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# Combating Moral Hazard: The Case for Rationalizing Public Employee Benefits

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RATIONALIZING PUBLIC EMPLOYEE BENEFITS**

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**COMBATING MORAL HAZARD:  
THE CASE FOR RATIONALIZING PUBLIC EMPLOYEE BENEFITS**

**Maria O'Brien Hylton\***

- **Professor of Law, Boston University School of Law. Thanks to Mia Midenjak and Jeremy Mason for excellent research assistance.**

**ABSTRACT:** the current crisis in public employee benefits is a fairly conventional moral hazard story about overly generous promises made by both private sector employers and politicians spending public dollars. The private sector, forced by the Financial Accounting Standards Board (FASB) in 1993 to confront the true cost of promises made to future retirees, dealt with the newly discovered debt in a number of ways, including the termination of defined benefit plans which were quickly replaced by defined contribution plans. The public sector was also forced to confront its own largesse with the implementation of GASB 45, which focused careful attention on the present value of the level of benefits promised. This period of scrutiny coincided with skyrocketing health care costs and a deep recession that saw enormous private sector job loss and, unsurprisingly, growing resentment by private sector employees of the relatively lavish benefits still enjoyed by unionized public workers. This paper describes the astonishing scope of public sector benefits-driven indebtedness and provides an account which contrasts the prudent self-correction process in the private sector with the ongoing struggle of many states to address the issue. In addition, the paper proposes specific reforms—the movement of all employees into DC plans; mandated use of realistic rates of return; the explicit promotion of the cultural norms of thrift and frugality; and, in extreme cases where the political landscape appears incapable of responding effectively to the crisis, the modification of legal regimes to prohibit collective bargaining over benefits – for policy makers to consider.

- I. **INTRODUCTION:** In the middle of the 20<sup>th</sup> century, both private and public employers committed themselves to employee benefits for current employees and retirees that would ultimately prove unaffordable as the population aged and the cost of health care soared. Many private enterprises, pushed by FAS 106<sup>1</sup>, took a series of steps designed to correct and rationalize these benefits beginning in the mid-1990s. The public sector, plagued as always by the presence of political factors, and allowed more time by GASB 45<sup>2</sup>, moved much more slowly to address the problem of unaffordable benefits for retirees and current workers. New Jersey, for example, is estimated to carry a pension obligation that equals 44% of its total GDP.<sup>3</sup> A little further to the west, Illinois is described this way:

After 30 years of the state's procrastination, the pension burden has grown backbreaking. Illinois' five pension funds are \$35 billion in the red, a serious

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<sup>1</sup> Financial Accounting Standards Board (FASB), Employers' Accounting for Postretirement Benefits Other Than Pensions, Statement of Financial Accounting Standards No. 106, Norwalk, CT, Dec. 1990. See Accounting Foundation, <http://www.accountingfoundation.org/cs/ContentServer?site=Foundation&c=Page&pagename=Foundation%2FPa ge%2FFAFSectionPage&cid=1176158231339> (last visited Aug. 8, 2011) ("Organized in 1972, the Financial Accounting Foundation (FAF) is the independent, private-sector organization with responsibility for: Establishing and improving financial accounting and reporting standards; Educating constituents about those standards; The oversight, administration, and finances of its standard-setting Boards, the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB), and their Advisory Councils; Selecting the members of the standard-setting Boards and Advisory Councils; and Protecting the independence and integrity of the standard-setting process.

Financial Accounting Standards Board (FASB): Established by the FAF in 1973, the FASB has been delegated the authority to establish standards of financial accounting and reporting for private-sector entities, including business and not-for-profit organizations. FASB standards are recognized as generally accepted and authoritative.")

<sup>2</sup> Governmental Accounting Standards Board (GASB), Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, Statement No. 45, Jun 2004.

<sup>3</sup> The Crisis in Public Sector Pension Plans: A Blueprint for Reform in New Jersey, Eileen Norcross and Andrew Biggs, June 23, 2010 ("New Jersey reports that its pension systems are underfunded by \$44.7 billion, when liabilities are discounted at the 8.25 percent annual return that New Jersey predicts it can achieve on funds' investment portfolios. However, when plan liabilities are calculated in a manner consistent with private sector accounting requirements, methods that economists almost universally agree are more appropriate, New Jersey's unfunded benefit obligation rises to \$173.9 billion. This amount is equivalent to 44 percent of the state's current GDP and 328 percent of its current explicit government debt. This calculation applies a discount rate of 3.5 (the yield on Treasury bonds with a maturity of 15 years) to reflect the nearly risk free nature of accrued benefits for workers. It is estimated if state pension assets average a return on 8 percent, they will run out of funds sooner. State actuaries estimate that under certain assumptions, New Jersey's pension plans will run out of assets to make benefit payments beginning in 2013").

shortfall for a state with a general operating budget of \$43 billion this year. Illinois owes \$2.6 billion this year, and within five years that will reach \$4 billion annually. By comparison the state will spend \$5.9 billion total on kindergarten through 12<sup>th</sup> grade education next year. “If we were a business we wouldn’t be in chapter 11, we’d be in chapter 13,” [sic] says Ralph M. Martire, executive director of the Center for Tax & Budget Accountability, a Chicago-based non-profit think tank. “We’d have to liquidate.” Illinois is not a fast-growing state that can hope that future population and tax growth will bail it out. D’Arcy of the University of Illinois calculates that Illinois should be 97% funded based on its rate of income growth. Instead retirement funds are 62% funded.<sup>4</sup>

And, even further west, the picture is just as grim. California is estimated to become insolvent by the early 2030s.<sup>5</sup> Smaller government bodies in the state are already leading the way. Vallejo<sup>6</sup> filed for chapter 9 in 2008 “after property tax revenues collapsed in the housing bust and a major employer—the U.S. government’s Mare Island Shipyard—closed. With the tax base hammered, rich public employee contracts granted in better times were devouring more than 90% of the city’s budget.”<sup>7</sup>

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<sup>4</sup> Special Report, Sinkhole! How public pension promises are draining state and city budgets, Bloomberg Businessweek, Jun 13, 2005, available at [http://www.businessweek.com/magazine/content/05\\_24/b3937081.htm](http://www.businessweek.com/magazine/content/05_24/b3937081.htm) (Of course, Mr. Martire meant Chapter 7 and not Chapter 13).

<sup>5</sup> Municipal Research Special Report, States’ Pensions: A Manageable Longer-Term Challenge, Barclays Capital, May 18, 2011 at 15, available at <http://www.nasra.org/resources/barclays1105.pdf> (Range of estimates from 2026 to 2044, with 2037 considered most accurate); see also The Day of Reckoning For State Pension Plans, Joshua Rauh, March 22, 2010, available at <http://kelloggfinance.wordpress.com/2010/03/22/the-day-of-reckoning-for-state-pension-plans/>.

<sup>6</sup> In re City of Vallejo, 08-26813, U.S. Bankruptcy Court, Eastern District of California, filed May 2008. See Jonathan Weber, For Vallejo, Bankruptcy Isn’t Exactly a Fresh Start, The Bay Citizen, Jan 22, 2011, available at [http://www.nytimes.com/2011/01/23/us/23bcweber.html?\\_r=1](http://www.nytimes.com/2011/01/23/us/23bcweber.html?_r=1) (Vallejo is set to emerge this summer with reduced health care payments and increased employee contributions, but pensions remain the same); see also Bobby White, Long Road Out of Bankruptcy, Wall Street Journal, May 5, 2011.

<sup>7</sup> Jonathan R. Laing, The \$2 Trillion Hole, Barron’s, Mar 15, 2010, available at [http://online.barrons.com/article/SB126843815871861303.html#articleTabs\\_panel\\_article=3](http://online.barrons.com/article/SB126843815871861303.html#articleTabs_panel_article=3).

This paper analyzes the core moral hazard problem<sup>8</sup> that has plagued public pensions and other benefits for those who work for the state—i.e. the apparently irresistible tendency of state legislators and executive branch officials to spend taxpayer dollars to enhance benefits and decrease contributions during flush economic times in exchange for voter support at the polls. By moral hazard I mean, essentially, the subsidization by taxpayers of unaffordable commitments entered into by their political representatives during the course of bargaining with public unions. (In general, moral hazard problems arise in the context of information asymmetry: one party (politicians) has more information and less concern about the consequences of their behavior than the party that must pay (taxpayers). The argument here is that politicians have essentially spent and committed future taxpayer dollars with far less care than they would have spent their own, private funds. This behavior is explained by a desire to gain the support of public sector unions and their members and encouraged by a generally ignorant and unsuspecting public.) Paul Krugman has described moral hazard as “... any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly.”<sup>9</sup> Part II retraces the history pre-dating the current crisis and the role that FAS 106 and GASB 45 played in finally forcing both public and private employers to disclose the true cost of their promised future commitments. Part III focuses on three states that have managed to rein in costs by adopting private sector-style reforms and three that have struggled and thus far failed to rationalize their public benefits cost structure. Part IV draws on the experiences of the most successful states and the private sector and proposes a menu of specific reforms designed to combat the worst tendencies of state politicians to spend without regard to future cost to the taxpayer. Only reforms like those forced upon the private sector by FAS 106 can bring down future benefits costs in the public sector. And, to avoid a repeat of the current fiscal crisis, states must eliminate, as much as possible, incentives that encourage decision

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<sup>8</sup> See <http://wordnetweb.princeton.edu/perl/webwn?s=moral%20hazard> (“moral hazard: (economics) the lack of any incentive to guard against a risk when you are protected against it (as by insurance)”).

<sup>9</sup> Paul Krugman, *The Return of Depression Economics and the Crisis of 2008*, (2009) at 63.

makers in the public sector to spend public dollars with much less care than comparable private dollars; in extreme cases it may be necessary to prohibit bargaining over health insurance and retirement income for current and future employees. Part V concludes.

## II. **How We Got Here: Measuring OPEB and Pension Liabilities**

The story of the current projected \$3.9 trillion shortfall<sup>10</sup> in promised state and local government retiree benefits is a classic public choice tale, consisting of the usual self-interested and vaguely disorganized politicians, an unsophisticated and ignorant electorate and well organized interests (in this case public employee unions) in search of maximum private benefit via access to public dollars.<sup>11</sup> The dominant theme is political self-interest, short horizons and a persistent disconnect between easy-to-make promises and their real, future cost. In the 1960s many large private enterprises began offering retiree health care and “other post-employment benefits” (OPEBs).<sup>12</sup> Private pensions, at this point in U.S. history, were almost invariably offered in the form of defined benefit (DB) plans—much like the pensions that still dominate the public sector today.<sup>13</sup> DB plans typically guaranteed

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<sup>10</sup> A gold-plated burden: hard pressed American states face a crushing pensions bill, *The Economist*, Oct. 14, 2010, available at <http://www.economist.com/node/17248984> (Joshua Rauh, of the Kellogg School of Management at Northwestern University, and Robert Novy-Marx, of the University of Rochester, estimate that the states’ pension shortfall may be as much as \$3.4 trillion and that municipalities have a hole of \$574 billion”).

<sup>11</sup> J.G. Cullis & P.R. Jones, Public Finance and Public Choice: Analytical Perspectives, 3rd ed., Oxford University Press (2009); see also S. Connolly & A. Munro, Economics of the Public Sector, Prentice Hall (1999); Peter Self, Government by the Market?: The Politics of Public Choice, (1993); J. Murray Horn, The Political Economy of Public Administration, institutional choice in the public sector, (1995).

<sup>12</sup> Martin Feldman & Roscoe Haynes, Effect of New GASB 45 Accounting Rules: What We Can Learn From FAS 106, *Benefits and Compensation Digest*, Mar. 2007 at 19-20.

<sup>13</sup> Eileen Norcross & Andrew Biggs, The Crisis in Public Sector Pension Plans: A Blueprint for Reform in New Jersey, Jun 23, 2010, available at <http://mercatus.org/pensions#end32> (“Under a defined benefit (DB) plan, the employer promises employees a regular pension payment (i.e. an annuity) over the worker’s retirement years. The amount of the benefit payment depends on the worker’s age, years on the job, and a measure of their final salary. More specifically, benefit formulas generally pay a given percentage of the employee’s final salary multiplied by the

workers a specific monthly retirement benefit based primarily on pay and length of service. Employers were not required to account on their balance sheets for the present value of OPEB promises; instead they used a pay-as-you-go system and reported only expenditures incurred in a given year for current retirees. Shorter life expectancies for an overwhelmingly male workforce (which was in turn a function of both less sophisticated health care for end-of-life conditions and popular (albeit unhealthy) habits such as tobacco consumption<sup>14</sup>) meant these OPEB debts were modest and of little concern.

The 1980s and 1990s witnessed an unprecedented bull run in the stock market as well as rising health care costs. In some years, medical costs increased by more than 20% per year.<sup>15</sup> Public pension funds began shifting assets into risky equities instead of the low risk, fixed income investments which had been long time favorites. The stock market's astonishing performance caused many (public and private) pension funds to appear overfunded; and, politicians were receptive to union requests for more pay and improved benefits at lower

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number of years of employment. In a defined benefit plan, investment risk is borne by the employer since the employer's payment is independent of the investment return earned by the pension's fund)."

<sup>14</sup>Barbara A. Lingg, Women Beneficiaries Aged 62 or Older, 1960-88, Social Security Administration at 3-4, available at <http://www.ssa.gov/policy/docs/ssb/v53n7/v53n7p2.pdf> ("During the past six decades, women have represented an increasing percentage of the Nation's workforce. In 1930, 10 million women workers accounted for 22 percent of the total workforce. Thirty years later, 23 million women workers accounted for one-third of the labor force. In 1988, the 55 million women in the labor force comprised 45 percent of the total workforce"). For statistics on smoking rates, see Marc Kaufman, Decades-Long U.S. Decrease in Smoking Rates Levels Off, Washington Post, Nov 9, 2007, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/11/08/AR2007110801094.html>; Morbidity and Mortality Weekly Report, Vital Signs: Current Cigarette Smoking Among Adults, Centers for Disease Control and Prevention, Sept 7, 2010, available at <http://www.cdc.gov/mmwr/pdf/wk/mm59e0907.pdf>; Smoking Prevalence Among U.S. Adults, 1955-2007, infoplease, <http://www.infoplease.com/ipa/A0762370.html> (Over 45% of the population smoked regularly in 1965, while only 20.8% of the population were smokers in 2007).

<sup>15</sup> Martin Feldman & Roscoe Haynes, Effect of New GASB 45 Accounting Rules: What We Can Learn from FAS 106, Benefits and Compensation Digest, Mar 2007 at 19-20.

contribution levels (in exchange, presumably for promises of ongoing support at the polls).<sup>16</sup>

Many fund managers began to expect annual returns of 8% or better.

### **The Private Sector Owns Up To Its Debt**

In 1990, when the Financial Accounting Standards Board (FASB)<sup>17</sup> issued FAS 106, private employers were required for the first time to account for the present value of OPEBs.

Actuaries were to apply a discount rate of 6% to determine the present value of all promised benefits. Six percent reflected a blended average of the historic rate of interest on U.S.

Treasuries and high-grade corporate bonds.<sup>18</sup> FAS 106 meant that shareholders and others could see how much debt a company was carrying in the form of future promised benefits to employees. (This change, long overdue, should be contrasted with the longstanding

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<sup>16</sup> Barro & Buck, Underfunded Teacher Pension Plans: It's Worse Than You Think, Manhattan Institute for Policy Research, Apr 2010 ("Instead of setting aside investment gains for future pension payments, state governments started 'shortening vesting periods, increasing the multipliers used in determining benefit amounts, decreasing the age at which employees could receive full retirement benefits and shortening the years of service needed to qualify. New York, New Jersey, Illinois, Pennsylvania, Kentucky, California, Colorado and other states increased benefits.' (Pew 2006, p.8)").

<sup>17</sup> Facts about FASB, FASB, 2007, [http://www.fasb.org/facts/facts\\_about\\_fasb.pdf](http://www.fasb.org/facts/facts_about_fasb.pdf) ("Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting Release No. 1, Section 101 and reaffirmed in its April 2003 Policy Statement) and the American Institute of Certified Public Accountants (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979). Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors, and others rely on credible, transparent, and comparable financial information. The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest"); see also Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, SECURITIES AND EXCHANGE COMMISSION [Release Nos. 33-8221; 34-47743; IC-26028; FR-70], available at <http://www.sec.gov/rules/policy/33-8221.htm>.

<sup>18</sup> Barro & Buck, Underfunded Teacher Pension Plans: It's Worse Than You Think, Manhattan Institute for Policy Research, Apr 2010, available at [http://www.manhattan-institute.org/html/cr\\_61.htm](http://www.manhattan-institute.org/html/cr_61.htm) ("Private plans generally choose a discount rate based on a blended average of corporate bonds in the Moody's Aa rating range, pegged by Mercer Consulting as of February 2010 at 6.06 percent over a fifteen-year plan horizon, the typical period used by public-sector plans").

requirement that employers account for future pension costs and set aside cash each year to satisfy those costs.)<sup>19</sup>

As employers began reporting their OPEB debt, FAS 106 generated unusual amounts of attention outside of accounting circles. The Big Three U.S. automakers alone reported a total OPEB liability of \$35.7 billion.<sup>20</sup> Private sector enterprises generally employed one or both of the following techniques in order to right size their OPEB liability: first, they took enormous write-downs. For example, General Motors wrote down \$23.5 billion in 1990<sup>21</sup>; AT&T took a \$7.5 Billion charge, and IBM took a “\$2.7 billion charge against \$37 billion in shareholder equity”. Second, many employers threatened bankruptcy or actually restructured themselves through bankruptcy, terminating defined benefit plans and moving employees into defined contribution plans en masse.<sup>22</sup> The new DC plans often required

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<sup>19</sup> Employee Retirement Income Security Act of 1974 (ERISA); see also Underfunding of Private Pension Plans, Federal Reserve Bank of San Francisco (FRBSF) Economic Letter, 2003-16; Jun 13, 2003, available at <http://www.frbsf.org/publications/economics/letter/2003/el2003-16.html> (“ERISA, which mandates the funding requirements for DB plans, requires companies to make a normal contribution to their pension plan that is equal to the normal pension cost, called the Net Periodic Pension Cost (NPPC). The NPPC is expensed in a sponsoring firm's income statement, and it includes changes in a firm's pension obligations as a result of services rendered by employees. But in calculating the NPPC, those costs are netted against the firm's expected return on plan assets. Note that the expected rate of return is determined by the sponsoring firm and could depart significantly from the plan assets' realized return.

ERISA also requires additional contributions based on a plan's funding status. In computing the funding status, ERISA compares the market value of plan assets to the ABO, which generally is less than the PBO. For a plan that is less than 90% funded, ERISA requires the sponsoring firm to make an additional contribution to the plan to reduce the funding deficiency within three to five years. There are exceptions, however. If a plan is over 80% funded today and was more than 90% funded for the past two years, the additional contribution requirement is waived. Furthermore, companies may request a hardship waiver or an extension period to meet the normal and additional contribution requirements”).

<sup>20</sup> Elizabeth K. Keating & Eric S. Berman, Unfunded Public Employee Health Care Benefits and GASB No. 45, Accounting Horizons, Vol. 21, No. 3, Sept 2007 at 248.

<sup>21</sup> Health-care bill: \$ 335B, Retiree liability expected to rise, USA TODAY, Dec 5, 1991 (“ AT&T's Tuesday announcement that it will charge up to \$ 7.5 billion against assets to comply with an accounting-rule change known as Financial Accounting Standard 106 adds to a fast-growing list of companies that have made the painful jump. “); Book value to get socked by FAS 106, THE DALLAS MORNING NEWS, Jan 3, 1993 (IBM took a \$2.7 billion charge).

<sup>22</sup> Bankers Up in the Air Over FAS 106 funds, U.S. Banker, Dec., 1993 (“Allan Martin, Bankers Trust New York Corp.'s managing director for retirement services, says most corporations have been focusing on their health care liabilities rather than on the accounting for them, in anticipation of FAS 106. He says many have been cutting

higher levels of employee contribution and, of course dramatically reduced performance risk for the sponsoring employer.<sup>23</sup>

Not all employers were able to reduce or eliminate their OPEB liability. Indeed a 2005 Standard and Poor's study pegged the total underfunded OPEB liability of all S&P 500 companies at \$292 billion— almost twice the size of their total pension liabilities.<sup>24</sup> Johnston & Johnston, General Electric and Boeing remain examples of large companies with substantial OPEB liabilities that have yet to be completely addressed<sup>25</sup>.

Between 2000 and 2006 a housing bubble formed in the U.S. that would make the earlier tech bubble<sup>26</sup> seem contained by comparison. One consequence of the rapid climb in

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benefits, capping them or switching them to defined-contribution plans"); see also Companies face up to retiree health liability, Pensions & Investments, Sept. 30, 1991 ("Chrysler was the first to disclose its potential liability of \$ 4 billion to \$ 6 billion and has implemented a defined contribution approach to controlling retiree medical costs").

<sup>23</sup> Firms continue to cut retiree health plans, Business Insurance, Dec. 6, 1993 ("Some 47% of surveyed employers reported having modified their retiree health benefits in the previous two years. Another 22% said changes were planned this year. Larger employers were more likely to make changes than smaller ones: 51% of those with 1,000 or more employees said they had made changes, compared with only 37% of smaller employers. Some 30% of all surveyed employers said they had raised retiree premium contributions, and 21% shifted costs by raising deductibles, coinsurance or out-of-pocket maximums. Eleven percent reported having tightened eligibility standards. 'Some changes were aimed at making retiree benefit cost more predictable, probably with (Financial Accounting Standard) 106 in mind: 9% of employers installed (or decreased) the lifetime maximum benefit, and 5% changed from a defined benefit to a defined contribution or fixed-dollar approach,' Foster Higgins said").

<sup>24</sup> S&P 500 Companies Significantly Under Funded for Other Post Employment Benefits (OPEB), Standard & Poor's, Dec 19, 2005, available at [http://www2.standardandpoors.com/spf/pdf/index/121905\\_500OPEB.pdf](http://www2.standardandpoors.com/spf/pdf/index/121905_500OPEB.pdf).

<sup>25</sup> S&P 500 2010: Pensions and Other Post Employment Benefits (OPEBs), S&P Indices, May 26, 2011, available at [http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldata&blobtable=MungoBlobs&blobheadervalue2=inline%3B+filename%3DSP\\_500\\_OPEB-Pensions-May26-2011.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1243908577565&blobheadervalue3=UTF-8](http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldata&blobtable=MungoBlobs&blobheadervalue2=inline%3B+filename%3DSP_500_OPEB-Pensions-May26-2011.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1243908577565&blobheadervalue3=UTF-8).

<sup>26</sup> Chris Gaither & Dawn C. Chmielewski, Fears of Dot-Com Crash, Version 2.0, Los Angeles Times, Jul 16, 2006, available at <http://articles.latimes.com/2006/jul/16/business/fi-overheat16> ("The market value of Nasdaq companies peaked at \$6.7 trillion in March 2000 and bottomed out at \$1.6 trillion in October 2002"). Total losses from peak of US property bubble are estimated at \$4.3 trillion. While this is a smaller number than the \$ 5.1 trillion lost in the NASDAQ, it affected a much broader base of the population. And, the dot-com bubble was fueled by paper gains, while the real-estate bubble lead to real debts.

housing prices during this time was a dramatic increase in property tax revenues<sup>27</sup>. State and local governments, flush with cash, responded to union demands in the same way they did when the stock market was rising inexorably. Numerous states granted public employees increased benefits at decreased contribution levels. In some states, contribution levels dropped below 2% and employees could retire in their 40s and 50s—many years before reaching the Medicare eligibility threshold of 65.<sup>28</sup>

Some states encouraged employees to use up saved vacation and over-time during their last year of employment in order to inflate their income; the state would then pay 90% of this “final salary”—an amount often greater than the retiree’s true base pay. For the first time large numbers of public employees began receiving six figure pensions. And, by some

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<sup>27</sup> Nin-Hai Tseng, The tax man doesn’t want housing to recover, Fortune, Jun 27, 2011, available at <http://finance.fortune.cnn.com/tag/property-tax/>; Charles Hugh Smith, Property Taxes Keep Rising as Home Values Keep Falling, DailyFinance, Dec. 18, 2010, available at <http://www.dailyfinance.com/2010/12/18/property-taxes-keep-rising-as-home-values-keep-falling/>; Natalia Siniavkaia, Property Tax Rates After the Housing Downturn, National Association of Home Builders, Apr 4, 2011, available at <http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=155396&channelID=311>. Florida experienced rapid property tax growth. See Tim Padgett, Florida’s Property Taxes Go Wacky in Housing Slump, Time, Jun 29, 2009, available at <http://www.time.com/time/business/article/0,8599,1907198,00.html>. Virginia, which did not see nearly as much development as Florida, still enjoyed substantially increased revenues. See John L. Knapp, How the Housing Boom Affects Virginia’s Real Estate Tax, The Virginia News Letter, Oct 2005, available at <http://www.coopercenter.org/sites/default/files/publications/vanl1005.pdf>; Gerald Prante, Property Tax Collections Surged with Housing Boom, Tax Foundation, Oct 2006, available at <http://www.taxfoundation.org/files/sr146.pdf>.

<sup>28</sup> Promises with a Price: Public Sector Retirement Benefits, Pew Center on the States, (2006) at 8, available at <http://www.pewcenteronthestates.org/uploadedfiles/Promises%20with%20a%20Price.pdf> (“Legislatures responded... by shortening vesting periods, increasing the multipliers used in determining benefit amounts, decreasing the age at which employees could receive full retirement benefits and shortening the years of service needed to qualify. New York, New Jersey, Illinois, Pennsylvania, Kentucky, California, Colorado and other states increased benefits”); see also A gold-plated burden: hard-pressed American states face a crushing pensions bill, The Economist, Oct 14, 2010, available at <http://www.economist.com/node/17248984> (“In New Jersey “Employees’ contributions were cut from 5% of payroll to 3%. New Jersey also increased benefits, giving pension rights to surviving spouses in 1999 and a boost of 9.1%, in effect, to scheme members in 2001, just as the dotcom bubble was bursting and the fund’s assets were falling in value”).

accounts public sector unions were so successful at securing salary and benefits increases that average public sector pay and benefits surpassed private sector averages.<sup>29</sup>

### **The Public Sector's Turn: GASB 45 and Discount Rates**

Finally, in 2004, the Governmental Accounting Standards Board (GASB)<sup>30</sup> effectively imported FAS 106 from the private sector. GASB 45 required the same kind of disclosure

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<sup>29</sup> Employer Costs For Employee Compensation, Bureau of Labor Statistics, Jun 8, 2011, available at <http://www.bls.gov/news.release/pdf/ecec.pdf> ("Total employer compensation costs for private industry workers averaged \$28.10 per hour worked in March 2011. Total employer compensation costs for State and local government workers averaged \$40.54 per hour worked in March 2011"); see Mortimer B. Zuckerman, Public Sector Workers Are the New Privileged Elite Class, U.S. News & World Report, Sept. 10, 2010, available at <http://www.usnews.com/opinion/mzuckerman/articles/2010/09/10/public-sector-workers-are-the-new-privileged-elite-class>; How to Tackle Government Labor Costs, The Wall Street Journal, Apr 29, 2010 ("Years ago, there was an informal "social contract" -- public employees generally received lower wages than private-sector workers, and in return they got earlier retirement and generous pensions, allowing them to catch up. That arrangement has long since gone by the boards. The result is a remarkable trend. State and local government employees for years have received pay increases in excess of inflation, and BLS figures show they now have wages that are 34% higher on average than in the private sector.

Partly responsible for these trends is unionization, which the Department of Labor reports has jumped to 37.4% of the public sector in 2009 from 24.1% in 1973 (unionization in the private sector declined to 7.2% from 25.4% in the same time period). The result is often pay levels higher than needed to attract qualified employees. The average quit rate among state and local employees is a third of that in the private sector.

Public employees also have a 70% advantage in benefits. Health insurance, retirement benefits, life insurance and paid sick leave are not only much more available to them, but much richer. In 2009, BLS figures indicate that the costs of health insurance were 2.18 times as much for state and local employees as for private-sector workers"); see also Adam Summers, Comparing Private Sector and Government Worker Salaries, Reason Foundation, May 10, 2010, available at <http://reason.org/news/show/public-sector-private-sector-salary>; George Stephanopoulos, Working in America: Public vs. Private Sector, ABC News, available at <http://blogs.abcnews.com/george/2011/02/working-in-america-public-vs-private-sector.html>; Dan Bobkoff, Public V. Private Sector: Who's Compensated More?, NPR, Feb. 25, 2011, available at <http://www.npr.org/2011/02/25/134065799/Truth-Squading-Public-Private-Pay-And-Benefits>

<sup>30</sup> Facts About GASB, Governmental Accounting Standards Board, 2010-2011, available at <http://www.gasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821770571&blobheader=application%2Fpdf> ("The Governmental Accounting Standards Board (GASB) is the independent organization that establishes and improves standards of accounting and financial reporting for U.S. state and local governments. Established in 1984 by agreement of the Financial Accounting Foundation (FAF) and 10 national associations of state and local government officials, the GASB is recognized by governments, the accounting industry, and the capital markets as the official source of generally accepted accounting principles (GAAP) for state and local governments").

procedures for state and local government accounting. Various government entities had to determine the present value of their pension and OPEB obligations. States and municipalities with annual revenues of \$100 million or more had until 2007 to begin reporting; smaller governments had until 2010.<sup>31</sup>

GASB advised governments to make an annual contribution that covered both current benefits and contributed to the cost of future benefits. Governments could either make a large down payment and set up a fund to cover OPEBs, or they could continue to use a pay-as-you-go system using a higher annual contribution rate (ACR).<sup>32</sup> If there was no money set aside, then the difference between the ACR and what was actually paid would show up as a liability on the balance sheet. The actual present value of the total unfunded debt was relegated to a footnote.<sup>33</sup>

Reaction to GASB 45 was swift and furious—politicians worried about political backlash from astonished taxpayers; unions feared public outrage (which, as we shall see, turned out to be a reasonable fear); and governments feared a drop in their credit ratings which were critical to raising substantial sums in the municipal bond market at low rates. As Joseph Mason of Fitch, a rating agency noted: “If governments do nothing, their credit ratings could be

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<sup>31</sup> Governmental Accounting Standards Board (GASB), Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, Statement No. 45, Jun 2004, available at <http://www.gasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820457538&blobheader=application%2Fpdf> at 11; see also Harvey M. Katz, Who Will Pay The Cost of Government Employer Retiree Health Benefits, Labor L. Journal, Spring 2008 at 41.

<sup>32</sup> Id.

<sup>33</sup> Technical Assistance Section, Other Post-employment Benefits, Department of Revenue, [http://www.mass.gov/Ador/docs/dls/mdmstuf/Technical\\_Assistance/Best\\_Practices/opeb.pdf](http://www.mass.gov/Ador/docs/dls/mdmstuf/Technical_Assistance/Best_Practices/opeb.pdf) (“While the new standards require state and local governments to include a footnote in their financial statements indicating the actuarial accrued liabilities, the standard does not include a funding requirement, which would have to be implemented through Legislative action. However, once the total liability, including the amount that is unfunded, is known, taxpayers, government employees, and municipal credit rating agencies will begin to take notice”).

damaged and their cost of borrowing could rise. With health care costs spiraling and workforces ageing, standing still isn't a viable option."<sup>34</sup> Texas went so far as to pass a statute ignoring GASB 45.<sup>35</sup>

The events of 2007-2011 did nothing to improve the balance sheets of most states. The recession increased the demand for Medicaid and other state-funded health services as large numbers of newly unemployed struggled to secure health insurance coverage.<sup>36</sup>

The costs associated with health care continued to rise and life expectancy was longer than

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<sup>34</sup> Clearly Unhealthy: Public Sector Employers Count the Cost of Their Health-Care Promises, The Economist, Jun 30, 2005 (noting that employees worried that employers will cut health care benefits as the private sector did when FAS 106 took effect).

<sup>35</sup> Texas HB 2365 (2007) Legislative Session 80(R), available at <http://www.legis.state.tx.us/tlodocs/80R/billtext/pdf/HB02365F.pdf> (This bill is still in effect).

<sup>36</sup> The Basics: Medicaid Financing, National Health Policy Forum, Feb. 4, 2011, available at [http://www.nhpf.org/library/the-basics/Basics\\_MedicaidFinancing\\_02-04-11.pdf](http://www.nhpf.org/library/the-basics/Basics_MedicaidFinancing_02-04-11.pdf) at 1 ("The Medicaid program, which provides health coverage to poor or disabled individuals, is jointly funded by the federal and state governments. Each state administers its Medicaid program within broad federal guidelines. In 2009, Medicaid provided coverage to an estimated 50.1 million people. Combined state and federal spending was \$380.6 billion, of which the federal government paid about 66 percent and states paid about 34 percent.

Medicaid is a sizeable portion of total state spending. Although the share varies by state, it is the first or second largest budget item for states next to elementary and secondary education. On average, state and federal Medicaid spending accounted for 21.1 percent of total state budgets in 2009. The federal and state governments jointly fund the Medicaid program. Because Medicaid is an entitlement program, there is no limit on the amount the federal government pays as long as the state pays its share. The federal portion of Medicaid spending in each state is called the Federal Medical Assistance Percentage and is commonly referred to as the FMAP. The federal formula is:  $FMAP = 1 - 0.45 \times (\text{State Per Capita Income} / \text{U.S. Per Capita Income})$  And the state formula is:  $STATE\ SHARE = 0.45 \times (\text{State Per Capita Income} / \text{U.S. Per Capita Income})$  The multiplier of 0.45 in the FMAP formula ensures that states with average per capita income receive a federal share of 55 percent. The statute also establishes a minimum FMAP of 50 percent for states, stipulating that no state shall bear more than 50 percent of total costs, regardless of the result of applying the formula. The statute also contains an upper limit on the regular FMAP of 83 percent"). For current trends, see National Summary of Medicaid Managed Care Programs and Enrollment as of June 30, 2009, Centers for Medicare & Medicaid Services, <https://www.cms.gov/medicaiddatasourcesgeninfo/downloads/09Trends.pdf>; see also Kaiser Commission on Medicaid Facts, State Fiscal Conditions and Medicaid, Kaiser Family Foundation, Feb 2010, available at <http://www.kff.org/medicaid/upload/7580-06.pdf> at 1 ("During an economic downturn, unemployment rises and puts upward pressure on Medicaid. As individuals lose employer sponsored insurance and incomes decline, Medicaid enrollment and therefore spending increase. At the same time, revenue losses make it more difficult for states to pay their share of Medicaid spending increases. Specifically, a 1 percentage point increase in the national unemployment rate is estimated to result in 1 million more Medicaid and CHIP enrollees and an additional 1.1 million uninsured at the same time as state revenues are projected to fall by 3 to 4%. Since the start of the recession in December 2007, unemployment has increased 4.8 percentage points which could result in an estimated 4.8 million more Medicaid and CHIP enrollees and over 5.2 million more uninsured").

ever.<sup>37</sup> Of course, revenue from property and sales taxes plunged<sup>38</sup>, as record numbers of Americans were foreclosed and stopped spending.<sup>39</sup> Pension funds—heavily invested in equities—were battered by several years of poor stock market performance.<sup>40</sup>

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<sup>37</sup> In US, average life expectancy increased from 70.2 years in 1965 to 78.7 years in 2009. See Life expectancy at birth, total (years), The World Bank, [http://data.worldbank.org/indicator/SP.DYN.LE00.IN?cid=GPD\\_10](http://data.worldbank.org/indicator/SP.DYN.LE00.IN?cid=GPD_10); see also, Laura B. Shrestha, Life Expectancy in the United States, CRS Report for Congress, Aug 16, 2006, available at <http://aging.senate.gov/crs/aging1.pdf> (“Life expectancy for women rose from about 70 years in 1945 to over 80 years in 2003, while life expectancy for men rose from 65 to 75 over the same time period”).

For information on rising health care costs, see Ben Furnas, American Health Care Since 1994: The Unacceptable Status Quo, Center for American Progress, Jan 8, 2009, available at [http://www.americanprogress.org/issues/2009/01/health\\_since\\_1994.html](http://www.americanprogress.org/issues/2009/01/health_since_1994.html) (“Per-person health care expenditures in the United States have risen 6.5 percent per year since 2000, and 5.5 percent per year on average since 1994. In contrast, consumer inflation has averaged just 2.6 percent per year”); see also 2010 Kaiser/HRET Employer Health Benefits Survey (EHBS), <http://ehbs.kff.org/>; The Burden of Health Insurance Premium Increases on American Families, Executive Office of the President, Sept 22, 2009, available at [http://www.whitehouse.gov/assets/documents/Health\\_Insurance\\_Premium\\_Report.pdf](http://www.whitehouse.gov/assets/documents/Health_Insurance_Premium_Report.pdf).

Some states went to drastic measures to reign in healthcare costs. See Arizona father needs liver but Medicaid cancels expensive operation, AP, Dec 18, 2010 (“In Illinois, a pharmacist closes his business because of late Medicaid payments. In Arizona, a young father's liver transplant is canceled because Medicaid suddenly won't pay for it. In California, dentists pull teeth that could be saved because Medicaid doesn't pay for root canals”); but see State's deadly delay unnecessary, The Arizona Republic, Apr 6, 2011, available at <http://www.azcentral.com/arizonarepublic/opinions/articles/2011/04/06/20110406wed1-06.html#ixzz1SCvCWxLD> (“After six dark months, Arizona is finally restoring transplant funding. The state will again pay for life-saving procedures that were dropped from AHCCCS coverage last Oct. 1”).

<sup>38</sup> Kelly Nolan, Fall in Property-Tax Revenue Squeezes Cities, WSJ, Jul 16, 2011, available at <http://online.wsj.com/article/SB10001424052702304521304576447940532071536.html> (“But total revenue from property taxes across the U.S. fell 3% in the fourth quarter of 2010 and 1.7% in the first quarter of 2011, compared with a year earlier. Consecutive declines hadn't happened before in census data stretching back to 1963. That has put a squeeze on already-strapped cities, counties and school districts... One reason is the sharp decline in property values, on which the taxes are based. Another factor: Statutory property tax caps in some states and taxpayer resistance to higher property-tax rates in others have prevented local officials from trying to raise rates enough to compensate for falling assessed values of homes, Mr. Ciccarone said. Property taxes had shown resilience until now because municipalities charge tax rates on assessed real-estate values that often lag market values by at least few years. So the sharp decline seen in property values during the recession is just starting to be reflected in some valuations”); see e.g. Byron Lutz, Raven Molloy & Hui Shan, The Housing Crisis and State and Local Government Tax Revenue: Five Channels, Finance and Economics Discussion Series, Federal Reserve Board, 2010, available at <http://www.federalreserve.gov/pubs/feds/2010/201049/201049pap.pdf>; see Erik Schelzig & Shannon McCaffery, States Face Long Slog After Recession, AP, Jun 13, 2011, available at <http://abcnews.go.com/US/wireStory?id=13828801>; Michael Cooper, Recession Tightens Grip on State Tax Revenues, NY Times, Feb 22, 2010, available at <http://www.nytimes.com/2010/02/23/us/23states.html> (“Over all, state tax collections fell to \$134.5 billion in the last quarter of 2009, a 4.1 percent drop from the \$140.2 billion collected during the same period a year earlier, according to the report, which will be released Tuesday by the Nelson A. Rockefeller Institute of Government. While the drop in tax collections was less severe than earlier in the year — the record for the steepest drop was set last spring when tax collections fell by 16.6 percent compared with the same period in 2008 — the continuing declines are putting even more stress on states”); see also Lucy

Combined, these forces put incredible stress on all levels of government, most of which responded by slashing budgets and avoiding pension contributions where possible. The one major counterweight to this widespread misery was the much-debated federal stimulus which, with the benefit of hindsight was now widely viewed as a failure.<sup>41</sup>

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Dadayan & Donald J. Boyd, Recession or No Recession, State Tax Revenues Remain Negative, State Revenue Report, The Nelson A. Rockefeller Institute of Government, Jan 2010, available at [http://www.rockinst.org/pdf/government\\_finance/state\\_revenue\\_report/2010-01-07-SRR\\_78.pdf](http://www.rockinst.org/pdf/government_finance/state_revenue_report/2010-01-07-SRR_78.pdf).

<sup>39</sup> U.S. Foreclosure Market Report, RealtyTrac, Oct 15, 2009, available at <http://www.realtytrac.com/foreclosure/foreclosure-rates.html> ("foreclosure filings — default notices, scheduled auctions and bank repossessions — were reported on 937,840 properties in the third quarter, a 5 percent increase from the previous quarter and an increase of nearly 23 percent from Q3 2008. One in every 136 U.S. housing units received a foreclosure filing during the quarter — the highest quarterly foreclosure rate since RealtyTrac began issuing its report in the first quarter of 2005"); see Joint Center for Housing Studies of Harvard University, The State of the Nations' Housing 2009, available at <http://www.jchs.harvard.edu/publications/markets/son2009/son2009.pdf>.

Regarding consumer spending, see Carla Fried, Fed: Consumer Spending Down \$7,300 Per Person Since Great Recession Began, CBS MoneyWatch, Jul 12, 2011, available at <http://moneywatch.bnet.com/economic-news/blog/daily-money/fed-consumer-spending-down-7300-per-person-since-great-recession-began/3140/#ixzz1SJARddzh> ("Kevin Lansing, an economist at the Federal Reserve Bank of San Francisco, took a look at how our current personal spending compares to what we would have spent if we had continued at the hectic, bubble-induced pace that ensued from 2000 until the Great Recession began in December 2007. According to Lansing, average per-person spending was \$7,356 less (in inflation-adjusted dollars) than if our pre-recession spending spree had continued apace"); see also Shobhana Chandra, U.S. Economy: Recession Eases, Consumer-Spending Slump Deepens, Bloomberg, Aug 1, 2009 available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aRV7ZR6CGNQY> ("Consumer spending, which accounts for about 70 percent of the economy, fell at a 1.2 percent pace following a 0.6 percent increase in the prior quarter. It was forecast to drop 0.5 percent, according to the survey median. Purchases slid 2 percent since the peak at the end of 2007 -- the most since a 2.4 percent decline in the 1980 recession.... The economy has lost 6.5 million jobs since the recession began in December 2007, and economists surveyed by Bloomberg last month forecast the jobless rate will exceed 10 percent by early 2010").

<sup>40</sup> Kathy Chu, States try to stem losses in public pension funds, USA Today, Nov. 7, 2008, available at [http://www.usatoday.com/money/perfi/retirement/2008-11-06-state-pensions-cutbacks\\_N.htm](http://www.usatoday.com/money/perfi/retirement/2008-11-06-state-pensions-cutbacks_N.htm) ("In the 12-month period ended Sept. 30, public pension plans lost 14.9%, according to Wilshire Associates, a consulting firm"); see also Deborah Brewster, US public pension funds face big losses, Financial Times, Oct 26, 2008, available at <http://www.ft.com/cms/s/0/29c8e0c8-a3a0-11dd-942c-000077b07658.html#ixzz1SJLzR51x> ("California's Calpers, the US's biggest pension fund, last week reported a loss of 20 per cent of its assets, or more than \$40bn, between July 1 and October 20 this year").

<sup>41</sup> Michael D. Shear & Alexi Mostrous, Biden Fires Back At Stimulus Critics; Administration Says Act Is Working, The Washington Post, Jul 17, 2009 ("Without naming Cantor, the vice president, whom President Obama has dubbed the "sheriff" of the stimulus plan, trained his rhetoric squarely at the Richmond lawmaker, who has helped hone one of the GOP's most effective lines of attack on the president: that the \$787 billion stimulus package has not produced jobs... "The point of these programs on the jobs front is to cushion the blow," said Jared Bernstein, Biden's chief economic adviser. "I feel very confident that the American people understand that it will take a very,

Most crises, however painful, provide a perverse kind of education and this one was no exception. A fundamental flaw in GASB 45 was exposed. The folly of permitting governments to select their own discount rate in order to determine the present value of

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very long time to fill what the president described as a very, very deep hole." Bernstein presented a series of charts indicating that \$226 billion has been put to work already, the leading edge of a wave of money flowing through the economy that he said would reduce the number of job losses that would have otherwise occurred").

For taxpayer reactions, see Kristen Schorsch & Julie Wernau, [Complaints rain down on stimulus program; Weatherizing jobs fail 1 in 7 inspections, concludes report on Chicago nonprofit, which says oversight has improved](#), Chicago Tribune, May 1, 2011 ("In early 2009, President Barack Obama called for infusing \$5 billion into the federal government's decades-old weatherization program to put people to work and lower energy costs. Illinois split a three-year, \$242 million grant among 35 agencies, CEDA being the largest... Critics say Illinois is one of a string of states that wasted taxpayer money through weatherization programs. "Weatherization is so vulnerable to fraud at every level," said Leslie Paige, spokeswoman for Citizens Against Government Waste, a nonpartisan group in Washington, D.C. "There's a lot of opportunity for sweetheart deals, self-dealing, all kinds of inappropriate uses of the money"); [see also](#) Kim Murphy, [Voters say all that pork is starting to smell; Sen. Patty Murray has brought billions of dollars to Washington state. Now her GOP rival and critics are using it against her](#), LA Times, Oct 27, 2010 ("Sen. Patty Murray has been one of the nation's biggest advocates of federal spending to boost the foundering economy. Here at the Hanford Nuclear Reservation, the country's worst atomic weapons contamination site, Murray scored \$1.9 billion in stimulus funds to speed cleanup and add 1,500 high-paying jobs in central Washington. But voters here have been ambivalent at best about all the money flowing in. During the primary, Murray trailed the local "tea party" candidate, who lost the GOP nomination to real estate investor and former legislator Dino Rossi. The Democratic incumbent now is waging the fight of her 18-year career against Rossi, fueled by conservative fears -- even in the Hanford boom belt -- that all the federal bacon comes with too much fat").

For reports on job-creation effects of the legislation, see Jim Mctague, [Overly Stimulating](#), Barrons, Nov 16, 2009 ("Economists generally feel that the data are inaccurate. Ethan Harris, a senior economist at Banc of America Securities-Merrill Lynch Global Research, says that collectively the stimulus, low federal-funds rates, TARP spending and the decision to keep systemically important companies from failing has saved millions of jobs. "Can I add it up and give credit to one particular policy? It's impossible," he says. Michael Balsam, chief solutions officer at Onvia, which runs the private Recovery.org Website, says many recipients lack the resources to accurately report data. Onvia measures actual government contracts, culling the information daily from 88,000 federal, state and local government Websites. No job is created until a contract is signed, he asserts. So far, about \$30 billion in contracts have been awarded, translating at best into 330,000 jobs versus 640,329 claimed by Obama"); [see also](#) <http://www.recovery.gov/Pages/default.aspx> (up-to-date figures on total stimulus amounts "\$264 billion awarded, 560,991 reported jobs as of 6/22/11"); American Recovery and Reinvestment Act of 2009, abbreviated ARRA, (Pub.L. 111-5), 111<sup>th</sup> Cong, Feb 2009.; Timothy Conley & Bill Dupo, [The American Recovery and Reinvestment Act: Public Sector Jobs Saved, Private Sector Jobs Forestalled](#), May 17, 2011, [available at](http://web.econ.ohio-state.edu/dupor/arra10_may11.pdf) [http://web.econ.ohio-state.edu/dupor/arra10\\_may11.pdf](http://web.econ.ohio-state.edu/dupor/arra10_may11.pdf) (arguing that the stimulus plan destroyed more private sector jobs than the public sector jobs it created, resulting in a net loss in jobs); Council of Economic Advisers, [The Economic Impact of the American Recovery and Reinvestment Act of 2009](#), Jul 1, 2011 at 1, [available at](http://www.whitehouse.gov/sites/default/files/cea_7th_arra_report.pdf) [http://www.whitehouse.gov/sites/default/files/cea\\_7th\\_arra\\_report.pdf](http://www.whitehouse.gov/sites/default/files/cea_7th_arra_report.pdf) ("CEA estimates that as of the first quarter of 2011, the ARRA has raised employment relative to what it otherwise would have been by between 2.4 and 3.6 million" but at a cost of nearly \$666 billion, that comes out to a cost to taxpayers of \$185,000 to \$278,000 per job").

their OPEB liability quickly became obvious. The idea had been that because governments do not go bankrupt like private sector companies, public sector retiree promises were somehow more secure. This security was in turn justification for investment by public sector funds in riskier assets.<sup>42</sup> Typically, public sector funds chose 8% as their discount rate; private sector pension of OPEB debt opted for the more conservative 6% rate based on high grade corporate bonds and other fixed income securities. From the beginning, this discrepancy effectively subsidized public sector pensions and OPEBs, allowing governments to set aside far less capital than private sector employers for equivalent obligations.<sup>43</sup>

Many analysts believe that the discount rate should optimally reflect the riskiness of the payout; and, because the payout in a DB plan is guaranteed, the discount rate should be at most 4%, which is considered by most actuaries to be a risk-free rate.<sup>44</sup> The official estimate

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<sup>42</sup> A Gold-plated Burden: Hard Pressed American States Face a Crushing Pensions Bill, *The Economist*, Oct 14, 2010 (“The more risk the pension fund takes (for example, by buying high-yielding bonds of companies with poor credit ratings), the lower its liabilities appear to be. Suppose that a state had to pay a bondholder \$30,000 a year for 25 years and to pay a pensioner the same sum for the same period. The bond obligation would have a present value of \$425,000 in its accounts but the pension liability, with the same cashflows, would be valued at just \$320,000”); see also, Douglas J. Elliott, The Financial Crisis’ Effects on the Alternatives for Public Pensions, The Brookings Institution, Apr 15, 2010 (“My own view is that an 8% return target is unreasonably high in today’s environment. Maintaining such a target level serves to mask the true extent of the pension deficits. Bad as those deficits look now, they would be significantly worse if the expected returns average 7% or 6%”).

<sup>43</sup> For anyone who is in doubt about the significance of a few percentage points, it is critical to note that a small spread in the discount rate unquestionably makes an enormous difference. At a rate of 6% the present value of unfunded government pension debt more than doubles the official figures which use a rate of 8%. See Gina Chon, U.S. News: Gurus Urge Bigger Pension Cushion, *WSJ*, Mar 29, 2010 at A2 (“The drop of one percentage point in the discount rate means a 10% to 20% increase in the total pension obligation, according to James Rizzo, senior consultant and actuary at Gabriel, Roeder, Smith & Co., a consulting firm for the public sector. For example, a pension system with a total liability of \$100 billion would have an obligation of as much as \$120 billion after a decline of one percentage point in the discount rate”).

<sup>44</sup> Barro and Buck, *supra* (“Discount rates should be derived from securities that have as little risk as the liabilities themselves”). The market value of liability theory, a complete discussion of which is well beyond the scope of this paper would treat the “risk” of the liabilities here as the likelihood that a plan would be able to escape its obligations to beneficiaries—i.e. the chance that the state would default or that it would somehow be found not liable for the contractually enforceable promises of future benefits made to its employees.

of the unfunded liability for public sector pensions stands now at about \$1 trillion; that number rises to \$3.5 trillion when a 4% rate is employed.<sup>45</sup>

When GASB 45 went into effect, numerous Wall Street banks began pitching OPEB bonds.

The sales pitch went something like this: issue billions of dollars in municipal bonds at 5%

interest and invest the proceeds in equities in anticipation of an 8% return. The banks

earned handsome fees on both sides of this arrangement, the governments took advantage

of a "legal arbitrage opportunity" and could make a large down payment on OPEB debt.

When instead the stock market lost over 20% of its value and governments fell deeper in

debt, the riskiness of this approach became apparent. Recently convicted governor Rod

Blagojevich left office in disgrace after the Illinois version of this scheme backfired and left

the state \$60 billion in debt.<sup>46</sup>

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<sup>45</sup> Eileen Norcross & Andrew Bigg, The Crisis in Public Sector Pension Plans: A Blueprint for Reform in New Jersey, Jun 23, 2010.

<sup>46</sup> Barro & Buck, Underfunded Teacher Pension Plans: It's Worse Than You Think, Manhattan Institute for Policy Research, Apr 2010, available at [http://www.manhattan-institute.org/html/cr\\_61.htm](http://www.manhattan-institute.org/html/cr_61.htm) ("In 2003, Illinois governor Rod Blagojevich, who left office in 2009 in disgrace, embraced a plan to "issue debt at a cost of 5.1 percent and then earn 8.5 percent or so investing the proceedings [sic]." This turned into "a disaster" when the market dropped last year, leaving Illinois about \$60 billion short (Fitch 2009)"); see also Amy Merrick, U.S. News: Big State, Big Cuts, Little Room --- Illinois Agency Has to Pare Hundreds of Millions, but Mandates Restrict Fall of the Ax, The Wall Street Journal, Jun 14, 2010 at A3 ("The state's debt exploded in 2003, when Democratic then-Gov. Rod Blagojevich pushed through a plan to borrow \$10 billion. From fiscal 2002 to fiscal 2003, Illinois's debt more than doubled, from \$9.54 billion to nearly \$21 billion. After Mr. Blagojevich was removed from office last year amid corruption allegations, which he denies, Mr. Quinn became governor"); Stephen Moore, State Spending Spree, The Wall Street Journal, Mar 22, 2007 at A16 ("Last year states cashed in on the boom times by hiking expenditures by almost 9%, according to the National Association of State Budget Officers, or three times the rate of overall inflation. This year at least a dozen states are contemplating double-digit rates of spending growth. If that happens, aggregate state budgets will be up nearly 20% in just two years. One politician tossing aside the "new Democrat" playbook of fiscal restraint is the just-re-elected Governor of Illinois, Rod Blagojevich. Mr. Blagojevich just recently announced a \$60.1 billion budget loaded with \$7 billion in new taxes and \$16 billion in new debt -- what the Chicago Sun Times calls "the largest tax increase and biggest borrowing spree in state history." Mr. Blagojevich intends to reward nearly every Democratic special interest group that helped elect him: the teachers unions (the school budget would rise by a whopping 23% in one year), public transit employees, health-care providers and the poverty industry. He calls his fiscal time bomb of debt and taxes "a moral imperative." Almost all the new costs of the social welfare pyramids he wants to fund would fall on businesses, which are likely to feel their own "moral imperative" to flee if the legislature in Springfield is foolhardy enough to pass this plan");

## **GASB 45 and Amortization**

One other feature of public pension plan reporting merits mention here. The choice of amortization period makes a huge difference in the size of OPEB debt. Private pension plans typically amortize over 15 years; governments use a 30 year period which permits the debt and losses to be obscured to a degree. Shorter amortization periods mean much larger present values<sup>47</sup>; longer periods mean much smaller present values. Public plans, with older workforces, cannot justify the use of a 30 year period because the number of years to retirement is nowhere near that long in most cases. With respect to health care, most public plans assume that health care costs will drop down to levels that are consistent with inflation. The experience of the last few decades suggests that such an assumption is overly optimistic and unjustified. Health care costs have consistently outstripped inflation since 1978<sup>48</sup> and show no sign of abating.<sup>49</sup> Future OPEB obligations are underestimated when based on such obviously fatuous assumptions.

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Christopher Wills, [Illinois deep in debt, doesn't pay bills](http://www.msnbc.msn.com/id/37136518/ns/us_news-life/t/illinois-deep-debt-doesnt-pay-bills/), AP, May 13, 2010, [available at](http://www.msnbc.msn.com/id/37136518/ns/us_news-life/t/illinois-deep-debt-doesnt-pay-bills/) [http://www.msnbc.msn.com/id/37136518/ns/us\\_news-life/t/illinois-deep-debt-doesnt-pay-bills/](http://www.msnbc.msn.com/id/37136518/ns/us_news-life/t/illinois-deep-debt-doesnt-pay-bills/) ("The practice of simply putting off payments became commonplace under ex-Gov. Rod Blagojevich, who liked to spend but adamantly opposed a tax increase to help cover costs. Before he was arrested and kicked out of office, Blagojevich's toxic relationship with legislators essentially paralyzed government, so bills just piled up"). For more background on this governor, see David Bernstein, [Mr. Unpopularity](http://www.chicagomag.com/Chicago-Magazine/February-2008/Mr-Un-Popularity/index.php?cp=1&cparticle=1&si=0&siarticle=0#artanc), Chicago Mag, Feb 2008, [available at](http://www.chicagomag.com/Chicago-Magazine/February-2008/Mr-Un-Popularity/index.php?cp=1&cparticle=1&si=0&siarticle=0#artanc) <http://www.chicagomag.com/Chicago-Magazine/February-2008/Mr-Un-Popularity/index.php?cp=1&cparticle=1&si=0&siarticle=0#artanc>.

<sup>47</sup> For example, assuming a 7% discount rate, the present value of a \$1 million obligation is \$362,446.02 when amortized over 15 years, which is 275% higher than the \$131,367.12 present value when amortized over 30 years.

<sup>48</sup> [Trends in Health Care Costs and Spending](http://www.kff.org/insurance/upload/7692_02.pdf), Kaiser Family Foundation, Mar 2009, [http://www.kff.org/insurance/upload/7692\\_02.pdf](http://www.kff.org/insurance/upload/7692_02.pdf) ("Spending on health care, which is a projected to be 17.6% of the U.S. gross domestic product (GDP) in 2009, has consistently grown faster than the economy overall since the 1960s"); see [Health costs race past inflation](http://money.cnn.com/2007/09/11/pf/health_costs_kaiser/index.htm), CNN Money, Sept 11, 2007, [available at](http://money.cnn.com/2007/09/11/pf/health_costs_kaiser/index.htm) [http://money.cnn.com/2007/09/11/pf/health\\_costs\\_kaiser/index.htm](http://money.cnn.com/2007/09/11/pf/health_costs_kaiser/index.htm) ("Since 2001, however, premiums for family coverage have increased 78 percent, while wages have gone up 19 percent and inflation has gone up 17 percent").

<sup>49</sup> Health-care costs are projected to continue to outpace inflation. See 2011 Segal Health Plan Cost Trend Survey, [available at](http://www.segalco.com/publications/surveysandstudies/2011trendsurvey.pdf) <http://www.segalco.com/publications/surveysandstudies/2011trendsurvey.pdf>.

### III. State Experience: Transforming An Entrenched Culture of Debt

In many states public employees—teachers, firefighters, police and civil servants—routinely retire in their early 40s with pensions close to the salary earned in the last few years of employment.<sup>50</sup> In some cases retired public employees can expect a pension that provides

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Some states have taken matters into their own hands. See Robert Weisman, [Health Care Hikes Rejected](#), Boston Globe, Apr 2, 2010, available at [http://www.boston.com/business/healthcare/articles/2010/04/02/state\\_rejects\\_health\\_insurance\\_rate\\_hikes/](http://www.boston.com/business/healthcare/articles/2010/04/02/state_rejects_health_insurance_rate_hikes/) (“Making good on Governor Deval Patrick’s promise to reject health insurance rate increases deemed excessive, the state Division of Insurance yesterday denied 235 of 274 increases proposed by insurers for plans covering individuals and small businesses”); see also Patrick-Murray Administration Proposes Comprehensive Health Care Cost-Containment Legislation, Feb 17, 2011, available at [http://www.mass.gov/?pageID=gov3pressrelease&L=1&LO=Home&sid=Agov3&b=pressrelease&f=110217\\_healthcare\\_cost\\_containment&csid=Agov3](http://www.mass.gov/?pageID=gov3pressrelease&L=1&LO=Home&sid=Agov3&b=pressrelease&f=110217_healthcare_cost_containment&csid=Agov3) (“Massachusetts led the nation on health care reform and is poised to lead again on health care cost containment,” said Governor Patrick. “With 98 percent of the Commonwealth’s residents insured, we have shown how government, consumers, insurers and providers can work together to realize the goals of health care reform. Our next major achievement in this arena will be controlling costs while ensuring that the people of Massachusetts continue to receive world-class care”).

<sup>50</sup> See, e.g., Mary Williams Walsh & Amy Schoenfeld, [Padded Pensions Add to New York Fiscal Woes](#), N.Y. Times, May 21, 2010 at A1; Ray Long & Todd Wilson, [Illinois might shift health care costs; Ex-state workers may be asked to contribute more](#), Chicago Tribune, Jan 24, 2011 at C6 (“The idea is to start charging the retirees who can afford to pay for their health care. And new state research shows some of the 84,100 retirees and survivors appear to possess the ability to pay -- the average annual household income for a retired state worker younger than 65 was nearly \$78,000. The sizable rocking-chair income is the result of waves of state workers taking advantage of sweet early retirement plans that allowed them to walk out of government jobs in their 50s, start collecting pension benefits and still have time to start a second career”); Jason Grotto, [CHICAGO'S \\$20 BILLION PENSION PROBLEM; How shortsighted political decisions drained city's funds of billions of dollars, putting public employees' retirements -- and taxpayers -- at risk](#), Chicago Tribune, Nov 17, 2010 at C1 (“In the name of labor peace, city officials and union leaders signed collective bargaining agreements that resulted in average salary increases of about 4 percent annually from 2000 to 2009, even though increases in Chicago's cost of living averaged just 2.2 percent during that time”); Michael B. Marois & James Nash, [Brown Measures Take Aim at California Pension 'Spiking' and Other Abuses](#), Bloomberg, Apr 1, 2011, available at <http://www.bloomberg.com/news/2011-04-01/brown-measures-take-aim-at-california-pension-spiking-and-other-abuses.html> (“Brown, a Democrat, offered seven measures yesterday that among other things would prohibit employees from pension “spiking” by manipulating overtime, unused vacation and special compensation to create an inflated benchmark for future benefits. Other bills would ban retroactive benefits and forbid workers from purchasing additional service credits”); Nannette Miranda, [Calif. Lawmakers approve proposal to end pension abuse](#), ABC News, May 4, 2011, available at <http://abclocal.go.com/kabc/story?section=news/state&id=8112710> (“Inside the Capitol, an Assembly committee helped the group's cause by approving a proposal to end pension abuses, especially spiking where public employees pad their last check with unused vacation and sick time and even car allowances. The proposal was a result of the city of Bell scandal, where former City Manager Robert Rizzo stood to make \$600,000 a year in retirement”); Adam Elmahrek, [Recently retired Santa Ana City Manager Dave Ream cashed out \\$230,366 in unused time off](#), Voice of OC, Mar 30, 2011, available at

*more than 100%* salary replacement.<sup>51</sup> Add to that a promise of fully paid health insurance until age 65 (the eligibility threshold for Medicare benefits)<sup>52</sup> and it quickly becomes apparent that employee benefits typical to the public sector are substantially more lavish than those generally available to private sector workers.<sup>53</sup>

The financial health of several states—California, Illinois and Colorado, for example—is so precarious that bankruptcy or the complete cessation of all state functions save paying benefits to retirees is not unthinkable. In the face of a credible bankruptcy threat by one or more of the populous states, it is not unreasonable to expect that the federal government would feel compelled to step in and assume most (or all) of the crippling future pension

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[http://www.voiceofoc.org/countywide/this\\_just\\_in/article\\_3821dcce-5afa-11e0-bbce-001cc4c03286.html](http://www.voiceofoc.org/countywide/this_just_in/article_3821dcce-5afa-11e0-bbce-001cc4c03286.html); Sam Allen, Public hospital president's retirement pay spotlights issue of 'supplemental' pensions, LA Times, Apr 28, 2011, available at <http://articles.latimes.com/2011/apr/28/local/la-me-pensions-20110428> (“When he turned 65 two years ago, Samuel Downing received a \$3-million retirement payment from a public hospital district in Salinas, Calif., where he serves as president and chief executive .But Downing continued working at his \$668,000-a-year job for another two years, and after he retires this week, he will receive another payment of nearly \$900,000. That comes on top of his regular pension of \$150,000 a year”). For a list of those with 6-figure pensions in CA, see Californians for pension reform, <http://www.californiansforpensionreform.com/database.asp?vtable=calpers>; Brad Branan, Six-figure pensions surge for Sacramento County, Sacramento Bee, Jul 19, 2011, available at <http://www.sacbee.com/2011/07/18/3776044/six-figure-pensions-surge-for.html#ixzz1SILhRf1W> (“Take George Anderson. He was 51 when he retired as undersheriff four years ago, because then-Attorney General Jerry Brown had named him head of the Justice Department's division of law enforcement. He earned a \$143,000 annual salary in the new job, on top of his \$173,559-a-year pension”); see also Ron Lieber, Battle Looms Over Huge Costs of Public Pensions, NY Times, Aug 6, 2010, available at <http://www.nytimes.com/2010/08/07/your-money/07money.html> (“Taxpayers, whose payments are also helping to restock Colorado’s pension fund, may not be as sympathetic, though. The average retiree in the fund stopped working at the sprightly age of 58 and deposits a check for \$2,883 each month. Many of them also got a 3.5 percent annual raise, no matter what inflation was, until the rules changed this year”); Richard G. Jones, Multiple Jobs by Public Workers Strain Pension Plan in New Jersey, NT Times, Sept 1, 2006, available at <http://www.nytimes.com/2006/09/01/nyregion/01pension.html> (“ New Jersey officials on Thursday released the salary records of the highest-paid public employees who have multiple public jobs. State lawmakers, who are struggling to curb soaring property taxes and cut state expenditures, say that the practice of holding multiple positions — and earning more pension credits as a result — has added a huge burden to the state’s troubled pension system”).

<sup>51</sup> Id. Padded Pensions Add to New York Fiscal Woes (“In Yonkers, more than 100 retired police officers and firefighters are collecting pensions greater than their pay when they were working. One of the youngest, Hugo Tassone, retired at 44 with a base pay of about \$74,000 a year. His pension is now \$101,333 a year”).

<sup>52</sup> 42 U.S.C. §426 (2010); 42 C.F.R. §406.5 (2010).

<sup>53</sup> Jonathan R. Laing, The \$2 Trillion Hole, Barron’s, Mar. 15, 2010 at 40. See Employee Benefit Research Institute, <http://www.ebri.org/>; see also note 28 supra.

liabilities. We have seen a mini version of this recently with the so called “bail outs” of the automobile<sup>54</sup> and financial services industries.<sup>55</sup> In each of these cases the federal government provided taxpayer dollars to industries that essentially privatized their growing wealth in good times and then anxiously spread the risk of default to all taxpayers in the midst of crisis.<sup>56</sup>

It is not clear how well this peculiar phenomenon is understood by the taxpaying public.<sup>57</sup> To the extent taxpayers understand what was done with their money and perceive little direct, personal benefit, one might expect many to oppose the more ambitious bailout of financially strapped states that would be required. On the other hand, taxpayers who approve of the bailout of, for example, General Motors<sup>58</sup>, might also favor a repeat

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<sup>54</sup> See Nick Bunkley & Bill Vlasic, Automakers to Seek More Money for Retooling Vehicle Plants, NT Times, Aug 22, 2008, available at <http://www.nytimes.com/2008/08/23/business/23auto.html?dbk>; Taylor A. Wall, Saving America’s Automobile Industry: The Bailouts of 1979 and 2009, An Overview of the Economic Conditions, Factors for Failure, Government Interventions and Public Relations, Senior Thesis, Claremont McKenna College, 2010 available at [http://scholarship.claremont.edu/cgi/viewcontent.cgi?article=1045&context=cmc\\_theses](http://scholarship.claremont.edu/cgi/viewcontent.cgi?article=1045&context=cmc_theses); see also Times Topics, Automotive Industry Crisis, NY Times, [http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit\\_crisis/auto\\_industry/index.html](http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_crisis/auto_industry/index.html).

<sup>55</sup> Officials say tracking bailout money is difficult, Associated Press, Jan 1, 2009; Mike McIntire, Bailout Is a Windfall to Banks, if Not to Borrowers, The New York Times, Jan 17, 2009; see also Deborah Solomon, Damian Paletta, Jon Hilsenrath & Aaron Lucchetti, U.S. to Buy Stakes in Nation’s Largest Banks, WSJ, Oct 14, 2008, available at <http://online.wsj.com/article/SB122390023840728367.html>.

<sup>56</sup> Yalman Onaran & Alexis Leonidis, Bank Bailout Returns 8.2% Beating Treasury Yields, Bloomberg, Oct 20, 2010, available at <http://www.bloomberg.com/news/2010-10-20/bailout-of-wall-street-returns-8-2-profit-to-taxpayers-beating-treasuries.html>; see also Bailout Recipients, ProPublica, <http://projects.propublica.org/bailout/list/index>; Stimulus.org, The Committee for a Responsible Federal Budget, <http://stimulus.org/?filter0=80&filter1=&filter2=&filter3=>.

<sup>57</sup> Dennis Jacobs, Six in 10 Oppose Wall Street Bailouts, Gallup, Apr 3, 2008, available at <http://www.gallup.com/poll/106114/six-oppose-wall-street-bailouts.aspx>; see also Robert Reich, Obama’s Wall Street Bailout failure, Salon, Mar 20, 2009, available at <http://www.salon.com/news/opinion/feature/2009/03/20/reich>.

<sup>58</sup> Josh Mitchell & Sharon Terlep, U.S. Unlikely to Recoup GM Bailout, Panel Says, WSJ, Jan 13, 2011, available at <http://online.wsj.com/article/SB10001424052748704803604576078501503246420.html> (“The U.S. government is unlikely to recover its entire \$50 billion investment in General Motors Co., in part because the Obama administration unloaded a big block of shares in the company’s initial public offering at \$33 a share rather than wait for a higher price, a federal panel said Wednesday”); GM has its price, Chicago Tribune, Nov 19, 2010, available at [http://articles.chicagotribune.com/2010-11-19/news/ct-edit-gm-20101118\\_1\\_gm-bondholders-gm-profits-toyota-and-other-rivals](http://articles.chicagotribune.com/2010-11-19/news/ct-edit-gm-20101118_1_gm-bondholders-gm-profits-toyota-and-other-rivals) (“The bill for taxpayers stands to keep growing. Because of special tax treatment

intervention to “save” their own state or one thousands of miles away. It is hard to know what the political response to history-making interventions will be. What is certain, though, is that the alternative—independent state efforts to right-size their budgets and constrain the growth in benefits costs, will require significant changes in the way states function as employers.

### **Benefits Reductions for Future Employees**

Some states have limited their reform efforts to constraining growth in *future* costs only.

These efforts have focused on higher employee contributions,<sup>59</sup> closing existing DB plans<sup>60</sup>

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connected to its bailout, GM can deduct its accumulated losses against future profits — avoiding at least some obligations it otherwise would have owed had it emerged from a typical bankruptcy. That tax break reportedly could be worth as much as \$45 billion over time”); Dave Boyer, [Watchdog questions GM bailout repayment](http://www.washingtontimes.com/news/2011/jun/2/watchdog-questions-gm-bailout-repayment/), Washington Times, Jun 2, 2011, available at <http://www.washingtontimes.com/news/2011/jun/2/watchdog-questions-gm-bailout-repayment/> (The Obama administration released a report Wednesday showing that taxpayers probably will lose \$14 billion of the \$80 billion that the government loaned to General Motors, Chrysler, auto lenders and suppliers”).

<sup>59</sup> Steven Greenhouse, [States Want More in Pension Contributions](http://www.nytimes.com/2011/06/16/business/16pension.html?pagewanted=all), NY Times, Jun 15, 2011, available at <http://www.nytimes.com/2011/06/16/business/16pension.html?pagewanted=all> (“So far this year, eight states, including Wisconsin and Florida, have decided to require government employees to contribute more, sometimes far more, to their pensions. Governors and legislators in 10 other states, including California and Illinois, are proposing their own pension changes as they grapple with budget deficits and underfunded pension plans”); Special Report, [State of war: Taxpayers versus public-sector workers](http://www.economist.com/node/18433186), The Economist, Apr 7, 2011, available at <http://www.economist.com/node/18433186>.

<sup>60</sup> [On Defined-Benefit Plans, Program Perspectives, Vol. 2, Issue 3](http://www.bls.gov/opub/perspectives/program_perspectives_vol2_issue3.pdf), U.S. Bureau of Labor Statistics, Apr 2010, available at [http://www.bls.gov/opub/perspectives/program\\_perspectives\\_vol2\\_issue3.pdf](http://www.bls.gov/opub/perspectives/program_perspectives_vol2_issue3.pdf); Indiana Senate Bill, No. 542, Feb 18, 2011, <http://www.in.gov/legislative/bills/2011/PDF/SB/SB0524.1.pdf>; Randall Jensen, [San Diego Ahead in Pension Reform](http://www.bondbuyer.com/issues/120_5/san_diego_pension-1021855-1.html), The Bond Buyer, Jan 7, 2011, available at [http://www.bondbuyer.com/issues/120\\_5/san\\_diego\\_pension-1021855-1.html](http://www.bondbuyer.com/issues/120_5/san_diego_pension-1021855-1.html) (“On a state level, Michigan and Alaska have adopted mandatory defined contribution plans, while Oregon and Indiana have implemented a mandatory hybrid plan, according to the Center for State and Local Government Excellence. Eight other states offer the option of a defined contribution plan”); [A Role for Defined Contribution Plans in the Public Sector](http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7BDE1B05E7-1053-4B2E-BEB3-F9C6C5371779%7D.PDF), Center for State & Local Government Excellence, Apr 2011, available at <http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7BDE1B05E7-1053-4B2E-BEB3-F9C6C5371779%7D.PDF>; but see Stephen C. Fehr, [States overhaul pensions but pass on 401\(k\)-style plans](http://stateline.org/live/details/story?contentId=582585), Stateline, Jun 21, 2011, available at <http://stateline.org/live/details/story?contentId=582585> (“No state this year replaced its traditional fixed-benefit pension with a new plan in which employees set aside a portion of their pay and assume the risk in making investment decisions. Only one state, Indiana, implemented such a plan for new employees, but made it optional”).

and pushing new hires into DC-like vehicles<sup>61</sup> on the pension side. With healthcare, the creation of Health Savings Accounts<sup>62</sup>, and higher co-payments and deductibles<sup>63</sup> seem to dominate state efforts focused on new hires.

None of these changes are easy to implement, especially where, as almost always, public union approval must be obtained. The added interference of elected officials also makes cost cutting hard. The Chicago Fed characterized the chief financial officer of the Chicago Public Schools system's efforts to contain OPEB liability as "always fighting a defensive battle to prevent plan expansions that are granted by the state legislature."<sup>64</sup> Additionally, the prospect of reduced benefits has resulted in many workers taking early retirement and other unanticipated side-effects<sup>65</sup>.

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<sup>61</sup> Ronald Snell, State Defined Contribution Hybrid Pension Plans, National Conference of State Legislatures, Jun 2010, available at [http://www.nasra.org/resources/NCSL\\_DC\\_Hybrid.pdf](http://www.nasra.org/resources/NCSL_DC_Hybrid.pdf); see also John E. Nixon, Bending the Curve- Long-term Pension Costs, Pew Center on the States, Jun 21, 2011, available at [http://www.pewcenteronthestates.org/uploadedFiles/wwwpewcenteronthestatesorg/Initiatives/States\\_Fiscal\\_Health\\_Project/Closing\\_the\\_Gap\\_Nixon.pdf](http://www.pewcenteronthestates.org/uploadedFiles/wwwpewcenteronthestatesorg/Initiatives/States_Fiscal_Health_Project/Closing_the_Gap_Nixon.pdf).

<sup>62</sup> Employer Health Benefits, The Kaiser Family Foundation, 2007, available at <http://www.kff.org/insurance/7672/upload/76723.pdf>; January 2007 Census Shows 4.5 million people covered by HAS/High-deductible health plans, Center for Policy and Research, Apr 2007, available at <http://www.kff.org/insurance/7672/upload/76723.pdf>; IRS Publication 969, Health Savings accounts and other Tax-Favored Health Plans, available at <http://www.irs.gov/pub/irs-pdf/p969.pdf>. Several states have begun experimenting with HAS's for their public employees, including: Indiana, see Mitch Daniels, Hoosiers and Health Savings Accounts, WSJ, Mar 1, 2010, available at <http://online.wsj.com/article/SB10001424052748704231304575091600470293066.html>; and Washington, see Washington State PEBB and Health Savings Accounts, Washington State Health Care Authority, Jan. 13, 2006, available at <http://www.pebb.hca.wa.gov/documents/board/011706HSastudy.pdf>.

<sup>63</sup> For a discussion of the legality of private employers insisting on coordination with Medicare, see AARP v. EEOC, 390 F. Supp. 2d 437, (Dist. Court, ED Pennsylvania 2005); Diane M. Juffras, Coordinating Retiree Health Benefits With Medicare: The EEOC Issues Its Long-Delayed Final Rule, Public Employment Law Bulletin, Number 34, Mar 2008, available at <http://sogpubs.unc.edu/electronicversions/pdfs/pelb34.pdf>.

<sup>64</sup> Richard H. Mattoon, Facing the Challenge of Retiree Health Care: Liabilities and Responses of State and Local Governments—A Conference Summary, Chicago Fed Letter, May 1, 2008, Issue 250a at 4.

<sup>65</sup> Changes in benefits and compensation for public employees are producing unanticipated results. In California, the L.A. Times reports a rise in felonious activity by sheriff's deputies, including insurance fraud, as a result of cut backs in available overtime. See Robert Faturechi, L.A. County is seeing a spike in deputy-fraud allegations, LA Times, Jul 19, 2011, available at <http://www.latimes.com/news/local/la-me-lasd-fraud-20110719,0,1484216.story>. And, in Ohio a recent and unexpected consequence of legislative changes to public employee bargaining rights appears to be a record number of retirement applications. The Ohio Public Employees Retirement System reports

Nonetheless, it appears some states have enjoyed success at controlling benefits costs for future hires.<sup>66</sup> The problem of benefits for current employees and retirees is, of course, more difficult to solve. As the tables below illustrate, Indiana, Washington and South Dakota have each managed make changes that reduce future liabilities.

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a 34 percent increase in applications to retire in 2011 over 2010, see [More Ohio State Workers Seek to Retire in Wake of Passage of Controversial Law](#), 38 BNA Pension and Benefits Reporter No. 26, Jul 5, 2011 at 1249 ([Ohio Senate Bill 5] “eliminates binding arbitration as the means to resolve police officer and firefighter contract disputes, prohibits all public employees from striking, eliminates automatic pay increases, removes seniority as the sole determinant for the order of layoffs, prohibits [local] governments from picking up any portion of their workers’ share of pension contributions, and requires workers to pay at least 15 percent of their health care costs. ...[H]ealth care, sick leave, and pension benefits would not be subject to bargaining and in cases of fiscal emergency, the law allows management to throw out standing labor agreements”).

<sup>66</sup> Jon Ortiz, [California pension proposal seeks to hike employee contributions](#), Sacramento Bee, Jul 12, 2011 at 1A, available at <http://www.sacbee.com/2011/07/12/3763140/california-pension-proposal-seeks.html> (“Nationally, 15 states have either bargained or legislated higher pension contributions from public employees, according to the National Conference of State Legislatures. Of those, eight states – including California – are offsetting the employee contribution increases with lower government contributions. CalPERS figures that those higher state worker payments will save government nearly \$407 million on its 2011-12 pension bill. New Mexico workers started contributing another 1.75 percent of their salaries into their pension programs on July 1. Their employers – state government, school districts and colleges – will save a combined \$50 million this year by reducing their pension payments by the same amount. Lawmakers in New Jersey, traditionally a union-friendly state, recently passed a landmark measure that increases employee pension payments. Unions there are suing to block the increases.

Unions also are fighting a new Florida law that required 560,000 employees to begin paying 3 percent of their salaries to the state retirement system on July 1. The contributions will save state and local governments \$806 million in the first year... CalPERS says about 175 cities and counties have either raised employee contributions, reduced pensions for new hires or both”); Jeannette Neumann, [U.S. News: State Workers, Long Resistant, Accept Cuts in Pension Benefits](#), The Wall Street Journal, Jun 29, 2010 at A9 (“This year, nine state legislatures have voted to reduce benefits, increase monthly contributions or both for current workers and sometimes retirees, according to Keith Brainard, research director for the National Association of State Retirement Administrators. Unions and workers’ associations in at least two-thirds of those states have supported the rollbacks”).

## The Challenge Presented by Current Employees and Retirees

Pew Center on the States- The Widening Gap	% Funded Pensions	% ARC Contributed in 2009
New York	101%	100%
Wisconsin	100%	100%
Washington State	99%	73%
North Carolina	97%	100%
Delaware	94%	97%
South Dakota	92%	100%
Tennessee	90%	100%
Wyoming	89%	63%
Nebraska	88%	100%
Georgia	87%	100%
Kansas	64%	68%
Connecticut	62%	96%
Alaska	61%	110%
Louisiana	60%	97%
Rhode Island	59%	100%
New Hampshire	58%	58%
Kentucky	58%	75%
Oklahoma	57%	77%
West Virginia	56%	96%
Illinois	51%	71%
* <a href="http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=85899358839">http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=85899358839</a>		

Washington is one of only four states in the union that enjoys a fully-funded pension system<sup>67</sup>. As far back as 1977, Washington took action to reduce pension debt, “raising the retirement age, requiring more cost-sharing between members and employers, and limiting

<sup>67</sup> [States cutting benefits for public-sector retirees](#), Associated Press, Financial Wire, Sept 16, 2010.

opportunities to inflate pensions with late career salary increases”<sup>68</sup>. Further, Washington closed down older plans and opened new, less generous benefit plans. In this recent pension crisis, Washington politicians have proposed a constitutional amendment that would require the state to make its full ACR towards their pension fund, and have repealed automatic annual benefit increases for those who make above the minimum benefit amount<sup>69</sup>.

South Dakota has also taken a proactive stance towards pension costs, and enjoys a 97% funded status as a result. “South Dakota... replaced its automatic annual COLA of 3.1% with a formula that determines the annual adjustment based on the funded status of the state's pension plans<sup>70</sup>.” Like Minnesota and Colorado, this action resulted in a lawsuit. While courts in Minnesota and Colorado have already thrown out similar suits, the case of *Tice et al v. South Dakota* is still pending<sup>71</sup>.

Indiana’s funded percentage is estimated at 72%, below the 80% funded ratio that experts consider to be the bottom of the healthy range for pension plans. However, the overall debt amount is by no means insurmountable. In fact, according to a study that determined the

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<sup>68</sup> Building a 21<sup>st</sup> Century Government: Reforming Pensions, Summary materials for Governor Gregorie’s Policy Proposals, Jan 2011, available at <http://www.drs.wa.gov/news-announcements/2011-Pension-Proposals.pdf>; see also Reforming Pensions to Hold Down Costs, 2011 Policy Brief, Governor Chris Gregorie, available at [http://www.governor.wa.gov/priorities/budget/pension\\_reform.pdf](http://www.governor.wa.gov/priorities/budget/pension_reform.pdf); James L. McIntire, Pension Funding Reform for Washington State, Washington State Treasurer, Sept 13, 2010, available at <http://www.tre.wa.gov/documents/pensionFundingReform.pdf>.

<sup>69</sup> Stephen C. Fehr, Judges uphold cost-of-living cuts to pensions, Stateline, Jul 1, 2010, available at <http://www.stateline.org/live/printable/story?contentId=585060>; see also Stephen C. Fehr, States overhaul pensions but pass on 401(k)-style plans, Stateline, Jun 21, 2011, available at <http://stateline.org/live/printable/story?contentId=582585>.

<sup>70</sup> COLA reduction laws under fire in 3 states; Efforts to alleviate underfunding face backlash, Pensions & Investments, Oct 4, 2010.

<sup>71</sup> Marianne Goodland, PERA lawsuit moves forward; court date set, Colorado Statesman, Jun 3, 2011, available at <http://www.coloradostatesman.com/content/992838-pera-lawsuit-moves-forward-court-date-set>.

necessary annual tax hike needed to achieve solvency of the state’s public pension system, “Indiana comes in last at \$329”<sup>72</sup>.

<b>Northwestern Univ. study: Needed tax increases for full pension funding</b>	
	<b>\$ per taxpayer</b>
Indiana	\$ 329
Arkansas	\$ 534
Utah	\$ 538
West Virginia	\$ 600
Arizona	\$ 608
Idaho	\$ 737
Maine	\$ 761
South Dakota	\$ 776
North Carolina	\$ 784
Georgia	\$ 803
Colorado	\$ 1,739
New Mexico	\$ 1,756
Illinois	\$ 1,907
Minnesota	\$ 1,928
California	\$ 1,994
Ohio	\$ 2,051
Wyoming	\$ 2,080
Oregon	\$ 2,140
New York	\$ 2,250
New Jersey	\$ 2,475
* <a href="http://kellogg.northwestern.edu/faculty/rauh/research/RDPEPP.pdf">http://kellogg.northwestern.edu/faculty/rauh/research/RDPEPP.pdf</a> at 40.	

Governor Mitch Daniels has pushed hard for getting the state budget under control<sup>73</sup>.

Indiana combined its various pension plans under one roof, to cut operating expenses<sup>74</sup>, and

<sup>72</sup> Robert Novy-Marx & Joshua D. Rauh, The Revenue Demands of Public Employee Pension Promises, Jun 2011 at 40, available at <http://kellogg.northwestern.edu/faculty/rauh/research/RDPEPP.pdf>.

is considering increasing its annual pension contributions<sup>75</sup>. Importantly, Indiana has a long-standing hybrid plan that combines elements of DB and DC plans, reducing the state's investment risk. Further, Indiana does not face the same legal roadblocks to changing benefits. "States such as Indiana and Texas still statutorily consider pension benefit payments as 'mere gratuities that do not vest and can be amended or modified at any time by the state'"<sup>76</sup>.

One approach, first considered, apparently, in Maine,<sup>77</sup> seeks to coordinate retiree pension costs with Social Security<sup>78</sup>. The situation in Maine is particularly interesting because "[Maine] avoided the common mistake of sweetening benefits when markets were strong."<sup>79</sup>; the shortfall Maine faces is simply the direct result of investment losses. The proposed law would, following a phase-in period, cover current pension promises with social security benefits and the state pension. In the long run, this would take pressure off of the Maine plan without any need repudiate earlier promises to retirees.

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<sup>73</sup> [USA: Gov. Daniels Signs Sen. Walker's New Public Employee Pension Bill Into Law](#), Right Vision News, Apr 15, 2011.

<sup>74</sup> [How Indiana and California Use Hybrid Pension Plans to Solve Their Funding Problems](#), Institutional Investor, Mar 2011.

<sup>75</sup> [Indiana Mulls Hike in Levels of Contribution to Pension Plans](#), Investment Management Weekly, Apr 11, 2011.

<sup>76</sup> [COLA reduction laws under fire in 3 states; Efforts to alleviate underfunding face backlash](#), Pensions & Investments, Oct 4, 2010.

<sup>77</sup> Mary Williams Walsh, [Maine Giving Social Security Another Look](#), NY Times, Jul 20, 2010, available at <http://www.nytimes.com/2010/07/21/business/economy/21states.html> ("Even if it fully embraces the proposal, Maine will have to come up with a considerable sum to sustain its existing pension plan, presumably through some combination of taxes and service cuts. After a phase-in period, Social Security would cover part of state retirees' benefits, with the state pension as the remainder. Many pension plans in corporate America coordinate their benefits in this way. The proposal has the advantage of not reducing promised benefits, guaranteed by the constitution in many states. The change would not be cheap, but it would reduce the role of Maine's pension fund and thus the risk of having to suddenly cover giant losses down the road"). Maine created a task force to generate report in 2009, see Chapter 111, S.P. 515 - L.D. 1431, [The Maine Unified Retirement Plan Task Force report](#), <http://www.maineperc.org/PDFs/other%20publications/MainePERS%20Final%20URP%20Task%20Force%20Report%203-9-2010.pdf>.

<sup>78</sup> Social Security Act, ch. 531, 49 Stat. 620, now codified as 42 U.S.C. ch.7.

<sup>79</sup> Mary Williams Walsh, [Maine Giving Social Security Another Look](#), NY Times, Jul 20, 2010, supra.

## Desperate Measures in Desperate Places

In some states the combination of generous benefits promises and the financial collapse of 2008 combined to produce a crisis atmosphere which, in turn, triggered the first serious debates about the appropriateness of collective bargaining in the public sector since the Depression.<sup>80</sup> The situation in Wisconsin is perhaps best known.<sup>81</sup> The magnitude of the

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<sup>80</sup> Room for Debate, Wisconsin's Blow to Union Power, NY Times, Feb 18, 2011, available at <http://www.nytimes.com/roomfordebate/2011/02/18/the-first-blow-against-public-employees>; Daniel Henninger, The Fall of the House of Kennedy, WSJ, Jan 21, 2010, available at <http://online.wsj.com/article/SB10001424052748704320104575015010515688120.html> ("In 1962, President John F. Kennedy... signed executive order 10988 allowing the unionization of the federal work force"); see also Joseph A. McCartin, What's Really Going on in Wisconsin?, The New Republic, Feb. 19, 2011, available at <http://www.tnr.com/article/politics/83829/wisconsin-public-employees-walker-negotiate> ("Following the example of cities like New York and Philadelphia, in 1959, Wisconsin became the first state to enact legislation recognizing the rights of government workers to bargain collectively. Similar laws spread in subsequent years, encouraged by Wisconsin's law and inspired by Executive Order 10988, signed by President John F. Kennedy in 1962, which allowed federal workers to bargain over some aspects of their work (but not their pay or benefits). Critically, this growth enjoyed bipartisan support: Governor Ronald Reagan signed the Meyers-Milias-Brown Act in 1968, which brought public sector bargaining to California. Through his own executive order in 1969, President Richard Nixon strengthened the bargaining rights Kennedy had first offered federal workers. As a result of this support on both sides of the aisle, between the mid-'50s and the mid-'70s, there was a tenfold increase in the membership of government workers' unions"); Public Sector Labor Unions Evolve Over A Century, NPR, Feb 24, 2011, available at <http://www.npr.org/2011/02/24/134017794/Public-Workers-History>; Steven Greenhouse, Most U.S. Union Members Are Working for the Government, New Data Shows, NY Times, Jan 22, 2010, available at <http://www.nytimes.com/2010/01/23/business/23labor.html> ("For the first time in American history, a majority of union members are government workers rather than private-sector employees, the Bureau of Labor Statistics announced on Friday. In its annual report on union membership, the bureau undercut the longstanding notion that union members are overwhelmingly blue-collar factory workers. It found that membership fell so fast in the private sector in 2009 that the 7.9 million unionized public-sector workers easily outnumbered those in the private sector, where labor's ranks shrank to 7.4 million, from 8.2 million in 2008... According to the labor bureau, 7.2 percent of private-sector workers were union members last year, down from 7.6 percent the previous year. That, labor historians said, was the lowest percentage of private-sector workers in unions since 1900. Among government workers, union membership grew to 37.4 percent last year, from 36.8 percent in 2008"); Economic News Release, Union Members Summary, Bureau of Labor Statistics, U.S. Department of Labor, Jan 21, 2011, available at <http://www.bls.gov/news.release/union2.nr0.htm>; Barry Bluestone, A future for public unions?, Boston Globe, Jul 18, 2009, available at [http://www.boston.com/bostonglobe/editorial\\_opinion/oped/articles/2009/07/18/a\\_future\\_for\\_public\\_unions/](http://www.boston.com/bostonglobe/editorial_opinion/oped/articles/2009/07/18/a_future_for_public_unions/) ("between 2000 and 2008, the price of state and local public services has increased by 41 percent nationally compared with 27 percent in private services. Even in the face of the worst fiscal crisis in decades, many state and local union leaders refuse to consider a wage freeze that could help preserve more of their members' jobs"); but see Elizabeth G. Olson, Are public unions our convenient economic scapegoats?, Fortune Magazine, Feb. 28, 2011,

problem in California, Illinois and Colorado is staggering and has left commentators wondering about the possibility of bankruptcy as a viable solution.

While the 81% present funded ratio on California's pensions are not among with worst offenders, the total size of California's unfunded liability, due it its large population and economy, is without peer<sup>82</sup>. Estimates on the total unfunded liability range from \$93 billion according to the official reports that use a 7.75% discount rate<sup>83</sup> to over \$500 billion based on a risk-free discount rate<sup>84</sup>. The primary culprit for these extraordinary debts are California's retiree benefit plans, which were regularly increased during economic boom

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available at <http://management.fortune.cnn.com/2011/02/28/are-public-unions-our-convenient-economic-scapegoats/> ("Unionized workers didn't sow the seeds of the economic downturn, deregulation of the financial industry did," says Robert Bruno, a University of Illinois professor of labor and employment relations. "We've suffered billions in losses because of greed, gross mismanagement and illegal activity in the financial industry").

<sup>81</sup> For background on the debate, see Amanda Terkel, The Wisconsin Collective Bargaining Fight: Behind The Scenes, Huffington Post, Jun 23, 2011, available at [http://www.huffingtonpost.com/2011/06/21/wisconsin-collective-bargaining-protests-behind-scenes\\_n\\_880625.html](http://www.huffingtonpost.com/2011/06/21/wisconsin-collective-bargaining-protests-behind-scenes_n_880625.html); Abby Sewell & Michael Muskal, Indiana Democrats flee to Illinois in protest of union legislation, LA Times, Feb 23, 2011, available at <http://articles.latimes.com/2011/feb/23/news/la-pn-0223-indiana-democrats-flee-20110224>; Dawn Rhodes, Hailey Branson-Potts & Erin Meyer, Wisconsin senators living day-to-day south of border, Chicago Tribune, Feb 21, 2011, available at [http://articles.chicagotribune.com/2011-02-21/news/ct-met-wisconsin-democrats-illinois-20110221\\_1\\_senators-wisconsin-constitutions-julie-lassa](http://articles.chicagotribune.com/2011-02-21/news/ct-met-wisconsin-democrats-illinois-20110221_1_senators-wisconsin-constitutions-julie-lassa). For the current status, see Monica Davey, Wisconsin Court Reinstates Law on Union Rights, NY Times, Jun 14, 2011, available at <http://www.nytimes.com/2011/06/15/us/politics/15wisconsin.htm> ("The Wisconsin Supreme Court cleared the way on Tuesday for significant cuts to collective bargaining rights for public workers in the state, undoing a lower court's decision that Wisconsin's controversial law had been passed improperly"); Amy Merrick, Wisconsin Union Law to Take Effect, WSJ, Jun 15, 2011, available at <http://online.wsj.com/article/SB10001424052702303848104576386122936205978.html>; see State of Wisconsin v Fitzgerald, et al, (Supreme Court of Wisconsin, 2011), available at <http://www.wicourts.gov/sc/opinion/DisplayDocument.html?content=html&seqNo=66078>.

<sup>82</sup> The Trillion Dollar Gap Grows Wider, Pew Center on the States, Apr 25, 2011, available at [http://www.pewcenteronthestates.org/initiatives\\_detail.aspx?initiativeID=85899358839](http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=85899358839).

<sup>83</sup> Daniel Borenstein, Public-pension accounting hides the size of the problem, Mercury News, May 29, 2011, available at [http://www.mercurynews.com/news/ci\\_18166578?source=rss&nclick\\_check=1](http://www.mercurynews.com/news/ci_18166578?source=rss&nclick_check=1) ("CalPERS assumes a 7.75 percent rate, similar to other public systems. The system says that's reasonable because it has earned an average 7.9 percent over the past 20 years. Yet, CalPERS actuaries recently recommended reducing the rate to 7.5 percent, a move the board of directors rejected. Critics say even that would not have been nearly enough. They note that the rate for the entire 20th century averaged about 6.2 percent, and that CalPERS' rate for the last 10 years averaged 4.3 percent. Investment guru Warren Buffett calls the rates used by public-pension systems "nuts" and "crazy," and suggests 6 percent would be more reasonable").

<sup>84</sup> David Crane, California's \$500-billion pension time bomb, LA Times, Apr 6, 2010, available at <http://articles.latimes.com/2010/apr/06/opinion/la-oe-crane6-2010apr06>.

cycles and never reduced during the inevitable bust cycles<sup>85</sup>. Reform measures have included increased contributions and higher retirement ages for current workers and decreased benefits for new hires<sup>86</sup>. Further proposals entail moving away from a DB plan towards a hybrid plan and instituting benefit caps<sup>87</sup>.

Forbes: overall ranking of all state debt
Utah
New Hampshire
Nebraska
Texas
Virginia
North Dakota
Nevada
Iowa
Montana
Colorado
Wisconsin
Massachusetts
Ohio
Mississippi
Louisiana
New Jersey
California

<sup>85</sup> Sinkhole! How public pension promises are draining state and city budgets, Bloomberg Businessweek, Jun 13, 2005, available at [http://www.businessweek.com/magazine/content/05\\_24/b3937081.htm](http://www.businessweek.com/magazine/content/05_24/b3937081.htm) (“California’s pension benefits are extreme. In 1999 and again in 2001, a time when the pension plans were flush with strong investment gains and state contributions were low, the state legislature upped the benefits to levels far beyond even the most generous public plans. A recent analysis by the LAO notes that for longer-term and some local employees, it’s quite possible to receive more annual income in retirement than when a worker was employed... This tendency to dole out goodies in fat times is the core moral hazard of public-pension plans. Politicians like to reward voters when they can, and public workers vote”).

<sup>86</sup> Selected Approved Changes to State Public Pensions to Restore or Preserve Plan Sustainability, National Association of State Retirement Administrators, available at <http://www.nasra.org/resources/SustainabilityChanges.pdf>.

<sup>87</sup> Sinkhole! How public pension promises are draining state and city budgets, Bloomberg Businessweek, Jun 13, 2005, available at [http://www.businessweek.com/magazine/content/05\\_24/b3937081.htm](http://www.businessweek.com/magazine/content/05_24/b3937081.htm).

Connecticut
New York
Illinois
* <a href="http://www.forbes.com/lists/2010/44/debt-10_Global-Debt-Crisis_Rank.html">http://www.forbes.com/lists/2010/44/debt-10_Global-Debt-Crisis_Rank.html</a>

The pension situation in Illinois is by far the most absurd in the nation. Illinois appears on the bottom rung on every analysis of state debt. The present funded ratio is a mere 51%, creating a \$62 billion shortfall, even when using highly optimistic official discount rates<sup>88</sup>. The situation is so dire that some economists have estimated that Illinois will run out of money to fund its pensions within seven years<sup>89</sup>.

<b>Northwestern Univ. study: Year that pension funds are expected to run out</b>	
	<b>Year</b>
North Carolina	NA
Utah	2042
Delaware	2040
South Dakota	2034
New York	2033
North Dakota	2033
Florida	2032
Tennessee	2032
Iowa	2032
Georgia	2030
Indiana	2021
Hawaii	2020
Kentucky	2020
West Virginia	2019
Arkansas	2019

<sup>88</sup> [The Trillion Dollar Gap Grows Wider](http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=85899358839), Pew Center on the States, Apr 25, 2011, available at [http://www.pewcenteronthestates.org/initiatives\\_detail.aspx?initiativeID=85899358839](http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=85899358839).

<sup>89</sup> Joshua Rauh, [The Day of Reckoning For State Pension Plans](http://kelloggfinance.wordpress.com/2010/03/22/the-day-of-reckoning-for-state-pension-plans/), Kellogg School of Management, Mar 22, 2010, available at <http://kelloggfinance.wordpress.com/2010/03/22/the-day-of-reckoning-for-state-pension-plans/>.

Connecticut	2018
New Jersey	2018
Illinois	2018
Louisiana	2017
Oklahoma	2017
* <a href="http://kelloggfinance.wordpress.com/2010/03/22/the-day-of-reckoning-for-state-pension-plans/">http://kelloggfinance.wordpress.com/2010/03/22/the-day-of-reckoning-for-state-pension-plans/</a>	

Illinois has a long and sorry history of shirking its ARC<sup>90</sup>, even in the midst of adding pension sweeteners, and charges of political corruption. Home to strong and influential unions, Wisconsin democrats received safe harbor in Illinois in their recent attempt to prevent Gov. Walker’s efforts to enact pension reform<sup>91</sup>. Reform measures, while rather late, have finally broken through in Illinois. The state “raised its retirement age to 67, the highest of any state, and capped public pensions at \$106,800 a year.<sup>92</sup>” Other reform measures have included a new formula for determining COLA’s, an optional 401(k) style plan, and closing loopholes that allowed for double-dipping and spiking<sup>93</sup>. In one more desperate measure,

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<sup>90</sup> Sinkhole! How public pension promises are draining state and city budgets, Bloomberg Businessweek, Jun 13, 2005, available at [http://www.businessweek.com/magazine/content/05\\_24/b3937081.htm](http://www.businessweek.com/magazine/content/05_24/b3937081.htm) (“According to an analysis by the Civic Federation, a Chicago research group sponsored by the business community, since 1970 Illinois has not once paid its annual pension bill in full... Over the years, even as the state failed to pay for existing pension promises, the Springfield politicians have added more. In the past 10 years benefit sweeteners have added \$5.8 billion in new benefits, largely through early retirement inducements. And there has been a general creep up in the level of promises made. Today, one-third of Illinois state employees get hazard rates of pension payments originally intended only for state police, according to the governor.... Illinois State Representative Robert S. Molaro, a member of a commission convened by the governor to make recommendations for fixing the pension system said, ‘It will be hard for us to go to the taxpayers and ask them to pay for our pensions with benefits you in the private sector couldn't even dream of’”).

<sup>91</sup> Mark Niquette & Stephanie Armour, Democrats From Wisconsin, Indiana Take Haven in Illinois to Block Bills, Bloomberg, Feb 23, 2011, available at <http://www.bloomberg.com/news/2011-02-23/wisconsin-indiana-democrats-flee-to-illinois-to-block-union-rights-votes.html> (“Illinois has become a haven for Midwestern Democratic lawmakers fleeing their states to stall votes on Republican-backed bills restricting union rights”).

<sup>92</sup> With severe budget troubles, states are taking aim at pensions, The Boston Globe, Jun 20, 2010.

<sup>93</sup> Selected Approved Changes to State Public Pensions to Restore or Preserve Plan Sustainability, National Association of State Retirement Administrators, available at <http://www.nasra.org/resources/SustainabilityChanges.pdf>.

“the Illinois Legislature recently gave the city of Chicago permission to operate a casino in order to raise money to help alleviate the pension funding crisis there.”<sup>94</sup>”

Forbes: unfunded pension debt per capita		
	\$	USD
	\$	
Nebraska	4,878	
	\$	
Tennessee	5,229	
	\$	
North Dakota	6,080	
	\$	
North Carolina	6,300	
	\$	
Florida	6,389	
	\$	
Delaware	6,872	
	\$	
West Virginia	7,054	
	\$	
Vermont	7,082	
	\$	
Utah	7,272	
	\$	
Indiana	7,418	
	\$	
New Mexico	14,614	
	\$	
Hawaii	15,526	
	\$	
Colorado	15,548	
	\$	
Wisconsin	16,418	
	\$	
New Jersey	16,838	
	\$	
Illinois	17,230	
	\$	
Connecticut	17,622	
	\$	
Alaska	18,797	
	\$	
Ohio	19,110	
	\$	
Rhode Island	20,271	

<sup>94</sup> Rachel Steingard, No fix in sight for Ill. Public pension woes, Soc. Of Am. Bus. Eds and Writers, Jun 2, 2011, available at <http://sabew.org/2011/06/no-fix-in-sight-to-ill-public-pension-woes/>.

Colorado is interesting for reasons other than its unremarkable 70% funding ratio for public pensions. Unlike many states whose shortfalls are due primarily to overly generous benefits, lack of funding and pension abuses, Colorado's underfunded liability appears to issue mainly from its attempt to reach overly optimistic projected rates of return by overweighting in risky equities and hedge funds<sup>95</sup>. However, it is the topic of pension reform where Colorado requires mention. Colorado was among the first set of states to reduce costly COLA's, which provides an immediate and substantial cost savings. This change resulted in a lawsuit, *Justus et al v. the state of Colorado*, which captured the eyes of pension reformers and unions across the nation. The judge in this case recently ruled that removing COLA is constitutional<sup>96</sup>, which may open the doors to similar reforms and judicial decisions across the nation.

Sadly, in spite of these often contentious efforts at reform of both the public collective bargaining process and the specific terms of benefits plans, each of these jurisdictions remains in precarious financial condition.

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<sup>95</sup> Sinkhole! How public pension promises are draining state and city budgets, Bloomberg Businessweek, supra ("Meredith Williams, executive director of Colorado's public employee retirement system, says that by 2000, his funds were 90%-invested in equities and real estate investment trusts. The bear market took Colorado's plan from 105%-funded to only 76%. That prompted Williams to cut stocks to something closer to 60% of total holdings. 'You live by that sword, you die by that sword,' he says"); see also Steve Eder, Gregory Zuckermen & Michael Corkery, Pensions Leap Back to Hedge Funds, WSJ, May 27, 2011, available at [http://online.wsj.com/article/SB10001424052702303654804576347762838825864.html?mod=googlenews\\_wsj](http://online.wsj.com/article/SB10001424052702303654804576347762838825864.html?mod=googlenews_wsj).

<sup>96</sup> Andrew Harris & William Selway, Colorado, Minnesota Courts Throw Out Suits Disputing Retiree Benefit Cuts, Bloomberg, Jun 30, 2011, available at <http://www.bloomberg.com/news/2011-06-30/colorado-minnesota-state-courts-toss-retiree-pension-benefit-cut-lawsuits.html> ("Judge Robert S. Hyatt in Denver... rejected claims by the former workers that they had a right to specific cost of living adjustments. Hyatt said that while the plaintiffs had a contractual right to their pensions, they didn't have a right to 'the specific COLA formula in place at their respective retirement, for life without change.' Johnson said Minnesota retirees didn't have a constitutionally protected property interest in COLA increases").

Moody's: total debt as % of personal income	
	%
Nebraska	0.1%
Indiana	2.5%
Tennessee	2.9%
North Carolina	3.3%
Iowa	3.4%
South Dakota	3.5%
Missouri	4.0%
Ohio	4.1%
Texas	4.5%
Pennsylvania	5.6%
Rhode Island	19.7%
Illinois	20.5%
Massachusetts	20.6%
West Virginia	20.9%
Kentucky	21.2%
Alaska	21.6%
New Mexico	21.9%
Connecticut	22.3%
Mississippi	22.8%
Hawaii	27.7%
* <a href="http://www.nasra.org/resources/Moodys1101.pdf">http://www.nasra.org/resources/Moodys1101.pdf</a> at 7-8.	

If these states were private firms, there is little doubt that bankruptcy would be their only viable option.

<b>Moody's: unfunded pension as % of GDP</b>	<b>%</b>
New York	-0.91%
Nebraska	0.06%
Wisconsin	0.11%
North Carolina	0.13%
Indiana	0.49%
Washington	0.59%
Ohio	0.62%
Delaware	0.69%
Missouri	0.80%
Tennessee	1.08%
South Carolina	7.71%
Maine	8.03%
Hawaii	8.09%
New Mexico	8.66%
Oklahoma	8.99%
Rhode Island	9.19%
Kentucky	9.54%
Illinois	9.85%
Mississippi	11.18%
West Virginia	11.31%
* <a href="http://www.nasra.org/resources/Moodys1101.pdf">http://www.nasra.org/resources/Moodys1101.pdf</a> at 11.	

Additionally, the legality of changes to benefits for workers whose benefits have “vested”—  
i.e. current retirees and long term employees—remains in doubt.<sup>97</sup>

All of the recent turmoil has raised doubts about the appropriateness of collective  
bargaining in the public sector. Some states, most notably Texas,<sup>98</sup> have never permitted

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<sup>97</sup> My colleague, Jack Beermann, is presently working on a paper which addresses the constitutionality of state efforts to change public employees' benefits.

their public employees to engage in collective bargaining. This alone did not shield Texas from the same morally hazardous behavior of other states<sup>99</sup>; it did however, make change easier to effect when it became apparent that the state could not afford the promises it had made.<sup>100</sup> The argument in favor of limiting public collective bargaining to wages and working conditions (thereby excluding bargaining over benefits) grows out of the public choice story and moral hazard analysis which provides the only coherent explanation for the persistent overpromising described in this paper.

At the heart of public choice theory is the simple insight that politicians are rational, self-interested actors like everyone else. The astonishing debt figures that GASB 45 finally forced states to report are the logical result of years of rent seeking by legislators and public sector unions. Well organized unions push hard for improved benefits. Politicians, who are legally

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<sup>98</sup> Texas has private sector unions, but they are heavily restricted and not allowed to use collective bargaining. See Mark Hemmingway, California unions stand in way of Texas-size success, San Francisco Examiner, Feb 10, 2011, available at <http://www.sfexaminer.com/opinion/op-eds/2011/02/california-unions-stand-way-texas-size-success#ixzz1SxgV4uXN> (“Texas has right-to-work laws, meaning the state forbids compulsory union dues as a condition of employment. California does not, and forced unionization means a much more expensive labor force... While Texas has public-sector unions, the state has instituted tight controls. Under Texas law, state employees cannot receive benefit increases unless the pension funds can meet their long-term obligations, and state employees are required to contribute 6 percent of their paycheck to their pensions”); but see David Madland, Public Sector Unions Should Have the Right to Collective Bargaining, US News and World Reports, Feb 25, 2011, available at <http://www.usnews.com/opinion/articles/2011/02/25/public-sector-unions-should-have-the-right-to-collective-bargaining> (“Texas, which does not allow collective bargaining and has a very weak union movement, faces a \$27 billion budget deficit over the next two fiscal years, a budget deficit similar in size to California's, but with a much smaller economy”).

<sup>99</sup> Kate Alexander, Texas public pensions under scrutiny in spite of protections, Austin-American Statesman, Dec. 11, 2010, available at <http://www.statesman.com/news/texas-politics/texas-public-pensions-under-scrutiny-in-spite-of-1114511.html>; The Trillion Dollar Gap Grows Wider, Pew Center on the States, Apr 25, 2011, available at [http://www.pewcenteronthestates.org/initiatives\\_detail.aspx?initiativeID=85899358839](http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=85899358839) (Texas has an estimated \$24.9 billion unfunded liability, but makes full ARC each year); see also Special Report, Global Debt Crisis, Forbes, Jan 20, 2010, available at [http://www.forbes.com/lists/2010/44/debt-10\\_Global-Debt-Crisis\\_UnfundedPensions.html](http://www.forbes.com/lists/2010/44/debt-10_Global-Debt-Crisis_UnfundedPensions.html) (Texas pension debt comes out to \$7,744 per person).

<sup>100</sup> Susan Combs, Robert Duncan & Vicki Truitt, House Bill 2365 Protects Texans From Far-Reaching Consequences of Government Accounting Rule, available at <http://www.window.state.tx.us/newsinfo/columns/070611gasb.html> (“Retirement health benefits for the state of Texas and most Texas governmental entities are not constitutionally mandated or contracted programs. Instead, the programs are reviewed and renewed during the regular budgeting process. ... Texas budgets within available revenue; however, what we can afford as a state changes each biennium. For example, in 2003 the Legislature faced a \$10 billion shortfall. Consequently, benefits were reduced”).

obligated to negotiate with these unions on behalf of the taxpayers, understand that strong union support in the form of votes and dollars can be secured by increasing compensation to the union's membership. Why benefits though and not wages? Both the union and the politician understand that large wage increases mean large increased expenses in the very short term—voter ire in response to the tax increases needed to fund the wage increases is likely and, no doubt, undesirable. Benefits are attractive precisely because they usually involve *future* promises. Mixed with long amortization periods, high discount rates and a few other optimistic assumptions, and the budget appears balanced. The politician secures desired support, unions report victory at the bargaining table to their membership and the taxpayer is happy that the budget is balanced without any appreciable increase in taxes.

The only problem with this, indeed with all stories about moral hazard, is that eventually the future arrives and the careless behavior in question must be addressed. As we've seen, there are only a few options—evisceration of the remainder of a state's budget in order to honor benefit promises; (relatively) easy changes in benefits promised to future hires; and, most difficult, a re-working of earlier promises. This latter option is being explored to one degree or another in every state examined for this paper. Some jurisdictions, most noticeably Massachusetts<sup>101</sup>, have managed to extract concessions without affecting the permissible scope

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<sup>101</sup> For background on this debate, see Michael Levenson, House votes to restrict unions, Boston Globe, Apr 27, 2011, available at [http://articles.boston.com/2011-04-27/news/29479557\\_1\\_unions-object-labor-unions-health-care](http://articles.boston.com/2011-04-27/news/29479557_1_unions-object-labor-unions-health-care); for an update on this debate, see Noah Bierman, Patrick, leaders strike deal on unions, Boston Globe, Jul 9, 2011, available at [http://www.boston.com/news/politics/articles/2011/07/09/patrick\\_leaders\\_strike\\_deal\\_on\\_union\\_bargaining\\_cu\\_rbs/?s\\_campaign=8315](http://www.boston.com/news/politics/articles/2011/07/09/patrick_leaders_strike_deal_on_union_bargaining_cu_rbs/?s_campaign=8315) ("The agreement, reached behind closed doors and slated for approval Monday, allows Patrick to argue that he is cutting health costs for cities and towns by \$100 million without gutting workers' rights. Patrick has been pitching himself nationally as a governor who can work with organized labor under tough budgetary circumstances, contrasting his approach with Republican governors who have fought divisive battles with unions this year").

of collective bargaining; others are gambling on judicial support for legislative changes;<sup>102</sup> still others are pursuing a combination of changes in benefit levels combined with the “fundamental reform” of limiting or eliminating collective bargaining.<sup>103</sup>

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<sup>102</sup> The case in Colorado is Justus v. State of Colorado, 10-01589, District Court for Denver City and County, Colorado (Denver), available at <http://www.copera.org/pdf/Misc/06-29-11Order.pdf>; the case in Minnesota is Swanson v. State of Minnesota, 10-05285, Ramsey County, Minnesota, District Court, Second Judicial District (St. Paul), available at <http://graphics8.nytimes.com/packages/pdf/business/20110701pension/swansonPera.PDF>, and the case in South Dakota is Merton B. Tice Jr. et al v. State of South Dakota et al, Civ No. 10-225, Sixth Judicial Circuit, Hughes County, South Dakota. See Mary Williams Walsh, Two Rulings Find Cuts in Public Pensions Permissible, NY Times, Jun 30, 2011, available at <http://www.nytimes.com/2011/07/01/business/01pension.html> (“The two court decisions, issued Wednesday, suggest that the legal tide may be changing for public pensioners. The political tide has already turned in some places — in addition to Colorado and Minnesota, South Dakota and New Jersey have also cut cost-of-living benefits for current retirees, and other states have been awaiting legal guidance before doing the same. In their court filings, retirees in Colorado and Minnesota had argued that their benefits were contractual in nature, and therefore protected by state and federal constitutional language barring the impairment of contracts. However, in his ruling dismissing the Minnesota case, Judge Gregg E. Johnson of the state’s Second Judicial District Court wrote that the retirees in that state ‘have not met their burden to show unconstitutionality beyond a reasonable doubt.’ Judge Robert S. Hyatt, a district judge in Denver, offered a different line of thinking, noting that the 2010 state law that cut the benefits did not actually allow the state to remove money from the pension fund and use it to balance the budget. Rather, he wrote, the law required the state to send even more money to the pension fund at the same time that it required retirees to give up part of their benefit, ‘in order to create a larger pool of investable funds and thus provide for sustainable pension benefits in the future”).

<sup>103</sup> For an example in New Jersey, see Richard Perez-Pena, New Jersey Lawmakers Approve Benefits Rollback for Work Force, NY Times, Jun 23, 2011, available at <http://www.nytimes.com/2011/06/24/nyregion/nj-legislature-moves-to-cut-benefits-for-public-workers.html?pagewanted=all> (“New Jersey lawmakers on Thursday approved a broad rollback of benefits for 750,000 government workers and retirees, the deepest cut in state and local costs in memory, in a major victory for Gov. Chris Christie and a once-unthinkable setback for the state’s powerful public employee unions”); this step has also occurred in Wisconsin, see Mary Williams Walsh, Pension Rates and Collective Bargaining, NY Times, Mar 10, 2011, available at <http://www.nytimes.com/2011/03/11/business/11pension.html?pagewanted=all>; Wis. Supreme Court Allows Walker’s Union Restrictions, Newsmax, Jun 14, 2011, available at <http://www.newsmax.com/Newsfront/US-Wisconsin-Budget-Unions/2011/06/14/id/400078> (“The Wisconsin Supreme Court handed Republican Gov. Scott Walker a major victory on Tuesday, ruling that a polarizing union law could take effect that strips most public employees of their collective-bargaining rights”); for the Indiana reform, see Indiana Gov. Mitch Daniels Is Tough On Budgets, NPR, Feb. 28, 2011, available at <http://www.npr.org/2011/02/28/134111630/indiana-gov-mitch-daniels-tough-on-budgets>.

Until it became more beneficial for politicians to fight union demands rather than agree to them, actual reform was, of course, hard to come by. The economic costs to individual taxpayers were mostly obscured and so the diffuse benefits of waging a campaign to counteract well-organized unions did not outweigh the costs. In truth, many of the people expected to bear the costs of these benefits were not old enough to vote. As the table showing per capita debt load demonstrates the more densely populated, industrialized states tended to have strong public unions and democratic majorities that support unions. In these states the pressure to grant union benefits was especially powerful and per capita debt load increased as one would predict.

It is impossible to predict which states will fully rationalize their promises. Maybe the long, painful period of reckoning in which most states now find themselves will serve as an effective push back against the next round of tempting over-promising when the economy rebounds.

#### IV. **Moral Hazard Pushback and Reform: Toward a Culture of Thrift and Transparency**

The task facing the many states that have overpromised benefits is essentially two-fold: first, implementing cost cutting strategies in order to avoid bankruptcy or the equally distasteful specter of a budget with one line-item--benefits payments. As the case studies make clear, without cost cutting or dramatic increases in revenue, it is not inconceivable that a state could, after honoring its health care and pension obligations, have little or no ability to pay for education, police and fire, social services (including its share of Medicaid) and so on. Such a state of affairs would radically alter the states' traditional role in the areas of education, law enforcement and social services. Experience to date suggests that cost cutting must be a significant part of any solution.<sup>104</sup>

Second, policymakers must recognize and reject the rent seeking<sup>105</sup> behavior that created the current unsustainable state of affairs. It is hard to say which of these the states will find

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<sup>104</sup> In better economic times and with a lower unemployment rate, increased revenue from property, income and sales taxes are also viable options.

<sup>105</sup> See Anne Krueger, The Political Economy of the Rent-Seeking Society, American Economic Review (1974) and Gordon Tullock, The Welfare Costs of Tariffs, Monopolies, and Theft, Western Economic Journal (1967); see also Dr. Paul M. Johnson, A Glossary of Political Economy Terms, Auburn University, [http://www.auburn.edu/~johnspm/gloss/rent-seeking\\_behavior](http://www.auburn.edu/~johnspm/gloss/rent-seeking_behavior) ([Rent-seeking is] "the expenditure of resources in order to bring about an uncompensated transfer of goods or services from another person or persons to one's self as the result of a "favorable" decision on some public policy. The term seems to have been coined (or at least popularized in contemporary political economy) by the economist Gordon Tullock. Examples of rent-seeking

more difficult, as morally hazardous behavior is notoriously difficult to constrain permanently.<sup>106</sup> The collective efforts of the “good” and “bad” states described above suggests several avenues for reform; the list below is also informed by the experience of private employers who resorted to bankruptcy, or took advantage of the flexibility of the ERISA plan amendment process<sup>107</sup> following the scrutiny triggered by FAS 106.

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behavior would include all of the various ways by which individuals or groups lobby government for taxing, spending and regulatory policies that confer financial benefits or other special advantages upon them at the expense of the taxpayers or of consumers or of other groups or individuals with which the beneficiaries may be in economic competition”); Kelley L. Ross, Rent-Seeking, Public Choice, and The Prisoner's Dilemma, available at <http://www.friesian.com/rent.htm> (“Public Choice theory is about the different *incentives* and processes that operate when goods are sought through political means rather than through purely economic means. The essential point is about the distribution of costs and benefits. The political appropriation and distribution of goods is attractive because it concentrates its benefits and disperses its costs. Many people can be taxed only a small amount and then a small number of people can be given large sums. This means that the many hardly notice the wealth that they have lost, while the few become active partisans of their own benefits. Politicians hear nothing from the many and a lot from the few, who also have some money to contribute to the politicians, money that may actually be, or be freed up by, the benefits they receive -- like the money teachers' unions get from compulsory union dues, from the money paid by the government to teachers. Thus, constituencies and interest groups are created for each particular political benefit program, and it becomes nearly impossible to get rid of them. The rent-seeking aspect of this is that the beneficiaries receive rents on the basis of their participation in the interest group.... Such things are hard for politicians to resist, since it holds the promise of a group of dedicated voters beholden for their own program”).

<sup>106</sup> See Everett Crosby, Fire Prevention, *Annals of the American Academy of Political and Social Science* (American Academy of Political and Social Science)(1905); Tom Baker, On the Genealogy of Moral hazard, *Texas Law Review* (1996) (“For example, ‘Why do farmers have difficulty finding effective insurance? The problems are several, and a handful of Nobel Prizes in Economics have been given to those who generated the key insights. First, ‘moral hazard’ is omnipresent; once insured, farmers are less likely to apply the extra fertilizer, labor, and other inputs needed to maximize chances of success: the very fact of being insured raises the probability of losses”); Jonathan Morduch, Micro-insurance: the next revolution?, NYU, Jun 1, 2004, available at <http://dri.fas.nyu.edu/docs/IO/12607/DRIWP12.pdf>; see also Ching-tp Albert Ma (Boston University Dept of Economics) & Michael H. Roirdan (Columbia University), Health Insurance, Moral Hazard, and Managed Care, Apr 2001, available at <http://www.columbia.edu/~mhr21/ma.pdf>; Richard Zeckhauser, Insurance, available at <http://www.econlib.org/library/Enc1/Insurance.html> (“Once insured, an individual has less incentive to avoid risky behavior. With automobile collision insurance, for example, one is more likely to venture forth on an icy night. Federal deposit insurance made S&Ls more willing to take on risky loans. Federally subsidized flood insurance encourages citizens to build homes on flood plains”); Selection on moral hazard in health insurance, available at <http://econ-www.mit.edu/files/6644>; Jay Bhattacharya, Kate Bundorf, Noemi Pace & Neeraj Sood, Does Health Insurance Make You Fat?, National Bureau of Economic Research, Jul 2009, available at <http://www.nber.org/papers/w15163>.

<sup>107</sup> Employers have almost complete freedom to amend health care plans, and less freedom to amend pension plans. Nonetheless, employers managed to terminate many DB plans and push employees into DC plans. See ERISA 4220- Procedures of PBGC Approval of Plan Amendment; see also Ellen E. Schultz, Companies Sue Union Retirees To Cut Promised Health Benefits, *WSJ*, Nov 10, 2004 at A1, available at <http://online.wsj.com/public/resources/documents/SB110003711129469246.htm>.

## Bankruptcy option

Thus far no state in the union has declared bankruptcy, although the frightening condition of many states' budgets has generated considerable discussion about the desirability of this option.<sup>108</sup> Short of bankruptcy, which would presumably permit a state to reject and re-

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<sup>108</sup> Kate Linthicum, Wall street warms to l.a. at last; City gets \$1.3 billion in loans at low interest rates after officials lobby investor, Los Angeles Times, Jul 2, 2011 ("Another critic of the city's fiscal outlook, former Mayor Richard Riordan, weighed in on the news of the city's favorable loan rates. In an interview with the Bond Buyer last month, Riordan said that he thinks that Los Angeles, like many cities and states, may go bankrupt soon because of dramatic increases in employee pension and healthcare benefit costs"); see Randall Jensen, Ex-L.A. Mayor Warns of Insolvency, Jun 17, 2011, available at [http://www.bondbuyer.com/issues/120\\_116/richard-riordan-profile-1027933-1.html](http://www.bondbuyer.com/issues/120_116/richard-riordan-profile-1027933-1.html); Mary Williams Walsh & Abby Goodnough, Central Falls- RI, Edging Toward Default, NY Times, Jul 12, 2011 ("The small city of Central Falls, R.I., appears to be headed for a rare municipal bankruptcy filing, and state officials are rushing to keep its woes from overwhelming the struggling state. The impoverished city, operating under a receiver for a year, has promised \$80 million worth of retirement benefits to 214 police officers and firefighters, far more than it can afford. Those workers' pension fund will probably run out of money in October, giving Central Falls the distinction of becoming the second municipality in the United States to exhaust its pension fund, after Prichard, Ala.... Some analysts fear that a Central Falls bankruptcy, and a whiff of other problems out there, could scare nervous investors away from bonds issued by Rhode Island's other municipalities, perhaps setting off a chain reaction that could push the state itself to the brink. There is a precedent: the last American state to default on its bonds, Arkansas in 1933, got in over its head by trying to help struggling municipalities"); but see Mary Williams Walsh, Two Rulings Find Cuts In Pensions Permissible, The New York Times, Jul 1, 2011 ("Public pensions are considered so bulletproof that when the city of Vallejo, Calif., recently restructured its finances in bankruptcy, it cut other costs but left worker pensions intact"); Michael Corkery, Illinois Treasurer Rejects State Bankruptcy, The Wall Street Journal, Mar 25, 2011 ("Someone has to go out and have the testosterone and deal with the problems, particularly with the public employee unions,' the state's Republican treasurer said in a forum this week at Cardozo Law School of Yeshiva University in New York. Testosterone, said Mr. Rutherford, is better than allowing states to seek bankruptcy protection so a judge can sort out fiscal problem such as pensions"); Roger Lowenstein, BROKE TOWN U.S.A., The New York Times, Mar 6, 2011 ("Even in Illinois, pensions will be paid. Failure to do so would embroil the government in court for years. That may be the hope of ideologues, who envision that the courts -- or possibly even a bankruptcy filing -- could be used to alter employee contracts. In the 1930s, progressives persuaded Congress to let cities declare bankruptcy to escape the clutches of creditors. Now, conservatives want Congress to authorize states to file for bankruptcy. 'Some people on the right see it as a chance to whack the public unions,' says David Skeel, a law professor at the University of Pennsylvania who has written in favor of state bankruptcy. It's not hard to fathom why Gingrich, who as speaker of the House in the 1990s briefly shut down the U.S. government, would favor default by the states"); David Skeel, A Bankruptcy Law- Not Bailouts- for the States, Jan 18, 2011 available at <http://online.wsj.com/article/SB10001424052748703779704576073522930513118.html>; see also Jeb Bush & Newt Gingrich, Better off bankrupt, Op-Ed, LA Times, Jan 27, 2011, available at <http://articles.latimes.com/2011/jan/27/opinion/la-oe-gingrich-bankruptcy-20110127>; Alison Vekshin, State Bankruptcy Weighed by Republicans Blocking Aid, Jan 21, 2011, available at <http://www.bloomberg.com/news/2011-01-21/u-s-state-bankruptcy-weighed-by-house-republicans-blocking-aid.html>. For current status, see Corey Boles & Siobhan Hughes, No State Bailouts, Lawmaker says, WSJ, Jan 25, 2011; Mary Williams Walsh, A Path is sought for States to Escape Their Debt Burdens, NY Times, Jan 20, 2011, available at [http://www.nytimes.com/2011/01/21/business/economy/21bankruptcy.html?\\_r=1&pagewanted=all](http://www.nytimes.com/2011/01/21/business/economy/21bankruptcy.html?_r=1&pagewanted=all);

negotiate its labor agreements, is the possibility of renegotiation *for the purpose of avoiding bankruptcy*. Even in bankruptcy, the legal standing for a state or local government to discharge pension and health benefits is unclear.<sup>108</sup> As the experience in Colorado demonstrates, for example, it is simply unclear whether the State Supreme Court will permit a catastrophe exception<sup>109</sup> to the generally accepted principle that the state cannot unilaterally breach a contractual obligation.

Although there is no state experience to provide guidance, bankruptcy by cities and counties may be instructive. Orange County's bankruptcy in the 1994 remains the largest municipal bankruptcy in history<sup>110</sup> and New York City narrowly averted bankruptcy in 1975<sup>111</sup>. As a result of unfunded pension responsibilities Vallejo, CA received bankruptcy protection, Central Falls, RI has recently entered bankruptcy, Hamtramck, MI is teetering on the edge of bankruptcy, Jefferson County, Ala is on the verge of the largest municipal bankruptcy ever and Prichard, Ala, simply stopped paying pension bills once they were denied bankruptcy protection.<sup>112</sup>

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to view the hearing, see State and Municipal Debt: The Coming Crisis?, Committee On Oversight & Government Reform, Feb 9, 2011, [http://oversight.house.gov/index.php?option=com\\_content&view=article&id=1101%3A2-9-11-qstate-and-municipal-debt-the-coming-crisisq&catid=34&Itemid=39](http://oversight.house.gov/index.php?option=com_content&view=article&id=1101%3A2-9-11-qstate-and-municipal-debt-the-coming-crisisq&catid=34&Itemid=39).

<sup>109</sup> Justus v. State of Colorado, 10-01589, District Court for Denver City and County, Colorado (Denver); see Andrew Harris & William Selway, Colorado, Minnesota Courts Throw Out Suits Disputing Retiree Benefit Cuts, Bloomberg, Jun 30, 2011, available at <http://www.bloomberg.com/news/2011-06-30/colorado-minnesota-state-courts-toss-retiree-pension-benefit-cut-lawsuits.html> ("Judge Robert S. Hyatt... rejected claims by the former workers that they had a right to specific cost of living adjustments. Hyatt said that while the plaintiffs had a contractual right to their pensions, they didn't have a right to 'the specific COLA formula in place at their respective retirement, for life without change'"). The order is available at <http://www.wikipension.com/images/6/66/Coloradoruling110629.pdf>

<sup>110</sup> Orange County Goes Bust, Time Magazine, Dec 19, 1994.

<sup>111</sup> Sam Roberts, When the City's Bankruptcy Was Just a Few Words Away, NY Times, Dec 31, 2005, available at <http://www.nytimes.com/2006/12/31/nyregion/31default.html>.

<sup>112</sup> Monica Davey, Michigan Town is Left Pleading for Bankruptcy, NY Times, Dec 27, 2010, available at <http://www.nytimes.com/2010/12/28/us/28city.html>; see note 6, supra; see also Michael McDonald & David McLaughlin, 'Dire' Finances Force R.I. City Into Bankruptcy, Bloomberg, Aug 1, 2011, available at <http://www.bloomberg.com/news/2011-08-01/-dire-situation-forces-rhode-island-city-of-central-falls-into->

Bankruptcy is probably most attractive to states that cannot persuade their unions to voluntarily agree to benefit cost reductions. Just a credible threat of bankruptcy may be sufficient in some cases to force labor to agree to increase employees' share of health costs and pension contributions; to extend retirement eligibility dates; and to reevaluate all promises made to current retirees. As some private employers found in the 1990s and still do today<sup>113</sup>, bankruptcy may prove to be the cleanest way to restructure employee benefit debt.

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bankruptcy.html; Phillip Inman, Bankruptcy threat to Jefferson County, Alabama, Jul 24, 2011, available at <http://www.guardian.co.uk/business/2011/jul/24/jefferson-county-alabama-bankruptcy>.

<sup>113</sup> In re General Motors Corp., 09-50026, U.S. Bankruptcy Court for the Southern District, New York (Manhattan). See 'Bankruptcy likely' for General Motors, AP, May 27, 2009, available at <http://www.independent.co.uk/news/business/news/bankruptcy-likely-for-general-motors-1691469.html> ("The UAW yesterday disclosed it agreed to take a much smaller 17.5 per cent stake in GM, plus a warrant for an added 2.5 percent stake to partially fund the \$20 billion that GM must put into a trust that will start paying retiree health care costs next year. In exchange for agreeing to a lower equity ownership stake, GM promised the union \$6.5 billion of preferred shares that pay 9 percent interest, plus a \$2.5 billion note. The union, facing the possibility that it may not be able to quickly sell GM shares to fund its trust, preferred the certainty of the \$585 million annual dividend that accompanies the preferred shares. The remaining \$10 billion will come from health care trust funds that GM already has set up. The trust will get a seat on GM's board as well, although it will have to vote at the direction of GM's other independent directors. The concession deal, on which roughly 61,000 workers will vote by tomorrow, also froze wages and cut retiree health care benefits, performance bonuses and cost-of-living raises"); Chris Isidore, GM Bankruptcy: End of an era, CNN Money, Jun 2, 2009, available at [http://money.cnn.com/2009/06/01/news/companies/gm\\_bankruptcy/](http://money.cnn.com/2009/06/01/news/companies/gm_bankruptcy/) ("In the end, even \$19.4 billion in federal help wasn't enough to keep the nation's largest automaker out of bankruptcy. The government will pour another \$30 billion into GM to fund operations during its reorganization... More than 650,000 retirees and their family members who depend on the company for health insurance will experience cutbacks in their coverage, although their pension benefits are unaffected for now"); Neil King Jr. & Sharon Terlep, GM Collapses Into Government's Arms, WSJ, Jun 2, 2009, available at <http://online.wsj.com/article/SB124385428627671889.html> ("General Motors Corp. became the second-largest industrial bankruptcy in history Monday as it filed its landmark case, with President Barack Obama predicting the humbled corporate titan will emerge from Chapter 11 "a stronger and more competitive" company within months"); Peter Whoriskey, GM Emerges From Bankruptcy After Landmark Government Bailout, Washington Post, Jul 10, 2009, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/07/10/AR2009071001473.html> ("Formed by the sale of most of the old company's assets out of bankruptcy, the new GM will be an anomaly among American businesses because most of it will be owned by the U.S. and Canadian governments. The U.S. Treasury owns 60.8 percent of the new company's common stock, the UAW retiree health trust has 17.5 percent and the governments of Canada and Ontario 11.7 percent... In a statement issued yesterday, Rep. Jeb Hensarling (R-Tex.) dismissed the company's boasts that it had completed the bankruptcy sale in far less time than many experts had predicted. It is 'amazing how fast a company can emerge from Chapter 11 when you inject \$40 billion of involuntary taxpayer capital into the process and trample over the rights of creditors in an unprecedented fashion,' Hensarling said. But U.S. Bankruptcy Judge Robert E. Gerber, who approved the sale, wrote in a July 7 ruling that a liquidation would be 'staggering' to the

## Lessons from the Private Sector Post-FAS 106

Besides bankruptcy, private employers, stunned by the results of calculations mandated by FAS 106, undertook to force employees to engage in more cost sharing with respect to both health care and retirement benefits. The flexibility afforded by ERISA via the procedures for plan amendment<sup>114</sup> resulted in health care plans that required increased co-pays and co-

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public. The company has 225,000 employees, 500,000 retirees, 6,000 dealers and 11,500 suppliers"); see also GM Viability Assessment, Executive office of the President of the United States, Mar 30, 2009, available at [http://www.whitehouse.gov/assets/documents/GM\\_Viability\\_Assessment.pdf](http://www.whitehouse.gov/assets/documents/GM_Viability_Assessment.pdf); official filings are available at <http://www.motorsliquidationdocket.com/>.

<sup>114</sup>Even in somewhat extreme cases, courts have enforced employers rights under ERISA to change existing plans. See McGann v. H & H Music Co., 946 F.2d 401, 403 (5th Cir. Tex. 1991) ("McGann, an employee of H & H Music, discovered that he was afflicted with AIDS in December 1987. Soon thereafter, McGann submitted his first claims for reimbursement under H & H Music's group medical plan, provided through Brook Mays, the plan administrator, and issued by General American, the plan insurer, and informed his employer that he had AIDS. McGann met with officials of H & H Music in March 1988, at which time they discussed McGann's illness. Before the change in the terms of the plan, it provided for lifetime medical benefits of up to \$ 1,000,000 to all employees.

In July 1988, H & H Music informed its employees that, effective August 1, 1988, changes would be made in their medical coverage. These changes included, but were not limited to, limitation of benefits payable for AIDS-related claims to a lifetime maximum of \$ 5,000. No limitation was placed on any other catastrophic illness. H & H Music became self-insured under the new plan and General American became the plan's administrator. By January 1990, McGann had exhausted the \$ 5,000 limit on coverage for his illness....McGann's claim cannot be reconciled with the well-settled principle that Congress did not intend that ERISA circumscribe employers' control over the content of benefits plans they offered to their employees. McGann interprets section 510 to prevent an employer from reducing or eliminating coverage for a particular illness in response to the escalating costs of covering an employee suffering from that illness. Such an interpretation would, in effect, change the terms of H & H Music's plan. Instead of making the \$ 1,000,000 limit available for medical expenses on an as-incurred basis only as long as the limit remained in effect, the policy would make the limit *permanently* available for all medical expenses as they might thereafter be incurred because of a single event, such as the contracting of AIDS. Under McGann's theory, defendants would be effectively proscribed from reducing coverage for AIDS once McGann had contracted that illness and filed claims for AIDS-related expenses. If a federal court could prevent an employer from reducing an employee's coverage limits for AIDS treatment once that employee contracted AIDS, the boundaries of judicial involvement in the creation, alteration or termination of ERISA plans would be sorely tested... ERISA does not broadly prevent an employer from "discriminating" in the creation, alteration or termination of employee benefits plans; thus, evidence of such intentional discrimination cannot alone sustain a claim under section 510. That section does not prohibit welfare plan discrimination between or among categories of diseases. Section 510 does not mandate that if some, or most, or virtually all catastrophic illnesses are covered, AIDS (or any other particular catastrophic illness) must be among them. It does not prohibit an employer from electing not to cover or continue to cover AIDS, while covering or continuing to cover other catastrophic illnesses, even though the employer's decision in this respect may stem from some "prejudice" against AIDS or its victims generally. The same, of course, is true of any other disease and its victims. That sort of "discrimination" is simply not addressed by section 510.

insurance<sup>115</sup>, tightening of pre-existing condition rules<sup>116</sup>, and myriad other changes designed to shift more of the cost of health care onto employees and their dependents.<sup>117</sup>

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Under section 510, the asserted discrimination is illegal only if it is motivated by a desire to retaliate against an employee or to deprive an employee of an existing right to which he may become entitled"); see also Messmer v. Xerox Corp., 139 F. Supp. 2d 398, 405 (W.D.N.Y. 2001) ("Plainly, then, neither Xerox nor Preferred Care obligated itself by contract to continue paying benefits once those benefits had begun to be paid. Rather, defendants reserved the right and authority to change plans, or the terms of the plans, from one year to the next. As the case authority cited above makes clear, ERISA permits them to do precisely that"); Inter-Modal Rail Emples. Ass'n v. Atchison, Topeka & Santa Fe Ry., 520 U.S. 510, 512 (U.S. 1997); Hines v. Massachusetts Mut. Life Ins. Co., 43 F.3d 207, 209 (5th Cir. Tex. 1995).

<sup>115</sup> Judy Ward, Total Benefits: Rethinking Retiree Health, Plan Sponsor Magazine, available at <http://www.plansponsor.com/MagazineArticle.aspx?id=6442460246&magazine> ("52% of companies offering retiree health care in 2000 said they would likely increase retirees' premium share in the next two years. Companies are regularly reconfiguring their retiree health benefits offerings these days, says Lou Mazawey, a Washington-based principal at Groom Law Group. "I do not see any stampede [to eliminate the benefits]," he says. "But, what more companies are doing-and this may accelerate even more with the economic downturn-is cutting back on retiree health benefits." Changes include capping annual or lifetime maximum benefits per participant, switching from indemnity plans to HMOs, substituting a defined contribution approach, and increasing retiree premium contributions, deductibles, and copays, he says. The squeeze prompts a couple of explanations. In the early 1990s, Financial Accounting Statement 106 required companies to begin recording unfunded retiree health benefit liabilities on their financial statements. Thus, many companies faced a big jump in their liabilities. "Instead of paying as they go, now employers actually had to accrue-much like employers had to do for retirement benefits," Coppock says. Very few companies actually fund their FAS 106 obligations in the sense of putting actual money into accounts and then gaining tax advantages as a result, he adds. Paul Fronstin, senior research associate at EBRI says "The main reason is the cost." In the mid- to late 1990s, "there was a little bit of a lull" in health-care costs, Coppock agrees. "That has certainly come back with a vengeance"); see also Private Supplemental Coverage Summary, National Bipartisan Commission on the Future of Medicare, available at <http://thomas.loc.gov/medicare/K-P-1499.html> ("In a recent survey of employers (Hay Group, 1998), 5 percent of employers had dropped retiree coverage since FAS 106 took effect and another 3 percent were considering dropping coverage. A more common response among employers was to require higher contributions from their retirees, 25 percent, as a means of offsetting FAS106 liabilities. Some employers have turned to Medicare risk HMOs as an efficient alternative. One survey, Mercer/Foster Higgins, found that the percentage of medium and large employers offering coordinated risk HMO plans rose from 7 percent in 1993 to 39 percent in 1997. Among employers offering this type of coverage, about one third provided some kind of incentive for retirees to join risk plans, resulting in about 39 percent of beneficiaries choosing this option").

<sup>116</sup> Efforts to place limits on coverage of preexisting conditions are now illegal under the recently passed Patient Protection and Affordable Care Act, Sec. 2704.; see Peter Grier, Health care reform bill 101: rules for preexisting conditions, Christian Science Monitor, Mar 24, 2010, available at <http://www.csmonitor.com/USA/Politics/2010/0324/Health-care-reform-bill-101-rules-for-preexisting-conditions>; Pub.L. 111-148, Patient Protection and Affordable Care Act, (PPAC) 124 Stat. 119, to be codified as amended at scattered sections of the Internal Revenue Code and in 42 U.S.C., available at <http://democrats.senate.gov/pdfs/reform/patient-protection-affordable-care-act-as-passed.pdf>.

<sup>117</sup> See note 112 supra; see also Retiree Health Benefits: Trends and Outlook, Employee Benefit Research Institute, Aug 2001, available at [http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content\\_id=152](http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=152) ("As a result of FAS 106, some employers placed caps on what they were willing to spend on retiree health benefits. Some added age and service requirements, while others moved to some type of "defined contribution" health benefit. Some completely dropped retiree health benefits for future retirees, while others dropped benefits for current retirees, although this has happened less frequently than the other changes").

## Defined Benefit to Defined Contribution Plans

The elimination of the DB vehicle as an option for government employers is primarily attractive because it combats the moral hazard problem directly. That is, because DB plans involve *guaranteed future* payments as opposed to a DC plan's limited promise to contribute toward a generalized savings goal, it is impossible for politicians and legislators to make promises without regard to cost. DC contributions are typically made on a real time basis; in contrast, DB contributions, as we've seen, are often manipulated or ignored in a manner consistent with the short term horizon of elected officials who figure that someone else will have to worry about how to pay tomorrow for promises made today. A switch to DC plans forces legislators to budget *now* for contributions that will be made in the very near future. The "kicking the can down the road" mentality that has dominated thinking about public sector benefits disappears with DC plans, and this is good for everyone concerned.

With DC plans, employees and governments understand exactly what they are promised and promising, respectively, and no one (least of all the taxpayer) needs to worry about overly optimistic discount and amortization rates. The contribute-as-you-go feature of DC arrangements also imposes precisely the kind of fiscal discipline that has been missing in the public sector for decades. To be blunt, politicians cannot promise any more than can actually be paid immediately in exchange for campaign contributions, votes and other support.

The ERISA rules governing the amendment of pension plans do not permit the same degree of flexibility as for welfare plans, like healthcare.<sup>118</sup> However, thousands of employers managed to terminate their DB plans in favor of contributory DC arrangements or hybrid plans.<sup>119</sup> The merits of this sea change have been debated in many corners.<sup>120</sup> In general

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<sup>118</sup>Public pension plans are governed by a different set of rules than welfare plans, which include healthcare. ERISA allows for employers to terminate a DB pension plan and substitute a hybrid or DC plan in its place. See note 107 and 115, supra; for a further discussion on the legal parameters of welfare plans, see Liability Issues Unique to Welfare Plans, Feb 17-20, 1999, ABA Section of Labor and Employment Law, Employee Benefits Subcommittee, available at <http://www.bnabooks.com/ababna/benefits/99/unique.pdf>; see, e.g. Chiles v. Ceridian Corp., 95 F.3d 1505 (10th Cir. 1996); Sprague v. General Motors Corporations, 133 F.3d 388 (6th Cir.) (en banc), cert. denied, 118 S. Ct. 2312 (1998); Mein v. Pool Co. Disabled Int'l Employee Long Term Disability Benefit Plan Co., 989 F.Supp. 337, 1350 (D.Colo. 1998).

<sup>119</sup> See Special Report, Over to you, Workers need to fend for themselves, The Economist, Apr 7, 2011, available at <http://www.economist.com/node/18502061> (“Between 1979 and 2009 the share of employees in DB pension plans in America fell from 62% to 7% of the total (see chart), according to the Employee Benefit Research Institute (EBRI), whereas those in DC plans rose from 16% to 67% (the rest had a bit of both)”); David Rajnes, An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans, Employee Benefit Research Institute (EBRI), Sept 2002, available at <http://www.ebri.org/pdf/briefspdf/0902ib.pdf>; Retirement Trends in the United States Over the Past Quarter-Century, EBRI, Jun 2007, available at <http://www.ebri.org/pdf/publications/facts/0607fact.pdf>; The Decline of Private-Sector Defined Benefit Promises and Annuity Payments: What Will It Mean?, Notes, Vol. 25, No. 7., EBRI, Jul 2004, available at <http://www.ebri.org/pdf/notespdf/0704notes.pdf>.

<sup>120</sup> Maria O'Brien Hylton, Together We Can: Imagining the Future of Employee Pension Plans, review of Employee Pensions: Policies, Problems & Possibilities, T. Ghilarducci & C. E. Weller, eds., ILR Press (2007), 12 Employee Rights and Employment Policy Journal 383 (2009) at 385-8 (“Simply put, a defined benefit plan is not an absolute guarantee to an employee of a stream of pension income that will see the employee and his spouse through to the end of their retirement. Defined benefit plans can and do fail as the faithful reader of any newspaper can attest: think about United Airlines, Polaroid, and Bethlehem Steel. Of course, the authors' objections to defined contribution plans are not without merit. It is just that organized labor's consistent advocacy on behalf of defined benefit arrangements is not supported by the economic experience of the past few decades”); see also Zvi Bodie, Alan J. Marcus & Robert C. Merton, Defined Benefit versus Defined Contribution Pension Plans: What are the Real Trade-offs?, National Bureau of Economic Research, University of Chicago Press (1988), available at <http://www.nber.org/chapters/c6047.pdf>; James Poterba, Joshua Rauh, Steven Venti & David Wise, Defined contribution plans, defined benefit plans, and the accumulation of retirement wealth, Journal of Public Economics, (2007), available at <http://www.sciencedirect.com/science/article/pii/S0047272707001144>; Joao F. Cocco & Paula Lopes, Defined benefit or defined contribution?: an empirical study of pension choices, Discussion paper: UBS Pensions Series 026, 505. Financial Markets Group, London School of Economics and Political Science, London, UK. (2004), available at <http://eprints.lse.ac.uk/24751/>. One serious cause for concern over 401(k) plans is the ability of unsophisticated workforce to manage their own assets for retirement. See Statement of David M. Walker, Comptroller General of the United States, Private Pensions: Key Issues to Consider Following the Enron Collapse, United States General Accounting Office, Feb 27, 2002, available at <http://www.gao.gov/new.items/d02480t.pdf> (“Even with opportunities to diversify, studies indicate that employees will need education to improve their ability to manage their retirement savings. Numerous studies have looked at how well individuals who are currently investing understand investments and the markets. On the basis of those studies, it is clear that among those who save through their company’s retirement programs or on their own, large percentages of the investing population are unsophisticated and do not fully understand the risks associated with their investment choices. For example, one study found that 47 percent of 401(k) plan participants believe that stocks are components of a money market

the merits of DC arrangements are that they encourage employees to take an active role in planning for their retirement and allow them to enjoy all of the upside risk during periods when plan assets are performing well.<sup>121</sup> There is, however, an alarming body of data which suggests that many employees have been unable or are unwilling to educate themselves about long term investing and, as a result, appear to be making very poor choices about retirement savings. The argument over the relative merits of DB over DC plans is, at bottom, a fight about paternalism. DB supporters generally believe that the average employee either cannot, will not or should not have to make investment decisions designed to prepare for retirement; retirement planning is viewed as the responsibility of the employer (ideally with input and oversight from employee representatives) whose sophistication and experience makes it ideally suited to this function. The widespread lack

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fund, and 55 percent of those surveyed thought that they could not lose money in government bond funds. Another study on the financial literacy of mutual fund investors found that less than half of all investors correctly understood the purpose of diversification. These studies and others indicate the need for enhanced investment education about such topics as investing, the relationship between risk and return, and the potential benefits of diversification"); as a result, most unions strongly prefer DB plans, see Union Workers Have a 'Union Advantage' in Pensions, AFL-CIO, available at <http://www.aflcio.org/issues/retirementsecurity/definedbenefitpensions/#2>.<sup>121</sup> John Broadbent, Michael Palumbo & Elizabeth Woodman, The Shift from Defined Contribution Pension Plans- Implications for Asset Allocation and Risk Management, Dec 2006, available at <http://www.bis.org/publ/wgpapers/cgfs27broadbent3.pdf> ("The transition from DB to DC plans in private sector pensions is shifting investment risk from the corporate sector to households. Households are therefore becoming increasingly exposed to financial markets, and retirement income may be subject to greater variability than before"); see Comparison of Traditional Defined Benefit with Traditional Defined Contribution Plans, Council of UC Faculty Association, available at [http://www.cucfa.org/news/pension\\_table.html](http://www.cucfa.org/news/pension_table.html); Defined Benefit vs. 401(k) Plans: Investment Returns for 2003-2006, Watson Wyatt insider, Towers Watson Research ("Achieving consistently high investment returns in volatile financial markets is challenging. The shift from defined benefit plans to 401(k) plans has raised concerns about whether today's workers will have sufficient resources for a secure retirement. In a defined benefit plan, the sponsor assumes the investment risk and, generally, the responsibility for providing lifetime retirement income. With 401(k) plans, however, it's up to employees to invest wisely and build up enough savings to last a lifetime"); for more information, see Ashby H.B. Monk & Steven A. Sass, Risk Pooling and the Market Crash: Lessons from Canada's Pension Plan, Center for Retirement Research at Boston College, Jun 2009, available at [http://crr.bc.edu/images/stories/Briefs/ib\\_9-12.pdf](http://crr.bc.edu/images/stories/Briefs/ib_9-12.pdf); see also Kelly Olsen & Jack VanDerhei, Defined Contribution Plan Dominance Grows Across Sectors and Employer Sizes, While Mega Defined Benefit Plans Remain Strong: Where We Are and Where We Are Going, EBRI, Oct 1997, available at <http://www.ebri.org/pdf/briefspdf/1097ib.pdf> at 9.

of retirement savings in the U.S.<sup>122</sup> by employees left to create and monitor their own §401(k) plans<sup>123</sup> suggests that there are valid concerns about retirement readiness.

However, DB plans, primarily because the sponsoring employer bears the risk of ensuring asset performance, are expensive.<sup>124</sup> Any firm in a market in which most competitors have switched to DC plans will find it hard to compete and keep labor costs in line if it clings to a DB plan. Recently, Georgia, Michigan, Alaska, Colorado and Utah have moved to shift new public employees out of traditional DB plans and into §401(k)-style vehicles.<sup>125</sup>

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<sup>122</sup> Retirement Savings Shortfalls for Today's Workers, Employee Benefit Research Institute, Vol. 31, No. 10, Oct 2010, available at [http://www.ebri.org/pdf/notespdf/EBRI\\_Notes\\_10-Oct10.RetShrtfl-Cobra.pdf](http://www.ebri.org/pdf/notespdf/EBRI_Notes_10-Oct10.RetShrtfl-Cobra.pdf) ("The aggregate RSS [retirement savings shortfall] for these age cohorts expressed in 2010 dollars is \$4.55 trillion, for an overall average of \$47,732 per individual. The average RSS varies by age cohort as well as gender and marital status. The RSS per individual is always lowest for households, somewhat higher for single males, and more than twice as large for single females. The estimated retirement shortfall for any gender/marital status combination increases for younger cohorts, largely due to the impact of health care-related costs rising faster than the general inflation rate").

<sup>123</sup> 26 I.R.C. (A)(1)(D)(1)(A) § 401(k)

<sup>124</sup> Kelly Olsen & Jack VanDerhei, Defined Contribution Plan Dominance Grows Across Sectors and Employer Sizes, While Mega Defined Benefit Plans Remain Strong: Where We Are and Where We Are Going, EBRI, Oct 1997, available at <http://www.ebri.org/pdf/briefspdf/1097ib.pdf> at 9; see also <http://retirement.unionplus.org/money-for-retirement/pension-plans.html> ("The number of companies willing to sponsor traditional pension plans is steadily shrinking. Employers continue to freeze or terminate their defined-benefit pension plans as they look for less expensive options"); Geoffrey Colvin, The end of a dream, Fortune, Jun 22, 2006, available at [http://money.cnn.com/2006/06/12/magazines/fortune/pension\\_retirementguide\\_fortune/index.htm](http://money.cnn.com/2006/06/12/magazines/fortune/pension_retirementguide_fortune/index.htm) ("Today's low long-term interest rates, combined with a stock market that's no higher than it was six years ago, have made traditional defined-benefit plans a crushing financial burden to many firms - just as they're feeling the heat from foreign businesses that don't have plans").

<sup>125</sup> Steven Greenhouse, Pension Funds Strained, States Look at 401(k) Plans, NY Times, Mar 1, 2011, available at [http://www.cnbc.com/id/41844284/Pension\\_Funds\\_Strained\\_States\\_Look\\_at\\_401\\_k\\_Plans](http://www.cnbc.com/id/41844284/Pension_Funds_Strained_States_Look_at_401_k_Plans) ("Lawmakers and governors in many states, faced with huge shortfalls in employee pension funds, are turning to a strategy that a lot of private companies adopted years ago: moving workers away from guaranteed pension plans and toward 401(k)-type retirement savings plans... Utah lawmakers voted last year to make a partial changeover to a 401(k)-type plan, following in the footsteps of Alaska, Colorado, Georgia, Michigan, Ohio and several other states, which offer at least some version of it. In February, Kentucky's Senate approved a full switch to a 401(k)-type plan, although the bill faces uncertain prospects in the House. In Oklahoma and Kansas, legislative committees will be studying the issue intensively over the next few weeks. Gov. Sam Brownback of Kansas has made it clear he hopes the state Senate will embrace some form of a 401(k)-type plan. Texas is also considering a switch... The new governors of Florida and Kansas, Rick Scott and Mr. Brownback, and lawmakers in North Dakota, Oklahoma, Virginia and several other states are seriously discussing adopting 401(k)-type plans for state employees"); John Beshears, James J. Choi, David Laibson & Brigitte C. Madrian, Behavioral Economics Perspectives on Public Sector Pension Plans, NBER State and Local Pensions Conference, Jan 15, 2010, available at <http://www.economics.harvard.edu/faculty/laibson/files/Behavioral%2BEconomics%2BPerspectives%2Bon%2BPu>

The experience of private sector employees with §401(k) plans has, of course, not been uniformly positive.<sup>126</sup> The Federal Thrift Savings plan, however, does provide a possible model for other public workers, with its low fees, automatic enrollment, matching contributions and straightforward investment options.<sup>127</sup> The purposes here is not to

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blic%2BSector%2BPension%2BPlans.pdf; see also Roads to Reform: Changes to Public Sector Retirement Benefits Across States, Pew Center on the States, available at [http://www.pewcenteronthestates.org/uploadedFiles/wwwpewcenteronthestatesorg/Roads\\_To\\_Reform.pdf?n=145](http://www.pewcenteronthestates.org/uploadedFiles/wwwpewcenteronthestatesorg/Roads_To_Reform.pdf?n=145) (“Alaska put all its new employees in a defined contribution plan in 2005... Georgia moved to a hybrid retirement system in 2008, offering new hires both a defined benefit plan that provides about half of the payout of the existing plan and a defined contribution plan with a mandatory 1 percent employee contribution and employer match. Employees may opt out of the 401(k)-style plan after 90 days.... Michigan, which in 1997 became the first state to scrap its defined benefit plan for new employees, expanded the program in 2010 to include newly hired K-12 teachers. They now will be offered a combination defined benefit and defined contribution plan. Employees hired before 1997 are still in the defined benefit plan”); Tim Hoover, Pension plans a sticking point for Colorado’s PERA, Denver Post, Apr 10, 2011, available at [http://www.denverpost.com/legislature/ci\\_17811063](http://www.denverpost.com/legislature/ci_17811063) (“[Colorado] in 2006 under Gov. Bill Owens, a Republican, gave new employees the option of choosing either the traditional PERA defined benefit plan or a defined contribution plan”).

<sup>126</sup> For a description of the shortcomings of 401(k) plans, see Eleanor Laise, Big Slide In 401(k)s Spurs Calls For Change, The Wall Street Journal, Jan 8, 2009 at A1 (“The most obvious pitfall is that 401(k) plans shift all retirement-planning risks -- not saving enough, making poor investment choices, outliving savings -- to untrained individuals, who often don't have the time, inclination or know-how to manage them. But even when workers make good choices, a market meltdown near the end of their working careers can still blow their savings to smithereens”); Move Public Employees Into 401(k)s?, NY Times, Room for Debate, Feb 2011, available at <http://www.nytimes.com/roomfordebate/2011/02/27/why-not-401ks-for-public-employees/start-paying-or-stop-promising>.

<sup>127</sup> Thrift Savings Plan, <https://www.tsp.gov/planparticipation/about/purposeAndHistory.shtml> (“The Thrift Savings Plan (TSP) is a retirement savings and investment plan for Federal employees and members of the uniformed services, including the Ready Reserve. It was established by Congress in the Federal Employees' Retirement System Act of 1986 and offers the same types of savings and tax benefits that many private corporations offer their employees under 401(k) plans. The TSP is a defined contribution plan, meaning that the retirement income you receive from your TSP account will depend on how much you (and your agency, if you are eligible to receive agency contributions) put into your account during your working years and the earnings accumulated over that time”). The Federal Retirement Thrift Investment Board oversees TSP accounts, see <http://www.frtib.gov/>. For investment returns, see <http://www.tspfolio.com/funds>. Advantages of the TSP plan include: Tax Deferred Contributions, very low administrative and investment expenses, matching contributions of up to an additional 4% and Catch-up Contributions. For more information, see <https://www.tsp.gov/planparticipation/benefits/benefitsSummary.shtml>; see also Walter Updegrave, Thrift savings plans: Retirement plans done right, CNN Money, Jul 6, 2011, available at [http://money.cnn.com/2011/07/05/pf/expert/thrift\\_savings\\_plan.moneymag/](http://money.cnn.com/2011/07/05/pf/expert/thrift_savings_plan.moneymag/) (“TSPs, which are like a 401(k)s for federal employees and people in the military, could actually serve as a model for private-sector retirement savings plans. One of the TSP's biggest attributes is its razor-thin costs... Another big plus is that TSPs offer a menu of investing options that are broad enough to build a well-balanced portfolio, but not littered with niche investments that are unnecessary (and unhelpful) distractions... A third TSP feature that I like is that it has no percentage-of-salary limit. While many 401(k) plans may limit your contribution to a certain percentage of your pay, TSPs allow

propose a specific alternative, but to include a move away from expensive DB models to viable alternatives as part of a package of reforms designed to bring public sector pension options in line with those available to private employees.

A great deal has been made lately of the importance of public sector benefits (pensions in particular) as setting a floor below which private sector benefits should not fall.<sup>128</sup> Ironically, this argument fails to appreciate the political dimension of any expense taxpayers are asked to bear. As some government unions feared<sup>129</sup>, GASB 45 focused unprecedented attention

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you to put as much of your salary into the plan as you want -- up to the maximum elective deferral ceiling, which is \$16,500 this year (just keep in mind that you can't contribute more than you earn)... The plan also has a pretty generous matching contribution policy").

<sup>128</sup> Many commentators argue that private sector workers should follow public sector workers to organize and demand comparative benefits from the wealthy elite, rather than fight one another. See, e.g. John Bellamy Foster, Public sector workers are a 'privileged new class,' says billionaire, PBS, Jan 17, 2011, available at <http://www.pbs.org/wnet/need-to-know/voices/public-sector-workers-are-a-privileged-new-class-says-billionaire/6442/> ("This is nothing but the age-old strategy of divide and conquer adopted by ruling classes throughout history, particularly in times of crisis when their own position is most shaky. The answer is to turn worker against worker, under the mantra that "the people divided will always be defeated." What the moneyed interests fear most is the united political struggle of the vast majority (private and public sector workers alike) in the interest of a more democratic, more egalitarian society — a world of common humanity").

<sup>129</sup> Eric S. Berman & Elizabeth K. Keating, Unfunded Public Employee Health Care Benefits and GASB 45, available at [http://aaahq.org/GNP/information/activities/2007MYM/Session12\\_KeatingBerman.pdf](http://aaahq.org/GNP/information/activities/2007MYM/Session12_KeatingBerman.pdf) at 18 ("At the GASB public hearing on GASB 43 and 45 in May 2003, union representatives testified, (a rarity at a GASB hearing), urging that the exposure draft be set aside and arguing that it could lead to the curtailment of long-standing governmental defined benefit plans. The unions' willingness to fight became apparent during the Christmas shopping season of 2005. Thirty thousand New York City transit workers went on strike illegally, primarily to protest being required to contribute for the first time to their health care costs. The Metropolitan Transit Authority was asking workers to contribute only 1.5% to their current and retiree health care costs"); see also The Attack on Pensions and Retirees Heats Up: GASB and FASB, UE Information for Workers, [http://www.ueunion.org/stwd\\_gasbfasb.html](http://www.ueunion.org/stwd_gasbfasb.html) ("Already some cities and towns are talking about reducing or eliminating health insurance for retirees as a way to reduce or eliminate these new liabilities. Even where unions are able to stop this, we will see millions of dollars that could be usefully spent diverted into banks, into new trust funds that will be set up to pay for OPEBs"); Bill Turque, Costly Change Looming for Retiree Benefits; Rule Aims to Force Public Sector To Tally Future Health Spending, The Washington Post, Jan 30, 2006 at B1 ("Maryland state employees, smarting from steep increases in prescription drug co-payments last year, worry that GASB 45 will eventually prompt the kind of wholesale reduction in benefits that private-sector workers began experiencing in the 1990s -- triggered, at least in part, by a similar change in accounting procedures. "As public employees, we felt we would be immune from that," said Curtis Johnson, president of the American Federation of State, County and Municipal Employees Local 266... "We're infuriated that they would even consider it," said Royce Treadaway, 46, also a union leader and a market analyst for the Maryland Port Authority in Baltimore... Gino Renne, president of United Food and Commercial Workers Local 1994, which represents about 6,000 Montgomery and Prince George's employees, said changes in accounting standards were

on the cost of public employee benefits. The gradual realization by taxpayers that police officers, teachers, sanitation workers and motor vehicle clerical workers enjoyed relatively lavish health care and pensions was certain to provoke a reaction from those who were obliged to finance these commitments. As private taxpayers' own benefits were adjusted to reflect the increased cost of health care, greater longevity and employer risk-shedding of pensions, it was just a matter of time before public benefits would encounter pressure to fall in line with private benefits. Squeezed by recession, a weak stock market and declining wealth following collapse of the housing market, taxpayers realized that they are (in an attenuated way) the true "employer" in the public sector and, in many states, decided that it was time to rationalize employee benefit costs via the political process. The popularity of Governors Christie (in New Jersey), Walker (in Wisconsin) and Daniels (in Indiana) reflects the determination of a majority of the electorate to right-size public sector benefits.<sup>130</sup>

### **Realistic Rates of Return and Amortization**

In the summer of 2011, GASB is expected to add refinements to GASB 45. Numerous commentators expect they will specify a discount rate and require increased prominence on the balance sheet of total unfunded debt. The expectation, clearly based on a growing realization that the states have continued to underestimate their benefits liabilities, is that

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used as "an excuse" by the private sector to cut benefits. Rather than focus on cuts, he said, the issue for state and local governments should be how to contain the growth of health care costs").

<sup>130</sup> Each of these governors has made it a personal mission to get their state budgets under control. Most have sacrificed support at the polls for dramatic budget reform. Approval numbers are as follows: Mitch Daniels: 75% (Katrina Trinko,, [Mitch Daniels's Next Hurdle](#), National Review, Nov 18, 2010, [available at](#) <http://www.nationalreview.com/articles/253474/mitch-danielss-next-hurdle-katrina-trinko>); Chris Christie: 42% ([Poll shows Gov. Christie's approval rating dive after public worker benefits overhaul, budget cuts](#), NJ.com, Jul 21, 2011, [available at](#) [http://www.nj.com/news/index.ssf/2011/07/poll\\_shows\\_gov\\_christies\\_appro.html](http://www.nj.com/news/index.ssf/2011/07/poll_shows_gov_christies_appro.html)); Scott Walker: 43% (Wisconsin Governor Walker: 43% Approval Rating, Rasmussen Reports, Mar 4, 2011, [available at](#) [http://www.rasmussenreports.com/public\\_content/politics/general\\_state\\_surveys/wisconsin/wisconsin\\_governor\\_walker\\_43\\_approval\\_rating](http://www.rasmussenreports.com/public_content/politics/general_state_surveys/wisconsin/wisconsin_governor_walker_43_approval_rating)).

rates of amortization and return will no longer be elective and disclosure will be even more prominent.

Among the board's proposed changes is disclosure of pension liabilities on the face on an entity's financial statements, as opposed to the footnotes. It also wants governments in some cases to calculate the present value of pension liabilities more conservatively, with a discount rate based on high-quality municipal bonds, rather than a plan's own expected return. Proposals also would require governments to amortize some pension costs based on an employee's time until retirement, rather than over 30 years.<sup>131</sup>

It is hard to see how, in light of recent experience, accounting standards designed to enhance transparency and push governments toward accurate evaluation of their plan assets and liabilities could be anything other than positive. It is true that lower discount rates will mean larger liabilities; however, pushing the public sector to mimic the practices of the private sector with respect to health care and pension benefits seems like a reasonable response. Indeed, as we've seen, the core problem in the public sector is its tendency to spend lavishly in good times, even locking taxpayers into imprudent commitments from which they cannot extract themselves. This spending is sanctioned, of course, by politicians intent on pleasing large blocks of voters who can then be counted on to return the favor at election time. Any reforms that encourage taxpayers to function like shareholders and others with a serious stake in the financial health of a private enterprise should provide some degree of push back to this widespread moral hazard problem.

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<sup>131</sup> David Reilly, [Pension Bombs Need Spotlight](#), The Wall Street Journal, Jun 17, 2010 at C10.

## Fundamental Change in Power—Prohibition on Collective Bargaining over Benefits in the Public Sector

Wisconsin and several other states<sup>132</sup> recently received a great deal of attention as governors and state legislators considered the serious question of whether, in effect, the problem of rent seeking described in this paper is so severe as to warrant an partial or complete ban on bargaining about benefits in the public sector. The argument in favor of a ban is simply that the incentives to behave in a morally hazardous way are so strong that no amount of tinkering (e.g. insisting on accurate discount and amortization rates) will make any difference. To borrow an example from insurance law, where there is no insurable interest,<sup>133</sup> insurers and state regulators will generally not permit the issuance of a policy of

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<sup>132</sup>Richard Simon, [Union battles spread; More states join push as wave of GOP-led bills sweep country](#), Chicago Tribune, Apr 2, 2011 at C1 (“The National Conference of State Legislatures is tracking an explosion of 744 bills that largely target public-sector unions, introduced in virtually every state... Nearly half of the states are considering legislation to limit public employees' collective bargaining rights”); Richard Perez-Pena, [In New Jersey, Bill Advances on Public Workers' Benefits](#), NY Times, Jun 20, 2011, available at [http://www.nytimes.com/2011/06/21/nyregion/nj-senate-votes-to-make-workers-pay-more-for-benefits.html?\\_r=1](http://www.nytimes.com/2011/06/21/nyregion/nj-senate-votes-to-make-workers-pay-more-for-benefits.html?_r=1) (“Mr. Christie insists that he is not trying to eliminate collective bargaining, but union leaders say the New Jersey bill would have a similar effect. Under current state law, in a contract impasse, a governor or mayor can go through a series of steps and impose terms on most employee groups — on every issue except health care. “If you take away health care bargaining, you take away bargaining,” Hetty Rosenstein, state director of the Communications Workers of America, said. “It’s the only leverage we have”); Amy Merrick, [Wisconsin Union Law to Take Effect](#), WSJ, Jun 15, 2011, available at <http://online.wsj.com/article/SB10001424052702303848104576386122936205978.html> (“Republican Gov. Scott Walker said the measure was needed to help tackle the state's budget deficit and give local governments needed flexibility. Democrats said it was an attack on unions”); Steven Greenhouse, [Ohio's Anti-Union Law is Tougher Than Wisconsin's](#), NY Times, Mar 31, 2011, available at <http://www.nytimes.com/2011/04/01/us/01ohio.html> (“After Wisconsin’s labor battle seized the nation’s attention, after nearly 100,000 people rallied in Madison to protest a bill to curb public-sector collective bargaining, the Ohio legislature has, with far less fanfare, enacted a bill perhaps even tougher on unions”).

<sup>133</sup>[BALLENTINE'S LAW DICTIONARY](#) (2010) (Insurable interest: An essential of a valid contract of insurance, being, in general, that which takes a contract out of the class of wagering policies; best defined in reference to the particular risk or thing insured”); see also [Black's Law Dictionary](#) (9th ed. 2009) (“*insurable interest*: A legal interest in another person's life or health or in the protection of property from injury, loss, destruction, or pecuniary damage. To take out an insurance policy, the purchaser or the potential insured's beneficiary must have an insurable interest. If a policy does not have an insurable interest as its basis, it will usu. be considered a form of wagering and thus be

life insurance because of the strong possibility that a hard-to-resist incentive to commit murder is created.<sup>134</sup> Even though it is surely the case that some beneficiaries would never engage in the ultimate act of moral hazard in the hope of securing a life insurance payout, sad experience has taught that incentives should not be ignored.<sup>135</sup>

Proponents of a ban on collective bargaining by public employees about benefits likewise point to a long and sorry history of behavior by elected officials who simply spend public dollars with far less care than they would spend private dollars.<sup>136</sup> The question is how to

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held unenforceable.”); for a textbook description, see Anthony Steuer, Questions and Answers on Life Insurance: The Life Insurance Toolkit, at 310 (2007).

<sup>134</sup> 3 Couch on Ins. § 36:78 (“[T]he most frequently advanced rationale is that the collateral effect of an assignment to a person having no insurable interest, generally speaking, is to afford temptation to the commission of crime. That is to say, where assignment of a life-insurance policy is permitted without requiring an insurable interest, there is a temptation to commit murder in order to obtain the proceeds of the policy”); see Liberty Nat. Life Ins. Co. v. Weldon, 267 Ala. 171, 100 So. 2d 696, 61 A.L.R.2d 1346 (1957).

<sup>135</sup> For a spectacular recent case, see People v. Rutterschmidt, 98 Cal.Rptr.3d 390 (Cal.App. 2 Dist.,2009); Jeanne King, Signed in Blood: The True Story of Two Women, a Sinister Plot, and Cold Blooded Murder, St. Martin's Press(2009); John Spano, Police Probe of Women Accused of Killing Men for Death Benefits Widens, LA Times, Aug 18, 2006, available at <http://www.latimes.com/news/printedition/la-me-olghahelen18aug18,1,108417.story>; for a discussion of the famous horse murders, see Ken Englade, Hot Blood: The Money, the Brach Heiress, the Horse Murders, New York, Macmillan (1997); William Nack & Lester Munson, Blood Money: In the rich, clubby world of horsemen, some greedy owners have hired killers to murder their animals for the insurance payoffs, Sports Illustrated, Nov 16, 1992, available at <http://sportsillustrated.cnn.com/vault/article/magazine/MAG1004483/1/index.htm>. For a discussion of the recent trends in life settlement and stranger-originated life insurance, including Larry King’s sensational case, see Anita Huslin, Wealthy Engage in Controversial Re-selling of Life Insurance Policies, Washington Post, Nov 27, 2007, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/11/26/AR2007112602182.html>; see also Ariella Gasner, Your Death: The Royal Flush of Wall Street’s Gamble, 37 Hofstra L. Rev. 2 (Winter 2008), available at [http://law.hofstra.edu/pdf/academics/journals/lawreview/lrv\\_issues\\_v37n02\\_dd2\\_gasner\\_final.pdf](http://law.hofstra.edu/pdf/academics/journals/lawreview/lrv_issues_v37n02_dd2_gasner_final.pdf). Even in cases where there is an insurable interest, sometimes the temptation towards homicide is too strong to resist, see Reynolds v. American-Amicable Life Ins. Co., 591 F.2d 343 (C.A.Tex., 1979); Prudential Ins. Co. of America v. Athmer, 178 F.3d 473 (C.A.7 (Ill.),1999); California-Western States Life Ins. Co. v. Sanford, 515 F.Supp. 524 (D.C.La., 1981).

<sup>136</sup> Steven Greenhouse, Strained States Turning to Laws To Curb Unions, NY Times, Jan 4, 2011 at A1 (“Republican lawmakers in Indiana, Maine, Missouri and seven other states plan to introduce legislation that would bar private sector unions from forcing workers they represent to pay dues or fees, reducing the flow of funds into union treasuries. In Ohio, the new Republican governor, following the precedent of many other states, wants to ban strikes by public school teachers. Some new governors, most notably Scott Walker of Wisconsin, are even threatening to take away government workers' right to form unions and bargain contracts. “We can no longer live in a society where the public employees are the haves and taxpayers who foot the bills are the have-nots,” Mr. Walker, a Republican, said in a speech... In the 2010 elections, Republicans emerged with seven more governor's mansions and won control of the legislature in 26 states, up from 14. That swing has put unions more on the

properly align the spending of public dollars with the best interests of the owners of those dollars—i.e. taxpayers. Taxpayers are notoriously disorganized and unfocused<sup>137</sup>; on the other side of the table are public employee unions which, to their credit, have every incentive to focus and target politicians who can be of assistance as the unions seek (as they should) better pay, working conditions and benefits for their members.

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defensive than they have been in decades... Many of the state officials pushing for union-related changes say they want to restore some balance, arguing that unions have become too powerful, skewing political campaigns with their large war chests and throwing state budgets off kilter with their expensive pension plans.

But labor leaders view these efforts as political retaliation by Republicans upset that unions recently spent more than \$200 million to defeat Republican candidates. "I see this as payback for the role we played in the 2010 elections," said Gerald W. McEntee, president of the American Federation of State, County and Municipal Employees, the main union of state employees. Mr. McEntee said in October that his union was spending more than \$90 million on the campaign, largely to help Democrats<sup>137</sup>; Sabrina Tavernise & Monica Davey, [Ohio Senate Passes Bill to Weaken Collective Bargaining Clout of Public Workers](#), NY Times, Mar 3, 2011 at A18 ("Ohio took its first step Wednesday toward passing sweeping legislation that would curtail collective bargaining rights for public sector workers by banning strikes and putting the power of breaking labor impasses in the hands of local elected officials. Unions call the bill the biggest blow to public sector workers since the legal framework was put in place to protect them in 1983. Republican lawmakers argued that it was required in order to keep financially pressed local governments solvent. "This is the first big step in restoring fiscal responsibility in Ohio," said Kevin Bacon, a Republican senator."... Lawmakers who supported the bill said it would allow government to function more like the private sector, with the flexibility to have more control over its operating costs. But its opponents argued that the private sector had slashed older workers, something the new bill was in danger of allowing); Nicholas Riccardi & Abigale Sewell, [Deadline nears, layoffs loom; Wisconsin governor says failure to pass his budget bill on Friday will cost 1,500 jobs](#), Chicago Tribune at C13 ("At a news conference Thursday evening, Walker said he wants to remove collective bargaining to give local governments the flexibility to avoid layoffs. "One of the toughest decisions I ever made was laying people off," said Walker, the former chief executive of Milwaukee County. "We need to avoid layoffs for the good of the workers, for the good of the people"); John Fund, [Cross Country: What's at Stake in Wisconsin's Budget Battle](#), Wall Street Journal, Feb 19, 2011 at A13 ("Mr. Walker's proposals are hardly revolutionary. Facing a \$137 million budget deficit, he has decided to try to avoid laying off 5,500 state workers by proposing that they contribute 5.8% of their income towards their pensions and 12.6% towards health insurance. That's roughly the national average for public pension payments, and it is less than half the national average of what government workers contribute to health care. Mr. Walker also wants to limit the power of public-employee unions to negotiate contracts and work rules -- something that 24 states already limit or ban. The governor's move is in reaction to a 2009 law implemented by the then-Democratic legislature that expanded public unions' collective-bargaining rights and lifted existing limits on teacher raises"); for further discussion, see Chris Edwards, [Public Sector Unions and the Rising Costs of Employee Compensation](#), Cato Journal, Vol. 30, No. 1 (Winter 2010).<sup>137</sup> See note 10 and note 105, supra; see also William N. Eskridge, Jr., [Politics Without Romance: Implications of Public Choice Theory for Statutory Interpretation](#), 74 Va. L. Rev. 275, 286 ("The free rider problem means that social and economic difficulties will not always stimulate group formation, especially for large, diffuse groups like consumers and taxpayers, and that (in contrast) small, elite groups might more easily organize, though for no other reason than to raid the public fisc.").

Opponents of a ban, and there are many,<sup>138</sup> argue that collective bargaining is a fundamental human right<sup>139</sup> and that its absence or restriction has implications far beyond

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<sup>138</sup> Prof. Paul Secunda of Marquette Law School is a vocal critic of bans on collective bargaining, see Paul M. Secunda, Walker's attack on unions is un-American, The Cap Times, Feb 19, 2011, available at [http://host.madison.com/ct/news/opinion/column/article\\_4004e07d-aad3-54e6-9697-3f6e058e6357.html](http://host.madison.com/ct/news/opinion/column/article_4004e07d-aad3-54e6-9697-3f6e058e6357.html); see further commentary by Professor Paul Secunda, available at [http://lawprofessors.typepad.com/laborprof\\_blog/2011/02/wisconsins-governor-takes-shot-at-public-unions.html](http://lawprofessors.typepad.com/laborprof_blog/2011/02/wisconsins-governor-takes-shot-at-public-unions.html); see also Kate Zernike, More Standoffs and Protests, Plus a Prank Call, New York Times, Feb 24, 2011 at A20 ("In Wisconsin, Democratic lawmakers said the state's Republican governor, Scott Walker, was out purely to bust the unions, noting that the unions had already agreed to the concessions on wages and benefits to balance the budget.... B. Patrick Bauer, the minority speaker of the House, said from Urbana that the union legislation had been but one of many "wrongful bills" that would "rip the heart out of the middle class"); Brady Dennis & Peter Wallsten, Obama joins Wisconsin's budget battle, opposing Republican anti-union bill, Feb 18, 2011 available at <http://www.washingtonpost.com/wp-dyn/content/article/2011/02/17/AR2011021705494.html> ("Some of what I've heard coming out of Wisconsin, where they're just making it harder for public employees to collectively bargain generally, seems like more of an assault on unions," Obama told a Milwaukee television reporter"); but see Rosalind S. Helderman, Union-free state not spared fiscal woes, Washington Post, Mar 20, 2011 at C5 ("Virginia helps illustrate a reality that complicates the political rhetoric for both sides in the debate over public employee unionization: When it comes to retirement plans, there seems to be little correlation between union membership rates and either the generosity of states as employers or the financial stability of their systems. The reality suggests that if more states went the way of Virginia and eliminated collective bargaining, it could be that neither union members' worst fears nor many Republicans' best predictions for retirement benefits would come true... Virginia's hostility to public sector unions is long-standing, dating at least to 1946, when Gov. Bill Tuck (D) delivered a harangue against unionization in his annual State of the Commonwealth Address to the General Assembly, calling it "utterly incompatible with sound and orderly government." In 1977, the Virginia Supreme Court ruled that collective bargaining by local governments was illegal, and the General Assembly codified its long-standing prohibition against the practice in the state workforce in 1993"). For further discussion, see Martin H. Malin, The Paradox of Public Sector Labor Law, Indiana Law Journal, Jan 2009, available at [http://works.bepress.com/cgi/viewcontent.cgi?article=1066&context=martin\\_malin](http://works.bepress.com/cgi/viewcontent.cgi?article=1066&context=martin_malin); Ann C. Hodges, "Lessons From the Laboratory: The Polar Opposites on the Public Sector Labor Law Spectrum, ExpressO (2008) available at [http://works.bepress.com/ann\\_hodges/1](http://works.bepress.com/ann_hodges/1).

<sup>139</sup> The ILO, a United Nations agency that promotes labor rights, is one of many groups that believe collective bargaining is a democratic right, not a mere economic procedure, see Freedom of association and the right to collective bargaining, International Labour Organization, available at <http://www.ilo.org/global/topics/freedom-of-association-and-the-right-to-collective-bargaining/lang--en/index.htm> ("The right of workers and employers to form and join organizations of their own choosing is an integral part of a free and open society. In many cases, these organizations have played a significant role in their countries' democratic transformation"); see also Article 23, United Nations General Assembly (1948), Universal Declaration of Human Rights, Paris, International Labour Organization (1998) ("Everyone has the right to form and to join trade unions for the protection of his interests"); Declaration on Fundamental Principles and Rights at Work, 86th Session, Geneva. ("Declares that all Members, even if they have not ratified the Conventions in question, have an obligation arising from the very fact of membership in the Organization, to respect, to promote and to realize, in good faith and in accordance with the Constitution, the principles concerning the fundamental rights which are the subject of those Conventions, namely: (a) freedom of association and the effective recognition of the right to collective bargaining"); Health Services & Support Facilities Subsector Bargaining Assn v. British Columbia (Supreme Court of Canada, 2007) ("The right to bargain collectively with an employer enhances the human dignity, liberty and autonomy of workers by giving them the opportunity to influence the establishment of workplace rules and thereby gain some control over a major aspect of their lives, namely their work... Collective bargaining is not simply an instrument for pursuing

the simple question of whether or not public employees' benefits are the product of a process that profoundly disadvantages taxpayers. The passion generated by initiatives to restrict collective bargaining suggests that, at a minimum, this option should be viewed as a last resort. In cases, however, where public employee unions are intransigent and unfazed by the prospect of bankruptcy or a state government reduced to a sole, benefits paying function, the game changing option of simply taking collective bargaining of benefits off the table may be a reasonable response.

Lost in much of the recent discussion about the relationship of the public sector to the private sector is the important fact that while the private sector has come to rely on the public for certain functions—defense, roads, public education, prisons and certain human services to name a few—with the possible exception of defense, everything that is done in the public sector can (and sometimes is) performed by the private sector. Private schools<sup>140</sup>, private hospitals<sup>141</sup>, private prisons<sup>142</sup>, and private roads<sup>143</sup> are all commonplace in the U.S.

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external ends...rather [it] is intrinsically valuable as an experience in self-government... Collective bargaining permits workers to achieve a form of workplace democracy and to ensure the rule of law in the workplace”).

<sup>140</sup> Private universities dominate the rankings of US News & World Report's top undergraduate universities, see <http://colleges.usnews.rankingsandreviews.com/best-colleges/rankings/national-universities/spp+50>. Private secondary schools also tend to have a better reputation and overall better student performance than public secondary schools, see Paul E. Peterson & Elena Llaudet, On the Public-Private School Achievement Debate, Kennedy School of Government, Harvard University, Aug 2006, available at <http://www.hks.harvard.edu/pepg/PDF/Papers/PEPG06-02-PetersonLlaudet.pdf>.

<sup>141</sup> Private hospitals also make a strong showing in US News & World Report's ranking of the top hospitals, see <http://health.usnews.com/health-news/best-hospitals/articles/2011/07/18/best-hospitals-2011-12-the-honor-roll>; see also Public hospitals decline swiftly, Washington Times, Aug 16, 2005, available at <http://www.washingtontimes.com/news/2005/aug/16/20050816-102614-7824r/>.

<sup>142</sup> The perverse incentives of private prisons, The Economist, Aug 24, 2010, available at [http://www.economist.com/blogs/democracyinamerica/2010/08/private\\_prisons](http://www.economist.com/blogs/democracyinamerica/2010/08/private_prisons) (“Inmates in private prisons now account for 9% of the total US prison population, up from 6% in 2000”); Stephanie Chen, Larger Inmate Population is Boon to Private Prisons, Nov 19, 2008, available at <http://online.wsj.com/article/SB122705334657739263.html> (“Outsourcing incarceration to prison companies can reduce a government's cost of housing those prisoners by as much as 15%, according to a study by the Reason Foundation, a research organization in Los Angeles. Private operators say they can build prisons more quickly and operate them less expensively than governments because their payroll costs are lower and they can consolidate prisoners from many far-flung jurisdictions into facilities located in areas where land and building costs are very low... The American Civil Liberties Union has filed lawsuits

Indeed, in many cases, the reputation enjoyed by comparable private institutions far outweighs that of the corresponding public ones. Public schools and hospitals are the obvious examples here.

The reverse is not true. Recent experience with private sector economies dwarfed by a huge public sector are not encouraging. The ongoing spectacle of painful restructuring that is just beginning in, for example, Greece<sup>144</sup>, Spain,<sup>145</sup> Ireland<sup>146</sup> and Portugal<sup>147</sup> is an example

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involving several prison companies over the past decade alleging poor treatment of inmates. Last year, the organization and other parties filed a lawsuit against Corrections Corp. and the Department of Homeland Security's Immigration and Customs Enforcement arm in federal court in San Diego, alleging that the company was operating an overcrowded, unsafe immigrant-detention center in that city. Detainees were routinely assigned in groups of three to sleep in two-room cells -- meaning one had to sleep on the floor near the toilet -- or to temporary beds in recreation rooms and other common spaces, according to the complaint. The suit also alleged that detainees had little access to mental-health care"); for additional reports, see Private Prisons in the United States, Abt Associates, Jul 16, 1998, available at <http://www.abtassociates.com/reports/priv-report.pdf>; for a variety of prison statistics, see National Prisoner Statistics, Bureau of Justice Statistics, available at <http://bjs.ojp.usdoj.gov/index.cfm?ty=dcdetail&iid=269>.

<sup>143</sup> Examples here include a recent deal for an Indiana toll road, see Daniel Schulman & James Ridgeway, The Highwaymen, Mother Jones, Jan/Feb 2007, available at: <http://motherjones.com/politics/2007/01/highwaymen>; the Reedy Creek Improvement District operated by Disney subsidiaries in the greater Orlando area, see <http://www.oppaga.state.fl.us/reports/pdf/0481rpt.pdf>; the Chicago Skyway, see Socialism in Reverse, WSJ, July 29, 2006; for a discussion of the history of private roads, see Gerald Gunderson, Privatization and the 19<sup>th</sup>-Century Turnpike, Cato Journal, Vol. 9, No. 1 (Spring/Summer 1989), available at <http://www.cato.org/pubs/journal/cj9n1/cj9n1-9.pdf>, for a discussion of the current trend towards privatization of public roads, see Emily Thorton, Roads to Riches, Bloomberg Businessweek, May 7, 2007, available at [http://www.businessweek.com/magazine/content/07\\_19/b4033001.htm](http://www.businessweek.com/magazine/content/07_19/b4033001.htm); see also Phineas Baxandall, Kari Wohlschlegel & Tony Dutzik, Private Roads, Public Costs, U.S. PIRG Education Fund, Spring 2009, available at <http://cdn.publicinterestnetwork.org/assets/H5QI0NcoPVeVJwymwIURRw/Private-Roads-Public-Costs.pdf>.

<sup>144</sup> For an interesting analysis of the background of the current Greek debt crisis, see Michael Lewis, Beware of Greeks Bearing Bonds, Vanity Fair, Oct 1, 2010, available at <http://www.vanityfair.com/business/features/2010/10/greeks-bearing-bonds-201010>; see also If Greece goes, The Economist, Jun 23, 2011, available at <http://www.economist.com/node/18866979>. The size of the Greek government debt is 142.8% of GDP, see eurostat newsrelease, Apr 26, 2011, available at [http://epp.eurostat.ec.europa.eu/cache/ITY\\_PUBLIC/2-26042011-AP/EN/2-26042011-AP-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-26042011-AP/EN/2-26042011-AP-EN.PDF); Why Greeks venerate their 'inefficient' public sector, BBC, Jun 30, 2011, available at [http://news.bbc.co.uk/2/hi/programmes/from\\_our\\_own\\_correspondent/9526090.stm](http://news.bbc.co.uk/2/hi/programmes/from_our_own_correspondent/9526090.stm) ("Up until now jobs in public institutions have been for life. Early retirement is common. Retirement packages are guaranteed and generous. About one in every four working people is believed to work for the state in one form or another"); Greece, 2011 Index of Economic Freedom, <http://www.heritage.org/index/country/Greece> ("In the most recent year, total government expenditures, including consumption and transfer payments, increased to 46.8 percent of GDP"); for information about the IMF bailout, see Greece, International Monetary Fund, <http://www.imf.org/external/np/exr/faq/greecefaqs.htm#q7>.

<sup>145</sup> The total size of Spain's public debt is 60.1% of GDP, eurostat newsrelease, supra; see also Spanish public sector on strike against austerity plan, BBC, Jun 8, 2010, available at <http://www.bbc.co.uk/news/10261567> ("Spain has

write large of the depths to which societies may be forced to sink when finally willing to confront unsustainable debt levels. Public enterprises cannot and do not perform most functions as efficiently as their private corollaries; this is not because people in the private sector are smarter or morally superior. It is simply because the incentives in the public sector, with its lack of effective competition, emphasize job security, maximizing compensation and job retention. In the private sector, competition and the absence of moral hazard in the setting of salaries and benefits results in generally nimble enterprises that can and must respond quickly to changing conditions.

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suffered one of the toughest recessions in the EU, and has its highest unemployment rate. It recently had its credit rating downgraded, amid fears it could follow Greece into a debt crisis. More than 2.5 million Spaniards work in the public sector, and the strikes were reported to be affecting hospitals and schools, fire stations and local government. Emergency responders were providing minimum services. With a budget deficit currently running over 11%, the government is under pressure from the EU to slash spending. In May, Spanish Prime Minister Jose Luis Rodriguez Zapatero announced a 5% cut in public sector pay, starting this month. Salaries will be frozen in 2011, pensions will no longer be adjusted for inflation and tax breaks for new parents will be dropped"); for a current discussion of Spain's austerity measures, see Miles Johnson, Spain approves more spending cuts, Financial Times, Jun 24, 2011, available at <http://www.ft.com/intl/cms/s/0/d9671dd8-9e66-11e0-8e61-00144feabdc0.html#axzz1QE2LJCD7>.

<sup>146</sup> For a dramatic narrative describing the background of the Irish debt crisis, see Michael Lewis, When Irish Eyes Are Crying, Vanity Fair, Mar 2011, available at <http://www.vanityfair.com/business/features/2011/03/michael-lewis-ireland-201103>; ("An Irish economist named Morgan Kelly, whose estimates of Irish bank losses have been the most prescient, made a back-of-the-envelope calculation that puts the losses of all Irish banks at roughly 106 billion euros. (Think \$10 trillion [in terms of US economy].) At the rate money currently flows into the Irish treasury, Irish bank losses alone would absorb every penny of Irish taxes for at least the next three years"); Ireland's government debt stands at 96.2% of GDP, and has a current budget deficit equal to 32.4% of GDP, see eurostat newsrelease, supra; for a discussion of Ireland's austerity measures, see Richard Wolf, Ireland's debt crisis, austerity offer a lesson for Obama, USA Today, May 23, 2011, available at [http://www.usatoday.com/money/world/2011-05-21-ireland-obama\\_n.htm](http://www.usatoday.com/money/world/2011-05-21-ireland-obama_n.htm); see also Landon Thomas Jr., Irish Debt Crisis Forces Collapse of Government, NY Times, Nov 22, 2010, available at <http://www.nytimes.com/2010/11/23/world/europe/23ireland.html>.

<sup>147</sup> Portugal faces a public debt that is 93% of GDP, see eurostat newsrelease, supra; for a discussion of Portugal's bailout, see Henry Chu, Europe scrambles to rescue Portugal from debt crisis, LA Times, Apr 8, 2011, available at <http://articles.latimes.com/2011/apr/08/world/la-fg-portugal-debt-20110408>; see also Portugal's 78bn euro bailout is formally approved, BBC, May 16, 2011, available at <http://www.bbc.co.uk/news/business-13408497>; Portugal's credit rating is now at junk status, see Sandrine Rastello & John Detrixhe, Portugal Government-Bond Ratings Cut to Junk by Moody's on Financing Risk, Bloomberg, Jul 5, 2011, available at <http://www.bloomberg.com/news/2011-07-05/portugal-s-bond-ratings-are-cut-to-junk-by-moody-s-with-a-negative-outlook.html>.

In addition, many see the loss of the right to bargain collectively as a profound attack on the value and dignity of public employees and, by extension all workers.<sup>148</sup> This view demands a response and a reminder about the fundamental distinctions between public and private employees. Unlike their counterparts in the private sector, public employees do not typically generate profits. The goal of private sector unions—to secure a larger share of profits created by employees—has no corollary in the public context. Public employees negotiate simply to obtain a larger slice of taxpayer dollars in the form of benefits and other compensation. When public employees strike, they strike against taxpayers. President Roosevelt considered this possibility “unthinkable and intolerable.”<sup>149</sup> And, as late as the

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<sup>148</sup> See note 138, supra; see also Julianna Goldman & Roger Runningen, Obama Tells Governors Public Workers Must Not Be ‘Vilified’, Bloomberg Businessweek, Feb 28, 2011, available at <http://www.businessweek.com/news/2011-02-28/obama-tells-governors-public-workers-must-not-be-vilified-.html> (“President Barack Obama said public employees shouldn’t be “vilified” or lose collective bargaining rights as states seek to balance their budgets... “If all the pain is borne by only one group, whether it’s workers or seniors or the poor, while the wealthiest among us get to keep or get more tax breaks, we’re not doing the right thing,” he said. “I don’t think it does anybody any good when public employees are denigrated or vilified or their rights are infringed upon”); many commentators agree, see Edgar Moore, Midlands Voices: Collective-Bargaining rights essential to worker dignity, Omaha.com, May 6, 2011, available at <http://www.omaha.com/article/20110506/NEWS0802/705069989/-1>; Michael Zimmer, Collective Bargaining as a Human Right, Feb 20, 2011, available at <http://michaelzimmer.org/2011/02/20/collective-bargaining-as-a-human-right/>; Susan Brooks Thistlethwaite, We need a new Social Gospel: the moral imperative of collective bargaining, Washington Post, Feb 23, 2011, available at [http://onfaith.washingtonpost.com/onfaith/panelists/susan\\_brooks\\_thistlethwaite/2011/02/we\\_need\\_a\\_new\\_social\\_gospel\\_the\\_moral\\_imperative\\_of\\_collective\\_bargaining.html](http://onfaith.washingtonpost.com/onfaith/panelists/susan_brooks_thistlethwaite/2011/02/we_need_a_new_social_gospel_the_moral_imperative_of_collective_bargaining.html).

<sup>149</sup> Franklin D. Roosevelt, Letter to president of National Federation of Federal Employees, Aug 16, 1937, available at <http://www.presidency.ucsb.edu/ws/index.php?pid=15445#axzz1TzS8bSgQ>; see James Sherk, F.D.R. Warned Us, NY Times, Feb 19, 2011, available at <http://www.nytimes.com/roomfordebate/2011/02/18/the-first-blow-against-public-employees/fdr-warned-us-about-public-sector-unions>; for further discussion and a background of the letter, see John Reiniers, FDR’s Warning: Public employee unions a no-no, Hernando Today, Oct 17, 2010, available at <http://www2.hernandotoday.com/content/2010/oct/17/ha-fdrs-warning-public-employee-unions-a-no-no/> (“All Government employees should realize that the process of collective bargaining, as usually understood, cannot be transplanted into the public service. It has its distinct and insurmountable limitations ... The very nature and purposes of Government make it impossible for ... officials ... to bind the employer ... The employer is the whole people, who speak by means of laws enacted by their representatives ... Particularly, I want to emphasize my conviction that militant tactics have no place in the functions of any organization of government employees. Upon employees in the federal service rests the obligation to serve the whole people ... This obligation is paramount ... A strike of public employees manifests nothing less than an intent ... to prevent or obstruct ... Government ... Such action, looking toward the paralysis of Government ... is unthinkable and intolerable.’ ... To get this in historical context, Congress enacted the landmark National Labor Relations Act (“Wagner Act”) in 1935 - the Magna Carta of the American labor movement. It excluded federal, state and local employees. It created the National Labor Relations Board to enforce the rights of labor”).

1950s, organized labor agreed that collective bargaining was inappropriate in the public sector. Indeed, the AFL-CIO Executive Council provided the following advice in 1959: “[i]n terms of accepted collective bargaining procedures, government workers have no right beyond the authority to petition Congress—a right available to every citizen.”<sup>150</sup>

The implications for governments, squeezed at the moment in the U.S. by declining tax revenues, and increasing health care costs and life expectancy rates, are grim. Failure to come to grips with the underlying dynamic of rent seeking by politicians in flush times may well lead to a historical first—bankruptcy by one or more states. Assuming the federal government does not intervene,<sup>151</sup> bankruptcy could result in leaner, more flexible states—much like the post-bankruptcy freedom GM now enjoys.<sup>152</sup> Of course, there are lots of

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<sup>150</sup> Leo Kramer, Labor’s Paradox: The American Federation of State, County and Municipal Employees, AFL-CIO (1962) at 41; see James Sherk, F.D.R. Warned Us, NY Times, Feb 19, 2011, available at <http://www.nytimes.com/roomfordebate/2011/02/18/the-first-blow-against-public-employees/fdr-warned-us-about-public-sector-unions>; see also James Sherk, Majority of Union Members Now Work for the Government, The Heritage Foundation, Jan 22, 2010, available at <http://www.heritage.org/research/reports/2010/01/majority-of-union-members-now-work-for-the-government>.

<sup>151</sup> See note 108, supra; see also James Pethokoukis, When States Go Bust, Weekly Standard, Feb 14, 2011, Vol 16, No. 21, available at [http://www.weeklystandard.com/articles/when-states-go-bust\\_541424.html](http://www.weeklystandard.com/articles/when-states-go-bust_541424.html); R. Eden Martin, Unfunded Public Pensions -- the Next Quagmire, Wall Street Journal, Aug 19, 2010 at A17 (“The troubles in Illinois and other states may soon force the federal government to choose among three options. The first is to do nothing -- in which case some pension plans will go bankrupt, retirees will suffer, and many local governments will face emergency cost-cutting and taxing scenarios that will drive out businesses and jobs. The second option is to yield to the pressures, especially from state officials and organized labor, for condition-free bailouts and loans. Finally, the feds could choose to pressure (“incentivize”) states and cities to straighten out their own affairs through loans to which they attach stringent conditions. The consequences of doing nothing would be painful. But they would be far less harmful than the consequences of an unconditioned federal bailout, which would mean massive new fiscal commitments at the federal level”); Michael Corkery, Global Finance: Group to Target States’ Woes, Wall Street Journal, Jun 23, 2011 at C3; Zachary A. Goldfarb, Obama has few options to aid states, Washington Post, Feb 28, 2011 at A5.

<sup>152</sup> See Peter Whoriskey & Kana Hedgpeth, GM swings to first profit in 3 years; U.S. to spend \$800 million to help redevelop plants, Washington Post, May 18, 2010 at A13; see also Nick Bunkley, G.M.’s \$4.3 Billion Loss Masks Progress, NY Times, Apr 7, 2010, available at <http://www.nytimes.com/2010/04/08/business/08motors.html> (“G.M. said Wednesday that it had positive cash flow of \$1 billion in the six months after it emerged from bankruptcy protection last July, but that it lost \$4.3 billion in that period, mostly because of the cost of settling with the United Auto Workers union over retiree health benefits, one of the burdens that helped bring the company to its knees... The bankruptcy cleared \$83 billion in liabilities from G.M.’s balance sheet, the company said. Wiping out that debt already has saved G.M. billions of dollars in interest; it paid \$28.6 million a day in

unknowns in a first-ever state bankruptcy and it is hard to predict what kind of rent seeking response one might see from politicians during and after such an event. Where possible, the more modest reforms—accurate amortization and discount rates, conversion of DB plans to DC plans, greater transparency and even limiting benefits as a subject of collective bargaining—are probably worth pursuing first.

## V. Conclusion

The public employee benefits crisis described in this paper is a direct result of taxpayer ignorance and/or apathy, morally hazardous behavior by elected officials concerned with pleasing public organized labor, and public unions' willingness to trade current salary increases for generous future benefits. Public sector unions have behaved just as we would expect—they actively sought to extract the largest amount of compensation possible for their members. This is neither surprising nor, by itself, particularly disturbing. However, when the predictable union push for an ever larger share of taxpayer dollars confronts an inattentive public and eager-to-please elected officials, the result is looming financial catastrophe. The only way forward is a series of reforms that address the underlying problem—i.e. the absence of a counterbalance to the tendency of politicians to over promise without regard to the consequences. In states with modest financial problems, some simple accounting changes—mandated rates of return and amortization—may be sufficient to avoid a future crisis scenario. In the many states with far more serious issues—those facing bankruptcy for example—the elimination of DB plans in favor of DC plans and even the prohibition of collective bargaining by public unions over employee benefits may be the only viable solutions.

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interest in the months before bankruptcy, but those payments dropped 86 percent, to \$4 million a day, after bankruptcy. With those debts gone, G.M. said gross margins on vehicle sales edged into positive territory, at 1.9 percent, compared with negative 18.5 percent in early 2009").