Shrouded costs of government: The political economy of state and local public pensions ☆

Edward L. Glaeser [a,b], Giacomo A.M. Ponzetto [c,d,e,*]

[a] Harvard University, United States
[b] NBER, United States
[c] CREI, Spain
[d] Universitat Pompeu Fabra, Spain
[e] Barcelona GSE, Spain

ARTICLE INFO

ABSTRACT

Why do public-sector workers receive so much of their compensation in the form of pensions and other benefits? This paper presents a political economy model in which politicians compete for taxpayers' and government employees' votes by promising compensation packages, but some voters cannot evaluate every aspect of promised compensation. If pension packages are "shrouded," so that public-sector workers better understand their value than ordinary taxpayers, then compensation will be highly back-loaded. In equilibrium, the welfare of public-sector workers could be improved, holding total public-sector costs constant, if they received higher wages and lower pensions. Centralizing pension determination has two offsetting effects on generosity: more state-level media attention helps taxpayers better understand pension costs, and that reduces pension generosity; but a larger share of public-sector workers will vote within the jurisdiction, which increases pension generosity. A short discussion of pensions in two decentralized states (California and Pennsylvania) and two centralized states (Massachusetts and Ohio) suggests that centralization appears to have modestly reduced pensions, but, as the model suggests, this is unlikely to be universal.

1. Introduction

Credit-card companies and hotels have long charged "shrouded" fees that were difficult for most consumers to assess at the first point of purchase (Gabaix and Laibson, 2006). States and localities commit to pension obligations that are similarly difficult for voters to assess. Novy-Marx and Rauh (2011) argue that states and localities have underestimated the shortfall in pension funding by trillions of dollars because of aggressive assumptions about returns on pension investments, and the continuing debate over their conclusions reinforces the point that pension promises are hard to evaluate (Mitchell and McCarthy, 1999). How does the difficulty of evaluating the costs of future obligations impact the level of public wages and benefits, and what institutions lead to better outcomes for taxpayers and public-sector workers?

After discussing the remarkable heterogeneity of local pension arrangements across the United States in Section 2, in Section 3 we present a political economy model in the spirit of Glaeser et al. (2005) and Ponzetto (2011). Politicians compete for votes by making binding promises about public-sector wages and pensions.[1] These promises ensure that public-sector workers prefer their jobs to the private sector. Housing prices equilibrate to make citizens indifferent about locations.

Policy promises are heard by only a portion of the electorate. We assume that pension promises are understood less well than promises about wages and that public-sector workers are more aware of these promises, especially pension promises, than ordinary voters. Public-sector workers certainly have far stronger incentives to understand the value of their own retirement packages. Our information structure follows if taxpayers and public-sector workers both have access to

[1] It is possible to craft a similar model with retrospective voting, as long as voters do not fully understand the long-term ramifications of pension promises.

public information sources (the "news"), but public-sector workers also have access to an added information source (the "union"), and all sources have a proportionally lower chance of appropriately reporting pension promises relative to wage promises.

Unlike Gabaix and Laibson (2006), we assume only limited information, not limited rationality, so the ignorant correctly infer what the politicians will do. Still, as in Glaeser et al. (2005), their ignorance impacts the political equilibrium because politicians cannot change the voting behavior of the ignorant by changing their promises. Our core political results would not change if uninformed voters naively underestimated future pension costs, as long as the marginal home buyer correctly anticipated the cost of pension obligations. Indeed, less rationality could easily strengthen our results.

As politicians are inherently identical in the model, a variant of the standard median voter result holds, and both politicians choose identical promises.[2] The pensions and wages offered by politicians reflect two first-order conditions that offset the benefits that workers receive against the cost imposed on taxpayers. The costs and benefits for the two groups are multiplied by the size of the group in the informed voting population. Some public-sector workers live outside the community, and this lowers their political clout; but public-sector workers are better informed, and this effect increases their importance in the politicians' calculus.

If relatively more union voters understand pension promises, then this information asymmetry pushes the equilibrium towards greater pension obligations. When public-sector workers have a greater advantage over taxpayers in understanding pensions than wages, public-sector consumption is higher post-retirement and public-sector workers would borrow against their future pensions if they could. We don't allow such borrowing, because in reality public pensions are not alienable and typically cannot be taken in bankruptcy. If borrowing against pensions was easy, then public workers would receive no wages and receive all of their compensation in the form of pension promises.

The informational advantages of public-sector workers cause them to earn rents or quasi-rents, and the political equilibrium leads to a situation in which voters and public-sector workers could both benefit from a different age-earnings profile for public-sector workers. If public-sector workers earned higher wages while young in exchange for lower pension benefits, their welfare could improve at no cost to the taxpayer. Fitzpatrick (2012) finds that Illinois teachers choose not to forgo cash today in exchange for future pensions that have a substantially higher net present value (evaluated at market interest rates).

A pre-funding requirement for pensions will lead to lower pensions in equilibrium. Public-sector workers themselves, being liquidity constrained, moderate their pension demands if they have to contribute to pre-funding during their working life. Pre-funding has no impact on overall public-sector wages, so it unambiguously causes public-sector worker welfare to decline and housing prices to increase.[3]

The spatial equilibrium structure of the model means that we can separately analyze the impact of higher reservation utility, which reflects the general level of prosperity in the country as a whole, and higher private incomes in the area, which will be offset by higher housing prices. Higher incomes lead to higher public-sector wages, because they cause the cost of housing to increase, and that in turn increases the marginal benefit to public-sector workers of receiving higher wages, while leaving the marginal cost to taxpayers untouched, since their real incomes are determined by the reservation utility. We assume that workers move when they retire, so higher incomes have no impact on the cost of living when old, and therefore no impact on pensions. An increase in the cost of living in the retirement community does, however, increase pension benefits.

Increases in the reservation utility, on the other hand, cause benefits to rise and have an ambiguous impact on wages. The ambiguous effect reflects two opposite effects. A higher reservation utility means that taxpayers have a lower marginal utility of income, reducing the cost of pensions to them; but it also reduces housing prices, causing the marginal benefit of wages to public-sector workers to fall as well.

As the share of public-sector workers that live in the community rises, the amounts paid to public-sector workers in both wages and pensions also increase, because the political power of the public-sector workers has risen. Liquidity-constrained public-sector employees most strongly desire higher wages, although they find higher pensions politically easier to obtain. Hence, when government employees are a larger share of the local electorate they leverage their numerical clout particularly into higher wages: the back-loading of public-sector compensation falls as the fraction of government employees living in the community rises.

As the informational advantage of public-sector workers about wages falls, public-sector wages fall. As a consequence, pensions also fall if there is a positive degree of pre-funding, because lower public-sector wages (caused by better taxpayer knowledge about wages) increase the marginal utility cost to the public workers of paying for their own pensions by decreasing their consumption while young. As the informational advantage of public-sector workers about benefits falls, benefits certainly decline, but wages remain constant. Lower public-sector pensions do not affect government employees' marginal utility of consumption when young, because the tax benefits of lower pension pre-funding are completely offset by higher housing costs. Therefore, the back-loading of public-sector compensation increases with information asymmetry about pensions, but decreases with information asymmetry about wages.

In Section 4, we use these results to discuss the impact of allocating control over public pensions to the state or to lower levels of government. We assume that there are two offsetting effects of allocating control to a higher level of government. First, there are state media sources that will supplement the knowledge about pensions and wages at the local level. Our information structure implies that this greater knowledge will increase the knowledge of taxpayers about both wages and pensions, but it will have a greater impact on knowledge of pensions because that knowledge started at a lower level. We also assume that the share of public-sector workers who vote in the relevant election increases, since public-sector workers are quite likely to live in the state where they work, but they are far less likely to live in the community where they work.

The overall impact on wages and pensions depends on which effect dominates. If the impact of public-sector workers voting is more powerful, then state control will lead to more generous wages and pension benefits. If the impact of reduced information asymmetries between taxpayers and workers is stronger, then state pensions and wages will be less generous. Our model suggests that the information effect may dominate the public-sector voter effect at least in larger cities, whose unionized government employees are likely to be city residents.

If the local news sources provide at least a modest amount of information, then moving to the state level will always lead to an efficient flattening of the consumption profile for state workers. Regardless of the relative importance of changes in the electorate and in the information set, the asymmetry between wage and pension knowledge declines, reducing the back-loading of public-sector compensation. This flattening means that if the move to state control held housing values constant, public-sector workers would be unambiguously better off.

---

[2] A slight perturbation of the model, following our earlier work, would give one of the politicians privileged communications with public sector unions and that would lead to policy divergence between the candidates, where the politician with extra access would promise more generous pensions.

[3] Pre-funding would have an even stronger impact if we allowed for ongoing construction. If housing supply growth is positive and public pensions are not fully pre-funded, the drop in the home values for current owners does not fully capture the cost of pension promises. Some of the costs of future pensions are borne by future developers rather than current voters. Hence city growth induces more generous and more back-loaded public-sector compensation, as voters support deficit spending through the pension system. Stricter pre-funding requirements mitigate this additional distortion.