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Interest Groups on the Inside: The Governance of Public Pension Funds

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Abstract: A subversive line of new scholarship in American politics argues that interest groups need to be brought to the analytic center of the field once again. This paper attempts to further that agenda. We reconnect with an older literature of great importance—on capture, subgovernments, and interest group liberalism—to study interest groups as insiders that play routine, officially recognized roles as part of government itself. Our empirical focus is on state-run public pension boards: which control trillions of dollars, have vast fiscal and social consequences, and are commonly designed to give public employees and their unions official roles in governing their own pension systems. We develop a theory arguing—contrary to existing scholarly work—that these groups can actually be expected to favor policies that undermine the fiscal integrity of these plans. Through an analysis of key decisions by 99 pension boards over the period 2001-2014, we show that this is in fact the case—and that, for public-sector pensions, these “interest groups on the inside” wield genuine influence that weakens effective government.

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Decades ago, interest groups were central to the study of American politics. Pluralists debated elitists. Researchers carried out innovative studies of community power, capture, and interest group liberalism. And group-based theories shaped the thinking of scholars about the whole of politics and government (Truman, 1951; Schattschneider, 1960; Dahl, 1961; Lowi, 1969; Wilson, 1974). In subsequent years, moreover, the numbers, types, and political activism of America's interest groups grew dramatically—reaffirming, it would seem, their exalted status in the field.

Yet that status was not to last. The Downsian revolution transformed the study of American politics during the 1970s and 1980s, giving rise to a new theoretical framing that understood politics in terms of politicians, voters, and the electoral connection—and had no analytic place for interest groups (Downs, 1957; Hacker and Pierson, 2014). Interest groups continued to be studied, but as something of a sidebar and with a considerably narrowed focus: on lobbying, PAC contributions, and questions of influence (Hojnacki et al., 2012; Leech, 2010). Long at the intellectual center, interest groups were quickly and inexorably pushed to the periphery.

Today, a counter-revolution is brewing. At the forefront of this new movement are Hacker and Pierson (2014), who, in challenging the mainstream, argue that policy-seeking interest groups are the driving force behind the policy process, and that American politics can only be understood when interest groups are central to theory. Also at the forefront are Cohen et al. (2008) and Bawn et al. (2012), who argue that American political parties are best understood as coalitions of interest groups, and that party politicians strategically choose policies that are beneficial to powerful groups but in the “electoral blind spot” of voters, who are too ill-informed to know that their own interests are not being served.

Exactly where this movement will lead remains to be seen. Its logic has yet to be fully developed, and the Downsian tradition has been highly productive and is likely to have staying power going forward. That said, we think it is quite clear that interest groups have been at the periphery of theory and research for far too long. The field would benefit if scholars devoted much more attention to them, and if, in doing so, they pursued analyses that go well beyond lobbying and PACs to explore the full range of avenues by which interest groups shape American government and politics.

This paper is an attempt to move that agenda forward. We reconnect with an older literature of great substantive importance that has largely been shunted aside in modern research on interest groups: the literature on capture, subgovernments, and interest group liberalism (Lowi, 1969; McConnell 1966; Schattschneider, 1960). The argument in this early work is that interest groups aren't just private actors that attempt to influence government from the outside through lobbying and campaign contributions. They are also pervasively active on the inside of government—within the bureaucracy, or in cooperation with bureaucratic actors—as regular, quasi-official, or even official participants in the making of governmental decisions, exercising their influence quietly, routinely, and shielded from public view. The modern-day focus on interest groups as outsiders, then, threatens to miss a vast realm of interest group activity that is of great importance for understanding their overall influence, and for understanding American government and politics more generally.

Interest groups can work themselves into the machinery of government in many ways. And political scientists need to carry out a great deal of new research to figure out how various types of groups manage to do that, how their involvement varies across policies, bureaucracies, and levels of government, and what the consequences are. In this paper, we take a useful step in

that direction by targeting a governmental arena of great fiscal and policy significance for the nation—public-sector pension funds—and exploring how their key decisions are shaped by “interest groups on the inside,” specifically, the organized interests of current and retired government employees.

Social Security aside, public pension funds have almost never been studied by political scientists. Yet they are profoundly important components of every state government (as well as many local governments). Their sheer economic significance is staggering: they collect, invest, and distribute astronomical sums of public money, and indeed, with assets of about \$4 trillion as of 2016, they represent the largest single pool of investment capital in the entire country. They are also crucial matters of public policy. They are crucial on social grounds alone, because they provide the main source of retirement security for many millions of active and retired public-sector workers. But they are also crucial because many pension programs, including some of the largest, are seriously underfunded—pressuring state and local budgets, crowding out other public services, and burdening future generations. These fiscal consequences are so severe and so widespread, in fact, that the underfunding of public-sector pensions looms as one of the great policy challenges of the modern era (Kiewiet and McCubbins, 2014).

Our argument here is that this challenge is especially difficult to deal with because of the way public-sector pension funds are governed. An important part of the problem (but not all of it) is that these systems are typically designed to involve a heavy dose of self-governance by the employees who are the beneficiaries of the system. On the surface, it might seem that endowing employee representatives with governing authority would work to ensure full funding, as it is the employees’ own retirement benefits that seem to be on the line. Yet there are strong theoretical reasons for believing that employee representatives actually have incentives to make policy

decisions that are detrimental to the fiscal well-being of their own pension funds. Their capacity to behave in these ways, moreover, is only enhanced by the great technical complexity of pension issues, and the operation of pension boards in the bureaucratic shadows of politics—which make pension decisions an inside affair most of the time, and a set-up for actions that are in the “electoral blind spot” of ordinary voters.

By putting our focus on the nation’s public-sector pension funds, therefore, we are in a good position to explore “interest groups on the inside” in an important realm of government policy—and theory suggests that the official incorporation of employee interests into the governance structures of public pension systems should tend to exacerbate the very funding problems that these systems most desperately need to avoid. In our empirical analysis, we bring evidence to bear by carrying out a study of 99 state-operated pension plans over the period 2001 to 2014—focusing on the composition of governing boards, key decisions that they make, and the impacts that employee interests have on decisional outcomes. The findings reveal that employee interests are in fact influential, and, as theory leads us to expect, that their official presence as bureaucratic insiders works to undermine the fiscal integrity of state pension systems.

With these findings, we think the analysis has something constructive to say about the governance of America’s public-sector pensions, its susceptibility to interest group influence, and the problem of underfunding. But more generally, our hope is that, by using this study of pension systems to highlight the role of “interest groups on the inside,” we can underline the value of bringing interest groups back to center stage in the field of American politics—and of reconnecting with an older political science literature that still has much to offer.

Background

Prior to 1900, public-sector workers were rarely granted pensions. That began to change during the Progressive Era, when the most powerful reform movement in the nation's history gave rise to governments at all levels that were larger, more bureaucratic, and more professional than their patronage-based predecessors, with greater capacity for addressing the problems and demands of a fast-industrializing nation. In this new institutional setting, pensions for public employees gained traction and slowly spread across jurisdictions as an integral component of the emerging American welfare state. By the end of the 1950s, all but 11 states had adopted pension plans for their own employees. And by the mid-1970s, every one of them had. Throughout the 1900s, local governments were moving in the same direction, and by the mid-1970s retirement programs for public workers were the norm at the local level as well, even in the South.¹

Two historical trends have shaped the mature pension systems that prevail today. The first is that many local plans were ultimately consolidated at the state level, where greater scale allowed for greater financial security and expertise. As a result, the vast majority of state and local employees came to be covered by pension funds controlled by their states. The second trend is that public-sector pensions were made much more generous over time for individual retirees—through increases in benefit levels, decreases in the normal retirement age, cost of living adjustments, and the like—which meant that public pensions also became quite a bit more costly to fully fund.

Over the decades the official word coming from state and local governments, including the pension boards themselves, was that the contributions going into their pension funds,

¹ The background information throughout this section is taken from Clark, Craig, and Sabelhaus (2011), which provides an excellent overview of the development of American state and local pension systems.

augmented by investment returns, were sufficient to ensure that the benefits promised to future retirees would be paid. All was supposedly good—until the Great Recession and ramped-up research by financial economists pulled back the curtain and revealed that it wasn't (e.g., Novy-Marx and Rauh, 2009). Indeed, the new research revealed that public-sector pension plans had been chronically underfunded for a very long time.

Many state governments were faced with fiscal calamity unless they took action to fix their pension systems, and pension reform quickly rose to the top of the political agenda. Most states have indeed followed up with reformist action, generating an unprecedented wave of change in public-sector pension systems. By almost any account, however, the reforms they have chosen to adopt, often with great fanfare and lofty claims, have not come close to bringing about full funding. State policymakers have done enough to avoid calamity in the present. But the underlying fiscal problems are still there, festering and unresolved (Kiewiet and McCubbins, 2014).

Theory

Why are state governments so fiscally irresponsible? With vast amounts of public money at stake, millions of public workers needing retirement security, and state budgets—and expenditures on other policies—threatened by any imbalances, the way these funds are managed has enormous consequences. The formula for protecting their financial integrity, moreover, is straightforward: the benefits promised to members must be covered by contributions and investment returns that are sufficient to pay for them. Yet the states don't do what they need to do. In explaining why their pension plans aren't fully funded, the politicians and bureaucrats in charge often point to hard economic times and down stock markets. But these challenges are

short-term, and the real problems are deep and endemic. They arise from the way pension systems are governed and the incentives of the people who govern them.

All but a few states follow the same basic model: they delegate authority to multi-member boards. These boards make a broad range of key decisions, many of them unfathomably technical, about the content of pension policy and the management of pension funds. Like virtually all bureaucratic agencies, their authority is not absolute. The legislature and the governor are ultimately in charge, and they can step in and pass laws (if they have the votes) on whatever matters they please. In practice, however, they mainly use their authority to set benefit levels, and sometimes contribution levels. Almost all of the other types of decisions are left to the pension boards.

The composition of these boards is set out quite specifically in state statutes, the details varying across states. The typical board consists of between five and fifteen trustees, some of them participating *ex-officio* (due to the public office they hold, such as state treasurer), and the rest representing various constituencies: active public workers, retired public workers, government employers (e.g., school districts, counties, state agencies), and citizens as a whole. The *ex-officio* trustees are on the board automatically. The other trustees are either appointed or elected. If appointed, they are almost always appointed by the governor. If elected—which is the norm for employee trustees, but not others—they are chosen by the specific constituencies they represent. Thus, for example, if two seats on the board are allocated to active public workers, then all government employees belonging to the pension system are eligible to participate in electing those two board members—and no other citizens are allowed to vote.

How should we expect these boards to behave in making decisions about state pension funds? This is a question that political scientists have not addressed. There is, however, a

scholarly literature on the topic—one that has its roots in the study of corporate governance. The thread that links these two realms is that corporations are run by boards of directors, whose composition has been shown to matter for corporate behavior. The notion is that the same line of analysis can be applied public pensions, where multi-member boards are in charge of running the pension funds (Hess, 2005; Stalebrink, 2014; Romano, 1995).

Throughout most of this literature, theory is guided by the logic of principals and agents. In studies of corporate boards, a central theme is that “inside” directors—who are appointed by or have connections to the management of the firm—have conflicts of interest that prevent them from serving as faithful agents of the stockholders (the principals); and that the inclusion of “independent” or “outside” actors—with no connection to management, and preferably with considerable ownership in company stock—is crucial if boards are to best represent stockholder interests. Board composition matters, then, and what matters most is the balance between “inside” and “outside” directors.

The same theoretical lens is applied to public pension boards. Here the inside actors are the ex-officio members and the political appointees, and the logic suggests that they are highly imperfect agents: for they seek their own political welfare, and are thus susceptible to political influences that lead them to take actions that are not best for the financial integrity of their pension funds—from the hiring of politically connected investment advisors to the favoring of home-state equity investments to the use of pension money to balance state budgets. At the other end of the spectrum are the trustees elected by active or retired members of the pension systems. As the beneficiaries of state pension plans, so the argument goes, they are the principals—and they have a direct stake in seeing to it that the plans are strictly monitored, expertly managed, and fully funded to yield the best possible fiscal outcomes. “Overall,” as Hess (2005, p. 200)

summarizes it, “member-elected trustees have strong incentives to perform their board-related duties, while politically affiliated trustees have incentives to shirk and act opportunistically.” The greater the representation of public employees on state pension boards, the better-run their pension funds will be (see also Stalebrink, 2014; Romano, 1995).

This literature is a valuable foray into uncharted territory, and it rightly seeks to understand problems of governance and incentives. But the analogy to corporate boards is somewhat misleading—governments are very different from business firms—and its analysis of incentives is incomplete and in some respects upside-down. This is a topic that political scientists would approach very differently, with different results.

The way to start, we believe, is by stepping back from the multi-member boards themselves and taking a broader view of the politics of pensions. Two features are especially important. The first is that pensions lend themselves very nicely to “fiscal illusion” (e.g., Buchanan and Wagner, 1977), which politicians can employ to their great advantage. Specifically, they can gain the political support of public workers and their unions by offering pension benefits that are very generous—and they can gain further by *not* requiring governments to make the high annual contributions that are necessary for fully funding those benefits. In this way, they keep current governmental costs artificially low; they keep voters unaware of the true total cost burden; and they make the states’ generous pension packages seem eminently affordable to one and all. The true costs will eventually come due, of course, and will have to be paid. But this won’t happen for decades—and by then *other* politicians (and taxpayers) will be responsible for paying the bill. In the meantime, the public money “saved” can be used to support other government services, to limit taxes, or to balance budgets. For all these reasons,

then, politicians have strong incentives to be fiscally irresponsible in their approach to public-sector pensions. There is much to be gained by behaving that way.

The second basic feature of pension politics is that public workers and their unions have incentives to believe (and reward) the benefit-promises of politicians—and in addition, to endorse the chronic underfunding of their own pensions. The main reason is that, due to provisions in state statutes and constitutions, as well as to judicial interpretations of the law, the pensions promised by state politicians are legally guaranteed almost everywhere. As a result, public workers know they will actually get what they are promised from state-run pension plans, even if these plans are severely underfunded. Governments in future years *will* be required to pay the bill. Indeed, because the full funding of pensions on a continuing, regular, responsible schedule would be tremendously costly for state (and local) budgets—crowding out other services, forcing higher taxes, and otherwise making the true costs of pensions painfully transparent to citizens—public workers and their unions have incentives to *prefer* that their pension plans be underfunded. Underfunding keeps current outlays low, and enables the fiscal illusion that pension benefits are much less expensive than they really are. If public workers and their unions want generous benefits, and want to see their benefits increased over time, they need to convince the public that these benefits are not costly to provide. Chronic underfunding is the way to do that. At the same time, it also serves to keep the workers' contributions to their own pension funds at artificially low levels. And it serves to free up public money for spending on other government services, thus keeping public workers employed and providing continuing funds for salaries and raises.

We have spoken here about what can be expected of public workers and their unions as they participate on public pension boards. This has been (and will continue to be) a convenient

short-hand. But it is important, given our larger concern with “interest groups on the inside,” that we take a more finely grained look at these two types of players rather than simply lumping them together.

If public workers were atomized and acted purely as separate individuals, they would have little basis for playing an influential role on pension boards. Pension policy is so incredibly arcane and complex that the vast majority would surely be quite uninformed about most of the relevant details. They would also be quite uninformed about pension board elections, as well as the candidates running for board positions—for these specialized elections are low visibility, low salience affairs that occur in the political shadows and involve candidates who are political unknowns. Under atomized conditions, then, there is little basis for thinking that workers would have the capacity to elect representatives who are expert enough, and accountable enough, to effectively represent their pension-related interests.

But workers are not atomized. They have organized interest groups to represent them. Of these, the most notable are the state (and local) affiliates of the nation’s major public-sector unions: AFSCME, the SEIU, the National Education Association, the American Federation of Teachers, the International Association of Fire Fighters, and others. In most states, these unions are large, well-funded, and politically active in lobbying and elections—and they are forces to be reckoned with even in the “nonunion” South (DiSalvo, 2015). They have every reason to care intensely about their states’ pension funds, which are not only of direct relevance to the material interests of their members, but are also hugely important to state budgets, to state spending and taxing, to the provision of other state services (and jobs)—and the discretionary investment and allocation of vast sums of public money. Ordinary workers may not know about pension policy, pension boards, or pension elections. But unions have strong incentives to be well-informed

about these things—and to put that information to use to get the right candidates to run for board positions, to educate public workers about pension elections and union-favored candidates, to mobilize the vote, and then, once their favored candidates are elected to the pension board, to provide these board members with expertise and advice to shape their decisions on pension policy.

Public-sector unions are not the only interest groups that represent employee interests on pension matters. Most states also have highly active retiree associations that organize retired public workers—and are focused like lasers on their state pension boards. Like the unions, these associations have strong incentives to get involved in elections, mobilize votes, get the right people seated on the boards, and provide them with expertise and advice once they are elected. There may sometimes be tension between unions and retiree associations. The unions, for example, may want to use pension funds to promote an agenda of social activism, e.g., by penalizing companies that export jobs or resist collective bargaining; and retiree associations may oppose that sort of thing. But the core employee interests that we discussed above, having to do with chronic underfunding, are *shared* by all these interest groups: they all want to promote the illusion that valuable pension benefits can be provided by governments at a low, affordable cost. And thus, even if these interest groups disagree about tangential aspects of pension policy, and indeed, even if they support different candidates in board elections, they should all approach the underfunding issue in the same way—and they should all behave irresponsibly.

In sum, then, if we take these broad features of the politics of pensions as a theoretical baseline, we arrive at a perspective on public pension boards that departs radically from the existing scholarly literature. It is a mistake, in our view, to portray politicians and political appointees as the source of fiscal irresponsibility, to portray the elected employee representatives

as champions of fiscal integrity, and to argue that pension boards will be better run to the extent that public workers have a greater role in governance. There are strong theoretical reasons, in fact, for expecting that *all* these players have incentives to govern public-sector pensions in a fiscally irresponsible manner—and for expecting, in particular, that employee representatives have incentives to undermine the fiscal integrity of their own pension funds.

These are the essentials. We could go on, at this point, to elaborate this simple theoretical foundation by exploring several additional considerations—having to do with political parties, for example, or the impact of the Great Recession—that might seem to affect the political forces at work on these pension boards and their various members. But we will do that later in the paper, as part of the empirical analysis.

The Mechanics of Public Pension Contributions

When it comes to funding public pensions, the mechanics differ somewhat from one plan to the next, but most state-operated plans have certain fundamentals in common. As we've already discussed, nearly all plans are governed by a board of trustees that derives its policymaking authority from the state legislature. And while there are many different decisions that affect a plan's overall funding ratio (including decisions about investments), the boards—sometimes in conjunction with state legislatures—make two main types of decisions that greatly affect how much governments contribute each year: decisions about actuarial assumptions, and decisions about how much of the officially “required” amount to actually contribute. To explain the set-up of our empirical analysis, we need to provide a brief overview of these decisions, who makes them, and why they matter so much for pension funding policy.

First, it is important to understand that public pension liabilities are supposed to be prefunded: governments and employees set aside funds each year for the retirement benefits that

have been earned by active employees that year. To determine what has to be contributed today in order to “fully fund” the benefits that will be paid in the future, the boards of trustees and their actuaries do an actuarial valuation, one important product of which is the calculation of the “actuarially required contribution,” or ARC. Of course, there is considerable uncertainty in these calculations, and the actuarial valuation involves a host of demographic and economic assumptions, such as assumptions about mortality rates, salary growth, and inflation. That means that decisions about the assumptions, which on the surface seem technical and nonpolitical, profoundly affect the calculation of the ARC—and thus what governments are officially called on to pay into pension funds each year.

One assumption that has the largest impact on the calculation of the ARC is the discount rate. Pension liabilities that will be paid in the future cost less than the same amount of money if it were due today—but *how much* less depends on the discount rate. For example, consider a payment of \$100 million due in lump sum in 20 years. How much is that worth in today’s dollars? If we use an 8% annual interest rate to discount that future liability, the answer is \$21 million. But if we use a 4% discount rate, the present value of the \$100 million is much larger: \$46 million. This is relevant for public pensions because in order to determine how much has to be set aside today to cover the stream of pension payments in the future, plan administrators have to decide on a discount rate—and, just as in the example above, the discount rate they choose has an enormous impact on the ARC. The higher the discount rate, the smaller the estimate of future pension liabilities, and the less governments are called on to contribute.²

² For more detailed overviews of pension mechanics, the assumptions, and discount rates, see Johnson, Chingos, and Whitehurst (2013), Brown and Wilcox (2009), and Novy-Marx and Rauh (2009, 2011).

Today, experts point to public plans' discount rates as a major contributor to underfunding. The standard practice among state pension boards is to set the discount rate equal to the expected rate of return on pension assets—which, at first glance, seems to make sense. If government officials know they will need \$100 million in 20 years, and they plan to invest money in the stock market with an 8% expected return, it seems entirely reasonable to use that 8% rate to determine how much money they have to invest today to get to the \$100 million target. And that is precisely what public pension administrators do. Public pension assets are heavily invested in stocks, private equity, and hedge funds, and so the expected rates of return—and thus the discount rates plans use—are high, typically around 8%. The problem, however, has to do with *risk*. Returning to our example above, there is a good chance that \$21 million invested in the stock market today will earn considerably *less* than 8% returns—and that in 20 years' time, government officials will have less than the \$100 million they owe. Can the government then just pay less than the full \$100 million when it comes due? In the case of public pensions, the answer, of course, is no. For *defined benefit* plans, the benefits have to be paid somehow, *regardless* of whether the funds available are sufficient. After all, those benefits are typically guaranteed by law.

Because of this, nearly all finance experts agree that the discount rates used by public pension plans are far too high. A basic principle of finance theory is that future liabilities should be discounted based on the risk that they will not be paid—*not* based on the assets chosen to back those future payments (Rauh, 2016; Brown and Wilcox, 2009). For public pensions, of course, the risk of governments defaulting on their benefit payments is very low, precisely because those benefits have strong legal protections. In practical terms, this means that public pensions should use discount rates closer to 4 or 5% (which, as it happens, are the rates used for

private-sector pensions). But the continued use of too-high discount rates is not an innocent mistake on the part of public pension boards. By keeping discount rates high, plan administrators make liabilities look smaller than they are, and thereby keep ARCs lower than they should be. If discount rates were lowered significantly, the result would be huge increases in what governments are called on to contribute to pensions each year—and a tremendous amount of political pain to go around.

Actuarial assumptions can therefore warp the calculation of the ARC, and that is an important and largely hidden way in which public pensions are underfunded. But the decisions to underfund pensions do not end there. Once the ARC is calculated, there is no guarantee that governments will actually pay that officially required amount. Oftentimes they do, and occasionally they pay slightly more than the ARC. But very frequently, participating governments pay only a fraction of the ARC—in spite of the fact that the ARC has *already* been manipulated (through the actuarial assumptions) to be artificially low. After the ARC is calculated, then, who decides what amount governments will actually pay into the funds?

Here, the decision is sometimes the prerogative of the board, as with CalPERS, or it can involve the legislature in some way. In some plans, the board decides what will be contributed, but the legislature has to approve the contribution rate, or has to directly appropriate funds to make the contribution, or places a cap on contributions. In a few other plans, the board is not involved in the final decision at all; instead, the contribution rate is determined by statute—one that usually specifies a fixed percentage of payroll that will be contributed year after year. Clearly, we need to account for this variation in our analysis. For the moment, though, we are simply pointing out that this decision—about how much of the official ARC to pay—is an important one for us to explore.

In our empirical analysis, therefore, we will focus both on decisions about the actuarial assumptions and decisions about how much of the ARC will be paid. These are the major channels through which policymakers can actively underfund public pensions. And our goal for the analysis is to assess whether government employees and their unions do in fact influence these decisions—specifically, whether they push for increased contributions and more responsible funding policies, or, as we have argued, they have political incentives to underfund pensions just like everyone else involved.

Data on Pension Boards of Trustees

To explore the effects of government employee involvement in pension governance, we assembled a new dataset. We started with the 2012 Public Plans Database (PPD) from Boston College’s Center for Retirement Research, which compiles key statistics from the Comprehensive Annual Financial Reports (CAFRs) of 104 state-operated pension plans. Then, for each of those 104 plans, we used LexisNexis Academic, the state legislatures’ websites, and the pension plans’ websites to locate all of the statutes that specify how their boards are composed. A typical statute lays out conditions for who the trustees have to be and how they are to be selected. After surveying the statutes in place for each plan from 2001 to 2014, we created five categories of trustees and coded each trustee as being one of the five types.

As we discussed earlier, it is very common for boards to designate a certain number of positions for active or retired government employees. Importantly, however, those employee trustees can be selected in different ways. Many of them are chosen by government employees who participate in the plan, with some plans holding elections in which government employees are allowed to vote on candidates, and other plans delegating the selection to state or local bargaining units. Other employee trustees are appointed to the boards by state-level politicians,

usually governors. While all of these are government employee trustees, we expect that those *chosen* by government employees—as opposed to appointed by politicians—will be the best, most reliable representatives of government employees’ interests. By contrast, employee trustees appointed by state politicians may have some loyalty to those politicians, or perhaps have political ambitions, and their decisions may not be an accurate reflection of government employees’ interests. For our analysis, therefore, we create two separate employee trustee variables: the percentage of board members who are employee trustees chosen by employees (which, for short, we will call *Percent elected employees*), and the percentage who are employee trustees appointed by politicians (which we call *Percent appointed employees*).³

There are three additional categories of trustees. First, most plans have positions reserved for state government officers, such as the governor or the treasurer, who sit on the pension board by virtue of being elected or appointed to their positions in state government. For each plan-year, then, we create a variable equal to the percentage of trustees who are ex-officio members. Second, some plans assign positions to representatives of government employers, almost all of whom are appointed by state officials, usually the governor. This, then, is our next variable: the percentage of board members who are employer trustees appointed by politicians. And finally, some statutes create positions for private citizens, taxpayers, or people with financial expertise; still others do not provide specific criteria for certain trustees. Nearly all such trustees, however, are appointed by state officials, usually the governor. Our final variable

³ Some plans have a provision in place by which the governor has to appoint an employee trustee from a restricted list of two to five nominees submitted by government employee unions. We code these trustees as employee trustees chosen by employees.

groups these miscellaneous trustees together: the percentage of board members who are either private citizen or other trustees.⁴

Of the 104 state-operated plans in the 2012 PPD dataset, 5 are not governed by a board of trustees: the University of California Retirement Plan and four plans in the state of Washington. Our dataset therefore tracks the composition of 99 boards, spanning 49 states, over the 14-year period from 2001 to 2014. While the size of the boards in our dataset ranges from 1 member (two plans in New York) to 18 members (two plans in Tennessee), more than half of the boards have between 7 and 11 members, and 81% have between 5 and 13 members.

What, then, do these 99 boards look like? How common is it for them to have government employee trustees? And when government employees do have a presence on the boards, are they a small minority, or do they have a sizeable presence? We begin our empirical study by answering these preliminary questions, and in so doing, we lay the foundation for our analysis of how government employees influence pension funding policy.

To start, we look at the overall share of government employee trustees on the boards: we add together the percentage of elected employee trustees and the percentage of appointed employee trustees and present the distribution of that combined variable—*Percent employees*—for all 1,386 plan-years in our dataset. See the top-left hand panel of Figure 1. Strikingly, the figure reveals that there are only 84 observations in our entire dataset for which *Percent employees* is zero. Of all 99 plans, 93 of them have at least some positions reserved for government employees.⁵ What is more, government employee trustees typically account for a large share of the seats. For example, on half of the 93 boards that have employee trustees, those

⁴ For a more detailed description of our coding, see the online appendix.

⁵ The plans with no employee trustees are the two in New York and one each in Delaware, Florida, Georgia, and Virginia.

employee trustees have 50% or more of the seats. Thus, in the case of pension funding policy, it is not at all uncommon for a key interest group to be in a position of policymaking authority. Indeed, it is the norm.

We next examine the two categories of employee trustees separately: the top-right panel of Figure 1 shows the distribution of *Percent elected employees*, and the middle-left panel shows *Percent appointed employees*. Clearly, it is much more common for employee trustees to be elected by employees rather than appointed by politicians. In all, there are 911 plan-year observations that feature at least some elected employees, and the mean of that variable is 0.33. By contrast, there are only 606 plan-year observations with appointed employees, and the mean of that variable is only 0.17. Across all plan-years, therefore, we find that it is much more common for the employee trustees to be chosen by government employees or unions. In our analysis, however, we will keep these variables separate to test whether elected employee trustees act more reliably in employees' interests than those appointed by politicians.

The distributions of the remaining three board composition variables are shown in the final three plots of Figure 1. Looking at the middle-right panel, we can see that 71% of the board-year observations have at least one ex-officio member, but ex-officio trustees rarely make up a large percentage of the board. In the bottom-left panel, we show that most boards—751 of the 1,386 observations—do not have any employer trustees, and that when employer trustees are present, they, too, are usually a small contingent on the board. And finally, the bottom-right panel shows that most plans do reserve a small share of their board seats for private citizens, taxpayers, non-beneficiaries, financial experts, or trustees for which no criteria are specified. When boards have this kind of trustee, they typically make up approximately a third of the

positions on the board. Thus, there is considerable variation in board composition across plans, and most boards have at least some ex-officio members and non-employee political appointees.

However, there is far less variation in board composition within plans over time. Over this 14-year period, 62 of the 99 plans had no changes at all to their board composition. In the remaining plans, there were 49 separate instances of changes to board composition, but those changes tended to be minor. For example, of the 48 changes that affected *Percent employees*, half of them changed the percentage by less than 6 points, and only three changed it by more than 14 points.⁶ Moreover, there is little general pattern to the direction of the changes. Overall, there were more changes that increased *Percent private citizen or other* than changes that decreased it, but there were still 13 instances of decreases. Thus, in the vast majority of plans, board composition has been stable, and in the few cases with changes, those changes have almost all been small and have not followed any clear pattern. Most of the variation we explore in what follows, therefore, is variation across plans.

(How) Do Government Employees Influence Pension Contributions?

By itself, this description of pension board composition reveals quite a bit that is new. In pension boards of trustees, we have examples of government agencies that place interest group stakeholders in positions of direct policymaking authority on issues of enormous economic consequence to them. The question, then, is whether this is an important (and overlooked) channel through which interest groups can influence policy—and whether, in the case of pensions, government employees are a force for more responsible decision-making. Now that

⁶ The three major changes were in South Carolina, which in 2013 reduced the percentage of employees' seats by 64 points on its two plans, and the New Hampshire Retirement System, which decreased it by 26 points in 2012.

we have laid out the basic patterns in state pension board composition across the United States, we can turn to that question.

The first dependent variable we analyze is the discount rate. While plans rarely make major changes to their discount rates from year to year, there is meaningful variation in the rates used by these 99 plans over the 14 years in our study. According to the PPD, our source of data on discount rates, the 1,386 plan-years in our dataset feature discount rates ranging from 0.0675 to 0.09, with both a mean and median of 0.08. In our analysis, then, we ask: Do government employees influence decisions about actuarial assumptions in a more responsible direction—meaning in the direction of *lower* discount rates? Or, as we have argued, do government employees have incentives to keep discount rates high—and thus official required contribution amounts low—just like all of the other political actors involved in these decisions?

In addition to the discount rate, we analyze the fraction of the ARC (which has the assumptions built in) that actually gets contributed each year, again using data provided in the PPD. For the plans and years in our dataset, the median value of this variable is 1, or 100% of the ARC paid. Occasionally, it is greater than 1 (in 239 plan-year observations). But even more frequently—in 44% of the plan-years in our dataset—it is less than 1, meaning that in those cases, governments contributed less than what was officially required to fully fund pensions. As with the discount rate, our goal is to test whether public employees influence this decision in the direction of more responsible funding. If they do, we should see that greater government employee presence is associated with a higher fraction of the ARC paid. If they do not, or if they have even greater incentives than other policymakers to keep contributions down, we should either find no effect or a negative effect.

To model these dependent variables, we use OLS with standard errors clustered by plan, regressing both the discount rate and the fraction of the ARC paid on the series of board composition variables. Because the five board composition variables are fractions that sum to 1, we set *Percent ex-officio* as the excluded category. That means that for each board composition variable in the model, the estimated coefficient can be interpreted as the effect of increasing the share of that type of trustee while decreasing the share of ex-officio members, holding constant the shares of the other three kinds of trustees.

To assess whether government employees influence pension funding, then, we will look to the coefficients on the employee trustee variables, especially the coefficients on *Percent elected employees*. But we also need to consider public-sector unions as potentially important actors here. When the unions are politically powerful, we expect that they can influence pension funding decisions in a few different ways. First, they can try to ensure that the “right” kinds of employee trustees are selected for the boards, and once those employee trustees are in place, they can try to inform their policy decisions. But the unions can also try to influence the selection and decisions of the *other* key decision-makers: the ex-officio trustees on the board (like the governor and state treasurer), the political appointee trustees on the board, and even the legislature. Therefore, there is good reason to think that when public-sector unions are strong, pension funding policy overall will be more aligned with government employees’ interests. In our models, then, we include a measure of public-sector union strength: the fraction of full-time state and local government employees in the state who are members of unions, compiled using

Current Population Survey data from 2000 to 2010.⁷ This measure ranges from 0.08 in Mississippi to 0.77 in Rhode Island.

In addition to these independent variables, we also need to consider whether economic conditions or the level of fiscal stress affect policymakers' decisions. In the pension funding literature, it is generally thought that administrators make less responsible decisions when fiscal conditions are poor (e.g., Mitchell and Smith, 1994; Stalebrink, 2014). This is a reasonable hypothesis: when government budgets are tight, policymakers will want to take actions to keep pension contributions low. For that relationship to hold, however, it would have to be true that governments are *more* responsible, and make adequate contributions, during times of low fiscal stress—and it is questionable whether they do that. Examples abound of governments taking “pension holidays,” lowering employer and employee contributions, and increasing benefits during good economic times. Thus, it is an open empirical question whether there is a systematic effect of fiscal stress on pension funding policy. To explore this, we include in our models both year fixed effects, which account for year-to-year variation in national economic conditions, including stock market returns, and the percentage change in state general revenue from the previous year, which accounts for variation in fiscal pressure from state to state.

Empirical Results

In column 1 of Table 1, we present the results of a model that includes the board composition variables, union membership, and the controls we just described. If the question is

⁷ Following the methodology of Hirsch and Macpherson (2003), we used the Current Population Survey to estimate the rate of union membership among government employees in each state. We excluded part-time workers and federal government employees from our calculations because both are less likely than full-time state and local employees to be members of unions. Also, because public-sector union membership tends to be very stable within states over time, we pooled surveys from the years 2000 to 2010 to increase the within-state sample sizes. Our union membership variable is therefore constant within states over time.

whether greater employee representation on pension boards is associated with lower discount rates, the answer is clearly no. The coefficient on *Percent elected employees* is not negative—it is strong and *positive*. This is precisely the opposite of what we should find if the elected employee trustees are a force for more responsible funding. Instead, they appear to be a force for *less* responsible funding decisions: on average, compared to boards with no elected employee trustees, boards that are 2/3 elected employee trustees have discount rates that are 0.37 percentage points higher. In the context of discount rates, this is a substantively large effect, equal to a shift of more than 86% of a standard deviation.

Next, we consider whether increasing the share of *politically-appointed* employee trustees has the same positive association with discount rates. Our expectation, explained above, is that these trustees should be weaker representatives of employee's interests, given that they presumably have some loyalty to the politicians who appointed them. In column 1 of Table 1, our results are consistent with that intuition: the coefficient on *Percent appointed employees* is statistically insignificant, and in an F-test, we reject that it is equal to the coefficient on *Percent elected employees*. Thus, in contrast to the employee trustees who are actually chosen by government employees, we find that increasing the share of politically-appointed employee trustees has no effect on plans' discount rates.

What about the non-employee political appointees? Does increasing their share of the board make a difference? In column 1 of Table 1, we find no evidence that it does. The coefficients on *Percent appointed employers* and *Percent private citizen or other* are both small and statistically insignificant, suggesting that these kinds of trustees do not push for different decisions on the discount rate than the ex-officio trustees.

We also find no clear effect of fiscal stress on plans' discount rates. The year fixed effects (not presented) show that average discount rates have gradually lowered over time, and state revenue growth has a positive but statistically insignificant relationship with discount rates. Neither of these patterns is consistent with the hypothesis that greater fiscal stress makes administrators more likely to keep discount rates high.

In fact, aside from the positive coefficient on *Percent elected employees*, the only other variable that has a clear, statistically significant association with discount rates is public-sector union membership, and that relationship is positive, not negative. Apparently, then, strong public-sector unions do not push boards to make more responsible actuarial assumptions—it is the opposite. On average, boards in states like Rhode Island, with 77% union membership, adopt discount rates that are 0.36 percentage points higher than boards in states like Mississippi, with 8% union membership. Again, this is a sizeable effect, equivalent to 86% of a standard deviation. That means that government employees not only influence discount rates by having their own representatives on the boards, but they also exert political pressure through their unions—the result being higher discount rates and ARCs lower than they should be.

Adopting overly optimistic actuarial assumptions is one important way that policymakers can keep pension contributions low, but even with those assumptions built into the ARC, policymakers still often contribute a fraction of the officially required amount. This, then, is the variable we model next: the fraction of the ARC paid. If plans with greater government employee representation are more dependable in paying the full ARC, then perhaps that partially or fully makes up for their rosier actuarial assumptions. If we find no effect, however, that would mean that plans with more employee representation have more distorted ARCs *and* are no

better at paying those distorted ARCs. That combination of findings would imply that on net, employee representation is associated with greater tendency to underfund.

To model the fraction of the ARC paid, we use the same general approach as before, with two important modifications. First, we have to account for the fact that decisions about actual contributions often involve the state legislature. In column 2 of Table 1, we do that by including a binary indicator variable called *Legislative involvement*, which equals one if the legislature plays any role in the decision about what amount gets contributed. However, in 349 of the plan-year observations, the contribution rate is set by statute, usually specifying that contributions will be a fixed percentage of payroll. Not only is the board not directly involved in these cases, but the ARC is not even the target amount. There is good reason to think these cases add noise to our models, and so in column 3 of Table 1, we run the estimation without them.

The second adjustment we make is to exclude a small number of cases in which the dependent variable takes on extreme values. As we mentioned earlier, the fraction of the ARC paid sometimes exceeds 1, and occasionally by a large amount. In Wyoming in 2001, for example, contributions to its state pension fund were almost five times the ARC, and including that observation in our analysis greatly affects the estimates. We researched all observations with a fraction of the ARC paid greater than 1.5, and we found that most either had contributions set by statute or involved special payments to the pension fund—for example, one-time payments using the proceeds of pension obligation bonds. In the models presented in Table 1, therefore, we drop 20 plan-year observations in which the fraction of the ARC paid is greater than 1.5.⁸

⁸ In the online appendix, we present the results of models that include these outliers. We are also missing the fraction of the ARC paid for 3 plan-year observations in our dataset.

Turning first to the estimates in column 2, is there any evidence to suggest that government employees are associated with more reliable payment of the ARC? The answer, in short, is no. Instead, we find that increasing the share of elected employee trustees relative to ex-officio members is associated with a *lower* fraction of the ARC paid. Specifically, increasing the share of elected employee trustees from 0 to 2/3 of the board is associated with a 6.3-point average decrease in the percentage of the ARC paid. Thus, not only are the employee trustees associated with significantly more distorted ARCs (because of their higher discount rates), but they are also associated with paying a lower percentage of those more distorted ARCs. This is hard to reconcile with the pension literature's argument that government employees should be a force pushing for more responsible funding.

Our conclusion here is only bolstered by the statistically significant negative coefficient on public-sector union membership. In column 2, we find that a shift from a low-union state like Mississippi to a high-union state like Rhode Island is associated with a 12-point drop in the percentage of the ARC paid. Therefore, it does not appear that strong unions work to ensure that governments pay the full ARC. In fact, when public-sector unions are strong, the result is less reliable funding of government employees' pensions.

As in the discount rate model, we find that increasing the share of politically-appointed employee trustees relative to ex-officio members has no significant relationship with the fraction of the ARC paid. We also estimate an insignificant coefficient on the share of appointed employer trustees (relative to ex-officio members). But one surprising finding here is the negative coefficient on *Percent private citizen or other*. We did not expect this relationship, nor do we have a good explanation for it. Because this category combines a few different types of trustees —private citizens, taxpayer representatives, finance experts, and trustees for whom the

statutes provide no criteria—it is difficult to tease out why it has a negative impact. One possibility is that these trustees are the most political of all, because they are all appointed by politicians, and because for this category those politicians have few constraints on who they can appoint. However, we did not find a similar effect in the discount rate model, which leads us to question whether this negative effect is meaningful.

Moving on from the board composition variables and union membership, it again does not appear that policymakers in fiscally stressed states are more likely to underfund their pensions. The negative coefficient on state revenue growth shows the opposite: plans in states that are experiencing more growth are actually *more* irresponsible in paying the ARC—taking pension holidays, reducing contributions, and spending public money on other priorities. Moreover, the negative coefficient on *Legislative involvement* shows that when the legislature gets involved, as it very often does, the impact on the fraction of the ARC paid is overwhelmingly negative. On average, plans that directly involve the legislature in the decision about contributions pay 16 percentage points less of the ARC.

So far, these results are based on models that include all plan-year observations (except for the 20 outliers)—even the ones that have contribution rates set by statute. In column 3, we drop those cases, and our findings from column 2 get even stronger. The negative coefficient on *Percent elected employees* grows to -0.127, significant at the 5 percent level. Here, we also estimate a significant negative effect of increasing the share of appointed employee trustees, one that is similar in magnitude to the effect of increasing the share of elected employee trustees. Also, compared to column 2, the negative coefficient on *Union membership* is even larger, and it is significant at the 1 percent level. We also continue to find negative effects of the share of private citizen and other trustees, growth in state general revenue, and legislative involvement.

As we expected, then, our results become clearer when we limit the analysis to cases where the board is involved and the ARC is a target used for deciding on contributions. When government employees are more involved in the decision, the result is a lower fraction of the ARC paid.

Finally, in column 4 of Table 1, we probe the possible channels through which strong public-sector unions negatively affect the fraction of the ARC that gets paid. In the case of the discount rate, this additional step wasn't necessary, because decisions about the discount rate are virtually always made by the board—and so the coefficient on public-sector union membership could reasonably be interpreted as union influence on the board of trustees. In contrast, with fraction of the ARC paid, it could be that strong unions pressure the board to contribute less than the full ARC, or it could be that the negative effect of unions primarily works through their influence on the legislature when the legislature is involved. In column 4, then, we interact *Legislative involvement* with public-sector union membership, again excluding the plan-years in which the contribution was set by statute.

The findings provide some insight into how, more precisely, strong public-sector unions lead to a lower fraction of the ARC paid. Interestingly, we find that when legislatures are not involved in the decision about contributions, strong public-sector unions are not associated with a lower fraction of the ARC paid. This does not mean that unions are inconsequential, however. After all, almost half of the plan-years in column 4 do involve the legislature in some way. And what the null coefficient on *Union membership* implies is that when it is entirely up to the board to decide on what fraction of the ARC to pay, public-sector unions have their influence in the assumption-setting stage—pushing the boards to adopt assumptions that will keep the ARCs artificially low so that they can then pay the full ARC.

When the legislature is involved, however, it a different story all together. Indeed, union strength has a very large negative influence on the fraction of the ARC paid when the legislature is part of the decision. In a state like Mississippi, with 8% public-sector union membership, having the legislature involved in the contribution decision has no discernable effect on the fraction of the ARC paid. In a state like Rhode Island, however, with 77% of state and local government employees in unions, legislative involvement is associated with a 35-point decrease in the percentage of the ARC paid. This is a very large effect—and one that is consistent with the notion that when legislatures are involved in the contribution decision, strong public-sector unions can successfully pressure legislators to keep contributions down.

We have covered a great deal of ground here—dealing with two technical dependent variables, each with their own complexities—but our general theoretical expectations remain straightforward. The political science literature on interest groups has been heavily focused on lobbying, campaign contributions, and questions of influence, and because it has met with an array of thorny endogeneity problems, there is still great controversy about whether interest groups do in fact have influence. Scholars of public pensions, on the other hand, argue that a key interest group affected by pension funding decisions—government employees—will push pension funding policy in the direction of more responsible decision-making. Our argument departs from both of these literatures. First, we explain that interest groups often sit in positions of direct policymaking authority in areas of profound importance to them, and that this is an important way in which they can influence policy. But in the case of public pensions, it turns out that the direction of that influence is precisely the opposite of what the pension literature suggests. We find that increasing the share of government employees on pension boards—especially those chosen by government employees—is associated with higher discount rates and

a lower fraction of the ARC paid. And when public-sector unions are strong, and can therefore influence everyone involved, the result, again, is higher discount rates and lower-than-necessary contributions. The general pattern, then, is actually quite clear: greater involvement of government employees is associated with less responsible pension funding.

Political Parties and the Scope of Conflict

So far, our emphasis has been on government employees and how their varying political presence affects pension funding decisions. We think this emphasis makes good sense given the phenomenon we are trying to explain (pension funding decisions) and our theoretical argument about the incentives of the key political actors involved. But we also want to consider whether there are other political variables that might affect these funding decisions—and that are important for us to explore in order to provide a full account of pension funding politics.

Perhaps the most obvious candidate is political party. At first glance, it would seem that Democrats and Republicans should approach public pensions very differently—and that the issue should be a setup for partisanship: it is both a labor issue and an issue of government taxing and spending—both of which tend to divide the major parties (see Jochim and Jones, 2012). However, in an earlier study, we found that under normal political conditions (before the Great Recession), state legislators' votes on increasing public pension benefits were actually strongly *bipartisan*. The reason, we explain in that article, is that Republicans had little political incentive to vote “no”: first, there was no attentive voter base to reward them for it, and second, the interest group system on the issue was one-sided—dominated by public-sector unions that clearly preferred more generous pension benefits. In normal times, then, political party actually mattered little for how legislators approached changes to pension benefits (Anzia and Moe, 2016).

Our focus here is still on public pensions, but rather than benefit levels, we are studying how responsible governments are in *funding* those benefits. These two kinds of decisions are related, of course. As we discuss in our earlier article, yet a third major reason why Republicans voted along with Democrats to increase pension benefits prior to 2009 was that there was little to no immediate cost of doing so: those politicians could promise government employees the expanded benefits they wanted and simply not set aside the funds to pay for them, leaving the costs for future politicians and taxpayers to deal with. *That* tendency—to act myopically, and to keep contributions low—is not a partisan phenomenon. And thus, on funding decisions as compared to benefit decisions, there is perhaps even less reason to expect the two parties to behave differently. Republicans and Democrats both have incentives to underfund pensions, free up money for other priorities, and push the political pain into the future.

That's not to say it isn't possible to come up with arguments for why one party might be more responsible than the other. One could argue, for example, that the Democrats should be the party that works to ensure the full funding of public pensions, because public-sector unions are their core constituency, and Democrats should want to ensure that there is enough money set aside to pay for their retirement benefits. But as we argued earlier, and as we just found in Table 1, there is no real basis for this. The unions *themselves* have strong incentives to underfund public pensions—and without that important constituency pushing Democrats to be more responsible, there is little reason to expect that they would be.

Others might argue that Republicans should be the more responsible party. After all, conventional wisdom would have it that they are the party of fiscal discipline. But as we argued earlier, politicians have strong incentives to take advantage of “fiscal illusion”—and there is little reason to think that Republicans would be an exception. For Republicans, just like everyone

else, keeping pension costs down is helpful for achieving other goals, such as cutting taxes, balancing budgets, and limiting government spending. And with this theoretical lens, there is no basis for expecting Republicans to be champions of full funding, or for expecting them to behave much differently than Democrats.

Considering these arguments together, we think there is little reason to expect one party or the other to be significantly better at funding public pensions. Still, we explore these matters in Table 2. Starting with decisions about the discount rate, we want to explore whether ex-officio members who are Democrats, and the various political appointee trustees who are appointed by Democrats, make different kinds of decisions than Republicans and their appointees do. To test for that, we add to the model an indicator of whether the governor in each state and year is a Democrat. Ultimately, the governor is almost always the one who does the appointing of the board members, and the ex-officio trustees—even if they are not governors themselves—are usually members of the governor’s party.

In column 1 of Table 2, therefore, we regress the discount rate on the variables from column 1 of Table 1, plus the party of the governor. All of our earlier findings are substantively the same. More importantly for our purposes here, we estimate a small and statistically insignificant coefficient on *Democratic governor*. Therefore, discount rate decisions made by boards operating under Democratic governors are not significantly different than decisions made by boards operating under Republican governors. We have also interacted *Democratic governor* with each category of politically-appointed trustee to test whether the party of the governor matters more for ex-officio members or certain categories of political appointees. (See the online appendix.) We find no evidence that it does. Having a Democratic governor (as opposed

to a Republican) does not change the relationships between the board composition variables and the discount rate.

Next, in column 2 of Table 2, we explore whether Democrats are associated with a higher (or lower) fraction of the ARC paid. The model is the same as column 4 of Table 1 except that we include three new predictors. The first is *Democratic governor*, again to test whether boards' decisions depend on the party of the executive branch. The second is *Democratic legislature*, which equals 1 if the Democrats have majorities in both chambers of the legislature and 0 otherwise, and the third is the interaction of *Legislative involvement* and *Democratic legislature*. With the second two variables, our goal is to test whether the effect of legislative involvement on the fraction of the ARC paid depends on which party has majorities in the legislature.

The estimates displayed in column 2 reveal no consistent pattern in the relationship between political party and fraction of the ARC paid. On the one hand, the coefficient on *Democratic governor* is negative, indicating that boards associated with the Democratic Party pay approximately 2.8 percentage points less of the ARC, on average. On the other hand, when legislatures are involved, non-Democratic legislatures pay less of the ARC than Democratic legislatures. All we can say, then, is that no clear pattern of partisanship emerges here. And there is good reason to expect this. Democrats have incentives to underfund, and so do Republicans. The pattern that *does* clearly emerge from this analysis, once again, is that having greater government employee representation on the board and stronger public-sector unions in the state *is* associated with these decisions—and in the direction of less responsible funding.

One final question worth asking is whether the politics of pension funding changed with the onset of the Great Recession. In our earlier article, we argued that the Great Recession triggered an expansion of the scope of conflict: voters were suddenly flooded with information

about public pensions, new interest groups became active on the issue, and the funds' staggering investment losses created enormous pressure for policymakers to "do something" to address the crisis. If decisions about pensions were made in the political shadows before 2008, then after 2008, they were in the spotlight.

How might this expansion in the scope of conflict have affected the politics of pension funding? One likely possibility is that the increased public scrutiny made it harder for policymakers to continue making irresponsible decisions. For example, with the onset of the Great Recession, many reformers, think tanks, and good government groups began to criticize plans' rosy actuarial assumptions. In this new environment, it presumably became more difficult for policymakers to stand pat with their high discount rates, or to pay less than the full ARC, without inciting criticism from the media or reform groups. One potential implication is that the influence of government employees and public-sector unions should have weakened with the onset of the recession. While they continued to hold positions on the board, and while they still had considerable clout in many state governments, we would expect them to have less ability to keep discount rates high and contributions low after the recession.

We investigate this expectation in a final set of models. In column 3 of Table 2, we return to our discount rate model and test whether the effects of our two key variables of interest—*Percent elected employees* and *Union membership*—decrease in magnitude in the post-2008 period. We do this by interacting both variables with *Scope*, which equals 1 for years later than 2008 and 0 otherwise. (We do not include *Scope* by itself because it would be collinear with the year fixed effects.) As we show in column 3, the coefficients on both interaction terms are negative, consistent with our expectations. The interaction of *Scope* and *Percent elected employees* is not statistically significant, but the interaction of *Scope* and *Union membership* is:

after the onset of the Great Recession, strong public-sector unions were still associated with higher discount rates, but significantly less so than they had been before the recession.

Finally, in column 4, we revisit our model of the fraction of the ARC paid, again to test whether our main effects of interest grew smaller with the onset of the recession. In Table 1, we found some evidence that both the elected employee trustees and the appointed employee trustees may have a negative influence on the fraction for the ARC paid, so in this model, we interact both of those variables with *Scope*. We also found (in Table 1) that when legislatures are involved *and* public-sector unions are strong, the effect is a lower fraction of the ARC paid. In column 4, then, we include a triple interaction of *Scope*, legislative involvement, and union strength (and all component interactions) in order to assess whether this effect of union strength decreased when the scope of conflict expanded.

Viewed together, the results presented in column 4 of Table 2 are largely consistent with our expectation. The coefficients on the interaction of *Scope* and the two employee trustee variables are statistically insignificant, but they are positive—the direction we expect. We also find strong evidence that the influence of public-sector unions diminished in the post-recession period. Focusing on the cases in which the legislature is involved in the setting of contributions, we find that until 2008, strong union states like Rhode Island paid an average of 38 percentage points less of the ARC than weak union states like Mississippi. After 2008, there was still a gap between strong and weak union states, but that gap had shrunk to 22 points—a statistically significant difference from the pre-recession period. Thus, strong unions were highly successful in pressuring legislatures to keep contributions low before the recession, and after the recession, their ability to do so was significantly weakened. The expansion in the scope of conflict

therefore did alter the ability of this key interest group to influence pension funding decisions. By no means was its influence eliminated, but it was substantially reduced.

These models are fairly simple, but the importance of our empirical findings should not be understated. The existing political science literature on interest groups has shown little consistent evidence of interest group influence on policy outcomes. Meanwhile, scholars studying pension boards have argued that government employees—actors considered to be “outsiders”—will be a force for more responsible funding decisions. Our theoretical expectations depart from both of these literatures. We argue that interest groups often do have influence, but that a considerable amount of that influence is exercised from their positions of direct policymaking authority and on technical issues well outside the public view. And in the case of public pensions, we argue that government employees and their unions—the key interest groups on the issue—have incentives to underfund just like everyone else. Our empirical analysis confirms these expectations. We find that government employees and public-sector unions are no more responsible than the other political actors involved. In fact, the evidence points strongly in the other direction: greater employee representation on the boards, and stronger public-sector unions, are associated with higher discount rates and a lower fraction of the ARC paid—both of which are *less* responsible funding decisions.

Conclusion

In *The End of Liberalism*, Theodore Lowi (1969) famously argued that American government is not a democracy-promoting arena of pluralist competition, but rather a corrupted version of that: a system of “interest group liberalism” in which groups colonize their own parts of government, exercise public authority as inside decision makers, and use government to promote their special interests—at the expense of ordinary citizens. Similar themes can be found in classic works by Schattschneider (1960), McConnell (1966), Bernstein (1955), and a number

of others, who describe a governmental world profoundly shaped by “interest groups on the inside.”

As the study of American politics has developed over the decades, models of politicians and voters have come to dominate theoretical thinking, and interest groups have been pushed to the periphery. When they have been studied at all, the focus has been narrowed to lobbying, campaign contributions, and questions of impact; and it is only a slight exaggeration to say that the serious study of “interest groups on the inside” has fallen off the scholarly radar screen entirely. This is unfortunate. As a subversive line of new scholarship is now arguing, interest groups are absolutely central to an understanding of American government and policymaking, as well as political parties, and they need to be brought to the analytic center of the field once again (Hacker and Pierson, 2014; Bawn et al., 2012; Cohen et al., 2008).

In this paper, our aim is to further that agenda—by focusing on interest groups, but also by expanding the way they are currently studied. Interest groups are more than just outsiders that influence government through lobbying and campaign contributions. They are often insiders that play ongoing, officially recognized roles as part of government itself—and in our view, this is just as true and just as consequential today as it was when Lowi and other prominent political scientists wrote about it decades ago. It is time for scholars to reconnect with this work, build upon it, and explore the full range of avenues by which interest groups shape American government and policy.

Our study of pension boards is a step in that direction. To many people, no doubt, pension boards couldn't be less interesting. But the fact is, they control trillions of dollars in funds; they have vast consequences for governments, public workers, and society as a whole; and their operation in the shadows of government, surrounded by mind-numbing technicalities, gives

interest groups every opportunity to exercise inside influence over key policy decisions. As Schattschneider (1960) emphasized long ago, it is precisely when policymaking occurs in the shadows—when the scope of conflict is narrow and only insiders participate—that interest groups are best-positioned to have their way.

Pension boards are commonly designed to allow for a strong measure of self-governance, with public employees and their unions playing official roles in governing their own pension systems. The existing scholarly literature, emerging from the study of corporate boards of directors, argues that this approach works well—because public workers, as pension-fund principals, have incentives to ensure that these programs are properly managed and fully funded, while politicians and their appointees, the agents, have incentives to be fiscally irresponsible due to their susceptibility to all manner of political influences.

As we show here, there are strong theoretical reasons for believing that the existing literature has it wrong—and that *all* the key actors in the governance of public sector pensions, including the public employees and unions that are supposedly the guardians of the system, in fact have incentives to behave irresponsibly and participate in the chronic underfunding of public pensions. For their part, public workers and their unions know that pension benefits, even if underfunded, are legally guaranteed and *will* be paid when they come due in future years—and that underfunding, by promoting the fiscal illusion that benefits are inexpensive and affordable, is the political key to gaining increases in benefit levels over time. Underfunding also frees up public money for other government services, and thus for higher public employment, salaries, and raises. For them, underfunding is smart politics. And much the same is true of politicians and their appointees, for whom fiscal illusion also has great political advantages.

Our empirical analysis of 99 state-run pension plans demonstrates that, as our theory suggests, public employees and their unions are not the champions of fiscal integrity. Indeed, the evidence shows that, in their key pension decisions—regarding the discount rate and the percentage of the ARC paid—they are consistently *less* fiscally responsible than the ex-officio politicians and (most) political appointees are. In this case, at least, self-governance and its official encouragement of “interest groups on the inside” tend to promote outcomes that undermine effective government. Further analysis shows that, with the Great Recession and an accompanying expansion in the scope of conflict—with pensions coming more fully into the public eye—the influence of these groups was lessened somewhat: a result that also makes good theoretical sense.

Much more remains to be learned about the politics of pensions, and the analysis we provide here is but an opening wedge. Among other things, for example, it would be instructive to explore how and why pension boards were designed as largely self-governing structures over the years, and what political efforts have been made to change their form of governance. It would also be revealing to look further into the incentives (and actual behavior) of politicians and their appointees, and, in particular, to ascertain whether their electoral connection to taxpayers—which public workers and their unions don’t have—leads them to be more fiscally responsible than the beneficiaries themselves: accounting, perhaps, for the empirical results we find here. It would also be helpful to explore the role of financial experts—who, in some capacity, are surely indispensable for the fiscal integrity of any pension system, but also have their own financial interests, and, if appointed by politicians, may well be susceptible to an array of political influences.

The study of pension boards is substantively important in its own right. But we study it here because it is one way of pursuing a larger and very promising agenda—that of bringing interest groups back to center stage in the study of American politics, with special attention to the pervasive ways that they colonize government and shape its policies from the inside. Our hope is that this paper, by spotlighting “interest groups on the inside,” takes a useful step in that direction, and in so doing will help to encourage new theory and research that extends across policy realms and throughout the full scope of American government generally—building on classic work in political science that still holds great value and insight.

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Figure 1: State pension board composition

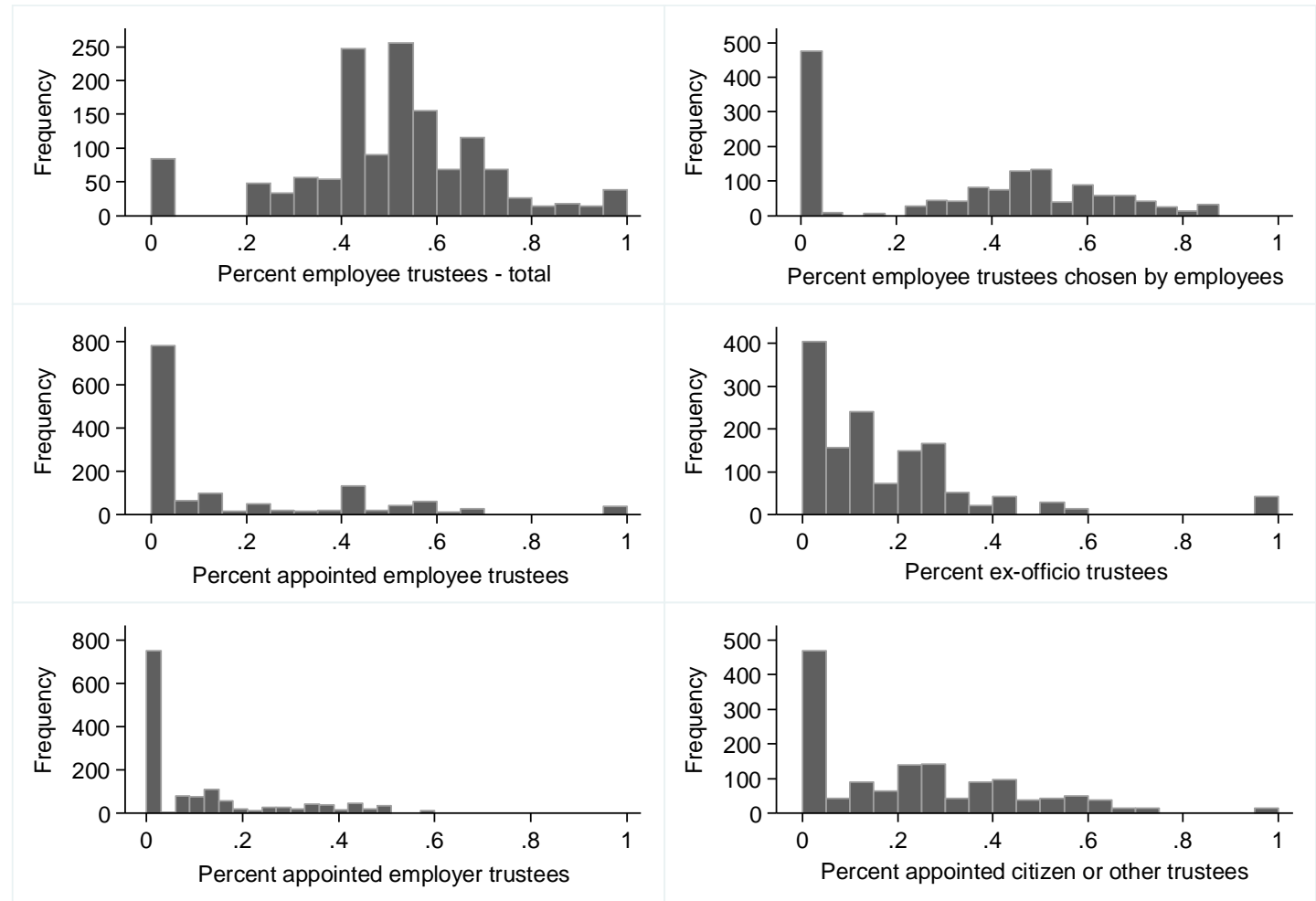


Table 1: Government employees, public-sector unions, and decisions about pension funding

	<i>Discount</i>	<i>Percent of ARC paid</i>		
	<i>rate</i>	(2)	(3)	(4)
	(1)			
% Elected employees	0.006*** (0.001)	-0.095* (0.050)	-0.127** (0.063)	-0.098* (0.056)
% Appointed employees	0.001 (0.001)	-0.044 (0.052)	-0.133** (0.060)	-0.072 (0.051)
% Appointed employers	0.00007 (0.003)	-0.035 (0.072)	-0.08 (0.088)	-0.081 (0.096)
% Private citizen or other	0.0003 (0.001)	-0.171*** (0.052)	-0.206*** (0.060)	-0.202*** (0.061)
Union membership	0.005*** (0.001)	-0.179** (0.073)	-0.229*** (0.080)	-0.041 (0.044)
% Change in state general revenue	0.002 (0.001)	-0.19** (0.094)	-0.196** (0.079)	-0.174* (0.088)
Legislative involvement		-0.161*** (0.023)	-0.169*** (0.033)	0.0003 (0.057)
Legislative involvement * Union membership				-0.413** (0.165)
R-squared	0.33	0.26	0.3	0.34
Observations	1,386	1,363	1,027	1,027

Notes: Standard errors clustered by pension plan in parentheses. The excluded board composition variable is % Ex-officio. All models include year fixed effects. Hypothesis tests are two-tailed.

*p<0.1; **p<0.05; ***p<0.01.

Table 2: Political parties, expansion in the scope of conflict, and public pension funding

	Discount rate (1)	% ARC (2)	Discount rate (3)	% ARC (4)
% Elected employees	0.005*** (0.001)	-0.111* (0.057)	0.006*** (0.001)	-0.123** (0.057)
% Appointed employees	0.001 (0.001)	-0.087* (0.049)	0.001 (0.001)	-0.085* (0.050)
% Appointed employers	0.0001 (0.003)	-0.069 (0.090)	0.00007 (0.003)	-0.084 (0.097)
% Private citizen or other	0.0003 (0.001)	-0.183*** (0.061)	0.0003 (0.001)	-0.202*** (0.060)
Democratic governor	-0.0005 (0.0003)	-0.028* (0.015)		
Union membership	0.005*** (0.001)	-0.039 (0.045)	0.007*** (0.001)	-0.048 (0.046)
% Change in state general revenue	0.002 (0.001)	-0.189** (0.092)	0.003* (0.001)	-0.169* (0.089)
Legislative involvement		-0.024 (0.056)		0.038 (0.060)
Legislative involvement * Union membership		-0.474*** (0.160)		-0.511*** (0.183)
Democratic legislature		0.005 (0.015)		
Legislative involvement * Democratic legislature		0.102** (0.045)		
Scope * % Elected employees			-0.001 (0.001)	0.062 (0.053)
Scope * Union membership			-0.004*** (0.001)	0.019 (0.043)
Scope * % Appointed employees				0.037 (0.049)
Scope * Legislative involvement				-0.085* (0.046)
Scope * Legislative involvement * Union				0.221* (0.128)
R-squared	0.33	0.37	0.34	0.35
Observations	1,386	1,013	1,386	1,027

Notes: Standard errors clustered by pension plan in parentheses. All models include year fixed effects. Hypothesis tests are two-tailed. *p<0.1; **p<0.05; ***p<0.01.