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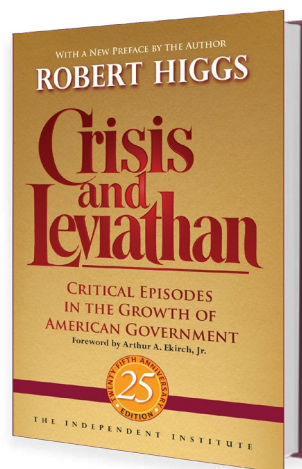
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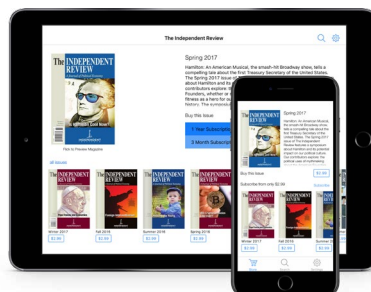
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Breaking Bad

Public Pensions and the Loss of That Old-Time Fiscal Religion

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DANIEL J. SMITH AND RANIA AL-BAWWAB

Despite maintaining strict balanced-budget requirements, U.S. state and local governments have accumulated trillions in unfunded pension liabilities (National Conference of State Legislatures 2010).¹ These unfunded liabilities represent a growing economic and budgetary concern for many state and local governments (Brown and Wilcox 2009; Ricketts and Walker 2012; U.S. State Budgets 2012; Kiewiet and McCubbins 2013). Although the extent of these unfunded liabilities varies according to assumptions, estimates generally range between \$3 and \$5.2 trillion (Biggs 2016; Foltin et al. 2017, 2018; Thornburg, Komissarov, and Rosacker 2017; Norcross and Gonzalez 2018). Using the latest available data from 2017 and a discount rate of 3 percent, the Stanford Institute for Economic Policy Research estimates these state and local pension liabilities to be \$5.176 trillion.²

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1. Forty-nine states have a balanced-budget requirement in their statutes or constitution, and up until 1990 these requirements fairly effectively restrained deficits except for during recessions (U.S. Council of Economic Advisors 2016, 63). Outstanding state debt stood at \$1.15 trillion compared to a national debt of \$19–20 trillion in 2017 (Census.gov 2017; FRED 2019; see also Eucalitto 2014).

2. The Stanford Institute figures are available at <http://us.pensiontracker.org/index.php>. For slightly dated but more detailed estimates, see Novy-Marx and Rauh 2009. See also Rauh 2017.

Many distal factors—such as liberal discount rates (Gold and Latter 2009; Waring 2012; Naughton, Petacchi, and Weber 2015), unsound investment policy (Ryan and Fabozzi 2002; Lucas and Zeldes 2009; Stalebrink 2014), accounting and disclosure policies (Marks, Raman, and Wilson 1988; Vermeer, Styles, and Patton 2012; Davidyan and Waymire 2018), and inadequate funding leading up the financial crisis (Munnell, Aubry, and Quinby 2011)—have been identified as causal explanations for this growth in unfunded pension liabilities.

More proximate factors, however, such as public-choice explanations, have been contested in the literature (Marks, Raman, and Wilson 1988). Public-choice theory makes symmetric behavioral assumptions across government and economic actors, assuming that both pursue their self-interest, broadly considered, and respond to the institutional incentives they face. In other words, once elected or appointed, policy makers do not suddenly switch from operating in a self-interested fashion in the market to operating in the public interest in government. More broadly, public choice examines government procedures and outcomes through the lens of economics. Whereas Olivia Mitchell and Robert Smith (1994), Cynthia Sneed and John Sneed (1997), Dashle Kelley (2014), and Steven Thornburg, Sergey Komissarov, and Kirsten Rosacker (2017) find evidence supporting public-choice explanations, including the median voter and special-interest-group models, Marguerite Schneider and Fariborz Damanpour (2002) find limited support for public-choice explanations.

This paper contributes to this literature by providing a previously overlooked public-choice explanation for the growth of unfunded public-pension liabilities: the undermining of the old-time fiscal religion. According to this theory, taxpayer willingness to pay or not pay taxes plays an important, albeit imperfect, role in signaling taxpayer assessment of government expenditures. This taxpayer calculus provides a check on government spending because taxpayers, bearing the full burden of current government expenditures, have more incentive to closely monitor and restrain the growth of government expenditures. The signal is most effective when governments maintain balanced budgets—that is, follow the “old-time fiscal religion”—because this ensures that spending and taxes are contained to the current generation.

The intergenerational transfer of spending and taxes undermines taxpayer constraint on the growth of government because future taxpayers are incapable of providing an assessment of that growth and because current taxpayers have a reduced incentive to monitor spending promises (and the taxes required to support them) because they will fall on future generations (Kotlikoff and Burns 2012). Importantly, once the old-time fiscal religion is discarded and taxpayers have less incentive to monitor expenses, government actors are better able to minimize resistance to the promises of increased retirement to public employees made through the use of inappropriate actuarial techniques that generate the fiscal illusion that these promises are funded (Buchanan 1999a, chap. 10). Fiscal illusion, by making it difficult for taxpayers to accurately assess the projected costs of the increase in retirement benefits, can enable policy makers to

deliver benefits to public employees, a concentrated and often well-organized special-interest group, at the expense of future taxpayers.

Public-choice theorists first used the old-time fiscal-religion theory to explain the substantial growth in deficit spending at the federal level following the Keynesian revolution. By removing the balanced-budget tradition, Keynesian economics helped undermine taxpayer constraint on the growth of government (Buchanan and Wagner 2000). Removing this constraint thereby permitted policy makers to utilize fiscal illusion more effectively, often in the form of hidden taxes or public debt, to maximize their spending (Buchanan 1999a, chap. 10).

This paper argues that the broad use of the defined-benefit model in public-pension plans has, like the rise of deficit spending under Keynesianism, undermined the old-time fiscal religion at the state and local level and, in combination with fiscal illusion and the argument that public pensions contribute to stimulating state and local economic growth, has led to substantial growth in unfunded pension liabilities. By enabling policy makers to push the costs of promises made to current employees onto future generations, defined-benefit public pensions have undermined taxpayer constraint. Thus, this paper complements the existing literature by providing an additional and overlooked public-choice explanation for the accumulation of unfunded pension liabilities.

Controlling the growth of unfunded pension liabilities would require restoring taxpayer constraint (Giertz and Papke 2007). One potential way to restore taxpayer constraint would be to transition new public employees to defined-contribution retirement plans. Defined-contribution retirement plans, by requiring upfront funding, would help prevent the intergenerational transfer of spending and taxation. Many states have taken steps toward reforming their pension systems either by lessening benefit generosity, tightening up their retirement provisions, or replacing their defined-benefit plans with either a hybrid defined-benefit/defined-contribution plan³ or a pure defined-contribution plan as a solution to the large funding shortfall in pensions (Snell 2012; Ali and Frank 2018; Gorina and Hoang forthcoming).

The first section of the paper provides a brief discussion of the history of pensions in the United States. In the second section, we briefly review the public-choice arguments for how Keynesian economics undermined the old-time fiscal religion. In the third section, we argue that defined-benefit public pensions have undermined the old-time fiscal religion in U.S. state and local governments. The paper closes by explaining how state and local governments can help revive the old-time fiscal religion by transitioning to defined-contribution retirement plans.

A Brief History of Pensions in the United States

The history of public pensions dates back to antiquity when rulers motivated their militaries with the promise of lifetime support, especially for those disabled in combat.

3. A hybrid pension plan combines smaller, defined-benefit pensions with defined-contribution plans.

Since then, many nation-states have adopted this practice of establishing pensions for military personnel. The Continental Congress created the first pension plan for navy personnel in 1775, financed by the sale of prizes seized by the Continental navy (Cogan 2017, chap. 3). Military pensions quickly became an expected entitlement for U.S. veterans, with the tendency for these programs to be expanded incrementally on a regular basis, especially during good economic times or for electoral gain, but with drastically underestimated costs (Costa 1998, chap. 8; Cogan 2017, 23, 40). For instance, with the Revolutionary War pensions, Congress “established unfortunate precedents by bailing out an insolvent navy fund with an annual infusion of general revenues and by using creative accounting procedures to mask the use of general revenues to finance pensions rather than earnings on trust fund assets” (Cogan 2017, 25).

These military-pension systems were extended to public employees during the late nineteenth and early twentieth centuries. Beginning in 1857, cities in the United States began to offer pensions for their nonmilitary employees, and in 1911 states began to follow this path (Clark, Craig, and Wilson 2003, 167). These early public pensions were introduced as part of an efficient contract necessary to attract workers in an era when employees often stayed with the same employer for life (Clark, Craig, and Wilson 2003, chap. 2, 154–55). They originated as disability plans and often were fully funded by the employee (Clark, Craig, and Wilson 2003, 167). These plans were offered by elected officials who recognized that government jobs were increasingly becoming lifetime careers rather than temporary appointments tied to a particular policy maker’s or party member’s term in office. This created a political opportunity for individuals running for office to secure electoral support in exchange for increased pension benefits, especially when these pensions were overfunded during periods of strong economic growth. Investment risk was initially minimized by restricting investment to the safest categories, but these restrictions were quickly subverted by governments that used public-pension assets to support their own debt or channeled them as investments to politically connected banks (Clark, Craig, and Wilson 2003, 205, 222).

The federal government followed suit in 1920 and adopted a universal pension plan for federal employees.⁴ States began to experiment with retirement assistance to the elderly in need, a program that was eventually subsumed and expanded at the federal level to all retirees in the form of Social Security, largely due to the growing political influence of retirees (Costa 1998, 4, 166).

Private pensions were slower to develop than public pensions. The first private pension established in the United States was by the American Express Corporation in 1875 (Latimer 1932, 21). The number of private-pension plans had increased only to twelve by 1900 (Costa 1998, 16). These private-pension retirement plans were

4. Before 1920, pensions were available for some retiring civil servants, but Congress created them on a case-by-case basis (Clark, Craig, and Wilson 2003, 157).

normally funded by the employee, provided modest retirement benefits, and could be terminated at will (Costa 1998, 17). By 1926, there were roughly two hundred private-pension plans (Conyngton 1926). Blue-collar unions played a pivotal role in the subsequent rapid adoption of private pensions, especially as a way to skirt around wage-and-price controls (Ellwood 1985, 24; Freeman 1985, 89). A U.S. Supreme Court decision in 1949, *Inland Steel Co. v. National Labor Relations Board* (170 F.2d 247 7th Cir.) made pensions a mandatory bargaining topic for collective negotiations, further expanding the number of private pensions in unionized firms (Freeman 1985, 89). Private pensions, but not public pensions, became governed by the Employee Retirement Income Security Act of 1974, which mandated uniform and transparent reporting of pension finances and required an assumed rate of return set within a range linked to market fundamentals (Ellwood 1985, 20).

That Old-Time Fiscal Religion

Although John Maynard Keynes famously argued that government budgets should never exceed 25 percent of gross domestic product and that deficits incurred during an economic downturn should be paid off when the economy turned around, the revolution inspired by his framework led to a paradigmatic shift in governmental accounting and budgeting that embraced deficit spending (Boettke, Smith, and Snow 2011, 16). The theoretical justification for deficit spending, according to Keynes and his followers, was based on the belief that government spending and direction of investment during a time when consumers were not spending would provide a stimulus effect that would boost the economy and thus restore full employment. Under Keynes's theory, taxes collected from the recovered economy would be readily available to pay off any accumulated deficits during the downturn.

This Keynesian framework stood in stark contrast to the budgeting milieu that existed prior to the Keynesian revolution. Up until that time, taxpayers provided a degree of constraint on the growth of government by maintaining the tradition that a well-managed government should balance its budget each year. By requiring that expenditures were in alignment with revenues, this tradition prevented the intergenerational transfer of spending and taxation. The necessity of collecting taxes to pay for government expenditures provided an important taxpayer constraint on government spending (Buchanan 1999b; Wagner 2012, 6). The willingness to pay taxes to finance government expenditures functions as perhaps the best, albeit imperfect, measure for policy makers to use to assess the appropriate level of government spending.

By toppling the old-time fiscal religion and undermining taxpayer constraint, Keynesian economics ushered in an era of deficit spending at the federal level (Bowen, Davis, and Kopf 1960; Buchanan and Wagner 2000; Cowen 2011; Wagner 2012).⁵

5. See Ferguson 1964 for more discussion and dissent regarding the effects of Keynesian economics.

This severing of the link between public expenditures and cost was also magnified by the adoption of artifices that intentionally or unintentionally hid the true cost of programs by creating a fiscal illusion for taxpayers (Wagner 1976; Buchanan 1999a, chap. 10). With the abandonment of the balanced-budget tradition, even federal constitutional and statutory spending restraints have failed to constrain deficit spending and the growth of government (Wagner 2012, chaps. 1 and 2).

Unfunded liabilities, including Social Security and Medicare, where government officials have been able to shift spending and taxation intergenerationally, have seen particularly substantial growth (Kotlikoff and Burns 2012). Laurence Kotlikoff and Scott Burns estimate that in total the true fiscal gap in the United States, including these obligations, is roughly \$200 trillion higher than officially reported federal debt (2012, 3).

Losing Our Religion: State and Local Public Pensions

Our core argument is that the defined-benefit structure of public pensions has allowed state and local governments to transfer pension liabilities from current taxpayers to future taxpayers. This transfer has enabled the growth of unfunded pension liabilities because it has undermined the incentive for taxpayers to monitor the growth of pension promises. In addition, the fiscal illusion generated by utilizing unconventional actuarial assumptions to overreport the expected growth of assets has also contributed to the growth in unfunded pension liabilities.

While state and local governments have increasingly engaged in deficit spending with their general budgets, the growth in unfunded pension liabilities has substantially outpaced official state debt. We argue that this swifter growth is due primarily to the intergenerational transference of spending and taxation enabled by defined-benefit pensions. Defined-benefit pension plans offer state and local public employees a guaranteed package of future benefit payments. Many states and courts hold public-pension benefits to be obligatory promises (Monahan 2010). With state and local pensions, this promise often involves a predetermined formula for calculating pension benefits based on the employee's salary and years of service.

The defined-benefit model stands in stark contrast to the defined-contribution model, which sets up individual retirement accounts for each public employee. Under a defined-contribution plan, state and local governments contribute a specified matching amount (typically a specified percentage of the employee's salary) to each employee's contributions. This type of plan ensures that the taxes necessary to fund promises made to current employees are paid by the current generation.

Although the private sector has largely abandoned defined-benefit pension plans, state and local public pensions continue primarily to employ the defined-benefit model. A recent national compensation survey found that 94 percent of state and local workers in 2018 had access to defined-benefit plans, compared to only 17 percent of private-sector workers (U.S. Bureau of Labor Statistics 2018). The same survey found that 34 percent of private union workers, however, had a defined-benefit pension option.

Under a defined-benefit pension, promises are made to current public employees regarding benefits that will be paid to them in the future (Ennis 2007). In theory, total employer and employee contributions to the pension system should fully fund the benefits paid out in the future. In practice, however, with the obligation to shore up any shortfall in the future falling on future taxpayers, these systems have nearly systematically been underfunded.⁶ Thus, future taxpayers often end up paying the obligations created by previous generations (De Mello et al. 2017). Richard Ennis writes that due to the use of the defined-benefit model in public pensions, “[c]urrent taxpayers can be enriched at the expense of future taxpayers” (2007, 42).

Because of the widespread use of the defined-benefit model, public-sector compensation benefits, especially retirement benefits, tend to be much larger than those received by the workers in the private sector (Biggs and Richwine 2014, 8).⁷ The retirement requirements for public pensions also tend to be far more lenient compared to those for private pensions (Kotlikoff and Smith 1983, 357). For instance, retirement age, years of service requirement, earning bases (i.e., whether the benefits-formula calculation uses an average of lifetime income or the highest years of salary), provisions for cost-of-living adjustments, and accrual rates are far more generous in the public sector (Kotlikoff and Smith 1983, chap. 6; Munnell and Soto 2007, 3).

The generosity of public pensions can be attributed in part to policy makers’ ability to understate the true unfunded pension liabilities as well as the cost of benefit increases (Novy-Marx and Rauh 2009; Biggs 2010, 2012; Elliott 2010; Kiewiet 2010; Norcross 2010; Rauh 2010; Russek 2011; Waring 2012; Naughton, Petacchi, and Weber 2015). Estimates of the extent of these unfunded pension liabilities vary, but they range from \$3 to \$5.2 trillion (Foltin et al. 2017, 2018; Thornburg, Komissarov, and Rosacker 2017; Norcross and Gonzalez 2018). Specific studies of individual states, including Delaware (Norcross 2013), New Jersey (Norcross and Biggs 2010), Illinois (Pozen and Khurana 2011; Davidyan and Waymire 2018), and Alabama (Smith and Dove 2016), have come to similar conclusions. In an updated analysis, Joshua Rauh (2017) finds that unfunded pension obligations have continued to grow because many state and local pensions continue to utilize overly optimistic assumptions in their actuarial calculations despite the new low-interest-rate environment.

State and local governments follow accounting guidelines set by the Governmental Accounting Standards Board (GASB), which is a private, nongovernmental body established in 1984. The GASB’s goal is to ensure that the general public and

6. Unlike private-pension plans, which are required to be fully funded according to strict accounting rules, public-pension plans do not have to be fully funded (Giertz and Papke 2007, 310).

7. There is an ongoing debate between scholars about the difference in compensation between public and private sectors. Some scholars argue that public-sector pension benefits are overgenerous compared to private-sector benefits (Biggs and Richwine 2011, 2014; Richwine 2013; U.S. Congressional Budget Office 2017). Others argue that the benefits are the same or even lower (Allegretto, Corcoran, and Mishel 2004, 2008, 2011; Bender and Heywood 2010; Schmitt 2010; Keefe 2011; Munnell et al. 2011). One source of disagreement is how to appropriately measure the value of public pensions (and other perks of government employment, such as job security).

decision makers have access to useful financial information about the status and use of public funds. To enhance the “transparency, accountability, and clarity” (Weinberg and Norcross 2017, 1) of local and state financial reporting, the GASB issues statements that set the new standards for local and state governments. However, GASB 25 and GASB 27, issued in 1994, were criticized for generating misleading information and failing to “fully measure or report plan liabilities” (Weinberg and Norcross 2017, 1).

Under the GASB, state and local public-pension systems are permitted to utilize overly optimistic assumed rates of return (Stalebrink 2014). They are also permitted to discount their liabilities at this same optimistically high rate of return (Kessler 2013; Naughton, Petacchi, and Weber 2015). The average expected rate of return on state plans is 7.52 percent (Weinberg and Norcross 2017). This assumed rate of return reflects the higher risk associated with equities and alternative investments, suggesting that public pensions must now make riskier investments than they did in the past to achieve this rate of return (Weinberg and Norcross 2017, 2). This practice thus provides the incentive for public pension systems to take on excessive levels of risk in their investment portfolios in order to reduce their future reported liabilities (Lucas and Zeldes 2009; Novy-Marx and Rauh 2009; Waring 2012; Biggs 2015; Smith and Dove 2016).

In an attempt to improve its accounting rules, the GASB released the new standards GASB 67 and GASB 68 (Weinberg and Norcross 2017, 1). The new rules, however, suffer from at least three problems. First, the underlying assumptions used to measure pension liabilities remain subjective and differ from one state to another. By permitting governments to use a “blended rate” approach, GASB 67 enables them to value the unfunded portion of the pension liability based on the lower-risk return on municipal bonds and the funded portion with a higher-risk discount rate. These rates, however, depend on the subjective assumptions of the actuaries, who can choose when to apply the blended rate to plan liabilities (Munnell et al. 2012; Mortimer and Henderson 2014; Weinberg and Norcross 2017). Second, the new standards allow governments to report pension liabilities from the end of the preceding fiscal year instead of using current pension numbers, thus rendering balance sheets inaccurate. Third, the use of measurement deferrals, a form of asset smoothing, increases the riskiness of plans due to the fact that they only gradually incorporate changes in market values (Weinberg and Norcross 2017, 5). Moreover, the actuaries continue to make optimistic assumptions, even when current plans are suffering, based on past funding behavior and the legislative intent to fund those plans, as in California and Kentucky (Weinberg and Norcross 2017, 5).

The complexities of pension accounting make it extremely difficult to monitor the fiscal health of defined-benefit pension plans, even in the private sector (Picconi 2006; Easterday and Eaton 2012).⁸ This means that when it comes to public pensions, boards

8. See Crew and Twhight 1990 and Dixit 1998 for discussions of asymmetric information and transaction costs in political decision making.

of controls, taxpayers, public employees, and even policy makers often find it difficult to monitor public pensions and to control costs (Mitchell 1988; Sneed and Sneed 1997; Star-McCluer and Sunden 1999; Dove, Collins, and Smith 2018).

The complexities and subjectivism of public-pension accounting enable policy makers and plan administrators to give the illusion that plans are properly funded. This illusion is enhanced by the fact that public pensions are not subject to the same laws and accounting standards that private pension plans are subjected to (Forman 2009). This absence of standard accountability influences how state and local governments report and fund their pension obligations. For instance, Kathryn Easterday and Tim Eaton find that actuarial assumptions for defined-benefit public-pension plans tend to be more optimistic than for defined-benefit plans offered by corporations (2012, 304). Thomas Vermeer, Alan Styles, and Terry Patton (2012) find that even with more relaxed standards, many local government pension plans, especially the ones with the most unfunded liabilities, fail to meet their disclosure requirements. Public pensions also tend to select public actuaries who are predisposed to continue to utilize actuarial assumptions that optimistically report financial health (Biggs 2009; Waring 2012; Glaeser and Ponzetto 2014; Mennis 2016; Anantharaman 2017). Moreover, the pension liabilities in the annual reports of public pensions are often reported using opaque language and complex technical jargon, making it nearly impossible for the average taxpayer to “understand and respond to the financial risks being taken by their elected officials in a timely manner” (Thornburg, Komissarov, and Rosacker 2017, 87). Easterday and Eaton conclude that “[i]n conjunction with other recent academic research on public sector pensions, our results suggest that differences between current GASB and FASB [Financial Accounting Standards Board] accounting and disclosure requirements may result in confusion or difficulties for stakeholders attempting to compare features common to DB [defined-benefit] pensions between the public and private sectors” (2012, 304).

An important factor undermining the old-time fiscal religion as it pertains to public pensions is the case made by public-employee unions and pension-fund managers that public pensions, even if underfunded, play a role in sparking economic growth (Apilado 1972; Hagerman, Clark, and Hebb 2007; Addy and Ijaz 2008). The argument being made here is that the increased economic growth will mitigate these costs in the long run and help shore up the pension in the future. For instance, Ilana Boivie writes that public and private pensions generated 7.5 million jobs and \$1.2 trillion in economic output in 2018 (2018, 1). This argument holds particular sway in areas or times with slow economic growth. In fact, some public-pension systems specifically prioritize stimulating economic growth and private-sector activity *over* investment-return performance (Ingram 2016, 2; Smith and Dove 2016; Fagan 2019; Niraula 2019). Similar to many arguments for Keynesian stimulus that undermined the balanced-budget old-time fiscal religion, these studies often do not account for what those dollars would have been put toward if they had not been (in the case of public pensions) taxed away from the private sector (Biggs 2016). Public-pension investments targeted at stimulating

state and local growth have on net a poor track record of generating economic growth (Hochberg and Rauh 2013; Bradley, Pantzalis, and Yuan 2016).

Defined-benefit pensions and the fiscal illusion generated by inaccurate reporting have enabled state and local governments to overturn the old-time fiscal religion (Ennis 2007). For instance, Barbara Chaney, Paul Copley, and Mary Stone (2002) find that both states with balanced-budget requirements and states facing fiscal trouble are more likely to accumulate unfunded pension liabilities and to utilize favorable discount rates to underreport these obligations (also see Eaton and Nofsinger 2004). Rejecting this old-time religion enables state and local governments to forgo traditional budget reporting and balanced-budget requirements for unfunded pension liabilities and enables government officials to utilize unrealistic assumptions in complicated actuarial calculations to underreport pension liabilities (Thornburg, Komissarov, and Rosacker 2017).

Overall, this incentive structure provides a payoff to current government officials because they can make promises to achieve short-term political goals, especially catering to organized public-employee groups, without having to implement politically unpopular taxes or debt (Giertz and Papke 2007; Naughton, Petacchi, and Weber 2015). As Thornburg, Komissarov, and Rosacker write, defined-benefit pensions “offer politicians a convenient way to satisfy public employee demands while providing the means to defer budgeted cash payments and obscure the accumulation of public debt from taxpayers” (2017, 87). Current taxpayers, knowing they are not on the hook for these obligations, have less incentive to carefully monitor and restrain the growth of these obligations that will fall to future taxpayers (Giertz and Papke 2007). Public employees, the only party that has the incentive to monitor government officials when it comes to the health of their retirement system, have a reduced incentive to monitor the health of the public-pension system due to the belief that they have a guarantee that any shortfall will be covered by future taxpayers (Monahan 2010). Public employees, may of course, also suffer from the fiscal illusion created by inaccurate reporting.

This intergenerational shifting of liabilities through defined-benefit pensions subjects state and local governments to substantial fiscal risk. State and local governments may not have the number of future taxpayers—or of taxpayers with sufficient wealth—needed to support future obligations, as cities such as Flint and Detroit, Michigan, demonstrate. Fiscally strapped cities and states, which often resort to imposing higher taxes or cutting essential government services, are apt to lose residents, especially with the capping of the state and local tax deduction in 2017 (Edwards 2018).

Solutions?

Although pension promises are often legally or even constitutionally protected, state and local governments overwhelmed by pension obligations may be forced into bankruptcy in order to reduce pension benefits (Giertz and Papke 2007; Monahan

2010).⁹ Politically, however, outside of default, pension reforms must often be directed toward future employees. J. Fred Giertz and Leslie Papke (2007) argue that the practical distinctions between defined-benefit and defined-contribution plans largely do not matter, that focusing on the structure (defined benefit or defined contribution) is less important than focusing on benefit and funding reforms. For instance, they write, “[W]hile a new DC [defined-contribution] plan could be less generous in order to reduce future benefits, similar cost saving could be realized from a less generous new DB [defined-benefit] plan that applies to future benefits”—that is, except for the fact that defined-contribution plans avoid the moral-hazard problem of underfunding because “the state is required to pay its share of the pension contribution in a timely manner so it can be invested in the employees’ DC accounts” (2007, 313, 314).

Yet, when viewed through the public-choice framework of taxpayer constraint, the structure of the retirement system *does* matter. One possible way to restore the old-time fiscal religion would be through transitioning defined-benefit public pensions to defined-contribution retirement accounts. Defined-contribution retirement accounts can avoid many of the problems that public-pension systems face using the defined-benefit model (Giertz and Papke 2007). Under a defined-contribution model, taxes are required at the front end, providing a credible commitment mechanism (Garon 2015). Increasing retirement benefits for public employees would then require either an increase in taxes or a reduction in the provision of other government services. This increase in taxes or reduction in services would be borne by the current generation, thus making the commitment to and receiving the benefits of public employees’ service as well as bringing the spending and taxes into alignment.

Under a defined-contribution retirement model, taxpayers would then have more incentive to monitor the level of public-pension retirement benefits. Importantly, policy makers would have a signal, the public’s willingness either to bear additional taxes or to reduce governmental services, to better assess the desired level of public-employee retirement benefits. Taxpayers and public employees would also have more incentive to curtail the use of misleading actuarial assumptions and the lack of transparency.

Conclusions

Although many state and local governments adhere to balanced-budget requirements, defined-benefit pensions have enabled them to undermine the old-time fiscal religion. Defined-benefit pensions have severed the link between spending and taxes by enabling pension benefits to be promised to current public employees by committing future

9. According to Wayne Weingarden (2014), public-pension debt is cited as a key contributing factor in the bankruptcy of some local governments, such as Jefferson County, Alabama; Harrisburg, Pennsylvania; San Bernardino and Stockton, California; Detroit; and others. Under chapter 9 of the Federal Bankruptcy Code (11 U.S.C., 109), local and state governments can file for bankruptcy and then reduce pension benefits, which is exactly what happened in Detroit in 2013, where pension checks were reduced by 6.7 percent for 12,000 retirees despite Michigan having a state constitutional guarantee regarding the payment of full pensions (Christoff 2015; Chambers 2016).

taxpayers to fund the payments. This has been exacerbated by the use of inappropriate actuarial practices that create a fiscal illusion for current taxpayers that these promises are properly financed.

Similar to the growth in federal deficit spending enabled by Keynesianism, the severing of this link between spending and taxes has undermined taxpayer constraint on the growth of government, leading to the accumulation of substantial unfunded pension liabilities at the state and local level. By interpreting this growth in unfunded liabilities through this public-choice framework, this paper helps provide a more comprehensive public-choice explanation for the growth in unfunded pension liabilities. Transitioning from defined-benefit pensions to defined-contribution retirement accounts would help restore taxpayer constraint on the growth of these unfunded liabilities.

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