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[How Public Pension Boards Are Making a Crisis Worse.]

Because of the way they're structured, they have incentives to ignore the retirement plans' long-term health.

For the last decade, analysts have been arguing over whom to blame for America's state and local pension crisis. Politicians? Public employee unions? Financial markets? Amid the din, the detrimental role of public pension boards has been overlooked.

There is a mounting body of evidence that pension boards, which oversee the funds created by employer and employee contributions, are partly to blame for the underfunding problem. Pension board members' incentives lead them away from a focus on the plans' long-term fiscal health. In a [new report], I document those incentives and their consequences and recommend ways to mitigate — and even eliminate — the governance issues.

The long-term costs of failing to act to deal with mounting pension debt are enormous. In 2015, the Federal Reserve estimated that states' and localities' pension funds had accumulated $5.52 trillion in liabilities but had set aside only $3.7 trillion in assets. To ensure that public employees receive the benefits promised by their plans, state and local governments are spending more every year on their pension systems. According to census data, those governments contributed $40.1 billion to their pension systems in 2000; by 2016, that number had skyrocketed to $140.5 billion. In addition, pension funds are making riskier investments in an effort to catch up.

How are public pension systems governed? For state pensions, the governor and the legislature determine what percentage of workers' salaries will be replaced in retirement and how much government employers contribute annually to the funds. Then state governments delegate authority to manage the funds to boards with, typically, 15 or so members.

These boards decide how fund assets are invested, designate money managers and determine the assumed rate of return on the funds' investments (these days, usually between 7 and 8 percent). The actual market performance of the pension funds affects taxpayers' future liabilities and governments' future contributions.

In theory, the pension boards are supposed to balance the interests of government employers and public employees. To strike this balance, boards are comprised of both employer and worker representatives. The employer side is made up of members appointed by governors or who hold other public office and serve ex-officio. The plan-participant side elects workers and retirees to the boards, individuals who are also often union officials.

The problem is that both the political appointees and the elected representatives have incentives to ignore the long-term health of the funds. Political appointees are responsive to constituencies, such as the governor who appointed them or local businesses, that distract them from managing the fund strictly in its beneficiaries' long-term interest. Meanwhile, public employees and their union representatives are tempted to trade pension savings tomorrow for higher salaries today.

How do these incentives play out? To hold down short-run costs, political appointees are likely to favor high assumed rates of investment returns, which keep employer contributions lower and avoid throwing a wrench in the governor's budget. Political appointees also tend to favor investing in local industries — whether or not they are actually profitable. Two Texas funds were heavily invested in Enron before it went bankrupt, for instance. And in 1990, Connecticut's state-employee fund lost $25 million investing in Colt's, the firearms manufacturer, to preserve local jobs.

Likewise, public employee representatives respond to workers' demand for higher salaries today by keeping the assumed rate of investment returns high. In a recent study, political scientists Sarah Anzia and Terry Moe found that elected representatives of public employees did not seek to impose more realistic — that is, lower — assumed rates of investment returns. Rather, they found, more worker representation on boards and stronger public unions led to more fiscally irresponsible decisions.

The larger consequence of the misaligned incentives of pension boards is that they don't protect employees and taxpayers from major financial risks. Poorly managed pension systems are now consuming the politics – and much of the budgets — of Connecticut, Illinois, New Jersey and other states.

Therefore, governments should take two steps. In the short term, they should require greater financial expertise, more clearly define fiduciary duties and implement other controls. In the longer term, states should move away from traditional defined-benefit plans and offer 401(k)-style defined-contribution plans for new employees. Since workers with defined-contribution plans decide for themselves on their contributions and investments, making defined-benefit plans a thing of the past would wisely eliminate the need for pension fund boards altogether.

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