Switzerland – Why Aren't We All Like the Swiss?

John B. Burke, MS, CFP® | November 2018

Diane and I recently returned from our annual international trip – this year to Switzerland. The country was incredibly beautiful, reminding me of our first trip to the Grand Canyon. You have to see it for yourself to grasp the enormity of the natural beauty. It was not only beyond words but even a picture doesn't quite do it, though I include a couple here.

Like most countries, a visit will reveal a few surprises. For example, the famous Lake Geneva is not actually named as we know it. The real name is Lake Leman. Further, there are many kinds of cheese in Switzerland, not just the cheese with holes in it. We visited Gruyere, for example, and had Gruyere cheese. The Swiss make lots of cheese, and don't like it when tourists think they only make what we call Swiss cheese.

While we were there, they celebrated their version of Thanksgiving, but not as we expected – they fast.

While most of us know that the Swiss are famous for their neutrality, perhaps you will be surprised to learn that they are neither part of the Eurozone nor the European Union. They use the Swiss Franc and are completely independent and neutral from the rest of Europe, though situated right in the middle of it.

You will find plenty of cheese, chocolate and watches in Switzerland, but one thing you will find very little of is debt. The government of Switzerland runs a surplus. They spend less than they tax. As a result, the Swiss holdings of foreign currency reserves are worth more than their outstanding debt, and at about $40 billion, their gold reserves are amongst the largest in the world.

Government policies reflect the conservative financial practices of the Swiss people. For example, to take out a mortgage, banks require a 30% deposit. And very few Swiss have credit card balances. They have become wealthy without the debt. Their living standard is the third highest in the world, ignoring micro countries like Liechtenstein and Monaco. The two countries with a higher living standard, Norway and Qatar, are rich because of their natural resources. Switzerland has the Alps, which generates tourism income, but otherwise have no natural resources that contribute to wealth.

Perhaps they are so wealthy because they are so careful with debt.

There have been recent headlines about countries like Argentina and Turkey that are in trouble with debt. Their currencies have collapsed, leading to a lower standard of living for their citizens. But we don't have to look that far to find debt problems. In fact, we believe that one of the biggest financial issues that we face here in the United States is debt.

The U.S. government is running up debt like never before. New debt issued by the U.S. government may be part of the reason that interest rates are rising. The 10-year Treasury rate has recently risen to 3.25%, from 1.36% in July of 2016. At least the U.S. government can print money to pay off the debt, though that may cause inflation.

We are more concerned about the affairs of the states. Though the official debt levels of the states have generally been flat for a long time, at about 4% of U.S. GDP, include the total obligations of the states and the numbers start to look almost hopeless. Obligations of the states include the cost of healthcare and pension payments to state retirees. Many states, including New Jersey, have woefully underfunded health and pension obligations.

To find out what can happen, consider the history of Bethlehem Steel. Bethlehem was ranked 8th in the Fortune 500 in 1955. This company built 1,127 ships during World War II, and also supplied the steel for San Francisco's Golden Gate bridge. At its peak in 1975, Bethlehem Steel employed 115,000 people.

But from it's Fortune 500 peak in 1955, Bethlehem Steel waned. Some blamed the union and contracts that didn't allow for head count reductions. Some blamed foreign steel imports made by lower wage earners in low income countries. Some blamed bad management. CEO Eugene Grace once remarked, "I have no doubt that the story will be one of increasing per capita use of steel in spite of the development of competing materials. I have no qualms about excess capacity. The United States will never catch up to its material needs and aspirations."

These confident, and in hindsight, overconfident remarks were reflected in company spending. In 1973, well after profits had started to fall, the company built a 21-story new headquarters which cost significantly more than was typical because it was designed to have as many corner offices as possible.

In 1986, Pulitzer Prize winning author John Strohmeyer wrote a book titled "Crisis in Bethlehem, Big Steel's Struggle to Survive." Strohmeyer blamed the union (pp 164), management (pp 142) and the decline in demand for steel (pp 180). But Strohmeyer, whose book was written 16 years before Bethlehem's demise, did not even mention the biggest risk for Bethlehem Steel.

Unfunded pension plans, and not bad management, foreign steel or union contracts, sunk Bethlehem Steel. Over the years, Bethlehem Steel chose to fund their pensions on a "pay as you go" basis, rather than funding pensions as they were earned. Shortly after the company closed in bankruptcy in 2003, Fortune Magazine ran a story called "The Sinking of Bethlehem Steel … a FORTUNE autopsy." Fortune concluded that "the ultimate error was the steel industry's pension and health benefits. The history here is revealing. From World War II on, wage and price controls intermittently slowed wage increases. Written into the contracts as offsets, though, were a long string of benefit improvements. These took up their role as company killers."

As further evidence that it was not bad management, union demands or foreign steel that did Bethlehem Steel in, consider US Steel. US Steel faced all of the problems that Bethlehem Steel faced, but is still around today because unlike Bethlehem Steel, US Steel funded its pension obligations.

The state of New Jersey is looking a lot like Bethlehem Steel. The issues for Bethlehem that made the headlines were union negotiations and decrease in demand. Governor Christie's union negotiations were constantly in the news, but the decrease in demand - not so much. But consider that demand is shrinking. Demand can be measured by population growth, and New Jersey is almost the lowest in the country. Further, New Jersey suffers from a loss of high wage earners who are moving out. For wage growth, therefore, New Jersey ranks 49th in the country. From wages come tax revenues.

Like Bethlehem Steel, labor negotiations and shrinkage in revenue are not the real problem. The real problem is that New Jersey is not funding its pension obligations.

In the 1950's, New Jersey centralized government worker pensions. Teachers, prison guards, local police, firefighters, general government workers, judges and state police workers all had their pensions consolidated and taken over by the state. The state government, however, skimped on contributions. Between the Whitman, McGreevey, and Corzine administrations, covering from 1994 through 2001, contributions were only $3.2 billion, far below what was needed.

Things reached a crisis level in the 2000 to 2002 recession. New Jersey's pension fund portfolio registered investment declines of 10.4% in 2000 and 9% in 2001, followed by a gain of just 3% in 2002. The combined shortfall of those years robbed the pension system of $21 billion in assets (NJ pension report pp 7). At the same time, state revenues declined because of wage declines. Required contributions rose to $1.5 billion by 2006 and such contributions were well beyond the state's ability to pay – so it didn't.

To its credit, the Christie administration did substantially increase contributions, but not by enough. According to the state's own 2018 budget report, "the rising costs of defined benefit pensions and health benefits continue to burden the State government and constrain the ability to be responsive to other priorities. As of June 30, 2015, the State's combined net pension liability was over $160 billion." According to the 2016 State Pension Funding Gap report prepared by the Pew Charitable Trust, New Jersey has only funded 31% of its pension obligation, which with Kentucky represents the lowest funding level in the country. The debt rating agencies have responded by cutting the ratings of New Jersey debt time and time again, from just below AAA to current ratings of A-, which are under review for further downgrades. According to Standard & Poor's, New Jersey has the worst pension crisis in the nation.

The current administration has responded by raising taxes on corporations and the wealthiest members. This won't work. In a quote in the Star Ledger, Assemblyman Jon Bramnick responded, "From small business owners to New Jersey's 22 Fortune 500 companies, nobody will like being treated like the Garden State piggy bank. The people who are most upset, you're never going to hear from, they don't do press conferences. They don't call and say 'Hey I'm leaving,' they just leave."

Famously, in 2016, David Tepper, the wealthiest resident of the state, left, costing the state hundreds of millions of dollars in lost tax payments. Several New Jersey lawmakers, who had to redo the budget, cited his relocation as proof that the state's tax rates are chasing away the rich. (New York Times, April 20, 2016 Robert Frank Inside Wealth).

The government watchdog Manhattan Institute put out a report in January of this year titled "Garden State Crowd - Out." The 13 - page report chronicles the crisis and concludes with this:

"Faced with the Garden State's ballooning pension costs, the New Jersey Pension and Health Benefit Study Commission ultimately recommended wide-spread changes to the state's pension system as well as additional cost-savings to employee benefits."

None of the changes were implemented by new Governor Phil Murphy, despite the fact that he headed the Commission while at Goldman Sachs.

The Manhattan Institute went on to say that "the Rockefeller Institute of Government defines a government pension system that's below 40% funded as in crisis. New Jersey's pension system is well below that line. Yet even when the costs were considerably less, the state's political leaders balked at fixing the system. We've now reached the point where neglecting to construct an adequate and lasting fix pushes the pension system on a path toward failure, a catastrophic scenario for New Jersey's public employees and taxpayers."

In an October 27, 2018 Wall Street Journal article, titled "Spelling Doom for Muni Bonds," author Spencer Jakab wrote, "If that sounds worrisome…The American Legislative Exchange Council determined that using more realistic assumptions, New Jersey is at 19.7% (funding)."

The 2008 recession was very painful and caused by too much mortgage debt. We believe that the next painful recession may well be caused by issues with a different kind of debt, government debt, and New Jersey is, unfortunately, at the forefront.

New Jersey has ignored the example that Switzerland set, and is following the path the Bethlehem Steel took to its demise. New Jersey won't go away but the state, unless it changes course, will be faced with raising taxes to pay for the pensions when they come due and there won't be enough taxpayers to tax. The state may well become only the second state in history to default on debt payments.

We will be vigilant, considering how this will affect our clients, but if you would like to discuss this risk, please bring it up with us.

Sincerely,

John B. Burke, MS, CFP®