# JOURNAL OF LAW, ECONOMICS & POLICY

**VOLUME 14** | **FALL 2017** | **NUMBER 1**

JOURNAL OF LAW, ECONOMICS & POLICY

VOLUME 14 | FALL 2017 | NUMBER 1

# CONTENTS

# PENSION FORFEITURE AND POLICE MISCONDUCT

*D. Bruce Johnsen & Adam David Marcus*

## INTRODUCTION

Empirical work on efficiency wages suggests that private sector defined benefit (DB) pension plans worked for many years to attract and retain high-quality workers.[1] Critical to building and maintaining a high-quality workforce was the ability to terminate employees who revealed their low quality in the form of misconduct such as negligence, subordination, dereliction of duty, or theft. Prior to passage of the *Employee Retirement Income Security Act* (*ERISA*), the prospective loss of pension benefits for misconduct fed into the system to screen out low-quality workers from the start.[2] Once *ERISA* mandated shorter vesting periods and prohibited pension forfeiture for misconduct the efficiency enhancing attributes of private sector pensions waned, as did their popularity.[3] With employers unable to punish worker misconduct with pension forfeiture, it is plausible to assume the incidence of misconduct increased and that the up-front screening effect of prospective pension forfeiture was lost as well.

This article applies the theory of efficiency wages[4] to public sector pension-covered workers for whom employee misconduct is most troublesome, namely state and local police. No doubt most police are conscien-

---

1 RICHARD A. IPPOLITO, PENSION PLANS AND EMPLOYEE PERFORMANCE: EVIDENCE, ANALYSIS, AND POLICY 107 (Univ. Chi. Press, 1997); Richard A. Ippolito, *A Study of the Regulatory Effect of the Employee Retirement Income Security Act*, 31 J. L. & ECON. 85, 114 (1988).

2 IPPOLITO, *supra* note 1, at 107; *See generally* Ippolito, *supra* note 1.

3 *See generally* IPPOLITO, *supra* note 1; Ippolito, *supra* note 1, at 98.

4 *See generally* EFFICIENCY WAGE MODELS OF THE LABOR MARKET, (George A. Akerlof & Janet L. Yellen eds., Cambridge Univ. Press 1986); George A. Akerlof, *Labor Contracts as Partial Gift Exchange*, 97 Q. J. ECON. 543 (1982); George A. Akerlof & Janet L. Yellen, *The Fair Wage-Effort Hypothesis and Unemployment*, 105 Q. J. ECON., no. 2, 1990, at 255; Daniel M. G. Raff & Lawrence H. Summers, *Did Henry Ford Pay Efficiency Wages?*, 5 J. LAB. ECON., no. 4, 1987, at S57; Steven C. Salop, *A Model of the Natural Rate of Unemployment*, 69 AM. ECON. REV., no. 1, 1979, at 117; Carl Shapiro & Joseph E. Stiglitz, *Equilibrium Unemployment as a Worker Discipline Device*, 74AM. ECON. REV., no. 3, 1984, at 433; Joseph E. Stiglitz, *The Causes and Consequences of the Dependence of Quality on Price*, 25 J. ECON. LITERATURE, no. 1, 1987, at 1. Efficiency wage theory asserts that the structure and magnitude of wages positively affects employee and employer incentives to provide inputs that are otherwise noncontractible. The structure of DB pensions has been recognized in the labor economics literature as one component of an efficiency wage, that is, a pattern of conditional wage payments providing both employees and employers with high-powered incentives to maximize joint surplus. To the extent police misconduct results not only in pension losses on termination, but the potential for complete pension forfeiture, the cost of misconduct to potential offenders increases and we should expect its frequency to diminish, perhaps substantially.

tious professionals capable of addressing tense or inflamed situations with the proper amount of restraint, but there is also a large and rising incidence of police excessive use of force and other forms of misconduct that needs to be addressed. At the same time, state and municipal pension systems are frighteningly underfunded owing to unrealistically high rate-of-return assumptions and implausibly high rates at which liabilities are discounted,[5] with several bankruptcies having already occurred or in process.[6] Robert Novy-Marx and Joshua Rauh put total underfunding across all 50 states between $1.26 and $2.49 trillion as of June, 2009.[7]

This paper examines how the rules regarding police pension forfeiture for misconduct vary across states and whether stricter forfeiture might help avoid fiscal crisis. The positive questions we ask are whether stricter pension forfeiture rules can realistically reduce either (1) pension liabilities owing to the increased prospect of for-cause termination or (2) state and municipal governments' legal liability under *respondeat superior* for officer misconduct. If the answer is yes to either question, the normative question is whether states can and, if so, should impose stricter pension forfeiture rules to directly or indirectly avert the looming public pension crisis. If not, the conclusion is that the use of public pensions to provide efficiency wages is severely limited, and that serious thought should be given to abandoning DB plans going forward in favor of defined contribution (DC) plans, which are far less costly to administer.

Our initial and admittedly casual evidence suggests that states with stronger pension forfeiture laws experience lower rates of police misconduct. Drawing any causal inference from this evidence requires far more data and rigorous empirical testing. Even if stricter police pension forfeiture is found to materially reduce the incidence of misconduct, the compelling conclusion is that it is unlikely to materially mitigate the looming public pension crisis because the amount of money at stake is so small. It is plausible, however, that the indirect fiscal effect of stricter police pension forfeiture for misconduct could be substantial because municipalities across the country currently pay out hundreds of millions of dollars annually on citizen suits for excessive use of force. With police pensions contingent on good faith performance in the line of duty, it is uncontroversial that misconduct will decline as the expected losses from misbehavior increase.

---

5 *See, e.g.*, Robert Novy-Marx & Joshua Rauh, *Public Pension Promises: How Big are They and What are They Worth?,* 66 J. FIN., no. 1, 2011, at 1211, 1213; *see also* PAULA SANFORD & JOSHUA M. FRANZEL, THE EVOLVING ROLE OF DEFINED CONTRIBUTION PLANS IN THE PUBLIC SECTOR (2012), http://www.nagdca.org/portals/45/ANC_NAGDCA_SLGE_The_Evolving_Role_of_Defined_Contribution_Plans_in_the_Public_Sector2.pdf.

6 Detroit is the most obvious example. Others include Stockton, San Jose, and San Bernardino, California, Jefferson County, Alabama, and now Puerto Rico.

7 Novy-Marx & Rauh, *supra* note 5, at 1213; SANFORD & FRANZEL, supra note 5.

This essay proceeds as follows. Section I provides an overview of private-sector DB pension plans, illustrating the high-powered incentives they are capable of creating and contrasting them with their closest alternative retirement savings vehicle, DC plans. It concludes by explaining the regulatory effects of *ERISA* and contrasts private-sector plans with their public-sector counterparts. Section II briefly examines seminal work on the economics of crime, punishment, and law enforcement. In a seminal article, Nobel Laureates Gary Becker and George Stigler demonstrated the power pension forfeiture can have in properly aligning police incentives with those of their employers. Section III presents evidence on police misconduct, including how it varies across states and how it relates to variations in state laws regarding pension forfeiture for misconduct. Section IV addresses whether stricter pension forfeiture is likely to have a substantial direct effect on the prospect of public pension solvency and also what its indirect effects are likely to be for the fiscal health of municipal and other state governments. It also provides concluding remarks and policy prescriptions, including the advisability of phasing out public-sector DB plans in favor of DC plans.

## I. THE IMPLICIT INCENTIVE EFFECTS OF PENSION CONTRACTING: EFFICIENCY WAGES

### A. *An Overview of Private-Sector Retirement Plans*

Private-sector employer-provided retirement plans have been around since at least the 19th century, but their use in the United States accelerated during and after World War II with the federal government's imposition of wartime wage and price controls. Unable to increase wages directly in the face of high labor demand and restricted supply during the war, employers began offering workers higher implicit wages in the form of so-called "fringe benefits" such as employer-funded health care and pension retirement savings plans. IRS rulings that employer contributions to pension trust funds were exempt from corporate profit taxes and would be taxed as ordinary individual income only when distributed as retirement benefits gave further impetus to all parties to adopt these plans. The use of private sector plans in the 19th century, prior to the advent of federal income taxes, clearly shows that DB pension plans are not purely a tax-driven phenomenon.

Ostensibly in response to the bankruptcy of several large manufacturers during the 1960s whose DB pension funds were severely underfunded,[8] Congress passed *ERISA* in 1974 to establish minimum 10-year cliff vesting[9] of actuarially accrued benefits, to ensure increased funding of private-sector single-employer plans on a going-forward basis, to prohibit pension forfeiture for misconduct, and to impose on plan sponsors a fiduciary duty to participants and the plan itself. Title IV of *ERISA* created the Pension Benefit Guaranty Corporation (PBGC) to provide insurance for participants in terminated, underfunded plans. *ERISA* also describes the procedures an employer must follow to terminate the plan entirely.

Prior to *ERISA*'s regulatory funding mandates there was no necessary reason an employer had to fund its pension liability by making pre-tax contributions to a retirement trust. Yet in fact, many employers voluntarily set up and contributed to pension trusts as a way to finance their pension promises, although they rarely fully funded them. One reason for making contributions is to demonstrate the credibility of the pension promise. Another is that contributions come out of pre-tax corporate income and accumulate based on investment performance free of corporate or personal income taxes. To the extent a firm underfunds the pension trust it must meet retirement liabilities from current or retained earnings, and these earnings are subject to a substantial corporate income tax.[10] Since tax benefits increase with funding levels, the question is why employers gave up the benefits of tax savings by underfunding in the absence of a regulatory mandate to do so. There must have been some offsetting cost from full funding.

### 1. Traditional Defined Benefit Plans[11]

Traditional DB plans were the original form of employer-provided retirement plan—historically known simply as "pensions"—in which the employer promised its workers a life annuity beginning on retirement, normally at age 65. Single-employer plans still exist in both unionized and nonunionized private-sector firms, although they are increasingly rare. Where the employer's labor force is unionized, the management bargaining unit is the employer. Labor law legislation notwithstanding, plan terms, the structure

---

8 Most notorious was the bankruptcy and plant closing of the Studebaker Corporation, which left nearly 7000 workers with 15 percent or less of their vested pension benefits. http://en.wikipedia.org/wiki/ERISA.

9 Cliff vesting is when the employee becomes fully vested at specified time rather than becoming partially vested in increasing amounts over an extended period of time.

10 *See generally* IPPOLITO, *supra* note 1.

11 This section discusses only single-employer pension plans. Certain types of workers have access to multi-employer plans. *See generally* D. Bruce Johnsen, *Who Captures the Rents from Unionization? The Case of Multiemployer Pension Plans*, 1 AM. U. BUS. L. REV. 193 (2012), http://www.law.gmu.edu/assets/files/publications/working_papers/1607.pdf.

and generosity of the retirement annuity, and the structure, provision, and generosity of related benefits are the subject of explicit contracting between the union and employer. Where the workforce is not unionized, they are the subject of employer policy constrained by labor market competition. Pension benefits are typically equal to a percentage generosity factor multiplied by years of service, all multiplied by the final average wage at retirement.[12] If *s* is the generosity factor (normally around 1.5 to 2.0 percent), *R* is years of service (and age at retirement assuming the start date to be age zero), and $W_R$ is the final average wage, the annuity on retirement is roughly as follows:

$$A = sRW_R.$$

By way of example, if the generosity factor is .015, years of service is 45, and the final average wage is $50,000, the retired worker receives an annuity from age 65 until death equal to $33,750 per year.

The Time-*R* capitalized value of this pension, *K**, is equal to the present value of the life annuity of $33,750 valued at Time-*R*. Assuming a 15-year life expectancy on retirement and a nominal discount rate of five percent, according to standard annuity tables the Time-*R* lump sum value of the pension is $350,313.

An important attribute of pension plans is that workers bear none of the residual risk from the investment performance of their pension trust. Instead, the employer bears the investment risk. If the account performs well, less of the employer's earnings saved outside the trust must be allocated to meet current pension obligations. If it performs poorly, the employer must make up the difference from outside the trust.[13] Ordinarily, a worker who terminates employment with a plan sponsor or suffers a voluntary break in service loses all unvested retirement benefits, and the employer is not required to pay vested benefits until the employee reaches retirement age. What is more, employers are free at any time to terminate plans that meet regulatory full funding rules for vested benefits and other requirements. Because these funding rules ensure only actuarial and not real, or *economic*, full funding, termination can impose a substantial capital loss on covered workers.[14]

---

12 Final average wage can be determined in any number of ways. It might be the average of the last three or five years of service, or in some cases the average of the highest three years of wages.

13 The employer also bears longevity risk resulting from retired workers under-living or outliving their actuarial life expectancy implicitly accounted for in the pension generosity parameter.

14 Obviously early termination reduces years of service, *R*, and therefore the value of the pension annuity. In addition, assuming wages grow over time the wage a worker earns prior to retirement will be less than $W_R$, perhaps by a substantial amount. *ERISA*'s full funding mandate requires the employer to fund the present value of retirement benefits based on the termination-date wage rather than the

One loss from which the pension promise does not insulate workers is employer insolvency. Employers who enter bankruptcy with insufficient assets to fully fund their pension liabilities sometimes leave their workers with only a fraction of their expected retirement benefits. Pension insurance through the Pension Benefit Guaranty Corporation only partially guarantees retirement benefits. The maximum guarantee is $54,000 per worker.[15]

### 2. Defined Contribution Plans

Workers in defined contribution plans bear investment risk but not employer insolvency risk. Rather than making a pension promise to workers in the form of a life annuity on retirement conditional on continued employer solvency, defined contribution plans make ongoing contributions to employee accounts for the duration of their working life. Oftentimes the plan offers employees the opportunity to self-direct their investment among a menu of publicly issued mutual funds, and their retirement benefits generally vary with market rates of return. Because returns tend to keep pace with inflation and wage growth over the long run, no indexing of retirement benefits to final average wage is necessary. Participants own their retirement account, which is at their discretion on retirement. If they want to invest their retirement assets in a life annuity on retirement they are free to do so. Once vested (often immediately), defined contribution plans are fully portable.

In 1978 Congress amended the IRS Tax Code to create Section 401(k),[16] which, in addition to the employer contribution typical of defined contribution plans, allows workers to make voluntary pre-tax contributions, often with employer-matching contributions as a ratio of employee contributions up to some limit (currently $18,000 for workers under 50 years of age) that are also tax deferred. Many employees take advantage of tax-deferred employer matching, but a substantial number fail to make their own contributions and thus forgo matching contributions. In essence, this permits the employer to offer a higher lifetime wage to high-quality workers, who select themselves for employment that offers an opportunity for matching contributions. Low-quality workers who find themselves in such settings tend to quit and cash out their accounts at a higher rate despite the

---

retirement date wage, $W_R$, and this is a second source of the capital loss workers suffer from early termination. The incentive effects of this plan structure will be discussed in detail below.

15 *See* PENSION BENEFIT GUARANTEE CORPORATION, PENSION INSURANCE DATA BOOK 2009, at 15 (2010), https://www.pbgc.gov/docs/2009databook.pdf.

16 26 U.S.C. § 401(k) (1978).

tax penalty, leading to improvements in an employers' workforce efficiency over time.[17]

## B. *The Economics of Efficiency Wages*

Over the past 30 years, labor economists have done a substantial amount of insightful work on the incentives employer-provided retirement plans provide. In contrast to early work, which assumed these plans were simply savings vehicles designed to capture the advantages of tax deferral, more recent work shows how the structure of retirement plans can enhance workplace productivity by providing the parties—both workers and employers—with high-powered incentives to maximize joint surplus by aligning incentives. As a foundational point, in an undistorted competitive labor market with free entry and exit the pension promise is not free to workers. The empirical economics literature on efficiency wage contracting clearly shows that workers pay for their retirement benefits by accepting lower cash wages during the term of their employment.[18] Workers earn a full wage at any given time that includes both their current cash wage and the present value of any credits they save toward their pension by forgoing current cash wages. Foregone wages cannot be directly observed and so must be estimated based on the wages comparable firms with no pension plan offer. Since pensions are not free, from the start of employment until death the capitalized value of future expected pension benefits must at least equal the capitalized value of forgone cash wages. Working backwards based on final wage and pension generosity, economists have been able to estimate the time path of foregone cash wages (pension savings) necessary to make the capital accounts balance in comparison to workers in non-pension-covered firms.[19]

Foremost in the pension literature is the extensive work by Richard A. Ippolito. He assumes employers and workers are rational wealth maximizers, where wealth is defined as the discounted present value of future net income (possibly including any on-the-job benefits). As such, it is necessary to focus on capital values (wealth effects) when assessing the parties' choices. This will often entail inter-temporal tradeoffs, with investments in workplace productivity being of primary concern.[20] Ippolito hypothesizes that DB plans reflect an implicit incentive contract between the employer

---

[17] *See* IPPOLITO, *supra* note 1, at 107.

[18] *See* IPPOLITO, *supra* note 1, at 10-18.

[19] *See* IPPOLITO, *supra* note 1, at 13; *see generally* Richard A. Ippolito, *The Labor Contract and True Economic Pension Liabilities*, 75 AM. ECON. REV., no. 5, 1985, at 1031, Richard A. Ippolito, *Efficiency with Costly Information: A Study of Mutual Fund Performance*, 104 Q. J. ECON., no. 1, 1989, at 1.

[20] In its simplest form, investment is simply the act of forgoing current consumption with the expectation of increasing future consumption by an amount sufficient to compensate for the delay.

and workers.[21] Workers save for retirement by foregoing some measure of current cash wages in exchange for the promise of a pension annuity on retirement. They expect to receive the capitalized value of pension savings (forgone cash wages) as retirement benefits conditional on staying with the firm and retiring at the optimal age or range of ages.

Among other things, DB plans encourage high-quality workers—those having relatively low subjective discount rates—to join and stay with the firm until retirement. This ensures the parties can take full advantage of long-term workplace productivity investments, which allows the employer to pay workers an *indenture premium* sufficient to compensate them for their loss of job mobility.[22] Low-quality workers—those having relatively high subjective discount rates—are unwilling to forego current wages for distant pension benefits and will, instead, choose to work for firms that have no pension plan but pay higher cash wages, all else being equal. Since the employer cannot directly observe worker quality up front, merely having a DB plan allows it to set up a system in which high-quality (long-tenure) workers self-select for employment based on private information about their own quality. In Ippolito's words:

> [DB plans] help employers reduce quit rates at early ages and increase retirement rates at later ages. … [A] less traditional, but perhaps equally important view [is that] pensions sort workers based on characteristics desirable to the firm. The focus is not on pensions' ability to influence behavior, but on their ability to attract workers who have desirable behavior patterns. In this view, pensions help the firm select a high-quality workforce, motivate the best workers to stay, and encourage the worst to leave.[23]

Quits impose costs on the employer. An obvious way to deter quitting is to impose vesting requirements. Ippolito reports that prior to *ERISA* nearly 40 percent of all workers participated in pension plans in which benefits vested only on retirement. The remaining 60 percent were subject to more liberal vesting requirements. Originally, *ERISA* mandated relatively liberal 10-year cliff vesting but has since moved to a five-year cliff vesting system.[24]

Even assuming pension benefits vest immediately on the date of hire, most DB plans discourage workers from quitting prior to retirement. To see this, assume a worker begins employment at age zero, with the expected retirement set at date $R = 45$. Let $a$ denote years of service at any time between the worker's start date and retirement, and assume pension benefits as described above vest from the start. If the worker quits before retirement age, he has a vested annuity collectable at Time-$R$ equal to

---

[21] *See generally* IPPOLITO, *supra* note 1.

[22] Workers with lower discount rates will exhibit lower absentee rates, higher investments in team production, greater willingness to train new workers, etc.

[23] *See* IPPOLITO, *supra* note 1, at 3.

[24] Ippolito, *supra* note 1, at 86.

$$A_a = saW_a,$$

where $W_a$ is his wage at Time-*a*. By way of example, for a worker who terminates after 25 years $a = 25$ in the pension formula. Assuming wages grow at the nominal interest rate of five percent and working backwards from a retirement date wage of $50,000, the yearly wage at Time-*a,* $W_a$, is equal to $18,840 and *A*a is equal to $7,065.[25] Not only does the worker lose credit for years of service equal to $R - a$, but he also forgoes wage growth in the pension formula.[26] From standard annuity tables, the Time-*R* capitalized value of this 15-year life annuity is $73,476, as opposed to $350,313. Designating this amount as $K_a$, note that it has the following relationship to $K^*$:

$$K_a = K^* \div (1 + i)^{R-a}.$$

This amount reflects the capitalized value of the annuity the worker can expect to collect on retirement from terminating at Time-*a* rather than at retirement. Early termination obviously imposes a substantial capital loss on the worker from early termination.

## C. *The Regulatory Effects of ERISA*

### 1. The Decline of Private Sector Pensions

When asked to explain the underlying purpose of major legislation such as *ERISA*, an economist's first job is to ask what market failure the legislation might have been designed to correct. Absent a plausible market failure, it may be motivated by interest group rent seeking that requires a public choice or political economy explanation. Ippolito uses the efficiency wage model of implicit pension contracting to assess whether *ERISA* had the effect of correcting a market failure.[27] He proposes the following hypotheses. The first hypothesis conjectures that employers dupe uninformed workers into believing they will receive full pension benefits in lieu of higher cash wages only to defraud them down the road by firing them or terminating the entire plan before retirement. According to this hypothesis, *ERISA* was designed to prevent employers from negotiating a low cash wage up front and later failing to fulfill their pension promise. The second hypothesis conjectures that employees are informed and cannot be duped in

---

25 (.015)(25)($18,840) = $7065.

26 Assuming no improvements in worker productivity, wage growth can be expected to increase at a rate equal to the nominal interest rate, *i*.

27 *See* Ippolito, *supra* note 1, at 90-91.

this way. If so, they should have reacted to protect themselves by investing only in *quit* pensions, inefficiently foregoing the full benefits of tax-deferred savings and the indenture premium. This represents a low-quality, degenerate equilibrium that *ERISA* was designed to repair by ensuring enforcement of the implicit pension promise, ensuring a high-quality equilibrium in which workers invest forgone cash wages in *stay* pensions.

The evidence shows that *ERISA* did not have the effect of correcting either labor market failure. To see why, it helps to recall that workers must pay for their pension benefits through forgone wages. Under the fraud hypothesis, if workers incorrectly believe they will receive full pension benefits in exchange for lower cash wages, and employers know otherwise, then employers will not only pay lower cash wages but they will employ more workers than otherwise, and they will engage in a pattern of late-age terminations. If *ERISA* was designed to correct this market failure it failed miserably, because the evidence shows that with its passage cash wages actually drifted upward and employment remained unchanged. Moreover, compared to non-pension covered firms there was no increase in late-age termination. The evidence therefore rejects the fraud hypothesis and fails to reject the implicit contract theory.

The degenerate equilibrium hypothesis predicts that if workers believe the employer is likely to terminate them or the plan in its entirety after vesting but before retirement, they will forego wages of no more (at any given moment in their tenure) than necessary to fund a quit pension. At any given time they will contribute no more to their pension account in forgone wages than the present value of the retirement-date benefits they can walk away with if they are terminated or quit. This implies a time-path of forgone cash wages that is back-end loaded, with the bulk of pension saving occurring in the very late years of employment. If, on the other hand, workers believe the employer will fulfill its pension promise and they have no intention of quitting, they will forgo larger wages early to fund a stay pension because this allows them to fully capture the benefits of tax deferral and a share of the productivity advantages of long tenure. This implies a level time-path of forgone wages. According to Ippolito, the evidence clearly demonstrates that prior to *ERISA* workers in firms covered by DB plans contributed over their working life at a constant rate and that quit rates were substantially lower than in similar firms that had no pension plan.[28] The evidence therefore rejects the degenerate equilibrium hypothesis and fails to reject the implicit contract theory from the efficiency wage model.[29]

---

28 *See* IPPOLITO, *supra* note 1, at 16.

29 Many plans offer the option of early retirement, in essence specifying an age range over which workers can choose to retire without having to bear a late retirement penalty. During this period, often age 55 to 65, the plan adjusts pension benefits in an economically fair way that leaves the worker's wealth unaffected. This adjustment must take into account the worker's longer expected retirement

Ippolito finds the political economy story more compelling than either hypothesis.[30] He argues that *ERISA*'s primary purpose was to effect rent transfers in the form of PBGC insurance to politically powerful subgroups within the labor market. He finds that the primary beneficiaries of PBGC insurance have been workers in underfunded plans whose employers faced high risk of insolvency. These workers were heavily concentrated in unionized firms. In his words, "virtually all systematic underfunding in private pension plans in the United States is attributable to underfunded plans covering unionized participants." Through 1986, "almost 95 percent of [PBGC] monies have been claimed by union participants."[31]

The interesting question is why underfunding would be heaviest in unionized firms. Ippolito's answer relies on a variant of implicit contract theory. The mirror image of employers' opportunistic termination of their pension promises is opportunism by a well-organized union. Assume a pension plan is fully funded owing to a bargain between the parties of a specific cash wage and pension promise. What prevents the union from unexpectedly increasing its wage demands by threat of strike after the terms of the implicit pension contract are set, even if it imposes substantial bankruptcy risk on the employer? If the employer later becomes insolvent, union workers could benefit over the short term from premium wages and still collect their full pension benefits. At the margin, according to Ippolito, employer underfunding of full pension obligations bonded the union against such opportunistic conduct. The benefit of the underfunded bond must have offset the foregone benefits of greater tax deferral. With passage of *ERISA* and the provision of PBGC pension insurance, the bond disappeared and opportunistic wage demands by unionized workers in dying firms followed, with underfunded pension liabilities indemnified by U.S. taxpayers at-large. According to the Congressional Record, Ippolito reports that through their public statements and lobbying efforts the unionized "benefi-

---

annuity through a reduction in pension generosity as a function of final average wage or a recalculation of final average wage.

Pensions also discourage workers from staying with the firm too long. Past some point workers' physical and mental capacities diminish and they are more prone to absenteeism. These costs must be borne in part by co-workers and the firm. Most pension plans address the problem of workers who might stay on the job inefficiently long by capping benefits in some way. The lump sum pension formula might be specified with a maximum value of *R*, in which case pension benefits are frozen beginning at *R*. Past *R*, say, 45 years, an additional year of service will add nothing to the lump sum value of the retirement annuity. The worker not only loses the additional year of service in the benefit equation but, assuming his decision to continue working past age 65 in no way effects his life expectancy (the duration of his annuity), he also loses one year of retirement benefits. The implicit wage tax from working past *R* can be as much as 30 percent of the yearly wage and can be seen as the penalty for late retirement. *See* IPPOLITO, *supra* note 1, at 12.

30 *See generally* IPPOLITO, *supra* note 1.

31 Ippolito, *supra* note 1, at 116-117.

ciaries of the insurance identified themselves beforehand and played key roles in enacting the insurance title of ERISA."[32]

Traditional DB pension plans, it seems, were efficient contracting devices designed to align worker and employer incentives to enhance workplace productivity. Following passage of *ERISA*, private-sector DB plans experienced a steady decline, with a corresponding rise in DC plans.[33] Whether or not *ERISA* was the sole cause is debatable, but it seems clear that it gutted the efficiency wage property pensions formerly provided.

### 2. Enter Defined Contribution Plans

No doubt regulatory changes brought by *ERISA* increased the administrative costs of smaller DB plans and contributed to the rise of DC plans. An increasing demand for employment mobility may have contributed to the trend, either because employees across all spectrums demanded it or because of rising relative employment in white-collar firms. The greatest gains by DC plans have been in small firms (those with fewer than 2,000 workers) and large, nonunionized manufacturing firms.[34] Today, DC plans constitute the bulk of private sector retirement plans.[35]

### 3. Public Sector Retirement Plans

In the public sector DB plans remain the norm, although DC plans are slowly increasing in popularity.[36] Despite their popularity, public-sector DB plans appear to mobilize few of the high-powered incentives once enjoyed by their private-sector counterparts. Vesting is often immediate, or nearly so, and the prospect of plan termination owing to employer insolvency until recently has been nil. It is clear, however, that an employee who terminates or is terminated early suffers the same capital loss as in the private sector, thereby selecting in favor of employees who expect to stay on the job until retirement.[37] What is more, benefit accruals do not appear to be capped in a way that encourages a retirement date decision that is jointly efficient as to employer and employee. The critical question is whether

---

[32] Ippolito, *supra* note 1, at 120.

[33] Novy-Marx & Rauh, *supra* note 5, at 1216-17.

[34] IPPOLITO, *supra* note 1, at 82-83.

[35] EMPLOYEE BENEFIT RESEARCH INSTITUTE, FAQS ABOUT BENEFITS – RETIREMENT ISSUES, https://www.ebri.org/publications/benfaq/index.cfm?fa=retfaq14; WILLIAM J. WIATROWSKI, U.S. BUREAU LAB. STAT., THE LAST PRIVATE INDUSTRY PENSION PLANS: A VISUAL ESSAY, MONTHLY LAB. REV. 3, 3 (Dec. 2012), http://www.bls.gov/opub/mlr/2012/12/art1full.pdf ("78 percent of state and local government workers had [defined benefits] coverage in 2011.").

[36] *See* Novy-Marx & Rauh, *supra* note 5, at 1216; SANFORD & FRANZEL, supra note 5, at 4.

[37] Note that this be inefficient for clerical, administrative, and white-collar employees.

public employees pay for their pensions in the form of forgone cash wages throughout their working life. The literature attempting to directly answer this question is thus far unconvincing as it is plagued by the absence of a relevant basis for comparison. Substantial indirect evidence suggests public employees do not pay for their pensions, however.[38]

Public-sector pension plans are exempt from *ERISA*'s mandates, although many of them purport to adhere to *ERISA* as a matter of best practices. Many governmental entities have failed to keep up with the annual payments needed to keep their pension funds on sound financial and actuarial footing. In 2014, 20 states paid less into their pension plans than was necessary to fund benefits for current and future retirees. Because states are obligated to make DB pension payments, many had to cut other programs and/or raise taxes to do so. One reason for the shortfall is the use of unrealistically high interest rates at which future liabilities are discounted, making the present value calculation unrealistically small. The Government Accounting Standards Board (GASB) allows state governments to discount liabilities at the same rate as the projected return on portfolio assets, often in the neighborhood of seven to eight percent. Using a much lower discount rate to properly reflect the low risk of pension liabilities yields an estimate of the total state funding shortfall in the range of \$1.26 to \$2.49 trillion as of 2011.[39] Although the amount varies by state, the national average is \$4,383 per person.[40] These figure reflect all *accrued* liabilities, which states would be required to pay out even if they terminated their plans on a going forward basis.

Underfunding appears to be the result of several questionable practices on the part of state and local governments. The first is the use of unrealistically high portfolio rate-of-return assumptions. In many cases real rates of return are projected to be in the neighborhood of seven or eight percent per year,[41] a practice that would clearly be considered imprudent by private-sector standards. The second as described above, is the use of unrealistically high interest rates at which future liabilities for pension annuity payouts are discounted. Together, these practices overstate expected assets and understate expected liabilities, making the plan appear closer to full funding than it actually is. Finally, employee contribution rates and benefit generosity are subject to political winds, with incumbent politicians often reduc-

---

38 *See generally* Maury Gittleman & Brooks Pierce, *Compensation for State and Local Government Workers*, 26 J. ECON. PERSPECTIVES 217 (2011); Richard T. Boylan & Dru Stevenson, *The Impact of District Elections on Municipal Pensions and Investment*, 14 J. L. ECON. & POL'Y. 1 (forthcoming 2018); Brigham Frandsen & Michael Webb, *Public Employee Pensions and Collective Bargaining Rights: Evidence from State and Local Government Finances*, 14 J. L. ECON. & POL'Y. 1 (forthcoming 2018).

39 Novy-Marx & Rauh, *supra* note 5, at 1213.

40 John W. Schoen, *Here's your share of state pension shortfalls*, CNBC (Jan. 19, 2016, 1:14 PM), http://www.cnbc.com/2016/01/19/heres-your-share-of-state-pension-shortfalls.html.

41 Novy-Marx & Rauh, *supra* note 5, at 1225.

ing the former and raising the latter to ensure re-election. Underestimates of pensioner life expectancy owing to ever-increasing longevity[42] and systemic spiking[43] are also partly to blame.

### D. *A Legal History of Pension Forfeiture*

Most pension forfeiture laws strip government workers of their pensions if they are convicted of a felony committed in the course of their employment. The reasoning for such laws appeals to a sense of "justice." As New York Governor Andrew Cuomo stated in his 2016 State of the State address, "[i]t is perverse that taxpayers' money would support officials found guilty of committing a felony against the taxpayers. We must take state pensions from those convicted of a crime related to their government service. Anything else shows disrespect for the rule of law and for the taxpayer."[44] But there are also a number of contrary arguments holding that pension forfeiture:

> (1) impinges on the public official's vested contractual rights since pension benefits are, in substance, a form of deferred compensation; (2) provides a disincentive for persons to enter into and remain in public service; (3) fails to recognize that public officials and, more importantly, their innocent dependents rely on pension benefits as a source of retirement income; (4) is inconsistent with federal law protecting private pensions from forfeiture in the case of employee misconduct; and (5) is insufficiently calibrated to the degree of wrongdoing to properly serve deterrent and retributive purposes.[45]

The first federal pension forfeiture law was the so-called "Hiss Act" passed in 1954 after the perjury conviction of Alger Hiss, a State Department aid accused of leaking confidential documents to a Communist agent. As originally enacted, the law was quite broad, "prohibiting the distribution of any federal retirement annuities to any federal officer or employee con-

---

42 Rick Lyman & Mary Williams Walsh, *Public Pension Tabs Multiply as States Defer Costs and Hard Choices*, N.Y. TIMES (Feb. 24, 2014), https://www.nytimes.com/2014/02/25/us/efforts-to-rein-in-public-sector-pension-costs-are-falling-short-experts-say.html.

43 The practice known as "spiking" occurs when government workers load up on overtime in the last years of their employment. With pension benefits indexed to their final average wage, they are able to increase the generosity of the resulting life annuity they receive on retirement. *See, e.g.*, Catherine Saillant, Maloy Moore and & Doug Smith, *Salary 'spiking' drains public pension funds, analysis finds*, L.A. TIMES (Mar. 3, 2014), http://articles.latimes.com/2014/mar/03/local/la-me-county-pensions-20120303.

44 *Transcript of Cuomo's 2016 State of the State Address*, N.Y. TIMES (Jan. 13, 2016), http://www.nytimes.com/2016/01/14/nyregion/transcript-of-cuomos-2016-state-of-the-state-address.html.

45 Gary Stein, *Pension Forfeiture and Prosecutorial Policy-Making*, 2014 N.Y.U. J. LEGIS. & PUB. POL'Y QUORUM 9, 15 (citing James B. Jacobs, Coleen Friel & Edward O'Callaghan, *Pension Forfeiture: A Problematic Sanction for Public Corruption*, 35 AM. CRIM. L. REV. 57, 81-88 (1997)).

victed of any offense relating to disloyalty, national security or defense, conflict of interest, bribery and graft or the exercise of the defendant's 'authority, influence, power, or privileges as an officer or employee of the Government.'"[46]

Seven years later, Congress amended the Act to limit pension forfeiture to offenses related to national security because it was concerned that "the original law 'went too far' and unduly punished former federal officials (and their innocent families) when the former employee or official, in addition to facing fine and imprisonment for an offense, may be left destitute without any retirement income at all for the violation of 'comparatively minor offenses.'"[47] In 2007, after several members of Congress were convicted on corruption charges, Congress adopted the *Honest Leadership and Open Government Act* of 2007 (*HLOGA*), which denies retirement benefits to any member of Congress convicted of bribery, perjury, conspiracy or related crimes committed in the course of carrying out their official duties.[48] *HLOGA* was expanded in 2012 to include "a host of other crimes, such as mail fraud, wire fraud, securities fraud, money laundering, extortion and tax evasion."[49] *HLOGA* applies only to members of Congress, leaving all other Federal employees safe from pension forfeiture. And *ERISA* prohibits ad hoc pension forfeiture in the private sector.[50] But state and municipal governments are free to enact pension forfeiture laws for their employees.

Thirty-three states have pension forfeiture laws.[51] Two states' laws apply only to elected officials or judges. Twenty-two states' laws can strip police officers of their pension after conviction of *any* felony related to public office. Another 9 states have pension forfeiture laws that apply to police but are triggered only by certain specific crimes (e.g. corruption, financial crimes, sexual crimes against minors, etc.) and would not be triggered by a police officer's conviction for excessive use of force.

Half of the states with pension forfeiture laws enacted them in 2000 or later.[52] Because these laws are relatively new, they vary greatly in how they

---

46 Stein, *supra* note 45, at 16 (quoting Hiss Act, Pub. L. No. 83-769, 68 Stat. 1142 (1954) (codified at 5 U.S.C. § 8311 *et seq.*)).

47 JACK MASKELL, CONG. RESEARCH SERV., 96-530, LOSS OF FEDERAL PENSIONS FOR MEMBERS OF CONGRESS CONVICTED OF CERTAIN OFFENSES 1, 1–2 (2012) (quoting legislative history), https://www.fas.org/sgp/crs/misc/96-530.pdf.

48 *Id.* at 6-10; Pub. L. No. 110-81, 121 Stat. 735.

49 Stein, *supra* note 45, at 17.

50 James B. Jacobs, Coleen Friel & Edward O'Callaghan, *Pension Forfeiture: A Problematic Sanction for Public Corruption*, 35 AM. CRIM. L. REV. 57, 58 (1997).

51 See appendix for a list of states with pension forfeiture laws that apply to police. Additionally, Texas Government Code 839.003 applies to impeached judges and the Maryland legislature's Joint Resolution 4 of 2010 applies to legislators convicted of a crime involving moral turpitude.

52 *Id.* Whether the employee or the employer is directly responsible for pension contributions, and to what extent, is economically irrelevant. As with taxation, who explicitly pays the tax has nothing to

operate. As explained above, different states have different qualifying crimes, though the laws of 21 states are silent on what happens if a conviction is later overturned. States also differ on whether employees stripped of their pensions get to keep any money they themselves contributed to their pension funds. And for those states that do return employee contributions, some also return the interest on those contributions and some do not.[53] In 21 states, the forfeiture is mandatory, but in three states, a court or the state pension board can optionally award some of a convicted employee's pension to a spouse or dependents. This is an attempt to address the concern that the family of a convicted employee is unfairly harmed by forfeiture of the employee's pension. In states where pension forfeiture is not mandatory, a retirement board reviews each case individually. And in some states, the attorney general has the authority to overrule decisions by the retirement board.

Even in states that have pension forfeiture laws in place, the laws usually apply only to employees who started after the law was enacted. The U.S. Constitution and many state constitutions prohibit states from passing ex post facto laws—laws that change the obligations of existing contracts.[54] In *Beazell v. Ohio*, the U.S. Supreme Court explained that "[i]t is settled, by decision of this Court so well known that their citation may be dispensed with, that any statute … which makes more burdensome the punishment for a crime, after its commission … is prohibited as *ex post facto*."[55] At the state level, at one extreme, the Illinois Supreme Court has found that public pensions are constitutionally protected from any impairment whatsoever,[56] while at the other extreme Texas and Indiana treat public employee pensions as a "gratuity" subject to *ex post* changes in administration policy.[57]

Pennsylvania and Vermont have included language in their pension forfeiture laws that attempts to avoid this problem. Pennsylvania's statute states "[e]ach time a public officer or public employee is elected, appointed, promoted, or otherwise changes a job classification, there is a termination

do with who bears the tax burden, which is determined by the relative elasticities of demand and supply. In the pension context, the relevant demand and supply are those for loyal employees.

53 For private sector plans, it is economically meaningless to distinguish between payroll deductions (cash) contributed by the employee to his or her retirement account and employer benefits because, as is well recognized in the labor literature, those benefits are in lieu of higher cash wages. Arguably, in the public sector employees do not forgo higher cash wages in consideration for employer funded pension benefits. This would seem to strengthen the case for forfeiture.

54 U.S. CONST. art. 1, § 9 ("No Bill of Attainder or ex post facto Law shall be passed."); U.S. CONST. art. 1, § 10 ("No State shall … pass any Bill of Attainder, ex post facto Law"); CAL. CONST. art. 1, § 9 ( "A … law impairing the obligation of contracts may not be passed.").

55 269 U.S. 167, 170 (1925).

56 *See generally* In re Pension Reform Litig., 32 N.E.3d 1 (Ill. 2015).

57 Kunin v. Feofanov, 69 F.3d 59, 63 (5th Cir. 1995); Ballard v. Bd. of Trs., 324 N.E.2d 813, 815 (Ind. 1975).

and renewal of the contract for purposes of this act."[58] Vermont's statute states "[e]ach time a member is hired, reassigned, promoted, demoted, enters into a new collective bargaining contract, or otherwise changes his or her employment relationship or status, he or she shall be deemed to consent and agree to be subject to the provisions of this subchapter, including to this condition precedent."[59] Whether these statutes can withstand challenge under the state or federal constitution has been only partially tested. The Vermont statute, enacted in 2013, has not (yet) been challenged in court. The Pennsylvania statute, enacted in 1978, has been challenged in Pennsylvania state courts and in the Third Circuit. Although the Third Circuit upheld the law, the Pennsylvania state Supreme Court found the retro-active provision a violation of the state constitution.[60] Notwithstanding the Pennsylvania state supreme court's holding, one could easily take the position that *ex post* changes to employment terms that are within the scope of *ex ante* consent do not violate the proscription on *ex post facto* laws.

## II. THE ECONOMICS OF CRIME, PUNISHMENT, AND LAW ENFORCEMENT

### A. *Crime*

One setting in which the incentive effects of DB pensions can be especially powerful is with respect to public safety personnel, specifically state and local police. The remainder of the paper explores police pension forfeiture as a way to select in favor of high-quality police recruits, that is, recruits who are disinclined to engage in misconduct. Much of the literature on the economics of crime, punishment, and law enforcement owes a huge debt to Nobel Laureate Gary Becker, who pioneered the field. Becker first wrote on the subject in a then controversial but now seminal paper in which he asserted that

> a [rational] person commits an offense if the expected utility to him exceeds the utility he could get by using his time and other resources at other activities. Some persons become 'criminals,' therefore, not because their basic motivation differs from that of other persons, but because their benefits and costs differ.[61]

This is as true for police officers as it is for any other member of society. The benefits from criminal activity can be classified as monetary (e.g.

---

58 43 PA. CONS. STAT. § 1313(c) (1978).

59 VT. STAT. ANN. tit. 32, § 623(a) (2013).

60 Brace v. Cty. of Luzerne, 535 F. App'x. 155 (3d Cir. 2013); Bellomini v. State Employees' Ret. Bd., 498 Pa. 204, 212 (1982).

61 Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON., no. 2, 1968, at 176.

the tangible gains obtained from theft, robbery, insurance fraud, etc.) or psychic (e.g. the thrill of danger, peer approval, retribution, public benefits, or even sadism, etc.).

Although police officers do not gain monetarily when they use excessive force, they may get psychic benefits. Approval by fellow officers may be a strong psychic benefit.[62] They may also truly believe that their behavior, though proscribed, benefits the public at large. The question is at what point do the costs outweigh the benefits. Excessive use of force goes against the long legal tradition of believing people are innocent until proven guilty,[63] and of course the same applies to claims of excessive use of force.[64]

## B. *Punishment*

In another seminal paper, Becker and Stigler find that criminal "offenders convicted of violating laws be punished by an amount related to the value of the damages caused to others, adjusted upwards for the probability that offenders avoid conviction."[65] To estimate the expected penalty a criminal should face, multiply all costs of punishment by the probability of being punished. It is important to recognize that if penalties are set at their maximum level there may be no additional penalty available for more severe crimes. If the penalty for mugging is the same as the penalty for murder, for example, rational muggers will kill their victims and any witnesses to decrease their chances of being caught. "Although the lower expected penalties will increase lesser crimes, the reduction in harm from the decrease in more serious crimes will more than offset the increase in harm from the lesser crimes, increasing social welfare."[66] Optimal punishment must therefore account for the problem of marginal deterrence.

In economic theory, the purpose of law enforcement is to maximize social welfare, which is defined as "the benefits that individuals obtain from crime minus the costs of committing crime, the costs of harm to victims,

---

62 Rich Martin, *Police Corruption: An Analytical Look into Police Ethics*, FBI LAW ENFORCEMENT BULLETIN (May 2011), https://leb.fbi.gov/2011/may/police-corruption-an-analytical-look-into-police-ethics ("In the corrupt subculture, fidelity becomes more important than integrity, and officers learn that their peers frown upon morality and independence.").

63 *See* Coffin v. United States, 156 U.S. 432, 453 (1895) ("The principle that there is a presumption of innocence in favor of the accused is the undoubted law, axiomatic and elementary, and its enforcement lies at the foundation of the administration of our criminal law.").

64 Claims of excessive use of force are troublesome in that establishing legal proof or disproof that an officer subjectively perceived a palpable physical threat is an evidentiary quagmire.

65 Gary S. Becker & George J. Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. LEGAL STUD. no. 1, 1974, at 1.

66 HENRY N. BUTLER, CHRISTOPHER DRAHOZAL & JOANNA SHEPHERD, ECONOMIC ANALYSIS FOR LAWYERS 408 (3d ed., Carolina Acad. Press 2014).

and the costs of enforcement."[67] The cost potential victims incur to protect themselves from crime should also be included. Governments can maximize social welfare through three policy instruments:

> [T]he probability of capture and punishment, the length of prison terms, and the level of fines. In setting these policy instruments at their ideal levels, the economic model assumes that criminals behave rationally and weigh the costs and benefits of criminal activity before turning to crime. … The optimal amount of deterrence occurs at the point where the marginal social cost of additional deterrence equals the marginal social benefit.[68]

If we ignore the gains to the criminals themselves, optimal deterrence occurs where the marginal enforcement costs are equal to the marginal enforcement benefits, which are equivalent to the marginal harm to victims.[69] Overdeterrence can also be a problem. In *United States v. U.S. Gypsum Co.*, the Supreme Court acknowledged the troubling possibility of Type II errors, that is, criminal sanctions that deter legal and socially beneficial behavior.[70] More recently, former FBI director James B. Comey has said that the recent increased attention on excessive use of force could make police officers less proactive.[71]

### C. *The Economics of Law Enforcement*

All may be well and good regarding the economics of crime and punishment, but an imbedded assumption is that law enforcers have the optimal incentive to ferret out and punish crime. Following Michael Jensen and William Meckling, law enforcement is subject to an agency problem because police officers (the agents) are not necessarily perfect guardians of the citizenry (their principals).[72] They argue that two mechanisms are used to address agent misconduct: monitoring by the principal (or other agents) and bonding by the agent. In their view, agents will try to bond themselves against misconduct because the benefits to the agent from misconduct fall short of the losses to the principal. Misconduct reduces the gains from trade, and limiting it therefore increases the parties' joint surplus. In yet another seminal paper, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, Becker and Stigler propose that the best compensation regime

---

67 *Id.* at 393.

68 *Id.*

69 *Id.*

70 438 U.S. 422, 441 (1978).

71 Andrea Noble, *Police fear 'YouTube effect' affecting work, contributing to rise in violent crime*, WASH. TIMES (Oct. 25, 2015), http://www.washingtontimes.com/news/2015/oct/25/police-fear-youtube-effect-affecting-work-contribu/.

72 Michael C. Jensen & William H. *Meckling*, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

for police officers is for them to "post a bond equal to the temptation of malfeasance, receive the income on the bond as long as they are employed, and have the bond returned if they behave themselves until retirement. Put differently, they forfeit their bond if they are fired for malfeasance."[73] To the extent police pensions can be forfeited for misconduct, they appear very much like a Becker-Stigler bond. Any pension-covered worker faces a capital loss from early termination, with the amount of this capital loss being greater for newer employees. Assuming it is vested, this is because their promised pension experiences no wage growth between termination and the time it is paid out starting on retirement. To the extent police face pension forfeiture as well as termination for misconduct, the potential capital loss increases and misconduct is further deterred. Knowing this up front, the prospect of pension forfeiture for misconduct induces self-selection in favor of recruits disinclined to engage in misconduct. According to a 2013 study, "[a]n estimated 81% of local police departments, employing 94% of all officers, offered sworn personnel a defined benefits (pension) plan."[74] But in many states, even police officers convicted of gross misconduct are entitled to their full pensions.

If DB pensions attract high quality workers who are inclined toward desirable behavior, then laws and policies allowing police officers convicted of misconduct to keep their pensions fail to mobilize the positive incentives a Becker-Stigler bond could provide. Indeed, the effect could be to select in favor of those inclined to engage in misconduct. One solution is to actually require police to post a bond at the time of hire, as in the Becker-Stigler model. In the efficiency wage model they do so implicitly by foregoing higher cash wages, but foregone wages are meted out at a level rate over the term of employment. This means that, at the margin, police officers who are early in their term of employment face a relatively small capital loss from pension forfeiture compared to those nearing retirement. On the other hand, if termination goes hand-in-hand with pension forfeiture, at the margin younger officers face a relatively large capital loss from termination.

## III. POLICE MISCONDUCT

The job of a police officer is unlike nearly every other profession in that police officers are authorized to exercise physical force against citizens within our borders as a primary component of their job. This alone should justify extreme measures to ensure that police officer misconduct, especially the excessive use of force, is appropriately minimized.

---

73 Becker & Stigler, *supra* note 65, at 9-10.

74 BRIAN A. REAVES, BUREAU JUST. STAT., LOCAL POLICE DEPARTMENTS, 2013: PERSONNEL, POLICIES, AND PRACTICES 7 (May 2015), http://www.bjs.gov/content/pub/pdf/lpd13ppp.pdf.

## A. *Monitoring Police Misconduct*

Dealing with police misconduct is, at heart, a matter of how principals (police commissioners and supervisors) monitor their agents (the rank-and-file police officers). Monitoring costs can include information costs (the cost of obtaining information about the agent's performance) and opportunity costs (the lost opportunity to spend those resources on something else). There are also the costs incurred by the principal when the agent deviates from the promised performance. Many municipalities spend millions of dollars every year to settle police excessive use of force lawsuits.[75] In 2010, U.S. cities spent an estimated $346 million in judgments and settlements in civil police misconduct cases.[76] The city of Chicago spent $642 million on police misconduct-related lawsuits from 2004 through 2015.[77] Police misconduct also lowers the public's trust in the police, and, in the case of police corruption, criminals remain at large.[78]

Although state and local governments have a solid reason to monitor police officers to detect misconduct, monitoring is costly and by any reasoned calculus should therefore be imperfect. At the margin, it simply does not pay to spend an additional dollar monitoring to avoid an injury whose expected social cost is only ninety cents. Knowing this, police officers, like any agents, will engage in some measure of shirking and, quite possibly, will consume the principal's resources for personal gains, so-called perquisite consumption. Shirking aptly describes how excessive force is commonly portrayed in movies and television. Police officers will regularly "rough up" suspects in an attempt to get a confession or witnesses in an attempt to get information. How accurate these portrayals are is an open question, but there is no doubt such conduct occurs to some extent. And the consequences for excessive force when it is discovered are often alarming. [79]

---

75 Radley Balko, *U.S. cities pay out millions to settle police lawsuits*, WASH. POST (Oct. 1, 2014), https://www.washingtonpost.com/news/the-watch/wp/2014/10/01/u-s-cities-pay-out-millions-to-settle-police-lawsuits/.

76 David Packman, *2010 NPMSRP Police Misconduct Statistical Report –Draft–*, CATO INSTITUTE'S NATIONAL POLICE MISCONDUCT REPORTING PROJECT (Apr. 5, 2011), http://www.policemisconduct.net/2010-npmsrp-police-misconduct-statistical-report/.

77 Andrew Schroedter, *Chicago Police Misconduct – A Rising Financial Toll*, BETTER GOVERNMENT ASSOCIATION (Jan. 31, 2006, 6:00 AM), http://www.bettergov.org/news/chicago-police-misconduct-%E2%80%93-a-rising-financial-toll.

78 *See generally* Talha Syed, *Not Victimless: Understanding the harmful effects of police corruption*, 91 SERVAMUS, no. 1, 1997, http://www.csvr.org.za/index.php/publications/1485-not-victimless-understanding-the-harmful-effects-of-police-corruption.html.

79 Former Chicago police commander John Burge has been called the worst cop in history. *See generally* Andrew Emett, *Govt Pays Millions in Reparations to 57 Victims of Worst Cop in History – Who Still Receives a Pension*, FREE THOUGHT PROJECT (Jan. 5, 2016), http://thefreethoughtproject.com/chicago-pays-5-million-57-victims-worse-cop-history-receives-

One recent technological solution to the problem of monitoring police is body-worn cameras (BWCs). More and more police departments are using them, but regulations *requiring* their use have been much more slowly adopted. Battery and storage technology has not reached the point where police can turn on their BWCs when they start their shift and leave them running the entire time (though this is possible for cameras mounted in police vehicles). And it is easy for officers to simply disable their cameras before committing an act of misconduct. Even if we get to a point where judges and juries refuse to believe a police officer's version of events if their BWCs are not recording,[80] BWCs don't solve the problem of misconduct that is done away from cameras or when an officer is off duty (e.g. accepting bribes).

Another simpler technology is using the GPS systems already installed in many police vehicles to ensure that officers stay within their patrol zones and that they're not parked in one place for too long, known as "cooping."[81]

---

pension/. Burge was found to have used false imprisonment and torture to force confessions (many of which were later recanted) from as many as 200 people, mostly African American males. This abuse took place over at least 44 years. His methods of torture included electrical shocks, genital torture, suffocation, bludgeoning, and isolation. "Beginning this school year, eighth- and tenth-grade students will examine Burge's crimes in U.S. History in regards to police brutality and the violation of constitutional rights." *Id.*

Burge was charged with police brutality but the trial resulted in a hung jury. He was later fired after a police department review board ruled he had used torture. He was then charged with obstructing justice and perjury in the earlier police brutality case and sent to prison for four years. *Cop Responsible for the Torture of Over 200 Citizens, Tied Bags Over Heads, Called N****ers and Electrocuted Penises*, FILMING COPS, http://filmingcops.com/cop-ties-bag-over-mans-head-calls-him-ngger-and-tases-his-genitals-gets-to-keep-pension/ (last updated Jan. 5, 2016); Ray Long, *After Burge kept pension, Illinois House votes to curb funds for crooks*, CHI. TRIBUNE (Nov. 19, 2014 7:10 PM), http://www.chicagotribune.com/news/local/politics/chi-burge-pension-bill-illinois-house-20141119-story.html; Steve Schmadeke, *State high court to weigh in on Jon Burge pension*, CHI. TRIBUNE (Jul. 2, 2014), http://articles.chicagotribune.com/2014-07-02/news/chi-state-high-court-expected-to-rule-on-jon-burge-pension-20140702_1_pension-board-david-kugler-burge-case; Wikipedia, *Jon Burge*, https://en.wikipedia.org/wiki/Jon_Burge. And yet Burge continues to collect a pension of $48,000 per year.

After Illinois' retirement board allowed Burge to keep his pension, state lawmakers found the result so "unconscionable" that they passed a law giving the state's attorney general the ability to overrule future retirement board decisions approving pension payments to convicted felons. *Governor Signs Law To Help Stop Public Pensions For Felons*, CBS CHI. (Dec. 30, 2014 8:10 AM), http://chicago.cbslocal.com/2014/12/30/governor-signs-law-to-help-stop-public-pensions-for-felons/.

But because the law is not retroactive, Burge keeps his pension. To date, Burge's actions have cost Chicago more than $100 million, including $100,000 in reparations to each of 57 of his victims. Emett, *supra*.

80 Catherine Crump & Matthew Segal, *Show Us the Videotape*, SLATE (Mar. 18, 2016 7:07 AM), http://www.slate.com/articles/technology/future_tense/2016/03/police_should_be_required_to_dashcam_everything.html.

81 Sandra Peddie & Adam Playford, *For Their Eyes Only: Police misconduct hidden from public by secrecy law, weak oversight*, NEWSDAY (Dec. 18, 2013), http://data.newsday.com/crime/police-misconduct/.

Surprisingly (or not), at least one police department is actually prohibited from using such systems to monitor its officers. In January 2007, Nassau County in New York approved an agreement with the Police Benevolent Association that prohibits the county from using these GPS systems to "initiate discipline" against officers.[82]

## B. *Punishing Police Misconduct*

Over 3,000 police departments voluntarily participate in the Law Enforcement Management and Administrative Statistics (LEMAS) survey, conducted every three to four years since 1987.[83] The 2013, 2007, and 2003 surveys ask about the number of use of force incidents or complaints.[84] Many Department of Justice consent decrees with police departments also require the departments to collect and report this information.[85]

Unfortunately, the definition of the term varies, making it impossible to do agency-to-agency comparisons. As a starting point, the April 2015 Los Angeles County settlement agreement with the Department of Justice defines a "reportable use of force" as "any use of force that is greater than that required for unresisted searching or handcuffing. Additionally, any use of force which results in injury or a complaint of pain must be reported."[86] But the Department of Justice has found that departments had ambiguous use of force reporting requirements or required officers to document only the most serious uses of force.[87] This problem is not new. A national survey of use-of-force reporting policies conducted in 1995 found:

---

82 *Id.*

83 BUREAU JUST. STAT., DATA COLLECTION: LAW ENFORCEMENT MANAGEMENT AND ADMINISTRATIVE STATISTICS (LEMAS), http://www.bjs.gov/index.cfm?ty=dcdetail&iid=248 (last visited Oct. 7, 2017).

84 BUREAU JUST. STAT., 2007 SURVEY OF STATE AND LOCAL LAW ENFORCEMENT AGENCIES 8, http://www.bjs.gov/content/pub/pdf/lemas07_cj44s.pdf.

85 Charles A. Gruber & Wayne W. Schmidt, *Mandatory Nationwide Use of Force Reporting by Police and Correctional Agencies—and Why This is an Important Issue*, 6 AELE MONTHLY L. J. 501, 506 (2015), http://www.aele.org/law/2015all06/2015-06MLJ501.pdf.

86 Settlement Agreement at 6, United States v. Los Angeles, No. CV 15-03174 (C.D. Cal. Apr. 28, 2015), https://www.justice.gov/sites/default/files/crt/legacy/2015/04/29/antelope_agreement_4-28-15.pdf.

87 Joanna C. Schwartz, *What Police Learn From Lawsuits*, 33 CARDOZO L. REV. 841, 869 n.155 (2012).

> Almost twenty percent of the departments did not require officers to submit a report after striking a civilian with a flashlight, approximately forty percent of the departments did not require an officer to submit a report after their police dog attacked a civilian, and over seventy percent of the departments did not require an officer to submit a report after using handcuffs.[88]

Ignoring all of the data issues with the LEMAS surveys, it is possible to compare the number of use of force complaints (or incidents) between states that have pension forfeiture laws for police officers and those that don't. In 2013, states with pension forfeiture laws in effect had an average of 41.81 use-of-force incidents per 100 officers, compared to 51.94 incidents per 100 officers in states without pension forfeiture laws.

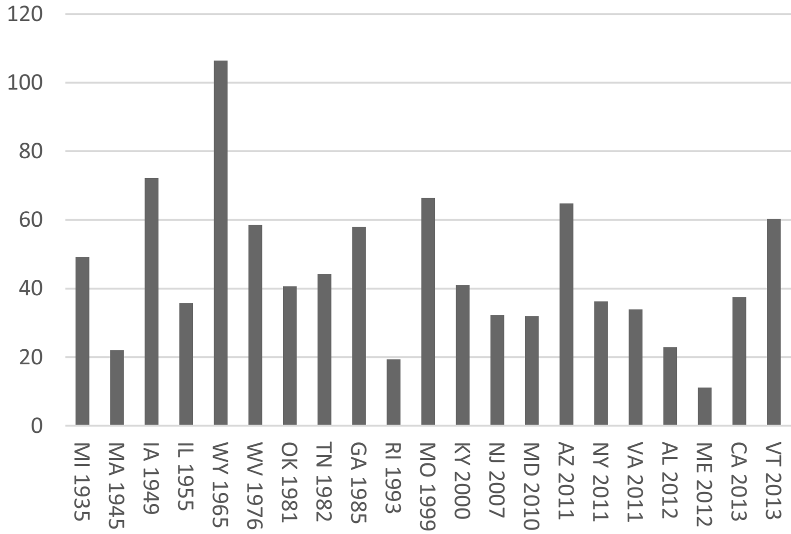



Figure 2: Use of Force Incidents in 2013 per 100 Sworn Officers for States with Pension Forfeiture Laws That Apply to Police Officers[89]

While the apparent positive effect of pension forfeiture laws is what economic theory predicts, it is difficult to determine statistical significance as there are likely many other factors at play that cannot be easily measured. If pension forfeiture laws were a major contributor to the difference, one would expect the ratio of use-of-force incidents to sworn officers to be

88 *Id.* at 868 (citing Anthony M. Pate & Lorie A. Fridell, *Toward the Uniform Reporting of Police Use of Force: Results of a National Survey*, 20 CRIM. JUST. REV. 123, 135-36 (1995)).

89 *See generally* BUREAU JUST. STAT., LAW ENFORCEMENT MANAGEMENT AND ADMINISTRATIVE STATISTICS (LEMAS) 2013, https://www.icpsr.umich.edu/icpsrweb/ICPSR/studies/36164.

lower for states that have had pension forfeiture laws for many years.[90] But there does not seem to be any relation between the two, as shown in the graph above. There are also large differences between states that had laws that took effect the same year.

Once police misconduct is identified, there are a range of options available for punishment: reprimand, loss of pay or vacation days, demotion, asking the officer to resign, dismissal, criminal charges, and pension forfeiture. In practice, punishment for police misconduct is both rarely imposed and minimal in severity.[91] According to the Bureau of Justice Statistics, of the over 26,000 excessive use of force complaints filed in 2002, only eight percent resulted in disciplinary action.[92] In New York between 2010 and 2015, even in cases in which the NYPD's office of the inspector general confirmed that officers had used unwarranted excessive force, officers were disciplined only 64.4% of the time.[93] A study of police arrests between 2005 and 2011 found that police officers are arrested at a rate of just 0.72 per 1,000 officers or 1.7 per 100,000 of the population.[94] By comparison, the overall arrest rate in the United States in 2012 was 3,888.2 arrests per 100,000 inhabitants.[95] And even when police are convicted, Cato's *National Police Misconduct Reporting Project* found that only 36% were incarcerated.[96]

A study of media reports from January 1, 2005 to December 31, 2007 found that only 1,746 sworn police officers were arrested (some more than once) and conviction rates varied between 77.5% and 89.1%, depending on

---

90 Because almost all pension forfeiture laws have only a prospective effect, the laws would not apply to any officers when first passed and would gradually apply to an increasing percentage of officers as new officers are hired and officers hired before passage retire.

91 Schwartz, *supra* note 87, at 844 ("[M]ost departments ignore lawsuits that do not inspire front-page newspaper stories, candlelight vigils, or angry meetings with the mayor. The city attorney will defend these suits, any settlement or judgment will be paid out of the city's coffer, and the department will not keep track of which officers were named, what claims were alleged, what evidence was amassed, what resolution was reached, or what amount was paid.").

92 Asa J., *How Much Do Taxpayers Pay for Police Misconduct?*, POLICE STATE DAILY (Apr. 28, 2016), http://policestatedaily.com/much-taxpayers-pay-police-misconduct/.

93 George Joseph, *Leaked police files contain guarantees disciplinary records will be kept secret*, GUARDIAN (Feb. 7, 2016), http://www.theguardian.com/us-news/2016/feb/07/leaked-police-files-contain-guarantees-disciplinary-records-will-be-kept-secret. *See also* ROBERT A. PERRY, N.Y. C.L. UNION, MISSION FAILURE: CIVILIAN REVIEW OF POLICING IN NEW YORK CITY (1994-2006), http://www.nyclu.org/files/ccrb_failing_report_090507.pdf.

94 Philip M. Stinson & John Liederbach, *Research Brief One-Sheet No. 7: Police Integrity Lost: Introducing a Study of Law Enforcement Officers Arrested*, CRIM. JUST. FAC. PUBLICATIONS (2016), https://works.bepress.com/philip_stinson/65/.

95 FED. BUREAU INVESTIGATION, CRIME IN THE UNITED STATES 2012 (2013), https://www.fbi.gov/about-us/cjis/ucr/crime-in-the-u.s/2012/crime-in-the-u.s.-2012/persons-arrested/persons-arrested.

96 Packman, *supra* note 76, at 25.

their number of years of service at the time of arrest.[97] Even at the higher conviction rate, that's an average of just 519 convictions per year across the United States. The reason is that juries are generally unwilling to convict police officers.[98]

A victim or their family can also sue an officer individually. From an economic standpoint, the optimal recovery amount is the amount they suffered in damages, excluding their enforcement costs, divided by the probability that their lawsuit will be successful.[99]

The first hurdle in suits against individual officers is defeating the officer's "qualified immunity," which "protects a law enforcement officer from liability, even if he has violated the plaintiff's constitutional rights, if he did not violate 'clearly established law'—a standard that, according to the Supreme Court, protects 'all but the plainly incompetent or those who knowingly violate the law.'"[100] "The Supreme Court's qualified immunity doctrine is designed to protect against overdeterrence because, the Court has assumed, the 'fear of being sued will dampen the ardor of all but the most resolute, or the most irresponsible [public officials] in the unflinching discharge of their duties.'"[101]

Even when officers don't qualify for immunity, they almost never actually pay any judgment imposed against them.

> Police officers are virtually always indemnified. Between 2006 and 2011, in forty-four of the country's largest jurisdictions, officers financially contributed to settlements and judgments in just .41% of the approximately 9225 civil rights damages actions resolved in plaintiffs' favor, and their contributions amounted to just .02% of the over $730 million spent by cities, counties, and states in these cases. Officers did not pay a dime of the over $3.9 million awarded in punitive damages. … Law enforcement officers … never satisfied a punitive damages award entered against them and almost never contributed anything to settlements or judgments— even when indemnification was prohibited by law or policy, and even when officers were disciplined, terminated, or prosecuted for their conduct.[102]

With the data available, it is impossible to determine the average damages and probability of punishment for any particular act of police misconduct. But if we follow the Becker and Stigler model[103] and assume *penalty*

---

97 Philip M. Stinson, John Liederbach & Tina L. Freiburger, *Exit Strategy: An Exploration of Late-Stage Police Crime*, 13 POLICE Q. 413, 420-21 (2010).

98 Mark Curriden, *When Good Cops Go Bad: The Justice Department has a new weapon to fight police brutality. The question is, how will the government use it?*, 82 A.B.A. J., no. 5, 1996, at 64 ("Police brutality cases are incredibly difficult to prove in court… Historically, most jurors have had a presumption in favor of the police officers. In most cases, jurors go into a case looking for reasons to convict. In police misconduct cases, they are searching for reasons to acquit.").

99 Becker & Stigler, *supra* note 65, at 14.

100 Joanna C. Schwartz, *Police Indemnification*, 89 *N.Y.U. L. REV.* 885, 887 (2014) (quoting Malley v. Briggs, 475 U.S. 335, 341 (1986); Harlow v. Fitzgerald, 457 U.S. 800, 818 (1982)).

101 *Id.* (quoting Harlow v. Fitzgerald, 457 U.S. 800, 818 (1982)).

102 *Id.* at 885, 890.

103 *See generally* Becker & Stigler, *supra* note 65.

= *costs of punishment* × *probability of punishment* and *costs of punishment* = *marginal victim settlement*, we can plug in the following variables:

1. Across 9,225 civil rights cases against police departments between 2006 and 2011 in which plaintiffs received payment, the total amount awarded in settlements and judgments was $735,270,772, an average of $79,704 per case.[104]

2. According to the Bureau of Justice Statistics, of the over 26,000 complaints about excessive use of force by police filed in 2002, only eight percent resulted in disciplinary action.[105]

3. The average net present value of an individual officer's pension in California and New York City is over $1 million.[106]

With an average award to victims of $79,704 and a probability of being punished of 8%, the expected penalty imposed on officers should equal $996,300, which appears to be well within the value of police pensions in at least two states. If the officer is not indemnified by the government, is unable to pay the full amount of the judgment from other assets, and has a pension, the plaintiffs can seek to garnish the officer's pension. But the Consumer Credit Protection Act limits pension garnishment to 25%.[107] With the average annual pension of roughly $60,000,[108] and assuming the entire judgment was to be paid from pension garnishment, it would take over 68 years to pay out.

This also assumes the officer has been on the force long enough to earn a pension large enough to satisfy the judgment. As Figure 3 below illustrates, the highest percentage of arrests of police officers occurred four years into their career.[109] Thus many officers convicted of misconduct may not have earned a large enough pension to cover the costs of the typical settlement. This may explain why victims so rarely seek recovery from officers directly and usually file lawsuits against police departments in-

104 Schwartz, *supra* note 100, at 912-13.

105 MATTHEW J. HICKMAN, BUREAU JUST. STAT., CITIZEN COMPLAINTS ABOUT POLICE USE OF FORCE (June 2006), http://www.bjs.gov/content/pub/pdf/ccpuf.pdf.

106 Rich Karlgaard, *The Millionaire Cop Next Door*, FORBES (Jun. 10, 2010 9:30 AM), http://www.forbes.com/forbes/2010/0628/opinions-rich-karlgaard-digital-rules-millionaire-cop-next-door.html ("$2 million also happens to be the implied booty of your average California policeman who retires at age 55."); Lawrence Mone, *Municipal 'millionaires,'* N.Y. POST (Dec. 1, 2011 5:00 AM), http://nypost.com/2011/12/01/municipal-millionaires/ ("[T]he vast majority of [New York] police and firefighters are millionaires, because the 'net present value' of their retirement benefits is well in excess of $1 million.").

107 15 U.S.C. § 1672(a). *See also* United States v. Otto, No. 3:10cr112, 2012 WL 2529406, at *7 (W.D.N.C. June 29, 2012).

108 Jen Chung, *Average Annual Pension For Cops: $58,563*, GOTHAMIST (Feb. 10, 2011 3:22 PM), http://gothamist.com/2011/02/10/average_annual_pension_for_cops_585.php.

109 Stinson, *supra* note 97, at 422-23.

stead. On the other hand, the graph is consistent with the notion that pension forfeiture has a material effect on the incidence of police misconduct.

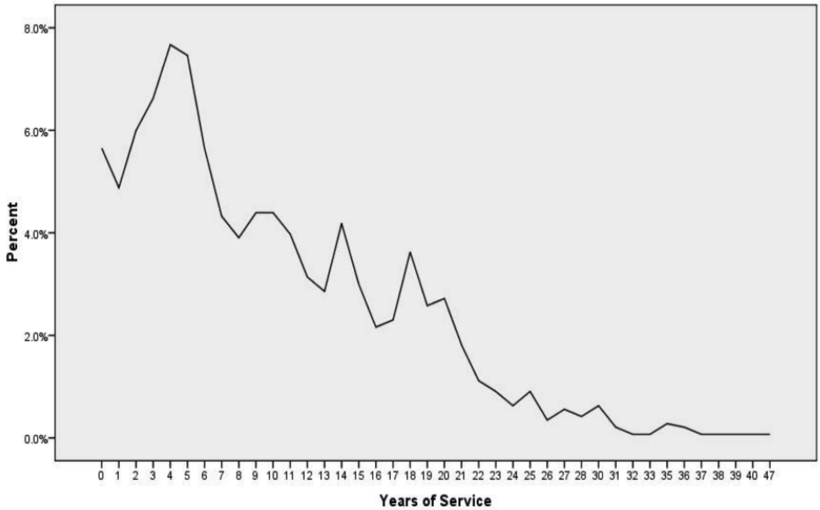



Figure 3: Arrests of police across the course of their careers (2005-2007)[110]

Most of the states with pension forfeiture laws require the public official to be found guilty, plead guilty, or plead nolo contendere to criminal charges before forfeiture can occur.[111] Because the likelihood of conviction is so low, pension forfeiture is currently an ineffective disincentive for police misconduct. Pension forfeiture also doesn't completely forfeit the Becker-Stigler bond because, as explained in the following section, the convicted officer may find work as a police officer in another department.

As Becker and Stigler note in their seminal paper, "[t]he prospect of losing the pension is an increasingly important deterrent to malfeasance as one gets closer and closer to retirement."[112] But for a newly-hired police officer with no accrued pension to lose, pension forfeiture is not a deterrent. Becker and Stigler suggest a solution: "charging an 'entrance fee' … equal to the temptation of malfeasance."[113] In the literature on incentive contracting, the bond is embedded in the time profile of foregone cash wages, which is somewhat front-end loaded to take advantage of tax deferral. What this means is that the prospect of pension loss is less onerous for new employees than for old, but the prospect of termination that imposes a capital loss is higher for new employees than for old.

---

110 *Id.*

111 *See* Appendix.

112 Becker & Stigler, *supra* note 65, at 8.

113 *Id.* at 9.

Most states require new police officers to first attend up to six months of specialized training at a police academy. Running counter to the Becker and Stigler model, almost all police departments pay trainees to attend the police academy, rather than the other way around. But there is another aspect of modern policing that serves a similar purpose: certification, or what is more commonly called occupational licensing.

> Today nearly one-quarter of all U.S. workers need a government license to do their jobs. The prevalence of occupational licensing has risen from less than 5 percent in the early 1950s with the majority of the growth coming from an increase in the number of professions that require a license rather than composition in the workforce.[114]

The same revolution has occurred for police licensing. "In 1960, New Mexico became the first state to grant authority to revoke the license of a peace officer for serious misconduct."[115] Today, forty-five states have police licensing laws.[116] And the National Decertification Index (NDI) serves as a national registry of these revocations, currently containing over 20,000 actions voluntarily submitted by 40 states.[117] When used, these two systems can ensure that a police officer found to have engaged in serious misconduct cannot simply travel to the next county or state and continue to work as a police officer.[118] Unfortunately, there is a persistent lack of compliance by police chiefs in reporting misconduct to state Peace Officers Standards and Training (POST) commissions.[119] And the Fraternal Order of Police is opposed to efforts to create an official National Decertification Index.[120]

If police officers believed that serious misconduct would result in them being unable to work as a police officer anywhere in the country, it could be a powerful disincentive to engage in serious misconduct. And if

---

114 WHITE HOUSE, FACT SHEET: NEW STEPS TO REDUCE UNNECESSARY OCCUPATION LICENSES THAT ARE LIMITING WORKER MOBILITY AND REDUCING WAGES (Jun. 17, 2016), https://www.whitehouse.gov/the-press-office/2016/06/17/fact-sheet-new-steps-reduce-unnecessary-occupation-licenses-are-limiting.

115 Roger Goldman, *A Model Decertification Law*, 32 ST. LOUIS U. PUB. L. REV. 147, 147 (2012).

116 Goldman, *supra* note 115, at 147; Roger Goldman, *Policing the Police – Licensing and Decertification for Police Officers* [podcast], NAT'L L. REV. (May 23, 2016), http://www.natlawreview.com/article/policing-police-licensing-and-decertification-police-officers-podcast.

117 International Association of Directors of Law Enforcement Standards and Training, *About the NDI*, https://www.iadlest.org/projects/ndi20.aspx (last accessed July 6, 2016).

118 Goldman, *supra* note 115, at 153 ("[W]here the officer has left the department, usually resigning under threat of termination, the chief may take the view, 'out of sight, out of mind.' That means the officer is likely to resurface at another agency, either inside or outside the state."); *see also* Goldman, *supra* note 116.

119 Goldman, *supra* note 115, at 153-54.

120 NATIONAL FRATERNAL ORDER OF POLICE, NATIONAL FRATERNAL ORDER OF POLICE ANALYSIS: INTERRIM REPORT OF THE PRESIDENT'S TASK FORCE ON 21ST CENTURY POLICING 15, https://fop.net/CmsDocument/Doc/TaskForceAnalysis.pdf.

police chiefs were sanctioned for failing to report serious misconduct to state POST commissions, it could increase reporting.

## CONCLUDING REMARKS

### A. *Will Pension Forfeiture Decrease Police Misconduct?*

A common generalization by those with judicial experience is that a change in the probability of punishment has a greater effect on the number of offenses than a change in the magnitude of punishment.[121] As explained above, the probability of a police officer being convicted of police misconduct is exceedingly rare. So increasing the penalty imposed on police officers convicted of misconduct by forfeiting their pensions is unlikely to decrease excessive use of force. This suggests that any hope of reducing this and other forms of police misconduct must rely on raising the probability that pension forfeiture is consistently and strictly imposed. The evidence presented above showing that states with police pension forfeiture laws experience lower rates of reported use of excessive force than states without forfeiture is suggestive, but any firm conclusions await extensive data gathering and conscientious econometric analysis.

### B. *Will Stricter Police Pension Forfeiture Help Solve the Public Pension Crisis?*

The recent bankruptcies of Detroit, Michigan, Stockton, California, Jefferson County, Alabama, and other state governmental entities highlight a looming public pension crisis throughout the U.S. The crisis appears largely the result of unrealistic actuarial and rate-of-return assumptions by defined benefit pension plan fiduciaries. Promises of unrealistic pension benefits and reduced employee contribution rates, as well as other questionable practices, appear also to blame.

It is unlikely that stricter police pension forfeiture rules will have any direct material effect on state or local government pension solvency. But it would be a mistake to completely dismiss the potential indirect effect by way of reducing police misconduct and the incidence of costly civil suits that are draining state and local government budgets. Stricter police pension forfeiture could help solve that problem.

If municipalities put financial responsibility for paying civil rights settlements on police departments, it may incentivize those departments to identify and deal with problem officers before they become a more serious

---

[121] Becker, *supra* note 61, at 176.

financial liability. Studies have shown that the majority of complaints are from a few "bad apple" police officers.[122] So even if only a few officers had to be terminated, the number of civil rights lawsuits could significantly decrease. And as discussed above, police departments and police commissioners could be further incentivized to deal with problem officers if they were sanctioned for not reporting serious instances of officer misconduct to state Peace Officers Standards and Training commissions.

A detailed study of the total nationwide state pension debt conducted in 2011 found a realistic assessment of the difference between assets and liabilities to be approximately $2 trillion.[123] Assuming each dismissed police officer forfeits a pension with a net present value of $1 million, two million police officers would need to lose their pensions to completely cover the pension deficit across all states. But according to a 2008 Bureau of Justice survey, there were only 765,000 sworn police officers in total.[124]

While police pension forfeiture will not completely solve the public pension crisis, Pennsylvania and Vermont's pension forfeiture laws provide a potentially powerful tool that can be applied to other types of public pension plans. They include language that neatly avoids the constitutional prohibition against *ex post facto* laws—laws that retroactively change the obligations of existing contracts.[125] Pennsylvania's statute reads as follows: "[e]ach time a public officer or public employee is elected, appointed, promoted, or otherwise changes a job classification, there is a termination and renewal of the contract for purposes of this act."[126] Vermont's statute reads: "[e]ach time a member is hired, reassigned, promoted, demoted, enters into a new collective bargaining contract, or otherwise changes his or her employment relationship or status, he or she shall be deemed to consent and agree to be subject to the provisions of this subchapter, including to this condition precedent."[127] Similar clauses could be enacted by other states (assuming they are not found in conflict with state constitutions).[128]

---

122 Rob Arthur, *How to Predict Bad Cops in Chicago*, SLATE (Dec. 15, 2015 4:28 PM), http://fivethirtyeight.com/features/how-to-predict-which-chicago-cops-will-commit-misconduct/. (An analysis of complaints filed with the Chicago Police Department between 2011 and 2015 found that "10 percent of the officers who had received complaints generated 30 percent of the total departmental complaints").

123 Novy-Marx & Rauh, *supra* note 5, at 1213.

124 The Bureau of Justice Statistics reported that there were about 765,000 sworn personnel (persons with the authority to arrest someone) in 2008. BRIAN A. REAVES, BUREAU JUST. STAT., CENSUS OF STATE AND LOCAL LAW ENFORCEMENT AGENCIES, 2008 1 (July 2011), http://www.bjs.gov/content/pub/pdf/csllea08.pdf.

125 U.S. CONST. art. 1, § 10 ("No State shall … pass any Bill of Attainder, ex post facto Law").

126 43 PA. CONS. STAT. § 1313(c) (1978).

127 VT. STAT. ANN. tit. 32, § 623(a) (2013).

128 *See supra* text accompanying note 53.

### C. *Are Defined Contribution Plans a Better Alternative?*

This article has shown that, pre-*ERISA*, private-sector DB plans provided powerful incentives for workers to self-select for high quality at the time of hire and to stay with the employer until retirement. Stay pensions gave both parties an incentive to make productive investments in one another, increasing the gains from trade and joint surplus. Employees benefited from a cash wage that included an *indenture premium*. *ERISA* appeared to have dramatically diluted these incentives leading, at least in part, to a steady decline in DB plans and a concurrent increase in the popularity of DC plans. No such transition has occurred in public sector plans, many of which remain entrenched in their legacy DB plans. With plan insolvency looming in many jurisdictions, however, it is time to pay serious attention to scrapping DB plans altogether and replacing them with DC plans. Such conversions have happened prolifically in the private sector,[129] and they could be accomplished in the public sector as well, either on a going forward basis or on negotiated basis with application to existing DB employees.

There are several arguments in favor of this approach. First, DB plans are far more costly for the employer to administer than DC plans. Second, they are far more susceptible to political whims in the form of unrealistic rate of return assumptions, liability discounting assumptions, labor union capture, and election politics. Although DB plans have the potential for providing valuable incentive alignment, there is little evidence the public sector has shown any inclination to take advantage of them. This is most striking in the context of police pensions and the law and practice of police pension forfeiture for misconduct. If the incentive alignment potential of DB plans is to be ignored in the public pension setting, the looming funding crisis might be averted by conversion to DC plans.

---

129 *See* Rich Berger, *From Defined Benefit to Defined Contribution: A Systematic Approach to Transitioning Retirement Plans*, SOC'Y HUM. RESOURCE MGMT. (Jan. 5, 2012), https://www.shrm.org/resourcesandtools/hr-topics/benefits/pages/transitioningplans.aspx.

# APPENDIX

| State | Effective Year | Applies to Use of Force | Requires Felony Conviction or Equivalent | Qualifying Crimes |
|---|---|---|---|---|
| Alabama | 2012 | Yes | Yes | Any felony related to public office |
| Alaska | 2007 | | Yes | Federal or state felony of bribery, receiving bribe, perjury, subordination of perjury, scheme to defraud, fraud, mail fraud, misuse of funds, corruption, or evasion committed in connection with person's official duties |
| Arizona | 2011 | Yes | Yes | Any felony related to public office |
| California | 2013 | Yes | Yes | Any felony related to public office |
| Connecticut | 2008 | | | Embezzlement, theft from government, bribery, fraud |
| Florida | 1984 | | | Theft, embezzlement, bribery, or corruption in connection with job; sex crimes against minors involving use of authority |
| Georgia | 1985 | Yes | | Public employment related crime in capacity of public employee, drug related crime |
| Illinois | 1955 | Yes | Yes | Any felony related to public office |
| Indiana | 1977 | | | Any "loss resulting from the member's criminal taking of the member's employer's property ... proven by an order for restitution in favor of the employer issued by the sentencing court following a felony or misdemeanor conviction." |
| Iowa | 1949 | Yes | Yes | Any felony |
| Kentucky | 2000 | Yes | Yes | Any felony related to public office |
| Louisiana | 2013 | | Yes | Any felony related to public office that attempted to realize a financial profit or involved a sexual act upon a minor |
| Maine | 2012 | Yes | Yes | Any felony related to public office |
| Massachusetts | 1945 | Yes | | Misappropriation of funds, bribery, extortion, or "a criminal offense involving violation of the laws applicable to his office or position" |
| Michigan | 1935 | Yes | Yes | Any felony related to public office |
| Missouri | 1999 | Yes | Yes | Any felony related to public office |
| Nevada | 2015 | | Yes | Bribes; embezzlement, extortion, or theft of public money; perjury; or conspiracy to commit one of these crimes |
| New Jersey | 2007 | Yes | | Coercion, theft by deception exceeding $10,000, extortion, theft of evidence exceeding $10,000 in value, bribery, money laundering, perjury, false contract payment claims, tampering with witnesses and public records, official misconduct |
| New York | 2011 | Yes | Yes | Any felony related to public office |
| North Carolina | 2012 | | Yes | Specified federal and state felonies involving corruption and perjury |
| Ohio | 2008 | | Yes | Felony third degree bribery, corruption, theft in office |
| Oklahoma | 1981 | Yes | Yes | Felony that violates his or her oath of office |
| Pennsylvania | 1978 | | | Theft, forgery, failure to make disposition of funds; tampering with records; misappropriation of property; bribery; perjury; false swearing; obstruction; tampering with evidence; witness intimidation; and equivalent federal offenses |
| Rhode Island | 1993 | Yes | | Any crime related to his or her public office or public employment |
| Tennessee | 1982 | Yes | Yes | Any felony related to public office |
| Utah | 2016 | Yes | Yes | Any felony related to public office |
| Vermont | 2013 | Yes | | Any crime related to public office |
| Virginia | 2011 | Yes | Yes | Any felony related to public office |
| Washington | 1937 | Yes | | Any felony, or becomes a "habitual drunkard, or shall fail to report himself or herself for examination for duty." NOTE: This law only applies to members of city pension plans, which haven't been used in decades. It applies to few, if any, officers today. |
| West Virginia | 1976 | Yes | Yes | Any felony related to public office |
| Wyoming | 1965 | Yes | Yes | Felony |

# PUBLIC PENSION FUND INVESTMENTS: THE ROLE OF GOVERNANCE STRUCTURES

*Odd J. Stalebrink*[1]

## INTRODUCTION

This paper reports findings from an ongoing research project that examines the role formal governance structures play in the success of state-administered pension fund investment programs. Toward this end, governance structures are defined narrowly as an arrangement of formal rules that have been adopted, by legislators and pension systems, for purposes of directing and controlling the management of public pension assets. Previous research has shown that these structures can play an important role in the performance of public pension fund investments.[2] As stated by Clark and Urwin, academic research suggests that "…the impact of good governance may be as much as 100-300 basis points per year."[3]

Despite this potential, research on the relationship between governance structures and performance is scant. To date, only a handful of research articles have been conducted that takes a systematic approach toward examining it in the context of public pension funds. The large majority of these have been centered on examining the effects of either individual rules[4] or a relatively limited set of rules on investment performance.[5] With the excep-

---

1 Odd J. Stalebrink is an associate professor of public administration at the School of Public Affairs at the Pennsylvania State University. He holds a Ph.D. in public policy from the Schar School of Policy and Government, George Mason University, Virginia, and masters and bachelor degrees in business administration from Jönköping International Business School (JIBS), Sweden.

2 Michael Useem & Olivia S. Mitchell, *Holders of the Purse Strings: Governance and Performance of Public Retirement Systems*, 81: 2 SOC. SCI. Q. 489, 489-506 (2000); Tongxuan Yang & Olivia S. Mitchell *Public Sector Pension Governance, Funding and Performance: A Longitudinal Appraisal*, *in* PENSION FUND GOVERNANCE A GLOBAL PERSPECTIVE ON FINANCIAL REGULATION 179-199 (John Evans, Michael Orszag & John Piggott, eds. 2008).

3 G. Clark, & R. Urwin, *Best- Practice pension fund governance*, 9 J. ASSET MGMT. 2, 4 (2008).

4 Nicholas A. Michas, *Pension Funds: More Diversification*, 10: 1 CAN. PUB. POL'Y 47 (1984); David Burgess & Joel Fried, *Canadian Retirement Savings Plans and the Foreign Property Rule*, 25 CAN. PUB. POL'Y 395 (1999); David Burgess & Joel Fried, *The Foreign Property Rule: A Cost-Benefit Analysis*, 4 J. PENSION ECON. & FIN. 273 (2005).

5 Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Olivia Mitchell & Ping L. Hsin, *Public Pension Governance and Performance* (Nat'l Bureau of Econ. Research, Working Paper 4632, 1994), http://www.nber.org/papers/w4632.pdf.; John R. Nofsinger, *Why Targeted Investing Does Not Make Sense!*, 27 FIN. MGMT. 87 (1998); Useem & Mitchell, *supra* note 2; Alicia Munnell & Annika Sunden, *Investment Practices of State and Local Pension Funds: Implications for Social Security Reform*, *In* PENSIONS IN THE PUBLIC SECTOR (Olivia S. Mitchell ed., 2001); Julia L. Coronado, Eric M. Engen &

tion of studies by Yang and Mitchell and Mitchell and Hsin considerations of the effect of rules that govern plan transparency and board member accountability (via requirements that board members carry liability insurance) have been ignored entirely.[6]

This study adds to the existing body of research in three important ways. First, it considers a broader set of rules, including rules governing oversight, transparency and the efficiency by which investment programs are carried out. Second, it centers on the long-term success of pension funds. Previous research centers on near-term investment performance. A focus on long-term performance is important because of the long-term investment horizon of pension fund investments. Finally, it uses updated data. As will be discussed in the paper, a paradigm shift has occurred during the past couple of decades in the design of governance structures. It is therefore important to re-examine the role of governance structures in this new context.

The study was carried out, using a binary logistic regression model to analyze the relationships between long-term investment performance and a set of formal rules that are hypothesized to influence the extent to which state pension funds meet long-term performance targets. The findings of the analysis indicate that pension systems are more likely to meet their performance targets if they are governed by a formal structure that (1) extends plan autonomy, (2) places emphasis on transparency, and (3) and limits inefficient investment practices. The results also indicate that pension plans that operate in states that are relatively corrupt are less likely to meet their investment goals. It might therefore be advisable for pension plans that operate in corrupt environments to limit autonomy and to adopt rules that increase oversight and public transparency.

## I. GOVERNANCE OF PUBLIC PENSION FUNDS

In this research, governance structures are defined narrowly as an arrangement of formal rules that have been adopted, by legislators and pension systems for purposes of directing and controlling the management of public pension assets. These rules fall into four general categories, including:

- *Investment rules:* Rules that govern how pension assets are invested, including rules that restrict and guide investment decision-making. Examples include lists of allowable investments (i.e. "legal lists"), prudent person statues, asset allocation limits and rules related to investments that are made for social or economic purposes (i.e., economically targeted investments (ETIs)).

---

Brian Knight, *Public Funds and Private Capital Markets: The Investment Practices and Performance of State and Local Pension Funds*, 56 NAT'L. TAX J. 579 (2003); Yang & Mitchell, *supra* note 2.

[6] Yang & Mitchell, *supra* note 2, at 196; Mitchell & Hsin, *supra* note 5, at 8.

- *Transparency rules:* Rules aimed at increasing transparency about public pension operations. They include but are not limited to conflict of interest disclosures, performance information and information about investment operations.

- *Oversight rules:* Rules that give an authority rights to review and monitor activities of a lower level authority.

- *Accountability rules:* Rules that assign responsibility for decisions to individuals or groups of individuals. An example is rules that hold board members personally liable for imprudent investment decisions.

Over the past three decades, the arrangement of these rules has undergone two fundamental changes. First, the scope of the rules has become more comprehensive. Prior to the 1980s, states and pension systems generally downplayed the importance of comprehensive governance structures. As noted by Miller et al, "…many governments operated under *de facto* policies, whereby a public official conducted investment operations in a vacuum while everyone else assumed that he or she would act responsibly."[7] This changed during the 1980s and 1990s, due to a number of developments that revealed a need for a more systematic approach to govern public pension funds. These developments included a growing significance of pension funds in fiscal matters, and a number of high profile investment debacles that revealed issues of underfunding and mismanagement of pension assets. As noted by Miller et al, "…only when things went awry did elected officials and the press begin to question the investment policies –or absence thereof."[8]

To address the need for a more systematic approach to public pension funds governance, elected officials and pension systems undertook a number of efforts. Important efforts have included the adoption of formal investment policies to direct investment decisions, and the enactment of state laws aimed at increasing oversight and transparency of investment activities. These efforts were often guided by professional organizations, such as the Governmental Finance Officers Association (GFOA) and the National Association of Retirement Administrators (NASRA), which placed priority on aiding state governments to adopt and implement formal investment policies. Survey data collected by the National Association of State Treasurers (NAST) indicate that the use of a comprehensive set of formal rules governing public pension fund investments had become ubiquitous across state-administered pension systems in the early 2000s. Specifically, the data indicates that 45 states had adopted state statues to govern its investment policies at that time, that 14 states regulated the policies via constitutional requirements, and that 36 states regulated them via administrative

---

7 Girard Miller, Corinne Larson & Paul Zorn, INVESTING PUBLIC FUNDS 35 (1998).

8 *Id.* at 35.

practice. Thirty-five states used some combination of constitution, statute and administrative practice.[9]

The second fundamental change is a shift in the goals of public pension investment programs. These programs have historically placed emphasis on preserving the principal (preservation of the principal) and as such sought to minimize risk. In some states this goal was a result of investment debacles that lead to a constitutional ban on stocks (e.g., South Carolina and Indiana). In other states it was simply adherence to a public value system that was inconsistent with speculation and risk. Typically, it led to investments in high-grade domestic fixed income securities, such as treasury issued securities.

Over the past three decades the emphasis on preserving the principal has shifted toward maximizing long-terms yield. Public pension fund scholars attribute this shift to several developments including growth in equity markets, the increased role of pension funds in fiscal affairs, and expanded investment opportunities. Additional developments that have contributed include expanded investment opportunities in financial markets, fiscal constraints (driven by expansion of benefits such as COLA additions), new knowledge about investing (e.g., modern portfolio theory), and a general acceptance of market solutions to improve the effectiveness and efficiency of government run operations (i.e., New Public Management).

In most US state pension systems, the shift toward yield maximization generated at least four important changes to the existing set of governance structures. First, decision-making authority was decentralized. This is partly exemplified by the enactment by state legislatures of a variety of laws that increased pension systems' autonomy over investment operations. For example, most states replaced legal list with prudent person statues to allow the funds to more easily adapt to changing market opportunities and conditions.[10] Autonomy is a core element of New Public Management (NPM). It proposes that autonomy will result in performance enhancements, as long as professionalism, expertise and proper economic incentives are present.

Second, the shift in emphasis toward yield maximization changed the demands for expertise and professionalism. The traditional goal of preserving the principal placed relatively limited demands on expertise and professionalism. In essence, investment strategies were aimed at minimizing risk and assuring sufficient liquidity to meet current obligations. The governance and implementation of such strategies were typically confined to immunization strategies, where maturities of fixed income securities issued by the US Treasury were matched with pension obligations. The successful

---

9 NATIONAL ASSOCIATION OF STATE TREASURERS (NAST), STATE TREASURY ACTIVITIES & FUNCTIONS 2000-2001, 42 (2001).

10 *See* Stephen Johnson, *Trustee investment: the Prudent Person Rule or modem portfolio theory, you make the choice*, 44 SYRACUSE L. REV. 1175 (1993); Paul Haskell, *The Prudent Person Rule for trustee investment and modern portfolio theory*, 69 N.C.L. REV. 87 (1990).

pursuit of yield maximization places higher demands on expertise and professionalism. It requires investment professionals to make complex choices and judgments across a large number of available opportunities in dynamic environments. Given these demands, many states and pension systems have added or strengthened eligibility requirements for serving as a member on public pension boards or as an investment official.

Third, the shift in emphasis toward yield maximization changed the demands for oversight. To offset the reduced control over public pension operations that resulted from decentralization of authority, legislators enacted laws to increase their ability to oversee the investment activities of public pension systems.

Finally, the shift changed the requirements for transparency and accountability. Given the focus on yield maximization and the use of more decentralized authority structures, increased emphasis has been placed on holding pension systems and investment officials accountable based on performance, rather than compliance.

The extent of these changes reflects a paradigm shift in public investing. Table 1, summarizes this paradigm shift by contrasting the main characteristics of governance structures associated with yield maximization and preservation of the principal.

**Table 1:** *Governance Structures*

| *Rules* | *Structure 1- Yield Maximization* | *Structure 2 – Preservation of Principal* |
|---|---|---|
| Distribution of control | Decentralized | Centralized |
| Expertise and professionalism | High demands | Limited demands |
| Oversight | High demands | Limited demands |
| Transparency and Accountability | Performance orientation | Compliance orientation |

## A. *Previous Research & Research Objective*

While the paradigm shift that has occurred in the governance and management of public pension assets has been ubiquitous across public pension systems, it has by no means lead to uniform governance structures. Some systems have proceeded relatively slowly while other systems have changed quickly. For example, most state legislatures passed legislation to allow for equity investments during the 1980s. However, West Virginia, Indiana and South Carolina did not remove their bans on investments in equities until the end of the 1990s. Furthermore, public pension funds vary in terms of the depth and relative emphasis they place on the various categories of rules that make up governance structures.

The objective of this research is to examine whether differences in governance structures can help to explain the success by which pension plans meet their long-term performance goals. As indicated in the introduction, the existing body of research is relatively narrow in scope, with the majority of studies centering on examining a relatively narrow set of formal rules. Some studies have been limited to examining the relationship between a single rule and investment performance, while other studies have focused on examining the relationship between investment performance and multiple rules. The former set of studies have largely centered on examining whether select diversification restrictions interfere with the creation optimal or efficient investment portfolios. [11] They have illustrated that overly restrictive quantitative restrictions imposed on the proportion of foreign investments that pension funds are allowed to hold can have an adverse effect on investment performance.

The other set of studies have primarily centered on rules governing socially and economically targeted investments, investment restrictions, independent performance evaluations and board composition.[12] Within this category of studies, two studies have tested models that consider all of these variables. One of the studies, conducted by Useem and Mitchell, is based on longitudinal data from 1993, collected by the Public Pension Coordinating Council (PPCC) and commonly referred to as the PENDAT data. The PENDAT data includes detailed survey data related to plan and governance characteristics for 291 state and local pension plans.[13] The study centers on examining how board size and composition, investment restrictions, performance evaluations, and investment decisions affect investment strategies and performance. The research shows that governance structures affect investment performance indirectly through the effect they have on investment strategies. Specifically, the researchers show that four types of governance structures affect investment strategies including investment restrictions, independent performance evaluations and board size and composition. They also show that investment strategies that center on equity and international investing and tactical investing can influence near term financial performance.

The other study, conducted by Yang and Mitchell[14] is based on an updated data set (using data from 1990-2000). Similar to the study by Useem and Mitchell, the research is based on the PENDAT data. In their study, Yang and Mitchell finds that board composition, investment practices and transparency can have an important impact on investment performance.

---

11 Michas, *supra* note 4, at 51; Burgess & Fried, *supra* note 4, at 395; Burgess & Fried, *supra* note 4, at 286.

12 Useem & Mitchell, *supra* note 2, at 490; Nofsinger, *supra* note 5, at 91; Munnell & Sunden, *supra* note 5, at 162; Yang & Mitchell, *supra* note 2, at 196.

13 Useem & Mitchell, *supra* note 2, at 492.

14 Yang & Mitchell, *supra* note 5, at 199.

Specifically, they found that pension plans run by a large proportion of trustees that are retirees tend to be less prone to risk-taking, because they do not bear the wealth consequences of their decisions.

This research expands on this previous research in three important ways. First, it examines a broader set of rules than previously has been considered, including rules that seek to reduce information asymmetry between principal and agents (i.e., monitoring efforts) and rules that seek to directly regulate the behavior of agents to act in the best interest of principals. Specifically, it considers rules governing oversight, transparency and the efficiency by which investment programs are carried out.

Second, it centers on the long-term success of pension funds. The studies by Useem and Mitchell and Yang and Mitchell center on near term performance. A focus on the effects that governance structures have on the long-term performance is important because of the long-term investment horizon of pension fund investments.

Finally, it uses updated data. Useem and Mitchell's study was based on data drawn from 1993 and the study by Yang and Mitchell is based on data from 2000. As discussed earlier, a paradigm shift has occurred over the past three decades in the management of public pension funds. This paradigm shift is characterized by a fundamental shift in the goals and strategies of public pension funds management as well as by the comprehensiveness of the structures that govern public pension funds. It is therefore important to re-examine the role of governance structures plays in public pension investing in its new context.

The focus on formal rules was selected because the majority of rules that affect investment decisions are established at the State and system level. The findings of this research can therefore be used to recommend actions that are under the control of elected officials and members of fiduciary bodies. Informal rules, such as norms and practices, are often more difficult to change and control.

### B. *Theoretical Perspective*

The theoretical foundation for this paper is principal agent theory. Grounded in economics and institutional theory, principal agent theory centers on diagnosing the causes and consequences of problems (agency problems) that arise whenever a person or a group of people delegates and entrusts another person or group of people (i.e., the agents) to act on their behalf (i.e., an agency relationship) (Jensen and Meckling 1976, Eisenhardt 1989). According to principal agent theory, this delegation gives rise to conflicts of interest and moral hazard. Conflicts of interest and moral hazard are problematic because they cause self-interested agents to make decisions that are not necessarily aligned with principals' best interests. This divergence results in a reduction in the welfare of principals, which is referred to as "residual losses."[15]

In the context of state administered pension funds, delegation of authority occurs primarily across three authority levels, including the state, system and operational level. At the state level, elected officials delegate decision-making authority to the pension system on behalf beneficiaries and constituents, via legislation. The resulting laws outline the basic parameters within which a pension system operates. At the system level, the fiduciary body (e.g., a pension board of trustees) delegates decision-making authority to the investment function. The fiduciary body typically consists of some combination of members that are political appointees (appointed by a governor or by legislators), elected by plan beneficiaries and members that serve in an ex-officio capacity. It is primarily charged with developing investment rules and overseeing the implementation of investment strategies.

Using principal agent theory framework, the relative success of the rules that make up formal governance structures can be assessed based on the contributions they make toward reducing residual losses. Conceptually, governance structures contribute toward the reduction of residual losses in three principal ways. First, by making stakeholders and legislative and oversight bodies knowledgeable about decisions that fail to serve the interests of the principals. In theory, such knowledge affects residual losses by deterring agents from engaging in imprudent activities. This deterring effect is a result of the increased risk of detection that agents face as principals gets more aware the consequences of agents' decisions. Two of the aforementioned types of governance structures contribute toward increasing this awareness, including oversight and transparency rules. Oversight rules contribute toward increased awareness by giving oversight bodies rights to review and monitor activities of a lower level authority. In the context of public pension funds, this oversight is conducted at two primary levels. Most important, it is conducted by the fiduciary body, which is charged with overseeing investment activities on behalf of the beneficiaries of the pension system. In addition, elected officials at the state level have a responsibility to oversee the affairs of pension systems on behalf of constituents.

Transparency rules contribute toward increased awareness by making information about pension operations available to the public, including information about conflicts of interest, performance information and information about investment operations.

The second way that governance structures contribute toward the reduction of residual losses is by preventing agents from making decisions that are not in the stakeholders' best interests. This is primarily achieved

---

[15] Michael C. Jensen & William H. Meckling, *Theory of the firm: Managerial behavior, agency costs and ownership structure*, 3 J. FIN. ECON. 305, 308 (1976).

via rules that impose restrictions on the type of investment activities that pension systems are allowed to pursue, such as legal lists.

The third way that governance structures contribute toward the reduction of residual losses is by guiding agents toward decisions that are aligned with the stakeholders' interests. This is primarily achieved via rules that clarify expectations about expected risk levels and investment strategies. A good example is the adoption of allocation targets for different classes of assets, such as stocks, bonds and alternatives.

## II. HYPOTHESES

Seven different hypotheses are developed and tested in this paper. These hypotheses are categorized into three categories, including transparency hypotheses (TH), oversight hypotheses (OH) and operational efficiency hypotheses (OEH). The former two categories are based on the above theoretical framework. They are included to examine how rules that influence transparency and oversight affect the success by which pension plans meet performance targets. As noted in the theoretical portion of the paper, these rules affects agency costs by disciplining agents to act in a manner that is aligned with the interests of the principals.

The third category (OEH) was added to capture the potential effects of rules that are aimed at improving the efficiency by which investment operations are carried out. Empirical evidence suggests that active investment activities often carry limited benefits when carried out in markets that are relatively efficient,[16] but that they can have merit in less efficient markets. As a result, pension systems sometimes adopt policies that restrict active investment activities to less efficient markets. For example, the Nebraska Investment Council makes this explicit as part of its investment philosophy, by recognizing that "[i]nvestment strategies will reflect a mix of active and passive investments, with passive investments being emphasized in the more efficient markets."[17]

Another related area of inefficiency could arise from investments in alternative assets. Efforts to acquire alternative investments are often challenging and costly due to high management costs and risks. Investments opportunities in some of these assets are plagued by substantial information asymmetries and high management costs. In addition, due to the rapid ex-

---

16 *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, J. L. ECON. 301 (1983); Eugene F. Fama, *Efficient Capital Markets: A Review of the Theory and Empirical Work*, 25 J. FIN. 383 (1970); Eugene F. Fama. *Efficient Capital Markets: II*, 6 J. FIN. 1575 (1991); Eugene F. Fama & Kenneth French, *Permanent and temporary components of stock prices*, 96 J. POL. ECON. 246 (1988); Roy D. Henriksson, *Market timing and mutual fund performance*, 57 J. BUS. 73 (1984).

17 NEBRASKA INVESTMENT COUNCIL, ANNUAL REPORT: CALENDAR YEAR 2015, at 85, https://nic.nebraska.gov/sites/nic.nebraska.gov/files/doc/Annual%20Report%202015_0.pdf.

pansion of private equity investments there has been an undersupply of quality agents. A large portion of these high-risk investments often performs poorly. As shown in the study by Stalebrink some pension funds have sought to overcome these challenges by building relationships over time.[18] Such relationship building holds promise for bridging the information asymmetry gap and to build networks aimed at gaining access to successful private equity funds. As such, it might be productive to explore regulatory approaches that reduce information asymmetries associated with private equity investments and approaches that facilitates network building.

### A. *Transparency Hypothesis 1 (TH1): Rules Governing Conflicts of Interest*

Rules governing conflicts of interests are intended to ensure that board members and individuals involved in the management of pension funds do not own assets or have interests that influence the decisions they make on behalf of the pension fund. They include asset disclosure forms for current members, restrictions to reduce the movement of high-level employees across the public and private sectors, and restrictions on gifts received by pension fund officials. Conflicts of interest are problematic because they result in self-interested agents acting in a manner that is inconsistent with the interests of the principals. In this research, it is hypothesized that pension systems that operate in an environment that is governed by rules that forbid and make conflicts of interest transparent reduces instances of conflicts of interest. If this holds true, then the presence of such rules would reduce agency costs and enhance the likelihood that pension funds meet their performance targets.

### B. *Transparency Hypothesis 2 (TH2) - Rules Governing Disclosure of Placement Agents*

Rules governing disclosures relating to placement agents are intended to increase transparency about fees and terms relating to services provided by placement agents. A placement agents is a well connected person, acting as a middle man, who helps entities that are offering investment services to connect with senior officials in pension funds (making introductions and setting up meetings). The background behind these rules is that placement fees, in many cases, have been considered to be too high in relation to the benefits they generate, thus, adversely affecting the performance of the funds. Examples of placement agent fees that have been considered

[18] *See* O.J. Stalebrink, *Public Pension Funds and Alternative Investments: A Tale of Four Swedish National Pension Funds*, 39 INT'L. J. PUB. ADMIN. 107 (2016).

excessive or problematic include Kentucky Employees Retirement Systems (14 million in fees between 2004 and 2009) and CalPERS (48 million in fees to a former board member).[19]

In this research, it is argued that these rules increase the risk that excessive fees are detected, disciplining agents to be more cautious in acquiring placement agents at excessive fees. As such, it is hypothesized that pension systems that operate in an environment that is governed by rules that require disclosures relating to placement agents are more likely to meet their performance targets, compared to systems that operate in the absence of such rules.

### C. *Transparency Hypothesis 3 (TH3) - Rules Governing Transparency about Investment Operations*

Rules governing the transparency of investment operations are intended to give citizens insight into the operations of public pension fund investments, including information about officials serving on the pension funds, and detailed information about investment activities and performance. To be effective, the information needs to be relevant and accessible in a timely manner. Given this, it is hypothesized that pension systems that operate in an environment that is governed by rules that requires disclosures about investment activities and investment personnel in a timely manner are more likely to meet their performance targets, compared to systems that operate in the absence of such rules.

### D. *Oversight Hypothesis 1 (OH1): Board Composition*

Previous research suggests that the ability of a fiduciary body to properly oversee public pension assets can be compromised by political pressure. This pressure can enter into the decision-making process through politically appointed board members.[20] While board members hold the principal responsibility for overseeing the management of pension investments, their proximity to the political process might lead them to pursue decisions that are not consistent with a yield maximization goal.

A possible result of political pressure is decisions to use public pension funds for purposes of supporting social and economic goals, including

---

[19] Matt Taibbi, *Looting the Pension Funds*, ROLLING STONE (Sept. 26, 2013) http://www.rollingstone.com/politics/news/looting-the-pension-funds-20130926.

[20] Kevin J. Murphy & Karen Van Nuys, *Governance, Behavior, and Performance of State and Corporate Pension Funds* (Harvard Univ. Working Paper, 1994); G.F. Davis & M. Useem, *Top Management, Company Directors, and Corporate Control in* HANDBOOK OF STRATEGY AND MANAGEMENT (Andrew Pettigrew, Howard Thomas & Richard Whittington eds., 2000); Coronado, *supra* note 5.

using pension assets to support economic development within the state (i.e., economically targeted investments) and banning investments in certain countries or industries (i.e., divestures). With the exception of a study by Munnell and Sunden[21], research on the effects of ETIs indicates that these investments lead to a sacrifice of investment returns on plan assets.[22]

Previous research has also shown that the proportion of politically appointed board members can influence the discount rate that pension systems use to discount their pension obligations.[23] Due to the large impact the rate has on the funding ratio and the funding of pension system, it is often tempting for fiduciary bodies to override an actuary's recommendation or selecting a "team player" that is likely to recommend a higher rate.[24]

The selection of an artificially high discount rate has two implications for the ability of pension plans to meet their long-term investment goals. The first arises from the fact that GAAP for state and local governments prescribes that the adopted discount rate should be based on the estimated long-term investment yield for the plan. Artificially high discount rates will therefore reduce the prospect of meeting performance targets. In addition, the adoption of a higher discount rate might result in irresponsible investment strategies, designed to meet the need for additional investment returns. Developing strategies to meet additional returns have been particularly challenging for systems that are required to hold a large portion of their assets in fixed income securities. The low yield on these securities have made it necessary for these systems to allocate a relatively large portion of their assets into riskier investment types, such as private equity. Some states, such as the case of South Carolina currently hold close to half of their assets in alternatives assets.

Given that the composition of boards of trustees can affect portfolio allocations and the actuarial discount rate, it is hypothesized that the proportion of politically appointed board members is negatively related to a systems success of meeting long-term performance targets.

### E. *Oversight Hypothesis 2 (OH2): Rules Governing Expertise*

The ability of a fiduciary board to properly conduct its oversight duties (and to develop proper investment strategies) is influenced by the level of

---

21 Munnell & Sunden, *supra* note 5, at 160.

22 Nofsinger, *supra* note 5, at 93; *See* Mitchell & Hsin, *supra* note 5, at 31; Coronado, *supra* note 5, at 592; Romano, *supra* note 5, at 826.

23 O.J. Stalebrink, *Public Pension Funds and Assumed Rates of Return: An Empirical Examination of Public Sector Defined Benefit Pension Plans*, 44 AMER. REV. PUB. ADMIN. 91 (2014).

24 D. Hess & G. Impavido, *Governance of public pension funds: Lessons from corporate governance and international evidence*, *in* PUBLIC PENSION FUND MANAGEMENT (A. Musalem & R. J. Palacios eds., May 2003), The World Bank Conference on Proceedings of the Second Public Pension Fund Management.

expertise that its members hold. In practice, this has meant that states have adopted rules that govern the level of expertise and professional backgrounds of board members. They are typically required to meet certain minimum eligibility requirements, related to educational background and experience working in the investment industry. As such, it is hypothesized that rules governing levels of expertise affects a plan's ability to meet its performance targets positively.

### F. *Operational Efficiency Hypothesis 1 (OH1): Rules Governing Efficiency of Investment Process*

As noted above, it might be productive to explore regulatory approaches that reduce information asymmetries associated with private equity investments and approaches that facilitates network building. A common issue for public pension funds have been the limited benefits they have gained through active portfolio management practices. Another area of inefficiency has been identified in alternative investing, as it relates to investments in private equity funds. Investments in private equity are valuable to pension funds as a result of the diversification benefits they offer.[25] However, they are also endowed with significant levels of risk and information asymmetry. To address these problems, it is deemed prudent for pension funds to increase their holdings slowly and over time and to limit their overall allocations.[26] Pension funds that adopt rules that limit the pace by which pension funds diversify into private equity and that sets limit on the overall level of allocations are therefore expected to have a higher tendency to meet their performance goals. Considering this, it is hypothesized that pension funds that proceed slowly and takes a cautious approach to investments in private equity are more likely to meet their performance targets, compared to funds that expand rapidly and aggressively into these investments.

### G. *Operational Efficiency Hypothesis 2 (EH2): Rules Governing Autonomy*

As noted earlier, the use of autonomy to achieve improved performance is a core element of NPM. It proposes that autonomy will result in performance enhancements, as long as professionalism, expertise and proper economic incentives are present (i.e., incentives that align the interests of principals and agents). Using this logic, it is hypothesized that rules governing levels of autonomy affect the financial performance of public pen-

---

25 *Id.* at 2.

26 *Id.* at 12.

sion funds, as long as professionalism, expertise and proper incentives are in place.

It should be noted that the incentive structure associated with public pension fund investment decisions is complicated by a lack of property rights to guide decision-making and a public value system that is often inconsistent with compensation tied to performance. In the absence of proper economic incentives, alternative drivers come into play. Niskanen, for example, argues that incentives in the public sector are tied to the political process and take the shape of "budget maximization."[27] A contrasting perspective is that public service is a calling, and that fiduciaries therefore can be relied on to act in the best interest of the public (i.e., to operate as benevolent public utility maximizers).

A summary of the six hypotheses is provided in Table 2.

**Table 2: Summary of hypotheses**

| *Hypothesis* | *Variable* | *Expected relationship* |
|---|---|---|
| TH1 | Conflicts of interest disclosures | + |
| TH2 | Placement agents disclosures | + |
| TH3 | Investment operation disclosures | + |
| OH1 | Board composition (political appointees) | - |
| OH2 | Expertise | + |
| OEH1 | Efficiency of investment process (private equity) | + |
| OEH2 | Autonomy | + |

H. *Methodology*

The quantitative study was carried out using a logistic regression model. The logistic regression model is appropriate when the dependent variable is dichotomous.

I. *Data*

The availability of recent data on governance characteristics of public pension funds is scarce. The PENDAT data used by the previously mentioned study by Yang and Mitchell was discontinued and replaced by a new

---

27 William A. Niskanen, *Nonmarket Decision Making: The Peculiar Economics of Bureaucracy*, 58 AMER. ECON. REV. 293, 294 (1968).

survey in 2000, known as the Public Funds Survey. Compared to its predecessor, it is more limited in terms of providing information on key governance characteristics. Given existing data constraints, data was collected from a combination of sources. First, data was collected from a combination of Comprehensive Annual Financial Reports (CAFRs) and from the Public Plans data that is developed and maintained through a collaboration of the Center for Retirement Research at Boston College, the Center for State and Local Government Excellence, and the National Association of State Retirement Administrators (Center for Retirement Research 2015). The public plans data provides plan level data for 78 state administered pension plans, covering the time period 2001-2013. These data sources were used for purposes of collecting data related to board composition and the performance of public pension funds.

Second, data was drawn from the 2015 State Integrity Investigation that is conducted by the Center for Public Integrity.[28] Based on interviews and survey data collected from relevant public officials, it assesses the rigor of efforts that state governments undertake for purposes of combatting corruption, including a variety of rules aimed at increasing transparency and reducing conflicts of interest. Moreover, the investigation provides assessments that are specific to the governance and management of public pension funds, including assessments of the extent to which individual states and pension systems require asset disclosure forms for current members, impose restrictions for purposes of preventing "revolving door" practices, and restrictions on gifts received by pension fund officials. The assessments are presented using numerical scores ranging from 0 to 100 on each of these items, with a higher score indicating the presence of more rigorous rules. A few items were rated as "moderate" or "no." In these cases, a rating of 75 was assigned for moderate and a rating of 0 was assigned no.

A potential issue with the data drawn from the center for public integrity is that it is more recent than the public plans data. However, given that formal rules change relatively slowly. As such, it was deemed to be an acceptable data source.

Finally, data was drawn from the most recent survey data collected by the National Association of State Treasurers (NAST). This survey was conducted in 2005 and provides a variety of data that can serve as proxy for autonomy. This data was tested for reliability, by comparing the data with information published in recently published CAFRs. The data was accurate in 92% of the cases sampled.

28 Yue Qui, C. Zubak-Skees et al., *How does your state rank for integrity*, CTR. PUB. INTEGRITY (Nov. 2015), https://www.publicintegrity.org/2015/11/09/18822/how-does-your-state-rank-integrity.

## J. *Dependent Variable*

The dependent variable in this research is a dichotomous variable that captures whether the pension fund, over time, has been able to successfully meet its adopted target returns. This dummy variable is calculated as the difference between the average return earned by pension funds from 2004-2013 and the average annually adopted target return for the same time period. Plans that successfully met or exceeded their performance targets over the given time period were coded with a 1, and plans that failed to meet their performance targets were coded as 0. The variable is referred to as "Performance."

The benefit of measuring performance in relation to investment targets is that it controls for differences in portfolio risk across pension funds. The dependent variable centers on deviations from the target return. It is assumed that portfolio risk is reflected in the target returns where plans that have riskier investment allocations apply higher target returns than funds that have less risky allocations. In addition, the focus on the long-term performance is consistent with the investment goals of pension funds, given their long-term investment horizon. The long-term focus removes the influence of short-term variations. The data for this variable was collected from the public plans data.

## K. *Independent Variables*

The analysis includes nine independent variables that are used to test the above hypotheses.

### 1. Rules Governing Conflict of Interest Disclosure (TH1) (+)

The first variable is used to capture the effect of rules that govern the rigor of conflicts of interest disclosures. As indicated above, these rules are intended to ensure that board members and individuals involved in the management of pension funds do not own assets or interests that influences the decisions they are making on behalf of the pension fund. Data for this variable was collected from The Center for Public Integrity (2015). It provides a numerical assessment of the extent to which individual states and pension systems (1) require current members to file asset disclosure forms, (2) impose restrictions for purposes of preventing movement of high level officials across the public and private sectors, and (3) impose restrictions on gifts received by pension fund officials. A scale ranging from 0 to 100 was used, based on six questions (questions 6 to 11 of the questionnaire) in the questionnaire that relate to conflicts of interests. The variable was calculated based on the combined score for the six questions, equally weighted. As indicated by the above hypothesis, it is expected that the presence of more rigid rules have a positive impact on pension funds' ability to meet performance goals. The variable is referred to as "ConflictofInterst."

2. Rules Governing Placement Agent Disclosures (TH2)(+)

The second variable was added to capture the effects of rules that combat issues relating to placement agents. Data for this variable was collected from the Center for Public Integrity. It provides a numerical assessment of whether placement agents are required to disclose fees and terms for providing services. A scale ranging from 0 to 100 was used. The score was based on three questions (the initial three questions of the questionnaire) that related to disclosures of fees and terms associated with services provided by placement agents. The variable was based on the combined score for the three questions, equally weighted. As indicated by the above hypothesis, it is expected that the presence of more rigid rules have a positive impact on pension funds' ability to meet performance goals. The variable is referred to as "PlacementAgents."

3. Investment Operation Disclosures (TH3) (+)

The third variable was added to capture the effect of rules that govern citizens' access to information about public officials in a timely manner, including disclosure forms related to officials serving on the pension funds, and detailed information about investment activities. Data for this variable was collected from the Center for Public Integrity. It provides a numerical assessment of whether pension funds are required to provide detailed information about their investment activities and whether the public have access to asset disclosures of decision-makers within a reasonable time and at no cost (questions 12 to 15 in the questionnaire). Again, a scale ranging from 0 to 100 was used and the variable was based on the combined score for the two relevant questions, equally weighted. As indicated by the above hypothesis, it is expected that the presence of more rigid rules have a positive impact on pension funds' ability to meet performance goals. The variable is referred to as "Investmentdisclosures."

4. Political interference (OH1) (+, -)

Two different variables were added to capture the effect of rules aimed at limiting political interference. The first measure was collected from the Center for Public Integrity. It provides a numerical assessment of the rigor of rules aimed at reducing political interference. Specifically, the questionnaire includes an assessment of the extent to which pension decision-makers are protected from political interference (question 5 in the questionnaire), using a scale ranging from 0 to 100. As indicated by the above hypothesis, it is expected that the presence of more rigid rules have a positive impact on pension funds' ability to meet performance goals. This variable is referred to as "Politicinterferrules."

The second measure was defined as the proportion of politically appointed board members. It was included to capture the effects of rules that govern board composition. It was calculated as the proportion of politically appointed board members in relation to the size of the board. The data was collected from CAFRs and public information about the boards that were available on pension system's individual websites. It is expected that the proportion of politically appointed board members have an adverse effect on pension funds' ability to meet performance goals. The variable is referred to as "PoliticalapptBRD."

5. Expertise (OH2) (+)

As discussed above, the ability of fiduciary bodies to fulfill their oversight duties (and other duties) is dependent on the level of investment expertise and experience they have. A variable was therefore added to capture the presence of rules that regulate the level of expertise that board members hold. Data for this variable was collected from the Center for Public Integrity. It provides a numerical assessment of whether pension investment decisions are made by independent experts, using a scale ranging from 0 to 100. As indicated by the above hypothesis, it is expected that the presence of more rigid rules governing expertise have a positive impact on pension boards' ability to fulfill their oversight duties. As such, it is expected to have positive impact on funds' ability to meet performance goals. This variable is referred to as "Expertise."

6. Autonomy (OEH2)(+/-)

The sixth variable was added to capture the effects of the relative autonomy that pension plans enjoy. The data was drawn from data provided by the National Association of State Treasurers (NAST)[29], CAFRs and public information about the boards that were available on pension systems' individual websites. Using the resulting data, an index was developed with a ranking from 1 to 3 (3 suggesting the lowest level of autonomy), based on the level of constraints that were imposed on portfolio allocation decisions. Plans were rank-ordered into three groups, based on whether investment

29 NATIONAL ASSOCIATION OF STATE TREASURERS (NAST), STATE TREASURY ACTIVITIES & FUNCTIONS 2004-2005 (2005).

decisions were governed by statue/constitution, prudent person rule, and investment policy. The plans received one point for each of these constraints if they were present. A total of 3 points therefore indicate the highest level of constraints and a score of 0 the lowest level of constraints. Using the score, the plans were codified as autonomous if they received a total score of 0 or 1 (the least amount of constraints and thus the highest level of autonomy), and less autonomous if they received a total score of 2 or 3. Autonomous plans were codified as 1 and less autonomous plans were codified as 0. The variable is referred to as "AutonomyDichotom."

7. Rules governing efficiency of investment process (OEH2) (+)

As indicated above, pension funds that adopt rules that limit the pace by which pension funds diversify into private equity and that sets limit on the overall level of allocations are expected to have a higher tendency to meet their performance goals. To test this relationship, a variable was generated using the public plans data. It provides allocations in alternative assets (excluding real estate investments) for the years 2001 to 2013. The resulting variable was codified as a dichotomous variable, based on three criteria. These included:

1. No more than 5 percent increase in the proportion of allocations (in relation to overall allocations) in any given year.

2. No more than 30 percent allocations in alternatives in any year.

3. At least 10 years of investments in alternatives.

If a pension plan met these three criteria it was coded as "1." If it failed to meet one or more of the criteria it was coded as "0." As indicated by the above hypothesis, it is expected that the presence of more rigid rules aimed at combatting inefficient investment practices will have a positive impact on pension funds' ability to meet performance goals. The variable is referred to as "Efficiencyofpractice."

8. Other Relevant Variables

An additional variable that is likely to influence the extent to which state pension funds breach fiduciary responsibilities is the presence of corruption in a particular government. In a recent study, Wald and Zhang found that pension funds in states with more corruption have lower performance.[30] A corruption variable was therefore added to list of independent variables. Data on corruption was retrieved from the website "538," which included data compiled and aggregated from a study by Dincer and Johnston.[31] In their study, Dincer and Johnston surveyed 280 state political reporters about their perception of how corrupt they thought the branches of their state governments were during the year of 2013, using a scale ranging from "not at all common" to "extremely common." Based on this data, a dichotomous variable was created that codified the top three most corrupt states as "1," and the remaining states as "0." It is expected that higher levels of corruption will augment agency problems and thus have a negative impact on the ability of a pension plan to meet its performance goals. The variable is referred to as "Corrupttop3rd."

---

30 John K. Wald & Hongxian Zhang, *Corruption, Governance, and Public Pension Funds*, (2015), http://www.efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2015-Amsterdam/papers/EFMA2015_0092_fullpaper.pdf.

31 Oguzhan Dincer & Michael Johnston, *Measuring Illegal and Legal Corruption in American States: Some Results from the Corruption in America Survey*, HARVARD UNIV. EDMOND J. SAFRA CTR. FOR ETHICS (Dec. 2016), https://ethics.harvard.edu/blog/measuring-illegal-and-legal-corruption-american-states-some-results-safra.

A summary of the variables in the model is presented in Table 3.

**Table 3: Summary of Variables**

| Variable | Data | Source | Time Period | |
|---|---|---|---|---|
| *Dependent* | | | | |
| Performance | Difference between the average return earned by pension funds and the average target return for the same time period | Public plans data (Center for Retirement Research 2015) | 2004-2013 | |
| *Independent* | | | Data Year(s) | Expected Relationship |
| Conflict of Interest | Average score of assessment areas relating to conflict of interest (equal weight). A higher score indicates more rigorous conflict of interest disclosure rules. | State integrity data (Qui, et al 2015). | 2013 | |
| Placement agents | Assessment score received on whether agents are required to disclose fees and terms for providing services. A higher score indicates more rigorous placement agent disclosure rules. | State integrity data (Qui, et al 2015). | 2014 | + |
| Investment Disclosures | A higher score indicates more rigorous disclosure rules about investment operations | State integrity data (Qui, et al 2015). | | + |
| Political Interference | Assessment of rules | State integrity data (Qui, et al 2015). | | + |
| | Proportion board members | CAFRs | | – |
| Autonomy | A higher score indicates more autonomy. | NAST (2005) | | + |
| Professionalism/Expertise | A higher score indicates higher degree of expertise. | State integrity data (Qui, et al 2015). | | + |
| Efficiency of practice | Dichotomous; 1 indicates presence of rule to regulate efficiency, 0 indicates lack of rules | Public Plans Data | 2001-2013 | + |
| Corruption | A higher score indicates more corruption. | Fivethirtyeight.com & Dincer & Johnson's (2014) surveys of State House reporters (Boylan and Long, 2003) | 2013 | – |

## III. ANALYSIS

This section presents the descriptive statistics and the preconditions for the analysis. Following this, the bivariate correlations and the regression results are presented.

## A. *Descriptive Statistics*

Table 4 presents the descriptive statistics for the variables that are included in the analysis. The data used in this research cover one or more state-administered pension plans from each of the 50 US states. In total, 76 plans were included in the study. These plans represent the largest plans in the US. According to NASRA, they account for over 80 percent of all participants and assets.[32]

The dependent variable in the study is "Performance." This variable is dichotomous, where the code "1" represents an outcome where the pension plan met its performance goal and "0" represents a situation where it failed to meet it. The average (0.3289) indicates that the majority of the plans did not meet their performance goals during the given time period. Specifically, 33 percent of the plans (n=25) in the data set succeeded in meeting their performance goals and 67 percent failed to meet them (n=51).

Four of the variables in the data set are discrete, including "Placementagents," "Politicinterferrules," "Investmentdisclosures," and "Expertise." The values represent the scores that the pension plans were awarded based on the assessments conducted by the Center for Integrity. As noted earlier, the scores ranged from 0 to 100. The maximum, minimum and standard deviation values indicate that there is a large variation in the assessments across the pension plans with regard to these variables.

The remaining three explanatory variables are dichotomous, including "Efficiencyofpractice," "Autonomydichotom," and "CorruptionDichotom." The statistics for the variable "Efficiencyofpractice" indicates that approximately half of the states in the data set approached alternative investing in a manner that is consistent with good practice. The variable "Autonomydichotom" indicates that a quarter of the states in the data set met the threshold for autonomy.

**Table 4:** Descriptive Statistics

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| Performance | 76 | .00 | 1.00 | .3289 | .47295 |
| PoliticalapptBRD | 76 | .00 | 100.00 | 53.3779 | 32.93328 |
| Conflictofinterest | 76 | 33.33 | 100.00 | 81.5537 | 19.03320 |
| Placementagents | 76 | .00 | 100.00 | 60.1964 | 30.21765 |
| Politicinterferrules | 76 | .00 | 100.00 | 85.0000 | 25.15287 |
| Investmentdisclosures | 76 | 12.50 | 95.00 | 59.8618 | 15.51593 |
| Expertise | 76 | .00 | 100.00 | 87.3026 | 21.34543 |
| Efficiencyofpractice | 75 | .00 | 1.00 | .5067 | .50332 |
| AutonomyDichotom | 76 | .00 | 1.00 | .2500 | .43589 |
| Valid N (listwise) | 75 | | | | |

32 NATIONAL ASSOCIATION OF RETIREMENT ADMINISTRATORS, STATE INFO (Sept. 1, 2016), http://www.nasra.org/states.

## B. *Bivariate Correlations*

Table 5 provides a correlation matrix that includes all of the variables that are included in the study. The matrix indicates that there are significant correlations between "Performance" and the variables "Investmentdisclosures," "AutonomyDichotom," "EfficiencyofPractice," and "Corrupttop3rd." It also indicates that the statistically significant variables carry the expected signs. A preliminary interpretation of the relationships that are studied, thus, is that at least four of the variables are able to explain the success by which public pension funds are able to meet their performance goals.

The correlation matric also indicates that there are statistically significant relationships across several of the explanatory variables, including "ConflictofInterst" and "Investmentdisclosures," "ConflictofInterst" and "Expertise," and "Placementagents" and "Expertise," "Investmentdisclosures," and "Corrupttop3rd." However, all the correlations are relatively low, suggesting that problems of multicollinearity are limited. The highest correlation is between "Politicinterferrules" and "Expertise," which has a correlation of 0.452.

**Table 5: Correlations**

| | Perfor mance | Political appt BRD | Conflict of interest | Placem ent agents | Politic interfere rules | Openess toPublic | Autono my Dichotom | Exper tise | Efficien yof practice | Corrupt top3rd |
|---|---|---|---|---|---|---|---|---|---|---|
| Performance | 1 | -0.151 | -0.008 | -0.104 | 0.011 | .250* | .307** | 0.102 | .245* | -.236* |
| | | 0.192 | 0.946 | 0.371 | 0.923 | 0.029 | 0.007 | 0.379 | 0.034 | 0.04 |
| Politicalappt BRD | -0.151 | 1 | -0.101 | -0.081 | 0.144 | -0.097 | -0.063 | 0.065 | -0.044 | 0.113 |
| | 0.192 | | 0.386 | 0.489 | 0.214 | 0.403 | 0.591 | 0.578 | 0.706 | 0.331 |
| Conflictofint erest | -0.008 | -0.101 | 1 | 0.217 | 0.194 | .303** | -0.084 | .313** | 0.037 | 0.188 |
| | 0.946 | 0.386 | | 0.059 | 0.093 | 0.008 | 0.468 | 0.006 | 0.753 | 0.104 |
| Placementag ents | -0.104 | -0.081 | 0.217 | 1 | 0.201 | 0.218 | -0.034 | .295** | 0.127 | .334** |
| | 0.371 | 0.489 | 0.059 | | 0.081 | 0.059 | 0.769 | 0.01 | 0.276 | 0.003 |
| Politicinterfe rrules | 0.011 | 0.144 | 0.194 | 0.201 | 1 | -0.079 | -0.006 | .452** | -0.013 | -0.138 |
| | 0.923 | 0.214 | 0.093 | 0.081 | | 0.497 | 0.958 | 0 | 0.911 | 0.236 |
| Investmentdi sclosures | .250* | -0.097 | .303** | 0.218 | -0.079 | 1 | 0.178 | 0.119 | 0.1 | .248* |
| | 0.029 | 0.403 | 0.008 | 0.059 | 0.497 | | 0.124 | 0.307 | 0.393 | 0.031 |
| AutonomyDi chotom | .307** | -0.063 | -0.084 | -0.034 | -0.006 | 0.178 | 1 | -0.034 | 0.023 | 0.031 |
| | 0.007 | 0.591 | 0.468 | 0.769 | 0.958 | 0.124 | | 0.77 | 0.845 | 0.793 |
| Expertise | 0.102 | 0.065 | .313** | .295** | .452** | 0.119 | -0.034 | 1 | 0.03 | -0.104 |
| | 0.379 | 0.578 | 0.006 | 0.01 | 0 | 0.307 | 0.77 | | 0.799 | 0.372 |
| Efficiencyof practice | .245* | -0.044 | 0.037 | 0.127 | -0.013 | 0.1 | 0.023 | 0.03 | 1 | -0.092 |
| | 0.034 | 0.706 | 0.753 | 0.276 | 0.911 | 0.393 | 0.845 | 0.799 | | 0.43 |
| Corrupttop3r d | -.236* | 0.113 | 0.188 | .334** | -0.138 | .248* | 0.031 | -0.104 | -0.092 | 1 |
| | 0.04 | 0.331 | 0.104 | 0.003 | 0.236 | 0.031 | 0.793 | 0.372 | 0.43 | |

*. Correlation is significant at the 0.05 level (2-tailed). **. Correlation is significant at the 0.01 level (2-tailed).

### C. *Regression Results*

Given that the dependent variable is categorical (dichotomous) and the predictor variables include a mix of discrete and categorical variables, a binary logistic regression was used to analyze the relationships between performance and the explanatory variables. Specifically, the regression is used to predict or determine the effects of the above explanatory variables on the likelihood that pension systems successfully meet their performance goals. The results from the regression analysis are presented in Table 7.

As indicated by Table 7, three of the variables are statistically significant, including the variables "Investmentdisclosures," "AutonomyDichotom," and EfficiencyofPractice." These also carry the expected sign. Hence, three of the four variables in the correlation matrix remain statistically significant in the full model. The fourth variable, "Corrupttop3rd," is statistically significant just outside the 5 percent level, carrying the correct sign.

Two of the statistically significant variables carry substantial strength. The first variable, "AutonomyDichotom," is a dichotomous variable. It has an odds ratio (Exp(B)) of 5.345. It suggest that pension systems that develops a governance structure that places emphasis on autonomy are 5.345 times more likely to meet their performance goals.

The second variable, "Efficiencyofpractice," is also a dichotomous variable. It has an odds ratio (Exp(B)) of 4.012. It suggest that pension systems that develop a governance structure that places emphasis on caution in investments in alternative assets are 4.012 times more likely to meet their performance goals.

The third variable that is statistically significant, "Investmentdisclosures," has less explanatory power. It has an odds ratio (Exp(B)) of 1.053. It predicts that the odds of a pension fund meeting its performance goal are 1.053 times higher for pension funds that have rules aimed at preventing conflicts of interest than they are for those that do not.

Two of the variables are not statistically significant, but carry the expected sign, including "Expertise" and "CorruptionDichotom."

Finally, two variables fail to show a particular direction and are also statistically insignificant, including PoliticalapptBRD, Politicinterferrules.

**Table 6:** Variables in the Equation

| | B | S.E. | Wald | df | Sig. | Exp(B) | 95% C.I.for EXP(B) Lower | Upper |
|---|---|---|---|---|---|---|---|---|
| Conflictofinterest | -.001 | .017 | .008 | 1 | .930 | .999 | .966 | 1.032 |
| Placementagents | -.011 | .011 | .971 | 1 | .325 | .989 | .967 | 1.011 |
| Investmentdisclosures | .051 | .024 | 4.704 | 1 | .030 | 1.053 | 1.005 | 1.103 |
| Politicinterferrules | .000 | .017 | .000 | 1 | .985 | 1.000 | .968 | 1.033 |
| PoliticalapptBRD | -.006 | .010 | .334 | 1 | .563 | .994 | .975 | 1.014 |
| AutonomyDichotom(1) | 1.676 | .693 | 5.847 | 1 | .016 | 5.345 | 1.374 | 20.797 |
| Expertise | .021 | .017 | 1.428 | 1 | .232 | 1.021 | .987 | 1.057 |
| Efficiencyofpractice(1) | 1.389 | .660 | 4.428 | 1 | .035 | 4.012 | 1.100 | 14.634 |
| Corrupttop3rd(1) | -1.343 | .724 | 3.441 | 1 | .064 | .261 | .063 | 1.079 |
| Constant | -5.391 | 2.504 | 4.634 | 1 | .031 | .005 | | |

Table 7, indicates that the model has a relatively high explanatory power. As indicated by the Nagelkerke R Square in Table 7, the model explains 38.7 percent of the variation in the dependent variable (Nagelkerke R Square=0.387).

**Table 7:** Model Summary

| Step | -2 Log likelihood | Cox & Snell R Square | Nagelkerke R Square |
|---|---|---|---|
| 1 | 70.992[a] | .279 | .387 |

a. Estimation terminated at iteration number 6 because parameter estimates changed by less than .001.

Finally, Table 8 indicates that the model correctly classified 78.7 percent of the cases.

**Table 8:** Classification Table

| | Observed | | Predicted Performance .00 | 1.00 | Percentage Correct |
|---|---|---|---|---|---|
| Step 1 | Performance | .00 | 45 | 5 | 90.0 |
| | | 1.00 | 11 | 14 | 56.0 |
| | Overall Percentage | | | | 78.7 |

a. The cut value is .500

## SUMMARY AND CONCLUSION

This paper has examined the role that formal governance structures play in the performance of public pension fund investments. The study was carried out, using a mixed methods approach, including a case study and a quantitative study. The findings of the study suggest that pension systems are more likely to meet their performance goals if they apply a governance structure that (1) extends autonomy to the plan, (2) places emphasis on ensuring public transparency, and (3) and prevents inefficient investment practices. In terms of transparency, it is important to note that a common concern about disclosures about investment operations is that successful funds become the subject for "copycat funds."[33] To avoid this problem, disclosures about investment operations need to be designed to ensure that they do not compromise an existing competitive advantage. Finally, the results suggest pension plans that operate in states that are relatively corrupt are less likely to meet their investment goals. It might therefore be advisable for pension plans that operate in corrupt environments to limit autonomy, and to adopt rules that increase oversight and transparency.

---

[33] Mary Margaret Myers et al., *Copycat Funds: Information Disclosure Regulation and the Returns to Active Management in the Mutual Fund Industry* (NBER Working Paper No. 8653, 2004).

# A JUDGE IN THEIR OWN CAUSE: GASB 67/68 AND THE CONTINUED MIS-MEASUREMENT OF PUBLIC SECTOR PENSION LIABILITIES

*Sheila Weinberg & Eileen Norcross*

## INTRODUCTION

In total, 90,000 state and local governments in the United States offer public employees a defined benefit pension plan.[1] In 2015 these plans covered over 20 million employees and 10 million retirees receiving total benefits of $286.5 billion.[2] According to the U.S. Census in FY 2015 assets totaled $3.1 trillion and total pension liabilities $4 trillion, producing total underfunding of $978 billion.[3]

Government estimates of plan underfunding are contested by economists, policy analysts, and financial practitioners as underestimating the full value of pension liabilities by several trillion.[4] The reason for such a large gap in measurement is due to the actuarial and accounting guidance that informs public sector pension reporting. The basis on which pensions are measured is central to their proper funding and sustainability. Inaccurate measurement of pension benefits has major financial implications for retirees, taxpayers and governments as the recent experiences of Puerto Rico, Detroit, and San Bernardino attest.

Public sector plans in the U.S. operate under actuarial and accounting guidance provided by the Government Accounting Standards Board (GASB) and Society of Actuaries. Until 2014, governments followed

---

1 PHILLIP VIDAL, U.S. CENSUS BUREAU, ANNUAL SURVEY OF PUBLIC PENSIONS: STATE-AND-LOCALLY ADMINISTERED DEFINED BENEFIT DATA SUMMERY BRIEF: 2015 1 (2016), https://www.census.gov/content/dam/Census/library/publications/2016/econ/g15-aspp-sl.pdf.

2 *Id.* at 3.

3 2015 SURVEY OF PUBLIC PENSIONS: STATE & LOCAL DATA, U.S. CENSUS BUREAU, https://www.census.gov/govs/retire/historical_data_2015.html.

4 Rauh calculates state and local public sector plans unfunded liabilities total $4.967 trillion as of FY 2015. JOSHUA D. RAUH, HOOVER INSTITUTION, HIDDEN DEBT, HIDDEN DEFICITS: 2017 EDITION: HOW PENSION PROMISES ARE CONSUMING STATE AND LOCAL BUDGETS 2 (2016), http://www.hoover.org/sites/default/files/research/docs/rauh_hiddendebt2017_final_webreadypdf1.pdf. However, more recent estimates suggest unfunded pension liabilities for state and local governments is $6 trillion. *See* Ed Bartholomew & Jeremy Gold, *The $6 Trillion Pension Hole We're All Going to Have to Pay For*, MARKETWATCH (Aug. 20, 2016), http://www.marketwatch.com/story/why-your-states-public-pension-plan-is-in-a-much-bigger-hole-than-you-already-fear-2016-08-16.

GASB Statements No. 25 and 27 to measure and value pension plan data. Based on criticism that these standards do not fully measure plan liabilities and generate misleading information, GASB 25 and 27 were replaced with GASB 67 and 68 in an attempt to ensure more accurate and transparent reporting. Early evidence suggests that the new guidance has an overall mixed effect and produces its own set of distortions. Liabilities continue to be dramatically understated while assets are reported on a sounder basis. Requirements to report the pension liability in financial statements, rather than in the notes, represent an improvement in transparency, yet, the liability figures themselves do not fully reflect the true unfunded liability for public plans.

This comment reviews the changes to GASB accounting guidance and how these changes affect the measurement and reporting of pension assets and liabilities. In particular, this comment explores the extent to which GASB 67 allows for a subjective approach to pension liability measurement. In this comment we select 144 plans that calculated the Unfunded Actuarial Accrued Liability (UAAL) as outlined in GASB 25 and the Net Pension Liability (NPL) as outlined in GASB 67 on the same valuation date to ensure comparability. Based on a review of these 144 plans as of June 2014 we find that the implementation of GASB 67 resulted in little change in the reported liability, contrary to the expectation of scholars. This is due to the discretion GASB 67 gives to actuaries in determining when a pension plan is likely to run out of assets. The result is that only a small fraction of plans applied GASB 67's recommended "blended discount rate" in FY 2014, leading to almost no discernable change in the size of unfunded liabilities for the majority of plans, and a slight improvement in the case of Illinois, a state among the most distressed pension plans in the nation. Secondly, we find that GASB 68, while revealing more of plans' underfunding in financial reports continues to conceal total amount of underfunding.

## I. GASB 25 VS. GASB 67: THE MEASUREMENT OF PENSION ASSETS AND LIABILITIES

### A. *Reporting*

In the mid-1990s GASB issued statements No. 25 and No. 27.[5] GASB 25 required governments' pension plan reports to include two reporting

[5] *See* GOVERNMENTAL ACCT. STANDARDS BOARD, SUMMARY OF STATEMENT NO. 25: FINANCIAL REPORTING FOR DEFINED BENEFIT PENSION PLANS AND NOTE DISCLOSURES FOR DEFINED CONTRIBUTIONS PLANS (1994), http://www.gasb.org/st/summary/gstsm25.html; GOVERNMENTAL ACCT. STANDARDS BOARD, SUMMARY OF STATEMENT NO. 27: ACCOUNTING FOR PENSIONS BY STATE AND LOCAL GOVERNMENT EMPLOYERS (1994), http://www.gasb.org/st/summary/gstsm27.html.

schedules.[6] The *schedule of funding progress* included the actuarial value of assets (AVA), the actuarial accrued liability (AAL), and the difference between them known as the unfunded actuarial liability.[7] The *schedule of employer contributions* included the annual required contributions (ARC) and the portion of the ARC the government contributed to the plan in that year.[8] GASB 25 also provided guidance on how to measure both the assets and the liabilities. This standard was amended on June 25, 2012 and replaced by GASB 67 which requires the calculation of a Net Pension Liability which is the Total Pension Liability (TPL) minus the Fiduciary Net Position.[9]

## B. *Asset Measurement*

Under GASB 25 assets were measured on a fair-market basis which permitted actuaries to "smooth" market fluctuations in asset returns. Smoothing produces an "actuarial value of assets" based on the multi-year average (usually five years) of market values. The intent of asset smoothing was to dampen swings in investment earnings in order to give sponsors predictability in their annual contributions. However, during significant market declines asset smoothing produces actuarial asset values that are larger than true market values contributing to a false sense of strong performance and masking the risk and volatility of pension asset portfolios. Under GASB 67 asset values are no longer "smoothed." Instead plans report assets on a market basis. Reviewing a sample of plans in which actuaries calculated both the UAAL and the NPL shows 144 state pension plans are reporting assets on a market basis.[10] The result is that these plans' asset values were 7 percent higher under GASB 67 (for FY 2014) as Chart 1 shows.

---

6 GOVERNMENTAL ACCT. STANDARDS BOARD, SUMMARY OF STATEMENT NO. 25: FINANCIAL REPORTING FOR DEFINED BENEFIT PENSION PLANS AND NOTE DISCLOSURES FOR DEFINED CONTRIBUTIONS PLANS (1994), http://www.gasb.org/st/summary/gstsm25.html.

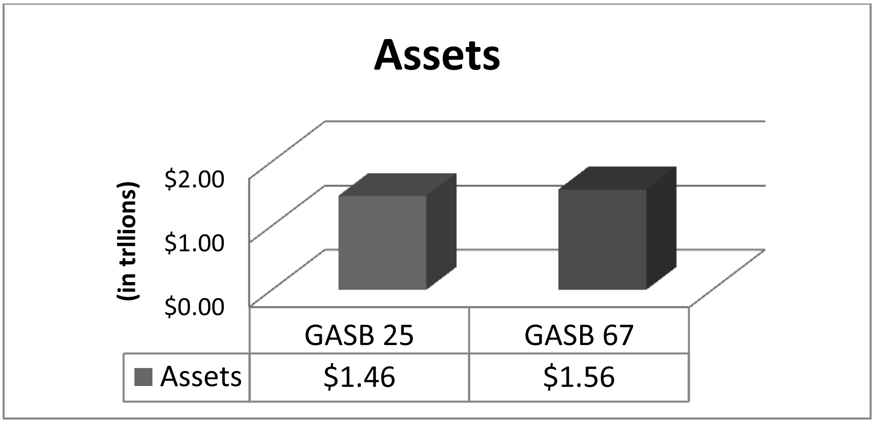
7 *Id.*

8 *Id.*

9 GOVERNMENTAL ACCT. STANDARDS BOARD, SUMMARY OF STATEMENT NO. 67: FINANCIAL REPORTING FOR PENSION PLANS-AN AMENDMENT TO GASB STATEMENT NO. 25 (2012), http://www.gasb.org/jsp/GASB/Pronouncement_C/GASBSummaryPage&cid=1176160219444&pf=true
.

10 *See* Appendix.

Chart 1. Asset values for 144 public sector pension plans under GASB 25 and GASB 67




C. *Liability Valuation*

Valuation of the liability associated with promised pension benefits depends on actuarial assumptions which relate to unknown, but somewhat predictable events including retirement ages, benefit structure, life expectancy, and other factors. In addition, actuaries must calculate the present value of the liability to determine what benefits due years in the future are worth in today's dollars and the contributions needed to fund the benefits. This calculation known as "discounting the liability" (i.e., reverse compound interest). It requires the selection of an interest rate known as the "discount rate" to transform the future value of pension benefits into a present value. GASB 25 indicates that the discount rate used may be based on the expected return on the pension plan's assets when invested in a mix of stocks and bonds, known as the historical rate of return. Pension plans have historically assumed an annual return of between 7.5 to 8 percent on their asset portfolios.[11]

Before discussing the impact of the new rule, it is necessary to consider why GASB modified its approach and the extent to which the new approach addresses the initial criticisms of economists. We next present the ongoing debate over the actuarial approach versus the economic approach on to how to select the discount rate to calculate the present value of a pension liability. According to the principles of finance the discount rate selected to value a stream of cash flows due in the future (in this case, pension

[11] U.S. GOV'T ACCOUNTABILITY OFF., GAO-14-264, PENSION PLAN VALUATION: VIEWS ON USING MULTIPLE MEASURES TO OFFER A MORE COMPLETE FINANCIAL PICTURE 49 (2014).

benefits) should be based on the guarantee and timing of those payments.[12] The value of plan benefits is independent from the value of the assets the plan holds. Public sector pensions are often protected in state statute or constitution as legally guaranteed, putting them on par with government debt. Economic theory suggests that the proper discount rate to use when valuing a debt-like pension liability is the return on bonds, currently valued at historic lows. The effect of selecting the lower return on bonds as the discount rate is to increase the size of the liability and the annual contribution required.[13] The earlier guidance of GASB 25 allowed guaranteed pension liabilities to be valued based on the expected returns on plan assets which consist of mixture of high risk stocks and bonds thus linking the funding of plans to the volatility of the stock market exposing the plan to underfunding. According to the economic approach, plans are effectively assuming a large risk premium when anticipating annual returns of 7.5 percent on a liability that is effectively the equivalent of a government-guaranteed bond, which currently return less than 2 percent annually.[14]

Economists stress that the discount rate used to value plan liabilities is independent from the plan's investment strategy. This theory holds that applying a discount rate to value plan liabilities based on the return on U.S. Treasuries does not imply a plan must invest the assets exclusively in bonds. The subject of how to invest pension assets may follow a number of suggested approaches according to this literature. The goal of the investment strategy is to hedge against changes in the value of pension benefits due to changes in wages, real interest rates, and inflation.[15] Waring sug-

---

12 This principle is defined in the Modigliani-Miller Theorem. *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and Theory of Investment*, 48 AM. ECON. REV. 261, 261-267 (1958).

13 A one-point decrease in the discount rate results in an increase in the liability of up to 20 percent increase in the present value of the liability. *See* V. Gopalakrishnan & Timothy F. Sugrue, *The Determinants of Actuarial Assumptions Under Pension Accounting Disclosures*, 8 J. FIN. & STRATEGIC DECISIONS 35 (1995).

14 One 2007 United States Government Accountability Office study noted that real returns on various investment instruments over the last 40 years was 5 percent. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-07-1156, REPORT TO THE COMMITTEE ON FINANCE, U.S. SENATE, STATE AND LOCAL GOVERNMENT RETIREE BENEFITS: CURRENT STATUS OF BENEFIT STRUCTURES, PROTECTIONS, AND FISCAL OUTLOOK FOR FUNDING FUTURE COSTS 28 (20007).

15 *See* George Pennacchi & Mahdi Rastad, *Portfolio Allocation for Public Pension Funds*, 10 J. PENSION ECON. & FIN. 221, 232 (2011). The authors note that previous research suggests pension funds invest in equities to hedge against wage uncertainty. *See generally* Fisher Black, *Should You Use Stocks to Hedge Your Pension Liability?,* 45 FIN. ANALYSTS J. 10 (1989); Mirko Cardinale, *Cointegration and the Relationship between Pension Liabilities and Asset Prices* 1-68 (Watson Wyatt Technical Paper Series No. 2003-TR-06, 2003); Deborah Lucas & Stephen Zeldes, *How Should Public Pension Plans Invest?,* 99 AM. ECON. REV. 527 (2009). This research is based on a positive correlation between equities and wages. Pennacchi and Rastad test this and find a negative correlation between growth in US state and local wages and US equities. They find that as the period grows longer, the negative correla-

gests a bond-centric Liability Matching Asset Portfolio (LMAP) with an optional Risky Asset Portfolio (RAP).[16] Pennachi and Madhi develop a "risk-minimizing allocation" for public plans in which the fund borrows via short positions to increase its investments in U.S. fixed income securities.[17] Public plans may also adopt a life-cycle fund approach in which allocations to risky assets should diminish as the employee reaches retirement. The rule of thumb suggests that the allocation to stocks in an investor's portfolio equal 100 minus their age. At age 20, an investor would hold 80 percent of their portfolio in stocks. At age 60 this would fall to 40 percent. Research by Biggs demonstrates that public pension plans could adopt a similar approach based on the age composition of plan participants.[18]

One corollary to the economic critique of how public plans select discount rates is that selecting a discount rate based on expected asset returns implies that liability valuation is dependent on asset performance. In order to meet high discount rate assumptions plans are incentivized to assume more investment risk, which may have a negative effect on plan funding.

A recent empirical study by Andonov, Bauer, and Cremers compares U.S. public pension plans to plans in Canada and Europe to determine how GASB regulatory incentives guide discount rate selection affects risk-taking in investment.[19] While U.S. public plans may select a discount rate based on the expected return on investments. U.S. private plans use a discount rate based on high-grade corporate bonds.[20] Until 2004, U.S. private plans were required to use the return on 30-year Treasury bonds.[21] Canadian pub-

---

tion increases. Thus, Pennachi and Rastad conclude that since the typical duration of a pension plan's liabilities is 15 years, stocks may not be the best hedge against wage risk.

16 *See generally* M. BARTON WARING, PENSION FINANCE: PUTTING THE RISKS AND COSTS OF DEFINED BENEFIT PLANS BACK UNDER YOUR CONTROL (2012).

17 This portfolio would consist of a 9 percent short position in equities, a 160 percent allocation to fixed income, a 24 percent allocation of private equity and a 27 percent short position in hedge funds.

18 Andrew Biggs, Investment-Based Transition Costs Associated with Closing a Defined Benefit Pension Plan 15 (February 2015) (unpublished working paper) (on file with Mercatus Center at George Mason University).

19 Alexander Andronov, Rob Bauer & Martijin Cremers, *Pension Fund Asset Allocation, and Liability Discount Rates* (May 2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2070054.

20 *Id.* at 2.

21 *Id.* at 10. In 2012 Congress voted to allow U.S. private plans to adjust their discount rate to reflect a 25-year average rate on corporate bonds as opposed to the 2-year average rate. This change had the effect of increasing the discount rate from 4 percent to 6 percent, thereby reducing reported liabilities and annual contributions. The secondary effect of the measure was to shift money from pension funds to corporate income statements increasing taxable income. The discount rate used for U.S. private sector plans is still selected, based on FASB guidance, with reference to corporate bonds, an approximation of the guaranteed nature of the pension benefit. *See* Robert C. Pozen & Theresa Hamacher, *A Realistic Discount Rate for Pensions*, BROOKINGS INSTITUTE (August 20, 2012), https://www.brookings.edu/opinions/a-realistic-discount-rate-for-pensions/; Jason Fichtner & Eileen Norcross, *Paving Over Pension Liabilities*, REAL CLEAR POLICY (June 15, 2012), http://www.realclearpolicy.com/articles/2012/06/15/paving_over_pension_liabilities_164.html.

lic and private plans use a discount rate based on high-quality corporate debt.[22] In the Netherlands plans must use a discount rate of a maximum of four percent.[23] Plans in the U.K. discount their private and public pension liabilities based on the yields on U.K. government securities.[24]

The authors find that an increase in the allocation of risky assets in public pension funds from 56.1 percent in 1993 to 72.4 percent in 2012 is mainly due to risk-taking by U.S. public funds.[25] By contrast, U.S. private funds decreased their allocation to risky assets by 2.8 percent over the same period. In particular, the authors find that more mature U.S. pension funds have a stronger incentive to invest in risky assets because reducing the discount rate has an immediate impact on increased contributions.[26] For every 10 percent increase in the percentage of retired workers, U.S. public plans increase their allocation to risky investments by 5.34 percent, while Canadian, European, and U.S. private sector plans decrease their allocation by 1.7 percent. Increasing risk as a plan matures is in contrast to the life-cycle investment approach described earlier.

To reconcile the critique of economists with the historic practice of actuaries in discount rate selection, GASB 67 attempted to merge the two approaches. As discussed, under GASB 25 the actuarial liability was calculated using the expected rate of return on plan assets (the historical rate). Under GASB 67, as long as the plan is projected to not run out of assets, plans may continue to use the historical rate. The "blended rate" is applied at the point in the future when the plan is projected to become insolvent. This date is estimated based on a projection methodology that takes into account future contributions (inflows) and pension payments (outflows).[27] Effectively, the portion of benefits backed by assets is valued based on the historical rate. Any remaining portion of the benefit not backed by assets is valued based on the low-risk index rate for 20-year tax-exempt municipal bonds. This is based on GASB's recognition that investment returns can't be earned unless there are assets available to be invested. Blending the (low-risk), low return on bonds with the (high-risk), high-return historic rate produces a lower overall blended rate, resulting in a higher reported liability.

During the comment period before the new guidance was implemented, several economists remained critical of the "blended rate" approach. The core criticism was much the same - the new approach continues to ap-

---

22 *Id.*

23 *Id.* at 11.

24 *Id.*

25 *Id.* at 13.

26 *Id.* at 6.

27 William Winningham, *GASB 67/68: Depletion Date Projections*, MILLIMAN 2 (March 2014), http://www.milliman.com/uploadedFiles/insight/Periodicals/peri/pdfs/gasb-depletion-date-projections.pdf.

ply the expected rate of return on the assets to value a portion of the plan liability. Economic theory stresses the independence of liabilities and assets for valuation purposes. Jeffrey Brown noted that even if one were to accept GASB's "blended rate" logic it is the unfunded assets that are at-risk, and to which the riskier discount rate should be applied while the risk-adjusted rate should be applied to the funded portion.[28] Brown further suggests that as a result of GASB 67, plans will have an incentive to invest in risker assets to justify a higher discount rate.[29]

The ongoing debate between economists and the actuarial profession over how to select a discount rate to value pension liabilities is certain to continue as the core objections remain the same. However this debate is resolved, we now move on to assess the implementation of GASB 67 and question whether it achieved its goal of ensuring plans report a fuller picture of plan funding status.

Several scholars and analysts anticipated that as a result of GASB 67 plans would apply a lower blended rate and report higher liabilities and lower funding ratios. Modeling 126 plans for FY 2010 Munnell et al. estimated, using 2010 data, that funding ratios were likely to fall from 76 percent to 63 percent under the new guidance.[30] Mortimer and Henderson, modeling 48 plans for FY 2010 projected that under the new standards, funding levels would fall depending on the size and funding ratios of the plan under the previous guidance.[31] Specifically plans with lower funding ratios under GASB 25/27 such as Illinois, Connecticut, and Kentucky were projected to run out of assets more quickly leading them to apply the low-risk rate sooner. Overall these states would be forced to apply the lower blended rate producing higher unfunded liabilities and lower funding ratios. The authors projected Illinois State Retirement System's liability to increase from $18.7 billion under GASB 25 to $36 billion under the new guidance and the funding ratio to fall from 37.4 percent to 23 percent.[32]

---

28 JEFFREY R. BROWN, GOVERNMENTAL ACCT. STANDARDS BOARD, COMMENTS ON EXPOSURE DRAFT OF ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS (PROPOSED AMENDMENTS TO GASB STATEMENTS 25 AND 27) (2011), http://www.gasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175823013470&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=651825&blobheadervalue1=filename%3D0065-34-E-JEFFREY_BROWNUNIV_OF_ILLINOIS.pdf&blobcol=urldata&blobtable=MungoBlobs.

29 *Id.*

30 Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz & Laura Quinby, *How Would GASB Proposals Affect State and Local Pension Reporting?* 3 (Ctr. for Retirement Res. B.C., Working Paper No. 23, 2011), http://crr.bc.edu/wp-content/uploads/2011/11/slp_23-1.pdf.

31 John W. Mortimer & Linda R. Henderson, *Measuring Pension Liabilities under GASB Statement No. 68,* 28 ACCOUNTING HORIZONS 421 (2014). Note that the authors refer to the guidance as GASB 68, however the guidance that pertains to the calculation of discount rates is described in GASB 67.

32 *Id.* at 446.

Conversely, states with robust funding levels under GASB 25 were projected to show very small changes in the size of unfunded liabilities under the new guidance. Overall Mortimer and Henderson project that the implementation of GASB 67/68 increases reported net pension liabilities by $9.2 billion and decreases funding ratios by 17.2 percent.[33]

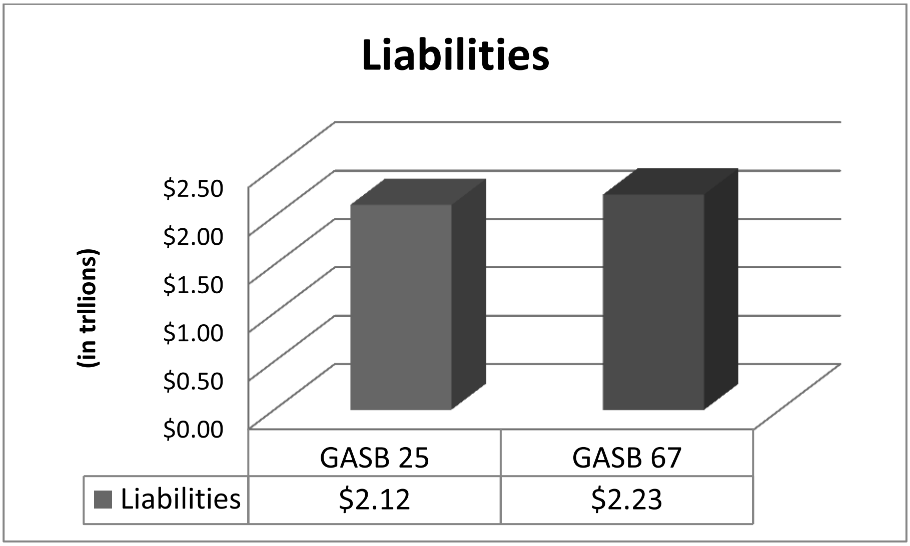
The main finding of Mortimer and Henderson is that GASB 67/68 affects plans differently. Plans that begin with lower funding ratios were projected to show a greater increase in liabilities and decline in funding ratios than those that begin with robust funding levels. This asymmetric effect is due to the fact that poorly funded plans have fewer years before they run out of assets. Thus they would apply the lower blended rate to a larger portion of the liability. Plans that begin from a relatively strong position have a longer horizon until they exhaust their assets and can apply the higher expected rate of return to value more of their liabilities.

## II. THE ACTUAL EFFECTS OF GASB 67 ON THE MEASUREMENT OF PLANS

With a full year of implementation of GASB 67, we can now test if the anticipated effects (higher reported liabilities and lower funding ratios for poorly funded plans) match the experience of pension plans. In FY 2014 pension plans adopted the new guidelines for valuing and reporting liabilities. A review of 144 plans show that the Total Pension Liability was only five percent higher than the previously reported AAL, increasing from $2.12 trillion to $2.23 trillion as Chart 2 shows. The vast majority of plan actuaries projected that plans would not run of out assets and calculated plan liabilities using the historical rate. The Appendix lists all 144 plans and their reported liabilities under both GASB 25 and GASB 67.

33 *Id.* at 436.

Chart 2. Comparison of liability reporting GASB 25 and GASB 67




Out of 144 plans studied only 13 applied the blended rate. Three states applied a blended rate to their major plans. These include all of New Jersey's pension plans, the Kentucky Teachers' Retirement System, and two of Illinois' plans: the State Employees Retirement System and State Universities Retirement System. Removing New Jersey's plans for the analysis leads to an overall decrease in the liability from state plans by $52 billion. That is, state plans are reporting *lower liabilities* under GASB 67 than under GASB 25, contrary to expectations. A few states applied the blended rate to smaller plans including Arizona Elected Officials' Retirement Plan, Colorado Judges Plans, and Rhode Island Judges plan.

For the plans that applied the blended rate, the calculation of the rate varies, highlighting the subjective judgments used to assess when plans will run out of assets.

## A. *Kentucky*

Kentucky applied a blended rate for the Teacher's Retirement Plan (KTRS) but not for the state's other major plan, the Employee Retirement System (ERS). Recent pension reforms require Kentucky to fully fund the Actuarially Determined Contribution (ADC) for the ERS beginning in 2015. Based on this legal commitment to future funding, actuaries projected the ERS would not run out of assets and could continue to use the historical discount rate of 7.5 percent to value the liability. This determination did not take into account the state's past history of underfunding and ERS' weak funding ratio of 25 percent which indicates the plan only has 25 cents for every dollar of benefits promised. Counterintuitively, actuaries assumed the Teachers' Retirement Plan would run out of assets, necessitating the use of a blended discount rate of 5 percent, even though it has a more robust funding ratio of 46 percent. Applying the blended rate to the Teach ers' Retirement Plan increases the liability $14 billion to $22 billion.

**Table 1: Kentucky application of GASB 67**[34]

| Kentucky | Assets | Liabilities | Unfunded Liability | Funding Ratio | |
|---|---|---|---|---|---|
| Kentucky Employees Retirement System | $3,139,774 | $12,366,960 | $9,227,186 | 25% | ** |
| Kentucky Teachers' Retirement System | $18,092,571 | $39,684,776 | $21,592,205 | 46% | * |
| | | | | | |
| * Blended rate used | | | | | |
| ** Did not use blended rate | | | | | |

34 TEACHERS' RETIREMENT SYSTEM OF THE STATE OF KENTUCKY, THE 76TH COMPREHENSIVE ANNUAL FINANCIAL REPORT 54 (2016), https://trs.ky.gov/wp-content/uploads/2016/12/2016.CAFR-FINAL.pdf; KENTUCKY RETIREMENT SYSTEMS, COMPREHENSIVE ANNUAL FINANCIAL REPORT 76 (2014), https://kyret.ky.gov/Publications/Books/2014%20CAFR%20(Comprehensive%20Annual%20Financial%20Report).pdf.

## B. *Illinois*

Illinois has a long history of inadequately funding its pension plans resulting in poor funding for its three major plans. Actuaries applied the blended rate for two plans – the State Employees Retirement System (SERS) and the State Universities Retirement System (SURS). The blended rate was not applied to the Teachers Retirement System (TRS) even though the plan's funding ratio of 43 percent is similar to that of SERS (35 percent) and SURS (44 percent). Even more surprisingly, actuaries project that the SERS and SURS will not run out of assets until after 2065. Thus, the blended rate applied to value the net pension liabilities of SERS and SURS, 7.09 percent, is not significantly different than the historical discount rate of 7.25 percent.

**Table 2. Illinois: Application of GASB 67**[35]

| Illinois | Assets | Liabilities | Unfunded Liability | Funding Ratio | |
|---|---|---|---|---|---|
| State Employees Retirement System | 14,581,566 | 41,685,086 | 27,103,520 | 35% | * |
| State Universities Retirement System | 17,391,323 | 39,182,306 | 21,790,983 | 44% | * |
| Teachers Retirement System | 45,824,383 | 106,682,655 | 60,858,272 | 43% | ** |
| | | | | | |
| * Blended rate used starting 2066 | | | | | |
| ** Did not use blended rate | | | | | |

C. *New Jersey*

New Jersey applied the blended rate to all of its major pension plans, including the Public Employees Retirement System (PERS), the Teachers Pension Annuity Fund (TPAF), the Police and Firefighters Retirement System (PFRS) and the State Police Retirement System (SPRS). The actuaries also projected an earlier run out date for assets, resulting the use of the lower blended rate instead of the historical rate. Consequently, the difference

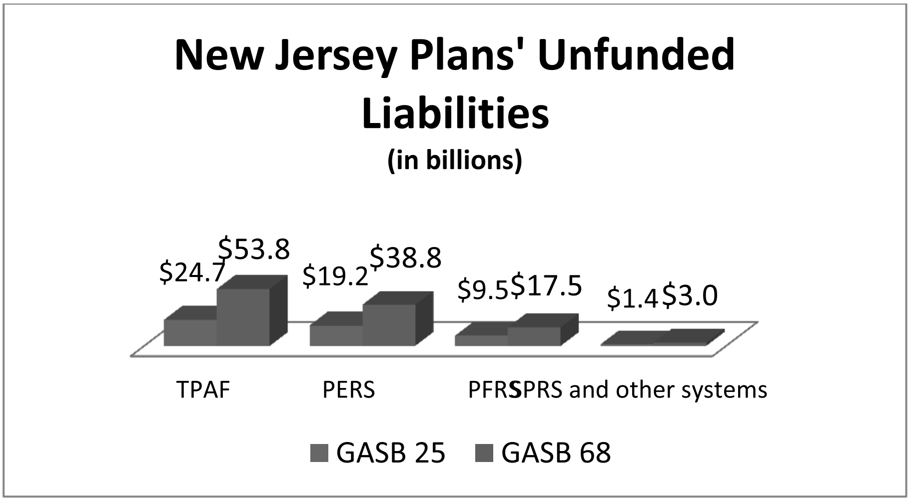
35 STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLIONIS, A PENSION TRUST FUND OF THE STATE OF ILLINOIS 38 (2014), https://www.srs.illinois.gov/PDFILES/oldAnnuals/sers2014.pdf; STATE UNIVERSITIES RETIREMENT SYSTEM OF ILLINOIS, COMPREHENSIVE ANNUAL FINANCIAL REPORT 43 (2014), http://www.surs.com/sites/default/files/annual_report/COMP-2014.pdf; TEACHERS' RETIREMENT SYSTEM OF THE STATE OF ILLINOIS, COMPREHENSIVE ANNUAL FINANCIAL REPORT 50 (2014), https://www.trsil.org/sites/default/files/documents/fy14.pdf.

between the liability calculated under GASB 67 and GASB 25 for New Jersey's plans is $58.4 billion, resulting in a 107% increase.

**Chart 3: New Jersey Plans' Discount Rates**[36]

| | Historical Rate | Blended Rate |
|---|---|---|
| PERS | 7.90% | 5.39% |
| TPAF | 7.90% | 4.68% |
| PFRS | 7.90% | 6.32% |
| SPRS | 7.90% | 5.12% |

**Chart 4: New Jersey Plan liabilities under GASB 68**[37]




D. *California*

California actuaries initially calculated the net pension liability for the Teachers Retirement System (CalSTRS) to be $167 billion under GASB 67. Upon the enactment of AB 1469 in which the state promised to fund the plan sufficiently to pay benefits in future years, the actuarial projections changed to indicate that its assets would not run out. Based on this expectation, CalSTRS is no longer required to use the blended discount rate resulting in a steep decrease in the size of the plan's NPL from $167 billion to

36 STATE OF NEW JERSEY, COMPREHENSIVE ANNUAL FINANCIAL REPORT 97 (2015), http://www.nj.gov/treasury/omb/publications/15cafr/pdf/fullcafr2015.pdf.

37 *Id.* at 31.

$58 billion. This adjustment by plan actuaries effectively implies that a legal promise to fund the plan is the equivalent of actual assets.

The implementation of GASB 67 is troubling. The intent of the guidance is to more accurately assess the size of pension liabilities so that sponsors contribute sufficiently to fund the benefits. However, the design and implementation of the rule shows that it allows for an entirely subjective assessment of plan funding status and an arbitrary calculation and application of discount rates. Scholars anticipated that the implementation of GASB 67 would naturally result in higher reported liabilities, in particular for poorly funded plans under GASB 25, assuming that the rule was applied consistently and transparently. Mortimer and Henderson suggest that as long as the return on municipal bonds remains low, pension plans with low funding ratios (the strongest candidates for using the lower, blended rate) may have the incentive "to encourage the use of optimistic estimates, especially related to future contributions, and accelerate annual pension fund additions while deferring annual deduction. These would minimize the number of GASB 68 funded years and hence reduce the reportable pension liability."[38]

Since a key assumption in calculating the blended rate is to determine when the plan is likely to run out of assets, GASB 67 may incentivize plans to project they are unlikely to run out of assets for many years, allowing them to continue using the higher discount rate. This points to not only a poor implementation of the guidance, but faulty design. The data bears this out. Remarkably, despite poor funding levels and decades of under contributions, Illinois's Teachers Retirement System projects a *lower liability* and a better funding ratio under GASB 67. Even though the accounting standard is designed to be more stringent, Illinois has seemingly improved its pension plan's health simply by assuming (based on future funding behavior) the plan will not run out of assets for several decades. The implementation of GASB 67 points to a concern raised by the American Institute of Certified Public Accountants (AICPA) at the time the new guidelines were issued that it is, "overly complex, subjective and ripe for abuse."[39] At issue is not only the opportunity for gamesmanship but the underlying logic to GASB 67. At the time of the rule's proposal, economists and financial experts identified the rule as intrinsically flawed. The main defect of the new guidance, the critics hold, is that the new GASB rules continue to use the expected return on assets to value the liability maintaining the notion that it is possible to erase pension liabilities by taking on more investment risk. The implication is that the design of GASB 67 may incentivize plan actuaries to forecast optimistic projections of plan health despite past performance and current funding shortfalls.

38 Mortimer & Henderson, *supra* note 31, at 450.

39 *Id.* at 427.

## III. GASB 27 VS. 68: GOVERNMENTAL REPORTING OF PENSION DATA

State and local governments produce several types of annual reports on the financial health of their operations, trust funds, and component units. The Comprehensive Annual Financial Report (CAFR) covers the entire scope of a state or local government's operations which includes general information on any employee pension or health benefits offered by the government. In addition, the individual plans produce an actuarial report annually which gives a detailed and technical analysis of plan data, valuation methods, assumptions, and investment information. Some plans also provide a CAFR which includes a more general overview of the pension system, its history and management. These reports are produced under various GASB directives on how financial information is to be measured and reported.

Until 2014, state and local governments presented pension liability and expense measures based on GASB 27 in their CAFR. GASB 27 provided standards on the measurement, recognition, and display of pension expenditures or expenses, related liabilities, assets, note disclosures and any relevant supplementary information. GASB 27 also required governments to disclose the annual required contribution to the pension plan. The ARC consists of two pieces: the cost of benefits earned in the current year, known as the "service cost" or "normal cost," and the amortization of the prior unfunded balance over 30 years plus interest. The ARC was reported as the "pension expense" and the liability associated with it was reported as the "net pension obligation" (NPO) in financial statements.

When the government paid the ARC, "pension expense," the NPO was reduced by that amount. Effectively this information provided a measure of how much should have been contributed to the plan as calculated by actuaries versus how much the government contributed to the plan annually. It did not provide a measure of total assets or liabilities.[40]

For example, if a government contributed $9,000 of the $10,000 ARC, the government reported a "net pension obligation" or NPO of $1,000. The NPO reflected the remaining balance of what the government was required to contribute in that year towards the pension system (i.e. the remaining annual payment to the debt). It did not capture the total unfunded liability (i.e. the total unfunded debt). This reporting convention (and inaccurately named accounting term) allowed governments that contributed more than the ARC (e.g. $11,000 paid towards a $10,000 Annual Required Contribution) in a given year to report a "net pension asset" despite the existence very large unfunded liabilities.

---

40 GOVERNMENTAL ACCT. STANDARDS BOARD, NO. 116-C, STATEMENT NO. 27 OF THE GOVERNMENT ACCOUNTING STANDARDS BOARD: ACCOUNTING FOR PENSIONS BY STATE AND LOCAL GOVERNMENTAL EMPLOYERS 3 (1994), http://www.gasb.org/resources/ccurl/44/286/GASBS-27.pdf.

Detroit provides an example of this confusing accounting term as Chart 5 shows. When the city declared bankruptcy in 2013, it reported "net pension assets" of $1.286 billion for primary government and $24.8 million in "net pension assets" for its component units in the city's Statement of Net Position. Despite the city's practice of making the full annual contribution, it did not actually have net pensions assets, but rather a large unfunded liability. This could be discovered by looking much further in the report on page 146 in the *schedule of funding progress* as chart 6 shows. The city reported unfunded actuarial accrued liabilities of $984.9 million.

Chart 5. City of Detroit Statement of Net Position, June 30, 2013

**City of Detroit, Michigan**
**STATEMENT OF NET POSITION**
**June 30, 2013**

| | Primary Government | | | |
|---|---|---|---|---|
| | Governmental Activities | Business-type Activities | Totals | Component Units |
| ASSETS | | | | |
| Cash and Cash Equivalents | $ 82,396,105 | $ 163,352,329 | $ 245,748,434 | $ 35,375,087 |
| Investments | 236,561,977 | 710,436,306 | 946,998,283 | 151,640,111 |
| Accounts and Contracts Receivable - Net | 76,382,614 | 224,365,022 | 300,747,636 | 7,335,636 |
| Internal Balances | 1,102,689 | (1,102,689) | — | — |
| Due from Primary Government | — | — | — | 9,125,372 |
| Due from Component Units | 2,890,675 | — | 2,890,675 | — |
| Due from Other Governmental Agencies | 100,682,629 | 11,041,400 | 111,724,029 | 6,871,396 |
| Inventory | — | 20,559,223 | 20,559,223 | 3,592,677 |
| Prepaid Expenses | 600 | 4,917,278 | 4,917,878 | 1,188,283 |
| Long-Term Receivable | — | 9,521,918 | 9,521,918 | — |
| Loans and Notes Receivable | — | — | — | 39,495,536 |
| Advance to Component Unit/Library | 24,016,604 | — | 24,016,604 | — |
| Other Assets | 1,044,242 | — | 1,044,242 | 32,192,037 |
| Restricted Assets | — | — | — | 6,062,086 |
| Net Pension Asset | 999,385,296 | 286,840,419 | 1,286,225,715 | 24,656,163 |
| Deferred Charges | 59,419,593 | 83,810,516 | 143,230,109 | 2,174,130 |
| Capital Assets: | | | | |
| Non-Depreciable | 508,968,614 | 422,474,218 | 931,442,832 | 28,026,898 |
| Depreciable, Net | 1,002,848,043 | 4,778,491,205 | 5,781,339,248 | 127,268,202 |
| Total Capital Assets - Net | 1,511,816,657 | 5,200,965,423 | 6,712,782,080 | 155,295,100 |
| Total Assets | 3,095,699,681 | 6,714,707,145 | 9,810,406,826 | 475,003,614 |

Chart 6. City of Detroit

June 30, 2013 - Schedule of Funding Progress

| Actuarial Value of Assets | Actuarial Value of Liabilities | Unfunded |
|---|---|---|
| (in millions) | | |
| General Retirement System | | |
| $2,806.5 | $3,644.2 | $837.7 |
| Police and Fire Retirement System | | |
| $3,675.5 | $3,822.7 | $147.2 |
| | **Total** | **$984.9** |

Disclosure under GASB 27 produced even greater confusion for multi-employer plans. These are plans which are managed by a state government in which other government employers participate, such as municipalities and school districts. Multi-employer plans were also required to report the ARC and NPO but they did not have to disclose the unfunded liability. Thus, states involved in multi-employer plans reported only a fraction of their unfunded pension liabilities (and in some cases net pension assets) in their financial statements, while not disclosing the plans' total unfunded liabilities.

Misleading accounting terms — labeling the government's annual contributions as "assets" or "obligations" — and inconsistent disclosure between single-employer and multi-employer plans resulted in incomplete estimates of total state pension liabilities in the state's CAFR. As indicated on Table B in FY 2014 states reported $80 billion in Net Pension Obligations on their balance sheets. Analysis of each state's CAFR, pension CAFRs, and pension system actuarial reports, including multi-employer pension plan data indicates the NPO represented less than 13 percent of total unfunded pension liabilities, which amounted to $628 billion.[41] Under GASB 27's "NPO" reporting convention, 33 states reported less than five percent of their pension liability on the balance sheet. Of these, 16 reported no pension liability and seven states reported "net pension assets."

[41] Sheila Weinberg et al., *2014 Financial State of the States*, TRUTH IN ACCOUNTING, (Sept. 2015), http://www.truthinaccounting.org/library/doclib/FSOS-Overview.pdf.

GASB 68 is intended to make pension reporting clearer on government financial statements. It eliminates the ARC, the NPO and net pension expense. State and local governments instead report a Net Pension Liability on their balance sheets in FY 2015. States must report this information for both single-employer and multi-employer plans, as well the state's proportionate share in the multi-employer plan.

In FY 2015 most state and local governments implemented GASB 68 in their CAFRs. State reported pension debt increased from $80 billion to $537 billion. As indicated on Table C, states' overall net positions declined by 29 percent from $1.3 trillion to $956 billion, most due to the negative effect of the new standard.

Table 3 lists five states with the largest unfunded debt per taxpayer,[42] and shows how the implementation of GASB 68 has increased the recognition of unfunded pension liabilities on states' balance sheets.

**Table 3: Change in reporting for unfunded pension liabilities between GASB 27 and GASB 68**

| **Reported Unfunded Pension Liability** *(in billions)* | **2014 (GASB 27)** | **2015 (GASB 68)** | **Difference** | **2015 Per Taxpayer ($)** | **Ratio of 2015 Pension Liability to General Revenues** |
|---|---|---|---|---|---|
| New Jersey | $16.02 | $82.41 | $66.39 | $26,761 | 2.50 |
| Connecticut | $2.56 | $24.57 | $22.01 | $19,294 | 1.49 |
| Illinois | $29.28 | $108.66 | $79.39 | $26,457 | 2.52 |
| Kentucky | $3.02 | $29.65 | $26.62 | $24,074 | 2.19 |
| Massachusetts | $2.36 | $26.34 | $23.98 | $10,643 | 0.99 |

Table 4 shows how the unfunded pension liability is included on the balance sheet under GASB 68, negatively affecting the net position of these five states. In each case the state's overall net position declined under the new guidance.

42 *Id.* These five states are taken from Truth in Accounting's analysis of state fiscal performance. New Jersey, Connecticut, Illinois, Kentucky and Massachusetts are classified as worst "sinkhole states," due to the level of unfunded debt per taxpayer.

**Table 4: Change in reporting for net position between GASB 27 and GASB 68**

| Reported Net Position (in billions) | 2014 (GASB 27) | 2015 (GASB 68) | Difference | 2015 Per Taxpayer ($) | Ratio of 2015 Reported Net Position to General Revenues |
|---|---|---|---|---|---|
| New Jersey | -$29.93 | -$96.98 | -$67.04 | -$31,492 | -2.94 |
| Connecticut | -$10.18 | -$32.88 | -$22.70 | -$17,868 | -1.99 |
| Illinois | -$32.48 | -$107.62 | -$75.14 | -$26,202 | -2.50 |
| Kentucky | $20.07 | -$5.88 | -$25.95 | -$4,773 | -0.43 |
| Massachusetts | $5.98 | -$19.83 | -$25.81 | -$8,016 | -0.74 |

GASB 68's new reporting requirements have an even more pronounced effect on the net position of local governments, in particular for those in multi-employer cost sharing pension plans. Table 5 shows the change in the reported unfunded liability for several major municipal governments.

**Table 5: Change in the reported unfunded liability for municipalities under GASB 27 and GASB 68**

| Reported Unfunded Pension Liability (in millions) | 2014 (GASB 27) | 2015 (GASB 68) | Difference | 2015 Per Taxpayer ($) | Ratio of 2015 Pension Liability to General Revenues |
|---|---|---|---|---|---|
| New York City[43] | $568 | $48,686 | $48,118 | $17,731 | 0.95 |
| Los Angeles County | $0 | $6,965 | $6,965 | $2,339 | 1.00 |
| Chicago Public Schools | $3,190 | $9,501 | $6,311 | $10,935 | 2.33 |

As with the states, municipal entities' reported net positions were also adversely affected by the inclusion of the unfunded pension liability, as Table 6 shows.

**Table 6: Change in the reported unfunded liability for municipalities under GASB 27 and GASB 68**

| Reported Net Position (in millions) | 2014 (GASB 27) | 2015 (GASB 68) | Difference | 2015 Per Taxpayer ($) | Ratio of 2015 Reported Net Position to General Revenues |
|---|---|---|---|---|---|
| New York City[44] | -$126,737 | -$190,216 | -$63,479 | -$69,274 | -3.44 |
| Los Angeles County | $10,863 | $1,346 | -$9,517 | $452 | 0.19 |
| Chicago Public Schools | -$3,959 | -$11,212 | -$7,253 | -$12,904 | -2.75 |

Baca County School District in Campo, Colorado, the second smallest school district in the state, is included in this discussion as a contrast to larger municipal governments. The district participates in state's multi-employer cost sharing plan. For FY14 under GASB 27, the district did not report any unfunded pension liability. On the district's FY15 balance sheet, it reported a $1.8 million net pension liability.

| **Reported Unfunded Pension Liability** *(in thousands)* | **2014** **(GASB 27)** | **2015** **(GASB 68)** | **Difference** | **2015** **Per Taxpayer ($)** | **Ratio of 2015 Pension Liability To General Revenues** |
|---|---|---|---|---|---|
| Baca County School District (Campo, CO) | $0 | $1,772 | $1,772 | $1,453 | 1.96 |

The district's FY14 CAFR indicated the district was in good financial shape with a net position of $2.6 million. In FY15 the district's net position dropped dramatically to only $827,815.

| **Reported** **Net Position** *(in thousands)* | **2014** **(GASB 27)** | **2015** **(GASB 68)** | **Difference** | **2015** **Per Taxpayer ($)** | **Ratio of 2015 Reported Net Position to General Revenues** |
|---|---|---|---|---|---|
| Baca County School District (Campo, CO) | $2,593 | $828 | -$1,765 | $679 | 0.91 |

The largest school district in Colorado, Jefferson County, is one of the most dramatic examples of the impact of GASB 68 on how governments are reporting their financial position. For FY14 the district reported a net pension asset of $43 million under GASB 27. In the FY14 CAFR, the only mention of an unfunded pension liability was in a discussion of the new pension standard, but no amount was included. In the district's FY15 CAFR under GASB 68, a $1.54 billion net pension liability was reported.

| **Reported Unfunded Pension Liability** *(in millions)* | **2014 (GASB 27)** | **2015 (GASB 68)** | **Difference** | **2015 Per Taxpayer ($)** | **Ratio of 2015 Pension Liability to General Revenues** |
|---|---|---|---|---|---|
| Jefferson County School District, CO | -$43 | $1,536 | $1,579 | $8,053 | 2.08 |

Similarly, the district's FY14 CAFR indicated the district was in good financial shape with a net position of $623 million. For FY15 the district reports a deficit of $862 million.

| **Reported Net Position** *(in millions)* | **2014 (GASB 27)** | **2015 (GASB 68)** | **Difference** | **2015 Per Taxpayer ($)** | **Ratio of 2015 Reported Net Position to General Revenues** |
|---|---|---|---|---|---|
| Jefferson County School District, CO | $623 | -$862 | -$1,484 | -$4,517 | -1.17 |

GASB 68 is placing more of government liabilities on the balance sheet, but shortcomings remain. Despite more demanding reporting requirements for pension liabilities, governments are still given discretion that poorly affects the accuracy of the reporting. These include flexibility in the selection of reporting periods and the use of deferrals to dampen the effects of asset fluctuations.

## A. *Timing of Reporting*

Governments may report either the Net Pension Liability from the end of its fiscal year, or from the prior fiscal year. The rationale for using the prior year's NPL in current year statements is that the most current information might not be available when the report is prepared. This ensures that governments do not have to wait on their plan actuaries to calculate the

NPL in order to release the government's financial report. Although this might seem like a benign allowance that expedites financial reporting, the time-lag produces a distorted fiscal picture.

For FY15, 39 states reported the prior year's NPLs for at least one of their pension plans. The NPL is the largest liability for most governments. Pension liabilities account for 29% of total state liabilities across the 50 states. Eighteen states have a pension liability greater than one third of total liabilities. Because pension liabilities make up such a significant portion of states' finances, it makes sense to delay financial reports to wait for such pertinent information.

Furthermore, allowing governments to use a measurement date that is different than the date of the financial report is counterintuitive to the concept that a balance sheet is a snapshot of an entity's financial position at one time.[43] Governments should wait until current pension numbers are available in order to produce a timely, truthful, and transparent balance sheet.

## B. *Deferral of Reality*

In addition to the issue of timing, GASB 68 permits for another technique that suppresses the impact of the full pension debt on governments' net positions. Pension plan actuaries and administrators periodically review the validity of the assumptions (e.g. discount rate, mortality tables) used to calculate the pension liability and adjust them to accommodate changing risks and realities. Under GASB 67 and 68, such changes immediately affect the calculation of the NPL. However, instead of adjusting the pension expense in one year, the recognition of the assumption changes that relates to current employees is deferred.

To accomplish this, governments are required to report an artificial asset, called "deferred outflows of resources," which is amortized over the remaining working lives of those employees.[44] Differences between the expected earnings on plan investments and actual investment earnings are to be recognized as an artificial liability, called "deferred inflow/outflow of resources" and included in expenses over a 5-year closed period.[45]

When GASB 68 was implemented in 2014, the market value of most pension assets was higher than it had been in the preceding five years. If GASB 27's "asset smoothing" guidance were applied during the same peri-

---

43 Since New York City implemented GASB 68 for FY2013, these amounts represent 2013 and 2014 amounts.

44 GOVERNMENTAL ACCT. STANDARDS BOARD, SUMMARY OF STATEMENT NO. 68: ACCOUNTING AND FINANCIAL REPORTING FOR PENSION PLANS-AN AMENDMENT TO GASB STATEMENT NO. 27 (2012), http://gasb.org/cs/ContentServer?site=GASB&c=Pronouncement_C&pagename=GASB%2FPronouncement_C%2FGASBSummaryPage&cid=1176160219492.

45 *Id.*

od it would have resulted in a lower actuarial value of assets, and higher unfunded liability for plans. Under GASB 68, the NPL is calculated using the current market value and reported on the balance sheet. The difference between the NPL calculated at market value and the NPL calculated based on 5-year smoothing is reported as deferred inflows of resources.[46] GASB 68 then requires governments to include in pension expense an amount to amortize this liability over five years.

The rationale for this practice is to avoid dramatic swings in pension expenses and income statements due to volatility in the market value of pension assets.[47] For example, if the market value of the assets improved a great deal in one year and this change was included in the pension expense, then the pension expense would be less. This may prompt elected officials to contribute less into the plan even though these gains could be short lived. Conversely a government's pension expense could be significantly increased because of current year market losses. To some this could indicate the contributions to the pension plan should be greatly increased.

Because the pension expense affects the government's net income, a large increase in the market value of the pension assets could result in an income statement that indicates the government ran a large surplus in one year. But an increase in the pension assets' market value does not equate to money that can be spent on government operations. On the other hand, a huge market decline like the one experienced from 2007 to 2009 would increase the pension expense and result in a huge reported deficit. The governments could not tax enough in one year to offset this deficit. But historically downturns in the market value of assets have rebounded.

GASB 68 also permits for deferrals that take into account contributions and investment gains and losses after the measurement date. For example, if the government reports in its FY 2015 report the NPL as of June 30, 2014, the contributions made to the plans during the FY15 would be included in the government's deferred outflows. The effect is to increase the government's net position.[48]

---

46 *Id.*

47 It is argued that including the impact of dramatic swings in the market value of pension assets in the government's pension expense and the resulting net income would put a focus on short-term investment earnings or losses, while pension measurements should be viewed in an ongoing context. *See* GOVERNMENTAL ACCT. STANDARDS BOARD, STATEMENT NO. 68: ACCOUNTING AND FINANCIAL REPORTING FOR PENSION PLANS-AN AMENDMENT TO GASB STATEMENT NO. 27 ¶ 269 (2012), http://gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160220621.

48 GASB Statement No. 71: Pension Transition for Contributions Made Subsequent to the Measurement Date amends GASB 68 allowing governments, for whom its is "not practical" to determine the investment gains or losses and other NPL activity since the measurement date, to only record the deferred outflow (an increase in net position). This could result in an artificial overstatement of a government's net position.

In addition to creating mass confusion, the use of these deferrals cushions the governments' financial statements from the real impact of changes in pension assumptions and market value. Governments' pension expenses and resulting net incomes do not include the real results of the market and the true impact of up-to-date actuarial calculations. The distortion of market or economic reality results in a distorted picture of governments' net positions.

If governments are going to offer and manage defined benefit plans, elected officials need to be aware of the fact that there are risks, including market volatility, involved. Factors like the long term nature of the plans and the short term nature of market fluctuations should be considered as a part of a responsible decision making process, not as a part of accounting rules.

## IV. RECOMMENDATIONS

Based on our analysis we recommend the following:

1) GASB continue to assess current guidance in light of the economic and financial literature on the selection of the discount rate.

2) With current GASB rules in place, consistent and transparent application requires the governments evaluate historical funding behaviors when determining when plan assets will be depleted and when the blended rate applied is applied.

3) Require governments to wait until current pension numbers are available in order to produce a timely, truthful, and transparent balance sheet.

4) Eliminate confusing deferrals, except those that relate to activity in the unfunded liability since the measurement date.

## CONCLUSION

The implementation of GASB 67 and 68 was intended to improve the accuracy and transparency of measurement and reporting for U.S. public sector pension plans. Each of these standards has had a mixed effect. GASB 67 put an end to practice of "asset smoothing" which allowed actuaries to average five years of actual market returns on pension assets to dampen swings in market performance and make contributions more predicable for sponsors. Now plans must report assets on a market value basis providing a more accurate measure of plan status. On the liability side, GASB 67 has replaced a flawed approach to measuring pension liabilities with an approach that is highly subjective producing arbitrary results. Contrary to expectations and early analysis, GASB 67 may create an incentive for actuaries to project robust funding levels far into the future to avoid calculating and reporting large unfunded liabilities. Of 144 plans assessed, only 13 plans applied the more stringent "blended" discount rate to value their liabilities. There is variation in how these plans assessed and measured their liabilities producing an uneven range of outcomes. New Jersey projected asset run out dates much sooner leading the state to report a doubling unfunded liabilities. Despite having weaker funding levels than New Jersey, Illinois projected it would not run out of assets until 2066 allowing it to report lower unfunded liabilities than the previous year.

GASB 68's fix for state and local government financial reports is also mixed. State and local governments are now required to report more of the unfunded liability on the state's balance sheet. Previously, under GASB 27, the information states presented on their balance sheet regarding pensions was misleading. The Net Pension Obligation was a measure of how much governments should have contributed annually to the plan compared to how much was contributed, not a measure of plan underfunding. The total unfunded liability was included elsewhere in the CAFR for single employer plans, and unreported for multi-employer plans. The effect was to present a confusing and incomplete picture of government's overall fiscal health. GASB 68 addresses this by requiring governments to report the unfunded pension liability on the balance sheet. The result is that states' net position declined in FY 2015 due to the size of these obligations. Alongside this improvement in transparency and accuracy are the continuation of accounting assumptions that obscure the true fiscal picture of pensions. GASB 68 permits states to present previous fiscal year information in the current year. And it allows for the continuation of a form of asset smoothing in how pension expenses (not pensions) are reported. Though these measures are justified as providing flexibility and practicality for governments, they only contribute to an artificial picture of a state's true fiscal results and thus affect important decisions on how states use resources.

APPENDIX

**Table B - Reported Unfunded Pension Liabilities**

| **Reported Unfunded Pension Liability** *(in billions)* | **2014 (GASB 27)** | **2015 (GASB 68)** | **Difference** | **2015 Per Taxpayer ($)** | **Ratio of 2015 Pension Liability to General Revenues** |
|---|---|---|---|---|---|
| Alabama | $0.00 | n/a | | | |
| Alaska | -$0.01 | $6.29 | -$6.30 | $23,042 | 1.57 |
| Arizona | $0.00 | $4.91 | -$4.91 | $2,634 | 0.35 |
| Arkansas | $0.00 | $1.22 | -$1.22 | $1,607 | 0.15 |
| California | $10.96 | $74.46 | -$63.50 | $6,496 | 0.52 |
| Colorado | $0.00 | $9.15 | -$9.15 | $4,969 | 0.80 |
| Connecticut | $2.56 | $24.57 | -$22.01 | $19,294 | 1.49 |
| Delaware | $0.12 | $0.74 | -$0.62 | $2,337 | 0.17 |
| Florida | $0.00 | $4.23 | -$4.23 | $706 | 0.10 |
| Georgia | $0.00 | $5.82 | -$5.82 | $2,175 | 0.28 |
| Hawaii | $0.00 | $5.76 | -$5.76 | $12,084 | 0.79 |
| Idaho | $0.01 | $0.21 | -$0.19 | $461 | 0.06 |
| Illinois | $29.28 | $108.66 | -$79.39 | $26,457 | 2.52 |
| Indiana | $1.07 | $11.88 | -$10.80 | $5,896 | 0.64 |
| Iowa | $0.06 | $0.83 | -$0.77 | $802 | 0.10 |
| Kansas | $0.00 | $2.00 | -$2.00 | $2,206 | 0.22 |
| Kentucky | $3.02 | $29.65 | -$26.62 | $24,074 | 2.19 |
| Louisiana | $0.26 | $8.80 | -$8.54 | $6,888 | 0.76 |
| Maine | $0.03 | $1.93 | -$1.90 | $4,334 | 0.45 |
| Maryland | $3.51 | $16.65 | -$13.14 | $7,931 | 0.82 |
| Massachusetts | $2.36 | $26.34 | -$23.98 | $10,643 | 0.99 |
| Michigan | $0.74 | $6.17 | -$5.43 | $2,021 | 0.21 |
| Minnesota | $0.14 | $3.49 | -$3.35 | $1,796 | 0.14 |
| Mississippi | $0.00 | $4.26 | -$4.26 | $5,944 | 0.53 |
| Missouri | $0.12 | $4.83 | -$4.71 | $2,637 | 0.41 |
| Montana | $0.00 | $1.56 | -$1.56 | $4,684 | 0.55 |

**Table B - Reported Unfunded Pension Liabilities (continued)**

| **Reported Unfunded Pension Liability** *(in billions)* | **2014 (GASB 27)** | **2015 (GASB 68)** | **Difference** | **2015 Per Taxpayer ($)** | **Ratio of 2015 Pension Liability to General Revenues** |
|---|---|---|---|---|---|
| Nebraska | $0.00 | $0.18 | -$0.18 | $291 | 0.03 |
| Nevada | $0.00 | $2.04 | -$2.04 | $2,304 | 0.37 |
| New Hampshire | $0.01 | $0.83 | -$0.83 | $1,636 | 0.37 |
| New Jersey | $16.01 | $82.40 | -$66.39 | $26,760 | 2.50 |
| New Mexico | $0.00 | $3.63 | -$3.63 | $6,454 | 0.45 |
| New York | $2.74 | $2.77 | -$0.03 | $436 | 0.03 |
| North Carolina | -$0.01 | $0.69 | -$0.70 | $247 | 0.02 |
| North Dakota | $0.00 | $0.37 | -$0.37 | $1,261 | 0.06 |
| Ohio | $0.03 | $5.04 | -$5.01 | $1,309 | 0.17 |
| Oklahoma | $0.11 | $1.57 | -$1.46 | $1,445 | 0.16 |
| Oregon | -$1.48 | -$0.63 | -$0.85 | -$500 | -0.09 |
| Pennsylvania | -$0.01 | $14.00 | -$14.00 | $3,292 | 0.40 |
| Rhode Island | $0.01 | $3.16 | -$3.16 | $8,683 | 0.94 |
| South Carolina | $0.01 | $5.12 | -$5.11 | $3,762 | 0.48 |
| South Dakota | $0.00 | -$0.28 | $0.28 | -$954 | -0.15 |
| Tennessee | $0.00 | $0.68 | -$0.68 | $360 | 0.04 |
| Texas | $5.42 | $35.87 | -$30.45 | $4,608 | 0.65 |
| Utah | $0.00 | $1.07 | -$1.07 | $1,340 | 0.14 |
| Vermont | $0.20 | $1.31 | -$1.11 | $5,783 | 0.42 |
| Virginia | $3.33 | $6.80 | -$3.46 | $2,448 | 0.28 |
| Washington | $0.38 | $3.92 | -$3.54 | $1,603 | 0.21 |
| West Virginia | -$0.78 | $3.57 | -$4.36 | $6,843 | 0.55 |
| Wisconsin | $0.00 | -$0.77 | $0.77 | -$388 | -0.05 |
| | $0.00 | $0.41 | -$0.42 | $2,020 | 0.11 |
| | | | | | |
| Total | $2,094.20 | $2,553.18 | -$457.97 | | |

**Table C - Reported Net Position**

| **Reported Net Position** *(in billions)* | **2014 (GASB 27)** | **2015 (GASB 68)** | **Difference** | **2015 Per Taxpayer ($)** | **Ratio of 2015 Reported Net Position to General Revenues** |
|---|---|---|---|---|---|
| Alabama | $34.86 | n/a | | | |
| Alaska | $89.76 | $79.39 | -$10.37 | $290,718 | 19.87 |
| Arizona | $26.72 | $23.75 | -$2.97 | $12,741 | 1.68 |
| Arkansas | $15.79 | $16.58 | $0.79 | $21,788 | 2.01 |
| California | $30.93 | -$16.83 | -$47.76 | -$1,468 | -0.12 |
| Colorado | $25.83 | $18.23 | -$7.60 | $9,907 | 1.59 |
| Connecticut | -$10.18 | -$32.88 | -$22.70 | -$25,825 | -1.99 |
| Delaware | $5.82 | $4.78 | -$1.04 | $15,111 | 1.09 |
| Florida | $124.73 | $125.89 | $1.16 | $21,002 | 3.01 |
| Georgia | $29.78 | $26.42 | -$3.36 | $9,871 | 1.25 |
| Hawaii | $8.08 | $2.72 | -$5.36 | $5,716 | 0.37 |
| Idaho | $12.10 | $12.50 | $0.39 | $27,732 | 3.44 |
| Illinois | -$32.48 | -$107.62 | -$75.14 | -$26,202 | -2.50 |
| Indiana | $33.24 | $25.38 | -$7.87 | $12,600 | 1.37 |
| Iowa | $19.53 | $19.20 | -$0.33 | $18,472 | 2.26 |
| Kansas | $17.66 | $15.61 | -$2.05 | $17,249 | 1.73 |
| Kentucky | $20.07 | -$5.88 | -$25.95 | -$4,773 | -0.43 |
| Louisiana | $16.61 | $6.22 | -$10.39 | $4,871 | 0.54 |
| Maine | $6.43 | $4.58 | -$1.85 | $10,300 | 1.07 |
| Maryland | $17.47 | $4.45 | -$13.03 | $2,118 | 0.22 |
| Massachusetts | $5.98 | -$19.83 | -$25.81 | -$8,016 | -0.74 |
| Michigan | $27.09 | $23.88 | -$3.20 | $7,817 | 0.82 |
| Minnesota | $29.74 | $26.67 | -$3.06 | $13,711 | 1.04 |
| Mississippi | $20.00 | $16.18 | -$3.82 | $22,590 | 2.00 |
| Missouri | $37.30 | $34.02 | -$3.28 | $18,567 | 2.88 |
| Montana | $10.71 | $9.52 | -$1.19 | $28,507 | 3.34 |

**Table C - Reported Net Position (continued)**

| Reported Net Position *(in billions)* | 2014 (GASB 27) | 2015 (GASB 68) | Difference | 2015 Per Taxpayer ($) | Ratio of 2015 Reported Net Position to General Revenues |
|---|---|---|---|---|---|
| Nebraska | $18.24 | $18.37 | $0.13 | $29,456 | 3.00 |
| Nevada | $8.77 | $7.11 | -$1.66 | $8,009 | 1.30 |
| New Hampshire | $4.31 | $3.51 | -$0.80 | $6,881 | 1.56 |
| New Jersey | -$29.93 | -$96.98 | -$67.04 | -$31,492 | -2.94 |
| New Mexico | $19.39 | $28.20 | $8.81 | $50,133 | 3.50 |
| New York | $65.98 | $72.52 | $6.54 | $11,408 | 0.89 |
| North Carolina | $65.46 | $68.86 | $3.40 | $24,531 | 2.46 |
| North Dakota | $17.78 | $20.12 | $2.34 | $69,462 | 3.54 |
| Ohio | $44.90 | $38.16 | -$6.74 | $9,917 | 1.28 |
| Oklahoma | $27.33 | $26.51 | -$0.83 | $24,385 | 2.67 |
| Oregon | $23.45 | $23.71 | $0.26 | $18,918 | 3.26 |
| Pennsylvania | $26.26 | $15.00 | -$11.26 | $3,529 | 0.43 |
| Rhode Island | $3.86 | $1.22 | -$2.64 | $3,349 | 0.36 |
| South Carolina | $28.72 | $24.18 | -$4.54 | $17,765 | 2.26 |
| South Dakota | $7.68 | $8.11 | $0.42 | $28,066 | 4.43 |
| Tennessee | $38.80 | $39.02 | $0.22 | $20,760 | 2.56 |
| Texas | $176.11 | $148.27 | -$27.84 | $19,048 | 2.68 |
| Utah | $29.60 | $30.14 | $0.54 | $37,650 | 3.91 |
| Vermont | $3.03 | $2.10 | -$0.94 | $9,255 | 0.68 |
| Virginia | $46.55 | $44.79 | -$1.76 | $16,137 | 1.82 |
| Washington | $23.74 | $21.43 | -$2.31 | $8,755 | 1.14 |
| West Virginia | $14.28 | $9.90 | -$4.39 | $18,962 | 1.52 |
| Wisconsin | $23.84 | $26.90 | $3.06 | $13,640 | 1.65 |
| Wyoming | $26.34 | $26.71 | $0.37 | $130,405 | 6.85 |
| | | | | | |
| Total | $3,352.08 | $2,935.78 | -$382.44 | | |

# RECOGNIZING TAXPAYERS AS STAKEHOLDERS IN MUNICIPAL BANKRUPTCIES

*Diane Lourdes Dick*

## INTRODUCTION

Recent large municipal bankruptcy cases have called into question the rights of debtor-cities to impair their capital markets creditors, on the one hand, and beneficiaries of their unfunded public pension promises, on the other. As I show in a companion work,[1] federal bankruptcy law generally allows debtors to impair each of these obligations. However, heightened judicial scrutiny may apply to plans that are crammed down on public pension benefit recipients.[2] Moreover, debtors and their stakeholders may still agree for a variety of reasons to pursue restructuring plans that preserve public pensions and impair the claims of capital markets creditors.[3]

But for all the focus on these two dominant creditor classes,[4] an important stakeholder—the debtor-city's taxpaying residents—has been largely overlooked in the public discourse. By "taxpaying resident," I mean persons who reside in the debtor-city and are subject to taxes (such as sales and property taxes) that are assessed and levied by the debtor-city to support services and infrastructure. This key stakeholder is likely to play a central role in the case, and is not only substantially impacted by the bankruptcy filing but also capable of substantially impacting any proposed restructuring plan. This is because, in an emerging prototype of municipal bankruptcy restructuring, debtor-cities slash services in the years and months leading up to the bankruptcy filing, and also rely in large part on tax increases to support their plans to exit bankruptcy with a stronger fiscal

---

1 Diane Lourdes Dick, *Bondholders vs. Retirees in Municipal Bankruptcies: The Political Economy of Chapter 9*, AM. BANKR. L.J. (forthcoming 2018).

2 *See* Amended Opinion Regarding Confirmation and Status of CalPERS at 47, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. Feb. 4, 2015).

3 *See, e.g.*, Daniel Gill, *San Bernardino's Debt Adjustment Plan Approved*, BLOOMBERG BNA (Feb. 22, 2017) (reporting on San Bernardino's consensual Chapter 9 plan of adjustment that severely impairs capital markets creditors while maintaining public pensions).

4 On the primacy of the conflict between bondholders, on the one hand, and public pension claimants, on the other in municipal bankruptcy, *see, e.g.*, Maria O'Brian Hylton, *Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings*, 59 WAYNE L. REV. 525 (2014); Daniel Fisher, *Municipal Bankruptcies Set Up War Between Pensioners and Bondholders*, FORBES (Apr. 3, 2013, 9:49 AM), http://www.forbes.com/sites/danielfisher/2013/04/03/muni-bankruptcies-set-up-war-between-pensionersand-bondholders/.

foundation.[5] This Article considers whether and to what extent a debtor-city's taxpaying residents are considered parties to the bankruptcy case, and whether they should have formal representation and a seat at the bankruptcy negotiation table. I join a small chorus of scholars and practitioners who argue that taxpaying residents should be granted standing and formal representation in the proceedings. To this body of work, I contribute an examination of whether and to what extent taxpaying residents are "stakeholders" of municipal debtor-cities under prevailing stakeholder analysis methodology.

This Article proceeds as follows. Part I introduces a detailed case study of a recent large municipal bankruptcy, that of the City of Stockton, California, paying particular attention to the ways in which taxpaying residents attempted unsuccessfully to interject in the proceeding and obtain an official taxpayers committee. Part II introduces recent scholarly and practice-oriented literature exploring the role of taxpaying residents in Chapter 9 bankruptcy, and considers how these interested persons may be classified under the Bankruptcy Code. This Part also contemplates the prevailing wisdom and methods of stakeholder analysis to determine whether the interests of taxpayers are adequately represented in prevailing Chapter 9 law and practice. Part III concludes.

## I. CASE STUDY: STOCKTON, CALIFORNIA

This section introduces a large and prominent municipal bankruptcy case—that of the City of Stockton, California—to provide a recent example of taxpaying residents attempting to gain influence in a Chapter 9 bankruptcy proceeding. By examining the arguments these taxpayers raised and the responses they received from the other parties, I attempt to provide richer context for the legal and theoretical questions taken up in subsequent sections.

On June 28, 2012, Stockton filed for bankruptcy protection in the U.S. Bankruptcy Court for the Eastern District of California.[6] The city's council had disclosed earlier that year that the city was unable to meet its financial obligations as they became due.[7] After months of mediation, city officials determined that only bankruptcy would offer the necessary breathing room

---

5 The emerging prototypical municipal bankruptcy restructuring is described in Dick, *supra* note 1.

6 Voluntary Petition of City of Stockton, California, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. June 28, 2012).

7 Declaration of Marc A. Levinson at 2, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. June 29, 2012).

to deal with spiraling public pension costs, burdensome bond debts, and other crippling secured and unsecured short- and long-term liabilities.[8]

In declarations explaining the decision to file for bankruptcy, city officials painted a bleak picture of a municipality that had been severely impacted by the housing bubble and bust. They described how tax revenues dried up while expenses swelled, leaving residents to endure "severe reductions in staffing and services, with serious repercussions to the safety and welfare of the City's residents,"[9] delayed response by public safety departments, which "potentially places people and structures at greater risk,"[10] and drastic reductions in community educational and recreational programming.[11] One official summarized the city's condition at the time of its bankruptcy filing thusly: "The City is not only already cash-insolvent. It is service-insolvent as well."[12] In other words, not only was the city unable to *pay* for necessary services; it was also failing to provide them.

Stockton's petition for relief—like all municipal bankruptcy filings—was governed by Chapter 9,[13] a portion of the U.S. Bankruptcy Code[14] devoted exclusively to the reorganization of municipalities, villages, counties, taxing districts, municipal utilities, and school districts.[15] Tucked between Chapter 7,[16] which addresses individual and business liquidations, and Chapter 11,[17] which deals primarily with individual and business reorganizations, Chapter 9 strikes a delicate constitutional balance between the federal government's authority to regulate bankrupt persons and the state's power to govern its political affairs.[18] In legislative history, drafters acknowledged that in Chapter 9, "[t]he powers of the court are subject to a strict limitation—that no order or decree may in any way interfere with the political or governmental powers of the petitioner, the property or revenue of the petitioner, or any income producing powers."[19]

Precisely because of these federalism concerns, Stockton's bankruptcy would follow a different path than most consumer and business bankrupt-

---

8 *Id.*

9 Declaration of Laurie Montes at 8-9, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. June 29, 2012).

10 *Id.* at 9.

11 *Id.*

12 *Id.* at 14.

13 11 U.S.C. §§ 901–946.

14 All references herein to the "Bankruptcy Code" or the "Code" are to the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101 et. seq.).

15 On the definition of "municipality," *see* Michael J. Deitch, *Time for an Update: A New Framework for Evaluating Chapter 9 Bankruptcies*, 83 FORDHAM L. REV. 2705 (2015).

16 11 U.S.C. §§ 701–784 (providing for liquidations of bankrupt persons).

17 11 U.S.C. §§ 1101–1174 (providing for reorganizations and liquidations of bankrupt persons).

18 *See generally* 11 U.S.C. §904; Ashton v. Cameron County Water Improvement Dist. No. 1, 298 U.S. 513, 538 (1936) (articulating the federalism issues inherent in municipal bankruptcy law).

19 121 CONG. REC. H39409–10 (daily ed. Dec. 9, 1975) (statement of Rep. Edwards).

cies. For instance, unlike Chapter 7, Chapter 9 offers no mechanism for liquidating assets and distributing proceeds to claimants. Instead, municipal debtors must negotiate with their creditors and obtain consensus to (and judicial confirmation of) a plan of adjustment to restructure debts and other obligations.[20] To this end, Chapter 9 bankruptcy process is similar to Chapter 11, in that the outcome of the case is determined to a large extent by party negotiations and settlements rather than judicial edict.[21]

But in Chapter 9, the U.S. Trustee and the bankruptcy court have even *less* control over the conduct of the debtor.[22] In fact, the court's exercise of its judicial powers over a municipal debtor primarily occurs at the commencement of the case, when the court must decide if the debtor is even eligible for bankruptcy protection. A city such as Stockton seeking to obtain relief under Chapter 9 must show that it is a municipality[23] authorized by the state to file for bankruptcy protection,[24] that it is "insolvent" (meaning for these purposes that the municipality is "generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or…unable to pay its debts as they become due."),[25] that it desires to effect a plan to adjust its debts,[26] and that it has negotiated in good faith with its creditors or that such negotiations would be futile.[27] The city bears the burden of proving that it satisfies each eligibility requirement.[28]

In *Stockton*, the city's eligibility for bankruptcy protection was hotly contested.[29] In first-day filings, the city identified the California Public Employees' Retirement System ("CalPERS")—overseer of the city's employee pension plan—as its largest creditor, holding an estimated $148 million contingent, unliquidated claim for unfunded pension costs.[30] The city's next largest debts consisted of approximately $124 million in pension obligation bonds, $40 million in variable rate demand obligations, $35 million in public facilities fees bonds, and $32 million in parking garage construc-

---

20 Plan confirmation requirements are set forth in 11 U.S.C. §943(b).

21 I explore this phenomenon in the Chapter 11 context in Diane Lourdes Dick, *The Chapter 11 Efficiency Fallacy*, 2013 B.Y.U. L. REV. 759 (2013).

22 *See, e.g.*, Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281 (2012); Michael W. McConnell & Randall C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425 (1993).

23 11 U.S.C. §109(c)(1).

24 11 U.S.C. §109(c)(2).

25 11 U.S.C. §109(c)(3).

26 11 U.S.C. §109(c)(4).

27 11 U.S.C. §109(c)(5).

28 *See, e.g.*, Int'l Ass'n of Firefighters, Local 1186 v. City of Vallejo, 408 B.R. 280, 289 (9th Cir. BAP 2009).

29 *See, e.g.*, National Public Finance Guarantee Corporation's Objection to the City of Stockton's Qualifications, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. Aug. 8, 2012).

30 List of Creditors Holding 20 Largest Unsecured Claims, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. June 28, 2012).

tion bonds.[31] Certain of these capital markets creditors[32] complained that the city had failed to negotiate in good faith with its creditors in an effort to avoid bankruptcy; they pointed to the fact that the city sought concessions from its capital markets creditors without seeking concessions from CalPERS.[33] In a pointed objection, one creditor alleged, "the City's entire purpose in filing this case has been to force...the…Capital Markets Creditors to pay for otherwise-unfunded benefits to labor—including CalPERS' ever-increasing pension benefit costs."[34] CalPERS, for its part, argued that the city's decision to pay pension-related claims in full and thereby maintain the relationship for the benefit of employees and retirees was a lawful exercise of business judgment.[35] Following a three day trial, the court decided in March 2013 that the city was eligible for Chapter 9 bankruptcy.

Attention then shifted to negotiating and finalizing the city's plan of adjustment so that it could exit bankruptcy with restructured finances. In *Stockton*, as in most large and complex bankruptcy cases, the most important, preliminary question was *who* would be recognized as having a seat at the negotiation table. In other words, who would the debtor and the court recognize as parties to the case, and what role would they be permitted to play in the proceedings?

The question is more complex than it may initially appear. For instance, although the debtor identified CalPERS as its largest creditor, the true owners of retirement benefit claims were the city's approximately 2,400 retirees. These individuals were initially represented in pre- and post-petition negotiations by the Association of Retired Employees of the City of Stockton, which advocated not only with respect to public pension benefits, but also with respect to retiree health care benefits.[36] And of course, CalPERS and the various employee labor unions advocated powerfully on behalf of public pension benefit recipients. But the U.S. Trustee would eventually appoint an official committee to also represent retirees. The U.S. Trustee has the authority to form this and other official commit-

---

31 *Id.*

32 I use the term "capital markets creditors" to refer generally to persons holding claims that originated from capital markets transactions, such as bond issuances. In many bankruptcy cases, such claims are held by bond insurers and other providers of financial guaranty insurance.

33 CalPERS is the country's largest government worker pension fund. On the fund's history, *see generally* Steven Malanga, *The Pension Fund That Ate California: CalPERS's corruption, insider dealing, and politicized investments have overwhelmed taxpayers with debt*, CITY JOURNAL, Winter 2013 (alleging that the fund's poor investment choices and mismanagement have crippled California's public finances).

34 Supplemental Objection of Assured Guaranty Corp. and Assured Guaranty Municipal Corp., *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. Dec. 14, 2012).

35 CalPERS Brief in Support of the City of Stockton's Petition, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. Feb. 15, 2013).

36 *See, e.g.*, Complaint for Declaratory and Injunctive Relief, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. July 1, 2013).

tees because Chapter 9 broadly incorporates[37] a provision of Chapter 11 that authorizes formation of "committees of creditors or of equity security holders as the [U.S. Trustee] deems appropriate."[38] Meanwhile, the city's capital markets creditors advocated on their own behalf during the proceedings. This is because, in contrast to Chapter 11, unsecured creditors' committees are not mandatory in Chapter 9. In further contrast to Chapter 11, Chapter 9 does not require debtors to shoulder the costs of attorneys and other professionals retained by official committees,[39] although debtors frequently agree to do so anyway.

Of course, even if the debtor-city declines to assume the costs of committee professionals, statutory committees still provide important benefits for stakeholders.[40] For one thing, official committees are generally regarded as having a seat at the negotiation table, meaning that courts will expect debtors to work with them to achieve consensual resolution of conflicts. Moreover, so-called statutory committees have important discovery rights, including the power to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor."[41]

In light of these important benefits, another group attempted to gain official committee status in *Stockton*. The self-described "Ad Hoc Taxpayers of Stockton Working Group" began to interject in the proceedings and also petitioned for an official taxpayers committee.[42] Initially, the members of the working group—five taxpaying residents of Stockton—were concerned that the city's plan of adjustment contemplated tax increases; later, they were concerned about the nature of the financial disclosures provided by the city to the voting public.

Although a Chapter 9 plan of adjustment may depend on tax increases for increased revenue, the plan itself is not necessarily capable of implementing the tax increase. This is because debtors are required to satisfy any legal conditions precedent to taking proposed actions under a plan of restructuring,[43] and this includes compliance with state or local laws requiring

---

37 11 U.S.C. §901.

38 11 U.S.C. §1102.

39 11 U.S.C. §901 (omitting sections 327 through 331 of the Bankruptcy Code, which govern matters relating to employment and compensation of professionals). It is important to note, however, that Chapter 9 incorporates Section 503 of the Bankruptcy Code, which contemplates that any person who can demonstrate that they have made a "substantial contribution" to the case may seek payment of costs and expenses, including professional fees. 11 U.S.C. §901.

40 I've considered this argument in the somewhat analogous context of Chapter 11. Diane Lourdes Dick, *Grassroots Shareholder Activism in Large Commercial Bankruptcies*, 40 J. CORP. L. 1 (2014). On recent developments in leading cases, see Ana Lucía Hurtado, *The Equity Committee Trend: When Shareholders of a Bankrupt Company Hope to Get More Than Nothing*, FORBES, Oct. 14, 2016.

41 11 U.S.C. §1103(c).

42 City's Submission of Response to Request for Appointment of Official Taxpayers' Committee at 1, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. July 1, 2013).

43 11 U.S.C. §943(b)(4).

voter approval of tax increases. Under the California State Constitution, cities must obtain the approval of a majority of voters for any new or increased general taxes, with a two-thirds majority approval required for any new or increased special taxes.[44] In first-day filings, city officials acknowledged the difficulty of meeting or exceeding these vote thresholds: "Obtaining voter approval for new taxes…is highly speculative under normal circumstances. It is even more uncertain given the City's historically high rates of foreclosures and unemployment and public concern over the City's past practices, including in establishing an overly generous retiree health program and incurring debt it now cannot afford to pay."[45]

Despite the political challenges, Stockton's proposed plan of adjustment relied upon a three-quarter cent sales tax increase ("Measure A").[46] The debtor explained, "[t]his Plan is predicated upon passage of Measure A. If Measure A fails to pass, the City will be compelled to implement a plan of adjustment that further slashes staffing and services provided by the City to its residents and will likely be unable to consummate the proposed settlements."[47] Then, to comply with California law, the plan also contemplated that the city would place the tax measure on the November 2013 ballot to gain the requisite majority approval.

In the months leading up to the November 2013 election, members of the taxpayers' working group were concerned that the city would not provide sufficient information about the nature of the increases and the intended uses of funds raised.[48] Specifically, the working group complained that the city publicly characterized tax increases as necessary to hire additional police officers, but did not actually file detailed plan-related disclosures containing any "enforceable commitment to hire and train police officers."[49] They argued that an official taxpayers committee was necessary to help the debtor overcome these and other deficiencies.

But the city vehemently opposed the appointment of an official taxpayers committee on the grounds that such a committee was not explicitly authorized by the Bankruptcy Code and, even if the Bankruptcy Code per-

---

44 Declaration of Vanessa Burke at 10, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. July 3, 2012).

45 *Id.*

46 Plan of Adjustment at 76, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. Oct. 10, 2013). Although the draft proposed plan was not released until October, the City Council had introduced Measure A months earlier at an emergency meeting. Ad Hoc Taxpayers Working Group's Submission of Reply to City's Response to Request to Appoint Official Taxpayer Committee at 2, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. July 8, 2013).

47 Plan of Adjustment at 76, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. Oct. 10, 2013).

48 Ad Hoc Taxpayers Working Group's Submission of Reply to City's Response to Request to Appoint Official Taxpayer Committee at 2, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. July 8, 2013.

49 *Id.* at 3.

mitted formation of such a committee, "such an appointment would be an affront to the only legitimate representatives of the taxpayers of Stockton—the duly elected City Council."[50] Drawing an analogy to a 2001 case in which a court overseeing a utility company's bankruptcy restructuring declined to order the appointment of an official ratepayers committee, the city argued that there is simply no legal basis for forming a taxpayers committee.[51] Moreover, the debtor pointed to the City Charter, which establishes a City Council, concluding that it is "flat out wrong" to claim that taxpayers have no representation.[52]

In a responsive pleading, the members of the working group agreed to table their demand for an official taxpayers committee.[53] However, they rearticulated their view that the debtor "needs the support of the taxpayers" in order to realize its plan of adjustment, and admonished the debtor for its outright "hostility" towards the working group.[54] Suggesting that taxpayers could not rely upon elected leaders to adequately represent them, the working group described the findings of a recent state audit of city finances: "The audit found the City's audit controls were ineffective....In summary, the audit report states, 'We found the potential for waste, fraud and abuse of public resources is extremely high due to numerous deficiencies.'"[55] The working group also emphasized its demand that "adequate information [be made] available for all of the City's taxpayers to review the City's plan of adjustment and make a decision on the tax increase."[56] Finally, the working group argued that the members of the working group—whether as an ad hoc or official committee—had an important role to play in the case: "The Working Group stands for transparency regarding the tax increase and the bankruptcy process—which the residents of Stockton are not receiving and the City seems determined to prevent."[57]

In the weeks and months that followed, the working group continued to intervene in the case to advance three goals: "to analyze and review on behalf of taxpayers the proposed tax increase…to ensure the Debtor's proposed plan provides the taxpaying residents a sufficient and reasonably acceptable level of health, safety and welfare services, and…to work with

---

50 City's Submission of Response to Request for Appointment of Official Taxpayers' Committee at 2, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. July 1, 2013).

51 *Id.* at 3. (discussing Memorandum Decision Regarding Motion for Order Vacating Appointment of Committee of Ratepayers, *In re* Pacific Gas & Electric Co., No. 01-30923 (Bankr. N.D.Cal. May 21, 2001).

52 *Id.*

53 Ad Hoc Taxpayers Working Group's Submission of Reply to City's Response to Request to Appoint Official Taxpayer Committee at 3, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. July 8, 2013).

54 *Id.* at 1.

55 *Id.* at 2.

56 *Id.* at 2.

57 *Id.* at 3.

the Debtor and all of the constituencies to ensure the plan of adjustment is feasible…and fiscally sustainable."[58] Over the working group's objections, the City Council unanimously approved putting the sales tax increase on the November 2013 ballot, clarifying that 35% of the associated tax revenues would go towards the city's general fund, while 65% would be used to enhance public safety.[59] Meanwhile, the City Council warned that if the tax measure failed to pass, financial consequences for the city would be profound: "Parks and libraries would be shut altogether. The fire department budget, already reduced 37 percent, would be cut an additional 14 percent."[60] In the campaigning period, supporters of the tax measure primarily argued that the new revenue was needed to bring about an end to the bankruptcy case, and that it was the only way to prevent additional service reductions and restore services that had been cut in the months and years leading up to the bankruptcy case.[61]

But it also appears that there was at least some misinformation circulated during the campaign. For instance, the "Secure Stockton" movement argued: "Municipal Bankruptcy (Chapter 9) does not eliminate the City's debt. Rather, it will restructure those debts in a way that buys time for our economy and revenues to grow, enabling the City to pay off the debt in the most equitable manner possible."[62] This statement was made notwithstanding the fact that the city had already proposed severely impairing its capital markets creditors.[63]

In a November 2013 election with a mere 21 percent voter turnout,[64] the Measure A narrowly passed, with just under 52 percent of voters favoring the tax increase.[65] And in early 2015, Stockton gained court approval of a plan of adjustment that implemented the tax increase, preserved the city's relationship with CalPERS in order to maintain retiree and employee pen-

---

58 Joinder of Ad Hoc Taxpayers Working Group to Dean Andal's Motion for Relief From Automatic Stay, Ad Hoc Taxpayers Working Group's Submission of Reply to City's Response to Request to Appoint Official Taxpayer Committee at 2, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. Aug. 5, 2013).

59 Ian McDonald, *Stockton City Council Votes Unanimously to Put Sales Tax Hike on Ballot*, FOX40 (July 10, 2013).

60 Alan Greenblatt, *What It's Like Living in a Bankrupt City*, NPR (Sept. 6, 2013).

61 CITY OF STOCKTON SALES TAX INCREASE AND ASSOCIATED ADVISORY VOTE, MEASURES A AND B (November 2013), https://ballotpedia.org/City_of_Stockton_Sales_Tax_Increase_and_Associated_Advisory_Vote,_Measures_A_and_B_(November_2013) (last visited Feb. 19, 2017).

62 *Id.*

63 *See, e.g.*, Plan of Adjustment, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. Oct. 10, 2013).

64 *Stockton Election Measures Pass, Election Turnout At 21 Percent*, CBSLOCAL (Nov. 5, 2013).

65 CITY OF STOCKTON SALES TAX INCREASE AND ASSOCIATED ADVISORY VOTE, *supra* note 60; *see also* Alison Vekshin, *Stockton Approves Sales-Tax Hike to Ease Bankruptcy Exit*, BLOOMBERG (Nov. 5, 2013).

sions, terminated certain ancillary retiree health care benefits, and also impaired capital markets creditors.[66]

In the years following *Stockton*, several prominent lawyers and academics have revisited the question of whether and to what extent taxpayers should participate as parties in interest to their city's Chapter 9 proceedings. The following Part explores these works and also contributes a novel theory of taxpayer participation and representation in municipal bankruptcies that is grounded in stakeholder analysis.

## II. DISCUSSION: RECONSIDERING TAXPAYERS AS STAKEHOLDERS

The issue of taxpayer participation and representation in Chapter 9 bankruptcy cases continues to be relatively understudied. However, although this is still fairly uncharted terrain, there have been some thoughtful and highly germane scholarly and practice-oriented contributions in the years following *Stockton*. Through legal, historical, and empirical analysis, these works help to shed new light on the questions surrounding taxpayer participation in municipal bankruptcy cases.

For instance, in a 2014 piece, bankruptcy attorney Christine Schleppegrell explored the threshold question: whether taxpaying residents are even "parties in interest" to a Chapter 9 case.[67] The inquiry is not as straightforward as it may initially appear, as Chapter 9 only explicitly confers party status on a narrow subcategory of taxpayers. In a municipal bankruptcy case, "special tax payers"[68]— meaning the owners of property that is the subject of a special assessment or tax levy—may object to confirmation of a plan that affects their interests.[69]

Beyond this narrow provision, taxpayers of a bankrupt municipality have standing to the extent they come within a much broader definition of "party in interest," which originates in Chapter 11 and is incorporated by reference into Chapter 9.[70] That provision provides that only a "party in interest" has a right to "raise and…appear and be heard on any issue."[71] The term "party in interest" is defined to include "the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee."[72] Courts have traditionally construed the inclusive definition broadly to permit board participation in

66 Amended Opinion Regarding Confirmation and Status of CalPERS, *In re* City of Stockton, California, No. 12-32118 (Bankr. E.D.Cal. Feb. 27, 2015).

67 Christine A. Schleppegrell, *Can Taxpayers Leverage the Ambiguity of "Party-in-Interest" to Enter the Chapter 9 Arena?*, 33 AM. BANKR. INST. J. 20 (2014).

68 11 U.S.C. §902(3).

69 11 U.S.C. §943(a); 11 U.S.C. §902(4).

70 11 U.S.C. §901.

71 11 U.S.C. §1109.

72 *Id.*

the case.[73] Meanwhile, federal rules of bankruptcy procedure also authorize courts to allow intervention by persons that do not otherwise have standing to participate in the case.[74] In exercising their discretion, courts should "balance the needs of a potential intervenor against any delay or prejudice which [will] result from such intervention."[75] In making the determination, courts typically focus on economic interests and whether the intervenors are already represented by parties in interest.[76]

Despite these broad and permissive standards for intervention in bankruptcy proceedings, Schleppegrell's survey of case law shows how, because of federalism concerns unique to Chapter 9, taxpayers have struggled to overcome a judicial presumption that they are merely "peripheral parties" to municipal bankruptcy cases.[77] The greatest challenges appear to be at the eligibility stage of a Chapter 9 case, when it may not be clear whether and to what extent the plan of adjustment will impact taxpayers. In contrast, landowning taxpayers have had some success intervening at the confirmation stage of the proceedings, particularly if the debtor has proposed tax increases as part of its plan of adjustment. Where courts have refused to grant taxpayers standing, they have cited the narrow purposes of Chapter 9 bankruptcy to effectuate debt adjustments, and the importance of respecting the municipality's right to manage its own policy choices and political affairs.[78] In order to make the requisite showing of a practical stake and pecuniary interest in the outcome of the case sufficient to overcome these judicial trepidations, the author recommends that taxpayers seeking to intervene in a Chapter 9 case emphasize "the effect that [any proposed] tax will have on individual citizens' finances," particularly as it relates to ongoing tax obligations and any impacts on property values.[79] Similarly, they should address any reductions in services that have occurred or that are likely to occur.[80]

Professor Christine Sgarlata Chung also argues in a 2015 article[81] that taxpaying residents should have standing in Chapter 9 cases; moreover, Professor Chung responds to arguments that taxpaying residents are already adequately represented by their elected officials. Examining legislative history of Chapter 9, she reminds that the drafters *always* recognized the

---

73 *See, e.g.*, *In re* Ionosphere Clubs, 101 B.R. 844 (Bankr. S.D.N.Y. 1989); *In re* FRG, Inc., 107 B.R. 461 (Bankr. S.D.N.Y. 1989); *In re* Public Service Co., 88 B.R. 546 (Bankr. D.N.H. 1988).

74 FED. R. BANKR. P. 2018.

75 *In re* Addison Cmty. Hosp. Auth., 175 B.R. 646, 651 (citing *In re* City of Bridgeport, 128 B.R. 686, 687 (Bankr. D. Conn. 1991)).

76 *See id.*

77 Schleppegrell, *supra* note 67, at 20.

78 *See In re* Addison Community Hosp. Authority, 175 B.R. 646 (1994).

79 Schleppegrell, *supra* note 67, at 61-62.

80 *Id.*

81 Christine Sgarlata Chung, *Municipal Bankruptcy, Essential Municipal Services, and Taxpayers' Voice*, 24 WIDENER L.J. 43 (2015).

important role residents and taxpayers play in the case, given the municipal debtor's unique status as a provider of essential public services.[82] She presents a compelling case study from Detroit's recent Chapter 9 filing, parsing through judicial decisions that emphasize the city's service insolvency and the devastating effects of the lack of basic services and infrastructure on city residents and taxpayers. Professor Chung argues that notwithstanding the obvious federalism issues that likely prevented the drafters of the Bankruptcy Code from requiring formal representation of taxpaying residents in bankruptcy proceedings, courts should use their discretion to grant taxpayers standing in appropriate cases. For instance, taxpaying residents should have standing to intervene where "[e]lected representatives may be compromised by corruption or special interest[, or where…a]ppointed officials may lack political legitimacy."[83]

In a similar way, Professor Scott Pryor also tackled the question of taxpayer participation in Chapter 9 in a 2015 article.[84] He pushed the envelope even further, arguing that taxpaying residents should not only be granted standing, but should also be afforded an opportunity to participate meaningfully in the proceedings through official taxpayers committees. He notes that because taxpayers are not classified as creditors under the Bankruptcy Code,[85] they are not entitled to vote on the debtor's proposed plan of adjustment, "which weakens whatever bargaining power they have."[86] He then considers the essential role of taxpayers in systems of governance, comparing and contrasting them to equity security holders of corporate debtors: "Taxpayers do not, of course, have a residual interest in municipal assets. On the other hand, taxpayers' long-term losses are not limited to the amount of their investment; their property is liable in perpetuity for the financial misfortunes of their municipality."[87] Moreover, he theorizes that while taxpayers do not receive distributions of property from the municipal debtor, they arguably receive distributions in the form of the ongoing services provided by the city to all residents.[88] Thus, "[a] plan that increases taxes is like a capital call on corporate shareholders, something that is not required under state or federal bankruptcy law."[89] For all of these reasons, he argues that taxpaying residents should be presumed to be parties in interest, entitled to an official taxpayers committee to represent them in the pro-

---

82 *Id.* at 55-56.

83 *Id.* at 79.

84 C. Scott Pryor, *Who Pays the Price? The Necessity of Taxpayer Participation in Chapter 9*, 24 WIDENER L.J. 81 (2015).

85 In deciding that taxpayers are not creditors, Professor Pryor considers the Bankruptcy Code's definition of the term "creditors" which refers to persons holding "claims" against the debtor. *Id.*; *see also* 11 U.S.C. §101(5); 11 U.S.C. §101(10).

86 *Id.* at 82.

87 *Id.* at 108.

88 *Id.* at 111.

89 *Id.*

ceedings.[90] He also argues that the debtor should bear the reasonable costs and expenses of the official taxpayers committee, including attorneys' fees.[91]

Meanwhile, Professor Jack Beermann has also examined the role of taxpayers in Chapter 9 in the course of an ambitious scholarly project yielding two recent articles on the public pension crisis.[92] Professor Beermann frames the issues regarding taxpaying residents and their interests in the case differently, though, arguing that, to the extent public pensions remain unfunded, the city's residents and taxpayers have been the primary beneficiaries. After all, they have enjoyed the services of city employees without fully compensating them for their labor.[93] In his view, the public pension crisis is the result of a deliberate, political strategy: "The primary pathology that led to the underfunding of public pensions is the political desire to provide more services to the public than the public is willing to pay for in current taxation."[94] Thus, to the extent a financially distressed municipality must allocate economic burdens between employees and retirees, on the one hand, and taxpaying residents, on the other, the economic burdens should be allocated to the latter.[95]

But the question of whether and how to allocate economic burdens in Chapter 9 is a separate question; presumably, this will be the focus of plan-related negotiations and confirmation proceedings. Thus, whether one believes that taxpaying residents should bear some, most, or even *all* of the economic burdens of the city's financial condition, it seems that taxpaying residents would still be recognized as important stakeholders, with more than a mere peripheral interest in the outcome of the case. To this end, an exercise known as stakeholder analysis,[96] which derives from business management studies, may provide additional assistance for courts seeking to determine whether and to what extent taxpaying residents should join the bankruptcy negotiation table.

This theoretical approach, which has been applied in recent years to other legal questions,[97] invites the analyst to focus on identifying and map-

---

90 *Id.* at 118-19.

91 *Id.*

92 Jack M. Beermann, *Resolving the Public Pension "Crisis,"* 41 FORDHAM URBAN L. J. 999 (2015) [hereinafter "2015 Article"]; Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3 (2013) [hereinafter, "2013 Article"].

93 Beermann, 2013 Article, *supra* note 92.

94 Beermann, 2015 Article, *supra* note 92.

95 *Id.*

96 *See generally* R. K. Mitchell, et. al., *Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts*, 22 ACAD. OF MANAGEMENT REV. 853 (1997).

97 *See generally* Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (with Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279

ping the stakeholders who are likely to be impacted by a plan, project, or transaction. Thoughtful consideration is given to how these stakeholders may influence the transaction, as well as how the transaction is likely to influence their interests. Sophisticated stakeholder analyses do not simply take it as a given that a particular stakeholder is represented by another stakeholder; rather, these direct and indirect relationships are explored so that parties may be properly classified as primary and secondary stakeholders.[98] Although the precise terms may vary, most analysts recognize some category of primary stakeholders, who are generally those likely to be most affected by the transaction and most critical for its long-term success, and some category of secondary stakeholders, who are less impacted by the transaction and less vital for its long-term success.[99] Meanwhile, leading proponents of stakeholder analysis urge analysts to appreciate the "intrinsic value" of stakeholders, reminding them that "they need to be treated as 'ends' rather than 'means' to succeed in achieving…objectives."[100]

Applying the prevailing insights and methods of stakeholder analysis to Chapter 9 bankruptcy, it appears that taxpaying residents are classifiable as one of the most important, primary stakeholders of a debtor-city. In their capacity as residents, they have likely endured reductions in services caused by the municipality's financial distress, and may have even suffered through service insolvency in the months or years leading up to the bankruptcy filing. They also depend on the city for its continued provision of necessary services and infrastructure. And, in their capacity as taxpayers, they are critical to the success of the plan of adjustment, particularly to the extent that it relies on tax increases. To the extent the debtor-city must obtain voter approval, then those taxpaying residents who are also voters will be even more directly critical to the success of the plan of adjustment. But even where a plan does *not* contemplate tax increases, it most likely relies on the continued maintenance of the city's existing tax revenue base, which is often the dominant source of municipal revenue. To the extent the debtor-city proposes impairing capital markets creditors, tax revenue will likely be even more important to the city in the future, as debt financing may not be as readily available.

Of course, within or outside of bankruptcy, taxpaying residents continue to be represented by their elected officials. But is this representation adequate for the purposes of representing their interests in bankruptcy? Like Professor Chung, I believe taxpayer representation in Chapter 9 is especially important when the political legitimacy of the municipal government has

(2001); Christopher R. Yukins, *Cross-Debarment: A Stakeholder Analysis*, 45 GEO. WASH. INT'L L. REV. 219 (2013).

98 *See, e.g.*, GREGOR GOSSY, A STAKEHOLDER RATIONALE FOR RISK MANAGEMENT 6 (2007) (summarizing stakeholder analysis literature).

99 *Id.*

100 *Id.* at 8.

been compromised. But even where political legitimacy it not at issue, stakeholder analysis cautions that city officials are *also* stakeholders in their own right, with unique interests and motivations that may conflict with the interests and motivations of taxpaying residents. For instance, city officials may feel pressure to satisfy the demands of other, powerful stakeholders, such as public pension claimants or capital markets creditors. These interests may compel them to work towards a plan of adjustment that placates powerful parties by allocating economic burdens to more widely dispersed stakeholders who do not have their own seat at the bankruptcy table, such as taxpaying residents. City officials may also overemphasize short-term goals and outcomes, particularly to the extent they are focused on their reelection prospects or on salvaging their own political or professional reputations. Taxpaying residents, on the other hand, are likely to focus on longer-term goals and outcomes, such as factors impacting property values over time and the quality of services and infrastructure that may benefit their children and grandchildren.[101]

Rather than causing a breakdown in democratic governance functions, bankruptcy courts that recognize taxpaying residents as parties in interest and grant them official committee status may actually help to facilitate important conversations between and among these important stakeholder classes. For instance, in jurisdictions that require voter approval of tax increases, allowing taxpaying residents to participate in the bankruptcy case may help to improve communication between municipal debtors and the voting public, and increase voter turnout for these important decisions. An official committee may, for instance, provide review of official statements from city officials to the voting public with respect to any proposed tax increases, and may also help to translate complex bankruptcy documents—including the debtor's proposed plan of adjustment—into information that taxpaying residents can more readily understand and appreciate. Similar to an advisory committee or citizen commission outside of bankruptcy, an official taxpayers committee may give taxpaying residents a vehicle to share their perspectives, consider proposals, and make recommendations to the debtor-city. For instance, an official committee could be empowered to collect public testimony and commission studies to help inform the debtor and the court on the needs and concerns of taxpaying residents. These are the roles presently played by official retirees committees in municipal bankruptcy, based upon the tacit recognition by bankruptcy courts that city officials, labor unions, and even the pension plan administrator may not be able to engage fully with the constituency to advance its interests. Taxpaying resi-

101 The unique interests and concerns of taxpayers is more broadly recognized in longstanding laws governing taxpayer standing outside of bankruptcy. See generally Joshua G. Urquhart, *Disfavored Constitution, Passive Virtues? Linking State Constitutional Fiscal Limitations and Permissive Taxpayer Standing Doctrines*, 81 FORDHAM L. REV. 1263 (2012) (exploring federal and state laws governing taxpayer standing).

dents are a similarly dispersed class of interested persons, and would benefit from comparable treatment. And, by enhancing stakeholder participation in this way, bankruptcy courts may also enhance the fairness and transparency of municipal bankruptcy process for the benefit of all constituents.

## CONCLUSION

A Chapter 9 debtor-city's taxpaying residents are key stakeholders who should be recognized as parties in interest with standing to participate in the bankruptcy proceedings. Taxpaying residents should also be entitled to form an official committee, which may serve an important advisory and communication function with respect to important decisions in the case. Although taxpaying residents continue to be represented by their elected officials within and outside of bankruptcy, stakeholder analysis suggests that this may not be adequate representation for the purposes of the bankruptcy case and the difficult decisions that must be made to restructure municipal finances. Whether or not a plan of adjustment contemplates tax increases, and whether or not those increases require voter approval, taxpaying residents are among the most important stakeholders with unique interests that do not necessarily align with the interests of other stakeholders.

# THERE IS A TANGLED WEB OF FACTORS CAUSING INAPPROPRIATE PENSION FUNDING BEHAVIOR

*Anthony Randazzo*

## I. UNDERFUNDED PUBLIC PENSIONS: THE WEB OF CAUSALITY

The Actuary Civil War of 2016 that broke out this past summer between the Society of Actuaries and American Academy of Actuaries is emblematic of the challenge facing public sector pension funds in America today.[1] There is considerable consensus that public plans are grossly underfunded. According to their own actuarial reports, the largest pension plans run by the 50 states had a cumulative overfunded position in 2001 that collapsed into roughly $1 trillion in unfunded liabilities by 2015.[2] There is profoundly less consensus on what factors have caused this underfunding to emerge and whether actuarial valuations are accurately reflecting the true health (or lack thereof) of American pension plans.[3]

Consider that at the heart of the Actuary Civil War is a disagreement over discount rate policy. Historically, public sector pension funds have used their assumed rate of return on assets to discount accrued liabilities. This flies in the face of how financial economics understands risk, which would suggest calculating the value of accrued pension liabilities should be relative to the risk of liabilities, not the risk of the plan assets.[4] The debate is important because if public plans were to use market based liability values, total unfunded liabilities for the biggest state plans combined would likely be closer to $3 trillion or $5 trillion.[5]

---

1 Press Release, Am. Acad. of Actuaries, Future of the Joint Academy/SOA Pension Finance Task Force (Aug. 1, 2016).

2 The author's own review and calculation of the pension plan valuations from all 50 states; plans considered were any state plan or combination of state plans comprising at least 75% of the collective liabilities of a state.

3 *See e.g.*

4 Aleksandar Andonov et al., *Pension Fund Board Composition and Investment Performance: Evidence from Private Equity*, (Hoover Institution, Working Paper No. 16104, 2016), https://papers.ssrn.com/sol3/papes.cfm?abstract_id=2754820; James Naughton et al., *Public Pension Accounting Rules and Economic Outcomes*, 59 J. ACCT. & ECON. 2 (2015); JENNIFER STAMAN, CONG. RESEARCH SERV., R41736, STATE AND LOCAL PENSION PLANS AND FISCAL DISTRESS: A LEGAL OVERVIEW (2011); Robert Novy-Marx & Joshua Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FIN. 4 (2011); U.S. CONG. BUDGET OFF., THE UNDERFUNDING OF STATE AND LOCAL PENSION PLANS (2011).

5 BOB WILLIAMS ET AL., UNACCOUNTABLE AND UNAFFORDABLE 2016: UNFUNDED PUBLIC PENSION LIABILITIES NEAR $5.6 TRILLION, AM. LEGIS. EXCH. COUNCIL (2016),

But there is a puzzle here, from the financial economics view of the world: pension funds explicitly choosing inappropriate discount rates have tacitly been underfunding their pension obligations for years by underreporting unfunded liabilities. Excessively high discount rates are therefore a proximate cause of at least part of the nation's unfunded liability growth problem. Thus, we could argue that low funded ratios for public sector pension plans are in part caused by inappropriate discount rate policies.

However, should a given pension fund decide to lower its discount rate (whether or not they are embracing a financial economics approach to valuing liabilities), the result would be the fund reporting a higher value of accrued liabilities, a higher recognized amount of unfunded liabilities, and then a lower reported funded ratio.[6] We know that as assumed rates of return have fallen over the past decade, so too have discount rates — the average discount rate used by public plans has fallen from more than 8% at the turn of the century to around 7.25% as of 2015.[7] Thus, we could also argue that low funded ratios for public sector pension plans are in part caused by more appropriate discount rate policies.

This duality poses a problem for the academic (and policy) quest to understand exactly what is going on with America's public sector pension plans: the metric we have for defining whether a plan is fiscally sound or not (the funded ratio) could be the product of either historically bad or recently good policy — or, in many cases, both.

## A. *The Limits of Directly Analyzing Funded Ratios*

As previously noted a given funded ratio or reported unfunded liability value could reflect either good or bad funding policy choices. Lowering the discount rate, adopting a newer mortality table, bringing salary growth assumptions in line with demographic trends, or other good funding policy

---

https://www.alec.org/app/uploads/2016/10/2016-10-13-Unaccountable-and-Unaffordable.pdf; Joshua Rauh, *Unfunded Pension Debts of U.S. States Still Exceed $3 Trillion*, FORBES (Aug 25, 2015, 12:30 PM), https://www.forbes.com/sites/pensionresearchcouncil/2015/08/25/unfunded-pension-debts-of-u-s-states-still-exceed-3-trillion/#7826c07c4d6a.

6 Anthony Randazzo, *How Public Sector Defined Benefit Pension Plans Are Funded*, REASON FOUNDATION (Mar 28, 2016), http://reason.org/news/show/how-defined-benefit-plans-funded (All else equal, the lower the discount rate, the higher the reported value of accrued liabilities, and thus—holding assets constant—the higher the recognized unfunded liability. To be clear, adopting a lower discount rate does not "increase" the value of unfunded liabilities, it simply increases the recognized amount of those unfunded liabilities on an actuarial accounting basis. For a more complete summary of defined benefit plan funding).

7 The reason for the decline in discount rates is related almost exclusively to plans lowering their assumed rates of return in response to market changes, not because of financial economics, but the effect of the change is the same and is in the direction that financial economists would guide pension plans.

choices may all result in an increase in reported accrued liabilities and thus lower funded ratios.

And yet, the majority of models in the public pension finance literature are focused on the funded ratio as the dependent variable.[8] There are many valuable contributions to the general understanding of pension plan insolvency in this literature, but much of it has mixed results, such as inconsistent findings on political party influence on funded ratios.[9]

One of the more conflicted parts of the literature is the influence of board composition. Dove and Smith point out that studies have found low funded ratios are associated with pension boards that have large plan participant representation, as well as pension boards made up primarily of elected officials or their appointees.[10] The inconsistency in statistical findings is likely due to a combination of variance in actuarial accounting expertise from board to board with variance in the web of causes for a specific plan's funded ratio.[11]

---

8 *See e.g.*, Qiushi Wang & Jun Peng, *An Empirical Analysis of State and Local Public Pension Plan Funded Ratio Change, 2001-2009*, 46 AM. REV. PUB. ADMIN. 1 (2016); Dashle G. Kelley, *The Political Economy of Unfunded Public Pension Liabilities*, 158 PUB. CHOICE 1-2 (2014); Edward L. Glaeser & Giacomo A.M. Ponzetto, *Shrouded Costs of Government: The Political Economy of State and Local Public Pensions*, 116 J. PUB. ECON., Apr. 2013; Alicia H. Munnell et al., *Public Pension Funding in Practice*, 10 J. PENSION ECON. & FIN. 2, (2011); Tim V. Eaton & John R. Nofsinger, *The Effect of Financial Constraints and Political Pressure on the Management of Public Pension Plans*, 23 J. ACCT. & PUB. POL'Y 3 (2004); Marguerite Schneider & Fariborz Damanpour, *Public Choice Economics and Public Pension Plan Funding: An Empirical Test*, 34 ADMIN. & SOC'Y 1 (2002); Olivia S. Mitchell & Robert S. Smith, *Pension Funding in the Public Sector*, 76 REV. ECON. & STAT. 2 (1994).

9 *See* Erick M. Elder & Gary A. Wagner, *Political Effects on Pension Underfunding*, 27 ECON. & POL. 1 (2015); *but see* Michael Thom, *Party Measurements and the Effect of Legislatures on State Policy Outcomes*, RES. & POL., Jan. - Mar. 2015; *but see* Michael Thom & Anthony Randazzo, *Underfunding Annual Pension Contributions Examining the Factors Behind an Ongoing Fiscal Phenomenon*, 47 ST. & LOC. GOV'T REV. 1 (2015); *but see* Michael Thom, *All of the Above: How Fiscal, Political, and Workforce Traits Affect Pension Funding*, 45 ST. & LOC. GOV'T REV. 3 (2013); *but see* Jerrell D. Coggburn & Richard C. Kearney, *Trouble keeping promises? An analysis Of Underfunding in State Retiree Benefits*, 70 PUB. ADMIN. REV. 1 (2010); *but see* Richard W. Johnson, *Pension Underfunding and Liberal Retirement Benefits among State and Local Government Workers*, 50 NAT. TAX J. 1 (1997).

10 Daniel J. Smith & John A. Dove, *The Economic Consequences of Pension Underfunding: Evidence from the Retirement Systems of Alabama*, Mercatus Center (Mar 2016), https://www.mercatus.org/system/files/Dove-Alabama-v3.pdf; *compare* Daniel Bradley et al., *The Influence of Political Bias in State Pension Funds*, 119 J.
FIN. ECON. 2 (2016); *and* David Hess & Gregorio Impavido, *Governance of Public Pension Funds: Lessons from Corporate Governance and International Evidence*, WBG (2003), https://openknowledge.worldbank.org/handle/10986/18125 (Studies finding low funded ratios are associated with pension boards that have large plan participant representation); *with* Tongxuan Yang & Olivia S. Mitchell, *Public Pension Governance, Funding, and Performance: A Longitudinal Appraisal* (Pension Res. Council, Working Paper 2005-2, 2005); Coronado et al., *Cash Balance Pension Plan Conversions and the New Economy*, U.S. FED. RES. (2003) (Studies finding low funded ratios are associated pension boards made up primarily of elected officials).

11 Robert L. Clark et al., *State and Local Retirement Plans in the United States*, 24 J. AGING & SOC. POL'Y 3 (2011); *see also* Kathryn E. Easterday & Tim V. Eaton, *Double (Accounting) Standards:*

Clark et al. point out that there is a high degree of heterogeneity in the actuarial funding policies selected by public plans, with discount rates having the strongest influence on variance, but actuarial smoothing methods and amortization methods having significance effect as well.[12] Even if all state pension plans adopted a uniform discount rate policy there would still be substantial variance in funded ratios related to explicit factors (budgetary choices on paying 100% of employer contributions, benefit changes, negative amortization policy, etc.). And it is these explicit behaviors that need to be at the center of work seeking to understand pension insolvency.

Encouragingly, there is an increasing amount of literature focused specifically on understanding explicit pension funding behavior itself, rather than just funded ratios.[13] This includes a better approach to examining pension board influence by Stalebrink, with a focus on the relationship between different board membership compositions and the investment decisions or assumed rates of return adopted by those boards (as opposed to models that associate board composition directly with overall funded levels).[14]

## B. *A Pension Web with Many Strands*

Looking past the funded ratio directly allows analytical focus to be put squarely on the pension funding behaviors themselves — and the factors that influence the behaviors in all of their interconnectivity.

A standard model in epidemiology for why disease occurs and spreads is to take account of the interconnected relationship of multiple factors.[15] This "web of causation" model can be applied in understanding unfunded liabilities as a disease plaguing state and municipal finances across the country. First, there are a myriad of behaviors, i.e. *explicit causes*, which can drive of unfunded liability growth, such as:

---

*A Comparison of Public and Private Sector Defined Benefit Pension Plans*, 24 J. PUB. BUDGETING, ACCT. & FIN MGMT. 2 (2012).

12 *See also* Kelley, *supra* note 9; Andrew G. Biggs, *Public Sector Pensions: How Well Funded Are They, Really?*, AM. ENTERPRISE INST. (Jul 19, 2012), https://www.aei.org/publication/public-sector-pensions-how-well-funded-are-they-really/; Jeffery R. Brown et al., *The Economics of State and Local Pensions*, 10 J. PENSION ECON. & FIN. 2 (2011).

13 Odd J. Stalebrink, *Public Pension Funds and Assumed Rates of Return*, 44 AM. REV. PUB. ADMIN. 1 (2012); *see also* Aleksandar Andonov et al., *Pension Fund Asset Allocation and Liability Discount Rates*, GLOBAL RISK INST. (Nov. 7, 2016) (Developing models that look directly at discount rate policies and asset allocation decisions, as well as a model that relates discount rates to funding ratios).

14 Stalebrink, *supra* note 14 (Finding an "investment return assumptions are partly determined by investment boards' affiliation with the political process.").

15 Nigel Goldenfeld, *Because*, EDGE (2011), https://www.edge.org/response-detail/11829 (introducing "web of causation" model).

- Underfunding actuarially determined contribution rates, either specifically in a given budget or systematically through statutory language;[16]

- Adopting actuarial assumptions that are misrepresentative of reality, including using old mortality tables or salary growth assumptions that are based on historic trends but not recent demographic patterns;

- Adopting an open amortization policy that leads to negative amortization;

- Adopting a poorly designed asset allocation strategy;

- Increasing benefits without ensuring the change is fully funded, whether changes to benefit multiplier or ad-hoc COLAs; and

- Using actuarial cost methods that allow for systematic asset depletion, such as granting credits against normal cost when actuarially overfunded or allowing for experience account programs that skim assets off the top of investment returns in good years to fund benefit increase programs.

Second, there is a range of actuarial experiences, i.e. *implicit causes*, which result in growing unfunded liabilities, such as:

- Underperforming investment returns;

- Changes in mortality rates;

- Changes in inflation trends;

- Death or disability shocks, particularly for smaller public safety plans; and

- Salary experience being adjusted due to a sudden change in hiring policy or economic growth.

While each of these explicit and implicit causes might be analyzed independently, rarely do they occur independently. Paying 100% of employer contributions in a given year may be related to a spike in actuarial experiences; underperforming investment returns may be specifically related to the adoption of unrealistic assumed rates of return; benefits may be increased because the actuarial assumptions used by a plan report strong funded status, even if the long-term reality under different assumptions shows a poorly funded plan.

---

16 GASB Statement No. 68, Accounting and Financial Reporting for Pensions--An Amendment of GASB Statement No. 27 (June, 2012) (Most state plans follow these guidelines although there are no federal statutes binding states to follow those rules for the purposes of determining funding policy).

Thus, when seeking to understand why a pension plan's unfunded liabilities have grown, we should consider more than just individual actuarial experience (implicit causes) or funding behaviors (explicit causes). Instead, those funding policy behaviors and their associated actuarial experience should be understood as an interconnected web that is being cohesively influenced by some set of factors.

### C. *A Model for Untangling the Web and Refining Our Understanding of What Causes Inappropriate Funding Policy Behavior*

The natural question that flows from this view is simple: what are the primary reasons that the stakeholders with the fiduciary responsibly to manage public sector pension plans — i.e. pension boards, fiduciary cabinet officers, elected officials — have failed in such a systematic way to adopt appropriate funding policies?[17]

I contend we can understand what is influencing the web of unfunded liability causing behaviors using a three-factor public choice theory model. The theoretical model contends that voters are rationally ignorant of pension financing and do not vote based on the policy promises or funding policy behavior of elected officials. In this vacuum, stakeholders who have minimal liability for pension contributions and an interest in short-term focused funding policy behaviors (e.g. certain elected officials, board members, labor leaders, and beneficiaries) will capture the decision making process that governs explicit behavior. And at the same time public sector employees will be seeking maximum possible rents with the least possible contribution rate or liability.

While each of these theories can partially illuminate the reasons for systematic funding policy failure, none is likely a robust explanation on their own. Thus, in this exploratory model *it is the interconnectedness* of rationally ignorant voters, poorly incentivized elected officials, self-interested pension board members capturing funding policy, and public sector worker rent seeking that has led to the funding policy behaviors that in turn have contributed towards the growth in unfunded liabilities.

Public choice theory posits that elected officials, fiduciary officers, plan administrators, pension boards, and public sector labor leaders will all act in their own self-interest, rather than the public interest.[18] From this

---

17 I define a appropriate funding policy as one that: (a) adopts a discount rate that reflects the risks of the liabilities of the pension plan, not the risk of the assets of the plan; (b) chooses an asset allocation that minimizes taxpayer risks and ignores historic plan performance in favor of more realistic market forecasts; (c) adopts other actuarial assumptions that are up to date (mortality tables, salary forecasts, inflation assumptions) and that minimize taxpayer risks; (d) adopts an amortization policy that pays off debt over a fixed, short time frame; and (e) pays 100% of the actuarially determined employer contribution every year.

18 *See generally* Schneider & Damanpour, *supra* note 9.

perspective in order for a pension plan to be fully funded, the more aligned the utility of plan stakeholders and administrators are with plan solvency, the stronger pension plan's net position. However, due to confluence of factors, such incentive structures are often misaligned.

Part II of this paper explores the first set of misaligned incentives in this theoretical model, specifically looking at how rational voter behavior is not to closely monitor pension funding behavior or the effectiveness of elected official oversight of pension plans.

Part III takes up the second leg of the theoretical model, examining the groups of actors associated with pension funding, and how there is a misalignment between the groups that have captured policy decision making and where the liabilities for those decisions ultimately rests.

Part IV discusses the final part of the public choice theory model; rent seeking by the various actors and organizations in pension funding policy.

The paper concludes with a brief discussion of how some meaningful pension reform efforts have been successful in recent years, despite the alignment of incentives that has tended to push plans towards insolvency. For organizations and pension plan stakeholders seeking to address pension insolvency issues, having more precise, complete articulation of the factors driving specific funding behaviors is critical to designing sound public policy solutions. But knowledge for its own sake will not improve the solvency of public sector plans, there much be strategies for how to act and address these behavior and incentive challenges.

## II. VOTER RATIONAL IGNORANCE OF PENSION FUNDING POLICY

The quantity of information about public sector pension financing that voters must acquire in order put adequate pressure on elected officials to adopt appropriate funding policies is substantial.[19] The first requirement is a baseline understanding of finance. One does not need to be an actuary to understand actuarial assumptions, but there is a time requirement needed to learn how pension funding works. Further, a voter would need to track down and digest often very opaque actuarial valuations and other reports to get a real sense of how well funded a plan is and what behavior factors might be involved.[20]

[19] By elected officials we mean those representing the employers, ranging from legislators who represent state-level agencies (e.g. state police, department of transportation, or a state university), to mayors who represent municipal-level service providers (e.g. fire fighters, teachers, or clerks).

[20] Kelley, *supra* note 9 ("With the opaqueness of public pension reporting, it is intuitively unlikely that the median voter in any state is actually aware of her share of the unfunded liabilities from state pension plans.").

Collectively this means there are real costs for a voter to invest in researching the pension funding status for their relevant local plans.[21] Even if a voter does acquire knowledge of pension finance, they still need to hear a politician make a policy promise related to pensions or be presented with a pension reform ballot initiative in order to act on their knowledge.[22]

At the same time, there can be positive short-term effects for residents of a municipal region when tax revenue is diverted from fully funding a pension plan towards the delivery of certain public services. Failed funding policies generally lead to the crowding out of public services, via a growth in unfunded liability amortization payments, but these typically only manifest in the long-run.

Thus, the expected benefits to a voter are very low for investing time in understanding how pension financing works.[23] Only when pension costs are crowding out public services or leading to proposed tax rate increases might the cognitive costs for the average voter to engage on pension financing possibly become worth the investment.[24] Pension reform ballot initiatives in places such as San Jose, CA or Arizona are examples of such instances.[25]

## A. *Incentives of Elected Officials*

The rational ignorance of voters means there is a relatively low political cost for elected officials—governors, state legislators, city and county commissions, special district board members, school board members, etc.—to ignore the funded level of a pension plan. Cost here being related to an officials chances being re-elected.[26] If voters are not making their decisions based on pension funding levels or costs until a particular tipping point,

---

21 *Id.*; Gordon Tullock, *Public Decisions as Public Goods*, 79 J. POL. ECON. 4 (1971).

22 Glaeser & Ponzetto, *supra* note 9.

23 *See generally* Jason Brennan, THE ETHICS OF VOTING (2012); DEMOCRACY AND DECISION THE PURE THEORY OF ELECTORAL PREFERENCE (Geoffrey Brennan & Loren Lomasky eds., 1997); *see also* César Martinelli, *Would rational voters acquire costly information?*, 129 J. ECON. THEORY 1 (2006); Roger D. Congleton, *Rational Ignorance, Rational Voter Expectations, and Public Policy: A Discrete Informational Foundation for Fiscal Illusion*, 107 PUB. CHOICE 1-2 (2001) (And that is even before we consider the general rational ignorance of voters based on the minimal likelihood of their vote making a difference in an electoral outcome).

24 Such crowding out is likely to happen in the long-term, meaning the elected officials responsible for poor funding policy will most likely not be in office when the unfunded liability amortization payment costs rise, requiring tough budgetary and tax policy choices.

25 Craig Harris, *Big Prop. 124 win to change public-safety pensions*, REPUBLIC (May 17, 2016 8:48 PM), http://www.azcentral.com/story/news/politics/elections/2016/05/18/big-prop-124-win-change-public-safety-pensions/84459132/; Jon Ortiz, *Measure to curb California public pensions is pulled – for now*, SACRAMENTO BEE (Jan. 18, 2016), http://www.sacbee.com/news/politics-government/the-state-worker/article55310175.html.

26 Schneider & Damanpour, *supra* note 9.

then the incentives for an elected official to learn about pension finance are low (in this sense elected official ignorance of pension finance could be considered rational).

With low political costs for bad funding policy behavior it is likely in the interests of any given elected official to focus on other spending priorities. For example, in order to balance the state's budget in 2014, New Jersey governor Chris Christie approved a plan to pay $2.3 billion less than the actuarially determined employer contribution rate—60% less than the state should have paid based on its own actuarial assumptions.[27] The relative political cost for cutting other state programs or raising taxes was higher than making pension fund contributions.[28] Gov. Christie justified his budgetary decision by arguing that the state's unfunded liabilities were due to "sins of the past." This framing was likely heard by some voters and accepted, heard by some voters and rejected, and simply ignored or misunderstood by the rest of the electorate.

## B. *Incentives Might Not Change With Greater Awareness*

When voters are rationally ignorant of pension finance their elected representatives have stronger incentives to ignore inappropriate pension funding behavior than to support behavior that promotes solvency. However, even as voters become more generally aware of pension challenges—for example, in relation to increased media coverage of pension woes in Illinois, New Jersey, or Detroit—that will not necessarily translate directly into a change in the incentives for elected officials. Rational ignorance creates strong incentives to ignore pension finance, but increased voter awareness may not necessarily change the politics of a state or local government's budget. Pension funding behaviors are still influenced by the trade-offs most elected officials make, often times favoring the short-term needs of the budget over the long-term needs of the pension plan.

The temporal factor to consider is how voters' behaviors will change over time given increased understanding of pension finance related issues. When pension funding rises to the top of priorities for voters, only then will

---

27 Hillary Rush, *NJ Governor Christie to cut pension payments to balance budget*, REUTERS (May 20, 2014), https://www.reuters.com/article/us-usa-new-jersey-budget/nj-governor-christie-to-cut-pension-payments-to-balance-budget-idUSBREA4J0TW20140520.

28 Thom & Randazzo, *supra* note 10 (To the degree that analysis focusing directly on funded ratios is meaningful; the study found that states without term limits for their elected officials and have high funded ratios are *more* likely to pay 100% of their actuarially determined employer contribution. Thus, elected officials with short-term time horizons are more likely to push the costs of funding retirement benefits off on to future generations in order to favor other spending or tax priorities; but elected officials who have a desire to be reelected several times into the future are more considerate of pushing off budgetary expenditures. In the case of Gov. Christie, he had just won re-election at the end of 2013 and was term limited as governor when making the 2014 budget balancing decision).

there be substantive shift in incentives for elected officials meaningfully change to be aligned with pension solvency.

## III. CAPTURE OF PENSION FUNDING POLICY

With traditional defined benefit pension plans, taxpayers bear the full liability for promised pensions.[29] It would thus be beneficial for taxpayers to act as a group (voters) and ensure their representatives (elected officials) act in order to protect their interests. However, with voters rationally ignoring pension finance issues, stakeholders with some special interest in the funding policy of the plan are instead able to capture the funding policy process and drive behavior that does not always promote plan solvency.

These stakeholder groups are always smaller than the taxpayer base as a whole, typically have no immediate or long-term liability related to a pension plan, and are able to more easily organize and influence both political outcomes as well as pension-funding behaviors directly.[30] The primary groups that look to capture funding policy can include: elected officials and their appointees (employers), active plan participants and their representatives (employees), plan beneficiaries and their representatives (retirees), ideologically driven groups (including legislative or executive branch budget offices, fiscal agencies, or lobbying groups), and occasionally plan actuaries and administrators.

### A. *Channels for Capture*

The capture mechanism for elected officials (e.g. legislators, governors, city councilmembers, and mayors) has three primary channels:

- Legislatively guiding funding policy from a budgetary perspective, such as setting the employer contribution rate in statute or defining in statue what actuarial assumptions to use in calculating the employer contribution rate;

- Legislatively assigning to fiduciary officers funding policy influence, such as state laws that grant unelected treasurers or comptrollers decision-making authority over asset allocation and exposure to investment risk; and

---

29 For most defined benefit plans, employee contribution rates are fixed. Exceptions include plan designs where both normal cost and unfunded liability amortization payments are split 50/50 (e.g. the Arizona State Retirement System and tier 3 of the Arizona Public Safety Retirement System), plans where employer contributions are capped at a fixed rate (e.g. tier 2 of the Utah Retirement System), and plans where the employee contribution rate is benchmarked to the employer contribution rate (e.g. the South Carolina Retirement System).

30 Mancur Olson, THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION AND SOCIAL RIGIDITIES (1982) (Classic argument related to the collective action of concentrated interests).

- Serving on directly or appointing members to a pension board that is granted authority to set funding policy via adopted actuarial assumptions.

The capture mechanism for active plan participants and their representatives also has three primary channels, depending on the state laws relevant to a given plan:

- Extracting concessions in a collective bargaining process;

- Direct lobbying of elected officials by labor representatives;

- Serving on directly or appointing members to a pension board that is granted authority to set funding policy via adopted actuarial assumptions.

Beneficiaries are often times represented by the employee labor organizations already engaged in the pension funding policy decision-making process, but the interests of retirees can differ from that of active members. Thus, many pension boards also have members that are specifically elected by retirees to advocate for their specific interests.

A more complicated special interest group is plan administrators, as this group's scope of power varies considerably from plan to plan. To the degree that plan administrators do seek to capture part of the funding policy process, their mechanism is primary through their influence on the pension board's decisions. However, plan administrators might also influence funding policy behaviors by limiting certain information disclosures to decision makers or explicitly making policy choices via authority assigned to them legislatively or by the board itself.[31] Plan actuaries may have a credibility stake that leads them to push for funding policy changes that trend towards improved solvency or in maintaining a contract by underplaying long-term risks that are unlikely to manifest in the near term.

Whether any of these groups is able to meaningfully capture the funding policy process and influence explicit behaviors depends on the degree of voter ignorance, the political capital of any one group, the relative size of each group, and how variant the policy goals are within groups (insofar as this makes them more or less able to organize).[32]

---

[31] Thomas Vermeer et al., *Do Local Governments Present Required Disclosures For Defined Benefit Pension Plans?*, 31 J. ACCT. & PUB. POL'Y 1 (2011).

[32] When pension issues gain public attention, such as in Detroit during the city's bankruptcy proceedings in 2014 and 2015 or in Chicago in 2016, it can be harder for a given group to robustly influence policy. Thus, the degree of voter ignorance matters for capture by special interest groups. Further, the legal framework for a given state — i.e. whether there is collective bargaining, so-called "Right to Work" laws, or a constitutional protection of benefits — will change the ability of employers, participants, retirees, or administrators to capture funding policy power.

Successful policy capture also depends on how effective monitoring by other groups that have some conceptual stake in the solvency of a plan, including bondholders; credit rating agencies, and the media.

Recent municipal bankruptcy ruling have largely considered pension liabilities senior to municipal bondholders, but generally, such cases of municipal bankruptcy have not been explicitly driven by unfunded pension liabilities. For example, even though a considerable portion of the city of Detroit's debt was related to unfunded pension liabilities, the pension funds themselves still had resources to pay out pension checks for more than another decade. The need to trigger a bankruptcy was in part related to pension funding draining city resources, but that was not the proximate cause of the ultimate decision to file for bankruptcy. Bondholder monitoring of pension liabilities has traditionally just not been robust.

Only recently have ratings agencies, theoretically with credibility liabilities, been putting more emphasis on pension funding in their municipal credit ratings. However, no credit rating model puts an overemphasis on the long-term funding policy of a plan, and contribution rates — whether based on an aggressive or conservative funding policy — are typically the more important concern.

Finally, the technical capacity and editorial judgment of the press in monitoring pension funding behavior also can influence the ability for any one group to capture funding policy decision making. Because of the highly technical nature of pension financing, and the ambivalence from the public, newspapers and television media outlets have not traditionally been chief monitors of pension funding policy.

## B. *Capture Objectives*

Setting funding policy for a defined benefit pension plan is ultimately a question of risk management: what assumptions about plan behavior should be used to calculate forecasted liabilities? And what actuarial practices should be used to calculate contribution rates relative to those liabilities, liabilities that are typically completely borne by taxpayers? In practice, however, when groups with limited or no liability capture pension-funding policy, decisions can emphasize risk transfer instead of risk management.[33]

From the perspective of the elected official that is seeking to retain voter approval and raise campaign resources, there are trade-offs between (a) acting in the interest of taxpayers, and (b) manipulating budgetary out-

[33] Nancy Mohan & Ting Zhang, *Public Pension Crisis and Investment Risk Taking: Underfunding, Fiscal Constraints, Public Accounting, and Policy Implications* (W.E. UPJOHN INSTITUTE FOR EMPLOYMENT RESEARCH, Working Paper No. 2012-013, 2012); Jeremy Gold & Nick Hudson, *Creating Value in Pension Plans (Or, Gentlemen Prefer Bonds)*, 15 J. APPLIED CORP. FIN. 4 (2003).

lays in ways that support policy goals other than pension plan solvency that are of importance to special interest groups with election influence. Similarly, the appointees of elected officials that are pension fiduciaries (e.g. appointed board members or ex-officio board members) may act in the interests of the elected officials they represent by not voting to adopt actuarial assumptions that would substantially increase contribution rates and create a near-term budgetary constraint.

Risk transfer in these contexts pushes off to future generations of taxpayers the liabilities for todays accrued pension obligations in favor of short-term budgetary and re-election interests.[34]

The interests and objectives of plan participants and their representatives (e.g. public sector unions, collective bargaining representatives, pension board members elected by employees) have a similar risk transfer effect, but are less uniform than those of the employers. First off, employees and labor representatives have an interest in keeping the budgetary costs of retirement plans low so that there is the potential for increases in benefits (whether these are increases in benefit formulas or cost-of-living adjustments).[35] Second, labor representatives may be incentivized to demonstrate near-term successes such as wage increases and in exchange may not pressure elected officials on the potential for long-term insolvency.[36] Third, insofar as employees are also taxpayers, they have an interest in the strong delivery of public services, and therefore could favor explicit funding behaviors that minimize contribution in the near-term and push off into the future responsibility for funding obligations.

Inasmuch as employees are future retirees they do have an interest in the long-term solvency of their pension plan. But as long as constitutional guarantees and judicially enforced contracts protect promised pension benefits, there are limited reasons for active members of a pension plan to fear for the solvency of their retirement benefits.[37] Only in a case where pension

---

34 Mohan & Zhang, *supra* note 35; Fred J. Giertz & Leslie E. Papke, *Public Pension Plans: Myths and Realities for State Budgets*, 60 NAT'L TAX J. 2 (2007); Robert P. Inman, *Municipal Pension Funding: A Theory and Some Evidence: A Comment*, 37 PUB. CHOICE 1 (1981); Dennis Epple & Katherine Schipper, *Municipal Pension Funding: A Theory and Some Evidence*, 37 PUB. CHOICE 1 (1981).

35 Many plans did offer benefit increases at least once between 1990 and 2005 when plan funded ratios looked strong. However, revaluing liabilities during that timeframe using market valued liabilities shows that many states that increased benefits did so under a false understanding of how strongly funded their pension plans were. If different actuarial accounting practices had been followed, it is possible that the impetus for increasing pension benefits would not have been as strong.

36 Kelley, *supra* note 9; Mitchell & Smith, *supra* note 9.

37 Alexander Volokh, *Overprotecting Public Employee Pensions: The Contract Clause and the California Rule*, FEDERALIST SOCIETY (Dec. 31, 2013), https://fedsoc.org/commentary/publications/overprotecting-public-employee-pensions-the-contract-clause-and-the-california-rule (Arguing that recent court rulings across the country have only cemented this view that in nearly every jurisdiction across the country, pension benefits are a contractual right that cannot be broken, even by the insolvency of the trust established to pay the benefits).

benefits appear to be threatened by severe underfunding (ex. Kentucky Retirement Systems, Dallas Police and Fire Pension System) or a fiscally challenged municipality (ex. Detroit, Chicago, San Jose) would concerns about solvency rise above other employee interests.

Retirees represent a subgroup of plan participants who have an interest in near-term solvency on a cash flow basis, but also the perception of long-term solvency on an accounting basis in order to avoid other stakeholders from seeking to reduce promised pension benefits as a part of an effort to improve plan solvency.

Of particular interest in seeking to understand plan participant and beneficiary capture of funding policy is this variance in interest of subgroups and their representation on pension boards. Ex-officio board members can often times be members of the plan themselves, participant elected board members might favor the interests of beneficiaries more than younger plan members by virtue of their longer years of service, and recent hires who have the largest interest in long-term solvency may have the least expertise or influence over their own labor representatives and thus not have much relational capital to capture funding policy power. This intragroup dynamic is also likely to result in transfer of risk from existing taxpayers and budgets out to future taxpayers and budgets.

Finally, for plan administrators the interest in capturing funding policy could depend on a range of self-interested factors. The administrator of a plan may have an interest in an investment allocation with larger degrees of risk because it allows themselves or their staff a larger capacity for performance-based compensation. Administrators might also see a meaningful change in actuarial assumptions as an admission of failure of past leadership. And an administrator might believe that acknowledging the current practice of inappropriate funding policy will give political capital to separate interests who are seeking to close the defined benefit plan they manage in favor of a defined contribution plan. Collectively, these interests are for emphasizing solvency in the short-term and funding policies that translate into lower contribution rates today.

Thus, whatever group is able to capture all or a portion of the ability to direct explicit funding policy behavior is likely to emphasize intergenerational risk transfer.[38] The primary variance is in what a given groups particular interests are for advocating short-term focused funding policy.

---

[38] Harrie Verbon, *Public Pensions: The Role of Public Choice and Expectations*, 6 J. POPULATION ECON. 2 (1993) (It is also worth noting that the interests of taxpayers are then split along generational lines as well); Friedrich Breyer, *On the Intergenerational Pareto Efficiency of Pay-as-you-go Financed Pension Systems*, 145 J. INSTITUTIONAL & THEORETICAL ECON. 4 (1989) (Today's taxpayer interests are near-term, favoring the maximum amount of tax revenue being spent on the delivery of public goods and services, while tomorrow's taxpayer interests are long-term, favoring the solvency of pension plans so that unfunded liability amortization payments do not crowd out the delivery of public goods and services. The growth of unfunded pension liabilities presents a distributional conflict between generations and can create incentives for even greater risk transfers).

## IV. RENT SEEKING THROUGH PENSION FUNDING POLICY

Of the stakeholder groups with a special interest in influencing explicit funding policy behavior plan participants—active and retired—have the largest financial interest.[39]

Thom's forthcoming survey of the literature has found a wide body of work demonstrating that public sector employee compensation contains substantial rents, including the kinds of benefits offered and amount of wages.[40] Given that public sector compensation is set via a political process, decision making related to compensation is open to considerable influence by lobbying, electoral contributions, and other public activism by government worker unions. In principle, such activism by labor representatives is rent seeking behavior as it is looking to increase transfers from taxpayers to public sector workers through various forms of compensation — which often times can most efficiently be done through deferred compensation programs like defined benefit pensions.[41]

Pension benefits can contain rents through various mechanisms. "Pension spiking" is a means of dramatically increasing retirement benefits without any requisite increase in output by the work, which in many cases leads to retirement pay being higher than salaries while working.[42] It occurs

---

[39] Plan administrators and their staff can potentially have some financial gain at stake, depending on the compensation structure for investment management. And to the degree that plan administrators seek to influence assumptions or asset allocation in a way that is personally beneficial, their activities could be constituted as rent seeking. On the whole, though, any economic rent transfers here are small in the aggregate.

[40] Glaeser & Ponzetto, *supra* note 9, at 90 ("The informational advantages of public-sector workers cause them to earn rents or quasi rents, and the political equilibrium leads to a situation in which voters and public-sector workers could both benefit from a different age-earnings profile for public-sector workers. If public-sector workers earned higher wages while young in exchange for lower pension benefits, their welfare could improve at no cost to the taxpayer."); *see also* Alberto Alesina et al., *Redistributive Public Employment*, 48 J. URBAN ECON. 2 (2000).

[41] Andrew G. Biggs & Jason Richwine, *Overpaid or underpaid? A state-by-state ranking of public-employee compensation*, AM. ENTERPRISE INST. (Apr. 24, 2014), http://www.aei.org/publication/overpaid-or-underpaid-a-state-by-state-ranking-of-public-employee-compensation/ (Comparing government worker total compensation to similar private workers finds that in 42 states government workers earn a positive premium and in 12 states that premium is 20% or higher); *see also* Bahman Bahrami, *Union Worker Wage Effect in the Public Sector*, 30 J. LABOR RES. 1 (2009); Timothy D. Chandler & Rafael Gely, *Protective Service Unions, Political Activities, and Bargaining Outcomes*, 5 J. PUB. ADMIN. RES. & THEORY 3 (1995); A. Gelb, *Public Sector Employment, Rent Seeking and Economic Growth*, 101 ECON. J. 408 (1991); William J. Hunter & Carol H. Rankin, *The Composition of Public Sector Compensation: The Effects of Bureaucratic Size*, 9 J. L. RES. 1 (1988); Don Bellante & James Long, *The Political Economy of the Rent-Seeking Society: The Case of Public Employees and Their Unions*, 2 J. L. RES. 1 (1981).

[42] *See* Catherine Saillant et al., *Salary 'spiking' drains public pension funds, analysis finds*, LOS ANGELES TIMES (Mar. 3, 2014), http://articles.latimes.com/2014/mar/03/local/la-me-county-pensions-20120303; Craig Harris & Dustin Gardiner, *Pension spiking may cost Phoenix $12 mil per year*,

when pay and benefits rules set by state or local governments allow workers to save up vacation and sick time to cash in during their final year or years of work, and that increases their total salary used to calculate their pension (which is based on a formula percentage of final salary).

Another mechanism is "employer pick up" in which the employer, the government, not only makes its own pension contributions but also agrees to pay some or all of the share of annual payments into the pension system that would normally come from workers.

An important mechanism for retirees in some plans is a legislatively granted ad-hoc cost-of-living adjustment. Some plans do not automatically inflation adjust benefits, and with such plans employers face regular pressure to increase benefits on an annual basis, benchmarked to a change in the cost-of-living. These benefit spikes are not always paid for with increased contributions to normal cost, and since they simply increase the benefit for an already retired work they are a straightforward transfer benefit that constitutes economic rents.

Considerable rent seeking activity goes into securing and defending changes to these pay and benefit rules.[43] Such political activity can lead to the creation of symbiotic relationships between employee groups and elected officials, all without the public being fully aware. Generally speaking, public sector workers and public sector unions are more informed about pension financing and better organized than taxpayers as a whole. Any one public sector worker will have a stronger incentive to understand the operational nature of the benefit programs they are participating in rather than a rationally ignorant voter.[44] And in turn, labor union leaders have a stronger incentive to learn the details about programs like defined benefit systems than the rank-and-file members.[45] Meanwhile, the voting public is reasonably unaware of the complex reporting standards for pension plan costs, the debates related to valuing unfunded liabilities, or related funding policy behaviors.

Beyond the typical lobbying channels used to pursue increased compensation without increased labor output, public sector workers in states where compensation is collectively bargained have a separate, fairly unique

---

REPUBLIC (Oct. 17, 2013 9:24 PM), http://archive.azcentral.com/community/phoenix/articles/20131015pension-spiking-may-cost-phoenix-mil-per-year.html.

43 Jason Hart, *Government labor union spends $65 million on politics*, WATCHDOG (Apr. 3, 2015), https://www.watchdog.org/issues/labor/government-labor-union-spends-million-on-politics/article_5c18b4d7-ff1c-502e-a8ca-a5e77e2e48b1.html (Just one public sector union, the American Federation of State, County and Municipal Employees, spent $65 million on 'political activities and lobbying in 2014).

44 *See* Glaeser & Ponzetto, *supra* note 9; Kelley, *supra* note 9.

45 But those union leaders may be very focused on the short-term (i.e. they will ignore low funded ratios until the funded ratios threaten their membership directly, see the case of AZ PSPRS union leadership).

second channel for rent seeking.[46] This 21st Century form of rent seeking simply uses the negotiating table to seek pension benefit increases, or to influence explicit funding policy behavior such that the accounting for pension costs does not weaken their negotiating position.

Ultimately, well-organized public sector unions can be effective in attaining transfers from less well-organized taxpayers by using the overlap of collective bargaining with more classic political activism. Attempts by state and local governments to address unfunded liabilities by reducing behavior such as pension spiking have almost universally been met by fierce defense from public sector union groups, and sometimes resistance by the members of a pension board itself. Even when elected officials overcome the incentives to ignore pension financing, they often must face off against rent seekers limiting the options for reducing unfunded liabilities.

## V. UNIFYING THE THREE FACTORS INFLUENCING PENSION FUNDING POLICY

As separate theories, voter rational ignorance, the capture of funding policy and pension boards, and rent seeking by public sector workers do not fully explain the systemic application of bad pension funding policies.

- Voters may not understand in intricacies of public sector pension plans, but their ignorance does not explain why active plan participants are not more engaged in seeking to reduce the volatility of risk in the plans offering them benefits.

- Knowing that elected officials underfunded a pension plan in order to spend taxpayer resources on other priorities does not explain why they are not subsequently voted out of office.

- And finding that labor unions have sought to encourage certain actuarial accounting practices that would allow a pension plan to report long-term solvency in order to allow political space to seek increases in compensation does not explain why retirees have not openly criticized inappropriate funding behavior that threatens the solvency of their plans.

*It is all three theories together* that tell a robust story about the underlying mechanisms that are leading the systematically adopted inappropriate funding policies that have in turn explicitly and implicitly to so much pension debt.

The conclusion is that rational ignorance of voters creates an opportunity for policy capture and rent seeking. Stakeholders with short-term interests and limited liability have captured the pension funding policy process. These stakeholders include elected officials (and their representa-

---

46 Karen Steffen, *State Employee Pension Plans*, *in* PENSIONS IN THE PUBLIC SECTOR (Edwin C. Hustead & Olma S. Mitchell eds., 2000).

tives) who are more concerned with near-term budget allocation than long-term solvency and employee groups who are rent seeking. And the funding policy behaviors that intentionally favor short-term outcomes have not been checked because voters are ignorant of the growth in liabilities they are responsible for.

The framework of pension insolvency as a function of an interconnected set of incentives and behaviors does provide some landscape for how stakeholders interested in pension reform can most effectively move forward. Untangling the web thus can start by changing voter awareness of pension reform, but there will still need to be political will. Untangling the web could mean having actors with incentives for pension solvency themselves seek to co-opt the pension funding process themselves, but they will still be facing agents who have strong incentives for rent seeking in the current climate that will stand in their way.

Ideally, pension reform would start with labor leadership recognizing the long-term solvency challenges for their members' retirement systems. Organizations or individuals interested in pension reform might, thus, focus on trying to increase education about pension financing and the visibility of the risks for labor leaders in an attempt to change the existing incentives that lead labor to be a poor monitor of pension solvency.

In 2015, labor leaders for Arizona's police officers and firefighters decided that they could no longer tolerate the risks of their members' pension fund becoming insolvent and approached the state legislature with a plan to address the problem. The Arizona state senate responded to this good faith effort by public safety union leaders in kind by offering a counter proposal for pension reform. Throughout the fall of 2015, representatives of labor, municipal employers, and the state legislators traded proposed reform ideas until mutually agree upon solution was reached that would address both the existing debt for the Arizona Public Safety Personnel Retirement System as well as reduce future liabilities of the plan by 50%.[47]

Realistically, pension reform will not always start with labor representatives because of the strength of the competing short-term incentives for most union leaders. Other successful models for reform have been cases such as Utah and Rhode Island, where a single elected official decided that taking on pension reform would be a meaningful political gambit and Michigan and Alaska where the political opposition to pension reform was weak enough as to not be able to stop a major change.[48]

---

47 Leonard Gilroy et al., *Arizona Enacts Groundbreaking Public Safety Pension Reform*, REASON FOUNDATION (Feb 16, 2016), http://reason.org/news/show/az-public-safety-pension-reform.

48 *See* Anthony Randazzo, *Pension Reform Case Study: Michigan*, REASON FOUNDATION (Aug 15, 2016), http://reason.org/news/show/pension-reform-case-study-michigan; *see also* Anthony Randazzo, *Pension Reform Case Study: Rhode Island*, REASON FOUNDATION (Jan 15, 2014), http://reason.org/news/show/pension-reform-rhode-island.

The pension reform leaders in Utah (State Sen. Dan Liljenquist) and Rhode Island (Treasurer Gina Raimondo) were relatively newly elected when taking on pension reform and did not have well-established political interests to compete with their interest in pension reform. Thus, many of the incentives that are present for elected officials were not applicable. Pension reform in Michigan and Alaska was generally moved without bipartisan consent. In the case of Michigan's 1996 closure of their state employee pension plan, it was passed during a lame duck legislative session. In the case of Alaska's 2005 closure of both their state employee and teacher plans, the reforms have since been challenged by labor in the courts multiple times.

When looking at the landscape of successful meaningful pension reform, there clearly has been a range of political approaches. Wherever pension reform has been successful, though, it has been because one or more of the strands of the bad pension funding behavior web have been broken. While there may not be a clear singular path for untangling the web, simply having a better awareness of its existence can help a given locality seek to find their unique path to navigating the ignorance of voters, the short-term interests of non-liability holding stakeholders, and rent seeking by employee groups.

## CONCLUSION

The argument that I have laid out in this paper is that to understand the nature of pension insolvency in America, the complex, interconnected web of funding policy behaviors that explicitly and implicitly cause the reported increases in unfunded liabilities should be the focus of study. And to understand what causes inappropriate funding behavior, I've sketched a theoretical public choice model arguing stakeholders with no liability have captured funding policy in order to advance short-term interests that are unrelated to plan solvency while also rent seeking without regard to the longevity of the plan. The capture and rent seeking by members without liability is possible because the party with liability, the taxpaying voters, is rationally ignorance of pension financing and costs.

In recognizing the existence of this web and the difficulty in finding ways to break through it, it appears there is an inherent instability with public sector defined benefit pension plans insofar as they are self-governed. Theories of self-regulation assume certain liability on the part of equity holders, owner-operators, and/or employees.[49] However, if plan participants and their representatives carry no liability (due to constitutional guarantees), and employers carry no liability (because voter rational ignorance does not hold elected officials and their appointees to account for behav-

[49] Kelley, *supra* note 9.

iors), then it is virtually impossible for the regulatory regime governing the plan to be optimal in terms of fully funding those liabilities.

Unfunded liabilities have grown because the stakeholders that carry the most liability with a defined benefit pension plan have the highest costs for understanding and engaging in public debate about pension finance. And the stakeholders that carry the least liability often lack the incentives to prioritize appropriate pension finance or have captured the funding policy process and focused it on protecting the interests of those with the most to gain in the near-term.

Improving the precision of knowledge on pension funding behavior is critical for informing the policy debates that surround addressing pension underfunding. Collectively, this analysis points groups and individuals interested in pension reform in a clear direction: any successful change to public sector pension plan design must realign the incentives of the stakeholders involved in the defined benefit pension plan. This has been successfully navigated in a few places over the past decade, but figuring out a more robustly applicable formula for how those incentives should be realigned, and what the dominant influences are on any given funding policy behavior at a local level is the next phase of where this analytical project needs to go. The academic quest to understand how public sector pension plans have fallen apart is fascinating on its own, but for taxpayers facing rising pension plan contribution rates that will crowd out other budgetary priorities this is a real and present solvency threat that needs clear solutions as soon as possible.

# THE IMPACT OF DISTRICT ELECTIONS ON MUNICIPAL PENSIONS AND INVESTMENT

*Richard T. Boylan & Dru Stevenson*

ABSTRACT: *The current fiscal crisis faced by American municipalities has elicited serious academic discussion of the causes of municipal bankruptcies and reform measures that could ameliorate existing problems or at least prevent the problems from arising in the future. Several lines of scholarship have focused directly on city financial management; at the same time, a large literature has emerged about election and voting laws in the municipal context, usually focused on the rights of minority voters, interest-group influence, or other political science issues. Our research ties these separate lines of scholarship together, demonstrating a causal connection between the system of district elections for city council (mandated in many places by judges' implementation of the Voting Rights Act, or VRA) and a specific combination of problematic spending problems. Cities that switch from at-large elections to district elections move to higher pension benefits for municipal employees, while simultaneously providing lower funding for those pensions, as well as a reduction in infrastructure spending. At the same time, this is not a simple problem of overspending on employees, as our data indicate that municipal wages do not vary with the type of electoral system. We conclude, therefore, that district elections lead to time-shifting of expenditures, pushing the problems forward to future voters. A brief conclusion offers possible approaches to remedy the problem highlighted in our findings, as well as suggestions for future research.*

## INTRODUCTION

In recent years, a financial crisis has emerged in many American cities, forcing some large municipalities into bankruptcy. Between 2007 and 2013, residents of twenty-eight cities suffered drastic cuts in fire and police protection, as their cities went into bankruptcy or receivership.[1] Many more

---

[1] *See* Michelle Wilde Anderson, *The New Minimal Cities,* 123 YALE L. J. 1118, 1120 (2014).

cities have imposed varying degrees of austerity measures, scaling back normal services and infrastructure spending. Academic commentary has turned to this subject, with commentators offering proposals and cautions regarding municipal bankruptcies.[2] Pensions for city workers – especially police and firefighters – feature prominently in the discussion,[3] as they often constitute one of the most overwhelming unfunded liabilities for cities, along with population losses.[4] In many municipalities, financial difficulties have been compounded by the need to repair an aging infrastructure.[5]

This Article is a companion piece to the recent empirical study done by one of the authors.[6] The purpose here is to situate the empirical study within the legal landscape of local election law, to use the findings from economics to analyze the effects of district elections for city councils. Our research looks at the effects of local election rules on municipal finances – specifically, whether city council elections are at-large (citywide voting for each candidate) or by district (regions of the city elect their own representa-

---

2 *See, e.g.,* Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 YALE L. J. 1150 (2016); James Naughton & Holger Spamann, *Fixing Public Sector Finances: The Accounting and Reporting Lever,* 62 UCLA L. REV. 572 (2015); Clayton P. Gillette, *Dictatorships for Democracy: Takeovers of Financially Failed Cities*, 114 COLUM. L. REV. 1373 (2014); Ashira Pelman Ostrow, *Emerging Counties? Prospects for Regional Governance in the Wake of Municipal Dissolution,* 122 YALE L. J. 187 (2013); David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?,* 50 HOUS. L. REV. 1063 (2013); David Schleicher, *City Unplanning*, 122 YALE L. J. 1670 (2013); Michelle Wilde Anderson, *Dissolving Cities*, 121 YALE L. J. 1364 (2012); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy,* 79 U. CHI. L. REV. 281, 283 (2012); Christopher R. Berry & Jacob E. Gersen, *Fiscal Consequences of Electoral Institutions,* 52 J. L. & ECON. 469 (2009).

3 Edward N. Tiesenga*, Great Rivers of Spending: The Legal Tributaries of Municipal Fire and Police Pensions*, 28 DUPAGE COUNTY BAR ASS'N. BRIEF 8 (2016) (discussing Illinois' underfunded municipal pensions and the statutory framework that contributed to the problem); Vaneeta Chintamaneni, *The Unraveling of an American City: Pensions, Municipal Debt, and Chapter 9 Bankruptcy,* 22 ELDER L. J. 523 (2015); Jackson T. Garvey, *Municipal Bankruptcy and Public Pensions: Detroit's Eligibility for Chapter 9 Relief and Legal Restraints on the City's Actions as a Debtor*, 89 NOTRE DAME L. REV. 2299 (2014); Andrew B. Dawson*, Pensioners, Bondholders, and Unfair Discrimination in Municipal Bankruptcy,* 17 U. PA. J. BUS. L. 1, 2-3 (2014); Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 33 REV. BANKING & FIN. L. 609 (2014); James E. Spiotto, *How Municipalities in Financial Distress Should Deal With Unfunded Pension Obligations and Appropriate Funding of Essential Services,* 50 WILLAMETTE L. REV. 515 (2014); Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3 (2013) (discussing both state and municipal pensions).

4 *See generally* Michael Cooper & Mary Williams Walsh, *Alabama Town's Failed Pension is a Warning,* N.Y. TIMES (Dec. 22, 2010); Steven Greenhut, *Vallejo's Painful Lesson in Municipal Bankruptcy,* WALL ST. J. (Mar. 27, 2010); Erika Niedowski. *Cash-Strapped RI City Files for Bankruptcy*. DESERET NEWS (Aug. 1, 2011).

5 *See generally* Charles R. Hulten & George E. Peterson, *The Public Capital Stock: Needs, Trends, and Performance*, 74 AMER. ECON. REV. 166 (1984); Cameron McWhirter. *Water-Wasting Leaks Plague Many Cities.* WALL ST. J. (June 21, 2016).

6 *See* Richard T. Boylan, *Impact of Election Rules on Municipal Reform, Pensions, and Investments* (2016) (forthcoming unpublished manuscript).

tives to the council).[7] The Voting Rights Act[8] (VRA) produced a significant change in this regard in the twentieth century, forcing many municipalities to change from at-large elections to district elections, with the goal of providing better representation to minority residents. This federally-mandated change in municipal governance provides a useful data set for research, as it is possible to track changes in municipal spending and finance before and after the change, as well as making city-to-city comparisons for the different election systems. This two-way comparison allows us to tease out causation – to show that district elections have a specific impact on city spending patterns. The empirical study that furnishes the basis for our observations examined a large set of data – a panel of 2,361 cites for the period from 1957 through 2014 – to make these comparisons.[9] The overall merits of the VRA, or its continued legal status in the wake of recent Supreme Court decisions,[10] is outside the scope of our discussion. Instead, our focus is on the growing, nationwide municipal financial crisis, to offer some insights for remedying current problems or avoiding future ones.

Cities with district elections for their council seats tend to have higher pension benefits, lower pension funding, and lower infrastructure investments.[11] Each of these factors are oft-observed contributors to the financial plight and physical decay of American cities.[12] Our observation is more nuanced than a generalized link to overspending – instead, we find lower spending on infrastructure and current contributions to pension funds, even while promised pension obligations spiral upward.[13] In addition, wages for municipal employees seem to stay the same regardless of the election rules, indicating that district elections do not necessarily favor city employees in every possible way.[14] Instead, it appears that district elections tend to shift spending increases to the future (a temporal shift).[15] Our explanation for this pattern is that various statutes, regulations, political pressures, and even some market forces impose limitations on cities' ability to increase current spending, particularly on city employees. Nevertheless, district elections appear to incentivize city councils (through their members) to provide more generous pensions to the workers, presumably to gain votes or benefit

---

7 *See id.*

8 Voting Rights Act of 1965, PUB. L. NO. 89-110, 79 Stat. 437 (codified as amended at 42 U.S.C. §§ 1971, 1973 - 1973bb-1 (2006)).

9 *See* Boylan, *supra* note 6, at 4.

10 *See* Shelby Cty. v. Holder, 133 S. Ct. 2612 (2013) (holding that Section 4 of the VRA is unconstitutional).

11 *See generally* Boylan, *supra* note 6.

12 *See* Chintamaneni, *supra* note 3 (explaining how pension mismanagement was merely symptomatic of generally irresponsible fiscal behavior by Detroit officials).

13 *See generally* Boylan, *supra* note 6.

14 *See id.*

15 *See id.*

workers in their individual districts.[16] We believe this is due to an agency cost problem – council members have less accountability in a district election for decisions that affect the city's overall long-term health. Alternatively, this could plausibly be an example of a common pool problem,[17] working within some exogenous constraints on immediate expenditures – meaning that the overspending to benefit one's own district, even at the long-term peril of the city overall, shifts to future obligations, such as pension benefits.[18]

---

16 *See also* Edward L. Glaeser & Giacomo A.M. Ponzetto, *Shrouded Costs of Government: The Political Economy of State and Local Public Pensions,* 116 J. PUB. ECON. 89 (2014) (arguing that in order to garner more votes, politicians promise "shrouded" compensation packages, meaning that the costs of such benefits are obscure to most voters (except the recipients), with the result that compensation becomes overly back-loaded).

17 A large literature has argued that legislatures representing different districts face a common pool problem. That is, a legislator fully values the benefits of public spending in their own district, but internalizes only a fraction of their costs. Such behavior can lead to higher taxes, fewer projects that benefit all districts, or higher debt. In particular, the common pool problem has been shown to lead to excess pork barrel spending, under-provision of public investment goods, and excessive debt. Formally, this has been modeled as inefficient universalism by Barry R. Weingast, Kenneth A. Shepsle, and Christopher Johnsen. *See* Barry R. Weingast, Kenneth A. Shepsle, & Christopher Johnsen, *The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics*, 89 J. POL. ECON. 642 (1981). Other researches frame it as spending that only benefits a minimum winning coalition of districts. *See* Marco Battaglini & Stephen Coate, *A Dynamic Theory of Public Spending, Taxation and Debt*, 98 AMER. ECON REV. 201 (2008); Timothy Besley & Stephen Coate, *Centralized Versus Decentralized Provision of Local Public Goods: A Political Economy Analysis*, 87 J. PUB. ECON. 2611 (1999); William Leblanc, James M. Snyder, & Micky Tripathi, *Majority-Rule Bargaining and the Under Provision of Public Investment Goods*, 75 J. PUB. ECON. 31 (2000).

18 Other legal commentators have discussed the common pool problem in the context of current municipal financial crises. *See, e.g.* Gillette, *supra* note 2, at 1422; Berry & Gersen, *supra* note 2, at 473 n. 7 ("Adding districts to a legislature should exacerbate the common-pool problem underlying the law of 1/*n*, but adding other nonlegislative elected offices should not. On the other hand, adding specialized elected offices unbundles policy authority, whereas adding seats in the legislature does not."); Omer Kimhi, *A Tale of Four Cities-Models of State Intervention in Distressed Localities Fiscal Affairs*, 80 U. CIN. L. REV. 881, 914-15 (2012) ("The city's budget can be viewed as a common resource pool that is controlled by the different groups that comprise the city coalition. Due to the shared control of the budget, each group fully enjoys the utility of its own budgetary demands but it shares the cost of those demands, namely the cost of a budget deficit, with all the other groups in the city."); Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 644 (2008) ("As the number of participants increases, the total budget expenditure increases as well. The reasoning behind this observation derives from the common pool problem: when multiple fragments of the community participate via their representatives in the budget process, each fragment fully enjoys the benefits of its own (successful) budgetary demands, but shares the costs of those demands with all other residents."); *but see* Vincent S.J. Buccola, *An Ex Ante Approach to Excessive State Debt*, 64 DUKE L. J. 235, 278 n. 187 (2014) ("The common-pool problem is of limited significance to a municipality. Under longstanding doctrine, creditors have minimal ability to foreclose on municipal assets and so to destroy going-concern value.").

Of course, other political characteristics of cities also affect city spending.[19] We anticipate that some readers may find it unduly narrow to focus on a single procedure for council elections. Historically, however, theorists and reformers have viewed the mode of election for councils as a major factor in whether a city receives sufficient investments in infrastructure.[20] The early twentieth-century reform movement (1890-1960) sought greater infrastructure investments by replacing mayors with a city manager appointed by the council, making the council elected at-large, and making elections non-partisan.[21] Excess municipal debt in the 1830s lead to municipal defaults, which in turn led states to limit the issuance of general obligation bonds.[22] We focus on at-large elections, rather than partisan elections and who holds executive powers, due to the availability of instruments. The VRA reversed the work of the earlier municipal reformers regarding city council elections, forcing many cities to switch (or change back) to district, to increase minority representation. Thus, the VRA led to an exogenous increase in the fraction of council members elected by district.[23]

This Article proceeds first with a brief overview of the legal background most relevant for our research – the VRA as it effects city council elections, and some of the legal restraints on city spending and fundraising (through taxation or bond issues). Part I covers these background issues that help set the stage for the inquiry that follows. Part II describes the new empirical research of one of our authors about the impact of city council election rules, over time and city-to-city, on municipal pension benefits and other important spending items that affect the long-term prosperity of the city itself. The conclusions of the study strongly suggest a causal correla-

---

19 Recent research appears to have debunked the older view that merely increasing the size of the city council automatically increases city expenditures. *See* Lynn MacDonald, *The Impact of Government Structure on Local Public Expenditures*, 136 PUB. CHOICE 457 (2008).

20 *See* Ellen Katz, *Documenting Discrimination in Voting: Judicial Findings under Section 2 of the Voting Rights Act since 1982* at *9-11 (2005), https://www.law.berkeley.edu/files/kats_discrimination_in_voting.pdf.

21 Most of the research done about municipal reform (1890-1960) analyzes the motives of reformers. Specifically, prior researchers focused on whether they sought efficient and non-corrupt government, or instead sought to put the interests of the upper class above the interests of immigrants and minorities. *See* Samuel P. Hays, *The Politics Of Reform In Municipal Government In The Progressive Era,* 55 PAC. NORTHWEST Q. 157 (1964); BRADLEY ROBERT RICE, PROGRESSIVE CITIES: THE COMMISSION GOVERNMENT MOVEMENT IN AMERICA, 1901-1920 (1977); Luis Ricardo Fraga, *Domination through Democratic Means: Nonpartisan Slating Groups in City Electoral Politics*, 23 URBAN AFFAIRS REV. 528 (1988). Our findings show that reform contributes to the financial health of cities could be consistent with either motive.

22 *See generally* D. Roderick Kiewiet & Kristin Szakaty, *Constitutional Limitations on Borrowing: An Analysis Of State Bonded Indebtedness*, 12 J. L. ECON. & ORG. 62 (1996).

23 *See* Boylan, *supra* note 6, at 5. By 'exogenous' we mean that it was unrelated to the desire of the city to increase municipal pension benefits, reduce pension funding, or reduce infrastructure spending.

tion. Part III explores some inferences of these findings and tentative policy suggestions for addressing the fiscal problems that emerge when cities rely on district elections. Part IV provides a brief conclusion and suggestions for future research.

## I. LEGAL BACKGROUND FOR THE CHANGE IN MUNICIPAL ELECTIONS

### A. *The Voting Rights Act, Its Purposes, and Consequences*

Congress passed the Voting Rights in 1964 as part of its civil rights initiative to bring equality to the nation's minority population. Subsequent amendments and Supreme Court glosses broadened its reach. For purposes of this paper, the most relevant effect was that many cities had to switch the city council elections from an at-large (citywide) system to a district representative system.

The fifteenth amendment restricts infringement on a citizen's right to vote based on race.[24] The purpose underlying the Voting Rights Act of 1965 is to "enforce the fifteenth amendment to the Constitution of the United States."[25] When the Voting Rights Act was first enacted, it was an extraordinary remedy departing from the American tradition of state sovereignty and adherence to the Constitution by requiring only certain states comply with its provisions.[26] Nonetheless, the Act was justified by an extraordinary problem of intentional voter suppression that was not remedied by litigation.[27]

Originally, the Act was to expire after five years.[28] Over the next 41 years, the Act became progressively more stringent as it was reaffirmed as constitutional by the Supreme Court, amended to add more requirements, and repeatedly reauthorized by Congress.[29] In 2006, the Act was reaffirmed and extended for another 25 years.[30] Section 2 of the Act was its core provision, which prohibits "voting qualifications or prerequisite to voting, or standard, practice, or procedure."[31]

Besides Section 2, the most relevant section for our purposes is Section 5, but this part incorporates by reference provisions of Section 4, which deserve brief mention first. Section 4 mandated when the Attorney General

---

24 *See* U.S. CONST. amend. XV, §§ 1-2 (right to vote "shall not be denied or abridged by the United States or by any State on account of race, color, or previous condition of servitude.").

25 Voting Rights Act of 1965, *supra* note 8.

26 *See* Shelby Cty. v. Holder, *supra* note 10.

27 *Id.*

28 *Id.* at 2620.

29 *Id.* at 2624.

30 *Id.* at 2621.

31 *Id.* § 2, 79 Stat. at 437.

must consent to the entry of a declaratory judgment and applied the review of the enactment to States or political subdivisions of a state that (1) "the Attorney General determines maintained on November 1, 1964, any test or device, and with respect to which (2) the Director of the Census determines that less than 50 per centum of the persons of voting age residing therein were registered on November 1, 1964, or that less than 50 per centum of such persons voted in the presidential election of November 1964."[32] The Act defined the test or device as any voting prerequisite – literacy tests, academic knowledge tests, morality tests, and recommendation of qualifications by other registered voters.[33] Forty-five percent of lawsuits under Section 2 between 1982 and 2005 were challenges to at-large election systems.[34]

Section 5 of the Act requires any State or political subdivision that sought to "enact or seek to administer any voting qualification or prerequisite to voting, or standard, practice, or procedure with respect to voting," to submit the proposed enactment to the United States District Court for the District of Columbia "for a declaratory judgment" that affirmed that the enactment did not abridge the right to vote based on color in either its purpose or its effect.[35] Until the declaratory judgment approving the enactment was entered, the enactment could not be enforced against anyone who failed to comply with it.[36] Under this section, the proposed enactment could be enforced without declaratory judgment if the proposal has been submitted for approval and had not received notice of objection within sixty days.[37] Actions brought pursuant to §5 were to be heard be a panel of three judges.[38] In litigation, Section 5 could make a significant difference between cities. Plaintiffs won their cases (courts found illegal vote dilution to be present) more often in Section 5-covered cities than in jurisdictions where it did not apply.[39]

At-large elections had become the norm in an earlier era of reform, when the driving concern was to end the corrupt "political machine" system in many large cities, in which a city government essentially traded benefits for specific neighborhoods (that did not benefit the city overall) in exchange for that neighborhood's votes. By having everyone in the city vote for each representative on the city council, cities could avoid the common pool problem and obtain more investment in overall infrastructure, as well as more fiscal responsibility across the board. At-large elections, however,

---

32 *Id.* § 4, 79 Stat. at 438.

33 *Id.* § 4, 79 Stat. at 438-39.

34 Katz, *supra* note 20, at *8.

35 *Id.* § 5, 79 Stat. at 439.

36 *Id.*

37 *Id.*

38 *Id.*

39 Katz, *supra* note 20, at *5.

strongly favored majorities and the wealthy voters at the expense of the poor and minority voters. Thus, the reforms of the civil rights era pushed against at-large elections in favor of a system in which poor or minority neighborhoods could elect their own representatives to the city council, and have a voice in local government. Even so, not all cities or states had to switch electoral systems, because the Voting Rights Act required a change to remedy historical patterns of discrimination or exclusion of minorities from city government. As a result, a number of cities in the second half of the twentieth century switched from at-large elections to district elections, but many did not. The 1975 amendments to the VRA expanded its coverage to language minorities, mainly Mexican-Americans, while the 1982 amendments made at-large elections potentially illegal, even in cases when plaintiffs could not prove that their intent was to keep minorities from office.

The Supreme Court added an important judicial gloss to the VRA in 1986, with a three-part test set forth in *Thornburg v. Gingles*.[40] The Court held that plaintiffs seeking to enjoin a city to adopt by-district council elections must show that (1) "the minority group must be able to demonstrate that it is sufficiently large and geographically compact to constitute a majority in a single-member district;"[41] (2) "the minority group must be able to show that it is politically cohesive;"[42] and (3) "a bloc voting majority must *usually* be able to defeat candidates supported by a politically cohesive, geographically insular minority group."[43] In practice, plaintiffs must show that the white majority votes as a bloc consistently (allowing for occasional exceptions), thereby usually defeating the minority's preferred candidate.[44]

The Voting Rights Act has subsequently come under criticism from commentators, and has faced court challenges on constitutional grounds[45] – some recent decisions by the Supreme Court have invalidated certain provisions of the Voting Rights Act, the most important of which is *Shelby County v. Holder*.[46]

*Shelby County* provides a snapshot of the contemporary workings of the Voting Rights Act. There, the Court upheld the prohibition on voting qualifications and prerequisites – Section 2 – while finding the application

---

40 478 U.S. 30 (1986).

41 *Id.* at 50.

42 *Id.* at 51.

43 *Id.* at 48-49.

44 *Id.*

45 Courts have consistently upheld the constitutionality of Section 2. *See, e.g.,* Mississippi Republican Executive Committee v. Brooks, 469 U.S. 1002 (1984); United States v. Blaine Cty., 363 F.3d 897, 904 (9th Cir. 2004); Sanchez v. Colorado, 97 F.3d 1303, 1314 (10th Cir. 1996); Jones v. City of Lubbock, 727 F.2d 364, 375 (5th Cir. 1984); United States v. Alamosa Cty., 306 F. Supp. 2d 1016 (D. Colo. 2004).

46 Shelby Cty. v. Holder, *supra* note 10.

of the Act to different states – Section 4 – unconstitutional.[47] The case began with when a county in Alabama (Shelby) sued for a declaratory judgment finding of facial unconstitutionality of Sections 4 and 5 of the Act – the sections that required only certain jurisdictions to submit proposed legislation for review and approval before enactment – requesting "a permanent injunction against their enforcement."[48] The County argued that the Act, in place to enforce the Fifteenth Amendment while remedying past voter suppression tactics in jurisdictions that engaged in them, no longer required the extraordinary remedy, as "voter turnout and registration rates now approach parity."[49] The DOJ feared that if Sections 4 and 5 were found unconstitutional, the jurisdictions bound by the Voting Rights Act review and approval process will return to using legislation as a way to engage in discriminatory voter suppression.[50] The Court ruled for the County, invalidating §4(b) of the Act and issuing no holding on §5.[51] The Court recognized that "the Federal Government retains significant control over federal elections," but states retain "'broad powers'" to regulate the exercise of the right to vote.[52] The Court reasoned that the "'fundamental principle of equal sovereignty'" supports the invalidation of § 4(b), as the regulatory provision of the Act required only a few states to obtain "'permission'" to enact laws that other states can enact almost immediately.[53] Ultimately, the Court noted that reauthorizing the Act in 2006 ignored the 40 years of history and change that occurred between the Act's original enactment and its reauthorization and is not a remedy that "speaks to current conditions."[54]

After *Shelby County*'s invalidation of §4(b) of the Voting Rights Act in 2013, the Court also decided the issue of whether districts drawn before the invalidation of § 4(b) to ensure compliance with the Act are unlawful as racial gerrymanders under the Fourteenth Amendment's Equal Protection Clause.[55] Cases following *Shelby County* tangentially relating to the right to vote address the judicial process within apportionment of congressional and

---

47 *Id.* at 2631.

48 *See id.* at 2621-22.

49 *Id.* at 2621.

50 *See id.* at 2627.

51 *Id.* at 2630.

52 *Id.* at 2623.

53 *Id.* at 2623-24.

54 *Id.* at 2629-30.

55 *See* Ala. Legis. Black Caucus v. Alabama, 135 S. Ct. 1257, 1262–63 (2015) (executing state goals of minimizing deviation from "'the theoretical ideal of precisely equal population'" and ensuring compliance with the Voting Rights Act would require the addition of individuals to underpopulated districts in the way that plaintiffs considered racial gerrymandering); Harris v. Ariz. Indep. Redistricting Comm'n, 136 S. Ct. 1301, 1306 (2016) (compliance with the Voting Rights Act is one of several "legitimate state considerations that can justify some deviation" from mathematical equality in population when drawing legislative districts).

legislative districts, state laws prohibiting judicial solicitation of funds for their campaign, laws mandating aggregate contribution limits to candidates or committees, and voter registration.[56]

There remains some uncertainty about the future of the remaining provisions and the legal applicability of the Act (including previous court decisions interpreting the Act but in which the now-invalidated provision was the central focus of the court's opinion). Cities and states responded quickly to the *Shelby County* decision by making changes to local elections laws that would have been previously impermissible under the VRA,[57] and the Department of Justice is free to decline involvement in many cases under a new administration.[58] For our purposes, the future of the VRA is not the issue, though it presents important policy concerns on other fronts. The point here is that there was a period when the VRA resulted in many cities agreeing to change their city council election systems,[59] and this change allows us to make before-and-after comparisons in the same city, as well as lateral comparisons to other cities (that had the same or the alternate system) on a year-by-year basis. Such comparisons reveal a significant difference in spending patterns and fiscal responsibility depending on the type of city council elections in use. Whatever the merits of district elections may be, they seem to lead to less responsible fiscal policies by the city.

We anticipate the objection that there is some historical "noise" in the correlation between cities that had to switch election systems under the VRA and fiscal mismanagement. Admittedly, many of the cities required

---

56 *See* Shapiro v. McManus, 136 S. Ct. 450, 453–56 (2015) (28 U.S.C. § 2284 entitles plaintiffs to challenge the constitutionality of the apportionment of congressional and legislative districts "before a three-judge district court."); Williams-Yulee v. Fla. Bar, 135 S. Ct. 1656, 1662–66 (2015) (the First Amendment permits restrictions on judges soliciting campaign funds, but the state must prove that the restriction is "narrowly tailored to serve a compelling interest." The "state's interest in 'protecting the integrity of the judiciary' and 'maintaining the public's confidence in an impartial judiciary'" are compelling interests and narrowly tailored); McCutcheon v. FEC, 134 S. Ct. 1434, 1442–56 (2014) (aggregate limits, which regulate "how much money a donor may contribute to all candidates or committees," are "invalid under the First Amendment" for "seriously restricting participating in the democratic process" and "are not 'closely drawn to avoid unnecessary abridgment of associational freedoms.'"); Arizona v. Inter Tribal Council of Ariz., Inc., 133 S. Ct 2247, 2260 (2013) (The National Voter Registration Act of 1993 preempts a state proof-of-citizenship requirement for voting registration applicants).

57 Ryan P. Haygood, *Hurricane SCOTUS: The Hubris of Striking Our Democracy's Discrimination Checkpoint in Shelby County & The Resulting Thunderstorm Assault on Voting Rights*, 10 HARV. L. & POL'Y REV. 11, 32-39 (2015). For example, Pasadena, Texas eliminated two district city council seats previously representing areas that were mostly Hispanic, replacing these council seats with at-large seats. *See id.* at 36. Galveston County cut justice of the peace and constable districts from eight to four, virtually eliminating "all of the Black – and Latino – held positions on both boards." *Id.* at 37. Shelby, North Carolina, considered consolidating five primarily black precincts into two. *See id* at 39.

58 *See* Cody Gray, *A New Proposal to Address Local Voting Discrimination*, 50 U. RICH. L. REV. 611, 615-17 (2016).

59 In Alabama between 1982 and 2006, "over 200 local and state voting practices" were prohibited or remedied by the VRA. *See* Haygood, *supra* note 57, at 23-24.

to change systems had a history of entrenched discrimination and de facto exclusion of minorities from the city council. Many of these same cities, of course, have longstanding endemic poverty and the typical socio-political problems that beset poor cities, such as high rates of crime and unemployment, outdated infrastructure, and so forth. Nevertheless, these factors vary enough by region over time that it is striking how consistent out result are nationwide, despite these background factors. Moreover, the fact that our data indicates changes in pension benefits and funding in before-and-after comparisons of the same city would suggest that district elections are not merely more common in particularly problematic cities. Instead, the same city – regardless of its history or pre-existing problems – will probably fare worse in terms of financial management after it switches from at-large to district elections.

As mentioned above, Section 5 of the VRA required DOJ pre-approval of any voting rule changes that affect minorities in jurisdictions that formerly had literacy tests and where less than 50 percent of persons of voting age were registered to vote on November 1, 1964.[60] In a series of cases beginning with *Allen v. State Board of Elections*,[61] the Supreme Court held that Section 5 applied not only to literacy tests, but also to electoral rules that reduce minority representation. The Southern states are defined as Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, Texas, and Virginia. Changes to voting laws brought about by Section 5 were gradual because of lack of prosecutorial resources. For instance, before 1978, the DOJ lacked formal procedures to verify that voting changes were submitted for review, exerted limited effort to inform jurisdictions of submission requirements, and had no follow-ups on submission objections. [62] One study conducted in 1979 and 1980 identified 1,000 voting rules changes that had not been submitted for pre-approval.[63]

Even so, in getting cities to adopt district elections, the DOJ had much greater leverage with Section 5 cities than with other cities because the DOJ could keep Section 5 cities from making any changes to their election laws until they had adopted district elections. For instance, the DOJ could prevent a city from annexing a nearby towns or changing election dates,[64] as could court orders.[65]

---

60 42 U.S.C. § 1973(c), *supra* note 8.

61 393 U.S. 544 (1969).

62 REPORT OF THE COMPTROLLER GENERAL OF THE UNITED STATES, "VOTING RIGHTS ACT – ENFORCEMENT NEEDS STRENGTHENING," GGD-78-19 (Feb. 6, 1978).

63 BY THE COMPTROLLER GENERAL, REPORT TO THE CHAIRMAN, SUBCOMMITTEE ON CIVIL AND CONSTITUTIONAL RIGHTS, COMMITTEE ON THE JUDICIARY HOUSE OF REPRESENTATIVES OF THE UNITED STATES, "JUSTICE CAN FURTHER IMPROVE ITS MONITORING OF CHANGES IN STATE/LOCAL VOTING LAWS," GAO/GGD-84-9 (Dec. 19, 1983).

64 *See, e.g.,* Bob Glendy & Gene Stowe, *Monroe Officials Hope U.S. Doesn't Delay Vote*, CHARLOTTE OBSERVER (June 19, 1991),

It is important to note the legal mechanism for the VRA's impact on cities. Many of these changes were not the result of litigation in which a court ordered a city to change its voting system in light of the VRA. Rather, the occasion for the switch to district elections was often a city's proposal to annex some neighboring unincorporated suburbs, especially in southern states in the second half of the twentieth century. Annexation of predominantly non-minority suburbs would boost the tax base for the municipality, but also threatened to dilute the voting power of inner-city minorities even more than before. The VRA, with its amendments and court glosses, required cities to obtain preapproval from the Department of Justice (DOJ) before proceeding with the annexation plans, and the DOJ would often impose an informal requirement that the city switch to district elections as a condition of approving—or at least not opposing—the proposed annexation.

The timing of the legislation, and the court decisions, leads us to the following predictions. The ability of the Voting Rights Act to force district elections grew during the 1970s and 1980s, although the crucial change was

---

http://infoweb.newsbank.com/resources/doc/nb/news/0F244B73BA4156E5?p=AMNEWS ("The U.S. Justice Department could force Monroe to adopt district representation for city elections because of annexation that takes effect June 30. Such a move by the justice department would delay elections for mayor and three council members until next spring."); Rick Sauder, *City Still Split Over At-Large Mayor,* RICHMOND TIMES-DISPATCH, (Nov. 12, 1990), http://infoweb.newsbank.com/resources/doc/nb/news/0EB4F82E8FA353F3?p=AMNEWS ("However, in 1970, Richmond annexed 23 square miles of Chesterfield County and touched off a legal battle that resulted in elections being suspended for seven years. When elections resumed in 1977, the city had been divided into nine wards, each of which was represented by one member of council. The ward system was the U.S. Department of Justice's remedy. . ."); Dawn Decwikiel-Kane*, Cutting New Paths in Civil Rights Law,* GREENSBORO NEWS & RECORD, (Aug. 16, 1990), http://infoweb.newsbank.com/resources/doc/nb/news/0EB19203EE5A77AC?p=AMNEWS ("The Greensboro City Council's change to a district election system in 1983 resulted not from a lawsuit, but from annexation."); Anrew Barron, *Reidsville Delegation Will Push Annexation,* GREENSBORO NEWS & RECORD, (Mar. 3, 1990), http://infoweb.newsbank.com/resources/doc/nb/news/0EB191E2C7CCF72B?p=AMNEWS ("Reidsville's plans to annex five areas bordering the city hit a snag Monday when the Justice Department requested more information on how the proposed annexation would affect minority voting and representation."); Dan Carney, *City Sets Annexation Machinery in Motion,* FAYETTEVILLE OBSERVER, (Feb. 2, 1988), http://infoweb.newsbank.com/resources/doc/nb/news/0F54EFF2B673A4F4?p=AMNEWS ("In 1985, the Justice Department forced the city to switch from an at-large to a mixed at-large/district system after the annexation of College Lakes decreased the percent of minority voters in the city."). It is not clear if Section 5 of the VRA remains operational in the wake of Section 4 being held to be unconstitutional.

[65] *See, e.g.,* Monte R. Young, *First Black Council Majority Forged in Pride and Tension*, RICHMOND TIMES-DISPATCH, (Apr. 19, 1987), http://infoweb.newsbank.com/resources/doc/nb/news/0EB4F6B2EA6CCFCC?p=AMNEWS ("Orders halting the 1972 election, issued a few days before it was to be held, and subsequent orders preventing additional council races were issued by the courts during litigation stemming from the 1970 annexation of part of Chesterfield County.").

removing the requirement of intent in 1982. Further, we expect these effects to be magnified in the areas where minorities had been disenfranchised to a higher degree, and which were covered under Section 5. Existing empirical evidence is consistent with these predictions. The VRA and its amendments have been shown to be effective at increasing the fraction of council members elected by district and at increasing minority representation.[66] Case studies have also shown that switching to district elections led to a greater number of candidates, lower campaign expenditures and a lessor role of the mass media, more party activity (even though the elections remained formally nonpartisan), and the dismantling of slating groups.[67] Thus, existing evidence shows that the Voting Rights Acts undid some of the municipal reforms of the early twentieth century. However, prior to this paper, no evidence has been provided showing how the dismantling of municipal reforms has affected the viability of cities.

### B. *State Laws and Rules Limiting Municipal Bond Issues and Other Types of Overspending*

Many states have laws (statutes or state constitutions) limiting the authority of municipalities to raise revenue, whether by tax increases[68] or bond

---

66 *See generally* Francesco Trebbi, Philippi Aghion, & Alberto Alesina, *Electoral Rules and Minority Representation in U.S. Cities*, 123 QUART. J. ECON. 325 (2008); Tim R. Sass & Stephen L. Mehay, *The Voting Rights Act, District Elections, and the Success of Black Candidates in Municipal Elections,* 38 J. L. & ECON. 367 (1995).

67 *See generally* Louis Ricardo Fraga, Domination through Democratic Means: *Nonpartisan Slating Groups in City Electoral Politics*, 23 URBAN AFFAIRS REV. 528 (1988); Bruce B. Clary & J. Oliver Williams, *The Impact of District Elections: A Case Study*, 14 STATE & LOCAL GOVERNMENT REV. 61 (1982).

68 *See, e.g.,* Erin Adele Scharff, *Powerful Cities?: Limits on Municipal Taxing Authority and What To Do About Them,* 91 N.Y.U. L. REV. 292, 296-98 (2016); Mike Ward, *Big City Mayors to Lege: Don't Mess with Taxes*, HOUSTON CHRON, (Feb. 16, 2015), http://www.chron.com/news/politics/texas/article/Big-city-mayors-to-Lege-Don-t-mess-with-taxes-6083909.php; Christine Sgarlata Chung, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities For Reform,* 34 CARDOZO L. REV. 1455, 1482 (2013); Federico Revelli, *Tax Mix Corners and Other Kinks,* 56 J. L. & ECON. 741, 743 (2013) (surveying sources); Lyle Kossis, *Examining the Conflict between Municipal Receivership and Local Autonomy,* 98 VA. L. REV. 1109, 1142 (2012) ("Constitutionally speaking, cities are limited in their ability to generate revenue due to state tax and expenditure limitations ("TELs"), while some are simultaneously required to spend money on certain projects due to constitutional spending commitments."); Erin Adele Scharff, *Taxes as Regulatory Tools: An Argument for Expanding New York City's Taxing Authority,* 86 N.Y.U. L. REV. 1556, 1573-76 (2011); Richard Briffault, *Foreword*: *The Disfavored Constitution: State Fiscal Limits and State Constitutional Law,* 34 RUTGERS L. J. 907, 915 (2003) (state limits on municipal borrowing); Michael R. Johnson et al., *State Constitutional Tax Limitations: The Colorado and California Experiences*, 35 URB. L. 817 (2003) (limits on cities' ability to raise tax revenue); David N. Figlio, *The Local Response to Tax Limitation Measures: Do Local Governments Manipulate Voters to Increase Revenues?,* 44 J. L. & ECON. 233, 253 (2001).

issues.[69] Most (thirty) have spending restrictions as well.[70] Traditionally, municipalities do not have independent political power or legal authority – instead, they derive their legal authority as a delegation of power from the state legislature (a principle known as "Dillon's Rule").[71] State governments thus have legal authority to expand or curb the legal powers of cities or city councils. Following periods of municipal bailouts by states, many states have adopted legal rules that severely limit a city's ability to raise it revenues through property tax increases, imposition of city sales taxes, or municipal bond issues.[72] All but four states now place limits on municipal authority to raise taxes.[73] As of 1990, thirty-nine states required a referendum for all local general obligation bond issues.[74] In other words, for increasing city revenue, a city's main alternative to property tax increases usually faces a legal restraint in the state statutes, requiring local bond decisions to be subject to a citywide referendum, rather than by district representatives.

City councils can use pensions to evade bond referenda.[75] First, cities can give employees higher pensions, thus committing the city to pay these higher benefits for many years. Giving employees higher pension benefits allows cities to shift part of the compensation of current employees onto the future, thus freeing more money for current spending. Generally, govern-

---

69 *See* Briffault, *supra* note 68, at 915-18.

70 *See* Brent T. White, et al., *Urban Decay, Austerity, and the Rule of Law*, 64 EMORY L. J. 1, 44-46 (2014) ("In response to this problem, the U.S. federal government and state governments have embraced a general commitment to austerity vis-à-vis local municipalities, through a variety of policies that combine balanced budget requirements, expenditure limitations, and other fiscal constraints."); Schragger, *infra* note 68, at 866; Kossis, *supra* note 68, at 1142-43. *See also* Sharmila L. Murthy, *A New Constitutive Commitment to Water*, 36 B.C. J. L. & SOC. JUST. 159, 223 (2016) ("In 1978, Michigan amended its constitution to impose limits on state and municipal spending and to require voter approval before new taxes could be imposed."); Nick Dranias, *The Local Liberty Charter: Restoring Grassroots Liberty to Restrain Cities Gone Wild*, 3 PHOENIX L. REV. 113, 185-86 (2010) ("In 1980, Arizonans amended the state constitution to restrict the growth of spending by counties, cities, and towns to a formula based on past revenues, adjusted by growth in population plus inflation."); Richard Briffault, *Our Localism: Part II—Localism and Legal Theory,* 90 COLUM. L. REV. 346, 350 n. 28 (1990) (providing examples of spending restrictions attached as conditions to grants).

71 *See* Comment, *The State's Vicarious Liability for the Actions of the City*, 124 HARV. L. REV. 1036, 1037-38 (2011), *citing* 1 JOHN F. DILLON, COMMENTARIES ON THE LAW OF MUNICIPAL CORPORATIONS § 237, at 449 (5th ed. 1911).

72 Richard C. Schragger, *Democracy and Debt*, 121 YALE L. J. 860, 862-63 (2012); Ved P. Nanda, *Limitations on Government Debt and Deficits in the United States*, 62 AM. J. COMP. L. 539, 554 (2014).

73 Currently, forty-six states severely restrict a municipality's authority to increase taxes. Samir D. Parikh, *A New Fulcrum Point for City Survival,* 57 WM. & MARY L. REV. 221, 235 (2015).

74 Advisory Commission on Intergovernmental Relations, 1993.

75 Other commentators have noted the incentives of city officials to try to work around bond referendum requirements. *See, e.g.,* Adam C. Parker, *Still as Moonlight: Why Tax Increment Financing Stalled in North Carolina*, 91 N.C. L. REV. 661, 716 (2013); Stacey L. Joseph Cardenas, *Constitutional Expansion of Local Government Financing Alternatives:* Wayne County Citizen Association v. Wayne County Board of Commissioners*,* 70 N.C. L. REV. 1947, 1954-55 (1992).

ment employees receive a larger fraction of their pay in retirement benefits, compared to their counterparts in the private sector. For example, in 2009, defined benefits and contributions accounted for 4.4% of employee costs for private employers vs. 8% for state and local governments.[76] Second, cities can reduce their contributions to the municipal retirement trust, which effectively commits future city council members to fund retirement payments out of general funds. Other researchers have found that many cities use discount rates that underestimate the future cost of pension benefits as a means of reducing current contribution to the municipal retirement trust.[77]

This legal framework is important for explaining one unexpected result in our research – that pension benefits increase with district elections, but employee wages do not. Earlier studies had suggested (with some ambiguity) that district elections increased both wages and benefits, but our data shows otherwise – wages for municipal workers, such as police and firefighters, stay the same regardless of the type of election, even though pension benefits increase. If the city council were merely trying to help city workers (perhaps because district elections creates more incentives for this), we would normally expect to see wages increase as well, but they do not. We believe this is because state laws, perhaps in combination with some monopsony effects for city wages and the market pressures creates by the trend toward privatization or outsourcing, prevent city councils from raising the wages. Instead, they shift the problem forward in time by promising larger pensions without providing any additional funding for those pensions now.

In terms of incentives, there are two alternative explanations for the influence of the local election rules on such borrowing against the future. One possibility, favored by the authors, is that district election systems make those council members less accountable to voters overall, and therefore less responsible in their fiscal policy decisions.[78] They have more of a captive market for their constituents, a much smaller pool of potential challengers, and so forth – making them harder to unseat when they are up for reelection. Earlier research by others[79] suggested that switching to district

---

76 *See generally* David Lewin, et al., *The New Great Debate About Unionism and Collective Bargaining in U.S. State and Local Governments,* 65 INDUST. & LAB. REL. REV. 749 (2012). If we include social security contributions, the difference is 9% vs. 11.7%.

77 *See generally* Robert Novy-Marx and Joshua D. Rauh, *The Crisis In Local Government Pensions in the United States,* in Robert Litan and Richard Herring, ed., GROWING OLD: PAYING FOR RETIREMENT AND INSTITUTIONAL MONEY MANAGEMENT AFTER THE fINANCIAL CRISIS (Brookings Institution 2011); Jeffrey R. Brown and David W. Wilcox, *Discounting State and Local Pension Liabilities*, 99 AMER. ECON. REV. 538 (2009).

78 In federal congressional politics, by way of analogy, the Senate has less turnover than the House, due in part to the difference in their respective terms (six years for Senators and two for Representatives).

79 *See, e.g.,* Richard Engstrom & Michael McDonald, *The Effect of At-Large Versus District Elections on Racial Representation in U.S. Municipalities,* IN BERNARD GRAFMAN, AREND LIJPHART,

elections did not produce significant changes in policy to favor minority residents or their neighborhoods, but instead resulted in self-interested pursuits by entrenched council members. Under this unfaithful-agent view, the future-shifting of city worker compensation is a symptom of a larger problem (self-interested politicians versus the common good), and probably represents the most convenient solution for resolving collective bargaining disputes with police and firefighter unions. Raising current wages for municipal employees would require shifting resources away from the council member's own pet projects, or from the pet projects of other members, which could be politically costly. Promising more generous pensions for workers, with payouts postponed until sometime in the future, are costless by comparison, from the standpoint of the council member's self-interest. State laws limiting the methods of increasing city revenues, or imposing functional caps on current spending, simply exacerbate these agency costs.

The other possibility is a variation on the common pool problem; district elections create incentives for city council members to vote for "pork" expenditures, expenditures that primarily benefit their own constituents (residents of their respective districts), such as pension benefits for municipal workers in those neighborhoods. If generous municipal pensions disproportionately benefit minority neighborhoods (either because a disproportionate number of city workers reside there, or because the pensions of the workers residing there are a disproportionate share of the neighborhood's income), then council members elected by district would have rather clear incentives to increase the pension benefits. Of course, the same line of reasoning would lead them to vote for wage increases (another way of benefitting the workers in their districts), but this does not seem to occur – municipal wages seem to be unaffected by the type of election. On this point, the state law constraints on current-year city budgets could be a major factor, effectively blocking city councils from approving wage increases that they would otherwise want. Foreclosing one method of benefitting workers would tend to shift efforts to the remaining available option(s) for achieving the same ends, such as more generous pension benefits in the future. In other words, if the common pool problem is the better explanation, the pension increases are a workaround for the constraints of state law.[80]

---

ELECTORAL LAWS AND THEIR POLITICAL CONSEQUENCES 218-21 (1986); ALBERT K. KARNIG AND SUSAN WELCH, BLACK REPRESENTATION AND URBAN POLICY 121-41 (1980); *see generally* Peter K. Eisinger, *Black Employment in Municipal Jobs: The Impact of Black Political Power*, 76 AM. POL. SCI. REV. 380 (1982). For a contrary view, *see* Melissa J. Marschall & Anirudh V. S. Ruhil, *Substantive Symbols: The Attitudinal Dimension of Black Political Incorporation in Local Government*, 51 AM. J. POL. SCI. 17 (2007) (showing that minority voters at least perceive their city's policies to be more favorable to them when they have members of their own group on the city council).

80 For an exploration of other examples of such workarounds, *see* Figlio, *supra* note 68, at 233 ("[S]ome cities subject to a statewide tax limit manipulate their mix of productive and administrative services in an attempt to get voters to override the statewide limit. When a statewide limit reduces a city's budget, one manipulative response is to cut 'service' inputs (for example, teachers or uniformed

We find the first explanation more plausible, especially because it fits with earlier research[81] showing that district elections did not yield policy changes favoring minority neighborhoods (the voter blocks supposed to benefit from the switch to district elections) – the agency costs of individual official's self-interest offset any gains from eliminating vote dilution. "The level of black representation on the council had minimal, if any, impact on any of the policy areas, including the social services category."[82] Even so, we cannot prove that the first option is correct and the second option is not, so it is worthwhile to mention both possibilities until further research clarifies this point.

The higher pension benefits in cities with district elections is also consistent with explanations other than the common pool problem. For instance, the higher pension benefits could reflect greater influence of employee unions. If district elections increased union influence, then district elections would be associated with higher employee pension benefits and higher salaries. The problem with this explanation is that we do not find higher municipal employee salaries in cities that adopt district elections. Consequently, the evidence is most consistent with district elections leading to greater common pool problem.

The increased registration by blacks brought by the Voting Rights Act may have also brought changes to municipal budgets. Cascio and Washington[83] show that counties with higher black population shares saw greater increases in state transfers from removals of literacy tests, compared to counties with lower black shares. Thus, the higher pension benefits for cities that switch to district elections could be due to greater resources. Again, this explanation is unlikely, as we do not find higher municipal employee salaries in cities that adopt district elections.

## II. RESEARCH AND FINDINGS

One of the authors examined a panel of 2,576 cities over fifty-seven years from 1957 to 2014, for a longitudinal view of district elections and the resulting financial decisions. Our sample includes the years of change introduced by the 1965 Voting Rights Act, along with its 1975 and 1982 amendments. In addition, there was an examination of data regarding the political system for 2,361 cities from 1957-2014,[84] to identify whether the

---

police officers) by a relatively large amount, while cutting administrative inputs by a relatively small amount.").

81 *See supra* note 78 and sources cited therein.

82 Engstrom & McDonald, *supra* note 79, at 221 (citing Karnig & Welch, *supra* note 79).

83 *See* Elizabeth U. Cascio & Ebonya Washington, *Valuing the Vote: The Redistribution of Voting Rights and State Funds Following the Voting Rights Act of 1965*, 129 QUART. J. ECON. 379 (2012).

84 International City Managers Association, Municipal Year Book, various years.

council members are elected at-large or district, whether elections are partisan, or nonpartisan, and whether the executive is the mayor, the city-manager, or a commission.

Over the sample period, 854 cities changed the fraction of the council elected at-large by at least 20%, 299 cities changed who has executive power (mayor, city manager, or commission), while 92 cities changed whether elections are partisan or nonpartisan. It is relatively common for cities to change political systems, although the most common change is increasing the fraction of council members elected by district. It is worth noting that the 2012 population in the cities in our sample is 149,524,304, approximately 48% of the residents of the United States, but this includes both cities covered under Section 5 of the VRA and cities that are outside its scope.

As mentioned above, we would expect the change in election method to be associated with the passage of the VRA and its amendments, and to vary by whether a city is covered under Section 5 of the VRA. The percent of the councils elected at-large drastically decreased from 1965 to 2004. In contrast, for cities not covered under Section 5 of the VRA and that had the entire council elected at-large in some year between 1965 and 1974, this percent decreased more slowly. Thus, the cities that were most affected by the VRA in this regard (changing their local election rules) were Section 5 cities that had the entire council elected at-large for at-least one year between 1965 and 1974. We use the remaining Section 5 cities as a control group to quantity the effect of the VRA on these cities.

Consider, for example, cities that had a council elected by an at-large system for at least one of the years between 1965 and 1974. If we look only at the first year in that period, 1965, 99% percent of the council was elected at-large in these cities. In cities that had at least some district elections for councilmembers in those years, however, the percentage in the year 1965 was much lower - 11%.[85] Thus, the percent of the council elected at-large was 88% points higher for the first group than the second group.

In 2012, the difference in percentage elected at-large between these two groups had shrunk to 28% points, thus leading us to conclude that the Voting Rights Act reduced the percent of the council elected at-large in Section 5 cities by 60% points. In contrast, for cities not covered under Section 5, the VRA reduced the percent elected at-large for cities by 21% points.[86] Thus, the incremental effect of Section 5 was to reduce the percent elected at-large by 39% points. This point should be uncontroversial – we would expect cities covered by a remedial statute to show the greatest change in the years following the statute's enactment.

We use the same methodology to examine the impact of the VRA on the percentage of city spending on infrastructure (buildings, grounds, and

---

85 Boylan, *supra* note 6, at 12 (Panel 1A, Table 1).

86 *Id.* (Panel 1B).

other improvements; and purchase of equipment, land, and existing structures).[87] Infrastructure represents 17% of overall municipal expenditures, with roads, sewer, and water utility comprising half of infrastructure spending. For those cities under Section 5, cities that had the entire council elected at-large spent 5-10% more on capital than other cities in early years, and 0-5% less in later years. Thus, implementation of Section 5 of the VRA has been associated with a decrease in infrastructure investment.

Our pension sample consists of a subset of 757 cities in 46 states that have city-administered pensions (the remaining cities have state administered pensions).[88] The 2012 combined population in these cities was 74,377,476. On average, each city has 3,083 members of its pension plan, and 1,545 beneficiaries, who receive an average of $9,404 in yearly benefits, in 1983 dollars. Further pension receipts average 254% of pension benefits.

The study compared two groups of cities to highlight differences in city government. The first group was cities where the proportion of the council that is elected at-large changed by less than 20% points over the years 1957 through 2014. Among these cities, in 1965, 22% had all council members elected at-large, 57% had all elected by district, and 21% had some council members elected at-large and some by district. The second group included cities where this change exceeded 20% points. For the "change cities," the proportion of council members elected at-large dropped drastically from 82% in 1977 to 22% in 2000. Thus, the timing of the decrease in at-large representation matches the timing of the legislation and court decisions discussed in the previous section. Cities that were more likely to have increased district representation were also more likely to have increased pension benefits. Conversely, cities that were more likely to have increased district representation were also more likely to have decreased funding of pensions. Overall, we find that cities with district elections have higher pension benefits, lower funding of pensions, and lower infrastructure spending, which is consistent with the hypothesis that these cities face a common pool problem.

These results also hold in regressions, thus allowing to control for factors such as city fixed effects, year fixed effects, population, income, age, race, ethnicity, collective bargaining laws, size of the council, city government (mayor-council, council-manager, or commission), whether elections are partisan, number of members and beneficiaries in the municipal pension, whether the state has property tax limits, and cluster errors by state. We obtained demographic variables from Decennial Census (various

[87] *See* id at 13. Data is obtained from U.S. Census of State and Local Finances, various years.

[88] Retirement data is obtained from the U.S. Census Survey of Public Pensions (1993 through 2014) and the Historical Database on Public Employee-Retirement Systems 1957-2007.

years), collective bargaining laws from Lawrence et al.,[89] and property tax limit laws from McCubbins and Moule.[90]

It is tempting to interpret higher pension benefits as manifestations of council members putting the interests of their districts above the interests of the city as a whole (a common pool problem). Alternatively, we could have interpreted higher benefits as elected officials caring more about municipal employees. Another possible explanation is that cities with district elections pay their employees more because they have more resources or have a higher cost of living. There is reason to doubt this last explanation – using data for municipal salaries was obtained from U.S. Census for Government Employment and Payroll, we did not find that cities that switch to district election pay higher salaries to their employees.

## III. INFERENCES AND POLICY SUGGESTIONS

Municipal pensions constitute a crucial part of the current financial crisis for American cities.[91] A large literature in the field of economics has demonstrated how underfunded pensions are hurtful for cities,[92] affecting the provision of local government services, the likelihood of bankruptcy, and even present home values. To the extent that workers would have preferred higher current wages over more generous pensions, the excessive pensions (and static wages) represent wasted resources.[93]

While district elections promised to bring better representation for urban minorities, there appear to be some downsides for the financial health of cities. District elections lead to larger pension benefits for municipal employees, underfunding for these pensions, and insufficient spending on infrastructure. As discussed above, we believe that this is due to an agency cost problem (unfaithful agents) – council members elected by district have less accountability (they represent fewer voters, face a smaller pool of potential challengers, and so on), and therefore are less careful with the city's long-term financial welfare than they otherwise would be. This fits with earlier research indicating that changing to district elections did not, in fact,

---

89 Geoffrey Lawrence, et al., *How government unions affect state and local finances: An empirical 50-state review*, HERITAGE FOUNDATION, (Apr. 11, 2016), http://www.heritage.org/jobs-and-labor/report/how-government-unions-affect-state-and-local-finances-empirical-50-state.

90 Mathew D. McCubbins & Ellen Moule, *Making Mountains of Debt out of Molehills: The Procyclical Implications of Tax and Expenditure Limitations*, 63 NAT'L TAX J. 603 (2010).

91 *See* Tiesenga, *supra* note 3, at 8.

92 *See* James M. Ferris & Sanford M. Groves, *Public Pension Funding and the Financial Condition of Local Government*, 76 PROCEEDINGS OF THE ANNUAL CONFERENCE ON TAXATION HELD UNDER THE AUSPICES OF THE NATIONAL TAX ASSOCIATION-TAX INSTITUTE OF AMERICA 237 (1983) (discussing the potentially large magnitude of impact which underfunding a pension system can have on the overall financial conditions of local governments).

93 *See* Glaeser & Ponzetto, *supra* note 16.

bring in policy changes that favored the minority residents that district elections were supposed to help.[94] Promising larger pensions is a way for city councils to push financial problems off onto future generations, but may present an easy-way-out to labor disputes with city workers, or could be politically popular (as in the aftermath of 9/11). An alternative explanation, which we acknowledge is plausible though less compelling than the unfaithful agent theory, is that council members elected by district are trying to shift resources to benefit constituents in their own districts, and that excessive pension benefits are one of the few options for government largess when state law restricts current spending increases, bond issues, local tax increases, or all three of these. This is a version of the common pool problem, with the feature of an unhealthy workaround for restrictive state rules.

A large literature has examined how electoral rules affect government decisions. For instance, Professor Persson and two sets of co-authors[95] found that proportional voting rules and parliamentary regimes lead to less under-provision of the public good and more rents to politicians, compared to majoritarian voting and presidential regimes. Thus, it is surprising that prior empirical work has not found a relation between city spending and whether city councils are elected by district or at-large.[96] We can show that switching to district elections decreases infrastructure spending, increases the generosity of pensions, and decreases funding of pensions. Thus, the previous results may have been driven by their examination of expenditures categories that are too broad to be able to identity an effect of district elections.

One obvious suggestion, though the benefits would take time to materialize, would be to switch back to at-large elections, which seem to yield policy decisions that are better for the long-term health of the whole city. At-large elections mitigate, if not eliminate, both the common pool problem and the unfaithful agent problem (providing more political accountability), thereby addressing both alternative views of the causation that are summarized above.

If district elections are indeed worth keeping for the sake of giving minorities a voice in local government (a question outside the scope of this paper), then measures are necessary to offset or compensate for the inherent downside of district elections. State law already regulate municipal financial irresponsibility regarding taxation, bond issues, and current expendi-

---

94 *See supra* note 94.

95 Torsten Persson, et al., *Comparative Politics and Public Finance*, 108 J. POL. ECON. 1121 (2000); Torsten Persson & Guido Tabellini, *The Size and Scope of Government: Comparative Politics With Rational Politicians*, 43 EUR. ECON. REV. 699 (1998).

96 Chris Tausanovitch & Christopher Warshaw, *Representation in Municipal Government*, 103 AM. POL. SCI. REV. 605 (2014); Stephen Coate & Brian Knight, *Government Form and Public Spending: Theory and Evidence from U.S. Municipalities*, 3 AM. ECON. J. ECON. POL'Y 82 (2011); MacDonald, *supra* note 19; Reza Baqir, *Districting and Government Overspending*, 110 J. POL. ECON. 1318 (2001).

tures, so it would be consistent to add state law restrictions on increasing municipal pension benefits. This could take the form of a cap on increases, or a complete takeover of the pension plans (and the benefits) by the state government itself. The problem with the latter approach is that some states, such as Texas, that have already done this have in turn delegated the pension decisions (including the city funding required) to private entities controlled by the workers' unions, as seen in recent litigation brought (and lost, at the Texas Supreme Court[97]) by the City of Houston.[98] This problem has emerged elsewhere as well.[99] In other states, such as Massachusetts and Ohio, centralization of public employee pensions has produced only a modest, and probably not universally reproducible, improvement.[100]

Other commentators have recently suggested that bankruptcy courts have much broader powers,[101] perhaps even to the extent of reorganizing city governments (regardless of the existing city charter),[102] at least temporarily, to break a cycle (or longstanding pattern) of dysfunctional governance and fiscal irresponsibility by local officials. This latter proposal focused on the power sharing between the mayor or other city executive, the city council, and other local authorities.[103] If indeed bankruptcy courts were to assume such powers in cases of municipal bankruptcy, our research indicates that they should consider the problem of district council seats versus at-large elections, especially in light of the Supreme Court's recent invalidation of Section 4 of the VRA. Similarly, Article III courts or common law courts addressing litigation over the pensions alone (outside the context of bankruptcy, but still in situations of financial crisis for the city) should consider the likelihood of an ongoing pattern of underfunded, over-promised pensions that go along with district election systems.[104]

## CONCLUSION

There exists a strong relationship between the structure of municipal elections and the strengths and weaknesses of a municipality's fiscal policy.

---

97 *See* City of Houston v. Houston Firefighters' Relief and Retirement Fund, 196 S.W.3d 271 (Tex. App. 2006).

98 *See id.* at *1-2.

99 *See* Tiesenga*, supra* note 3, at 9-12.

100 *See generally* Glaeser & Ponzetto, *supra* note 16 (comparing centralization programs in MA and OH with decentralized systems in CA and PA).

101 *See generally* Dawson, *supra* note 3; Spiotto, *supra* note 3 (arguing that courts should simply reduce the pensions).

102 *See generally* Gillette & Skeel, *supra* note 2.

103 *See id.*

104 Judicial abrogation of the pension contracts themselves – the shortcut route to resolving the crisis – could implicate constitutional Contracts Clause issues. *See* Whitney Cloud*, State Pension Deficits, the Recession, and a Modern View of the Contracts Clause*, 120 YALE L. J. 2199 (2011).

District elections, designed to give direct representation to smaller geographic areas at the cost of at-large representation of the entire city, have increased in prominence due to the Voting Rights Act and similar legislative and judicial municipal-election reforms. In municipalities with representation based on district elections, spending tends to increase without a corresponding increase in fundraising. Such municipalities often increase pension spending, which shifts costs to future budgets to make room for present spending, effectively shifting the burden of new spending to future budgets and therefore to taxpayers down the line. One possible explanation for this shift is that district representatives feel political pressure only from their district, so they tend to allocate municipal funding toward their district, even if such an allocation does not benefit the city at-large. A somewhat more likely explanation, however, is that district elections reduce the overall political accountability for individual council members, creating an agency problem – with the result that city councils act less responsibly regarding the city's long-term health. A return to at-large municipal representation would realign the incentives of the representatives to the benefit of the city at-large, thereby reducing losses due to the common pool problem and allocating more present costs to their present beneficiaries.

# THE LEAD LEMMING: ILLINOIS ON THE PENSION-CRISIS BRINK

*Scott Andrew Shepard*

## INTRODUCTION

Very serious financial difficulties – and increasingly, partly as a result, social and even constitutional difficulties – have befallen the State of Illinois. The cause of Illinois' parlous condition is the comprehensive mismanagement and corruption that has characterized its political and economic life for decades; the chief form of its catastrophe arises from its government-employee pension obligations. These have, it appears, never received proper funding, and now stand at the threshold of financial collapse.

The Illinois State Supreme Court compounds this situation by reading the state constitution's pension-protection amendment to require that the state honor, for current public employees, any pension promises made to those employees at any time during their service for the whole period of that service – even if the service has not yet been performed (and may not be performed for decades), and thus the benefit not yet earned or accrued. The Court simultaneously refuses to recognize any constitutional obligation for the legislature or the municipalities offering the benefits to provide actuarially sound, ongoing funding for these doctrinally ironclad pension benefits; rather, it fairly airily posits that the state constitution requires the taxpayers to fund the benefits, somehow, as they come due, without regard to the legislature's prior funding efforts or the state or municipality's ability to pay. This conjunction of interpretations – along with the historically louche nature of Illinois government – has rendered the state uniquely vulnerable to the low-nominal-return investment scenario that has played out since the financial crisis of 2008, and which shows no reliable sign of abating in the foreseeable future. And in the foreseeable future, time runs out for Illinois.

The state was not primordially bound to this fate. Ultimately, of course, it could at least in theory have undertaken sound government in the preceding century, as by (relevantly) funding its pension promises in actuarially sound ways as it went along. Alas, were wishes horses. It may now be too late – the math not just difficult, but effectively impossible – for the state to save itself. But it may not. The political branches have acted with extravagant dissipation, and the state supreme court with almost willful bone-headedness. This could yet be altered, however, in ways discussed in this paper. Given the powers of sovereignty and the protections of semi-sovereignty as a junior dual sovereign in a federal system, even this last minute reversal of course, if speedily attempted, fully completed, and bravely carried forward, might just prove sufficient to ward off disaster.

Should the various branches of Illinois government fail in this last opportunity, however, the state's remaining options grow increasingly bleak. There is little hope that the federal courts will intervene: at least under present understandings and precedent, its remit does not reach so far. The federal political branches eventually would have to: in this interconnected era of easy transportation and investment flows, the federal government could hardly allow one of the largest industrial states to slide into effective anarchy, and it won't, especially while the sitting Speaker of the House of Representatives calls a town less than one hundred miles north of Illinois his home. Likewise, though, there is little doubt that Washington will demand – and has the constitutional and practical power and necessity to obtain – a high and steep penalty from Springfield for any conceivable bailout.

In Section I of this article, I recount briefly the history and establish the scope of the financial crisis into which Illinois has cast itself, a result of as much as a century of public-pension mismanagement by the political branches and nearly half a century of increasingly internally incoherent Illinois State Supreme Court interpretation of the state's pension-protection amendment, written into the state constitution in 1970. In Section II, I turn from effect to causes, reviewing the Illinois Pension-Protection Amendment ("the IPPA") directly, including its adoption and subsequent interpretation; and the train of political missteps and misdeeds that prompted and have followed that adoption. In Section III, I consider the options remaining to the Illinois state government as an independent actor. I conclude that the state might (though time may perhaps have grown already too short) just about be able to reverse course, but only if the political branches recognize clearly the internal and interpretive incoherence – a fundamentally unnecessary incoherence – of the state supreme court's interpretation of the IPPA, and present it rapidly, with a clear explication of its error and a face-saving way of correcting itself, in the form of a new pension-reform statute that makes careful and well-explained distinctions between already-earned and still-prospective pension benefits, preserving the former entirely while decreasing the latter materially. I also consider the possibility that a pension-tax levy – whether uniquely targeted at public-employment retirees or at all pensioners more broadly – might offer an additional tool in meeting this crisis. In Section IV, I consider the possible and likely results awaiting if Illinois cannot or will not put its own fiscal and constitutional house back in order. I conclude that the federal government will eventually be forced to act, but that in doing so it will demand, and has the constitutional power and political need to get, a massive and long-term surrender of a significant portion of Illinois' sovereign and governing authority in exchange.

## I. HISTORY & EXTENT OF THE CRISIS

Illinois' pension crisis–and therefore its financial state generally–has grown grave. Its pension obligations are only – at very best[1] – less than 42 percent funded,[2] the lowest aggregate funding level in the Republic. It labors under the lowest credit rating in the nation.[3] It has run without a budget since 2014,[4] and its state government at Springfield shows no sign of finding a way through the impasse.[5] Its metropolis faces these same problems, somewhat in miniature but really in magnification, and partly as a result is descending into ungovernability.[6]

---

1 Using a newer and more conservative metric to determine total funding levels, Moody's concluded in 2013 that Illinois is only 24 percent funded. *See* John Mauldin, Somehow, *Illinois Will Have to Find an Extra $210 Billion Over the Next 10 Years*, BUS. INSIDER (Sept. 15, 2013, 7:23 AM), http://www.businessinsider.com/illinois-underfunded-pensions-2013-9. (The relative effect of various discount rates is discussed *infra* this section.).

2 *See* Dave McKinney & Karen Pierog, *Illinois' Governor's Office Warns of Crippling Pension Payment Hike, Reuters*, CHI. TRIBUNE (Aug. 23, 2016, 4:55 PM), http://www.reuters.com/article/us-illinois-pensions/illinois-governors-office-warns-of-crippling-pension-payment-hike-idUSKCN10Y28Z (presently 41.9 percent funded at an 8 percent inferred discount rate for the fund that makes up more than half of the shortfall).

3 *See, e.g.*, T. Leigh Anenson, et al., *Reforming Public Pensions*, 33 YALE L & POL'Y REV. 1, 6, 41 (2015).

4 *See, e.g.*, Memo from Michael Mahoney, Governor Rauner's Senior Advisor for Revenue and Pensions, to Governor's Chief of Staff Richard Goldberg (re: Teachers' Retirement System Board intention further to reduce its imputed discount rate) (Aug. 22, 2016) (cited in, *e.g.*, Dave McKinney & Karen Pierog, *supra* note 2).

5 *Id.* (The government continues partially to function under a part-year budget, but a full budget or general agreement on broader issues seems nowhere in sight.).

6 *See, e.g.*, Mark Berman, *Chicago Surpasses 600 Homicides in 2016 and is on Pace to Have its Deadliest Year in Two Decades*, WASH. POST (Nov. 1, 2016), https://www.washingtonpost.com/news/post-nation/wp/2016/11/01/chicago-surpasses-600-homicides-in-2016-and-is-on-pace-to-have-its-deadliest-year-in-two-decades/?utm_term=.b83369010537; *Chicago Has its Deadliest Weekend of the Year: 17 Killed, 42 wounded*, L.A. TIMES (Oct. 31, 2016, 10:55 AM), http://www.latimes.com/nation/la-na-chicago-violence-20161031-story.html; Violence in Chicago – in Five Shocking Stats, BBC NEWS (Aug. 29 2016), http://www.bbc.com/news/world-us-canada-37216025; Jeremy Gorner, et al., *August Most Violent Month in Chicago in Almost 20 Years*, CHI. TRIBUNE (Aug. 29, 2016, 8:25 PM), http://www.chicagotribune.com/news/local/breaking/ct-august-most-violent-shootings-chicago-20160829-story.html ("New York, with more than three times the population of Chicago, has recorded 760 shooting victims and logged 222 homicides, according to NYPD crime statistics through Aug. 21. In Los Angeles, a city of about 4 million, 176 people have been slain and 729 people shot, according to LAPD crime data through Aug. 20."); Juan Perez, Jr., et al., *Chicago Public Schools Faces Cash Crunch Now, Possible Crisis in the Fall*, CHI. TRIBUNE (June 21, 2015, 12:21 PM), http://www.chicagotribune.com/news/ct-cps-financial-crisis-met-20150622-story.html (highlighting how education funds were cut to pay for pension funding); Tim Jones, *Illinois Towns Drowning in Pension Debt from Hundreds of Funds*, STATE JOURNAL-REGISTER (Aug. 24, 2015, 1:10 PM), http://www.sj-r.com/article/20150824/NEWS/150829776 (highlighting municipalities cutting essential public services to fund pensions); *America's Greece? Illinois Risks Default if it Fails to Tackle*

The fecklessness which has driven Illinois into its desperate strait is worth considering in some swift detail. According to the state's supreme court, Illinois has never responsibly funded its government-employee pension promises.[7] The City of Chicago revoked many of its underfunded promises during the Depression.[8] Even in the flush decades after World War II, the state so chronically and comprehensively failed of fiscal responsibility toward these pension promises that the Illinois Constitutional Convention of 1970 added a provision to the state constitution of that year, the IPPA, barring future legislatures from reducing or diminishing pension benefits after they had been granted.[9]

Despite this constitutional protection, the legislature continued to underfund the state's pension promises, while both increasing the level of benefits and building in mandatory annual increases–untethered to broader economic circumstance[10] – so that by the middle 1990s the funds had reached a state of crisis. Its purported "solution" then to its pension crisis constituted effective – even if not quite legal – fraud on the Illinois taxpayer (and, if the pension promises cannot eventually be fulfilled, on state workers of that and the next era). As the Chicago Tribune has explained:

> Illinois' artful bungling traces to a notorious 1994 episode: Then-Gov. Jim Edgar signed into law a pension funding plan, supported by Statehouse Democrats and Republicans, that was all but doomed to fail: It gave lawmakers a lavish 50 years, rather than the customary 30, to backfill their underfunded system. It asked them only to achieve 90 percent of full funding, not the necessary 100 percent. And lest the plan cramp lawmakers' yearning to spend state money on more popular pursuits, it began with a 15-year "ramp" of inadequate contributions.[11]

---

*its Public-Pension Crisis*, ECONOMIST (Dec. 20, 2014), https://www.economist.com/news/united-states/21636786-illinois-risks-default-if-it-fails-tackle-its-public-pension-crisis-americas-greece.

[7] *See* In re Pension Reform Litig., 32 N.E.3d 1, 6 (Ill. 2015) ("In the resulting political give and take, public pensions have chronically suffered. As long ago as 1917, a report commissioned by the General Assembly characterized the condition of State and municipal pension systems as "one of insolvency" and "moving toward a crisis" because of financial provisions which were "entirely inadequate for paying the stipulated pensions when due."") (citation omitted).

[8] *See, e.g., id.* at 19.

[9] *See infra* note 37.

[10] *See, e.g.*, Dave McKinney, *The Illinois Pension Disaster: What Went Wrong?*, CRAIN'S CHI. BUSINESS (August 10, 2015), http://www.chicagobusiness.com/section/pensions (Thus, for instance, in 1989, the state established a compounding, 3-percent annual increase to pension benefits for retirees. Further benefit enhancements arose about a decade later.).

[11] *Illinois: From Deadbeat to Fraud*, CHI. TRIBUNE (March 13, 2013), http://articles.chicagotribune.com/2013-03-13/opinion/ct-edit-sec-20130313_1_pension-mess-pension-burden-pension-obligations/2 (citing Illinois, Securities Act Release No. 9389, 2013 WL 873208 (Mar. 11, 2013)).

This bipartisan 1994 deal also placed the authority to set the actuarial discount rates – and thus complete practical control over present funding – with interested politicians.[12]

In other words, the Illinois government "dealt" with a pension crisis in 1994 by establishing a paper solution that actually guaranteed permanent pension underfunding, while pushing any real funding obligations to 2010 and beyond, with the most significant and serious funding obligations – for an already extant and critical funding shortfall – disappearing beyond the period by which non-negligently funded pension obligations would normally have been funded entirely.[13] So, by way of example, the "ramp"-mandated pension contribution in 1996 was $614 million, which constituted 2.9 percent of the state's budget that year. Conversely, the ramp mandates a state contribution in the 2016-17 budget year of $7.6 billion, which represents nearly a quarter of the state's general fund. Had the ramp been honored as written without additional pension benefits being promised in the fifty succeeding years, it would have mandated funding pegged at roughly that same quarter-of-the-budget amount through the 2045 "payoff" year, when the state's pensions would still only be 90 percent funded.[14] And, of course, all of this massive out-year funding obligation represented what, both on past form and certainly in retrospect, turned out to be preposterously over-optimistic calculation, based on the historically ludicrous assumptions that (a) the stock market would keep growing forever as it grew in the salad days of the late 1990s, (b) the government at Springfield would honor for fifty years the funding terms of the proposal; and (c) that same government would not opt for easy popularity now and further pain tomorrow by increasing pension benefits for current workers during the coming half century.

None of these things happened. The dot-com bubble and the ramifications of 9/11 shattered the idyll of the 1990s. And almost as soon as the Illinois state government had struck this illusory deal, it abandoned it–even in the aggressively underfunded "ramp" period prior to 2010. First, in an attempt to reduce inefficiently overstaffed state payrolls, the state, avoiding the pain now of firing incompetent workers, or laying off unnecessary workers, instead set up an early-retirement program.[15] This program pushed the pain into the future; the costs exceeded state estimates by 300 percent,[16]

---

12 *See Illinois: From Deadbeat to Fraud*, *supra* note 11; In re State of Illinois 2013 WL at 873208.

13 *See, e.g.*, McKinney, *supra* note 10; Eric Zorn, *Column: The "Edgar Ramp" Took Illinois Downhill, but Many Share the Blame*, CHI. TRIBUNE (June 14, 2016, 5:00 PM), http://www.chicagotribune.com/news/opinion/zorn/ct-edgar-ramp-illinois-pensions-zorn-perspec-20160614-column.html. (The 1990s "response," and particularly the 15-year upfront underpayment punt, has been labeled the "Edgar Ramp").

14 McKinney, *supra* note 10.

15 *Id.*

16 *See id.* (From $543 million to $2.3 billion.)

while a generation not yet conceived will pay taxes before the whole cost of the program is even theoretically realized.[17]

According to at least one author, though, the chief driver of the state's last descent into ruin was that man of national infamy, Governor Rod Blagojevich, now famously residing at the pleasure of the federal government in Colorado.[18] As that author picks up the tale:

> Illinois is not unique because it has struggled to manage its budget in the [years since the 2008] recession; many states have similarly failed to act responsibly in the last four years. It is much more notable as a place that let its fiscal problems spiral out of control while the economy was strong, leaving an unusually daunting mess for lawmakers to clean up[.]
>
> Of course, [Blagojevich] didn't act alone. Illinois made bad pension decisions before he was elected, and the Legislature approved his worst ideas. But the governor pushed other lawmakers to give in to their most irresponsible impulses.
>
> One of his first initiatives was a pension-obligation bond plan. For years, Illinois had been struggling to come up with enough cash to make required payments into its pension system (even though its law stating what was "required" was more lax than what was recommended by the Governmental Accounting Standards Board). Blagojevich proposed that the state shore up its pension funds by issuing $10 billion in bonds and investing the proceeds in the pension fund. In principle, nothing is wrong with pension-obligation bonds. They simply swap one form of indebtedness (unfunded pension obligations) for another (bond debt). But in practice, when a jurisdiction issues these bonds, it is usually up to no good, and this was no exception.
>
> The pension funds would invest the proceeds in stocks and bonds with a target investment return of 8.5 percent a year, but the interest on the bonds was only about 5 percent. This was marketed as a free lunch, but it wasn't one: Interest payments were fixed but Illinois taxpayers were on the hook to pay if the assets underperformed, which they did.
>
> A second problem was that the governor used the expected free lunch to justify putting only $7.3 billion of the $10 billion in bond proceeds into the pension fund. The remaining $2.7 billion went to pay bond interest and to cover part of the state's required pension contributions in 2003 and 2004–freeing up money to spend on other initiatives, including an aggressive expansion of Medicaid and the Children's Health Insurance Program. This meant that when you added together the unfunded liability and the outstanding balance on the bonds, the plan widened Illinois' overall funding gap for pension benefits [while also multiplying Illinois' other out-year liabilities.]
>
> Even after the proceeds from the pension-obligation bonds had run out, Blagojevich and the Illinois Legislature continued to underpay the required pension contributions, by $300 million in 2005, $1.2 billion in 2006 and $1.1 billion in 2007.

---

17 *See id.*

18 Monica Davey, *Blagojevich Sentenced to 14 years in Prison*, N.Y. TIMES (Dec, 7, 2011), http://www.nytimes.com/2011/12/08/us/blagojevich-expresses-remorse-in-courtroom-speech.html?mcubz=3.

> As the recession hit, the Legislature started passing budgets it knew were unbalanced, causing the state to run out of cash mid-year and run up billions of dollars in unpaid bills. Periodically, the state would issue general-obligation bonds to pay off the bills backlog, again shifting pension liabilities into bond debt.

> Even as the state budget fell apart and he spent profligately, Blagojevich, a Democrat, steadfastly opposed increases in the income or sales tax. He even alleged that his impeachment on the grounds of having tried to sell Barack Obama's Senate seat was a plot to get him out of the way so that the Legislature could raise the income tax.[19]

The state's departures from the "reform" of 1994 thus worsened when, as part of the bond-funding agreements, Blagojevich and the legislature agreed to "pension holidays" – meaning pension funding holidays – in the years approaching Blagojevich's re-election.[20]

Meanwhile, whatever Blagojevich's conspiracy theories, income tax was temporarily raised by two-thirds (from 3 percent to 5 percent) for five years. This rise increased revenue to the general fisc by 20 percent, but still left a current-accounts deficit of more than $1 billion per year.[21] That tax increase lapsed in 2015, though, and because Governor Quinn (Blagojevich's successor) and the legislature had done nothing during the intervening years to address the state's (unconstitutional) debt of nearly $8 billion or shore up the pension accounts, while the Illinois Supreme court had blocked any meaningful efforts – as we have seen – to rein in prospective pension expenses, current Governor Rauner, who defeated Quinn in 2014, has refused to reauthorize the tax. In part because of this decision, but more broadly for partisan political reasons, Illinois has not produced a regular budget during Governor Rauner's term.[22] Nor does it seem likely to.[23]

Thus the state of Illinois now finds itself with a pension-funding shortfall of – at best, on paper – $111 billion.[24] And even that figure radically underestimates the full extent of Illinois' unfunded liability because it is based on a discount rate[25] that is far higher than has actually been achieved since the 2008 panic, or that seems likely to arise in the foreseeable future.[26]

---

19 Josh Barro, *Illinois is Pension Basket Case You Forgot About*, BLOOMBERG (April 9, 2012), https://www.bloomberg.com/view/amp/articles/2012-04-09/illinois-is-pension-basket-case-you-forgot-about.

20 *See, e.g.*, McKinney, *supra* note 10; *Illinois: Deadbeat to Fraud*, *supra* note 11.

21 *See* Barro, *supra* note 19.

22 *See, e.g.*, Memo from Michael Mahoney, *supra* note 4.

23 *See id.*

24 *See* McKinney & Pierog, *supra* note 2.

25 Robert C. Pozen & Theresa Hamacher, *A Realistic Discount Rate for Pensions*, BROOKINGS (Aug. 20, 2012) https://www.brookings.edu/opinions/a-realistic-discount-rate-for-pensions/. (The actual discount rate is essentially the rate of return on investment that the funds dedicated to payment of future pension obligations, and meanwhile invested, can expect to earn on aggregate during the period until those funds will have to be paid to pensioners. Because the rate-of-return includes a return for inflation, this discount rate is a nominal rate (i.e., it includes both the real return on investment and the result of inflation). When inflation is perceived as being particularly low, as it has been since 2008, nominal

> Economists agree that the discount rate on the riskiness of the payout should be about half [of the amount] states typically designate; that is, around four percent rather than the inflated eight percent used by many states. With an arguably correct rate, unfunded liabilities for public sector pensions more than triples [sic] from $1 trillion to over $3 trillion [nationwide]. For individual states, a market-based discount rate can raise unfunded debt obligations even more.[27]

Illinois' largest pension fund (the Teachers' Retirement System ("TRS") fund, which makes up more than half of the total funding shortfall)[28] used an 8.5 percent discount rate until 2012, which was then "tied for the most aggressive investment assumption among state pension funds in the country,"[29] resulting in its undertaking highly risky investment strategies for very little net benefit.[30] Yet, lowering the discount rate to something more in line with present expectations carries its own practical, real-time consequences.

When the TRS fund lowered its imputed discount rate to 7.5 percent in 2014, "the state's pension payment increased by more than $200 million" per year, with "Illinois' fiscal 2017 pension payment to its five retirement systems [being] estimated at $7.9 billion, up from $7.617 in fiscal 2016 and $6.9 billion in fiscal 2015."[31] This modest corrective appears to have exhausted the state's present ability to deal in fiscal reality. The TRS governing board raised the issue of lowering the imputed discount rate again in August of 2016. In response, Governor Rauner's office warned against the move, citing real and significant but unquantifiable dangers. Such a move would act to recognize additional present-funding obligations, and thus raise the state's automatic pension-funding obligations and worsen the state's present budget crisis. Rauner's senior advisor for revenue and pensions warned that changing the discount rate now, in the absence of a budget that would allow responsibility to be pushed down the road yet again, would result in "unforeseen and unknown automatic cost increases [that]

---

rates of return fall precipitately below historical averages. If pension funds assume a discount rate based on historical averages, this assumed discount rates proves not only irrelevant but straightforwardly disastrous: relying on it results in the sort of underfunding multiplication described in the text above).

26 *See* Mauldin, *supra* note 1.

27 Anenson, *supra* note 3, at 47-48 (citations omitted) (Some other calculations put the multiplier at 4 or higher); *See, e.g.*, Mauldin, *supra* note 1.

28 Mauldin, *supra* note 1 (teachers' pension fund used an 8.5 percent discount rate in 2012; other funds used figures ranging from 7.0 to 7.75; only one fund came significantly within four points of its target in the five years to 2012, and only one within 2 points over a ten-year range; the teachers' pension fund makes up 55 percent of the total funding shortfall as of 2016).

29 Barro, *supra* note 19.

30 *See id.* ("Pensions & Investments Magazine says it has the fourth-riskiest pension investment portfolio in the U.S., with less than 17 percent of its investments in fixed income and cash … Indeed, the system's funding status is so poor that it achieved a 23.6 percent return on investments in 2011 and still managed to shave only $2 billion off its $46 billion unfunded liability. And it's not as though the fund can make such gangbuster returns consistently – in 2009, it returned negative 22.7 percent.").

31 McKinney & Pierog, *supra* note 2.

would have a devastating impact' on Illinois' ability to fund social services and education."[32]

Illinois cannot go on like this in even the near-moderate term. Were an appropriate discount rate to be applied, Illinois' unfunded state-employee pension liabilities would total $250 to $300 billion over the next 10-odd years,[33] without taking account of the unfunded pension liabilities of its municipalities, especially Chicago. That city's pension funds are now expected to be insolvent within a decade, even employing an artificially high discount rate.[34] The last complete Illinois state budget that for fiscal 2015 passed in calendar 2014, by contrast, indicated total annual state general-fund revenues of less than $36 billion.[35] In other words, genuine full annual pension funding would require dedicating something between five-sevenths and six-sevenths of the state budget to pension-funding obligations into the foreseeable future, while failures to achieve those impossible funding levels will raise the absolute and relative funding obligations for each of the next thirty years above the present baseline.

In other words the state government now finds itself in a situation in which it cannot find more than one-quarter of the funds it needs to meet its pension funding obligations each year, which magnifies the shortfall in every future year. As a result of this massive imbalance, it can neither formally acknowledge the full scope of the problem, because of the automatic budget effects of such an acknowledgement, nor pass a budget under any set of discount-rate assumptions whatever. The situation is quite dire.

---

32 *See id.* (quoting Mahoney Memo to Goldberg). *See also*, Governor Pat Quinn, Budget Speech (to legislature for 2014 fiscal budget) (March 6, 2013) ("Inaction on comprehensive pension reform has left our state with less revenue for our most important priorities. Without pension reform, within two years, Illinois will be spending more on public pensions than on education. As I said to you a year ago, our state cannot continue on this path. Pension reform is hard. But we've done hard things before."). As it played out, the TRS ignored the governor's office's imprecations and reduced the discount rate from 7.5 percent to 7 percent. *See, e.g.*, Pam Eggemeier, *Illinois Teachers' Pension System needs $4.6 Billion – Just For Starters*, SAUKVALLEY.COM (Oct. 30, 2016), http://www.saukvalley.com/2016/10/30/illinois-teachers-pension-system-needs-4-6-billion-just-for-starters/afdemzb/?__xsl=/print.xsl; Elizabeth Campbell, *Illinois Pension Crisis Builds as Market Turmoil Deals a Setback*, BLOOMBERG (Sept. 7, 2016), https://www.bloombergquint.com/markets/2016/09/07/illinois-pension-crisis-builds-as-market-turmoil-deals-a-setback. The TRS then failed, though, to follow through on its accounting recognition, requesting "only" $4.56 billion in financing for the TRS fund in fiscal 2018, despite the fact that its new discount rate implied a $6.88 billion funding liability for fiscal 2018. As a result, Illinois will increase total pension underfunding in 2018 by yet another $2.32 billion, even at the still significantly inflated 7 percent discount rate.

33 *See* Campbell, *supra* note 32; Mauldin, *supra* note 1.

34 *See, e.g.*, Jones v. Mun. Emp.'s Annuity & Benefit Fund of Chi., 50 N.E.3d 596, 600 (2016).

35 Memo from Michael Mahoney, *supra* note 4; ILL. OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2015: ENACTED BUDGET (2015) (The "enacted budget" for 2015 totaled $91 billion dollars, but only about a third of that is discretionary, general-fund spending and revenue).

## II. LOCKED INTO DISASTER

Seven states, starting with New York in 1938, have enacted constitutional provisions that have, as a class, come to be called pension-protection amendments. All of these amendments protect pension benefits for which employees (or retirees) have already completed the work to the full amount promised. A few of these, most notably Illinois, have also been interpreted to protect prospective — not yet earned — benefits from diminution, even if the employees putatively heir to these benefits work at will, and so have no concomitant protection for their jobs.[36]

Many of these pension-protection amendments have also been read to require states to fund their pensions on an ongoing, actuarially sound basis, so that the funds are available when the promised payments come due. Only the IPPA has been interpreted to maximize protected benefits but not to require funding for those benefits until, effectively, the moment that they come due.

Additionally, while many states have been lax in their ongoing pension-funding efforts, Illinois has taken the prize in this regard, using one short-term dodge after another to put off the politically unpalatable task of raising the money with which to satisfy its ever increasingly extravagant pension promises. The cumulative result of this towering irresponsibility was presented in the last section; the stops along the road are detailed in this one.

All of this has combined to put Illinois firmly on the road to disaster, and if nothing changes, to have barred all of the off ramps on the way to that destination.

### A. *The Illinois Pension Protection Amendment*

The IPPA states relevantly that "[m]embership in any pension or retirement system of the State . . . shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[37] The

---

[36] This is not to say that even were the employees to leave or get fired, they would continue to collect pension benefits. Rather, in Illinois and Arizona (and possibly in New York, though, as discussed *infra*, that is nothing like as clear as the Illinois Supreme Court asserts it to be), the pension-protection amendments are read to forbid any diminishment in pension benefits, once promised, for so long as the public employees remain employed without regard to whether the work has been completed or not.

On the other hand, it is somewhat specious to refer to Illinois Public Employees as "at will." Almost all enjoy extensive due-process protections from discharge or other employment action. *See, e.g.*, 5 ILL. COMP. STAT. 315/1–28 (1984).

[37] ILL. CONST. art. XIII, § 5. The whole Amendment reads:

Amendment was added by the Illinois Constitutional Convention of 1970 to the charter that it produced.

During the proceedings of that convention, the proponents of the IPPA stated their intentions in offering the amendment directly. Delegate Henry Green, a sponsor of the IPPA,[38] noted that in the preceding twenty-two years (i.e., from the late 1940s into the dawn of the 1970s), the state's pension liabilities had grown by a factor of more than six, while the legislature's funding of those liabilities had lagged constantly and increasingly behind.[39] Green and another proponent explained that they considered that the IPPA would "mandate[] a contractual relationship between the employer and the employee[,]" and thus provide "a basic protection against abolishing their rights completely or changing the terms of their rights after they have embarked upon the employment—to lessen them."[40]

In fashioning this amendment, the sponsors looked directly to a similar provision in the New York State Constitution,[41] and in fact adopted its language nearly verbatim.[42] Green expressly hoped thereby to achieve the same results — including a constitutional requirement mandating the constant and sufficient funding of state pension obligations that New York had achieved since adopting the original of the IPPA in 1938.[43]

---

PENSION AND RETIREMENT RIGHTS: Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.

38 *See* DIANA FURCHTGOTT-ROTH, EMPOWERING ILLINOIS' PENSION REFORM 5, MANHATTAN INST. FOR POL'Y RES. (April 2016), https://economics21.org/sites/e21/files/Illinois%20Pension%20Paper.060816.pdf.

39 In re Pension Reform Litig., *supra* note 7, at 6-7 (quoting 4 Record of Proceedings, Sixth Illinois Constitutional Convention at 2925 (statements of Delegate Green)).

40 *Id.* at 12-13.

41 *Id.*

42 *See* N.Y. CONST. art. V, § 7 ("After July first, nineteen hundred forty, membership in any pension or retirement system of the state or of a civil division thereof shall be a contractual relationship, the benefits of which shall not be diminished or impaired.").

43 In re Pension Reform Litig., *supra* note 7, at 11(As Green put the proposition, "Our language is that language that is in the New York Constitution which was adopted in 1938, really under a similar circumstance. In 1938 you were about at the end of the Depression, but there was a great consideration on the part of the New York General Assembly to really cut out some of the money that they were giving to the pension programs in New York; and it was for this reason that the New York Constitution adopted the language that we are suggesting. Since that time, the state of New York – the pension funds for public employees have been fully funded, and so I think we have good reason to believe that this type of language will be a mandate to the General Assembly to do something which they have not previously done in twenty-two years," i.e., fund its pension liabilities(emphasis added)); *See also Id.* At 11-12 (quoting similar comments of Delegate Bottino, 4 Proceedings 2930–31).

## B. *Illinois Supreme Court Interpretation*

The Illinois State Supreme Court has interpreted the IPPA to require complete payment, without diminution of any pension promises made at any point during a public employee's service. At the same time, it has refused to construe the amendment to place any obligations on the Illinois legislature to maintain any particular funding levels, or in fact to allow the legislature to tie itself or its municipalities to the mast of obligatory, scheduled payments in the face of its having struck down legislative efforts to curtail as-yet-unearned pension benefits for future service by presently employed public employees.[44]

### 1. Aggressive Protection of Accrued and Unaccrued Pension Benefits

In a fairly late-in-the-game, emergency effort at least partially to mitigate its pension crisis,[45] the Illinois legislature and governor, all in the control of Democrats, passed and signed Public Act 98-599 in the fall of 2013.[46] The Act would have altered the way in which pension benefits accrued to public employees who had been hired before 2011.[47] Inter alia, the Act would have:

> (a) Delayed the time at which employees who were under the age of 46 upon the effective date of the statute would be permitted to begin to receive retirement benefits;[48]
>
> (b) Capped the "highest-years" salary that could be used when calculating retirement benefits;[49]

---

[44] *See generally*, In re Pension Reform Litig., *supra* note 7; Jones v. Mun. Emp.'s Annuity & Benefit Fund of Chi., *supra* note 34 (Illinois Supreme Court consideration of Public Act 98-641 (2014), a public act and decision which largely replicated the proceedings in In re Pension Reform Litigation, at the city rather than state level).

[45] *See* In re Pension Reform Litig., *supra* note 7, at 19 ("By the end of June 2013, the five State-funded retirement systems contained a total of only 41.1% of the funding necessary to meet their accrued liabilities based on the market value of fund assets. Commission of Government Forecasting and Accountability, Illinois State Retirement Systems: Financial Condition as of June 30, 2013, 27 (Mar. 2014). The funding rate was thus nearly unchanged from the 41.8% funding rate prior to ratification of the 1970 Constitution and its pension protection clause.").

[46] *See* 2013 Ill. Legis. Serv. P.A. 98-599 (S.B. 1) (West); In re Pension Reform Litig., *supra* note 7 at 21 .

[47] Public employees hired after January 1, 2011 are eligible only for much reduced "Tier 2" benefits, while employees hired before that date are considered "Tier 1" employees. The pension-payment reformed attempted by the Act would have affected only Tier 1 employees. *See* 2010 Ill. Legis. Serv. P.A. 96-889 (S.B 1946) (West).

[48] *See* 40 ILL. COMP. STAT. 5/2-119(a-1), 14-107(c), 14-110(a-5), 15-135(a-3), 16-132(b).

(c) Replaced a guaranteed annual three-percent pension increase with something more closely resembling a limited cost-of-living adjustment;[50]

(d) Eliminated some prospective annual annuity increases for still-working employees, depending upon their age[51]; and

(e) Changed the base-pay determination for the "money-purchase" buy-out formula for those who elect to employ that option after the effective date of the Act.[52]

The Illinois Supreme Court found, based in part upon admissions made in the legislative record by sponsors of the Act,[53] that the effect of the act would be to "reduce the benefits" of "current employees."[54] Having

---

49 *See* 40 ILL. COMP. STAT. 5/2-108, 2-108, 14-103.10(h), 15-111(c), 16-121.

50 *See* 40 ILL. COMP. STAT. 5/2-119.1(a-1), 14-114(a-1), 14-115(d), 15-136(d-1), 16-133.1(a-1), 16-136(b-1) (West Supp. 2013).

51 *See* 40 ILL. COMP. STAT. 5/2-119.1(a-2), 14-114(a-2), 15-136(d-2), 16-133.1(a-2), 16-136.1(b-2) (West Supp. 2013).

52 *See* 40 ILL. COMP. STAT. 5/15-136, 16-133 (West Supp. 2013).

53 In re Pension Reform Litig., *supra* note 7, at 12-13.

54 *Id.* (The exchange relied upon by the Court:

"Senate Bill 1, which became Public Act 98-599, was explained to the Senate through presentation of a conference committee report by one of the bill's chief sponsors, Senator Kwame Raoul. Senator Raoul described the various provisions of the bill as "all part of an integral bipartisan package" designed to reduce unfunded liabilities in the pension systems which had resulted, principally, from "the State not contributing what it should have" to those systems. He noted prior government reports which had found that "the reality is that the primary cause of the State['s unfunded] liability is Illinois' decades-long failure to make its full actuarial required employer contributions to the five pension systems." He advised his colleagues that the bill would reduce the unfunded pension liability by $21.4 billion, and then summarized the specific provisions of the law that would make that possible, including the critical benefit reductions described above.

During discussion of the bill, Senator Hutchinson asked: "Am I correct that the legislation intends to and will have a direct and substantial impact on the benefits of current employees and retirees by reducing their benefits?" Senator Raoul responded: "Yes. You are correct."

This colloquy followed:

"SENATOR HUTCHINSON: I know that one of the objectives of this legislation is really to improve the State's credit rating. Is that correct? I mean, that's why we're here.

SENATOR RAOUL: It—it's one of—one of—one of the State's fiscal issues, yes, and one—one of the objectives.

SENATOR HUTCHINSON: So, then, is it fair to say that we are sacrificing a substantial amount of people's pension benefits to protect the State's finances?

SENATOR RAOUL: Yeah, I—you know, that's a harsh characterization, but—but I—I suppose yes.

SENATOR HUTCHINSON: The bill's legislative statement states in the fourth paragraph that this 'is intended to address fiscal issues facing the State and its retirement systems in a manner that's feasible.' So, by using the word 'feasible,' does that mean that there are other feasible alternatives to this bill?

SENATOR RAOUL: Certainly there are. I mean, certainly, you know, as has been mentioned, a lot of these levers are—are levers that can be tweaked one way or the other, and there are other proposals that were entertained by the conference committee. But—but, you know, we're trying to move from a stalefound these provisions of the statute to therefore "diminish or impair" benefits, the Court struck them down. In the process, the Court made an adamantine declaration that once an employee has worked a day under a given benefits structure, that structure must continue without reduction throughout that employee's career: "[o]nce an individual begins work and becomes a member of a public retirement system, any subsequent changes to the Pension Code that would diminish the benefits conferred by membership in the retirement system cannot be applied to that individual."[55]

The Court then proceeded to find the whole Act invalid under Illinois state constitutional law both because of the in-severability clause of the act itself and because of background severability considerations. As described by the Court,

> [t]he presumption of severability reflected in an express severability clause will be overcome, and the entire statute will be held unconstitutional, if the legislature would not have passed the law without the provisions deemed invalid. To determine whether the legislature would not have passed the law without the invalid parts, the courts consider whether the legislative purpose in passing the act is significantly undercut or altered by the elimination of those invalid sections. Even in cases where the valid sections of an act are complete and capable of being executed, the entire act will be de-

---

mate. So, yes, there are other alternatives, but, you know, this is an effort to move from a—from a stalemate.

SENATOR HUTCHINSON: Would another alternative be the proposal that the Center for Tax and Budget Accountability outlined before the conference committee, which would have re-amortized the current unfunded liabilities to a new gradual [level] dollar payment schedule to achieve well over eighty percent by 2059?

SENATOR RAOUL: Yes. So that—that and many other things could have been possible alternatives.

SENATOR HUTCHINSON: [The last sentence of the fourth paragraph of the report contains the phrase] that the legislation is 'minimizing the impact on current and retired State employees.' So by using 'minimizing,' does that mean that the legislation is somehow the least restrictive means available to us?

SENATOR RAOUL: Yeah, I—you know,—I don't know what the least restrictive means are. I—I think what we're doing just reflects what the political climate is. Again, I've—I've—I've said, time and again, that we've been cemented in a stalemate, and I, for my part, don't want to see the State sink as a result of that stalemate. So, it may not be the least restrictive means, but the political climate, I believe, allows for us to—to—to take the step that we're—we're hopefully now taking."

Following this exchange and remarks by Senator Hutchinson, the Senate's presiding officer recognized one final speaker, Senator Christine Radogno, another of the bill's sponsors. In urging passage of the legislation, Senator Radogno characterized it as "the one opportunity that we have to finally, finally address the most important economic issues that are facing this State, and that includes our credit ratings, our financial position, our jobs climate, and, frankly, our reputation in the global economy."

55 *Id.* at 16-17 (In order to avoid any confusion whatever on the question, the Court reviewed with approval a then-recent Arizona decision, which itself relied on previous Illinois Supreme Court decisions, which declared that public employees "ha[ve] a right in the existing formula by which his benefits are calculated as of the time he began employment and any beneficial modifications made during the course of his employment.") (Note though that Fields has been pre-empted and overturned by swift action of the Arizona legislature and polity, *see infra* note 55, and that because Fields itself relied exclusively on Illinois precedent to reach its extensive conclusion, the Illinois Court's reliance on Fields was never anything more than an obscured citation to itself. *See infra* at note104.

> clared void if, after striking the invalid provisions, the part that remains does not reflect the legislature's purpose in enacting the law.[56]

The Court then noted that the proponents of the statute had admitted that each of the provisions of the statute were "all part of an integral bipartisan package," and that because the point of the package was to "shore up state finances" by "diminishing . . . the amount of retirement annuity benefits paid to Tier 1" employees, such benefit reductions constituted the statute's "very reason for being. [ . . . ]To leave those remaining provisions standing once the core sections are stripped away would, under these circumstances, yield a legislation package that no longer reflects the legislature's intent. The circuit court was therefore correct when it concluded that Public Act 98-599 is void and unenforceable in its entirety."[57] The Court did note that "[t]he legislature is, of course, free to reenact any provisions of the Public Act that do not violate the constitution."[58]

Amongst the provisions swept away by this in-severability determination were measures that the Court itself recognized as being not only purely prospective, but also as applying only voluntarily or to employees not yet hired. These included provisions permitting some employees to switch to defined-contribution plans;[59] prohibiting some members of government-support non-profit organizations from receiving pensions once the Act had gone into effect;[60] and "prohibit[ing] new hires from using accumulated sick or vacation time to boost their pension benefits."[61]

### 2. No Legislative Obligation to Fund Pension Liabilities (until, presumably, presently due)

Another provision of the Act that the Illinois Supreme Court struck down in finding its provisions inseparable was a feature designed to ensure that future legislatures actually stick to the new liability-funding schedule included in the Act. The legislation attempted to "tie to the mast" of obligation subsequent legislatures by setting up a fixed funding schedule for the

---

56 In re Pension Reform Litig., *supra* note 7, at 29-30 (citing Best v. Taylor Machine Works, 179 Ill.2d 367, 460-62 (1997)).

57 *Id.* at 30.

58 *See id.* at 30 n. 15.

59 *See* In re Pension Reform Litig., *supra* note 7, at 11; 4040 ILL. COMP. STAT. 5/2-165, 14-155, 15-200, 16-205 (West Supp. 2013).

60 *See* In re Pension Reform Litig., *supra* note 7, at 11; 40 ILL. COMP. STAT. 5/7-109 (West Supp. 2013).

61 *Id.* (citing 40 ILL. COMP. STAT. 5/7-116, 7-139, 9-219, 9-220, and other sections of the Act) (West Supp. 2013).

state's pension funds,[62] and permitting the state pension board to seek mandamus relief in the Illinois State Supreme Court should future legislatures fail of this obligation.[63] The Court found this provision, too, to be an in-severable facet of the total Act, and thus struck it down as well. Presumably the state could draft a "clean" provision binding itself in this manner, but even were such a "clean" provision politically viable, it would (as the IPPA is currently interpreted) constitute mere legislation of the sort that any future legislature could overturn simply by adding a provision to a budget bill (or any other piece of legislation, in fact) either revoking the provision entirely or suspending it for the budget year in question.

This in-severability determination presents an exacerbation of the court's underlying position that the IPPA, while absolutely requiring fulfillment of any pension promise ever made to public employees, does not coordinately require the legislature actually to fund these promises annually. Needless to say the absolute obligation to eventually pay–without any obligation to coherently fund – such enormous obligations creates what might lightly be called a serious practical tension. The Court, however, simply staves off this practical tension.

In fact, this portion of the Court's opinion takes on a distinctly otherworldly mien. The Court recognizes, quite correctly – though not completely, as its very treatment of this question aggressively underscores – that the political branches, as representatives of the people of Illinois, had gotten themselves into the present mess. "[P]ersistent underfunding aggravated actuarial deficits and made pensions susceptible to the stock market plunge [of 2008-09] in the first place."[64] It then airily informs those branches, and the taxpayers of the state – particularly, of course, those not wise enough to have taken public employment before 2011 – that having made their collective bed, they could damned-well figure out how to pay for it. "[N]o possible claim can be made that no less drastic measures were available when balancing pension obligations with other State expenditures became problematic."[65] Further amortizations could be attempted; taxes could be raised as necessary.[66] Come what may, however, the people would be obliged to fulfill these Court-defined pension benefits entirely. The police power could not avail efforts to modify those benefits.[67] After all, the legislature, having made this crisis, could hardly rely on the crisis itself as an excuse to violate the state constitution as the Court had interpreted it.[68]

---

62 *See* 30 ILL. COMP. STAT. 122/20, 25 (West Supp. 2013); 40 ILL. COMP. STAT. 5/2-125 (West Supp. 2013).

63 *See id.*

64 Anenson, *supra* note 3, at 33.

65 In re Pension Reform Litig., *supra* note 7, at 22.

66 *Id.*

67 *Id.* at 18-29.

68 *Id.* at 27-28.

> The people of Illinois give voice to their sovereign authority through the Illinois Constitution. It is through the Illinois Constitution that the people have decreed how their sovereign power may be exercised, by whom and under what conditions or restrictions. Where rights have been conferred and limits on governmental action have been defined by the people through the constitution, the legislature cannot enact legislation in contravention of those rights and restrictions. Our court made this clear in an opinion published 186 years ago in the very first volume of our official reports. As we explained then, the Constitution "is the form of government instituted by the people in their sovereign capacity, in which first principles and fundamental law are established. [It] is the supreme, permanent and fixed will of the people in their original, unlimited and sovereign capacity, and in it are determined the condition, rights and duties of every individual in the community." Phoebe v. Jay, 1 Ill. 268, 271 (1828). "From the decrees in the Constitution there can be no appeal, for it emanates from the highest source of power, the sovereign people. Whatever condition is assigned to any portion of the people by the Constitution, is irrevocably fixed ***.[69]

The Court failed to recognize that its own arguably quite anomalous interpretations may have played any role in creating the crisis which presently faces the state.

### C. Comparison to Other States

Many other states have PPAs of some kind.[70] At least one of these (New York) is essentially identical to, and in fact provided the template for, the IPPA.[71] Two others – Alaska and Arizona – have interpreted their amendments to protect prospective benefits just as Illinois has,[72] though the legislature and polity of the latter responded to this interpretation with a speedy constitutional amendment modifying Arizona's PPA and (at least for the nonce, at least partially) reversing the error.[73] None, though, has

---

69 *Id.* at 79.

70 *See supra* at pp. 6-7.

71 *See* discussion *infra* Section II. D.

72 Hammond v. Hoffbeck, 627 P.2d 1052, 1057 (Alaska 1981) (As will be discussed *infra* however, the Alaska Supreme Court, like New York's highest court, has interpreted its pension-protection amendment not only to protect prospective benefits from being cut, but to protect them from effective state insolvency by requiring mandatory, actuarially sound funding levels. *See also* Municipality of Anchorage v. Gallion, 944 P.2d 436 (Ala. 1997)).

73 *See* Arizona Proposition 124 (approved May 17, 2016) (The proposition added a section D to the Arizona PPA. Section D served one purpose: it explicitly instantiated into the state's constitution S.B. 1428, and act of the Arizona legislature that had been signed into law in February 2016. *See* Ariz. CONST. art. XXIX, § 1 (D)); *see also* Alexander Volokh, *Arizona Voters Approve Major Overhaul of Public Safety Officers' Pensions*, REASON FOUNDATION (May 19, 2016), http://reason.org/news/show/arizona-ballot-pension-overhaul; Sasha Volokh, *Public-safety pension reform wins big in Arizona!*, VOLOKH CONSPIRACY (May 19, 2016), http://www.washingtonpost.com/news/volokh-conspiracy/wp/2016/05/19/public-safety-pension-reform-wins-big-in-arizona (This provision, which passed in plebiscite by a 70-30 vote, substitutes for retirees and already employed workers a compounding COLA capped at two percent for the permanent fixed-benefit increases that had previously been promised); *see also* 2016 Ariz. Sess. Laws 2, SB 1428 (This "fix" is very much an *ad hoc* one-off, but the speed of its enactment in response to the Arizona Supreme

worked itself into so comprehensively disastrous a position as has the Land of Lincoln. Both the size of the fiscal shortfall and the essential incoherence of the Illinois State Supreme Court's interpretation of the IPPA, place Illinois at the front of the line – and nearest the financial cliff.

As with the Illinois Supreme Court's interpretation of the IPPA, all states (and state courts) face two distinct obligation questions in enacting and interpreting pension-protection amendments: what is the state obliged to pay to present and future pensioners; and what is the state (or its municipalities and other subsidiaries) obliged to pay into pension funds in order to make satisfaction of its liabilities practically possible. As will be considered in detail throughout the remainder of this section, only Illinois has interpreted its pension-protection amendment to require full funding of all earned and prospective pension benefits without diminution, while failing to recognize any constitutional obligation to fund those benefits in an actuarially sound manner in the years until the full bill comes due.[74]

### 1. Theories of Pension Payment Obligation

Plausible theory provides four ways in which states might elect to treat pension liabilities to public employees. The path to both least protection (for employees) and least restriction (for legislatures and for state and municipal budgets) would be to treat pension promises entirely and forever as "gratuities" of the sovereign, to be altered or entirely withdrawn at the whim of the legislature, with no recourse available to current or retired employees. This has been the traditional view in Anglo-American jurisdictions (including Illinois[75]), surviving well into the 20$^{th}$ century even in states

Court's Field decision, *see infra* note 104, and its hearty approval by the voters – along with the relative manageability of Arizona's shortfall – suggest that this *ad hoc* method might be enough for Arizona).

74 Amy B. Monahan, *Statutes as Contracts? The "California Rule" and its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1046, 1071-74 (2012) (It is true that states following the "California Rule" have adopted prospective-benefit protections, and that some of those states have fallen significantly behind in their funding obligations – California itself providing the shining (or, really, most-tarnished) example. But these states are in no constitutional bind; as Professor Monahan, who has conducted the lead study into the issue, has concluded, the California Rule (as applied in California, at least) relies merely on constantly metastasizing misreading of a single piece of antiquated dictum, while the state courts that have independently adopted the California Rule have done so "without much discussion, appearing to merely find it the most attractive of the available nongratuity options. … [N]one went through a typical analysis of statutory language or surrounding circumstances before finding the California Rule applicable." As a result, the legislatures in each California Rule state should be able to correct their state courts' reading of state law at any time, either by statute or state constitutional amendment. And in fact, a handful of states that initially adopted the California Rule have since modified its application. At all events, the Monahan article provides an excellent treatment in detail of the California Rule, and a review of that rule's application, vel non, elsewhere.).

75 *See, e.g.*, Dodge v. Bd. of Educ., 302 U.S. 74, 78-79 (1937) (Upholding Illinois Supreme Court ruling that pensions were gratuities even if government employee-retirees had both fulfilled duties to

now providing strong pension guarantees,[76] and continuing effectively to provide at least the underlying understanding in others.[77]

The next-least rigorous protection regime would be to consider pension benefits as vested (and unable to be diminished) upon retirement, but to remain unvested and malleable for all still-employed public workers.[78]

A third choice would be to consider benefits vested upon some threshold of service (say, five years), and thereafter to accrue untouchably to employees who serve a longer term, with payment to proceed irrevocably as dictated by the terms of the pension during the period the benefits had been earned. (A slightly more aggressive interpretation of this position would hold benefits to begin to accrue instantly upon initiation of employment.) Under this rubric, pension benefits could be changed without employee recourse of any kind until the moment of vesting; after vesting, the legislature would still be free to change the manner and mode in which pension benefits accrue (if at all) for any periods for which service has not yet been performed. However, already accrued and vested benefits would enjoy full protection, and could not (under any circumstances) be stripped from employees. This is the position that Texas, for example, has functionally staked out, as have many of the states with pension-protection amendments.[79]

Finally, a state could organize its affairs so that any pension promises in place at the time of a public-employee's employment must remain undiminished throughout the whole of that employee's tenure, and guarantee full payout on conditions no less favorable than those initial conditions (plus any later promises, from the time of the promises) throughout the whole of the retirement period, though that period runs decades further into the future. This is where Illinois[80] – as well as a number of other states, by one means or another[81] – have landed.[82]

---

which pensions were appurtenant and had relied upon the legislative promise of pension benefits in agreeing to perform those already completed duties); *see also* Eddy v. Morgan, 75 N.E. 174 (Ill. 1905).

76 *See, e.g.*, Andria L. Bentley, *The New York State Comptroller as Sole Trustee of the Common Retirement Fund: A Constitutional Guarantee?*, 72 ALBANY L. REV. 763, 767 (2009) (citing Roddy v. Valentine, 197 N.E. 260, 262 (N.Y. 1935)) (reviewing the mutation of pension protections in New York from pure gratuities to something approaching quasi-contract, but recognizing that even as of 1935, such pension benefits could be stripped entirely away even after an employee's retirement); *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 994-1003 (1977).

77 *See, e.g.*, Anna K. Selby, Pensions in A Pinch: *Why Texas Should Reconsider its Policies on Public Retirement Benefit Protection*, 43 TEXAS TECH L.R. 1211 (2011) (describing the baseline proposition).

78 *See, e.g.*, Bentley, *supra* note 76, at 764 (citing Pennie v. Reis, 132 U.S. 464, 471 (1889)); State *ex rel.* Horvath v. State Teachers Ret. Bd., 697 N.E.2d 644, 654-55 (Ohio 1998)); Monahan, *supra* note 74, at 1036 (citing Klamm v. State *ex rel.* Carlson, 126 N.E.2d 487, 489 (Ind. 1955).

79 *See generally* Van Houten v. Fort Worth, 827 F.3d 530 (5th Cir. 2016).

80 *See supra* pp. 1, 8-9.

81 *See* Monahan, *supra* note 74, at 1036 (citing Singer v. Topeka, 607 P.2d 467, 475-76 (Kan. 1980); Betts v. Bd. Of Admin., 582 P.2d 614, 617 (Cal. 1978); Calabro v. Omaha, 531 N.W.2d 487, 489

Supporters have offered various justifications for these positions. In favor of the first, the entire-gratuity position, courts traditionally asserted that the legislature was not to be bound by – and could not itself bind future polities with – long-term obligations. In some iterations, this injunction was completed "unless it does so expressly;"[83] in a more rigorous form, such binding of future polities was considered impossible unless incorporated into the state's constitution.[84] Moreover, as the label suggests, pension promises were traditionally considered to be gifts to loyal state servants rather than part-and-parcel of the employee's compensation package.[85] As the Illinois State Supreme Court itself once held a pension is a bounty springing from the graciousness and appreciation of sovereignty. It may be given or withheld at the pleasure of a sovereign power. Because one is placed upon a pension roll under a valid law is no reason why that law may not be repealed and the pension ceased.[86]

This view has fallen from favor in recent decades. As public employees (and everyone else) have both lived longer and retired for substantially longer periods,[87] legislatures, electorates, and courts have all grown more sympathetic (and empathetic) to the interests of the aged and retired. The idea of throwing the retired and elderly out of their promised pensions just as they came to need them – and had grown increasingly incapable of working further to support themselves – grew increasingly insupportable.[88] Those employees, like most Illinois public-sector workers,[89] whose governments had elected them out of social-security benefits, presented a particularly sympathetic case. Without their pensions, they would lack any viable old-age security whatsoever, other than their own capital investments. Moreover, the understanding arose that pension benefits derived not

(Neb. 1955)); Anenson, *supra* note 3, at 22-25 (such states include Alaska, California, Nevada and, at least for a time, Massachusetts and Colorado: Alaska is the other state that, like Illinois, finds state-constitutional grounding for this position.) (citations omitted).

82 This fourth, absolute-and-instant protection option is sometimes called the "California Rule," it having been adopted there early and wholly by judicial fiat. *See, e.g.*, Monahan, *supra* note 74, at 1031-33 (2012).

83 *See generally* Eric A Posner & Adrian Vermuele, *Legislative Retrenchment: A Reappraisal*, 11 YALE L.J. 1665 (2002).

84 *See id.*

85 *See, e.g.*, Selby, *supra* note 77; Van Houten v. Fort Worth, 827 F.3d 530 (5th Cir. 2016).

86 Eddy v. Morgan, 75 N.E. 174, 178 (Ill. 1905) (quoted in Monahan, *supra* note 74, at 1035).

87 *See, e.g.*, Life Expectancy Graphs, at http://mappinghistory.uoregon.edu/english/US/US39-01.html.

88 *See, e.g.*, Selby, *supra* note 77, at 1218.

89 *See, e.g.*, Anenson, *supra* note 3, at 31, 71 (Noting that, along with Illinois, Alaska, California, Colorado, Connecticut, Kentucky, Louisiana, Maine, Massachusetts, Missouri, Nevada, Ohio and Texas have withdrawn their government workers, in whole or part, from the social-security system, "[i]ndeed, in considering the public pension crisis, many scholars have emphasized that the absence of additional federal benefits places these particular public workers in a more precarious position.") (citing Monahan, *supra* note 74, at 1076).

merely from the kindness of the state, but from binding contractual obligations undertaken by public employers during the employees' tenures.[90]

From this latter proposition, it proved just a short step in reasoning to conclude that public employees ought to be able to rely with contractual security upon any pension benefits for which both a governmental promise had been made and the work actually completed.[91] After all, public employees have historically accepted what have arguably been lower salaries,[92] when compared to their private-sector compeers, in exchange for increased security of tenure and the promise of a certain fixed level of pension benefit.[93]

The rationale for the fourth position cannot as easily be explained or defended. While public employees may well be succored into their state employment by the promise of future pension benefits, it may hardly be argued that they whose very benefits are at stake are either incapable of recognizing when those benefits will for future work be altered, or of reacting accordingly by moving on to ventures they find more remunerative, should such exist. Should no such better positions exist despite the diminution in prospective pension benefits, this would suggest both that the total-compensation package enjoyed by public workers had both been, prior to the reduction, significantly higher than those available in the private sector for correlative work, and an unjustifiable burden on general taxpayers. The rationale that has been advanced is that those who choose the public sphere over the private thereby make a permanent life choice and commitment to the common good that renders them thereafter somehow incapable of moving to the private sphere, as though the skills required of public employees were so specialized and so rare that they were both hard to replace and intransmissible to private employment. This assertion, though, bears so little

---

90 *See, e.g.*, Anenson, *supra* note 3, at 26, 28 (such states include Kentucky, Louisiana, Missouri, Ohio and, at least for a time, Maine) (citiations omitted).

91 *See, e.g.*, Monahan, *supra* note 74, at 1032 (as of the 21st Century, the proposition "that the [public-employee] contract protects … accrued benefits" had become "a relatively uncontroversial position").

92 A number of studies suggest that in recent years, public employees have not only enjoyed greater security of position but greater overall remuneration as well. *See, e.g.*, MARK J. WARSHAWSKY & ROSS A. MARCHAND, THE EXTENT AND NATURE OF STATE AND LOCAL GOVERNMENT PENSION PROBLEMS AND A SOLUTION 7, MERCATUS RESEARCH (Jan. 2016) (citing Maury Gittleman & Brooks Pierce, *Compensation for State and Local Government Workers*, 26 J. ECON. PERSP. 217-41 (Feb. 2012) (reviewing the evidence collected by the Bureau of Labor Statistics).

93 *See, e.g.*, Anenson, *supra* note 3, at 27-29. (Relatedly, or perhaps just put in a somewhat different way, the employees develop a cognizable reliance interest in receiving what they have been promised and have already performed the work for. "[T]his more moderate method of ascertaining constitutional safeguards directs attention to the reliance interests of public workers. Specifically, rights may arise pre-retirement eligibility under the doctrines of promissory estoppel or quasi-contract. Employment benefits are protected as a result of proven reliance. Moreover, at some point during the employment relationship, reliance is presumed as a matter of law.") (citations omitted).

reflection – it cannot survive even the snort-of-derision test – that it must be dismissed as a make-weight.

Taxpayers – and all members of the public – suffer as a result of these expansive prospective-benefit protections in more ways simply than because it forces them to overpay for public services, through their tax bills and otherwise. As was considered above, Illinois already finds itself unable to pay its bills, to make budgets, or to fund basic services such as education and policing properly. The people of Illinois will not simply have to pay more to satisfy these pension obligations, but they will get fewer of the fundamental protections that governments are established to provide (whatever one's view of right government may be).

Nor may it be argued that prospective-benefit protection for presently employed state workers protects all public workers. No state has asserted – nor coherently could assert – that current pension promises must apply not only to workers employed at the time at which such promises are made, but to all employees hired forever after.[94] In fact, prospective-benefit (for current employees) protection leaves government employers very little choice in attempting to rein in explosive pension costs but to reduce benefits for future employees.[95] As a result, unlucky employees hired after spendthrift legislatures are forced to finally grapple with their incautiously created financial calamities and to bear much of the weight of the prospective protections that pertain to their luckier colleagues.[96]

Of course, these later hired employees must also be charged with knowledge of the value of their compensation packages, and with the ability to find private employment elsewhere should they object to the present terms of engagement. But this does not change the fact that compensation packages for similarly situated workers doing similar work would be significantly more equal but for the prospective-benefit-protection-for-senior-employees rules. "Equal pay for equal work" raises grave ethical and even civil-rights concerns in other quarters.[97] And if women – or, for that matter, protected groups of any kind – are entering the workforce now in greater numbers than in prior decades, then the costs and inequities of these pro-

---

94 *See* In re Pension Reform Litig., *supra* note 7, at 1 (Permitting the legislature to reduce benefits for employees hired after January 1, 2011, or "Tier II" employees wherein the "Tier 2" benefits for workers hired after that date were not challenged).

95 *See, e.g.*, Monahan, *supra* note 74, at 1032 ("The practical result of this rule is that … the only readily available option for changing employee pension benefits in these states is to limit such changes to new hires.").

96 *See, e.g.*, Anenson, *supra* note 3, at 52 ("Illinois, California and some other states are in a situation where young educators [and other public employees] may not be getting their fair share of the retirement pie.").

97 *See* Equal Pay Act of 1963, Pub. L. No. 88-38, 77 Stat. 56 (Since 1963 it has been illegal to pay women less than men to do the same work at the same workplace); Civil Rights Act of 1964, Pub. L. No. 88-352, 78 Stat. 241 (Title VII of the Civil Rights Act expanded these gender-based protections, while Title VI protected minority groups similarly).

spective-protections for older employees must necessarily fall particularly on younger, more female (or otherwise protected) cohorts, thus creating a gender-based (or otherwise enumerated) pay gap for concurrently undertaken work of a similar kind in similar situations. Even without the gender or other civil rights considerations that may arise, prospective-protection raises the specter of manifest unfairness. Younger workers already get paid less than do older workers for the same work done, and younger workers will already bear a disproportionately heavy proportion of the costs to be paid for baby-boomer retirement packages in terms of higher taxes, fewer employment opportunities, and lost economic growth. Prospective-benefit protection for current employees merely (but significantly) exacerbates this manifest inequity.

Incredibly, the ethical and economic rationale for the prospective-benefit position remains deeply suspect even when only the interests of covered employees come into frame. As Professor Monahan has explained, the theory "create[s] economic inefficiency, in that it fixes in place one part of an employee's compensation" without itself fixing anything else about the employee's total employment package, including salary or even tenure of employment.[98] As with minimum-wage increases, prospective-benefit pension-protection regimes may well have the result of protecting (and maximizing) total lifetime compensation for those employees lucky (or skilled, or connected) enough to remain employed throughout a full career, but of harming those theoretically "protected" employees who end up being laid off or finding their salaries reduced because of the overall financial burdens created by the "protections" themselves.[99]

---

98 Monahan, *supra* note 74, at 1033 ("Given the option, an employee may prefer to accept lower future pension accruals in return for avoiding termination or a reduction in current compensation, but such deals are hard to accomplish in a system that protects the rights of future accruals.").

99 *See, e.g.*, UNIV. OF WASH., REPORT ON THE IMPACT OF SEATTLE'S MINIMUM WAGE ORDINANCE ON WAGES, WORKERS, JOBS, AND ESTABLISHMENTS THROUGH 2015 3 (2016) ("In a region where all low-wage workers, including those in Seattle, have enjoyed access to more jobs and more hours, Seattle's low-wage workers show some preliminary signs of lagging behind similar workers in comparison regions. The minimum wage appears to have slightly reduced the employment rate of low-wage workers by about one percentage point. It appears that the Minimum Wage Ordinance modestly held back Seattle's employment of low-wage workers relative to the level we could have expected. Hours worked among low-wage Seattle workers have lagged behind regional trends, by roughly four hours per quarter, on average. Low-wage individuals working in Seattle when the ordinance passed transitioned to jobs outside Seattle at an elevated rate compared to historical patterns.") (Suggesting, where minimum wage has risen by local ordinance businesses cope by employing fewer employees for fewer hours)

### 2. Theories of Funding Obligation

The options available to state supreme courts on the question of funding obligations are simpler. Here, courts effectively have two choices. First, state courts – especially state courts faced with pension-protection amendments that they have read to protect both already-earned and still-prospective pension benefits – may concomitantly find that the state legislature, as a result of this obligation, also faces the corollary obligation to undertake ongoing funding of the state's pension funds actuarially sufficient to permit those funds to make the promised pension payments when the time comes. The second choice is, essentially, to punt. Alaska, which has interpreted its pension-protection amendment to protect prospective benefits, has also required ongoing funding.[100] New York (though that state's high court has not officially bound it to pay prospective benefits)[101] has likewise found its pension-protection amendment to require sound funding of the pension fund.[102] And while the Arizona Supreme Court has used its amendment to protect purely prospective benefits[103] (only to face a swift, ad hoc slap-down by the state's political branches and voters)[104], that state's amendment also (explicitly) requires regular pension funding "using actuarial methods and assumptions that are consistent with generally accepted actuarial standards."[105]

Only Illinois, as detailed above, has found that its PPA requires it to pay prospective pension benefits without diminution – somehow – when they come due, without finding the corollary viable ongoing-funding obligation.[106]

---

100 *See* Hammond v. Hoffbeck, *supra* note 72, at 1057.

101 *See* E.J. McMahon, *As goes Illinois, so goes New York?*, PUBLIC SECTOR INC. (Dec. 5, 2013), http://www.publicsectorinc.org/2013/12/as-goes-illinois-so-goes-new-york/.

102 *See* McDermott v. Regan, 624 N.E.2d 985, 986-87 (N.Y. 1993).

103 *See* Fields v. Elected Officials' Retirement Plan, 320 P.3d 1160, 1166 (Ariz. 2014) (Arizona has shown itself both able and willing to make significant *ad hoc* amendments to its pension-protection amendment in the wake of its Supreme Court's adoption of what might be called "the Illinois Interpretation" of such amendments).

104 *See id.*

105 ARIZ. CONST. amend. XXIX, § 1, cl. A ("Public retirement systems shall be funded with contributions and investment earnings using actuarial methods and assumptions that are consistent with generally accepted actuarial standards.").

106 Only Alaska, Arizona, Illinois and New York have constitutional amendments that have been interpreted to protect both earned and prospective pension benefits. Hawaii, Louisiana and Michigan also constitutionally protect pension benefits – but only earned, not prospective. *See, e.g.*, Stephen D. Eide & Dean Ball, *Constitutional Public Pension Guarantees: Unfair, Unaffordable, and Bad Policy*, ISSUE BRIEF NO. 25 (Aug. 2013) (citing the Center for Retirement Research at Boston College; ALASKA CONST. art. XII, § 7; ARIZ. CONST. art. XXIX, § 1, cl. C; HAWAII CONST. art. XVI, § 2; ILLINOIS CONST. art. XIII, § 5; LA. CONST. art. X, § 29, cl. A-B; MICH. CONST. art. IX, § 24; NEW YORK CONST. art. V, § 7).

### D. *Critique of the Illinois State Supreme Court's Interpretation (Or: Can't Anybody Here Play this Game?)*[107]

It would be hard to imagine a governmental entity of any kind getting itself into Illinois' present morass without all of the instrumentalities of that entity contributing to the disaster. No such imagination is required here. This calamity was a group effort. The ultimate responsibility – for anything, in a representative democracy – must lie with the voters. They elected, for decades on end, this crowd that could not govern straight. They put up with the famous Chicago- and Illinois-style corruption, the backroom deals, the punts, and the faux solutions.

Narrowing in concentric levels of sovereignty, the delegates of the Illinois Constitutional Convention of 1970 must bear their own portion of blame. They acquiesced in the push by a few motivated delegates to incorporate New York's pension protection + pension-funding mandate PPA into the constitution it drafted (and the people of Illinois ratified). Yet in adopting the New York Constitution's language essentially verbatim, the convention failed to notice that the language did not spell out expressly the second half of the formulation – thus opening room for the fundamentally incoherent but textually defensible "half-reading" which the Illinois Supreme Court has applied to it in the intervening half century.

The primary actors in this tragedy of governance, though, have necessarily been the three active branches of government. At the broadest levels, Illinois' governors and legislators have connived together to offer ever-expanding pension benefits to ever more state employees without making even cursory efforts at actuarially sound or ethically defensible funding levels. This connivance has crossed parties and stretched back, apparently, to the inauguration of state pensions in Illinois. Likewise, the state Supreme Court cannot evade (merely by failing to acknowledge, while pointing the finger everywhere else) responsibility for its incoherent interpretation of the IPPA.

At a narrower level, the *in extremis* actions by all three branches of government, in the years since the depth and breadth of the crisis have become unavoidably clear, both to illustrate and underscore the comprehensive government failure that has made Illinois' plight possible.

The Illinois Supreme Court's interpretation of the IPPA – in general since 1971, but particularly in the three cases it has decided since the crisis has been recognized – stands open to significant criticism. The Court's treatment of the IPPA is weirdly quasi-literal, quasi-formal, and quasi-*ad*

---

107 *Cf.* JIMMY BRESLIN, CAN'T ANYONE HERE PLAY THIS GAME? (1963) (Breslin attributed the quotation, to Mets manager Casey Stengel, apocryphally referring to the inaugural Mets of that season – who went 42-120to become, and remain, the worst team in Major League Baseball history. *See, e.g.*, Robert Lipsyte, *Welcome to Loser Town, U.S.A*,. N.Y. TIMES (Sept. 29, 1996) (recounting Breslin's admission that he made up the quote)).

*hoc*; there is no consistency in its approach. It recognizes, for instance, that the language of the IPPA was lifted effectively verbatim from the New York PPA, and on that basis "follows" New York in concluding that the IPPA protects not only earned but prospective pension benefits, even though it appears unlikely that New York has ever actually expressly embraced that position.[108]

The Court sticks to this position even though there is nothing in the text of the IPPA that compels that reading. As noted above, the IPPA provides that "[m]embership in any pension or retirement system of the State . . . shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[109] This is inelegant language, and is hard to construe. It certainly can be read to protect all benefits conferred at any point during the membership of the employee in the pension system, which is to say during the employee's employment, but it surely need not. Rather it can as reasonably be read this way:

> (1) Employees who have earned pension benefits may rely on those benefits with contractual solemnity, and those will not be reduced or diminished; though,
>
> (2) because work not yet performed raises no contractual considerations – at least for at-will employees, and only to the end of the contract term for employees under contract – pension benefits for that period of employment can merit no protection under the amendment.[110]

Finally, in supporting its prospective-benefit protection position, as also noted above, the Court has looked to the proceedings of the 1970 state constitutional convention.[111] But nothing in the excerpts of those proceedings relied upon by the court suggests anything about prospective, unearned-benefit protection.

It appears, therefore, that the flank of this wing of the Court's interpretation rather dangles without any real support at all.

The Court's determination that the IPPA does not require the legislature to fund its pension obligations in a manner consistent with actually being able to pay them when the time comes hangs similarly in the air. Of course, nothing in the express language of the IPPA requires on-going, sufficient funding any more than it expressly requires prospective-benefit funding. New York's PPA, however, which had putatively been the source

---

108 *See* E.J. McMahon, *supra* note 101 (asserting that it hasn't); *see also* In re Pension Reform Litig., *supra* note 7, at18 (citing Fields, *supra* note 103, at 1166) ( The Court never cited any New York source for its prospective-benefit protection at all. Rather, the only foreign source cited in support of its prospective-benefit position was the Arizona case Fields, which itself relies on older, untethered Illinois Supreme Court precedent.)).

109 ILL. CONST. art. XIII, § 5 (1970).

110 This is at all events the only interpretation consistent with economic theory and common sense and justice. *See* Monahan, *supra* note 74, at 1033.

111 *See* In re Pension Reform Litig., *supra* note 7, at 6-8.

and informant of the Illinois provision, has expressly been interpreted to require on-going sufficient funding; in fact, any reduction of the funding formula has been recognized as a violation of New York's amendment.[112] In diverging from the follow-New-York rule in finding no ongoing-funding obligation, the Illinois Court again purported to look back to the proceedings of the 1970 convention.

We have again examined the debates concerning the application of this provision to the necessity of providing certain funding to the various pension plans during a particular fiscal period. As recognized in Peters, the tenor of the debates was primarily concerned with assuring members of pension plans that they would receive the money due them at the time of their retirement. The question of the specific funding of compulsory pension programs was discussed, and Delegate Kinney, a cosponsor of the provision, stated: "It was not intended to require 100 per cent funding or 50 per cent or 30 per cent funding or get into any of those problems, aside from the very slim area where a court might judicially determine that imminent bankruptcy would really be impairment."[113] Comparable interpretations of the provision's effect as applied to these appeals were echoed by Delegates Lyons, Whalen and President Witwer.[114] While Delegate Green expressed the opinion that the legislature should adequately fund the pension systems in accordance with the actuarial principles,[115] the convention debates do not establish the intent to constitutionally require a specific level of pension appropriations during a fiscal period.[116]

But this support fails on its face to support the Court's recent decisions. First, those recent decisions rely explicitly on Delegate Green's assertion that the amendment should require ongoing-pension funding, and he is the delegate who draws the New York state PPA comparison the Court purports to rely on for the prospective-benefit protection interpretation. It seems odd to (assertedly) privilege Delegate Green's position in one context, but to deprecate it in another. And as the Court itself recognizes, the convention's proceedings were at best contradictory and unhelpful – in normal circumstances. But even the delegate who alone provides the Court's "solid" support in favor of the proposition that the IPPA creates in the state no obligation to maintain sufficient ongoing funding, himself recognized "the very slim area where a court might judicially determine that imminent bankruptcy would really be an impairment."[117] In other words, all evidence in the proceedings of the 1970 constitutional convention indicate that the delegates understood that the IPPA would require sufficient ongo-

112 *See* McDermott, *supra* note 102, at 986-87.

113 4 Record of Proceedings, Sixth Illinois Constitutional Convention 2926, 2929.

114 *Id.* at 2932.

115 *Id.* at 2925, 2931.

116 People *ex rel.* Ill. Fed'n of Teachers v. Lindberg, 60 Ill.2d 266, 271-72 (1975).

117 *Id.*

ing funding to avoid effectively insolvent pension funds (far less the effective insolvency of the whole of the state of Illinois, the condition into which things have now fallen). Yet the Court has in the present crisis refused not only to recognize an obligation in the state to maintain actuarially sufficient funding, but refused to find that the fairly minimal efforts by the state to tie itself to the mast of some guaranteed level of funding was severable from the other provisions of Public Act 98-599,[118] and refused the state's request (on police-power grounds) either to reconsider its prospective-benefit protection position, or to remand the issue to the state to demonstrate the depth and breadth of the present funding crisis.

Not that the political branches of the state government have made things easy on the Court. As the Court retails in In re Pension Reform Litigation, those branches have long known that the Court has read the IPPA to protect prospective as well as earned benefits once a benefit-computation formula has been established during an employee's tenure.[119] Yet the legislature might still have sent the Court a bill that tested, inarguably and explicitly, the distinction between already-earned and prospective benefits, and whether the Court really intended to completely protect purely prospective benefits for current employees. It could have done this (and still could do it) by fashioning an act that incorporated explicit "hybridization" provisions (i.e., the act would have protected X formula – the formula in place for services already rendered − while substituting Y formula, which would have represented a decrease in benefits – for any service performed after the effective date of the statute).[120]

This hybrid formulation may still have been struck down by the Court. However, using it would have allowed the state to make a much more sophisticated defense of its pension reforms. It could, in effect, have argued to the Court that its previous prospective-benefit protection had been unnecessarily (and perhaps even inadvertently) overbroad, and could have presented the textual analysis that appears above in this section. At the very least it would have permitted the Court cover for a dignified retreat in the

118 In re Pension Reform Litig., *supra* note 7, at 29-30. (The Court did rightly recognize that the statute itself made the mandatory ongoing-payment provisions inseverable from many provisions that the Court had independently struck down. By the Court's own lights, though, this represented only the first step in severability analysis. As noted above, the Court considers its own independent severability analysis to trump "advisory" statements appearing in statutes). *Id.* at 15. Given this view of the matter, the Court must surely – if it had remembered the only basis upon which it had thus far failed to recognize a mandatory, constitutional obligation in the legislature to provide ongoing, actuarially coherent (or at least coherent enough to avoid the present race to insolvency) funding – at very least have found this first effort at legislative financial responsibility not only severable, but requisite.

119 In re Pension Reform Litig., *supra* note 7, at 16-17.

120 *See* Van Houten, *supra* note 79 (As that case itself expressly recognizes, the background pension rules in Texas are rather different than those that the Illinois Supreme Court has asserted. Employing a formula like the one Galveston used in Houton would still have had the effects discussed above, however.).

face of such comprehensive real proof of the incoherence of its prospective-benefits-protected-but-provision-of-funds-for-payment-not-required interpretations theretofore.

Instead, Public Act 98-599 reduced benefits in ways that unavoidably implicated not only prospective but also already-earned benefits.[121] As a result, the state found itself reduced to an argument that the present emergency justified the state's application of the police power to obviate its constitutional obligations, a position that the Court makes short but fairly complete work of.[122]

And so, both late and soon, all parties have played their necessary roles in wrecking the train of state.

## III. RAPIDLY NARROWING OPTIONS (OR: THERE MUST BE SOME KIND OF WAY OUT OF HERE)[123]

Illinois' options shrink quickly. Because of the complexity, supermajority requirements, and years-long process involved, a state constitutional amendment to revise or replace the IPPA seems impossible to accomplish and anyway would likely come too late even if the process were begun with full and sufficient Springfield and state-wide backing as soon as tomorrow. Bankruptcy is impossible under federal law and it is unlikely to become permissible anytime soon, as it would – under any plausible scenario – place the state in a federal receivership of a sort, and under significant federal control. Default is both deeply unattractive and ultimately largely unhelpful, as the state's IPPA-irreducible pension-payment obligations dwarf its bond-payment obligations (and, in fact, every other line-item in the state budget).

What remains to the state (if it wishes to retain its sovereignty and power) is to push through a new pension-reform act that lays out a clear path for the Illinois Supreme Court, showing the Court how to it can affect a volte-face while saving nominal face. Such an act would make sharp and explicit distinction between already-earned pension benefits and prospective benefits, protecting the former catholically, while cutting the latter ag-

---

121 *See* In re Pension Reform Litig., *supra* note 7, 1-12 (detailing the central pension-reduction efforts in the Act along with citations to their locations in the text of the Act. To take one example: the Act would have "delay[ed], by up to five years, when members [i.e., public employees] under the age of 46 are eligible to begin receiving their retirement annuities" (citing 40 ILL. COMP. STAT. 5/2-119(a-1), 14-107(c), 14-110(a-5), 15-135(a-3), 16-132(b)). It could be argued that in many cases this provision would often roughly parallel an explicit earned-benefits/prospective-benefits hybridization. However, (a) the state did not argue that; and (b) this argument would certainly not have invited the Court to search for a way to recognize the earned/prospective distinction in the same way that a clear hybridization would have.

122 *See id.* at 20-29.

123 *Cf.* BOB DYLAN, ALL ALONG THE WATCHTOWER (Columbia 1967).

gressively. It would include in its preamble a careful explanation of the distinction and of how the IPPA can be interpreted to embrace the distinction and to permit the incorporated prospective-benefit; explain the necessity of the move and (implicitly, but gently) the economic and social incoherence of the Court's present IPPA interpretation; and show the Court how it could find the act constitutional under the IPPA without explicitly reversing any of its previous reasoning (though it would of course have to reverse its conclusion that prospective benefits are protected, a conclusion that has arisen, as it turns out, more out of imprecise initial expression and continued iteration rather than out of the logic of the Court's chain of cases).

The act would also commit the state to ongoing funding of its pension obligations at the most actuarially sound rate the state's finances will reasonably permit, while expressly demonstrating to the Court that mandatory funding – at least in the throes of a desperate funding crisis like the one that now besets the state – was always an explicitly intended feature of the IPPA as passed by the 1970 Illinois Constitutional Convention.

It might also include a new tax levy either on public-employee pensions exclusively, or on all pensions received by citizens of Illinois.[124] The former might offend even an earned-benefits-only interpretation of the IPPA, while the latter would have the effect of driving at least the marginal pensioner from the ranks of snow birds to that of tax exile.[125] Given the potentially objectionable nature of the proposition, the act should be written expressly to render this provision severable from the rest of the act, should the Court strike it down.

Given the incredible seizure of the political engine in Springfield, a sane bettor would offer only slim odds on an act of this nature becoming law anytime soon. The political branches there may be spurred to unexpected concord, however, by the prospect of what must come without swift agreement. Illinois simply cannot muddle and evade its way through the crisis much longer. Without serious, concerted, careful and quick state action, opportunities for such action will eventually "all fall back into the past-not only distant, but prosaic."[126] Illinois will face an insoluble math problem if it does not change its course, it cannot possibly afford to pay for all of the promises that its Supreme Court has declared undiminishable. Should it fail to right itself under its own sail, it must necessarily seek shelter in federal ports. And, as discussed in the next section, the federal gov-

---

124 *See e.g.*, Alejandra Cancino, *Illinois Awash in Tax Breaks*, BETTER GOVERNMENT ASSOCIATION (Oct. 19, 2016), https://www.bettergov.org/news/illinois-awash-in-tax-breaks (Illinois presently exempts all retirement income from state income tax).

125 Unless Illinois moved from a residency-based income-taxation model to a source-based income-taxation model. *See infra* Section III. C. for further discussion.

126 *Cf.* Winston Churchill, Speech to the House of Commons (June 4, 1940) ("[T]he Knights of the Round Table, the Crusaders – all fall back into the past, not only distant, but prosaic").

ernment can, must, and will demand a high price for providing a berth for Illinois to ride out the storm.[127]

## A. *Unlikelihood of State Constitutional Amendment*

A successful state constitutional amendment to revise the IPPA seems unlikely. Outside of the context of a constitutional convention, state constitutional amendments of a substantive nature require the approval of sixty percent of each house of the legislature, and then sixty percent approval by voters who vote for or against the amendment, or a simple majority of all votes cast in that particular election.[128] This may prove impossible. In 2012, the legislature gave supermajority approval to an amendment merely forbidding the legislature to increase pensions.[129] However, even this largely symbolic effort, which was fought for hard by the state-employee unions, garnered only 56 percent of the electorate's support, and thus failed passage.[130] More aggressive efforts to amend the IPPA since that vote have died in committee.[131] Given that it has proven impossible even to pass a budget in Springfield since the state elected a Republican governor in 2014,[132] such a prospect seems decreasingly likely over time – at least in the short run.[133] As the time frame lengthens, the likelihood that an amendment comes in time to help shrinks proportionally.

Neither are there timely or likely opportunities to alter Supreme Court conclusions by altering Supreme Court personnel. In neighboring Wisconsin, the forces opposing public-pension reform – after the failure of their filibuster-by-flight efforts in the legislature[134] – sought to thwart reform (which reform has resulted in Wisconsin's achieving the best-funded pen-

---

127 *Id.* ("…to ride out the storm of war…").

128 ILL. CONST. Art. XIV.

129 John O'Connor, *Illinois Pension Benefit Amendment Fails*, STATE JOURNAL-REGISTER (Nov. 12, 2012), http://www.sj-r.com/article/20121107/news/311079889.

130 *See* Paul Merrion, *Amending the Illinois Constitution a Tough Path for Pension Reform*, CRAIN'S CHICAGO BUS. (July 16, 2014), http://www.chicagobusiness.com/article/20140716/NEWS02/140719888/amending-the-illinois-constitution-a-tough-path-for-pension-reform.

131 *See id.*

132 *See* McKinney & Pierog, *supra* note 2 (explaining that "[a]n impasse between the Republican governor and Democrats who control the legislature left Illinois the only state without a complete 2016 budget" which would have been passed in calendar 2015 for the 2015 fiscal year. "A six-month fiscal 2017 spending plan was passed in June" of 2016).

133 The short-run difficulties are magnified by the fact that the Illinois Constitution requires a six-month wait, even after bicameral support is achieved, to place a constitutional amendment on the ballot.

134 *See, e.g.*, *Wis. Democrats Flee to Prevent Vote On Union Bill*, NPR (Feb. 17, 2011, 4:26 PM), http://www.npr.org/2011/02/17/133847336/wis-democratic-lawmakers-flee-to-prevent-vote.

sion system in the country)[135] – by attempting to recall the governor and a number of state legislators who had supported reform.[136] After these efforts failed,[137] the forces opposing reform opposed various state-supreme court justices who favored reform with candidates expressly opposed to such measures, and dedicated to finding them unconstitutional.[138] These efforts, too, proved unsuccessful.[139] They are largely unavailable as tools to deploy in the opposing cause in Illinois. Recall in Illinois is available only against the state's governor, not judges.[140] And natural electoral attrition – even if politically feasible – would take a very long time indeed, and is structurally very unlikely. The next supreme-court justice up for retention is Justice Anne M. Burke in 2018; a majority of the court cannot even theoretically be replaced until 2020.[141] Meanwhile, Illinois retention elections require that sixty percent of the votes cast in the election be cast for the sitting justice in order for retention to occur, but these elections are uncontested,[142] which is to say that replacing any justice (except by retirement) requires convincing more than 40 percent of that portion of the electorate that can be bothered to care about an uncontested judicial retention election to vote, explicitly, for no one. Only if that process proved successful once in 2018 and three times in 2020 could the process of replacement elections then begin in 2021.

## B. *The Deadend of Default*

Bankruptcy protection is presently unavailable to states, and cannot become available without an independent act of Congress.[143] Default, as on bond obligations, is available, but is so unattractive that only one state –

---

135 *See, e.g.*, M.D. Kittle, Report: State Public Pension Unfunded Liabilities Soar to $5.6 Trillion, WATCHDOG (Oct. 19, 2016) (citing *Unaccountable and Unaffordable 2016: Unfunded Pension Liabilities Near $5.6 Trillion.* AM. LEGIS. EXCHANGE COUNS. (Oct. 2016), https://www.alec.org/app/uploads/2016/10/2016-10-13-Unaccountable-and-Unaffordable.pdf).

136 *See, e.g.*, Jason Stein, *Supreme Court Upholds Scott Walker's Act 10 Union Law*, MILWAUKEE J. SENTINEL (Aug. 1, 2014), http://archive.jsonline.com/news/statepolitics/supreme-court-to-rule-thursday-on-union-law-voter-id-b99321110z1-269292661.html/.

137 *Id.*

138 *See, e.g.*, M.D. Kittle, *Justice Rebecca Bradley's Victory Bodes Well for Wisconsin's Right to Work Law*, WATCHDOG.ORG (April 11, 2016), https://www.watchdog.org/issues/justice/justice-rebecca-bradley-s-victory-bodes-well-for-wisconsin-s/article_9da9923e-4fea-57b5-a1cf-f43e5434922e.html; Laurel White, et al., *Bradley Wins Full Term on Wisconsin Supreme Court*, WIS. PUB. RADIO (April 5, 2016), https://www.wpr.org/bradley-wins-full-term-wisconsin-supreme-court.

139 *See supra* note 138.

140 *See* ILL. CONST. ART. 3, § 7.

141 *See id.* ART. 6, §§ 10, 12; *see, e.g.*, Illinois Supreme Court, BALLOTPEDIA, https://ballotpedia.org/Illinois_Supreme_Court (last visited Nov. 4, 2016).

142 *See* ILL. CONST. ART. 6, § 12.

143 *See* David A. Skeel, Jr. *States of Bankruptcy*, 79 U. CHI. L.R. 677, 679-80 (2012) (The possibilities and ramifications of federal action are considered *infra* Section IV).

Arkansas, in the depths of the Depression – resorted to it in the 20th Century.[144] The reluctance to default arises in part because

> a state default[] would be the financial equivalent of a tsunami. First, default would impose large, sudden losses on the creditors affected. This likely would include bondholders, since many bondholders are out-of-state individuals and institutions, and other obligations will seem more urgent. Second, the state would have almost complete control over which creditors to pay and which to stop paying, which would create deep uncertainty. This uncertainty would roil the credit markets long before the state actually defaulted. Finally, default would not relieve the state of its obligations. If the state defaulted on its bonds, for instance, it would still be obligated to pay them, which would bring ongoing hassles such as the need to defend against bondholders' efforts to collect. The ugly repercussions of default would linger.[145]

Arguably, Illinois has already advanced far along this parade-route horribilis; it already has the worst bond rating in the nation, a rating that has fallen steadily as this crisis has advanced and the possibility of default grown.[146] It is in fact far enough down the road to perdition that default will not help at all, while the possibility of default is–as the falling bond-ratings suggests–magnifying its problems.[147] Were Illinois to default on, for instance, its Blagojevich-era pension bonds, it would be relieved, temporarily, of the expense of paying the five-percent return on the bonds, but at the expense of losing further borrowing facilities entirely, and without, in even the medium term, reducing its overall indebtedness. Nor would this help anything anyway: this issue the state faces is not unpayable debt *per se*, but unpay able pension obligations upon which its Supreme Court has forbidden it to default to any degree under any circumstances whatever, including, presumably, absolute extension and exhaustion of the taxing power (which, as considered elsewhere in this article, still very possibly would not suffice). Default of bond or other debt obligations would only make things vastly worse the day after tomorrow without materially improving anything at all today.

---

144 *See id.* at 679.

145 *Id.* at 706.

146 Ray Long & Monique Garcia, *Illinois Credit Rating Sinks to Worst in the Nation*, CHI. TRIBUNE (Jan. 25, 2013), http://www.chicagotribune.com/news/local/politics/chi-illinois-credit-rating-sinks-to-worst-in-nation-20130125-story.html.

147 *See, e.g., Illinois' $1.3 Billion Bonds Fetch Hefty Yields,* RUETERS (Oct. 13, 2016, 5:30 PM), http://www.reuters.com/article/us-illinois-bonds/illinois-1-3-billion-bonds-fetch-hefty-yields-idUSKCN12D2ZW; Martin Hutchinson, *State Pension Problems Create Hidden Muni Risks,* WALL STREET DAILY (March 25, 2015), https://www.wallstreetdaily.com/2015/03/25/state-pension-municipal-bonds/.

## C. *The Taxing Power*

As the U.S. Supreme Court's decision in the Affordable Care Act (popularly recognized – and recognized by the President – as the "Obamacare Act")[148] amply demonstrated, the taxing power extends further than do general regulatory powers, at all levels of government.[149] Under present interpretation, the IPPA will not allow reduction even of not-yet-earned pension benefits, much less already-earned and in fact being-received benefits for retirees through direct legislative act. This, however, leaves open the possibility of reducing the effective pension-funding commitment, and also recouping some of the costs of that commitment, by the state's establishment of a tax on those benefits.

This tax could come in two potential forms. Under the first option, the state could target the tax exclusively at public-employee pensions (the "narrow option"). In the second, it would tax all pensions earned by Illinois taxpayers who receive pensions (the "broad option").

The first carries the most-direct benefit. Illinois has over-promised its public-employees, beyond its ability to pay. The narrow option would allow the state to broaden and render more equitable its necessity of calling back some of that promise in a narrowly inclusive way, by taking back some of the over-largesse not only from the "accounts" of those employees still in service, for the prospective-work period only, but from all pension benefits and beneficiaries, whether earned or prospective, whether still working or retired. This would broaden the base upon which recoupment occurs, and thereby decrease its effect on any given current or former public employee, in ways that would minimize the unintended consequences of such a move. And it could be made progressive, so that for instance less or none of the pain would fall on retirees with relatively modest pensions.

Although, this strategy also carries significant risk. The IPPA effectively makes public employees – or at least, under the constrained and sensible interpretation of the IPPA, already-earned public-employee pension benefit –a suspect or protected class or artifact (if the protected benefits only). The Illinois Supreme Court might (and might rightly, perhaps) refuse unequivocally – however artfully the rest of the act were drawn, and however willingly it were to accept the interpretative assertions contained in that act – to permit such a protected class or artifact to be targeted by state tax law, whatever the merits of the justifications for such targeting. Given this concern, the legislature would have three options: it could drop the idea as needlessly dangerous (at least in the act; perhaps a separate, later

---

148 Peter Grier, *"Obamacare" v. "Affordable Care Act:" Does the Name Matter*?, CHRISTIAN SCI. MONITOR (Nov. 29, 2013), https://www.csmonitor.com/USA/Politics/Decoder/2013/1129/Obamacare-vs.-Affordable-Care-Act-Does-the-name-matter ("The Obama administration appears to again prefer 'Affordable Care Act,' whereas previously, the president had embraced the label 'Obamacare.'").

149 *See* Nat'l Fed'n of Indep. Bus. v. Sebelius, 567 U.S. 519, 563-65 (2012).

effort might be tried were the act to survive scrutiny); it could make this provision explicitly severable; or it could resort to the broad option.

The broad option will not raise as insistently the specter of state supreme court rejection. All pensioners (current and prospective) are not a protected class under any reasonable interpretation of the IPPA or anything else. Taxes constantly target narrow groups on almost innumerable bases; the progressive tax itself targets earners on the basis of their earning power explicitly. The broad option would thus not likely fall afoul of the Court's IPPA enforcement.

It would, however, present other difficulties. A special tax on pensions earned by residents would make Illinois relatively unattractive, on a tax basis, when compared to any state that lacked such a tax. Retirees are by definition more capable of taking their leave of a jurisdiction than other state residents. Given Illinois' weather, many retirees have already partly decamped for more solicitous climes, some of which lack an income tax entirely.[150] A special levy on all resident pensions would necessarily push the marginal retiree to make the winter residence the income-taxable residence. The state-fiscal equation that would arise would be: will we drive more taxable income away than we will reap? If the answer to this question is yes, then the legislature might consider switching the whole basis of its state income-taxation scheme from a residency base to a source base, a move consistent with U.S. constitutional precedent.[151] This possibility in turn raises the concomitant question of whether such change in basic foundation of the state's income-tax regime would prove a net positive or negative. The answers to these practical accounting questions lies well beyond the scope of this paper.

It may well be that, given the challenges involved, neither of these options is a good one. But were the political branches of Illinois' dysfunctional government to find some way to write the act proposed in this section, and were the financial enormities sufficiently dire, one or the other of these options might be worth including.

### D. *The Vicious Cycle*

The Illinois Supreme Court noted that the state had allowed a 66 percent individual income tax increase and a 30 percent corporate tax increase to lapse (partially) at the end of 2014, and rather cavalierly suggested that

---

150 *See* Dan Dzombak, *These States Have No Income Tax*, USA TODAY (April 26, 2014), https://www.usatoday.com/story/money/personalfinance/2014/04/26/these-states-have-no-income-tax/8116161/ (These include Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Tennessee and New Hampshire have "nearly" no income tax.).

151 *See, e.g.*, Comptroller of the Treasury v. Wynne, 135 S. Ct. 1787, 1820-21 (2015) (confirming that states may elect either regime).

the state merely tax its way out of its pension-promise predicament.[152] This blithe proposal is, at very best, deeply incomplete and under-considered.

The tax hikes that partially expired at the end of 2014 were generally recognized as being fairly massive[153] (it is somewhat rare when a 66 percent increase of a flat tax is not universally recognized as highly significant, while the corporate tax hike made the state's the fourth-highest in the country). Nevertheless, the increases only brought in – and so the treasury only "lost" upon its surcease – some $4 billion (upon the partial reversion).[154] This is not a small amount of money, surely. But remember that the fully realized (i.e., upon recognition of a realistic discount rate) actuarially appropriate contribution required of the Illinois fiscal for each of the next thirty years stands in the neighborhood of $20 - $25 billion.

There is good reason to think that there is absolutely no way for Illinois to raise that type of money for that long. Contra the Supreme Court's implicit understanding, Illinois residents and businesses face no obligation to continue working – and producing tax income – in Illinois forever, regardless of the state's tax burden, regulatory regime and business friendliness. Chicago already carries the highest big-city sales-tax rate in the country.[155] Eventually, increasing taxes will set off a "vicious cycle," in which large businesses begin to relocate their headquarters, medium-sized, regional businesses that are able (especially near the state borders) will move across the state line, and small and support businesses will start to go under.[156] All of this will cause the decamping employers' workers to need to follow (or want to) other workers to seek jobs in states in which its easier to prosper, and some remaining workers to lose their jobs, earn less, or increase grey- and black-market activity.[157] Lather, rinse, repeat, collapse.

---

152 *See Illinois Lawmakers Pass 66 Percent Income Tax Increase*, FOX NEWS (Jan. 12, 2011); Kail Padgitt & Joseph Henchman, *Illinois Approves Sharp Income Tax Increase, Fourth-Highest Corporate Tax Rate*, TAX FOUNDATION FISCAL FACT NO. 256 (Jan. 13, 2011).

153 *See* Padgitt & Henchman, *supra* note 152 (In 2015, "the individual income tax decrease[d] to 3.75%. Then in 2025, the individual income tax rate will drop to 3.5%. The corporate tax will follow a similar schedule of rate decreases: in [2015] the rate [dropped to] 7.75% and then in 2025 it will go back to the [pre-2012] rate of 7.3%.").

154 *Id.* Before the decrease, the tax increases brought in about $6.5 billion/year.

155 *See* Hal Dardick, *2016 Brings Tax Hikes for Chicago, Cook County, City Schools*, CHI. TRIBUNE (Dec. 31, 2015), http://www.chicagotribune.com/news/local/politics/ct-illinois-new-taxes-fees-20151231-story.html (Chicago also enacted the biggest income tax increase in its history explicitly to fund city-worker pensions, and has passed entirely unique taxes on Netflix and on Uber and other ride-sharing services.).

156 *See, e.g.*, Padgitt & Henchman, *supra* note 152 (The temporary 2011 tax increase decreased the state's business-friendliness ranking from 23rd to 36th.); FURCHTGOTT-ROTH, *supra* note 38, at 10-11 (suggesting that this process is already well under way).

157 Recent evidence underscores the problem. *See, e.g.*, Lauren FitzPatrick, *CPS Has Lost Nearly 11,000 Students Since Last Fall*, CHI. SUN TIMES (Oct. 21, 2016), https://chicago.suntimes.com/news/cps-has-lost-nearly-11000-students-since-last-fall/ (nearly 60,000 fewer students than at the enrollment height at the beginning of the millennium. Most of the losses in the

Even if the state does not raise taxes in a way to set off a full-scale vicious cycle, every increase in the marginal tax rate – any tax rate – will shift the marginal business, worker or dollar spent out of Illinois and into a more-inviting economy. All of this sets a hard limit on the amount of money that a government can tax out of any theoretical polity that it represents, and also guarantees that the marginal tax dollar is more expensive, in aggregate social welfare, to bring to the treasury than the previous dollar.

The Court's other suggestion of how the state had not completely run out of options other than restraining public-employee pensions lacked any relationship to economic, financial or accounting reality. The Court suggested that the state could decrease its present obligations by further increasing its amortization schedule, without recognizing that the state has already used that gimmick to extend the obligations 66 percent further than is generally thought actuarially appropriate, and without considering the unintended market and other consequences almost certain to follow from such a move.[158]

---

last year have come at the primary and intermediate levels. The article notes that "[t]he district has chalked up some of its recent losses to low birth rates overall, and the reversal of immigration trends to Chicago."); Michael Lucci, *4 Manufacturers Announce Plans to Shut Down or Move Out of Illinois*, JOBS + GROWTH ILL. POL'Y INST. (Nov. 1, 2016); Michael Lucci, *New 2014 IRS Migration Data Show Wealth and Youth Are Fleeing Illinois*, ILL. POL'Y INST. (Nov. 3, 2016), https://www.illinoispolicy.org/new-2014-irs-migration-data-show-wealth-and-youth-are-fleeing-illinois/; Madelyn Harwood, *U-Haul Rental Rates Reflect Illinois' Out-Migration Crisis*, ILL. POL'Y INST. (Oct. 19, 2016), https://www.illinoispolicy.org/u-haul-rental-rates-reflect-illinois-out-migration-crisis/.

158 Illinois does enjoy additional means of raising at least some revenue that could be dedicated to meeting its pension obligations, however interpreted. The current governor, for instance, is attempting to sell off valuable state assets, such as the James R. Thompson Center in Chicago, while privatizing various government services. *See, e.g.*, Brett Chase, *Selling Off Illinois: Governor Wants More Revenue But Spinning Off Taxpayer-Owned Assets and Services is Risky Business and Ultimately Requires Asking the Tough Question "Why Do This?" – A BGA Rescuing Illinois Report*, ILL. TIMES (Dec. 10, 2016), http://illinoistimes.com/article-16508-selling-off-illinois.html (detailing a variety of sale and privatization efforts, and opposition to these efforts). Even in these desperate times, though, there is no guarantee that the political branches in Illinois will restrict these extreme measures to addressing the pension-funding crisis. *See, e.g.*, Ben Jorasky & Mike Dumke, *FAIL, Part One: Chicago's Parking Meter Lease Deal*, CHICAGO READER (April 9, 2009), https://www.chicagoreader.com/chicago/features-cover-april-9-2009/Content?oid=1098561 (detailing Chicago's transfer of parking-fee, parking-meter-fee, tollway-fee, and other revenue streams to private companies for extended periods in exchange for piles of cash then dedicated to filling current-accounts deficits); Greg Hinz, *Emanuel Revises Chicago Parking Meter Deal, but How Good is it Now?*, CRAIN'S CHI. BUS. (April 29, 2013), http://www.chicagobusiness.com/article/20130429/BLOGS02/130429788/emanuel-revises-chicago-parking-meter-deal-but-how-good-is-it-now.

## E. *That Which Can't Happen, Won't*

Just continuing on the present course will not do; it represents a disaster for all parties. "The pension funds in . . . Illinois . . . could default in the next decade unless drastic reform measures are taken. The financial condition in [Illinois] . . . led one analyst [Maria O'Brien Hylton][159] to conclude that 'bankruptcy or the complete cessation of all state functions save paying benefits to retirees is not unthinkable.'"[160] Realistically, it really is unthinkable that Illinois will devolve entirely into Anarchy on Lake Michigan, a failed-state with a functioning pension fund (though the skyrocketing rate of violent crime in Chicago and the rolling, endless budget crisis in Springfield suggest that some movement in that direction is already occurring).[161] As a result, Hylton's speculation serves to demonstrate that as a practical matter – rather than one of Illinois Supreme Court assertion – the Court's reading of the IPPA to forbid prospective changes to as-yet-unearned pension benefits now could well result in more drastic and less thoughtful reductions later as a matter of simple economic necessity. And while the government-employee unions have thus far served as the most recalcitrant opponents of compromise and reform, they would do well to think anew. "In theory, the promise of a pension benefit creates a concomitant duty on the part of the state. In reality, however, employees bear the risk that state governments will fail to provide such benefits."[162]

## F. *Summary: What Illinois Can Do; What Illinois May Do; What Illinois Probably Will Not Do*[163]

Illinois' government has left itself with a festival of bad options. Its wisest course – by the lights both of fidelity to the interests of that unhappy commonwealth and its duties to it; as well as to the narrow interests of its actors as empowered representatives of a sovereign government – would be for:

---

159 *See* Maria O'Brien Hylton, *Combating Moral Hazard: The Case for Rationalizing Public Employee Benefits*, 45 IND. L. REV. 413, 434 (2012).

160 *Id.* at 434.

161 *See supra* Section I.

162 Anenson, *supra* note 3, at 6 (citing LAWRENCE A. FROLIK & KATHRYN L. MOORE, LAW OF EMPLOYEE PENSION AND WELFARE BENEFITS (2012)); EVERETT T. ALLEN ET AL., PENSION PLANNING: PENSION, PROFIT-SHARING, AND OTHER DEFERRED COMPENSATION PLANS 401-02 (9th ed. 2003); Karen Eilers Lahey & T. Leigh Anenson, *Public Pension Liability: Why Reform is Necessary to Save the Retirement of State Employees*, 21 NOTRE DAME J. L. ETHICS & PUB. POL'Y 307, 310-311 (2007)).

163 *Cf.* William Shakespeare, Much Ado About Nothing (IV, I, 19-21) ("O, what men dare do! What men may do! What men daily do, not knowing what they do!").

(1) The political branches to pass a new pension-reform bill that

(a) adopts the "hybrid" form, protecting all earned benefits while adjusting still-prospective benefit formulae for still-working employees hired before 2011; and

(b) sets out an as-rigorous-as-the-state-can-reasonably-manage amortization schedule (tied to a realistic discount rate) that will, in the shortest reasonable time, fund the revised pension obligations fully; while

(c) revising whatever discount-rate related triggers appear in present statute, so that recognizing the scope of the problem and planning accordingly does not itself trigger instant state fiscal collapse; and

(d) expressly declaring the political branches' understanding that – per the Illinois Supreme Court's own logic, at least in times of imminent financial collapse – the IPPA actually and independently requires the court to enforce, by mandamus proceeding or otherwise – the statutorily agreed funding schedule as the very best that the state can do to fulfill the ongoing funding obligations necessarily implicit in the IPPA; and

(e) further declaring the political branches' understanding that the Court had not yet, except in dictum, determined the earned benefit/prospective benefit issue, but is essentially compelled by Illinois and foreign precedent and logic to make the distinction; and finally,

(f) linking the two interpretations, and their consequences, inseverably.

(g) The act might also include either the narrow pension-taxing option, wholly severably, or the broad option.

(2) Then, of course, the Supreme Court would have to accept this deftly plattered invitation to render doctrinally, textually, logically and economically coherent its divergent threads of IPPA interpretation without significant loss of face.

This may not work, even as a theoretical matter; it may just be too late for Illinois to save itself. Nor, given the state of complete breakdown that presently characterizes the Illinois state government, would a betting spectator wager on it actually happening. The relevant actors simply must try, though: the state lacks other good options. State bankruptcy does not exist, and its available analogs would (as discussed further below) likely spare the state none of the reality-based pain awaiting it while depriving all branches of Illinois government of the power it so (sometimes questionably) enjoys. And if the window has not already shut on the state's opportunity to save itself, it cannot long stay cracked.

## IV. FEDERAL RESCUE? (OR, HELP US UNCLE SAM; YOU'RE OUR ONLY HOPE!)

If the state has let things go too long, or cannot or will not act in time, what options remain? The only recourse then available – one way or another – will be to look to the federal government for assistance. This, too, might not avail Illinois, and it almost surely will not come in any form that virtually any of Illinois' government actors will care to contemplate. Should Illinois' all-party logjam continue to flood the straits down which the state has floated itself, though, no other possible options will remain.

### A. *Potential Relief from the Federal Political Branches*

If Illinois cannot chart its own course out of the morass, it will have to look to the federal government for assistance, and particularly to Congress. The federal government, meanwhile, will eventually have to intervene if Illinois descends through deadlock into semi-governed quasi-insolvency. It seems exceedingly doubtful, though, that Congress will provide any such assistance without demanding concessions, concessions that will include at least some transfer of political power away from Springfield.

#### 1. A Kinder, Gentler Escape[164]

What Illinois needs most desperately is escape from the economically and morally incoherent prospective-benefits protection read into the IPPA by the Illinois State Supreme Court, along with a reversal of the equally incoherent refusal of that Court to read the IPPA to require ongoing funding sufficient to permit the state to honor the promises the court does read into the IPPA. The last section drew out a path by which Illinois might be able, realistically, to achieve that end on its own terms. If the state finds this path impossible to tread, the second-best possible result, from the point of view of state government actors, would be for the federal Congress to step in to solve that problem for them without attaching other conditions to their intervention.

Diana Furchtgott-Roth has proposed exactly this. In *Empowering Illinois' Pension Reform*, Furchtgott-Roth argued in favor of "creat[ing] a new section of the U.S. Bankruptcy Code, Section 113, a 'Limited Proceeding to Ensure the Undiminished and Unimpaired Performance of Essential State Services.'"[165] This new section, though inserted into the Bankruptcy Code,

---

164 *Cf.* George H.W. Bush, Nomination Acceptance Speech, Republican National Convention (Aug. 18, 1988) ("I want a kinder, gentler nation.").

165 FURCHTGOTT-ROTH, *supra* note 38, at 1.

would not actually require – or allow – a state to declare bankruptcy (at least not technically).[166] It would instead preempt state law and state-constitutional injunction[167] to "allow [states] to reform their pensions after the legislature had voted to do so," so that "states would have the opportunity to solve crises attributable to pensions, even though existing state laws [or constitutional interpretations] prohibit changes to such obligations."[168]

This kinder, gentler approach would not invade on state sovereignty to the extent that would necessarily follow from congressional adoption of, and state resort to, either full bankruptcy or, worse, a federal bailout (both considered in detail below). It would not, however, prove costless on this front. Furchtgott-Roth's proposal would permit resort of the Code provision "only after a serious analysis shows that funding for pensions impedes other state actions. States would publish their analysis after a public notice, and then file a proceeding in a federal court to identify suggested changes."[169] In other words, were states interested in – or practically obliged to – resort to Section 113, they would find themselves obliged to submit to federal rules and federal oversight, at least with regard to their pension-setting and funding determinations.

Nor is it at all certain that, were Congress to adopt Furchtgott-Roth's proposal, it would do so "cleanly," without adding additional oversight or disclosure obligations on states taking advantage of the provision. Representative Devin Nunes of California, for instance, has introduced the Public Employee Pension Transparency Act.[170] This act would "deny tax benefits related to bonds issued by a state or political subdivision during any period in which such state or political subdivision is noncompliant with specified reporting requirements for state or local employee pension benefit plans."[171]

---

166 *See id.* at 16.

167 *See id.* at 17 (citing Sturges v. Crowinshield, 17 U.S. 122 (1819)) (Asserting that this power has long been held to fit within the powers granted to the U.S. Congress under the federal Constitution, both in its Supremacy Clause and in its enumerated grant of bankruptcy-law oversight to Congress).

168 FURCHTGOTT-ROTH, *supra* note 38, at 16.

169 *Id.*

170 Public Employee Pension Transparency Act, H.R. 4822, 114th Cong. (2016).

171 *Summary of H.R. 4822 (114th): Public Employee Pension Transparency Act*, GOVTRACK.COM, https://www.govtrack.us/congress/bills/114/hr4822/summary (last visited Oct. 23, 2016) ("[t]he bill requires plan sponsors of a state or local government employee pension benefit plan to file with the Secretary of the Treasury a report for each plan year beginning on or after January 1, 2017, setting forth: a schedule of the funding status of the plan; a schedule of contributions by the plan sponsor for the plan year; alternative projections for each of the next 60 plan years of the cash flows associated with the current plan liability; a statement of the actuarial assumptions used for the plan year; a statement of the number of plan participants who are retired or separated from service and are either receiving benefits or are entitled to future benefits and those who are active under the plan; a statement of the plan's investment returns; a statement of the degree to which unfunded liabilities are expected to be eliminated; a statement of the amount of pension obligation bonds outstanding; and a statement of the current cost of the plan for the plan year. The Secretary shall develop model reporting statements and create and main-

It is difficult to see why this proposed act, or others like it, might not be attached to any bill adopting the Furchtgott-Roth proposal, at least insofar as to apply to states that took advantage of the new Section 113.[172]

And for Illinois, this bankruptcy-light option might just not be enough. If it is true that the state is too far down the road to insolvency to be able to solve its pension-funding crisis without resorting to full bankruptcy or even extending its cap to the federal fisc, then there can be little doubt that it will be obliged to sacrifice yet further sovereign authority.

### 2. Bankruptcy Reform and the State Bankruptcy Chapter Option

Some authorities, most particularly Professor Skeel, have argued that Congress should enact a full state-bankruptcy article in the federal bankruptcy code.[173] Much good could arise from such a development. As Professor Skeel explained, "[w]ith a state's unfunded pension promises, a court would likely conclude that the promises constituted a valid property right to the extent the state set aside designated revenues for them. But an unfunded promise would be treated as an ordinary unsecured claim, subject to restructuring."[174]

Given how aggressively underfunded Illinois' pension obligations are, and how strapped the remainder of its finances, a bankruptcy on these terms would almost certainly require all pensioners and all state employees to take a haircut, not just of prospective benefits but of earned benefits, which commits direct and express violence to the clear central meaning of the IPPA. As was noted just above, the federal government likely has the power to supersede the IPPA's provisions in this way. But as has also been considered, cutting already earned benefits – including benefits for already retired workers – hardly constitutes either a morally or politically favored outcome.

Meanwhile, this dispensation from the historical course of state political development will necessarily come at the cost of significant cession of

---

tain a public website, with searchable capabilities, for purposes of posting pension plan information required by this Act.").

172 *See, e.g.*, FINANCIAL STABILITY OVERSIGHT COUNCIL, 2016 ANNUAL REPORT 16 (2016), https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/FSOC%202016%20Annual%20Report.pdf (last accessed Nov. 5, 2016). (hereinafter "Pension Data") (The Dodd-Frank Act established, among many other bureaucracies, the Financial Stability Oversight Council which is charged, *inter alia*, with "recommend[ing] that pension regulators continue to work to improve the timeliness and the quality and depth of disclosure of pension financial statements, and will continue to monitor financial developments in pensions.").

173 *See generally* Skeel, *supra* note 144.

174 *Id.* at 697-698 (Expressing optimism, though not certain, that the courts would find such congressional action effective in retroactively trumping state provisions – even state-constitutional provisions – to the contrary).

sovereign political power during the course – and likely after the end – of the bankruptcy proceedings. By its very nature, the process of bankruptcy would transfer significant political powers away from all branches of Illinois government to the receiver in bankruptcy or its equivalent. So, for that matter, would virtually all quasi-bailout alternatives, especially quasi-bailout agreements with the federal government in exchange for a partial federal bailout, or other related options.[175]

### 3. Quasi-Bankruptcy and the Possibility of Federal Bailout

Just possibly, depending on the definition of "bailout," the federal government has, sort of, bailed out a destitute and insolvent state before: Arkansas, at the very nadir of the Depression.[176] Even then, though, the federal government's assistance came in the form of loan guarantees, not cash infusions or other more-direct alternatives.[177] That the latter recourse was not attempted even in the try-anything, rewrite-the-book, early days of Roosevelt's first administration goes a long way to suggest the unlikelihood of it being made available in any conceivable pension-propelled crisis in Illinois or any other state. Other historical and modern-day precedent (although arising from situations involving entities other than full-fledged States of the Union) and fundamental concepts of economic theory ramify this conclusion.

The historical analog arises from the (contextually relevant) 1970s. Mayor Beame's New York City (or rather, the disaster of Mayor Lindsay's New York City, that Mayor Beame had recently been handed) had descended into something approaching bankruptcy.[178] The mayor's office sought a federal bailout. President Ford told the city, per the famous headline of the New York Daily News, to "Drop Dead."[179] In stepped the new New York Governor Hugh Carey who, in exchange for state-loan guarantees, placed

---

175 *Id.* at 732-33 (Professor Skeel believes that a full-blown bankruptcy provision would prove less intrusive upon state-government power than the quasi-bankruptcy possibilities considered in the next subsection and a bankruptcy would pass the state's fiscal authority to a bankruptcy judge rather than a congressionally appointed committee. The power, though, would still be gone from the branches, all the branches, of Illinois government to solve their own – homemade – problems. With the power would go all the perquisites and opportunities of power, save only the titles and the salaries (and perhaps the pension benefits). Illinois' government class has no history whatever of a willingness to forgo those.).

176 *See, e.g.*, Monica Davey, *The State that Went Bust*, N.Y. TIMES (Jan. 23, 2011), http://www.nytimes.com/2011/01/23/weekinreview/23davey.html.

177 *See, e.g.*, John Maudlin, *Don't Be So Sure That States Can't Go Bankrupt*, FORBES (July 28, 2016), https://www.forbes.com/sites/johnmauldin/2016/07/28/dont-be-so-sure-that-states-cant-go-bankrupt/#4b9802592f2d.

178 *See, e.g.*, Ralph Blumenthal, *Recalling New York at the Brink of Bankruptcy*, N.Y. TIMES (Dec. 5, 2002), http://www.nytimes.com/2002/12/05/nyregion/recalling-new-york-at-the-brink-of-bankruptcy.html.

179 NEW YORK DAILY NEWS Cover (Oct. 30, 1975) ("Ford to City: Drop Dead").

the city under the control of, inter alia, the Municipal Assistance Corporation, which took control over New York City's sales tax; and the Emergency Financial Control Board, which took overall financial and budget control from the city.[180] Only then did Ford and Congress agree to a federally financed bailout package.[181] The latter still remains in place.

The recent "bailout" of Puerto Rico (which is a territory, not a state, and therefore is not a perfect analog[182]) has involved similar power transfers.[183] Puerto Rico has amassed, in the last 20-odd years, territorial and municipal debts totaling more than $70 billion, a tremendous sum to be owed by a political entity the gross annual product of which reaches only barely above $100 billion.[184] The sum proved, in fact, too large even to permit minimal interest payments by Puerto Rico; the territory defaulted on scheduled payments in June and July of 2016.[185] In order to stave off complete territorial meltdown, Congress passed legislation in August, which provided Puerto Rico with the opportunity to invite the federal government to intercede. Puerto Rico immediately took advantage of the opportunity and invited the intercession.

This legislation did not open the federal fisc to pay off Puerto Rico's debts. Not only does it not promise federal bailout funding for the island territory, but it was explicitly configured as an effort to avoid providing any such funds.[186] Rather, the invitation that it permitted Puerto Rico to offer or abjure (which Puerto Rico instantly offered) was for Puerto Rico to cede significant powers of its financial sovereignty in exchange for a short respite from immediate default proceedings and the opportunity – under federal supervision and upon federal approval – to negotiate haircuts with its lender parties while cutting territorial services, pensions, benefits, and other outlays.[187]

---

180 *See, e.g.*, Skeel, *supra* note 143, at 727-29 (citing extensively Martin Shefter, POLITICAL CRISIS, FISCAL CRISIS: THE COLLAPSE AND REVIVAL OF NEW YORK CITY (1985); Robert W. Bailey, THE CRISIS REGIME: THE MAC, THE EFCB AND THE POLITICAL IMPACT OF THE NEW YORK CITY FINANCIAL CRISIS (1984)).

181 *Id.* at 729.

182 Susan Cornwell, *Senate Passes Puerto Rico Debt Bill, Sends to Obama*, REUTERS (June 29, 2016), http://www.reuters.com/article/us-puertorico-debt-senate/senate-passes-puerto-rico-debt-bill-sends-to-obama-idUSKCN0ZF1XL.

183 *See id.*

184 *See, e.g.*, *Puerto Rico GDP*, TRADINGECONOMICS, http://www.tradingeconomics.com/puerto-rico/gdp (last visited Nov. 6, 2016).

185 *See, e.g.*,WHARTON SCH., UNIV. OF PA., *A Puerto Rico Primer: Why The Debt Problem is Our Problem*, KNOWLEDGE@WHARTON (May 20, 2016), http://knowledge.wharton.upenn.edu/article/why-puerto-ricos-debt-problem-is-our-problem/.

186 *See, e.g.*, Lorraine S. McGowen, *The Impacts of the New Restructuring Law on Puerto Rico Creditors*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE AND FIN. REGULATION (Aug. 20, 2016), https://corpgov.law.harvard.edu/2016/08/20/the-impact-of-the-new-restructuring-law-on-puerto-rico-creditors/.

187 *See id.*

It is hard to imagine any state "bailout" that included actual federal bailout funding that would not require a state to give away similar authority to some federally constituted oversight commissions. Even if some national political eruption permitted complete and overwhelming temporary control of the federal government by powers otherwise disposed to bail out Illinois, moral-hazard concerns would still render the proposition so wildly and obviously dubious – not just to the sitting representatives but to the polities whom all must still face ere long – that an Illinois-specific bailout would still likely fail of passage.

While Illinois stands rather closer to the brink than others, some compeers lag not-too-far behind, including the colossus California. Any bailout of Illinois would signal to laggard lemmings that their wisest course lay not in achieving austerity but instead in following Illinois off the cliff, and into the embrace of federal bailout.

Meanwhile, this first bailout – and any potential follow-on efforts – would have to be paid for somehow. In a fit of unexpected fiscal prudence, the federal political branches might pay for it by levying additional federal taxes, taxes that would apply nationwide, but that would constitute a fairly obvious transfer of wealth from national citizens to the state of Illinois alone. This would prompt such obviously negative political results for the party in power that it would almost certainly be avoided. The remaining option would then be to add the charge to the federal debt, which recently topped $20 trillion without even taking into account the federal government's own massive benefit-obligation shortfalls. Perhaps the Illinois bailout program could be dressed up a bit, extended to the several states generally, and provide the vehicle for the "helicopter money" QE(Nth) that some more aggressive economists have in desperation recently considered,[188] while the majority have mocked (whatever their thoughts about quantum-easing ab initio) as the reduction ad absurdum of an already exhausted policy.[189] But it does not seem likely.

#### 4. Potential Avenues to State Quasi-Bankruptcy and Bailout

Because state insolvency is so rare, Congress has never produced a bankruptcy code for states before, and no state – whatever one makes of the Arkansas asterisk of the early Depression years – has ever expressly sought a federal financial bailout as a means of keeping the state from financial collapse. Doubt may be raised as to just what the Constitution permits in this complicated arena of competing sovereignties, guarantees, polities,

---

188 *See* Neil Irwin, *Helicopter Money: Why Some Economists Are Talking About Dropping Money From the Sky*, N.Y. TIMES (July 28, 2016), https://www.nytimes.com/2016/07/29/upshot/helicopter-money-why-some-economists-are-talking-about-dropping-money-from-the-sky.html?_r=0.

189 *See id.*

jurisdictions, and expectations. Yet just as practicality would forbid the federal government to watch passively as one member of the Union descended into financial collapse and anarchy, so too does it seem that the Constitution may have provided the federal government – and, specifically Congress – power to act broadly to avoid just such incipient disaster.

The federal Constitution guarantees to each state perpetuation[190] of its (smaller, of course) republican form of government. It also forbids states, along with the federal government itself, from granting titles of nobility to any of its citizens (or, presumably, anyone else). Together these provisions – along with later developments, most especially the Civil War Amendments – have reasonably been taken to guarantee states a government that allows individual, minimally competent adult citizens of a state a genuine representative voice in their state governments, governments that shall proceed according to the rule of law. In other words, the citizens of the states are at one extreme guaranteed against rule by a particularized, state-favored class of people (an aristocrat class, whether hereditary or personal) whose position grants them a unique right to enjoy the premier privileges of the state. They are at the opposite extreme protected against a breakdown of the rule of law, that rule by the mob – by lawless elements of society ungoverned by the forms and methods of regularly constituted republican government – supplants civil life.

Illinois does not yet fully resemble either one of these bleak marginal situations, but it might with some fairness be characterized as careening toward both. As Governor Rauner's pension expert's recent plea to the TRS governing board not to recognize an even marginally lower (and thus commensurately less financially irresponsible) discount rate starkly indicated that Illinois lacks any present ability to recognize the depth of its plight, much less to deal with it. But ignoring this problem can only compound it. While it is straightforwardly impossible to dedicate at least five-sevenths of Illinois' annual budget for the next 30 years to state pension funding, each year's failure to hit that already impossible target makes the obligation in the remaining years until 2045 that much the greater. And for reasons behind the logic of the vicious cycle considered above,[191] every year in which

---

190 One may say "perpetuation" here rather than "establishment" because it has practically been presumed – though no case-law has arisen on this point – that Congress' admission of a state into the Union, a process that includes congressional "blessing" of the new state's new state constitution – constitutes implicit recognition by Congress that the new state charter has effectively (or at least sufficiently) embraced republican principle. By similar logic, it stands to reason that the Confederation Congress would not have transmitted to a state for ratification, nor the Constitutional Convention have presumed the participation of, one of the original thirteen states had that state not evinced a sufficiently republican character at the time of the federal founding. The Confederation Congress did not, for instance, invite nascently "republican" France to join the Union (though there might reasonably also have been other relevant considerations at play in that decision). (The importance of congressional recognition of sufficient republicanism manifests itself in the immediately subsequent paragraphs.)

191 *See supra* Section III.B.

this underfunding obligation gets worse, everything else worsens also, including future increases in the total lack of funds. Should nothing change – and it appears that nothing much can change for the better anymore – not too many years will pass before Illinois' imputed minimum annual pension payment obligations represent the whole of the state's annual revenues. Already Chicago effectively fails to uphold even the rudiments of the rule of law in vast swathes of its territory.[192] The state government cannot pay its bills,[193] fund its schools,[194] make a budget,[195] or do many of the other "Acts and Things" that modern states are rightly expected to do.[196] And the vicious cycle along with the medium-term unlikelihood of a significant, stable,[197] nominal interest-rate increase renders improvement in these conditions unlikely. How long can anything resembling civil government survive under such conditions?

Meanwhile, of course, this descent into anarchy arises for the exclusive benefit of a privileged, narrow class of state-favored beneficiaries: public employees and retirees hired before 2011. Illinois has not granted historically recognizable titles of nobility to its state employees, but guaranteed, generous pensions promised decades into the future for work as yet undone, undiminishable without regard to any other consideration of state finances or governances, or any outside economic, social or political fact, sure looks a good deal like "present[s] [and e]moluments" of office.[198] Nor can a citizen voting or a representative elected in, say 2025, be thought to enjoy or partake of representative, participatory government if that government has been reduced in practice to an anarchy managing an inviolable pension fund.[199]

It is not at all obvious what federal judges would make of these arguments on their merits, either now, or as matters in Illinois continue to dete-

---

192 *See supra* Section I.

193 *See id.*

194 *See id.*

195 *See id.*

196 *Cf.* THE DECLARATION OF INDEPENDENCE, peroration, (U.S. 1776) ("… and do all other acts and things which independent states may of right do.").

197 A stable interest rate rise to historical norms, one which would at least – by external causes – swamp the presently eviscerating effects of the three-percent, compounding annual retiree-benefit increases; and lower the real interest rates of the pension-bond floats of the last decade, would probably, at least for a few more years, improve the situation for Illinois appreciably. But an unstable, '70s style interest-rate breakout could just spell disaster a different way for the state sporting a nearly junk-bond credit rating and needing to borrow massive amounts in coming years regardless of other considerations. In this latter scenario, disaster might very well be spelled "Caracas."

198 U.S. CONST. art. I, § 9, cl. 8 (The phrase appears in the section of the federal Titles of Nobility clause dealing expressly with grants from foreign sovereigns, but provides at least some basis for providing content to the term "titles of nobility" in the state clause).

199 ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 13-14 (5th ed. 2011) (This line is a shameless reworking of an old joke that by the 1990s General Motors had become a pension fund (and/or a credit-card company) with a car company attached).

riorate; and it is fairly easy to make entirely respectable arguments that, however likely these scenarios as statements of the present condition of the state or predictions of its future, they just miss the real meaning of the constitutional guarantees of representative government. What the federal courts would say in the face of such arguments, though, is easy to predict: they would say nothing whatsoever. It has been thoroughly established that the Republican Form of Government Clause is non-justiciable.[200] It lies with Congress, not the courts, to declare if and when republican government in a state has failed, and to proceed accordingly.

The effect of this fact is to render the possibility of a "clean" federal bailout (a bailout without any surrender of state sovereignty) of Illinois almost vanishingly unlikely, and to raise an entirely different — and perhaps slightly less unlikely — specter. This latter would be of a relatively "clean" declaration by Congress that the IPPA — as interpreted by the Illinois Supreme Court these last decades, allowing decades of irresponsibility by the Springfield government — had rendered functionally representative government under the rule of law effectively impossible. To such a declaration, the IPPA must fall, under U.S. Supreme Court precedent. As that Court explained in Baker v. Carr, upon "resort to the Guaranty Clause . . . as the source of a constitutional standard for invalidating state action[,]" the courts will remain silent, both as against individual claims that the Clause must be triggered obverse against similar "challenges to congressional action on the ground of inconsistency with that clause."[201] In other words, should Congress conclude — on reasoning similar to that above or on other grounds — that an anarchy with a pension fund cannot constitute a proper representative government, and on those grounds invalidate the IPPA under conditions then existing, no court could gainsay the decision.

### 5. Nasty & Brutish, but Likely Not Short: The Likeliest of a Bad Lot[202]

Given Congress' unfettered opportunity on these grounds (along with the opportunities arising from its constitutionally specified bankruptcy-regulating power) the likeliest result of a request for congressional assistance would be a "mixed" result, involving some federal funding, but also an overriding of the IPPA (as currently interpreted) and an additional suite

---

200 Baker v. Carr, 369 U.S. 186, 209, 223-24 (1962), (The Court expressly recognized the facts of the case did not raise the issue of the Republican Form of Government Clause, however "[they] hold that the claim pleaded here neither rests upon nor implicates the Guaranty Clause, and that its justiciability is therefore not foreclosed by our decisions of cases involving that clause." The Court conducted a comprehensive review of the long string of precedent finding the Clause entirely nonjusticiable—and thus a matter entirely for the other branches of government).

201 *Id.* at 223-24.

202 *Cf.* THOMAS HOBBES, LEVIATHAN (1651).

of congressionally dictated oversight and control, constraint and interference, sufficient to ensure that other states would be chastened, rather than encouraged, by the example, and other state polities mollified by the severity of the conditions imposed.

### B. *Potential Relief from the Federal Courts (Or, Abandon All Hope . . . ?)*[203]

Another route potentially available to some, or other actors, in this tragedy would be to appeal to the federal courts to declare the IPPA — at least as interpreted by the Illinois Supreme Court and applied in this situation — unconstitutional under the federal charter. The chief barrier to this effort would of course be the Illinois Supreme Court's decisions themselves, as those decisions take a variety of potential lines of arguments out of the briefs of any putative litigants.

Though events would not actually have to unfold in this order, it is conceptually most useful to posit that resort to federal remedies will have arisen only upon the state actors' failure to put their own house in order. This presumes as well that the Illinois Supreme Court, whether with or without wise and timely prompting by the state legislature as proposed above,[204] will not have amended any of its present interpretations. These include, as has been noted,[205] the Court's conclusions that the IPPA represents an ultra-contractual, constitutional promise to public employees and retirees which is not amenable to normal types of contract-clause or police-power-reservation analysis. States may not weaken protections offered in the United States Constitution, but may expand them. And where state courts have so acted the United States Supreme Court may not gainsay.[206] Hence, no grounds will exist upon which to make contract-clause or police-power arguments to the U.S. Supreme Court.

An equal protection argument will almost surely prove similarly unavailing. The IPPA hurts all Illinois taxpayers who do not enjoy its narrow protections, while equal protection generally protects relatively weak minority groups.[207] Even where equal protection casts its favors more broadly,

---

203 *Cf.* DANTE ALIGHIERI, THE INFERNO, 9 (Robert & Jean Hollander trans., Anchor Books 2002) (1320) (The lintel-text of Hell: "Abandon all hope, ye who enter here.").

204 *See supra* Section III.

205 *See supra* Section III.

206 *See* Minnesota v. Nat'l Tea Co., 309 U.S. 551, 559 (1940) (Hughes, C.J. dissenting) (dissenting in the decision to remand, but not with regard to the proposition) ("The state court may be persuaded by majority opinions in this Court or it may prefer the reasoning of dissenting judges, but the judgment of the state court upon the application of its own constitution remains a judgment which we are without jurisdiction to review.").

207 *See, e.g.*, Adarand Constructors v. Pena, 515 U.S. 200 (1995); Washington v. Davis, 426 U.S. 232 (1976).

it does so only in protection of fundamental rights, none of which — as currently defined — are implicated here.[208] Thus any equal protection challenge that might be raised against the IPPA would have to demonstrate that the amendment lacked any "rational basis," which is to say that the amendment is not "reasonably related" to any "legitimate government interest," whether or not anyone had adduced that government interest or its reasonable relationship to the IPPA at any time prior to the case coming before the court.[209] And the state (or the public-employee unions, if the attorney general's office had the sense not to defend the Illinois Court's IPPA interpretations), not bound by economic rationality, could concoct all sorts of plausible sounding, government interests, however incoherent they might be. These might arise at least in part as variations of a fairly strong (though not really relevant to the prospective-benefits provisions of the Illinois Court's IPPA interpretation) consideration: that most Illinois public employees, having been withdrawn from social security many years ago, lack anything other than their state-funded public pensions to rely on in their retirement. Arguments arising from this fact alone are extremely likely to allow defenders of the IPPA to step over the pitiably low bar of rational-basis review.

## CONCLUSION

For a century, the state of Illinois has made pension promises to its employees that its political branches have failed — and, at this remove, failed catastrophically — to fund. The people of the state have enjoyed the services of these public employees while continuing to elect as their representatives the public officials who have, across parties and generations, facilitated this gross mismanagement. In 1970, the people's representatives in the assembled constitutional convention compounded the state's already manifest difficulties — and mismanagement — by adopting into the Illinois constitution of that year an ill-crafted pension-protection amendment. Thereafter, the political branches continued woefully and dangerously to underfund state-worker pensions. The state's supreme court completed the tragi-farce by interpreting that amendment in a way that illogically maximized the benefits protected by the amendment while saddling the political branches with an absolute obligation to pay all earned or prospective pension benefits whenever they might come due without also finding in the amendment any obligations of fiduciary responsibility at any moment be-

---

208 *See, e.g.*, Fisher v. Univ. of Texas at Austin, 136 S. Ct. 2198 (2016); Harper v. Virginia State Bd. of Elections, 383 U.S. 663 (1966).

209 *See, e.g.*, FCC v. Beach Commc'ns, Inc., 508 U.S. 307, 313 (1993) (providing that economic regulations satisfy the equal protection requirement if "there is any reasonably conceivable state of facts that could provide a rational basis for the classification.").

fore each bill is presented. The result has been that prospective benefits have been promised, and responsible funding delayed, until — or very possibly well past — the point at which any funding efforts whatsoever can possibly bridge the gap between promise and ability to honor the promise.

If Illinois hopes to remain a fully sovereign state of the Union, in charge of its own purse and its own promises and its own destiny, it must move with startling and unanticipated dispatch and clarity to curtail not-yet-earned state-employee pension benefits severely, while protecting already earned benefits, and presenting to the Illinois Supreme Court a full and complete accounting of the necessity of the action and its constitutionality even under the constitutional interpretations that the court has thus far delivered. If it can manage this, it may avoid one or another sort of real or de facto federal receivership.

If it cannot, it will not. Recent history demonstrates the vanishing speck of possibility that Illinois will manage to pass an amendment to the IPPA in time to right its ship or raise funds sufficient to meet the whole of its state-employee pension obligations as currently construed by the Illinois court. In short, if it cannot thread a micron-thin needle's eye, it is going to go bust. If it does — if it can no longer provide the basic services of modern government while meeting its own self-established obligations to its pensioners, and also cannot under its own power resolve the impossible challenge which it has presented to itself — then it will have to go to the federal government to seek relief. Whether that relief comes in the form of bankruptcy-light provisions, a new bankruptcy code for states, or quasi-bankruptcy-plus-a-bailout, the state will be obliged to sacrifice significant swathes of its sovereignty in exchange for the relief sought. The federal government will be obliged to intervene; it can hardly allow one of its large industrial states to sink into anarchy. But it must and will demand extensive oversight rights in exchange. The prospect is one that no parties can contemplate in equanimity, and that must particularly pain the political actors in Springfield, from whose sovereign authority springs their aggressively manipulated political influence.

As no other state has as yet gotten itself into so comprehensive and immediately overwhelming a waking pension nightmare, as has Illinois, each may presently profit by her example.[210] The other states that have adopted pension-protection amendments must avoid both of the Illinois Supreme Court's mistakes. It makes no legal, moral, or economic sense to protect inviolable pension benefits for work not yet completed (and, not yet explicitly protected by contract, as by through a term of a collective-bargaining agreement) by government employees. It makes even less sense, whatever the state's pension-protection amendment is understood to protect, to expect states to make payments when due but not to consider the

[210] *Cf.* Patrick Henry, The Stamp Act Resolves/Treason Speech to the Virginia House of Burgesses (May 30, 1765) ("[A]nd George the Third may profit by their example!").

promises to pay to be backed by implicit obligations of the political branches to undertake the ongoing funding to make such payments possible. Both mistakes must be avoided. Similarly, states now following the California Rule must similarly reverse course at first opportunity, protecting earned pension benefits while allowing wholesale alteration of prospective benefits. States without pension-protection amendments would similarly be well served by establishing for themselves constitutional obligations to undertake ongoing funding sufficient to meet whatever sorts of pension (or other benefit) promises they have undertaken. States should tie themselves to the mast now, obliging themselves to fulfill their sovereign duties while time and finances permit, and while their sovereignty remains intact.

If Illinois must be the lead lemming, let it be the lone lemming also.