, capital injection or additional financing alone would not improve the carrier's prospects, as asserted by the November 14, 2009, news report of *Reuters*, because of its severely underfunded pension plans. JAL president Nishimatsu met with the leaders of the airline's retirees association to seek their approval on pension payout reductions. Media reports say that the leaders have expressed their desire to cooperate in some ways with management to save the airline, but many retirees are expected to oppose strongly the proposed pension cuts.

The cancer of depression has been metastasizing across the Pacific through the yen-carry trade foolishly encouraged by the Federal Reserve and the Bank of Japan as a way to push interest rates even lower in the United States. Rather than analyzing the Japanese example and drawing the appropriate conclusions, American policy-makers have an irresistible itch to follow Japan's jump into the abyss of the Black Hole of zero interest. The result, perfectly predictable, is catastrophic.

What should American labor leaders do?

American labor faces its greatest challenge ever. Its achievements on the wage front and on the pension front are at stake, due to inane government policies of destabilizing the rate of interest, causing an unprecedented destruction of capital, in particular, destroying the capital of pension plans.

If labor leaders want to preserve the achievements of the labor movement, they must address the root cause of the problem: the regime of irredeemable currency. *Interest rates can be stabilized and pension plans can be saved only through outlawing of the irredeemable dollar.*

We are currently on a course that will result in the total destruction of pension funds. If not wiping them out altogether, the irredeemable dollar will drastically reduce the pension rights of the workers. This is a wake-up call. *Unions must act now and demand that the Supreme Court of the United States declare the legal tender protection of Federal Reserve notes unconstitutional.* The manner in which these are presently issued is the root cause of our economic instability and the vicious swings between inflation and deflation. The unions must demand through legal challenges in the courts, that wages, salaries, and pensions be paid in constitutional dollars, that is, dollars redeemable in the coin of the realm, defined as a fixed weight and fineness of gold and silver.

The U.S. Mint must be open to the unlimited coinage of gold and silver free of seigniorage charges. To prevent future tinkering with the monetary system by charlatans, the metallic value of the dollar ought to be enshrined in the Constitution, so that any change in the gold content of the dollar would take a constitutional amendment — rather than merely an executive proclamation.

U.S. government bonds must be deprived of their monopoly position. They must be exposed to competition with the gold coin, in order to offer the saving public a meaningful choice. This is indispensable for the stabilization of the rate of interest, but also for the health of the pension funds. Government bonds are unsuitable for pension funds to hold on capital account. In case of a demographic shift such as that when more people leave the labor force to draw pensions and fewer are entering it while contributing to pension plans, the net selling of government bonds from the portfolio of the funds may collide with selling by the government. This would cause an unwarranted rise in the rate of interest. Note that in the case of net selling of corporate bonds from portfolio the same problem would not arise. Such selling would be treated by the corporations as a signal to retrench.

If American labor leaders fail to challenge the constitutionality of the irredeemable dollar and ask the Supreme Court for the protection of the pension funds on constitutional grounds, then a century of gains on the pension front will be irretrievably lost. Penury for the retired segment of the population will follow. The plight of the JAL pensioners is not some kind of an aberration. It is the future norm.

Unless the current irredeemable currency system is replaced with a gold standard.

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Reference

Economic Aspects of the Pension Problem, Ludwig von Mises, *The Commercial and Financial Chronicle*, February 23, 1950.