Letter from America —

Dispatches from the gloom: or the moon over Texas

In the second of this year's letters, Angus Deaton looks at the impact of the recession on university and state finances when the administrators of both follow their own version of balancing the budget.

THERE IS A STORY about two blondes sitting on a park bench in the moonlight in Texas. 'Which do you think is closer,' muses one, 'the moon, or Houston?' 'Duh.' 'What do you mean, duh?' 'Duh, can you see Houston from here?' Less than ten per cent of Americans can 'see' any effects of the stimulus on unemployment. Republican candidates for senior office are running, apparently successfully, on platforms that promise to cure unemployment by eliminating red ink in Washington. The dismal state of American education doubtless bears some responsibility for these views, but it is hard not to identify some of the failure as ours; economics has failed to set any limits on the public debate about cause and effect in macroeconomics. Economics has become like evolution, where what people think is well predicted by their political ideology; it is not fanciful to imagine school boards in Texas legislating against the teaching of Keynesian economics, even before they get to the relative position of Houston and the moon. While I am not naïve enough to suppose that economics has a core scientific content that can be separated from politics, an outsider might wonder just what we have all been doing for the last eighty years.

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While the universities in which economists live are being hurt — something that is about to come in Britain too — they are not being hurt as much as many Americans think they deserve. At a time when unemployment is high, there is a good deal of irritation over tenure, and a lack of understanding why a bunch of academics, with short work hours and high salaries — and a notable inability to predict or handle the crisis — should somehow be exempt from the insecurities experienced by others. The irritation is not mollified by the cost of university education rising much faster than the price level, nor by the stock of student-loan debt having grown larger than credit card debt. Tenured professors are about as popular as bankers. Universities have made substantial cuts, in support staff — who are not guilty but are vulnerable — and, especially outside the top tier, by accelerating the gradual replacement of tenured faculty by 'adjuncts,' who have heavy teaching loads, no research time, and low salaries. By some estimates, more than two-thirds of university teaching is now done by non-tenure track adjuncts. A recent study by Jeff Brown and his colleagues shows how universities responded to the last shock to their endowments, the bursting of the dot.com bubble, and argues that this likely applies again now. Universities took most of the 20th century to move out of bonds and into equities, but only twenty years to adopt the more aggressive investment strategies that were pioneered at Yale, including private equity, venture capital, and hedge funds, as well as commodities. Over the last two decades, their collective endowments exploded, from under $50 billion in 1986, to more than $350 billion on the eve of the financial crisis, with a brief interruption from 2000 to 2003. Even a 30 per cent reduction since the peak would eliminate only the previous two years returns so that, even *after* the crisis, the search for 'absolute return' has paid off handsomely for universities as a whole.

One might have thought that, with such portfolio gains, universities would have been well-placed to ride out the financial storm. After all, why exactly *was* Harvard sitting on $37 billion in June of 2008? Or (say) $25 billion now? Yet there is evidence that administrators, as they did in the dot.com collapse, are more concerned to use the university to protect the endowment than to use the endowment to protect the university. Ben Bernanke, when still at Princeton, complained that the administration's only concern was to make the endowment 'as big as the moon.'

While it is far from clear what sort of rule administrators *should* follow in the face of financial fluctuations — no one can smooth against a random walk — it would seem reasonable for endowments to be run down further after the crash, not rebuilt. But universities typically use spending formulas that are a percentage (say five percent) of their average endowments over a number of past years. Although conservative on the way up, these rules have nevertheless generated large new expenditures in recent years, some of which are probably of low inherent value but which are hard to eliminate. As a result, even though universities are still much better off than they were only a few years ago, the spending rules cannot be re-established without cuts, and administrators (and trustees) have typically been unwilling to allow more than temporary increases in the spending rule. Indeed, setting expenditures on the basis of endowments that no longer exist has terrified many administrators, and according to Brown, the typical behaviour has been to *cut* the spending rate to try to rebuild the endowment, which then becomes a millstone, not a life preserver. Universities are cutting the sizes of their incoming classes, reducing financial aid, and cutting everything except the number of administrators. Some have also borrowed very large sums in order to deal with the liquidity crises induced by their private equity and venture capital activities, a possibility that appears to have been entirely unanticipated.

Outside the academic gates of Princeton is the state of New Jersey which, like most other states, is having acute problems of its own. The majority of American states are constitutionally required to balance their budgets, so that they have had no option but to fire employees as their revenues have decreased. For a while, there was help from Washington through the stimulus package, but this is now unwinding.

Desperate for cash, states, like the universities, have been seeking 'absolute return' through alternative investments, particularly for the pension funds that support the (still mostly defined benefit) pensions of their retired workers. Many state pensions are protected by constitutional guarantees that make them almost impossible to change or modify (and many state workers are not covered by the social security system, and so have no other source of pension income), and some — although by no means all — states are clearly going to be unable to meet their obligations. When there is almost nothing left, a high-stakes poker game (or shooting the moon?) may offer the only chance of solvency, albeit a very slim one. States are also allowed to discount their pension obligations at the projected rate of return of their investments, which once again encourages the resort to hedge funds and the like. But now the game is unwinding. Joshua Rauh has calculated that even if states obtain the eight per cent return that most are assuming, Illinois will run out of money to pay pensions eight years from now, with Connecticut, New Jersey, and Indiana only a year behind. These projections are optimistic if there is net outmigration in response to the higher taxes needed to balance the funds, or if workers retire early in an attempt to obtain at least some of their threatened benefits. They are, of course, pessimistic if the state treasurers get rich in the poker game. The current financial situation is making it almost impossible for the states to repair these problems in a prudent way, and politicians, even more than individuals, have enormous incentives to avoid pain now at the expense of much greater pain later. Illinois made its federally required contribution to its pension fund this year by borrowing the funds from the pension fund itself. The State of New Jersey was sued by the Security and Exchange Commission for securities fraud for lying about the solvency of its pension fund and other states are under investigation. Rauh calculates that when Illinois runs out of funds in 2018, and puts its pension funds on a pay-as-you go system, the additional taxes will be more than a third of current state revenue, something that clearly is not going to happen.

Princeton and Harvard are not going to go bankrupt any time soon, and their employees are 'safely' — at least from the universities' perspective — bearing the risk of their own pensions. Texas, in spite of (or perhaps because of) the moon and its school board's views on evolution, has a pension fund that is safe until 2037. As to the prospects for macroeconomics, I must leave that to others.

Note:
The papers referred to are Jeffrey Brown, Stephen G. Dimmock, Jun-Koo Kang, and Scott Weisbenner, 'Why I lost my secretary: the effect of endowment shocks on university operations', NBER Working Paper No. 15861, April 2010, and Joshua Rauh, 'Are state public pensions sustainable', Working Paper, May, 2010, Available at SSRN: http://ssrn.com/abstract=1596679