THE LIMITS OF RETRENCHMENT
The Politics of Pension Reform

Daniel DiSalvo
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**Executive Summary**

The Great Recession sparked a powerful movement to rein in public-employee pension systems across the United States. Since the economic downturn that began in 2008, all 50 states and Puerto Rico have enacted some sort of pension change: 21 states did so in 2010, and 29 did so in 2011. A few more states did so in 2012 and 2013, while others modified legislation passed in 2010–11. The thrust of these changes was almost universally toward pension retrenchment.

States sought to make their pension plans less generous in order to take pressure off their budgets. Most states increased employee contributions and lowered benefits for new hires. Other changes included raising retirement ages, lengthening vesting periods, reducing cost-of-living adjustments, and eliminating spiking options. Barring future changes, state pensions in the long run will be less generous, and public employees will receive less in overall compensation.

On the surface, it seems that state politicians did not, in Rahm Emmanuel’s now-famous dictum, “let a serious crisis go to waste.” However, many observers believe that few of the aforementioned reforms fully addressed states’ long-term fiscal problems. Most of the changes apply only to new hires, not to existing employees or those already in retirement. Therefore, the savings from these plans will take decades to materialize. That even passing mild pension reforms proved contentious reflects powerful political alignments that militate against retrenchment. The key players in pension reform have strong incentives to push costs into the future and avoid tough choices in the present. Consequently, most states did just that.

But a handful of states took more dramatic action, genuinely trying to do something about their pension systems with a view to the long term. States where major reform did occur stand out: they include (but are not limited to) Rhode Island, Utah, Virginia, and New Jersey. These few states offer lessons about when and why pension reform can work. They point the way toward successful political strategies for serious pension reform that might be emulated elsewhere.

A number of factors conditioned which states were willing to enact far-reaching reform. Most states found themselves constrained by some combination of voter apathy, public-employee union pressure, existing legal provisions, and politicians’ desire to avoid blame. Yet some states managed to overcome those barriers. A few things helped them do so:

1. A leader (or leaders) emerged who understood public pensions and was willing to tackle the issue. Reform requires a person with the credibility to serve as the public face of change. These leaders were willing to engage in a serious campaign of civic education. The way they framed the issue was hugely important, as it reduced the appearance that reform was designed to punish public employees or those already in retirement.

2. Preexisting fiscal conditions often shaped which states determined to take action. Whether the states had long-standing problems or took a particularly hard hit during the 2008–09 recession often provided the impetus for putting pension reform on the agenda.
3. Legal barriers—from state constitutions to statutes to collectively bargained contracts—allowed less flexibility in some states than in others. A few, such as Illinois, are in bad fiscal shape, but the state constitution has severely limited what legislators could do to address the problem. Other states confront lower legal hurdles to reform.

4. The power of interest groups, especially public-sector unions, shaped what policy options were on the table, how hard fought the politics would prove to be, and the extent of litigation after the passage of new legislation.

Genuine reform, rather than just kicking the can down the road, can happen. States that are serious about getting a hold on pension costs are increasingly introducing defined-contribution options or hybrid plans. At present, at least a dozen states offer such plans. As more states take this step, it will become less controversial and easier for other states to follow suit. This bodes well for the next round of pension reform.

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INTRODUCTION

The Great Recession created a huge budget crunch in U.S. state and local government. But with private-sector activity picking up, many assume that state and local government’s budget picture will consequently improve. However, there are good reasons to believe that the fiscal health of state and local government will remain under stress for years to come. We may be entering a new “fiscal ice age,” where tax revenues translate into far fewer government services. Such fiscal stress threatens these governments’ financial well-being and their ability to deliver high-quality services to citizens. One of the key drivers of this problem is the rising costs of public-employee retirement benefits, which includes pensions.

The problem is very large. Government pension systems cover approximately 20 million public (nonfederal) employees and 7 million retirees. Using traditional government accounting standards, post-recession estimates found that state and local pensions were underfunded to the tune of $700 billion to $1 trillion. More sophisticated analysis by financial economists Robert Novy-Marx and Joshua Rauh has shown the underfunding problem to be much worse; a better measure of the underfunding gap at the end of 2011 was more than $4 trillion, or one-third of total U.S. GDP. This estimate suggests that the pension underfunding problem is right up there with the fiscal crisis of America’s federal entitlements.

The financial-market implosion that set off the Great Recession exacerbated the situation. Pension plans lost approximately $1 trillion in assets. In addition, public employees began retiring in record numbers.
numbers, drawing on their pension assets sooner than expected. If states and cities do not raise more revenue, a large number of plans are likely to run short of cash in coming decades. Pension expert Alicia Munnell has estimated the exhaustion date based on different scenarios. Assuming an 8 percent return on pension assets and ongoing contributions to the plans, Munnell estimates that they will run out of money in 2029. This average for all states masks severe shortages in states such as Illinois, New Jersey, and Connecticut, which are predicted to run out of assets within the next five years.

One might think that with a problem of this scale and scope, state governments would be taking dramatic action. But even getting modest reforms passed by state legislatures and signed by governors has proved challenging. Why has there not been more comprehensive reform to address the budget problems induced by pension liabilities? Why have governments been providing, and citizens consuming, so many public services with the promise to pay for them later?

Most analyses of public pensions have been written by financial economists. These studies tend to be inscrutable to the layperson. They cover the formulas, funding levels, liabilities, discount rates, annual required contributions, investment strategies, rates of return, and other financial features of the plans. They reveal the fiscal crisis that pension liabilities have created in all its gory detail. However, these financial analyses do not address why state politicians make the decisions that they do about pensions. Whatever the numbers say, governors and state legislators exercise ultimate control over public-employee pension plans. The fiscal crisis is simply the manifestation of an underlying political crisis.

The pension crisis has been poorly framed. Most people think of it in complex actuarial terms, beginning with funding ratios; but it is really a problem of democratic politics. At the deepest level, it raises the question of whether democracy and fiscal responsibility can be combined. More immediately, the political crisis is rooted in the way pension policy generates powerful incentives to shift costs to future generations. In addition to running the numbers, we need to focus more on the behavior of state politicians.

I. OBSTACLES TO PENSION RETRENCHMENT

The Great Recession opened a window for pension retrenchment. Yet the politics of pensions creates huge obstacles to significant reform. In fact, all the political incentives encourage policymakers to slowly but surely increase the generosity of pension plans. It was only because of the temporary crisis in state and local government finances that retrenchment could be undertaken. To better understand why a handful of states undertook genuine long-term reform, it is helpful to examine the basic forces that structure pension politics. These forces explain why politicians have tended to favor expansion in good fiscal times, as well as the methods they use to push the problem onto future generations in bad fiscal times (Figure 1).

Voters

The first feature of U.S. pension politics is that the majority of voters lack an understanding of the major issues. Newspapers devote limited coverage to them. And their actuarial complexity is daunting. Prior to the recession, most people knew little and probably cared even less about public pensions. Pension politics took place in a low-visibility environment. However, the government’s own employees have a knowledge of and an interest in pension plans, and they vote in every legislative district in America’s state and local pension underfunding gap at the end of 2011 was more than $4 trillion—one-third of U.S. GDP and right up there with the fiscal crisis of federal entitlements.
the nation. In fact, they often turn out to vote at higher rates than other citizens. The policy of providing public workers pension benefits has, as one might expect, created a voting constituency willing to defend them. Politicians—of both parties—seeking election pay attention to such voters. What public employees want is more generous pensions—or, at least, no diminishment of their current plan. If politicians respond to the strong preferences of public employees in their role as voters, they should therefore favor benefit expansion.

**Interest Groups**
The primary interest groups with a stake in public pensions are public-employee unions and associations representing government workers. Public-sector unions today are among the most politically active interest groups in U.S. state and local politics. The unions use their political power to encourage politicians to expand benefits—or, at least, maintain the status quo. Whether they should pressure policymakers to fully fund pensions is a secondary issue for most unions. (It should be noted that analysts have found no empirical evidence that the strength of public-sector unions causes pension underfunding).

The other major group with an interest in pensions is the financial-management firms that seek to win business from pension funds. Like the unions, they have incentives to favor expanded benefits: the more generous the benefits, the larger the portfolios of assets they get to manage and the larger the fees they can charge. Many firms also earn money from the sale of pension-obligation bonds. Pennsylvania is currently considering issuing $3 billion of such bonds.

What is notable is that there are no well-established interest groups pushing politicians to rein in the generosity of pension plans. Various taxpayer and good-government groups exist, but their attention to pensions is episodic, at best. Other groups with an interest in pension politics are rating agencies (Standard & Poor’s, Moody’s, Fitch) and bondholders. The ratings agencies might put a slight brake on expansive pension policies insofar as their estimates of future interest payments make politicians think twice about their decisions. But that is a marginal check. In sum, the interest-group environment is weighted in favor of groups that favor expansion.

**Policy Structure**
Political scientists have long argued, in E. E. Schattschneider’s famous dictum, that “a new government policy creates new politics.” This insight is particularly apposite for public pensions, whose basic structure helps explain why the political scales are tilted in favor of expansion.

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**Figure 1. Barriers to Pension Reform**

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<th>Voters</th>
<th>• The majority of voters are poorly informed</th>
<th>• Public employees have more knowledge of and interest in pensions</th>
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<td>Interest Groups</td>
<td>• Public-sector unions favor expanded benefits</td>
<td>• Financial-management firms favor expanded benefits</td>
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<td>• Liberal civic groups favor retrenchment</td>
<td>• Credit-rating agencies encourage creditworthiness</td>
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<td>Defined-benefit model encourages politicians to:</td>
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<td>• Short funds to free up revenue for other priorities</td>
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<td>• Avoid transparency</td>
<td>• Plead ignorance of systems</td>
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<td>Legal provisions can limit reform options:</td>
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<td>• Collectively bargained contracts</td>
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<td>Political Culture</td>
<td>• Reduced skepticism about borrowing from future generations to pay for present amenities</td>
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Most public pensions fit into the defined-benefit model. Such plans stipulate in advance an amount of income that a worker will receive in retirement and then try to figure out how to pay for it. The definition of the benefit is usually based on a formula that calculates the number of years worked and the average earnings in several years leading up to retirement. These plans are then financed by contributions from employers and employees that go into pooled funds that are invested, mostly in equities (such as mutual funds or stocks) and a smaller portion in bonds. The assumption is that the investments will produce returns sufficient to pay a fixed stream of retirement income.

This policy structure creates perverse incentives for politicians. First, politicians have little incentive to make sure that contributions are sufficient to fund future payouts; instead, they are incentivized to promise current public employees more generous pensions, whose costs will be borne in the distant future, when other politicians and other taxpayers are on the hook. In the current incentive structure, this strategy is vastly preferable to, say, increasing salaries, which show up in current budgets.

Second, by pushing costs into the future, politicians can get more of what they want in the present. Democrats can win plaudits with public-employee unions and government workers who vote in their districts. By shorting the pension fund, Democrats can free up precious budget dollars for other programs. Conversely, by allowing greater benefits, Republicans can curry favor with police officers, firefighters, and other public workers in their districts. And by shorting the fund, they, too, can create space in the budget to do things that they want to do, such as cut taxes.

Making matters worse, the vast majority of state legislators lack a firm grasp of many of the technical features of pension systems. Even a leader of the pension reform movement, former Utah state senator Dan Liljenquist, stated: “Pensions are a tough issue. When I went into the legislature, I knew absolutely nothing about pensions, and I had to educate myself first. And this is a complex issue, and it took some time to understand what actuarial rates of return are, for example, or what actuarially required contributions are, what the different rules around smoothing gains and losses are, et cetera.”

In sum, neither party has strong incentives to push for transparency or retrenchment.

Legal Constraints

Existing state law and state constitutional provisions limit policymakers’ options. In some states, strong constitutional guarantees protect those already retired and the prospective benefits of current employees. Such provisions often take retrenchment off the table. For example, in 2013, Illinois passed a law raising the retirement age for younger employees and capping cost-of-living adjustments (COLAs) for current retirees. But these reforms were overturned in 2015, when the state supreme court invoked a constitutional provision of a “contractual relationship, the benefits of which shall not be diminished or impaired.” New York and other states have nearly identical language in their constitutions.

Consider, likewise, the “California Rule,” a state constitutional doctrine that prohibits the modification of current public employees’ pension benefits. In the private sector, corporations can (and often do) freeze pension plans, which means that employees keep the money that they have earned to that point, but future accruals come in a different form—usually a defined-contribution model. Such freezes are prohibited for state and local government workers in California.
Further, altering arrangements for current employees who are covered by collectively bargained contracts usually requires that new agreements be negotiated between unions and management; but public-sector unions often oppose any diminishment in deferred compensation for their members, making such negotiations contentious. Agency managers and elected officials thus have incentives to avoid negotiating. In sum, the legal environment surrounding pensions tends to keep retrenchment off the table, preserve the status quo, and make increasing the generosity of existing systems the only available change option.

**Political Culture**

A final feature of pension politics is a shift in American attitudes toward public finance. Before the 1960s, there was something of a moral bar against borrowing from future generations to pay for present amenities. This acted as a check on the rational incentive of every voter and politician to borrow money for things that they want but cannot persuade other citizens to pay for with higher taxes. However, as James Q. Wilson observed, the public and policymakers have become more accepting of a government that saddles one’s grandchildren with the costs of efforts to address problems in the here and now.25

All told, the basics of pension politics point in the direction of expanding benefits. Neither voters nor interest groups nor politicians are likely to muster the wherewithal to push consistently for retrenchment. This explains why the general thrust of pension politics prior to the recession was in favor of expanding and enhancing workers’ benefits. For instance, during the late 1990s, public pension funds across the U.S. accrued large actuarial surpluses. Momentarily flush conditions spurred legislators in many states to substantially expand retirement benefits for public workers.26

**II. POSTRECESSION POLITICS**

The Great Recession scrambled past political alignments. The media woke up to the pension problem and started covering it. Some voters gained new information. The partisan alignment in the states changed dramatically, as Republicans took over a record number of statehouses and governors’ mansions. From 1978 to 2010, Republicans controlled both chambers of state legislature in, on average, only 13 states. From 2011 to 2015, they controlled both chambers in, on average, 27 states. Today, they control 30 states and have an all-time high of 4,111 state legislative seats—compared with 11 legislatures for the Democrats and only 3,136 seats.27

Conservative civic groups, foundations, and think tanks also began to push Republicans to favor reining in benefit schemes (Figure 2).28 Democrats split, as governors and mayors became concerned with the number of dollars in their budgets devoted to pension payments. Legislators of both parties could also draw on the experience of the private sector, which has moved away from defined-benefit plans and toward other 401(k)-style plans in recent decades. And the recession created a sense of crisis, as well as a huge budget problem for many states, which increased pressure for action.

Pension politics—as political scientists Sarah Anzia and Terry Moe have shown in a detailed empirical analysis—which had hitherto been largely consensual and bipartisan, became increasingly partisan, as

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**Figure 2. Ways to Modify Pension Plans**

- Reduce cost-of-living-adjustments (COLAs)
- Increase employee contributions
- Hybrid plans (defined contribution and defined benefit)
- Reduce the multiplier
- Increase early retirement age
- Introduce defined-contribution plans for new hires
- Let current workers choose to switch from defined benefit to defined contribution
- Increase maximum pension service years
- Lengthen the vesting period
- Eliminate spiking options

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Figure 3. State Pension Plan Changes, 2010-2013*

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<th>States</th>
<th>Increase Employee Contribution Rates</th>
<th>Decrease COLAs Multiplier</th>
<th>Increase Benefit Multiplier</th>
<th>Increase Age</th>
<th>Limit Deferred Retirement Options</th>
<th>Higher Benefit Reduction Factor</th>
<th>Increase Vesting Requirement</th>
<th>Increase FAC/Prohibit Spiking</th>
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*Many states have multiple pension plans covering different types of employees. Many of the above changes only apply to certain plans and certain categories of employees.

Source: National Conference of State Legislatures
Republicans began to introduce more bills seeking to prune pensions. Anzia and Moe found that of the 63 pension bills passed by state legislatures in 2010 and 2011, 59 were retrrenchments. This put Democrats and their union allies on the defensive. Whether a new style of pension politics will emerge and endure, or prove fleeting, remains to be seen.

Overall, during 2010–13, every state undertook some modification of its public-employee pension plan (Figure 3). In 2009–12 alone, 28 states reduced COLAs. Seven such states reduced COLAs for current employees as well as new hires, while 16 states reduced COLAs only for current employees and five states only for new hires. In this same period, 35 states, as well as Puerto Rico, increased employee contributions. A handful of states introduced hybrid plans—which offered a defined-contribution plan—for the first time.

Despite the significant change in U.S. pension politics since the recession, the basic elements of pension politics have not disappeared. Other features of American state government have also conspired to limit the extent of reform. First, Democrats, even if they cannot push for expansion under current conditions, are still under pressure to maintain the status quo. Second, Republicans still have public employees in their districts who vote, and they need to be sensitive to them.

Third, it is not clear how long the new conservative groups can sustain the pressure for reform or whether their attention will be diverted. Fourth, serious reform would address a long-term problem but impose much short-term pain. Fifth, state politicians can sometimes take pressure off their budgets by pushing problems down to the local level of government. These factors conspire to encourage politicians to want to do something to respond to current pressures but not necessarily to undertake major reform.

From the self-interest of many state politicians, the best solution was to trim a little, which offered the symbolism, if not the substance, of reform, and then push as much of the costs into the future. This is what, by and large, has happened. Much of the onus of policy change fell upon what public-employee unions call “the unborn,” meaning those not yet hired. For politicians and union officials, the political logic of doing this is evident. Future workers do not belong to unions now and will not be voting in the next union leadership election. Nor will they be protesting on the steps of the state capitol. Current workers, on the other hand, have a voice in their union, and their union is likely to make that voice heard in the political sphere.

Maryland provides an example of how a state can spread the political pain of pension adjustment, leave the basic system intact, and generally push the problem into the future. When Maryland entered its 90-day legislative session in 2011, it was one of the few remaining states with unified Democratic control of its electoral institutions. Governor Martin O’Malley had won reelection in a strongly Republican year. Maryland is also a strong public-employee-union state, where the local AFSCME and NEA-affiliated teachers’ unions are particularly powerful.

The state’s pension system, however, was in bad shape and getting worse: a $19 billion unfunded liability. In 2003, state lawmakers, in league with the state’s public-employee unions, defied pension-fund managers and reduced the government’s annual required contribution. In addition, under Republican governor Robert Urlich, the state had expanded benefits by increasing its multiplier to 1.8 percent—the percentage used to calculate the final pension amount. Consequently, the plan’s funding ratio began to fall; by 2010, it was only 63 percent funded and was on course to fall to 59 percent funded by 2012. (A funding ratio below 70 percent begins to worry bond buyers and investors.) And costs had tripled to more than $1.5 billion over the previous decade. With the worst funding ratio among states with a triple-A credit rating, the credit-rating agencies were threatening a downgrade. Governor O’Malley noted that pensions presented a “credit challenge for the state.”

Governor O’Malley initially proposed a bold set of proposals. He called for a new defined-contribution
Further, the new revenue from the bond sales or from the good performance of the bond money in the markets encourages politicians to reduce or skip annual pension contributions.

The real financial savings of recent reforms will thus occur far in the future—if they occur at all. Many states have histories of sweetening pension plans when economic conditions are flush. The problem that limited action raises is that now that states have picked the low-hanging fruit of increased employee contributions and eliminated COLAs, their options will be greatly constricted in the future. When the next downturn in the economy strikes, states will be confronted with much more difficult choices.

III. PENSION REFORM AND REFORMERS

Such are the forces at work in the pre- and post-recession politics of America’s public-employee pensions. But how did a few states (Figure 4) defy the normal incentives of pension politics? How did select politicians surmount the forces arrayed against them? What lessons can be drawn from their experience that would prove useful to politicians in future rounds of reform?

Leadership

Strong leadership proved essential to making significant pension reform possible. Where states enacted major changes, a dynamic leader emerged as the public face of reform. That leader was willing to confront opposition and spend significant political capital—a key element of such leadership was how each leader framed the issue, changed the conversation, and defined the terms of the debate.34

Utah, Rhode Island, and New Jersey are often cited as the states that enacted the most far-reaching or innovative pension reforms in recent years. The architect of Utah’s reforms, as incarnated in Senate Bill 63 and Senate Bill 43, was state senator Dan Liljenquist. His efforts earned him plaudits as one of Governing magazine’s top public officials of 2010. As a freshman legislator with a background in finance, Liljenquist sought a post on the Senate Retirement Committee, a committee that other
legislators deemed a backwater. He then used that post as a platform to launch a major overhaul of the state’s pension systems. Liljenquist’s first step was to request comprehensive, long-term actuarial models. He then used the data to create a presentation that he gave to legislators and civic and business groups across Utah.

In Rhode Island, Gina Raimondo became a lone crusader for pension reform. Elected state treasurer in 2010, Raimondo—a Yale-trained lawyer and a former Rhodes Scholar and venture capitalist—had no previous political experience. She was inspired to run for office by seeing the effects of rising pension costs crowd out local library and bus services in Providence. Raimondo’s experience in finance and status as a political outsider gave her particular credibility in tackling pension reform.

She began by persuading the Rhode Island Retirement Board to adopt more realistic actuarial assumptions, which lowered the expected rate of return on pension-fund investments by three-quarters of a point and extended life expectancies. Raimondo did this by bringing a lawyer to her initial meeting with the board to remind them of their legal fiduciary responsibilities. This produced a far less favorable funding ratio, thereby dramatically increasing the state’s unfunded liability from $4.7 billion to $7 billion (a jump that explains why six of the board’s seven union representatives voted against changing the actuarial assumptions). The larger figure added impetus to Raimondo’s claim that the system needed serious reform.

Raimondo then produced an in-depth report in May 2011, which described Rhode Island’s large and growing pension problems. It detailed how the generosity of benefits had grown over time, with no corresponding commitment of new revenue, creating a system that was increasingly out of whack. Raimondo used this report as the basis of a presentation, “Truth in Numbers,” that she delivered at more than 50 civic forums throughout the state. She stressed that the need for reform was driven by “math, not politics.” The data in the report were also posted online and picked up by the national press corps.

Raimondo convinced Governor Lincoln Chafee that the pension problem was more serious than he had previously thought. Together, they created a 12-member pension-advisory group to gather more information and make proposals to the state legislature. The group comprised representatives from organized labor, the business community, academia, and the political establishment. The group held numerous public hearings to open lines of communication about the state’s pension problems and build public support.

In New Jersey, leadership came from the top of the political system. State senate majority leader Stephen Sweeney put pension reform on the agenda. Sweeney,
a former president of an ironworkers’ union, had chaired his union’s pension fund. He understood the actuarial language and the numbers. Sweeney’s status as a union man partly immunized him from attacks by public-employee unions. As the bill moved through the legislature, he became the key powerbroker. Yet the public face of reform and the lightning rod for criticism became the newly elected Republican governor, Chris Christie. Christie had backed pension reform during his campaign as part of his program of reducing taxes and public spending. Once in office, the governor canvassed the state, giving speeches and meeting with civic groups to promote reform. Christie’s willingness to take much of the criticism from opponents reduced the pressure on Sweeney and Democrats in the state legislature.

As these examples attest, strong leadership matters. Liljenquist, Raimondo, and Sweeney all had experience in finance and pensions. They understood the actuarial language and were better positioned to explain the issues to their colleagues and the public. In addition, Liljenquist, Raimondo, and Christie were political outsiders, recently elected to their first government positions, and new to the political scene in their states. This status gave them credibility in claiming that they were offering fresh perspective. Nonetheless, all leaders had to be willing to endure criticism, especially from public-employee unions.

Advocates of reform managed to frame the conversation as a question of math, not politics. Math was irrefutable, while politics implied that various groups would be privileged or punished. Pungent examples of how pension costs threatened the delivery of other key state services also helped make the case that public-employee pensions were something that average citizens should care about.

Crisis Mentality
Budget pressure and the sense of crisis certainly help push pension reform onto the agenda in many states. While in some places, such as Illinois and California, it was insufficient to drive change, in other places it was part of the equation that made innovation possible. Timing played a crucial role in passing pension reform in Rhode Island: just when debate was breaking down in the legislature, the town of Central Falls declared bankruptcy. This renewed the urgency of addressing the pension issue.

For most states, it was the recession that drove the sense of crisis. Utah entered the recession in good shape, but its pension fund lost some 22 percent of its assets with the stock-market crash of 2008. This provided the impetus for Liljenquist to declare that the instability of the system boded ill for the long-term future of the state’s finances.

Similar dynamics were at work in Virginia. During the recession, the state’s unfunded pension liability increased from $11.8 billion in 2009 to $19.9 billion in 2011. Stated differently, the Virginia Retirement System (VRS) was 80 percent funded on the eve of the recession, but fell to only 70 percent funded in 2011. The situation was exacerbated when Governor Bob McDonnell, faced with a $3 billion budget shortfall, “borrowed” $620 million from the pension system to balance the state’s budget in 2010.

Virginia had long struggled with pension funding, as the government’s contribution rates were set annually by the General Assembly. In flush years, there was a powerful temptation to defy the recommendations of VRS actuaries by lowering rates, thereby shorting the fund. In addition, Virginia was one of only four states where employees did not contribute anything to their pensions. This curious system dated from a deal between the state and its employees in 1983, when workers accepted an elimination of their pension contribution in lieu of a pay raise.

Therefore, in the teeth of the recession, Virginia’s long-term finances appeared to be in serious doubt. The situation was sufficiently worrisome that, as 2010 came to a close, the governor traveled to New York City to meet with S&P, Fitch, and Moody’s to ensure that the state’s triple-A bond rating was not in jeopardy. While the governor said that he had heard
nothing bad about Virginia’s finances, he claimed merely to want to shore things up in person.

Almost simultaneously, Governor McDonnell proposed a significant reform of the VRS, which covers approximately 600,000 current and retired workers. The subsequent passage of Senate Bill 497 was hailed as one of the “biggest achievements” of the 2011–12 legislative session. The centerpiece of the new legislation was the creation of a hybrid plan that combines elements of a 401(k)-style plan for new hires.

A final example: when the recession hit, New Jersey had already established its reputation for fiscal irresponsibility in meeting pension obligations. Pension expert Alicia Munnell listed the state as a “bad actor.” New Jersey had stopped making its full annual required contribution in the 1990s and for some years had contributed nothing to its pension fund. If that were not bad enough, the state passed a major pension expansion in 2001. Flush from the stock-market highs of the dot-com boom, Republican governor Donald DiFrancesco and the Republican-controlled state legislature increased pension benefits by 9 percent. The expansion relied on rosy projections that stock-market returns would remain high forever. When they did not, a sense of crisis took hold.

Consequently, for the first time in decades, the Garden State enacted significant pension reforms in 2011. It eliminated COLAs, raised current employee contributions, increased the retirement age for new hires, and adopted a funding schedule meant to prevent the state government from skipping its annual required contributions.

**Policy Design**

Central to the degree of difficulty of pension reform are the specific changes proposed and how such changes affect different stakeholders. The potentially affected are public-worker constituencies, including retirees, current workers at various stages in their careers, and future workers.

Policy changes that affect existing retirees are usually the most difficult to enact. There are high legal barriers to diminishing pensions for those already in retirement. And there is moral concern about diminishing payouts to those already on a fixed income. Among current workers, it is difficult to tinker with those who have already vested in the current system and slightly easier to change aspects of plans for those who have not yet vested. The easiest thing for policymakers to do is to change plans for those yet to be hired. There is no legal or moral obligation to offer a particular pension plan to them.

For states such as Virginia and Utah, which were in sufficiently good shape to confine reforms to new hires, the politics of reform were easier. Lawmakers could promise current retirees that their benefits would not be touched, emphasizing that those benefits would, in fact, be safeguarded by changes to benefits not yet accrued—changes that would make the pension system as a whole better funded. Drawing such distinctions helped lawmakers drive a wedge between active and retired government workers, thereby fracturing the antireform coalition.

Creating new defined-contribution plans for new hires is easier because there are advantages to these systems for workers. In general, there is usually no vesting period, and the benefits accrued are portable (i.e., should a worker change jobs, he can take his...
pension savings with him). This stands in contrast to defined-benefit plans, where workers receive essentially nothing if they change jobs before they have vested. Even if they vest and then leave before getting close to the retirement age, they are likely to receive far smaller pensions than those who remain in the system to the end. In that respect, as Josh McGee and Marcus Winters have argued, current defined-benefit systems are actually highly unequal in the way, depending on years of service, that they treat public employees.38

Utah had the easiest path to pension reform because its plan applied only to new hires and did not change benefits for current employees or retirees. The big change that Liljenquist proposed was an end to the state’s defined-benefit plan for new hires. Because Utah’s plan was in reasonably good shape, no action was needed that would cut into workers’ pay (by increasing workers’ contributions) or benefits (by reducing future COLAs). Instead, the reforms eliminated the state’s existing defined-benefit pension plan for new hires and created a new defined-contribution-style retirement plan. This would mean a different mode of pension delivery but not necessarily a smaller stream of income for future retirees. Similarly, Virginia enacted Plan 2 in 2010, increasing the retirement age to 65 and revising the COLA formula. In 2012, it created a new hybrid system. All such changes applied only to new hires.

At the other end of the spectrum, Rhode Island and New Jersey had the toughest paths to reform. They reduced COLAs for those already retired, increased contributions for current workers, and reduced benefits for new hires. In short, they imposed some pain on every constituency. This helps explain why opposition to pension reform in those states was so intense.

Utah had the smoothest path to pension reform. In the Senate, the GOP held a 22–8 majority, and in the House, it had a 59–16 majority along with a Republican governor. Given that Republicans control the state legislature and are the swing voters on pension legislation, this made assembling a reform coalition easier. Although public-employee associations opposed the bill and launched protests on the steps of the state capitol, unions are politically weak in Utah. Once a bill was introduced in early February, it quickly made its way through the legislative process and was signed into law by the governor in late March.39

Rhode Island was an unlikely candidate for major pension reform in 2011. The new governor, Lincoln Chafee, a former Republican who had switched parties, opposed pension reform during his campaign, which helped him secure the endorsement of the state’s public-employee unions. In contrast to the Tea Party wave of Republican victories in state legislative seats in the 2010 elections, the state legislature remained strongly Democratic (65–10 in the House and 29–8 in the Senate, with one independent). In the fall of 2011,
the leadership of Rhode Island’s legislature had to call for a special session to consider a pension bill. All of the state’s public-sector unions adamantly opposed the final legislation. Yet with Raimondo’s energy, the governor’s support, the creation of the pension-advisory board, a special session of the legislature, and new outside groups supporting reform, the final bill passed by overwhelming margins (57–15 in the House and 35–2 in the Senate).

New Jersey undertook pension reform with Democrats in control of the legislature and a Republican in the governor’s mansion. New Jersey’s public-employee unions, led by the New Jersey Education Association and representing the state’s 400,000 workers, led the opposition to the bill. The NJEA spent $6 million on ads opposing the governor and pension reform over a two-month period. In the end, the reform coalition that formed in the state legislature comprised Republicans and more conservative Democrats, many with ties to private-sector unions that were skeptical about the generosity of public-sector benefits. The final votes (25–14 in the Senate and 46–32 in the Assembly) reflected the close, hard-fought nature of the policymaking process.

Virginia, too, enacted pension changes under conditions of divided government. In 2010 and 2011, Democrats controlled the state senate and Republicans controlled the House of Delegates and governorship. Yet Virginia has weak public-employee unions and is among the few states that completely prohibit collective bargaining in government. Nonetheless, pension reform faced some opposition. Public-employee associations—most notably, of teachers and firefighters—protested the changes.

As the aforementioned examples attest, the greater the number of Democrats in the state legislature and the more powerful the state’s public-employee unions, the bigger the battle to enact serious pension reform. Rhode Island thus stands out as a truly remarkable pension-reform story—Raimondo had the highest hill to climb from what was, in many respects, the weakest institutional position.

Lawsuits
In states where the political battle over reform is especially intense, one can expect opponents who lose in the legislature to take the matter to court. This is exactly what happened in Rhode Island and New Jersey. In both states, a number of public-employee unions sued to have the pension reform overturned. The lesson for future reformers is to prepare for litigation, as things aren’t over with a governor’s signature on a new law.

A year after the passage of the Rhode Island Retirement Security Act in 2011, government unions filed multiple lawsuits against it. The judge in the case ordered the parties into talks overseen by a federal mediator. In 2014, Governor Chafee and Treasurer Raimondo reached an agreement with the unions that preserved most of the key elements of the original legislation. The deal, which preserved 90 percent of the savings, was finalized in court in June 2015.

New Jersey’s experience has been even more fraught. To close budget gaps, Governor Christie abandoned the state’s new commitment to fund its pensions, paying less into the fund than the new legislation appeared to require. A coalition of public-sector unions sued. The judge in the case sided with the unions and ordered Christie and the legislature to come up with another $1.6 billion to make a full $2.25 billion state contribution, as called for in the reform legislation.

The governor responded that the state simply does not have the money and appealed the decision. He has also called for another round of pension reform, which would freeze the old defined-benefit system and move all employees into a hybrid plan. In addition, the governor’s commission has floated the idea that if state workers accepted more cuts, they would seek to secure a state constitutional amendment ensuring full payments into the system. In June, the New Jersey State Supreme Court ruled in favor of the Christie administration. The court declared that the new law was not a contractual obligation that obliged the state to make the entire contribution to its pension system.
CONCLUSION

Serious pension reform remains pressing for states across the country. Absent successful efforts to address pension costs, we risk hollowing out government. Addressing the pension problem is a way to ease budget pressures and ensure that government does not end up doing less but costing more. The present path is one where current public priorities will be constrained while we continue to pay off the costs of public services that we have already consumed.

As pension costs rise, state and local government must impose some version of austerity budgeting by raising taxes, slashing services, or increasing debt. Austerity is not a welcome outcome for Democrats or Republicans. Democrats cannot responsibly launch new programs; Republicans cannot responsibly call for tax cuts in a period of austerity budgeting. For both parties, this means that government is less able to do the things that citizens expect it to do, which undermines trust in government.

As ever larger slices of state and local budgets are precommitted to pensions, there are fewer budget decisions that voters understand or that politicians can make, loosening the connection between budgeting and self-government. Pension retrenchment is therefore essential not only for states and localities to get their fiscal houses in order but to restore a degree of democratic responsibility. Indeed, moving more in the direction of defined-contribution plans will eliminate some of the current perverse incentives for politicians and induce greater fiscal modesty.

Reconfiguring pension systems would also introduce greater equity among public employees. As matters currently stand, younger workers, as well as those who work for government for only a brief period, end up subsidizing the retirement of workers who spend their entire careers in government. (It is, moreover, far from clear that generous pensions are the best way to attract talented people.) For many who aspire to public service but do not want to spend their entire lives in government, portable defined-contribution plans make far more sense.

Serious pension reform will improve state-budgeting processes, relieve fiscal stress, improve government performance, and enhance equity among workers. The big enemy of these improvements is the power of the status quo. But this can be overcome.

2. Legislative summaries by the National Conference of State Legislatures.


33. Walsh, “Borrowing to Replenish Depleted Pensions.”


35. McDonnell proposed that Virginia’s 87,000 public employees, along with 130,000 teachers, make contributions to its pension fund of 5 percent of their salaries, while the state would offer pay increases of 3 percent, which meant that there would be only a 2 percent reduction in take-home pay. These changes in the governor’s plan would have affected current workers and new hires. The governor also promised to make the largest government contribution to the system ever ($2.2 billion) over the next two years, in order to shore up its finances.


37. See http://leg1.state.va.us/cgi-bin/legp504.exe?ses=111&type= bil&val=hb2410.

40. See http://www.njleg.state.nj.us/bills/BillView.asp.
41. Virginia's opposition to public-workers' unions dates to the 1940s, when then-governor Bill Tuck (D) declared in his State of the Commonwealth Address that it was “utterly incompatible with sound and orderly government.”
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