1 Introduction

Public pensions in the United States face an impending funding crisis (Beerman 2013; Coggburn and Kearney 2010; Ricketts and Walker 2012). This is especially true in the wake of the Financial Crisis. Josh Rauh (2019) estimates that unfunded public pension debt in the United States exceeds $4.1 trillion, and the extent of the economic impact of COVID-19 on public pensions, at the time of this writing, remains to be seen. While no one foresaw the particular manifestations of the Financial Crisis or COVID-19 ahead of time, economists and financial experts do realistically expect periodic recessions. Public pensions, however, are not structured conservatively to withstand these expected ups and downs of the business cycle.

With annual pension payments already amounting to 8 percent of state and local tax revenue, these growing liabilities can crowd out other government expenditures, forcing state and local governments to cut essential government services (Kiewiet and McCubbins 2014; Novy-Marx 2014). According to a 2012 Chicago Booth IGM survey of economists, experts are concerned that, without reforms to their public pension plans, some states will have to drastically cut spending, default on pension benefits, or get a federal bailout (IGM Forum 2012). The possibility of a federal bailout represents a growing threat to federalism in the United States.

While many states guarantee or protect public employee pension benefits, high taxes can potentially drive residents away, leaving underfunded public pension systems with no option but to cut benefits *if* federal legislators reject bailouts due to the potential moral-hazard problems a federal bailout would create. Worse yet for these public employees, some of these underfunded public pension plans exempt their employees from social security benefits, meaning that these public employees are at even greater risk of retirement financial insecurity (Quinby et al. 2020).[1]

This Element examines the political economy of the United States public pension crisis.[2] More specifically, we detail the political economy problems inherent in defined-benefit public pension plans. We do so from an institutional perspective that factors in the knowledge and incentive problems faced by stakeholders. These political economy factors are what ultimately led to the development of this crisis. They also stand in the way of substantial reform.

[1] Public employees participating in social security are, of course, at risk to the extent to which social security is also underfunded (Kotlikoff and Burns 2012).

[2] While we focus on the United States, many of the political economy factors are likely generalizable to public pension plans elsewhere as well.

Current public pension institutions are built on the premise that stakeholders have the knowledge and motivations necessary to oversee and maintain these retirement promises made to public employees. In this Element we argue that defined-benefit public pensions thus systematically fail a robustness test because public pensions are unlikely to overcome the knowledge and incentive problems faced by stakeholders. To be successful, reforms will have to render public pensions robust to these knowledge and incentive problems.[3] Robust public pensions must be designed to be operable in a real world typified by deviations from the idealized assumptions.

To inform our understanding of the development of the pension funding crisis and reform efforts, we identify three primary institutional reasons for why public pensions as currently designed tend to fail the robustness test: (1) fiscal illusion, (2) governance, and (3) pension accounting and reporting.

Fiscal illusion is operative due to the presence of special interest groups and the ability of policymakers to misleadingly push costs into the future through the use of politically opportunistic accounting.[4] Thus, it is connected to both governance and accounting problems. Fiscal illusion enables the adoption of public pension structures and benefits beyond what taxpayers would be willing to support if they (the taxpayers) held a realistic assessment of the full costs of the program. Public employee unions are highly organized and thus very effective at lobbying for more generous pay and benefits for their members. With constitutional or legislative guarantees for funding their public pension, public employees lobby for increased benefits even when they might understand that the state or local government will struggle to procure the resources to meet those promises in the future. With their legal protection, they can rely on their lobbying power vis-à-vis the general public to help ensure that any future funding gaps will fall on future taxpayers at the local or federal level and not result in reduced benefits for themselves.

As mentioned, the governance structure of public pensions is replete with knowledge and incentive problems for stakeholders, decision makers, and technical experts. Elected officials, especially state and local politicians, often lack the expertise to accurately evaluate pension accounting or to gauge the full costs and benefits of potential reforms, especially when confronted with competing interpretations offered by actuarial auditors, employees' unions, and lobbyists. Policymakers also face incentive problems in that they have scarce time and budgetary dollars to allocate to understanding and properly funding

[3] For more on robust political economy outside the context of public pensions, see Boettke and Leeson (2004), Leeson and Subrick (2006), Levy (2002), and Pennington (2011).

[4] We adopt Stalebrink's (2014) apt phrase of "opportunistic accounting" throughout (also see Stalebrink and Donatella 2020).

public pensions. With the general taxpayer often being misled or unaware of pension finances, policymakers often have a strong incentive to cater to special interest groups.

Board members appointed to oversee public pension performance also face knowledge and incentive problems. Ex officio and appointed members are likely to make recommendations that advance their career opportunities in the eyes of taxpayers who elected them or the policymaker(s) that appointed them. Plan members serving the boards of public pensions, on the other hand, have the incentive to encourage the use of misleading actuarial reporting as it maximizes their opportunity for expanding additional benefits.

Pension plan CEOs, while well-informed, have the incentive to chase after high returns with riskier investments in order to keep contributions low and improve fund performance, especially during times of fiscal stress. While accounting and actuarial professionals are relatively highly informed, these groups face incentive problems as evidenced by the fact that they explicitly fought to avoid the implementation of accepted modern financial practices to public pensions. They went so far as to separate themselves from the Financial Accounting Standards Board by starting their own Governmental Accounting Standards Board (Flesher et al. 2019). Alongside state and local governments, accounting and actuarial professionals also lobbied to be excluded from the pension governance of the Employee Retirement Income Security Act of 1974 (Peng 2009, p. 88). They did so primarily to protect the current status quo of widespread opportunistic accounting.

Even public employees themselves may serve as a barrier to reform, despite the fact that it is their own retirement that is underfunded. This is because, as stated previously, most states constitutionally or legally protect their pension benefits. Politically, it is much easier to lobby for retirement benefits, with the costs pushed onto future taxpayers, than it is to lobby for current pay raises or other benefits, including retirement benefits that would properly be funded today, as that would require unpopular tax increases or budget cuts elsewhere (Anzia and Moe 2019; Bahl and Jump 1974; Bleakney 1973; Wagner and Elder 2021).

Throughout the remainder of this Element, we detail the precise political economy origins of the current pension crisis. We also provide recommended reforms grounded in robust political economy.

Section 2 uses the concept of fiscal illusion from public choice economics to explain how the funded health of public pensions became a crisis. Sections 3 and 4 respectively detail how governance and pension accounting and reporting contributed to the current state of this crisis and inhibit reform. Section 3 does this by addressing the governance problems inherent to defined-benefit public

pensions and the knowledge and incentive problems faced by stakeholders. Section 4 examines the political economy of pension accounting and reporting. Section 5 examines the current state of pension reform and then provides specific accounting, governance, and structural reforms that incorporate concerns for robust political economy. Section 6 concludes by taking a broader look at the threat that the public pension crisis represents to federalism. We also discuss how the COVID-19 pandemic has further exacerbated the inherent problems with the current structure of public pensions in the United States.

2 Fiscal Illusion

While not a common household word, the concept of fiscal illusion is a primary factor behind the growth of unfunded pension liabilities (Hall and Hovey 1980; Inman 1982; Al-Bawwab and Smith 2020; Sneed and Sneed 1997). Fiscal illusion occurs when voters are led – through intentional deception or institutional design – to inaccurately assess the fiscal costs or benefits of an existing or proposed program (Da Empoli 2002; Oates 1988; Puviani 1903). Fiscal illusion can emerge whenever the costs or benefits of a program extend, especially in an obfuscated manner, into the future.

Policymakers seeking to create, support, or expand public programs to boost their odds of reelection can take advantage of fiscal illusion to provide explicit short-term benefits to electorally strategic groups through a misrepresentation of the long-term costs of the program to voters (Ostrom 1997, pp. 56–58 & 140). Voters can thus be led to tolerate or even endorse programs they would otherwise not if they had an explicit and accurate accounting of both the short- and long-term costs and benefits of the program.

Voter ignorance, which is undeniably a pervasive and inveterate feature of democracy (Brennan 2011; Caplan 2007; Somin 2016), is a necessary, but insufficient, condition for the emergence of fiscal illusion. This is because, on average, political ignorance will tend to cancel out due to the law of large numbers (Wittman 1995). Fiscal illusion, however, "implies a persistent and consistent behaviour" that does not average out (Oates 1988, p. 67). Thus, fiscal illusion requires "recurring, and presumably predictable, biases in budgetary decisions" on the part of voters (Oates 1988, p. 68). This means voters would have to be systematically biased (Caplan 2007) when it comes to a fiscal illusion.[5]

These biases could theoretically result in a public sector that is too small, where voters accurately perceive (or overestimate) the short-term costs of

[5] Caplan (2007) identifies four such biases among citizens in the United States; antimarket bias, antiforeign bias, make-work bias, and a pessimistic bias.

funding government programs but underestimate its long-term benefits (Downs 1960; Galbraith 1958). Fiscal illusion could also result in a public sector that is too large, if voters accurately perceive (or overestimate) the short-term benefits but underestimate its long-term costs. Figure 1 shows the possible outcomes from different combinations of biases on the part of voters regarding the costs and benefits of a government program.

Absent any systematic errors, the stable equilibrium should converge to optimal decision-making (Wittman 1995). Even in the presence of biases, entrepreneurial policymakers, or prospective policymakers, will have the electoral incentive to design programs and political messaging that will enable them to increase their electoral chances. Under- or overinvestment in a program based on biased beliefs on the part of voters opens a political opportunity for a policymaker to disabuse voters of their misperception and build a new winning coalition on the foundation of a more accurate understanding of the costs and benefits of the program, toward the optimal decision-making space. In a situation where there is overinvestment in the public sector, for instance, an entrepreneurial policymaker may have the electoral incentive to support programmatic or institutional reforms that would more accurately state the costs of programs (Holcombe 2002; Martin and Thomas 2013; also see Fink and Wagner 2013 and Wagner 2007).

While, as mentioned, theoretically fiscal illusion can result in too large or too small government programs, public choice economics suggests there is a strong tendency for policymakers to actively design and promote programs so as to maximize their perceived benefits and to minimize, or push into the future, their perceived costs (Buchanan 1960[2001], 92–97; Dell'Anno and Mourão 2012; Dollery and Worthington 1996; Mourão 2007; Oates 1988; Olson 1965; Ostrom 1997). There are two relevant insights from public choice that would explain why there is not a convergence toward optimal decision-making, especially when it comes to public pensions.

The first is the presence of special interest groups, especially well-connected and politically influential public employees. Due to the concentrated benefits they expect to receive from the program, special interest groups have a strong incentive to invest in lobbying policymakers (Olson 1965). Once a program is

	Overstated Benefits	**Accurate Benefits**	**Understated Benefits**
Overstated costs	Optimal political decision-making	Underinvestment in the public sector	Substantial underinvestment in the public sector
Accurate Costs	Oversized public sector	Optimal political decision-making	Underinvestment in the public sector
Understated Costs	Substantially oversized public sector	Oversized public sector	Optimal political decision-making

Figure 1 The sustainability of fiscal illusion

established, the tendency is for the beneficiaries to protect their privileged program, even after the benefits of the program have been capitalized, due to the transitional gains trap (Tullock 1975).[6] Established bureaucracies and public sector workers involved with the program are, similarly, vested in preserving the program and have the organizational structure to effectively lobby their position (Tullock 2005).[7]

Very few, if any, general voters, however, are concerned enough about underfunded public pensions as a single, predominant issue. Rather, they often have a wide range of additional political considerations that take priority over public pension issues (to the extent a general voter thinks at all about public pensions). With the costs of the program disbursed widely among all taxpayers, individual taxpayers have little incentive to invest in researching public pensions and lobbying for reforms.

This means there is little incentive for a policymaker to try to move toward optimal decision-making when there is an entrenched special interest group and general voter disinterest, as it would require immense political capital and resources to overcome special interest groups (public employees) with little, if any, electoral gain from voters. Thus, special interest groups severely limit the ability of any political entrepreneur to take political advantage of an oversized public program, such as public pensions, by more accurately stating the costs and benefits to voters.

The second public choice insight that explains the failure to converge toward optimal decision-making, especially when it comes to public pensions, is the ability for policymakers to push costs into the future (Buchanan and Wagner 1977[2000]; Eusepi and Wagner 2017), which minimizes voter resistance to the program. It may actually increase voter support for the program given that it enables them to reap the benefit of the program without having to shoulder the costs. This would especially be true of taxpayers, such as the wealthy, currently paying the majority of taxes to support government programs. They may even avoid future taxes for the program if they plan on retiring (and thus having lower taxable income) or intend to move to a different city or state (Inman 1981 & 1982; Sneed and Sneed 1997).

This second public choice factor can only be truly operative if Ricardian equivalence – where voters see tax-financing and debt-financing as equivalent –

[6] In regard to public pensions, a more generous public pension increases the competition and thus costs of securing a public employee position. Thus, even if the benefits of public employment are capitalized by the increased upfront costs of securing a job, a decrease in benefits would harm the public employee.

[7] This is even true of emergency programs designed to address a specific, temporary crisis (Higgs 1987).

does not hold. If Ricardian equivalence holds, then a political entrepreneur could gain electoral support for more accurately stating the costs of the project. Ricardian equivalence, however, doesn't hold in the presence of fiscal illusion (Eusepi and Wagner 2017, pp. 14-17). On average, we do owe our debt to ourselves, so the average level of debt appears not to matter. But, individuals do, in fact, face different circumstances. Individuals currently paying the majority of taxes are more likely to support, or at least tolerate, a program if they know that these costs will fall on unspecified future taxpayers (Eusepi and Wagner 2017), meaning different outcomes are possible when debt is used to finance a public project rather than current taxes.

Both of these public choice factors encourage an oversized public sector. When it comes to public pensions, both insights provide a theoretical explanation for sustained fiscal illusion when it comes to public pensions. This would suggest a tendency toward generosity in pension structures and benefit levels above what voters would be willing to support if they had a more accurate assessment of their costs.

This is, in fact, what we do see. Public sector employees are highly organized and effective special interest groups (Anzia and Moe 2015, 2017 & 2019; Wagner and Elder 2021). The evidence strongly suggests that pension underfunding is exacerbated by public employee unionism (Johnson 1997; Marks et al. 1988; Mitchell and Smith 1994; Wagner and Elder 2021). The support or fierce opposition of public employee unions can make or break a policymaker's chances of obtaining office. Even on basic reforms on non-pension-related issues with strong support from voters, it is difficult for policymakers to overcome opposition from public employees: for example, the inherent difficulty policymakers have had reforming policing (DeAngelis 2018; Fisk and Richardson 2017) and education (Moe 2011) in the United States, despite strong support from voters on both the left and the right for reform. When it comes to legislation affecting pensions, public employees are particularly intense and well coordinated.

Policymakers have abundant opportunities to take advantage of opportunistic accounting to misrepresent the costs of public pensions to voters (Kaspar 2011; Stalebrink 2014; Thornburg and Roasacker 2018). We will discuss many of these opportunities in more detail in Section 4, but some discussion here is warranted for demonstration purposes. For instance, pension plan contribution policy can be influenced by actuarial and accounting manipulation, increasing risk-taking in investments, and/or reducing or skipping regular contributions (Randazzo 2017). More specifically, measuring plan liabilities and assets can be manipulated by altering the actuarial assumptions regarding the discount rate to value plan liabilities, amortization schedules,

the selection of mortality tables, salary growth assumptions, and/or asset smoothing.

Opportunistic accounting is feasible because, contrary to the practice of private sector defined-benefit plans, public plans in the United States do not use fair-value accounting to report pension liabilities (Easterday and Eaton 2012). Instead, they are given far greater latitude in government accounting standards to select discount rates based on expected asset returns. These misrepresentations end up also affecting the incentives of pension administrators. For instance, by discounting liabilities with the expected asset return rate, administrators have the incentive to incur greater investment risk in their portfolios in order to inflate their discount rate. A higher discount rate serves to lower their reported liabilities.

Since the 1980s, defined-benefit plans have gradually shifted from portfolios consisting largely of government securities to portfolios heavily invested in higher-risk, higher-return equities and alternatives, a trend also prompted by changes to pension plans governance as we discuss in Section 3 (The Pew Charitable Trusts and the John Arnold Foundation 2014). Valuing guaranteed pension benefits based on high-risk investment returns, by keeping the present value of plan liabilities and current-period employee and employer contribution low, enables policymakers to push costs in an obfuscated manner onto unspecified individuals in the future.

In addition to the incentive to take on investment risk in the asset portfolio in order to keep contributions low, the annual employer contribution is often subject to the discretion of the sponsor. The annual pension contribution consists of two components: the return on pension investments and a regular contribution from the employee and the employer. The investment component of the contribution is subject to some degree of volatility depending on the performance of the plan's asset portfolio.

Employee contributions are generally stable as they are typically set in negotiations with employees and deducted automatically from payroll on a regular basis.[8] Absent a constitutional or statutory provision that mandates the annual employer contribution, a sponsoring government may, however, elect to reduce or skip the employer's contributions to the plan. And, they often do. Gorina (2018), for example, finds that state plan contributions are influenced by fiscal stress, voter preferences for increased service, collective bargaining, pension board characteristics, and legislative professionalism.

[8] Alabama offers a recent example of employee contributions being changed. Members of the Teacher Retirement System and the Employee Retirement System in the Retirement Systems of Alabama saw their contribution rates rise from 5 percent to 7.5 percent (Dove and Smith 2016, p. 25).

Revenue structure may also play a role in affecting employer contributions at the local level, compounding the effects of fiscal illusion. A greater reliance on volatile sources of revenue, such as fees, sales, and income taxes, or increased reliance on intergovernmental transfers, may lead sponsors to underfund pensions in periods of low revenue, increasing unfunded liabilities (Gorina 2018).

Undervaluation of pension liabilities, volatile asset performance, and systematic under-contribution from the sponsor all serve to increase plan costs. These unspecified costs *will* fall on some combination of taxpayers in the form of higher taxes, citizens in the form of reduced government services, and/or public pension retirees receiving reduced benefits.

These avenues for mispresenting the financial health of public pensions are enabled by the fact that taxpayers largely do not have an adequate understanding of pension liabilities (Epple and Schipper 1981). Understanding actuarial accounting – even among investors (Picconi 2006), pension board members (Clark et al. 2006), and public employees (Mitchell 1988; Starr-McCluer and Sunden 1999) – even without the use of misleading reporting, is inherently difficult. Given the uncertainty of who the costs of underfunded pensions will fall on, as well as the complexity of actuarial reporting, means that few taxpayers will be drawn to a political entrepreneur attempting to accurately state these costs. This is especially true given the full array of other pressing political issues that will hold more prominence for voters than public pensions.

Public employees seemingly are the only group who would have the incentive to avoid the fiscal illusion and better understand the true costs and benefits of a public pension system. But, as mentioned, the evidence suggests that even public employees lack an adequate understanding of basic public finance. The incentive to dispel the illusions is also curbed due to the fact that cutting pension benefits substantially, if at all, is a very unlikely option even if pensions are underfunded. This is because pension benefits to public employees are legally or even constitutionally protected by many state governments (Giertz and Papke 2007; Monahan 2010; The Pew Charitable Trusts 2019a). In fact, because of this guarantee, public employees may even have the incentive to be implicit in understating pension costs, so as to maximize their opportunity to secure even further pension benefit increases or current salary increases (Anzia and Moe 2019; Bahl and Jump 1974; Bleakney 1973). They may also be secure in the proven effectiveness of their lobbying power, even as retirees, to ensure that any future funding shortfalls fall on the backs of taxpayers or citizens (receiving reduced government services) rather than in the form of a reduction in retirement benefits.

Given that public pensions in the United States both have entrenched special interest groups invested in protecting their privileges and are structured in a manner that enables costs to be pushed to the future, the fiscal illusion that generated the underfunded pension crisis is both a stable and expected outcome. For instance, Bagchi (2019) finds that as political competition among municipal governments increases, politicians vie for electoral support by offering increasingly more generous pension benefits and pushing costs into the future, a strategy that, of course, depends on the degree to which voters are informed about pension underfunding (Bagchi 2019). Wagner and Elder (2021) find that state teachers' unions receive a return of nearly 1,500 percent on campaign contributions in the form of increased pension generosity.

Without institutional reform, many state and local governments will remain in this equilibrium. As Oates (1988, p. 67–68) notes, however, fiscal illusions "can only operate over a limited range" due to the fact that fiscal illusions become increasingly more difficult to hide as inevitable reckonings draw near. These days of reckoning can be forced on a government earlier than anticipated during an economic downturn, when the rising share of expenditures going to support underfunded pension promises becomes obvious and painful.

When reality does set in, state and local governments will need to raise taxes, reduce government services, lower benefits, or, secure a federal bailout. This creates a moral hazard (Pauly 1968), introducing another reason to expect overpromised and underfunded public pensions, at least as currently structured in the United States, to be a stable equilibrium.[9] If a bailout can be reasonably expected, perhaps justified during an economic downturn, than state and local governments have less incentive to properly fund their pensions in anticipation of a bailout.

Public pension experts, however, have not been fooled by the fiscal illusion, as evidenced by the strong consensus among economists and finance experts that public pensions are underfunded (IGM Forum 2012; Novy-Marx and Rauh 2009; Ricketts and Walker 2012). The Financial Crisis heightened awareness of state and local governments' indebtedness in the form of both bonded, or

[9] Once a federal bailout is executed, and thus in the range of political possibilities, state and local policymakers will have even less incentive to reform public pensions. The recent request of a federal bailout of state governments, to address the impact of COVID-19 with an unrestricted federal bailout, or, in the case of Illinois, an explicit request for support for their underfunded pension systems, demonstrates that states with poorly funded public pensions will have the incentive to leverage crises to pursue bailouts (Walsh 2020). The European Debt Crisis provides a vivid modern example of how the moral hazard of bailouts reduces the incentives for needed reforms.