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Abstract

The Pew Center estimates that as of July 2008, state and local governments in the United States had promised current and future retirees \$3.34 trillion in benefits but had only \$2.35 trillion of projected assets to pay for them. The investment losses that public employee pension funds experienced during the market downturn of 2008-09 made the trillion dollar gap much larger. In this paper I discuss how the pension funding gap has developed, compare the situation in California with that of other states, and discuss the ways in which the state government and local governments in California are responding to the increasing strains pension obligations place on their finances. I recommend that the constitution of California be amended to forbid the state and all local governments from ever again issuing pension obligation bonds, and to forbid the state of California, as well as all local governments within the state, from ever again offering their employees defined benefit pension plans.

Keywords: public employee pensions, pension funding, defined benefit pension plans, pension obligation bonds

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The Day after Tomorrow: The Politics of Public Employee Retirement Benefits

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Introduction

The Pew Center (2010) estimates that as of July 2008, state and local governments in the United States had promised current and future retirees \$3.34 trillion in benefits but had only \$2.35 trillion of projected assets to pay for them. The investment losses that public employee pension funds experienced during the market downturn of 2008-09 made the trillion dollar gap much larger; recent estimates range as high as \$3 trillion. State and local governments have also promised retired employees generous medical care and other nonpension benefits, but only a handful of states have set aside any funds to pay for these obligations.

According to Novy-Marx and Rauh (2009), conventional funding formulae are too optimistic and lead to overinvestment in risky assets. Bornstein et al. (2010) calculate that if CalPERS and other major California retirement funds were to adopt more prudent rate-of-return assumptions and rely upon less volatile investments, funding levels would need to be about 30 percent higher than those currently targeted. By their calculations the pension gap in California alone is over half a trillion dollars, and thus, larger than the long-term debt of the state and all local governments.

How did we get to this juncture? Does the underfunding of public employee retirement benefits constitute a fiscal crisis for state and local governments in California? How much worse is the situation in California than in other states? How are

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the state government and local governments in this state responding to the increasing strains that pension obligations are placing on their finances? What should they be doing instead? Would additional constitutional restrictions on policymaking be appropriate and salutary? This paper takes up each of these questions in turn.

Underfunding Public Employee Pension Funds: How Did We Get Here?

From a Marxist point of view, the looming crisis in financing public employee pensions can be seen as arising from the internal contradictions of the welfare state, and takes on the inevitability of a Greek tragedy (no pun intended). More specifically, the granting of generous postemployment benefits to larger numbers of public sector workers without simultaneously funding these obligations results from the combined, negatively synergistic effects of the following Laws of Political Economy:

Wagner's Law: As national income increases, the public sector's share of income increases as well. Today Wagner's Law is not an entirely accurate description of the data, in that the public sector's share of GDP has topped out at around 50% in most advanced industrial nations. In any case, the citizens of wealthy countries have chosen, through electoral democracy, to grant themselves generous retirement pensions and medical care benefits, and have chosen government to be the delivery vehicle. Demographic trends that have been operating for generations—declining birth rates and increasing life expectancies—have led to burgeoning populations of longer living retirees supported by fewer and fewer workers.

Voters in the United States have expanded the public sector by hiring more and more government workers, particularly at the state and local level. There are approximately three million federal employees, but over 20 million employees of state and local governments. Government employees have come to make up a large share of the labor force, and former government employees compose a large and growing fraction of all retirees making claims on postemployment benefit plans.

Four million Californians, or over 10% of the state's population, are currently enrolled in public employee retirement systems. About 60% are currently working, 25% are beneficiaries, and 15% are former employees who will receive some benefits in the future (Chiang 2010). The number of state government retirees and covered dependents in California has been increasing by about 4% a year, a rate that is far more rapid than the growth of the population or labor force. For many years medical care costs have been increasing more rapidly than the costs of goods and services in general, and constitute a large and growing share of postemployment benefits (Legislative Analyst's Office 2006).

Niskanen's Law: The benefits of government spending accrue disproportionately to public sector employees. According to Niskanen (1971), government agen-

cies thrive by exploiting the difference between the willingness of citizens and/or the politicians they elect to pay for public services, and the actual cost of provision. Niskanen's model has been criticized for making highly stylized assumptions, most notably that government agencies behave as if they are unitary actors, that they have complete knowledge of their legislators' demand schedules, and that their putative legislative masters know nothing about their costs of production.

But Niskanen is on the right track. When it comes to such services as protection from destructive fire and criminal mayhem, demand from the public is strong and inelastic. Agencies may not be able to make take-it-or-leave-it offers to the legislators who fund them, but most are shielded from the rigors of market competition.¹ These factors translate into higher salaries and better benefits for public employees, particularly when they are unionized.

Compared to their counterparts in the private sector, public-sector employees make more money while working fewer hours, taking more vacation days, and, until recently, encountering virtually no risk of being fired or laid off. They retire at younger ages with benefits that, by private-sector standards, can be quite generous (Edwards 2010). Data from Britain similarly show large public-sector wage and benefit premia (Holmes and Lilico 2010).

True, public- and private-sector jobs are not the same, so simple difference-in-mean comparisons might be misleading. Bender and Heywood (2010) point out that the percentage of employees with college degrees is nearly twice as high in the public sector as in the private, and that public-sector workers are older. Once wage determinant regressions control for age and education, the public-sector wage premium largely disappears.

But are such "controls" reasonable? That public-sector employees are much more likely to have a college degree may only mean that a college degree is used as a selection filter to ration excess demand for public-sector jobs. When direct comparisons of employees in the same occupation can be made, differences in compensation are impressive. A recent study based upon BLS data reports that public school teachers make 61% more on average than private school teachers, and in large cities in California public school teachers make twice as much per hour as their private school counterparts (Greene and Winters 2010). Public school teachers generally work in more hazardous and chaotic environments, but this cannot plausibly account for the entirety of the pay differential.

In the end, the question of whether government employees deserve higher salaries and better benefits than private-sector workers is not at issue here. What is at issue is that the state of California's annual costs for retirement benefits are projected to increase from around \$6 billion today to about \$27 billion by the end of the decade. Counties, cities, and other local jurisdictions confront increases of similar magnitude. The question we face, then, is whether state and local governments can

provide a reasonable level of public services while simultaneously paying retirees the pension and nonpension benefits that they have been promised.

Ledyard's Law: If you cannot steal from future generations, who can you steal from? According to Barro (1974), to the extent individuals are ensconced in multi-generational family structures and voluntarily make altruistic transfers within their families, debt is a tax bill that must be paid later. Appropriately discounted, debt and taxation are the same thing, and people with rational expectations should regard them as such—a statement that has come to be known as the Ricardian equivalence theorem.

This is an elegant piece of economic theory, perhaps, but it does not comport with reality. To paraphrase Don Michael Corleone, if anything in this life is certain, if history has taught us anything, it is that human beings, whether they be politicians or the voters who elect them, strongly prefer debt financing over current taxation. Ricardo himself was fully aware of this fact: “It would be difficult to convince a man possessed of £20,000, or any other sum, that a perpetual payment of £50 per annum was equally burdensome with a single tax of £1000. He would have some vague notion that the £50 per annum would be paid by posterity, and would not be paid by him” (1951, p. 187).

Ledyard's Law is simply a statement that human beings seek to enjoy benefits today and defer costs until the day after tomorrow. It is one of the cornerstone principles of modern political economy. Studies of public opinion have repeatedly found voters reluctant to make tradeoffs between taxation and government services. They much prefer the cheery premise that they can obtain something for nothing—or at least that somebody else will pay for it later (Sears and Citrin, 1982).

What does this have to do with public employee pensions? Plenty. About 80% of all public-sector employees are covered under defined benefit plans, wherein annual pension payments = final (or highest) compensation level x years of service x benefit factor. In a typical case, a public employee with 30 years of service earning a maximum salary of \$100k and subject to a benefit factor of 2.5% would receive an annual pension of \$75k.² Eligibility requires reaching retirement age, which in California is typically 50 for public safety employees (police and firemen) and 55 to 60 for other employees.

Underfunding occurs when actuarial projections indicate that current assets, future contributions, and investment returns are not sufficient to pay for the benefits promised under defined benefit formulae. As indicated earlier, most government retirees also receive a monthly payment to cover the cost of medical insurance, but these are almost always paid out of general budgets and so are 100% underfunded. In contrast, over 80% of all private-sector retirement plans are 401(k) type defined contribution plans into which employees and (sometimes) employers make regular contributions. Retirement benefits are a function of contributions and investment

returns. Contributions cease when employment ceases, no particular level of benefits is guaranteed, and so by design such plans cannot be underfunded.

Properly speaking, then, retirement benefits are deferred compensation, which means that underfunding retirement benefit obligations is just another form of government borrowing. Government borrowing is not in and of itself undesirable. When it comes to infrastructure projects like bridges and highways that yield benefits far into the future, selling bonds and paying them off with interest over time produces a better temporal alignment of cost and benefits. But underfunding public employee pensions destroys the temporal alignment of costs and benefits. The benefits rendered by the service of retired employees have already been realized. Future generations are saddled with the bill for these benefits, which they of course cannot and will not receive.

Of all the laws of political economy, Ledyard's Law is the most powerful. We see throughout the world a large and growing gap between the promises that governments have made to retired workers and the ability of governments to pay for these promises. Being underfunded is a characteristic that public employee pension plans in California share with virtually every other government retirement system in the world. Indeed, the current extent of underfunding in the Social Security and Medicare Trust Funds—on the order of \$10¹⁴—dwarfs that of state and local government employee pension funds (Jackson 2008).³

While the current shortfall between public pension fund obligations and pension fund assets is often blamed on recent investment losses, state and local governments have underfunded employee pensions even during prosperous times (Pasantino and Summers 2005). In his 2008 Letter to Shareholders, which preceded the large declines in asset values that public employee pension funds suffered in the next few years, the Oracle of Omaha attributes the ultimate cause of pension underfunding not to Wall Street, but rather to the moral hazard that is at the heart of Ledyard's Law:

Whatever pension-cost surprises are in store for shareholders down the road, these jolts will be surpassed many times over by those experienced by taxpayers. Public pension promises are huge and, in many cases, funding is woefully inadequate. Because the fuse on this time bomb is long, politicians flinch from inflicting tax pain, given that problems will only become apparent long after these officials have departed (Buffett 2008, p. 20).

By the way, the reader is advised that if you Google Ledyard's Law, you will not find it. This is because my colleague John Ledyard stated it to me some years ago in one of our many fruitful discussions about political economy. Perhaps it should instead be called Buchanan's Law, as formulated in *Democracy in Deficit* (1977), or the Sears and Citrin (1982) Something-for-Nothing Principle. I prefer

Ledyard's formulation, however, because I believe it best captures the larcenous nature of voters' and politicians' calculations.

Do Underfunded Public Employee Pensions Constitute a Fiscal Crisis?

Estimates of the extent to which public employee retirement benefits are underfunded are large and growing rapidly, but these estimates are surrounded by great uncertainty. In order to calculate the amount of money a pension fund needs to meet its obligations, we need to know the following: (1) how many covered employees are going to be retiring over time; (2) the cost of the benefits they have been promised; (3) how long they and their covered dependents are going to live; (4) the amount of money that is going to be contributed into the fund by current and future employees, and (5) the fund's return on investment of assets.

The number of retirees can be known with a high degree of precision. Actuarial tables provide good estimates of life expectancy, although these estimates tend to be revised upward over time. Public employee pension benefits are a function of final salary, years of service, and benefit factor, and so we can estimate these with reasonable accuracy. Future contributions depend upon the outcome of future collective bargaining agreements and future legislation, so this variable is the source of significant uncertainty. The real wild card, however, is return on investment, which brings us to the fourth Law of Political Economy:

Morgan's Law: Asked how he believed the stock market would perform in the next year or so, J. P. Morgan is famously quoted as saying, "It will fluctuate." The last three decades in the equity markets have seen the best of times and the worst of times. According to the S&P 500/Case-Shiller Index, the compound annual growth rate of stock market investments, in real dollars, averaged 12.0% in the 1980s and 14.9% in the 1990s, making them two of the best decades in the market's history. During this period the largest California public employee retirement systems (CalPERS and CalSTRS) relied primarily upon returns from stock market investments to grow their assets (Kogan and McCubbins 2010).

It is not surprising that it was in 1999 that the California Legislature passed and Governor Gray Davis signed SB400, which granted significant upgrades in pension benefit factors and retroactive cost of living increases to state government employees. Based upon past investment returns, SB400 was projected to cost the taxpayers nothing. It was also at the tail end of this period (2001) that Los Angeles voters approved Charter Amendment A, the measure that created the "Tier 5" benefit levels for police and firemen. Although it now seems like a very long time ago, labor markets were very tight at this time and supporters of Charter Amendment A argued that better retirement benefits were necessary to attract high-quality candidates to

the LAPD. Supporters also asserted that by consolidating four existing pension funds, Charter A would actually save taxpayers hundreds of millions of dollars.

As investors know, however, every mutual fund prospectus comes with the caveat that past performance is no guarantee of future results. From 2000 to 2009, a portfolio composed of the S&P 500 lost 3.4% per year on a compounded annual basis. The last 10 years thus constitute a significantly worse decade for stock market investors than the Depression years of the 1930s. Then real returns averaged a meager but nonetheless positive 2.0%. These investment losses did not cause the current problem of underfunded public employee pension funds. But they did dramatically exacerbate the extent of underfunding in the short-term, thereby bringing us much nearer to the day after tomorrow.

So, does the underfunding of public employee pensions constitute a fiscal crisis? Not necessarily. If the investment returns experienced in the 1980s and 1990s were to reappear, the S&P 500 would quadruple in less than 10 years and quadruple again in the decade after that. The good old days would be here again, as public employee pension funds could pay ever-increasing benefits and remain fully funded while requiring little or nothing in the way of new contributions. If investment returns are unspectacular, as they surely have been recently, California faces a ticking fiscal time bomb (Kogan and McCubbins 2010).

Given that investment returns cannot be predicted with any useful degree of certainty, the Novy-Marx and Rauh (2009) prescription of managing funds so as to achieve an 80% probability of being 80% funded is the most prudent course of action. This entails accepting a lower average rate of return than might (but might not) be achieved with a riskier mix of assets. In any case, the vast majority of state and local governments have set aside no funds whatsoever to pay for health insurance and other nonpension benefits. These obviously cannot be financed by investment returns, and are growing rapidly. What we do know with virtual certainty, then, is that paying for retiree health insurance and other nonpension benefits while simultaneously backfilling underfunded pension funds will place an ever-worsening strain on state and local governments that are already hard pressed to maintain present levels of services to their citizens.

How Much Worse Is California Than Other States?

Because of extensive media coverage of ongoing budgetary shortfalls, the failure of the state government to pass budgets on time, and a cultural tendency toward self-flagellation, California is often identified as the worst case scenario of borrowing and underfunding, providing a cautionary tale of How Bad It Can Get. Will (2010), for example, describes Los Angeles as a place “where the climate is Mediterranean and the fiscal climate Greek.” The major public employee unions—

the California Service Employees International Union, the California Teachers Association, the California Organization of Police and Sheriffs, and the unions representing the prison guards and firefighters—are regarded as especially powerful and insatiable (Greenhut 2009). Large numbers of Democrats serving in the state legislature and on city councils, reflective of this blue state’s general ideological leanings, are seen to function primarily as their minions (Malanga 2010). Another explanation for why things are so bad in California is that Ledyard’s Law is particularly powerful here; underfunding is indicative of a general pathological tendency toward borrowing, and that states whose governments have issued the most debt, e.g., California, are also the most prone toward underfunding pension obligations (Gelinias 2010).

There is, to begin with, much that is unhelpful, if not wrongheaded, about blaming the underfunding of public employee pension funds on plundering labor unions and feckless legislators. We would, of course, expect the unionization of public employees to lead to higher pay and better benefits. As Farber (1986) explains, “Unions are fundamentally organizations that seek to create or capture monopoly rents available in an industry” (p. 1044). Obtaining higher wages and more benefits for their members is what unions do. We might as well blame carnivores for eating smaller animals. But why would public employee unions have any interest whatsoever in having their pension funds become underfunded? This makes no sense, as this is where the money for their members’ pensions comes from!

Second, while our elected officials may in fact be feckless, there is no reason to believe that they are any more feckless than the voters who elected them. As indicated earlier, when voter approval was required to increase public employee pension benefits (as in Los Angeles in 2001), voter approval was forthcoming. We are emerging, albeit slowly and reluctantly, from a long period of abysmal saving rates during which it became common for Americans to max out their credit cards, borrow as much as possible against the equity in their house, and put no money away for retirement. Ledyard’s Law applies at least as strongly to voters as to the politicians they elect.

As it turns out, the portrayal of California as a case study in profligacy is not an accurate one. According to the Pew Center’s figures, states varied dramatically as of 2008 in the extent to which their public employee pension funds were underfunded. Public employee pensions in some states, including the large states of Florida and New York, were fully funded, and California was also in relatively good shape. The three major public employee pension funds (CALPERS, CALSTRS, and UCRS) were 13.1% underfunded, which was significantly better than the national average of 19.4 %, and better than 32 other states. To be sure, these funds subsequently lost approximately one fourth of their value, but the other states’ public employee pension funds suffered large losses as well. When it comes to underfunding public

employee pensions the real basket case is Illinois, not California. The Pew Center's figures indicate that in 2008 the major public employee retirement funds in Illinois were 46% underfunded—the worst level of all 50 states.

To gain some additional insight into the role played by public employee unions and other factors in pensions and pension funding, some simple regression analyses were performed on state-level data. The first equation seeks to explain variation across states in public employee compensation, as measured by the average annual wages and benefits received by full-time state and local government employees in 2008. The dependent variable in the second equation is the amount by which major public employee pension funds are underfunded, expressed as a percentage of the funds' total amount of obligations to current and future retirees. These two variables were regressed upon average per capita personal income, the percent of state and local government employees who belonged to labor unions, Erikson et al.'s (1993) measure of state ideology, and per capita long-term debt issued by state and local governments. Results are reported in Table 1. The top number in each entry is the estimated regression coefficient; the number in parentheses below is the standard error. Coefficients that are twice the size of the standard error can be regarded as statistically significant.

The results in the first column in Table 1 indicate that public employee unions do what they are supposed to do—higher levels of unionization lead to higher levels of compensation. The coefficient for this variable indicates that unionizing an additional 10% of government workers in a state would lead to an increase of \$1,560 in additional annual compensation per employee. Higher state per capita personal income, which probably reflects differences in cost of living as well as income, also increases public employee compensation. However, public employee compensation was not related to state ideology or to a general proclivity for borrowing, at least as registered by the level of per capita long-term indebtedness.

The R^2 of .57 indicates that this simple model accounts for over half the variation in public employee compensation, but there is still much variation that is not accounted for. According to Edwards (2010), in 2008 the Bureau of Economic Analysis found that California public employees earned an average of \$86,417, making them the highest paid in the nation. This is due in part to California's relatively high level of per capita personal income (11th highest among all states) and strength of public employee unions (62% of state and local government employees belonged to a union, which was the 9th highest figure). Analysis of residuals, however, reveals that state and local government employees in California receive over \$15,000 more than can be accounted for by these variables. Feel free to speculate as to the reasons why this is the case.

Coefficients associated with the second equation, in contrast, indicate that strong unions are not the authors of underfunding. Indeed, none of the variables specified

Table 1. Effect of Unionization and State Ideology Upon Employee Compensation and Pension Underfunding

	Employee Compensation	Unfunded Pension Obligations
C	42970 (8487)	7.02 (19.3)
Per capita income	432 (197)	.197 (.447)
Percent union	156 (63)	-.018 (.144)
Ideology	121 (152)	-.024 (.344)
Per capita debt	70 (528)	.686 (1.20)
R ²	.57	.02

Data sources: Employee compensation and unionization figures are from Edwards (2010). Data on pension fund obligations and underfunding are from the Pew Center (2010). The source of the state ideology measure is Erickson et al (1993). Per capita personal income (from 2007) is taken from the U.S. Census Bureau's *2010 Statistical Abstract*. Per capita long-term debt figures are taken from the U.S. Census Bureau's *2008 State and Local Government Finances*.

in this equation had any impact whatsoever on the extent to which public employee pension funds were underfunded. Pension funds in some states are substantially more underfunded than in other states, but this is not due to the strength of their public employee unions, to their ideological tendencies, or to a general tendency toward overborrowing as reflected in high levels of bonded indebtedness.

Contrary to California's portrayal in the media, then, the data indicate that public employee pension funds are in better overall shape here than in most states.

What data aggregated to the state level do not reveal is that local governments in California face greater problems than the state government. Moreover, some local governments face more severe problems going forward than others. Vallejo declared bankruptcy in 2008. Oakland and other smaller cities in the Bay Area have badly underfunded pension funds and rapidly growing obligations, but so do the two largest cities in the state. The city of Los Angeles now devotes over 25% of its payroll to pension fund contributions, and allocates another \$300 million to retiree health care. In the next four years pension and nonpension costs are set to increase by an additional \$2.5 billion, while projected revenue, even under rosy scenario projections, is seen to grow from \$4.3 billion to \$4.75 billion per year (Riordan and Ruralcava 2010; Goichman and Ralston 2010).

Increased pension costs, in short, will greatly outpace any conceivable increase in revenue. San Diego is currently making large annual payments on a 20-year amortization schedule to backfill an unfunded liability of more than \$2 billion in its public employee pension funds, and next year will inject 40 cents per every dollar of payroll into its pension system (Erie, Kogan, and MacKenzie 2010). Cities like Oakland, Los Angeles, and San Diego can continue to meet their employee pension obligations. Or they can provide a reasonable level of services to their citizens. It is hard to see how they will be able to continue doing both.

The Response of State and Local Governments to Increasing Employee Retirement Costs

The budget of a state or local government, be it a city, school district, or special service district, can be characterized in the following way:

$$R_t + R_b + R_f = E_{rb} + E_{cs}$$

where R_t is revenue from taxes and fees, R_b is revenue from borrowing, R_f is revenue received from the federal government, E_{rb} is expenditures on retirement benefits, and E_{cs} is expenditures on current services. The problem that state and local governments face is to balance this equation when one of the terms—retirement benefit expenditures—is large and increasing rapidly. Over the past year alone the state of California has needed to increase its contribution to CalPERS by 18%, from \$3.3 billion to \$3.9 billion, and by similar amounts for CalSTRS and UCRS (but not to worry—the money is to come from transportation and other special funds, and will be paid back, presumably, the day after tomorrow). Expenditures on retiree medical benefits are slated to increase by 9% to \$1.4 billion. Counties, cities, and school districts must also make much larger expenditures on retiree benefits for the

coming year. And retirement benefit expenditures are projected to increase for as long as one cares to project.

The first alternative to consider is to pay for the growing costs of retiree benefits by increasing taxes, but this does not look particularly promising. The severe downturn in the California economy has led to a sharp decline in tax revenue over the past few years. The economy will eventually improve and tax revenue will increase, but it could be a while before that happens. There is also the problem that increasing state sales and income tax rates may end up yielding less tax revenue, as doing so would encourage even more job-creating private firms to flee to states with more congenial tax and regulatory regimes.

Local governments in California face an additional hurdle in the quest for more revenue in that they have little ability to influence the amount of money they take in through taxation. They receive a share of state income and sales tax revenue on a formulaic basis, and cannot directly alter property tax rates. What they can do to collect tax revenue over and above the Proposition 13 default level is to impose a parcel tax. This type of levy requires the approval of two-thirds of the voters in their jurisdiction. About one fourth of the school districts in the state (typically wealthy ones like San Marino and Palo Alto) currently have a parcel tax in place, as do a few cities and some special service districts. As shown in Table 2, voters in California have approved 56 of the 79 parcel tax proposals put before them since the beginning of 2009, so super-majority approval is not an insurmountable obstacle even during hard economic times.

It would be a mistake, however, to infer from the 71% approval rate for parcel tax elections over the past few years that all local governments have a good chance of winning approval for a parcel tax. Cities, school districts, or other jurisdictions seeking a parcel tax must pay for the administration of the election, and so these proposals are presumably put before the voters only when prospects for approval are quite good. Most parcel taxes are modest; of the 56 that were approved in 2009-10, only 20 yielded a tax in excess of \$200 annually per single-family residence. The entries in Table 2 also show that voters in 2009-10 were much more likely to approve measures to extend or modestly increase existing parcel taxes (28 of 31) than they were to approve a new tax (28 of 48). For these reasons local governments in California should not count on the parcel tax to provide significant amounts of new revenue.

In addition to income, sales, and property taxes, revenue is raised through fees, charges, and fines. In FY2008 state and local governments in California collected about 24% of their total revenue from tuition at public colleges and universities, charges for use of public hospitals, sewerage and waste treatment fees, and similar payments for services. This figure is virtually identical to the national average, but the 8.2% share of revenue derived from public utilities was considerably higher

Table 2. Parcel Tax Elections in California, 2009-10

	Approved	Failed
School Districts:		
Renew Existing Tax	9	1
Increase Existing Tax	11	2
New Tax	16	13
Cities and Special Districts:		
Renew Existing Tax	8	0
New Tax	12	7
Total	56	23

than the 5% national average (see Cain and Noll 2010 for an extensive set of comparisons of California revenues and expenditures with those of other states).

In response to their budgetary difficulties, the state and local governments in this state have sharply increased many of these charges, and are instituting new charges. Among other things, citizens of some California cities are now charged for calling 911, or for cleanup costs after traffic accidents. The state and most cities in California have significantly increased fines for parking and moving violations, and are enforcing parking and traffic regulations more aggressively. Is there someone out there who has not noticed this?

How much additional revenue these initiatives will yield depends upon how much state and local governments actually collect from those who have been fined. A recent audit in Los Angeles found that the city collected only about half of the \$250 million in parking citations written last year (McDonnell 2010). On the whole, higher fees, charges, and fines should yield more in terms of increased revenue than taxes per se. But it is still unrealistic to believe that increases in revenue from fees, charges, and fines will close more than a small portion of the pension funding gap.

The second term on the revenue side of the budget equation is borrowing, which is how the federal government currently obtains over 40 cents of every dollar going into its coffers. State and local governments face something vaguely resembling a balanced budget requirement, at least over the short and medium term, and so face much tighter constraints on borrowing. They can, however, issue long-term bonds, backed by either the taxing power of the government (general obligation bonds) or by a specific stream of revenue (e.g., parking fees).

Bond financing has conventionally been used to fund major infrastructure projects. Some state and local governments have also issued long-term bonds to cover unfunded pension obligations, seeking thereby to push the day of fiscal reckoning out to the day after the day after tomorrow. State and local governments in Cali-

fornia have issued about \$14 billion in pension obligation bonds over the past two decades. This is more than any other state, but five other states have issued more on a per capital basis (Munnell et al. 2010).

Not to put too fine a point on it, issuing pension obligation bonds is nuts. First, borrowing of this nature runs directly contrary to the traditional public finance rationale for long-term debt financing. Because major infrastructure payments like bridges and highways yield a flow of benefits that extend far into the future, selling bonds and paying them off over time produces a better temporal alignment of cost and benefits. As noted earlier, borrowing to backfill underfunded pension funds, like underfunding pensions in the first place, turns this logic on its head. The benefits rendered by the service of retired employees have already been realized, but future generations are being saddled with the bill.

This is, of course, what Ledyard's Law is all about. Issuing pension obligation bonds merely replaces unfunded pension liabilities with long-term debt. It is equivalent to taking an advance on a new credit card in order to continue making payments on the credit cards one already has. The U.S. Treasury regards this exercise, correctly, as one of risk arbitrage. This means that interest paid on such bonds is taxable, so the interest rates the issuing governments must pay for these bonds is correspondingly higher than for conventional, tax-free municipal bonds. The risk premia demanded by investors also increases the cost of this money.

The record of governments that have made heavy use of this dubious practice is not encouraging. Turning to pension obligation bonds in the 1990s in a gamble for redemption, the city of Pittsburgh only dug itself deeper into the hole. It currently devotes over 20% of its budget to debt service, and its major pension funds have less than 30% of the assets they need to meet future obligations (McKee 2009). Closer to home, the city of Pasadena will need to devote roughly 10% of its budget in coming years on paying off \$100 million of pension obligation bonds issued in 1999 (Armstrong 2010).

The state of Illinois borrowed \$10 billion in pension obligation bonds in 2003, but, as noted previously, its public employee pension funds are more severely underfunded than those of any other state. The Chicago Transit Authority issued \$1.9 billion in pension obligation bonds in 2007, but, like Pittsburgh, found that risk arbitrage is harder than it looks. It has needed to pay a high rate of interest to bondholders, while experiencing losses on the investments made with the money it borrowed. In early 2008 the state of Connecticut needed to pay an interest rate of nearly 5.9% to attract investors to its \$2.2 billion pension obligation bond issue, and I am pretty sure they have not realized the 8.5% return that they had projected to achieve on investing the proceeds. Illinois recently returned to the market for another \$3.5 billion in pension obligation bonds, and may try for more later this year. Maybe they will get lucky. Maybe they won't.⁴

In managing the budgetary demands of paying for steadily increasing employee retirement benefits, the revenue side of the equation thus offers little help. Significant increases in tax revenues cannot be counted upon, and borrowing to cover unfunded pension liabilities, is, in the words of former New Jersey governor John Corzine, “the dumbest idea I ever heard” (quoted in Munnell et al. 2010).

The third term on the left hand side of the budget equation is revenue received from the federal government. In fiscal year 2008, 16.3% (\$58 billion out of \$354 billion), or slightly more than one sixth of all state and local government revenue in California, came from Washington. The federal government was the source of 14% of California state and local government revenue in 1998 and 14.8% in 2004, so federal assistance was becoming slightly more important as a source of revenue in the decade before the Great Downturn.

The \$787 billion stimulus package that was enacted in 2009 included an additional \$11.2 billion for California for MediCal, \$6 billion for school districts, and \$220 million for law enforcement. This large infusion of federal funds surely staved off large-scale layoffs of state and local government employees, but it was a temporary measure at best. A follow-up bill passed recently that provides an additional year of bailout money for Medicaid and for school districts is much smaller than the 2009 bill, and required tax increases and cuts in food stamps to gain passage. As indicated earlier, the Social Security and Medicare programs present the federal government with funding problems of its own that are many times worse than the underfunding of state and local government employee retirement benefits.

It is highly improbable, then, that significant amounts of bailout money will continue to flow from Washington. In any case, state and local governments have no control over the amount of revenue they receive from the federal government. One does not need to ride a Streetcar Named Desire to know that it is unwise to rely upon the kindness of strangers. As in the case of the other two revenue sources considered, revenue received from the federal government will not begin to close the gap between the retirement benefits that public employees have been promised and the funds that state and local governments have to pay for them.

An additional term that might be included on the revenue side of the budget equation for local governments is the potential for being bailed out by the state government. In the past, states have rescued cities in deep financial distress by paying their vendors and guaranteeing their debt obligations while simultaneously placing them in receivership. In 1975, for instance, the state of New York created and funded the Municipal Assistance Corporation to assume control of New York City’s finances when that city stood on the brink of insolvency.

In the context of today’s budgetary climate, a bailout of local governments by the state government of California would be a terrible idea—something akin to a small boat that is sinking being rescued by a ship that is itself taking on water. It is,

in fact, an even worse idea than the boat analogy implies, as the specter of moral hazard once again rears its ugly head. This is because the prospect of a bailout lessens the incentive to make responsible decisions and corrective changes. Why worry about taking on more debt and additional pension obligations if the state or federal government will bail us out when we can't make the payments?

The next alternative to consider in attacking the problem of increasingly onerous retirement benefit expenditures is on the expenditure side, and that is the direct approach of reducing retirement benefit expenditures—or at least the rate of increase in retirement benefit expenditures. Like the revenue-based alternatives, however, this one runs rather quickly into a dead end. States vary in terms of the precise legal justification that is invoked, but retirees covered by public employee pension plans have strong legal and constitutional guarantees that their pension benefits will never be reduced. Some states treat pensions as property, and thus protect them under the just compensation and due process guarantees of the Fifth and Fourteenth Amendments. In California, as in most other states, pension benefits are considered as part of the contract that is struck between employer and employee at the moment employment commences. Such contracts are typically created through collective bargaining agreements, but the courts have ruled that benefits defined by statute, as they must be in California, must be afforded contract status as well.⁵

In any case, these agreements are protected by the Contracts Clause of the U.S. Constitution, which prohibits states from taking actions that impair contracts. California's constitution has a contract clause of its own and specifically guarantees that public employees will receive the retirement benefits they have been promised. Because public employee compensation in California must be set by statute, the matter of retirement benefits raises the thorny constitutional question of the extent to which an elected body can prevent future versions of itself from altering policy in the future. This necessarily occurs when contractually guaranteed vesting in pension benefits are created. Locking in policy in this manner constrains the ability of elected officials to change policy in response to changing conditions, and runs counter to traditional interpretations of democratic theory.

At present, there is considerable uncertainty as to whether retired public employees have the same contractual protections when it comes to other postemployment benefits (OPEBS), most notably their health care benefits. The County Employee Retirement Act of 1937 explicitly states that in choosing to provide such benefits, county governments do not grant vested rights in these benefits, but in *Thorning vs. Hollister School District* (1993) the court ruled that an implied contract existed, thus creating vested rights.

In 2006 the Orange County Board of Supervisors voted to place retirees, who had previously benefited from inclusion in the same risk pool as current employees, into a separate risk pool. This effectively reduced their health care benefits by

an average of \$160 a month. The district court ruled against the retirees in their subsequent lawsuit, noting, among other things, that, “the requirement to provide lifetime healthcare benefits does not establish a right to a specific method of rate setting” (quoted in Yeung 2010). In the end state and local governments may be given some ability to reduce retirees’ nonpension benefits, particularly when the only argument for the existence of an implicit contract is that the employer has been providing a particular set of benefits for a long time. This case has recently been handed over to the California Supreme Court, and years of litigation are likely to ensue regardless of the verdict.

In contrast to the privileged status of retirees, current employees may be subject to adverse changes in the parameters of their retirement plans. In an excellent primer on the legal basis of public employee pension plans, Monahan (2010) reports that the courts have allowed state and local governments to make such modifications as long as they come with offsetting benefits. In *Houghton v. City of Long Beach* (1958) a new requirement that workers contribute 2% of their salary to their retirement fund was offset by the benefit that the currently insolvent plan would be made solvent (p. 21). Recently, Governor Schwarzenegger has reached agreement with several public employee unions to increase their employee contributions.

Some state and local governments have been able to increase the minimum age of benefit eligibility for employees who are more than five years away from retirement (Monahan 2010, p. 26). So far, however, reductions of any kind in the actual retirement benefits that have been promised to current government workers have remained off the table.

New hires, in contrast, are fair game. State and local governments throughout the country have responded to the fiscal duress they are currently enduring by reducing any and all parameters of the retirement benefit equation (Mendel 2010). Compared to current workers and retirees, newly hired workers must contribute a larger percentage of their pay in return for benefits that are a smaller percentage of their final salary. They must also reach an older chronological age before they become eligible to receive retirement benefits; a typical reform is to increase the retirement age from 50 to 55 for police, firemen, and other public safety workers and from 55 to 60 (or 65, or even, as in Illinois, to 67).

Some states, like West Virginia, have reduced or even eliminated medical insurance coverage prior to eligibility for Medicare. In Utah new employees no longer are covered by a defined benefit plan, but instead, like the vast majority of workers in the private sector, by either a defined contribution or “hybrid” plan. The city of San Diego and Orange County also provide new hires with hybrid plans that have both defined contribution and defined benefit elements.

It is possible that retrenchment of current retirees’ benefits might meet legal muster if they were achieved as part of a collective bargaining agreement. In *Vil-*

lage of Fairpoint vs. Newman (1982) the court ruled that unilateral amendments to a pension plan are not acceptable, but employers and the unions are free to negotiate and could agree upon changes (Monahan 2010, p. 10). Presumably the courts would also have to agree that any reductions in current retiree benefits were offset by the benefit of restoring an insolvent pension fund to solvency. But public employee unions would be loath to sign on to such an agreement. First, many public employee unions, like private-sector unions, are dominated by retirees and soon-to-be retirees to such an extent that we can view them purely as pension protectors.⁶ Future hires, in contrast, do not vote in union elections. Perhaps the representative union member recognizes that the benefits he is now receiving come out of the wallets of future hires—but try telling him that is a bad thing. Perhaps more importantly, the reputation of the union is at stake. If a union cannot defend the benefits won for previous workers who are now retired, why would current workers believe that the union can protect them?

All indications are that public-sector unions will follow the same course as the private-sector unions that have withered away in this country, and accept “two-tier” pay systems that entail large reductions in compensation for new workers in order to protect existing pension benefits. They will eat their young. It is hard to know exactly how stark a trade-off public employee unions are willing to make between the interests of retirees and new hires. If the history of the United Auto Workers is any guide, an agreement reducing new hire compensation by 10% and retiree benefits by 1.0% would be rejected in favor of an agreement that reduces new hire compensation by 50% but keeps benefits for current retirees at current levels.

By concentrating the retrenchment of employee retirement benefits on new hires, state and local governments avoid impairing contracts and, thus, stay out of court. But in so doing they will have to wait for decades before realizing significant reductions in retirement benefit expenditures. The current wave of “pension reforms” are systematic attempts to avoid real reform, or to at least to delay it as much as possible. They do nothing to alter the upward trajectory of retirement benefit expenditures that state and local governments must confront over the next several years. Pension reforms that apply only to new hires mirror and reinforce what current pension systems do, and that is to borrow from the future in order to maintain benefits for current retirees at high and possibly unsustainable levels.

The fifth and last term in the budget equation is expenditures on current services. Over the past few years local governments in California have made significant reductions in such expenditures (Sun 2009). These spending cuts have been made in response to the acute crisis precipitated by a significant drop in tax receipts, but they provide a guide as to what course of action counties, cities, and school districts are likely to follow in responding to chronic budgetary duress due to steadily increasing expenditures on retirement benefits.

In evaluating the impact of reduced spending on current services it is useful to recall Niskanen's Law: government agencies feed on the surplus that is the difference between the cost of providing public services and the willingness of the citizenry (or their elected representatives) to pay for them. The value of the services citizens receive from government agencies is not, in other words, identical in value to the amount of money government agencies spend. Sheltered from the disciplinary forces of market competition, government agencies can, thus, possess much in the way of slack resources.

In principle, this is good news. Budgetary duress could induce government agencies to utilize and/or eliminate their slack resources to thereby achieve efficiency gains in service delivery. Neither individuals nor organizations spend much time or effort pursuing gains in efficiency unless they are truly forced to do so. If there is a silver lining here, it is that state and local governments should be able to reduce expenditures significantly before citizens notice a decline in services. At a minimum, budgetary duress heightens awareness of the more egregious examples of excessive spending on current services as well as pension benefits. The embattled citizens of Bell (pop. 36,552), for example, recently discovered that their top city administrators were earning salaries (and pensions) considerably larger than those earned by similarly placed administrators in the city of Los Angeles (population 3,831,868).⁷

Gains in service delivery efficiency can come from innovation, and many government agencies have displayed ingenuity in doing more with less. The city of Lakewood, Washington, for instance, chose not to buy new police cars, but to overhaul its existing fleet of Crown Victorias and retrofit them with a custom performance package. This option cost about half as much as buying new, and the revamped cars were more powerful, safer, and more durable than the 2010 models (Glenn 2010). Local governments can provide more and better service at lower prices by bidding out garbage removal and other tasks to private firms (Dubin and Navarro 1988).

A third source of efficiency is consolidation. By firing all its employees and contracting out the provision of all public services to Los Angeles County and to neighboring cities, the city of Maywood found it could obtain better services for its citizens at lower cost (Vives et al. 2010).

The extreme case of consolidation is disincorporation, in which a city turns over responsibility for all services to the county and ceases to exist as a legal entity (Scott 2010).

More generally, budgetary duress should encourage voters and their representatives to take a closer, more critical look at the information emanating from public employee unions concerning the relationship between expenditures and services provided. Policemen, for example, interact with unpleasant people that most of us

strongly prefer avoiding, and for that reason deserve some wage and benefit premia. They experience, in most years, an on-the-job fatality rate of around 20 per hundred thousand, which is considerably higher than the average of 3.6 per hundred thousand for all occupations.

But, there are many jobs that are much more dangerous (farmers, fishermen, loggers, iron workers, truck drivers) and pay far less. Moreover, policemen do not, on average, die young as a consequence of their career choice. Life expectancy of public safety employees (police and firemen) at time of retirement is indistinguishable from that of government employees in general (Greenhut 2009). In a similar vein, the California Federation of Teachers has long championed the idea that the key to better education is smaller class size. The state of California has spent tens of billions of dollars to hire more teachers in order to reduce average class size in the public schools. It has been extremely difficult, however, to reliably establish a causal relationship between class size and educational attainment (Hanushek 1999).

All in all, it is unwise to expect too much from state and local government efforts to eliminate inefficiency (also known as waste, fraud, and abuse), assuming that they are motivated or compelled to do so. Among other things, collective bargaining agreements make it difficult for state and local governments to fire, demote, or discipline employees for being troublesome or unproductive. It is virtually impossible, for example, to fire a teacher because they are bad at teaching. At some point, reductions in expenditures must result in real reduction in services that disproportionately affect those who disproportionately rely upon them—the poor and disadvantaged.

Because the bulk of spending on current services is devoted to the wages paid to employees performing these services, cuts in such expenditures are achieved primarily by cutting jobs and cutting wages. State and local government employees are contractually guaranteed the pension benefits that they have been promised, but no such guarantees apply to the salary or wages they are paid, to how many hours they work, or even to continued employment (Monahan 2010, p. 32). While it is extremely difficult, as noted above, to cut the pay or to fire public employees for being troublesome and unproductive, it is much less difficult to cut wages across the board, and much less difficult to get rid of those who lack seniority.

Public employees have long enjoyed a high level of job security—the private sector has shed 8 million jobs over the past few years and the public sector almost none—but this is starting to change. A recent study conducted for the National League of Cities reports that during the past year 71% of the cities surveyed had frozen hiring, 51% had frozen or cut wages, 25% had laid off employees, and 19% had given their employees furlough days. Over a fifth had made cuts in spending on police and fire protection. Officials in half the cities surveyed expected to make

additional cuts in jobs and wages as tax revenues continued to lag (McFarland 2010).

By not hiring new employees, laying off current employees, and reducing wages, state and local governments will also reduce future expenditures on retirement benefits. Eventually there will be fewer public employees retiring, and, because their final years of compensation will presumably be lower, they will receive smaller pension payments. Such savings will, over time, bend the cost curve on retirement benefits downward.

Reducing retirement benefit expenditures in this way, however, comes at considerable cost. For the next couple of decades at least, in order to pay retirees the benefits they were promised, what services state and local governments continue to provide will be generated by a smaller, overstretched work force receiving lower wages and benefits than the previous generation of employees. What we can anticipate for many years down the road, particularly in those cities that have especially large pension funding gaps, is a steady degradation in public services combined with rising fees, charges, and fines.

Retirement Benefit Expenditures Revisited

Consideration of the various approaches that might be taken to address the problem of funding public employee retirement benefits is disheartening. State and local governments are contractually obligated to pay retirees the pension benefits they were promised on the day they were hired. At some point some of them may be able to scale back their health care benefits, but this depends upon the outcome of litigation that could wind its way through the courts for a long time. As retirement benefit expenditures inexorably increase and revenue growth remains an uncertain prospect at best, the arithmetic of the budget equation dictates that the primary response of state and local governments will be to continue to reduce expenditures on current services. Rationally, we should seek to avoid this corner solution and make more reasonable trade-offs between the benefits promised to retired employees and the compensation received by current employees.

But how could this possibly be achieved? Logically, there is but one way for state and local governments to reduce the pensions and other benefits that they are contractually obligated to pay retired workers: break the contract. They could do so by simply defaulting on their payments. Cities like Los Angeles and San Diego that have their own pension funds could continue paying pensions until the funds run out of money and then stop. The state of California and local governments in the CalPERS system, as well as public school districts that pay into CalSTRS, could engage in *de facto* default by decreasing or halting entirely the money they pay into these funds.

According to Monahan (2010), there are legal grounds for breach of contract by public agencies. Breach can be “justified by an important public purpose and if the action taken to advance the public interest is reasonable and necessary” (p. 6). Second, state and local governments always retains the power to amend contracts if doing so is necessary to exercise their inherent police powers in order to protect the safety and well-being of the citizenry (p. 7).

There is abundant precedent for state and local governments failing to abide by the terms of their contracts, at least in the area of bonded indebtedness. Several states defaulted on their bonds in the 1830s, and after the Depression of 1873 about one fourth of all municipal bonded indebtedness was in default. New York City defaulted on its bonds in 1975, Cleveland in 1978, the Washington Public Power Supply System in 1983. Litvack and McDermott (2003) report that between 1980 and 2002 there were 2,339 instances of local governments defaulting on bonds totaling \$32.8 billion in face value.

Monahan (2010) indicates that in practice it is much more difficult to stiff retired public employees than bondholders. Specifically, the argument that it would be more beneficial to spend money on providing current services than to pay benefits to retired employees, which is the primary motivation for retrenching retirement benefit expenditures, has been rejected by the Supreme Court:

Merely because the governmental actor believes that money can be better spent or should now be conserved does not provide a sufficient interest to impair the obligation of contract. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all (*U.S. Trust Co. v. New Jersey 1977*, cited by Monahan 2010, p. 26).

Simply defaulting on retirement benefit payments thus does not appear to be a workable option. As indicated earlier, it might be possible for a state or local government to seek reductions in retirement benefits through a collective bargaining agreement, but this assumes that the government would be able to convince the court that the disadvantages of benefit reductions are offset by the benefits of making an insolvent pension plan solvent. Whether this argument could be stretched to apply to retirees in addition to current employees is hard to know, but it would be a major additional hurdle to clear. For these reasons, local governments choosing to renege on contractually guaranteed retirement benefits will almost surely declare bankruptcy under Chapter 9 of the Federal Bankruptcy Code.

In the private sector, bankruptcy has served a number of functions. It allows firms or parts of firms that are otherwise economically viable “going concerns” to get a fresh start by negotiating new terms with their creditors and reorganizing their operations. For those that are not viable, it allows for an orderly liquidation of assets and prevents opportunistic behavior on the part of the firm’s principals.⁸ Chapter 9

bankruptcy, in contrast, does not allow for disincorporation or the liquidation of assets (McConnell and Picker 1993). Furthermore, the separation of powers doctrine forbids courts or court-appointed agents to act as trustees or debtors-in-possession and to thereby directly intervene into the ongoing policymaking processes of the local government.

Chapter 9 is instead solely a mechanism for obtaining relief from debt burdens that cannot be paid. Private and public bankruptcy also differ in the status they afford to collective bargaining agreements (McConnell and Picker 1993, p. 467). Under Chapter 11, private debtors have little or no ability to renege on collective bargaining agreements, while under Chapter 9 local governments may do precisely that, as Judge Michael McManus clearly affirmed in the 2008 Vallejo bankruptcy case.

Since the creation of Chapter 9 during the Great Depression, fewer than 500 local governments have declared bankruptcy, and almost all of them were special districts and not cities or counties. These jurisdictions typically filed for Chapter 9 protection after being hit with a personal injury or wrongful death award that was far in excess of what they could conceivably pay. When Vallejo, California, declared bankruptcy in 2008, however, it was in large part because the city could not pay retirement benefits that included \$135 million for medical care and the \$84 million it owed to CalPERS. In court, Vallejo pointed to “hundreds of millions of dollars in debt that the city shoulders now for services rendered in the past, such as bonds, pensions, and retiree health benefits that consume a large and growing portion of the City’s annual budget” (quoted in Gelinas 2010).

Advocates of pension retrenchment were initially heartened by Judge McManus’ ruling that under Chapter 9 Vallejo had the right to renegotiate terms of its pension plan. When the initial work-out plan left existing pension levels in place, they viewed the Vallejo bankruptcy as a blown opportunity to establish a crucial precedent. On the other hand, the work-out plan does call for reducing health insurance subsidy payments to the cost of the basic Kaiser plan up to a maximum of \$750 per month. These changes reduce Vallejo’s cost of retiree medical care going forward from \$134 million to \$35 million.

A \$100 million retrenchment in retirement benefits would seem to vindicate Vallejo’s decision to enter into bankruptcy, and so provide strong encouragement to many other cities in the state facing similar financial burdens to choose the Chapter 9 option. In a future bankruptcy the city involved could seek to go beyond the Vallejo settlement and seek reduction in pensions as well as in medical care expenditures. A potential focal point for renegotiating pension payments is the policy of the Pension Benefit Guaranty Fund, which assumes the pension obligation of bankrupt private firms. The PBGF currently caps the payments it makes to retirees of defunct firms at \$54,000 a year.

In all likelihood, Vallejo is not the first wave of a coming tsunami of municipal bankruptcies. First, cities seeking protection under Chapter 9 may not receive it. They must first convince the court that they are indeed insolvent, which is not a straightforward exercise. There is no bright shining line demarcating a solvent city from an insolvent one, or a metric signaling that a pension fund has become too badly underfunded to ever be restored to actuarial health. In opposing the Vallejo bankruptcy, for example, the public employee unions identified monies in several special funds that could be tapped (and presumably repaid the day after tomorrow) in order to continue funding retirement benefits.

Poor credit ratings are probably a necessary condition for declaring bankruptcy but not a sufficient one. Many local governments in California have bonds that are rated below investment grade, but are not candidates for bankruptcy. In order to go bankrupt a city must also demonstrate to the court that holders of a majority of claims have consented (we can assume that public employee unions will not so consent) or that they have made a good faith but unsuccessful effort to reach a settlement with claimholders.

Bankruptcy is also ugly and expensive. Among other things, a work-out plan involves bondholders as well as pensioners; Vallejo, for instance, has not paid full interest on its bonds since going bankrupt, and is seeking a three-year deferral of interest in its work-out plan (Gelinas 2010). The Vallejo case thus shows that a city entering into Chapter 9 can expect large legal expenses, years of uncertainty, and little or no access to the credit markets.

The most significant obstacle to Chapter 9 bankruptcy, however, is political opposition within the city itself. Public employee unions can be counted on to fight a bankruptcy filing tooth and nail, as potential retrenchment represents not only a loss of benefits to their members but a dangerous threat to their reputation. As indicated earlier, if a union cannot defend the benefits won for previous workers who are now retired, its credibility with current workers would surely suffer.

There is also a stigma attached to bankruptcy that makes it anathema to politicians and voters alike. Pension funds for the employees of San Diego have been chronically underfunded, and the city has lurched from one budgetary crisis to the next (Erie, Kogan, and McKenzie 2010). In 2005 then City Attorney Mike Aguirre advocated a renegotiation of the terms of the city's pension plans, or, failing that, filing for bankruptcy in order to avoid significant tax increases or cuts in public services.

As it is written, however, a prophet is not without honor except in his hometown. Aguirre was defeated for reelection in November 2008 by an establishment Republican candidate strongly backed by the public employee unions. Even though it may well be in the best long-run interests of many California cities to file for bankruptcy

under Chapter 9, those who govern them, as well as the citizens who reside within them, appear to be extremely reluctant to go gently into that good night.

Repealing Ledyard's Law: Constitutional Constraints on Stealing from the Future

The constitution of the state of California is a long, complicated document composed of 35 articles and literally hundreds of subsections. Much of it reflects policy approved over the years by the voters through the initiative process. According to Buchanan and Wagner (1977), this is not what a constitution should be; "genuine constitutional measures," they assert, should instead be "rules designed to constrain the short-run expedient behavior of politicians" (p. 8). The three amendments to the constitution of California proposed below are in keeping with Buchanan and Wagner's view of constitutions as constraints. More specifically, they are intended, at least in the realm of public employee compensation, to repeal Ledyard's Law.

First, the constitution of California should be amended to forbid the state of California, as well as all local governments within the state, from ever again issuing pension obligation bonds. Public officials have neither the time, the training, nor the inclination to successfully engage in risk arbitrage. Borrowing money to replenish underfunded pension funds is one of the most reckless of all budgetary ploys available, and, as some critics have noted, can be done without voter approval. Frankly, this amendment is necessary to make sure such bond issues are not put before the voters, as there is a strong possibility they would approve pension obligation bonds if given the chance to do so. Pension obligation bonds should be banned, period.

Second, the constitution of California should be amended to forbid the state from guaranteeing, assuming, or subsidizing either the debt or pension obligations of local governments. In present circumstances this is such a bad idea that even the California State Legislature might refrain from considering it. But let's not take the chance.

Third, the constitution of California should be amended to forbid the state of California, as well as all local governments within the state, from ever again offering their employees defined benefit pension plans. They could instead offer 401(k) defined contribution plans, which is the form of retirement plan offered by almost all private firms today. Adopting a defined contribution plan need not be a round-about way of providing new employees inferior pension benefits. State and local governments, like many private-sector firms, could make these plans quite generous by matching employee contributions.

Defined benefit plans also allow employees to make their own investments and choose the level of risk to which they are exposed, rather than be included with millions of others in CalPERS or similar one-size-fits-all retirement systems. But

make no mistake. Switching from a defined benefit to a defined contribution plan is a fundamental reform. It means that state and local government employees would be compensated for services rendered at the time those services were rendered. What government officials and the voters who elect them would no longer be able to do is obtain services today in return for retirement benefits to be paid for the day after tomorrow.

Three states—Alaska, Nebraska, and Michigan—currently have mandatory defined contribution plans for state employees, and six other states provide optional defined benefit plans. It turns out that nearly half a million public employees in California already participate in a defined contribution plan (Chiang 2010). The proposed amendment would permit California state and local governments to adopt a cash balance plan such as that in Nebraska. This plan requires both employees and employers to make regular contributions into an account, guarantees an annual rate of return (5% in the Nebraska plan), but at the time of retirement the employee cashes out by either buying an annuity, taking the lump sum, or taking a series of installment payments (Snell 2010).

Governor Schwarzenegger proposed conversion to defined contributions five years ago (Broder 2005), as advocated by Passantino and Summers (2005). This initiative was never placed on the ballot, but such a measure could be put to the voters in the near future. If so, available polling data indicates it would be favorably received, at least initially. A January 2010 PPIC opinion survey asked the following question: “Would you favor or oppose changing the pension systems for new public employees from defined benefits to a defined contribution system similar to a 401(k) plan?” Californians deemed by the pollsters to be likely voters supported this proposal by a 70-21 margin (Baldassare et al., 2010).

It will be decades, of course, before any of the benefits of these proposed amendments are realized. For the next several years, as retirement benefit expenditures inexorably increase, state and local governments will continue to rein in expenditures on current services and increase fees, charges, and fines wherever they can. Ledyard’s Law is one of the strongest of all laws governing human nature, so it may be wishful thinking to believe that these three amendments could ever be adopted. But repealing Ledyard’s Law, if only in the realm of public employee retirement benefits, is something of great value that we can bequeath to future generations.

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Notes

While most government agencies do not face competition in the marketplace for the goods and services they produce, they do face competition from other government agencies, as well as from private firms, in the labor market. A police department seeking to hire new officers, for example, must offer salaries and benefits that are competitive with those offered by other departments. This competition, however, acts to increase an agency's costs of production, and not to lower the price they can command for their services.

² Some public employees have been allowed to include overtime, unpaid vacation, and sick leave to increase their final year's salary so as to "spike" their pension payments. More generally, state and local governments have "picked up" some or all of employees' pension contributions. In addition to reducing or eliminating employee contributions, employer contributions are counted as additional salary in the calculation of pension benefits.

³ 10^{14} equals one hundred trillion, but scientific notation is generally used when dealing with such large values. Besides being much larger in magnitude, the Social Security and Medicare Trust Funds face worse funding predicaments than public employee pension funds because they are constrained by law to invest all their assets in "special issue" U. S. Treasury securities. These debt instruments define safety, but correspondingly yield very low rates of return.

⁴ In 2004 the city of San Diego planned to backfill its actuarially unsound employee pension funds by borrowing \$600 million in pension obligation bonds, but the adverse reaction of bond rating agencies blocked their access to the market and thus prevented them from doing so (Erie, Kogan, and McKenzie 2010).

⁵ I would like to thank Amy Monahan for pointing this out to me.

⁶ Available data on union elections indicates that retirees are much more likely to vote than active working members. In a 2007 New York United Federation of Teachers elections nearly as many ballots were received from retirees (22,500) as from active members (24,235) even though the latter group was far larger (Philips 2010).

⁷ The city of Bell scandal might be an unusually flagrant case, but it is not difficult to find other examples. One hundred public school administrators in Illinois, for instance, are projected to receive over \$1 billion in retirement benefits (Barone 2010).

⁸ In an excellent review of private bankruptcy practice, Baird and Rasmussen (2002) observe that, for the most part, bankruptcy no longer functions as an institutional framework to facilitate bargaining between distressed firms and their creditors. It has become instead a mechanism to formally ratify bargains already been struck prior to filing.