THE POLITICS OF PUBLIC PENSION BOARDS

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Executive Summary

Most public pension plans are in poor fiscal health. Funding ratios have deteriorated over the past two decades, as the plans accumulated $5.52 trillion in liabilities and set aside only $3.7 trillion in assets in 2015. Thanks to underfunded pensions, state and local governments have had to make greater and greater contributions to pay for their employees’ retirement benefits, at the expense of spending cuts to education, infrastructure, and other public services.

Among the sources of the underfunding malaise are the boards that oversee the pension funds. Boards make decisions about how funds are invested and determine the assumed rate of return on those investments. Unfortunately, the incentives of board members lead them away from protecting employees and taxpayers from major financial risks.

Political appointees to pension boards are responsive to constituencies—such as local industry or the governor’s budget—that steer them away from acting in the long-term interest of the pension fund’s fiscal integrity. But the representatives of public employees and their unions on these boards are also tempted to trade pension savings tomorrow for higher salaries today.

The incentive problem is inherent in the structure of public pension fund boards. The only lasting solution is to replace state-administered, defined benefit pensions with defined contribution pensions, which, by definition, cannot be underfunded. In a defined contribution plan, employee contributions, combined with government employer contributions, would be managed by major money-management firms that are not exposed to political interference.

Defined contribution plans do transfer risk to employees, though no more so than in the IRAs and 401(k)s that are common throughout the U.S. economy. Meanwhile, defined benefit plans also pose risks that are borne both by employees and taxpayers, at the expense of other government programs and services.
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Introduction

Most public pension plans are in poor fiscal health. Funding ratios—which measure the degree to which plan assets can meet current and future liabilities—have deteriorated over the past two decades; according to Wilshire Associates, the average funding ratio for state pension plans fell from 73% to 69% in 2016. In 2015, the Federal Reserve estimated that public pension funds had accumulated $5.52 trillion in liabilities but only set aside $3.7 trillion in assets. Hoping to make up the shortfall, pension funds have increased their investments in corporate equities and other risker assets. Nevertheless, to ensure that retirees and current workers receive the benefits promised by their plan, state and local governments must now commit greater resources to their pension systems. According to U.S. Census data, state and local governments contributed $40.1 billion to their pension systems in 2000 and $140.5 billion in 2016.

Underfunded pensions are thus a source of stress for many state and local government budgets. The portion of tax revenue dedicated to meeting pension obligations has reached an all-time high. Even as state government tax receipts have increased 10 years into a bull market, pension costs are increasing even faster and governments are cutting services to balance their books. University of California–Berkeley political scientist Sarah Anzia studied 219 U.S. cities from 2005 to 2014 and found that as their pension expenditures increased, spending on education and infrastructure fell.

Although there are many contributors to the public pension malaise, the boards that oversee pension funds haven’t attracted as much attention as they deserve. Research suggests that board governance policies have a direct effect on funds’ investment decisions, which affect their performance. Pension boards aggravate the underfunding problem because board members’ incentives are not aligned to protect workers or taxpayers from major financial risks. Crucially, the structure of public pension fund boards is flawed.

In the private sector, corporations aim to balance the interests of managers and stockholders through a board of directors that includes representatives of both. The reason is that management has conflicts of interest that can hurt the firm’s long-run performance. Stockholders, on the other hand, have the firm’s long-term profitability at heart, since they own the company.

The boards of public pension funds are supposed to balance the interests of government employers and the beneficiaries of the plans. Board members appointed by state governors, or who hold public office and serve ex officio, cannot be counted on to tend exclusively to the interests of the employees (including retirees). Therefore, public employees themselves or their union representatives are put on boards and are supposed to be the guardians of the plan’s fiscal integrity.

The problem is that both types of public pension board members have incentives to neglect the fiscal health of the pension fund. On the one hand, political appointees are responsive to constituencies—such as local industry or the governor’s budget—that steer them away from acting in the interest...
of long-term pension fund performance. On the other hand, public employees and their union representatives are also tempted to trade pension savings tomorrow for higher salaries today.

Boards make decisions about how funds are invested and determine the assumed rate of return on those investments. The performance of pension funds in the market, in turn, affects the future liabilities of taxpayers.

The incentive problem is inherent in board structure. It cannot be eliminated. The only lasting solution is to replace state-administered, defined benefit pensions with defined contribution pensions. Many states moved in this direction after the Great Recession of 2008. By 2012, 18 states had adopted retirement plans for general state employees that depart from the traditional defined benefit model, and 12 states had done so for teacher pensions.11

In a defined contribution plan, employee contributions, combined with government employer contributions, are managed through major money-management firms. By definition, such plans cannot be underfunded. While it can rightly be said that moving to defined contribution plans will transfer risk to employees, it must be recognized that current systems are hardly risk-free. The risks described in this paper—including underfunding and investments made for political reasons—are borne both by employees and taxpayers, who may be called upon to make pension systems whole, at the expense of other government programs and services.

The Mechanics of Pension Fund Boards

There are 299 state government defined benefit pension systems and 6,000 local government-administered retirement systems in the U.S.12 More than 20 million employees participate in these plans, and nearly 10 million currently retired workers are receiving benefits.13 Approximately 90% of public pensions are defined benefit plans.14 The economic significance of public pension funds is enormous—they hold nearly $3.7 trillion in assets, which is the largest pool of investment capital in the U.S.15 Eight of the 10 largest pension funds in the U.S. are for government workers.16 These funds are among the most powerful institutional investors in the country, owning more than 10% of the equities market.17

American states are responsible for their employees’ pension systems.18 The legislature and the governor set benefit levels (how much workers receive in retirement) and annual contributions to the funds. They delegate authority to run the plans on a day-to-day basis to multi-member boards.

State laws define the composition of these boards.19 The typical board has five to 15 trustees. Some members are ex officio (such as the state comptroller), but most are representatives of specific groups, including current workers, retired workers, public employers, and taxpayers. While ex-officio members are on the board by virtue of the position they hold, all other members are either appointed (usually by the governor) or elected (usually by the group they are supposed to represent). As a general rule, board members receive no compensation for their service. Based on data from the Government Finance Officers Association and the Public Pension Coordinating Council, David Hess of the University of Michigan found that the average board had 36% elected trustees, 15% ex-officio trustees, and 44% appointed trustees.20

Pension board decisions fall into two baskets. One basket concerns investments. Boards allocate assets to stocks, bonds, cash, and real property. Some states prescribe the investments that a fund can make, either by providing an itemized list or a general fiduciary standard. Then, within each asset category, the boards choose investment products. To carry out those decisions, boards also hire investment managers.

The other basket involves choosing the fund’s assumed rate of return on investments, called the discount rate. Most plans today set the discount rate at 7%–8%. Boards can choose to raise, lower, or hold the rate constant. Doing so affects the annual required contribution (ARC), which is determined by actuaries.21 Lowering the discount rate increases liabilities and contributions while increasing it decreases them.22

Board decisions most in keeping with a plan’s fiscal health would make conservative investments and tend to keep the discount rate lower. But that is not what happens.

The Incentive Problem

Scholars point to political manipulation as the source of pension underfunding.23 To hold down short-run costs, politicians favor a high discount rate. A high discount rate makes it appear as though the pension plan is fully funded because it assumes a high rate of return on existing assets. The higher discount rate, in other words, lowers the government employer’s ARC. Even if actu-
aries call for greater employer contributions, state and local elected officials can always short the fund. In fact, the percentage of the required contribution paid to state and local plans fell from 100% in 2001 to 88% in 2014.\textsuperscript{24} Yet, since the end of the Great Recession, plan sponsors have increased the percentage of required contributions paid to above 90% today.\textsuperscript{25}

Politicians from both parties have incentives to short-change the actuarially required contribution. For Democrats, holding down pension contributions frees up money for other public programs. For Republicans, holding down pension contributions creates the budget space for tax cuts. Voters get more generous programs or tax reductions in the here and now, while future generations will be required to pick up the tab.

What has been insufficiently appreciated is that similar incentives infect the boards of public pension plans.\textsuperscript{26} Much of the focus in the existing research is on the politically affiliated board members—because political appointees and ex-officio board members are either servants of the politicians who appointed them or elected officials in their own right with their own constituencies. A board member appointed by a governor is likely to be sensitive to the governor’s budget proposals and unlikely to push for a lower discount rate that would drive up the ARC and jeopardize the governor’s agenda. Politicians, meanwhile, can encourage politically affiliated board members to take riskier investments in hopes of increasing the fund performance. Finally, politicians pressure political appointees to invest locally or employ well-connected money managers. Such conflicts of interest are widely known, and a battery of studies find that politically affiliated board members weaken pension fund performance.\textsuperscript{27}

But board members beholden to politicians are not the only problem. Board members elected by government workers and retirees—or their unions—also have perverse incentives.

Government workers and their unions are acutely conscious that increasing pension contributions reduces a government’s ability to pay higher salaries. Board members representing these interest groups have a built-in motive to keep the discount rate high and contributions to the pension fund low. Moreover, these board members can rely on the strong legal protections that public pensions enjoy to ensure that workers will be paid in the future, no matter what.

Economists Olivia Mitchell and Robert Smith found that higher unionization rates reduced pension funding in the public sector.\textsuperscript{28} The reason: collective bargaining tends to drive up salaries, which strains budgets and incentivizes government employers to reduce pension contributions. Over time, higher salaries mean more expensive pension obligations—though few people outside the public pension world ever take notice of this.

Political scientists Sarah Anzia and Terry Moe studied government employee representation on boards. They found that elected representatives of this interest group did not seek to impose more realistic (i.e., lower) discount rates. Nor did they encourage the government employers to consistently make the full annual required contribution. Rather, the opposite was the case. Pension systems with more plan participants on the board and strong public unions were associated with more fiscally irresponsible decisions. Discount rates were higher, and a lower percentage of the government’s required contributions were paid.\textsuperscript{29}

If board seats allocated to plan participants are supposed to be a force for a pension’s fiscal integrity, then plans where public workers and public-sector unions are well represented should skew in the direction of full funding. That is not what happens.

To be sure, some states, such as New York—which has the highest public-sector union rate in the nation for state and local workers, at 67.4%—are close to fully funded, at least according to its accounting methods (accounting methods that prevail in government and are not used in the private sector). However, other strong union states, such as New Jersey, Connecticut, and Illinois, have pension systems that are woefully underfunded.\textsuperscript{30} Still, states with weak public-sector unions also have problems funding their pensions. This suggests that it is not only union representatives on public pension boards that skew incentives in the wrong direction.

Ultimately, the incentives of almost all board members consistently point to their favoring short-term policies at the expense of pension plans’ long-term health. This includes the politically affiliated as well as the representatives of plan participants and unions. While a few boards have seats for taxpayers of the public broadly understood, they are such a small proportion as to be relatively insignificant.

\section*{Politics and Governance}

How do the perverse incentives of board members work themselves out in practice? Students of pension boards have focused on how “politics” interferes with board decisions, to the detriment of fund performance.\textsuperscript{31} Such political interference can occur through
six distinct channels (the first of which has already been discussed).

1. Pension boards can keep the assumed rate of investment returns—the discount rate—high. The result is to reduce the annual required contribution of government employers and the value of pension obligations reported to the public. It also encourages investment in riskier asset classes and the issuance of pension obligation bonds.32

2. Pension funds can engage in “socially conscious” investing, irrespective of its effects on the bottom line. For instance, money managers are directed by boards or state law to pay attention to environmental, social, and corporate governance issues in their investment strategies. Political pressure can also be applied to encourage boards to avoid investment in certain companies. Limiting the firms in which funds can invest—in due to their labor or environmental records—can lower fund returns.33

3. Pension funds make (or are required to make) local investments (economically targeted investments, or ETIs) that do not perform well.34 Daniel Bradley of the University of South Florida and his colleagues found that public pension funds overweight local firms by 26% relative to the market portfolio.35 This was especially true for firms that contributed to politicians’ campaigns or made significant lobbying expenditures. However, the examples of local investments by pension funds turning out badly are legion. For example, two large Texas plans were heavily invested in Enron prior to its demise.36 In 1990, Connecticut’s state employee fund invested in Colt Firearms to preserve jobs and lost $25 million.37

4. Pension funds can attempt to reform the companies in which they invest through shareholder activism. In particular, they can use the company’s proxy ballots to change the character of a corporate board or alter the company’s executive compensation practices. However, such activism can have a detrimental effect on the company’s stock price. By targeting companies for reform, pension funds undermine the value of firms in which they are major shareholders and negatively affect their own portfolios.38

5. Pension boards can select politically connected money managers regardless of their performance. Conversely, they can avoid other money managers because of their private political activities. In the worst-case scenario, boards can engage in pay-to-play with money managers even if their performance is poor. For instance, in 2003, Paul J. Silvester, a former Connecticut state treasurer, was convicted of taking bribes to direct pension fund money to certain private equity funds.39

6. Governments can use pension funds as “safety valves” in times of fiscal stress. During its financial crisis of the 1970s, New York City required the teachers’ pension funds to buy newly issued bonds to keep the city afloat. In recent years, some state and local governments in tight budget circumstances have issued pension obligation bonds (POBs). For POBs, state and local governments borrow against future tax revenue, invest the proceeds in equities or other high-yield investments, and thereby reduce unfunded pension liabilities. In theory, the investments will produce a higher return than the interest rate on the bond, earning money for the pension fund; in practice, maybe not. POBs played important roles in the bankruptcies of Stockton and San Bernardino, California.40

In sum, public pension boards are subject to incentives that can conflict with their obligation to be good stewards of the funds they oversee. It should, therefore, come as little surprise that public pension plans do not perform as well as private plans.41 This creates serious risks for taxpayers, public service users, and government workers.

The Way Out

Many current proposals for reform seek to mitigate the conflicts and perverse incentives inherent in the boards of public pension plans. The Manhattan Institute’s James Copland and Steven Malanga have argued, for example, that to improve pension board governance, states should require greater financial expertise, more clearly define fiduciary duties, and implement other controls.42

While mitigation is the best that can be done in many policy areas, reforms cannot eliminate the incentive problems on public pension boards. However, there is a genuine alternative: move away from defined benefit pension plans.
State governments could adopt defined contribution or hybrid plans for new employees and allow their existing defined benefit plans to expire with the current workforce. Defined contribution plans do not require boards to make the kinds of decisions that imperil the funds of defined benefit pensions and the interests of taxpaying citizens. The problems of political bias and misaligned incentives are eliminated.

Many people assume that defined benefit plans are risk-free for employees. However, current underfunding and the bankruptcy court rulings in Detroit and Stockton show that they are not. Nor are they risk-free for future public employees who already are, or will be, shunted into less generous plans. Defined contribution plans have other policy advantages:

- Defined contribution plans are better for women, who are more prevalent in the public workforce but often have interruptions in their careers due to child-rearing, which makes it difficult for them to earn full pensions.

- Defined contribution plans empower individuals with choice and control over their retirement.

The current structure of public pension governance has proved to be riddled with problems. The sickness of many public pension funds now threatens the fiscal health of many state and local governments. Some states have begun to move away from traditional plans. A look at the perverse incentives of pension boards should spur others to follow them.

- When there is no longer a pool of assets larger than annual budgets of most states, there is no longer a fund for politicians to manipulate during periods of fiscal stress.

- Defined contribution plans are more secure in the long term because they cannot be underfunded.

- Defined contribution plans are portable; workers can take them from job to job. Few workers actually work in one place for their entire careers, and those who exit early (in the private as well as the public sector) can lose out in defined benefit systems. The result is that public pension systems are highly inequitable. They privilege the longest-serving workers at the expense of those who spend only a few years in government employ.
Endnotes


4 “State Public Pension Investments Shift over the Last 30 Years,” Pew Charitable Trusts and John and Laura Arnold Foundation, June 2014.


13 Vidal, “Annual Survey of Public Pensions.”


18 Compared with the fiduciary duties that federal law (ERISA) requires of private pension plans, the state laws that govern public pension boards are more lenient. In addition, state laws also dictate the types of investments or fiduciary standards to which boards will be held.

19 Generally speaking, state governments defined the powers and memberships of these boards in law many years ago. Some laws were passed in the 1930s and 1940s and have not changed since then. Others were passed or modified in the 1970s and have not changed since then.


21 The annual required contribution (ARC) is the amount of money that must be added to a pension plan to keep it 100% funded. The ARC consists of the “normal cost,” which represents the amount necessary to provide the future benefits (liabilities) earned that year by current employees, and the amount necessary to amortize any unfunded benefits (liabilities) earned in prior years. In 2014, the new Government Accounting Standards Board standard replaced the ARC with the Actuarially Determined Employer Contribution (ADEC). The ADEC includes the normal cost plus a payment to amortize the unfunded liability over a specified time frame, usually 20–30 years.


24 “Public Plans Database,” Center for Retirement Research at Boston College, 2018; Aubry, Crawford, and Munnell, “State and Local Pension Plans Funding Sputters.”
25 Aubry, Crawford, and Munnell, “State and Local Pension Plans Funding Sputters.”
29 Anzia and Moe, “Interest Groups on the Inside.”
35 Bradley, Pantzalis, and Yuan, “The Influence of Political Bias in State Pension Funds.”
Abstract

As the funding ratios of most public pension plans have deteriorated over the past two decades, state and local governments have had to make greater contributions to pay for their employees’ retirement benefits. These spending increases have come at the expense of cuts to education, infrastructure, and other public services.

Among the sources of the underfunding malaise are the boards that oversee the pension plans. Boards make decisions about how funds are invested and determine the assumed rate of return on those investments. Unfortunately, the incentives of board members lead them away from protecting employees and taxpayers from major financial risks.

Political appointees to pension boards are responsive to constituencies—such as local industry or the governor’s budget—that steer them away from acting in the long-term interest of the pension fund’s fiscal integrity. But the representatives of public employees and their unions on these boards are also tempted to trade pension savings tomorrow for higher salaries today.

The incentive problem is inherent in the structure of public pension fund boards. The only lasting solution is to replace state-administered, defined benefit pensions with defined contribution pensions, which, by definition, cannot be underfunded. In a defined contribution plan, employee contributions, combined with government employer contributions, would be managed by major money-management firms that are not exposed to political interference.