The New Jersey Pension Crisis

Flailing in Deep Waters

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Abstract

New Jersey has a deep pension-funding crisis. It has made excessively generous pension promises without funding them; simultaneously, it has run up some of the highest debts, lowest credit ratings, highest tax rates, lowest citizen satisfaction rates, and highest out-migration rates of any state. Its responses have proven futile or counterproductive. While the pension crisis has arisen largely from a lack of citizen oversight, the state has recently increased government-worker control. While it has failed to fund its pensions, it has recently made a cosmetic dedication of lottery revenues that will only serve to hide—not correct—underfunding. And while the state already shows signs of tax-base flight, it contemplates enormous tax increases. New Jersey's future likely requires its officials to reduce pension promises for work not yet performed and to trim some already-granted pensions that run in excess of earnings during working years and reasonable New Jersey compensation levels.

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The New Jersey Pension Crisis: Flailing in Deep Waters

Scott Andrew Shepard

Though one of the wealthiest states in the Union,[1] New Jersey faces one of the country's deepest budget crises. A 2017 Mercatus Center report ranked the state's financial condition as the worst in the nation;[2] other good judges reach similar conclusions.[3] It has the highest taxes, the worst business climate (or one of the very worst),[4] the second-lowest credit rating,[5] and one of the most sclerotic state governments[6] of any US state.

In common with most of the states now in the worst fiscal shape, New Jersey's woes arise largely from the financial burdens created by decades of underfunded, overgenerous government-employee pension promises.[7] For many years, the state and municipal office holders have been able to make pension promises to government workers, satisfying influential

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[1] *See, e.g.*, *BEA Fact Sheets: New Jersey* (US Department of Commerce, Bureau of Economic Analysis, Mar. 28, 2017) (third-highest personal income per person).

[2] *See* Eileen Norcross & Olivia Gonzalez, *#50: New Jersey*, *in* RANKING THE STATES BY FISCAL CONDITION 41 (2017 ed.).

[3] *See, e.g.*, Volcker Alliance, *New Jersey*, *in* TRUTH AND INTEGRITY IN STATE BUDGETING (Nov. 2, 2017). The Volcker Alliance is slightly less bleak. It has given New Jersey D or D-minus grades over the last three years for budget forecasting, "budget maneuvers," and legacy costs, but B grades for reserve funds and transparency. *See also* Mike Lilley, *New Jersey Is Dying: A Special-Interest-Dominated Status Quo Is Hurting the State's Economy*, *in* AEI LEGAL CORRUPTION SERIES V (Nov. 2017); Jared Walczak, Scott Drenkard & Joseph Bishop-Henchman, *2018 State Business Tax Climate Index*, TAX FOUNDATION (Oct. 17, 2017), https://taxfoundation.org/state-business-tax-climate-index-2018/ (worst business taxes in the country); Arthur B. Laffer, Stephen Moore & Jonathan Williams, RICH STATES, POOR STATES 32 (ALEC-Laffer State Economic Competitiveness Index, 10th ed., 2017) (47th for economic performance; 48th for economic outlook); Dale Buss, *CEOs Rank 2017 Best & Worst States for Business*, CHIEF EXECUTIVE (Apr. 26, 2017).

[4] *See* all sources cited in note 3, *supra*.

[5] *See, e.g.*, Elise Young, *Christie's Final Budget, and No Repair for Worst-in-U.S. Pension*, BLOOMBERG.COM (Feb. 27, 2017), https://www.bloomberg.com/news/articles/2017-02-27/christie-s-final-budget-and-no-repair-for-worst-in-u-s-pension.

[6] *See, e.g.*, Eileen Norcross & Frederic Sautet, *Institutions Matter: Can New Jersey Reverse Course?* (Mercatus Center at George Mason University, Working Paper No. 09–30, 2009).

[7] "Expenditure growth is driven primarily by the State's required public employee pension contribution, which represents an increase of $554.5 million over the fiscal year 2016." Office of Management and Budget, *Section C, Summaries of Revenues, Expenditures and Fund Balances*, *in* FISCAL YEAR 2017: THE STATE OF NEW JERSEY DETAILED BUDGET C-2 (Feb. 16, 2016); Elise Young, *Whoever Replaces Chris Christie Faces Lingering Fiscal Headache*, BLOOMBERG.COM (Oct. 30, 2017), https://www.bloomberg.com/news/articles/2017-10-30/whoever-replaces-chris-christie-faces-lingering-fiscal-headaches (NJ pensions the worst funded in the country).

government-employee lobbies,[8] without themselves facing any negative consequences. They would safely have retired or moved on to different positions long before the vast cohort of the baby boomer generation would begin to retire and to present the bill for their largesse—while they themselves, as government employees and public officials, gained personally and professionally from their generosity with taxpayer funds. Now, however, the baby boomers are retiring. The pension-payment bills have begun to come due and will continue to arrive every month for decades to come.

Those bills, when properly calculated, are and will continue to be staggering. New Jersey's annual budget runs to approximately $35 billion.[9] A variety of state constitutional provisions, state supreme court mandates, and obligations under federal programs such as Medicaid render most of the state's budget automatic—earmarked and essentially untouchable.[10] The state can spend only a relatively small fraction of that $35 billion with discretion.[11] From this fraction the state must fund any number of obligations, including worker salaries, general operations, facilities maintenance—and government-worker pensions and retiree healthcare costs. New Jersey almost certainly cannot meet its present pension promises out of these funds nor raise enough new revenue to meet them.

The "normal costs" (i.e., the amount required to fully fund the current year's government-worker pension and healthcare costs), when added to each year's annualized liability for accumulated funding deficits, already impinge heavily on this discretionary budget, while the state's Pension and Health Benefit Study Commission looks for retiree-benefit costs to double by

[8] *See, e.g.*, Mike Lilley, *Job Number One: The New Jersey Education Association's Role in New Jersey's Disastrous Pension and Benefits Crisis, in* AEI LEGAL CORRUPTION SERIES III (Nov. 2017) [hereinafter Lilley III] (describing power of the NJEA, the state's largest government-employee union and largest political donor).
[9] *See, e.g.*, Lilley, *supra* note 3, at 1.
[10] *See, e.g.*, Norcross & Sautet, *supra* note 6.
[11] *See id.* at 71.

2022 unless changes are made.[12] In other words, unless pension and healthcare benefits are cut significantly, New Jersey will soon find itself unable to fund these benefits even were it to dedicate the whole of the state's discretionary budget to the effort. While this is obviously impossible, the full scene grows darker still. The figures already considered arise using a discount rate (i.e., the rate the state expects to earn on the funds that have been set aside to meet these bills) on pension assets already collected—a rate that most observers recognize as significantly too high; the official rate was reduced in 2017 from 7.9 percent to 7.65 percent,[13] and it will be reduced again to 7.5 percent in 2018.[14] But this number must fall further—arguably

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[12] *See* NEW JERSEY PENSION AND HEALTH BENEFIT STUDY COMMISSION, SUPPLEMENTAL REPORT ON HEALTH BENEFITS (Feb. 11, 2016) (the most recent report generated by the commission).
[13] *See, e.g.*, John Reitmeyer, *Unfunded Liability of Public-Employee Pension System Closes In on $50 Billion*, NJSPOTLIGHT.COM (Mar. 6, 2017), http://www.njspotlight.com/stories/17/03/05/unfunded-liability-of-public-employee-pension-system-closes-in-on-50-billion/.
[14] *See, e.g.*, Samantha Marcus, *Christie Move Will Force a Big Boost in Pension Price Tag for Phil Murphy*, NJ.COM (Dec. 20, 2017), http://www.nj.com/politics/index.ssf/2017/12/christie_accounting_change_drives_pension_price_ta.html; Andrew Coen, *New Jersey Zigzags on Pension Fund Discount Rate*, BOND BUYER (Mar. 2, 2018), https://www.bondbuyer.com/news/murphy-administration-in-new-jersey-zigzags-on-pension-fund-discount-rate. New Jersey has done more than most states to comply with GASB 67, which "advises plans to value the funded portion of liability based on the higher-risk discount rate and value any unfunded portion of the liability based on the low-risk return on tax-exempt municipal bonds. . . . In New Jersey, actuaries projected an earlier run-out date for plan assets, resulting in the fullest use of the blended rate out of all state plans. As a result, New Jersey's pension liability increased by 107 percent owing to the application of the new standard. By contrast, other state plans with significant unfunded liabilities did not apply the more conservative blended rate, but continued to use more generous assumptions." Sheila Weinberg & Eileen Norcross, *GASB 67 and GASB 68: What the New Accounting Standards Mean for Public Pension Reporting* 1–3 (Mercatus Center at George Mason University, Mercatus on Policy, June 2017). New Jersey's adoption of the GASB recommendation does not affect its determination of its total unfunded pension liability using its established discount rate, for policy purposes, however. *Cf.* "Does the Net Pension Liability Affect the Unfunded Liability for the Defined Benefit Program," *GASB 67–68 Frequently Asked Questions, General Information*, CALSTRS.COM (2018), https://www.calstrs.com/general-information/gasb-67-68-frequently-asked-questions.

to the risk-free rate that US treasury bonds pay.[15] Even a much smaller cut, as to the average actual return earned over the past 10 years, would add significantly to the state's annual pension-funding obligations.

Meanwhile, these figures fail to account for the fact that the state has never paid its full normal costs, plus full annualized deficit-reduction contribution, in any year and has no plausible plan to do so.[16] The real pension-funding shortfall already runs to about $200 billion (or closer to $300 billion if healthcare benefit promises and local-government obligations are included) if the state uses a risk-free rate matched against current "closeout" obligations.[17] And as ludicrous as these numbers are now, they compound every year, while something less than the full amortized underfunding payments are made.

And so we reach the crisis: it is hard to imagine a scenario under which the current pension and healthcare promises could be honored. Cutting them appears to be the only option.

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[15] *See, e.g.*, Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSPECTIVES 191, 193, 195, and *passim* (2009) (risk-free rate most appropriate, matched against the present value of the liabilities, known as the "accumulated benefit obligation"); John A. Turner et al., *Determining Discount Rates Required to Fund Defined Benefit Plans*, ACTUARIES.ORG (Mar. 2015), http://www.actuaries.org/oslo2015/papers/PBSS-Turner&GO&McC&B-P.pdf (preferred "rule would be to select a discount rate that is less than the expected rate of return on assets but greater than the risk free rate, with the discount being greater the higher the percentage of the portfolio invested in equity and the longer the duration of the liabilities"); Alicia H. Munnell, *Appropriate Discount Rates for Public Plans Is Not Simple*, MARKETWATCH.COM (Oct. 5, 2016), https://www.marketwatch.com/story/appropriate-discount-rate-for-public-plans-is-not-simple-2016-10-05 (6 percent). *See also* Robert Novy-Marx & Joshua D. Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?* 66 J. FINANCE 1211 (2011) (determining public debt using accumulated benefit obligation method); Alicia H. Munnell et al., *The Funding of State and Local Pensions 2012–2016* (Ctr. for Retirement Research at Boston Coll., Issue In Brief No. 32, July 2013), http://crr.bc.edu/wp-content/uploads/2013/07/slp_32.pdf (same); SOCIETY OF ACTUARIES, REPORT OF THE BLUE RIBBON PANEL ON PUBLIC PENSION PLAN FUNDING 23 (Feb. 2014); Jed Graham, *50 States of Gray: Aging America Faces Retiree Battles, Even Slower Growth*, INVESTOR'S BUSINESS DAILY (Aug. 18, 2017), https://www.investors.com/news/50-states-of-gray-aging-america-faces-retirement-benefit-battles-even-slower-economic-growth/ (governments outside the United States tend to adopt a discount rate of around 3 percent, broadly tracking the risk-free return thesis).

[16] *See, e.g.*, Steve Eide, *Connecticut's Fiscal Crisis Is a Cautionary Tale for New Jersey* (Garden State Initiative, Working Paper No. 11, undated) ("As Moody's recently explained, even under optimistic assumptions of economic growth and investment return," the current plan to achieve full annual funding by 2023 will in fact produce only a little more than half of what would be necessary in that year.).

[17] *See, e.g.*, Bob Williams et al., *Unaccountable and Unaffordable 2016: Unfunded Public Pension Liabilities Near $5.6 Trillion* (Am. Legislative Exch. Council, Working Paper, Oct. 2016) (using a risk-free discount rate, derived from an average of 10- and 20-year Treasury bond returns, of 2.344 percent); Lilley, *supra* note 3, at 1 (Stanford researchers put the state's unfunded pension and healthcare liabilities at $253 billion [$186 billion for pensions, the remainder for healthcare benefits] and local liabilities at $41 billion).

The state's own pension commission has recognized flatly that "[a]ny attempt to fully fund the existing pension benefits, whether under the terms of the proposed pension funding amendment or any other schedule, will inevitably force cuts in essential services such as education, infrastructure and public safety," while "[t]he tax increases which have been discussed to date as the answer to the funding crisis would only raise a small percentage of the revenue needed."[18]

But most of New Jersey's public officials want nothing to do with cutting these benefits. The New Jersey teachers' union has, by far, the best-funded and most powerful lobby in the state.[19] It and the other government-employee unions have had great and sustained influence on New Jersey politics and policy. As a result, one of the first acts of the new administration of Governor Phil Murphy has been to enact legislation shifting control over pension investments and benefits—but not responsibility for losses or underfunding—to the uniformed-employees' union.[20] Murphy has further promised to honor all of the state's pension promises in their entirety while raising taxes significantly.[21] His task has been complicated, however, by the

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[18] NEW JERSEY PENSION AND HEALTH BENEFIT STUDY COMMISSION, SUPPLEMENTAL REPORT ON HEALTH BENEFITS i (Feb. 11, 2016). The commission calls for significant cuts to government-employee healthcare benefits as the measure necessary—and in the commission's view, sufficient—to permit the state to pay all of the pension benefits already accrued for work already performed. The cuts and reforms are wise and necessary, but they are insufficient. They would bring in about $2.25 billion per year. *See id.* Exhibit 11 and explanatory text. If all of that savings were dedicated to paying down the state's current accrued pension fund shortfall, then it would come within $250 million or so of closing the annual retirement-benefit funding gap, but only at the 7.65 percent discount rate that the state had already abandoned. If an even more realistic rate than the new 7 percent rate were used, then even these significant reforms would fall far short of closing the funding gap. Solving the problem, then, requires not only this healthcare benefit reform and shifting benefits for work not yet performed to a defined-contribution system, but also the sort of reform to already-accrued benefits that is proposed in the final section of this paper.

[19] *See infra* notes 20 and 60.

[20] *See, e.g.*, Joe Mysak, *New Jersey Police and Firefighters Aggravate Pension Mess*, BLOOMBERG.COM (Mar. 27, 2018), https://www.bloomberg.com/news/articles/2018-03-27/new-jersey-police-firefighters-aggravate-pensions-mess-mysak; Samantha Marcus, *Phil Murphy Takes Action on Bill Giving Police, Firefighters Control over Pensions*, NJ.COM (May 10, 2018) (Murphy has conditionally vetoed the bill for now. The condition relevant to the considerations of this paper is that the bill be amended to remove from the union-dominated oversight board the power to set its own discount rate. This is a wise condition, but it still leaves the oversight board with power to increase its own benefits. The legislature has indicated that it will make the required changes in its June 7 session, and thus enact the bill.).

[21] *See infra* note 50.

federal tax bill that became law in 2017.[22] Among other provisions, it has limited the federal deduction for state and local taxes paid ("the SALT deduction") to $10,000.[23] This limitation will raise taxes for a significant group of higher-end earners in high-tax, high-cost New Jersey.

The government of New Jersey, then, has shown no inclination to begin limiting or reducing pension benefits—likely the only effective solution available to it. Rather, it has focused only on patches. These include dedicating the state's lottery profits to pension funding for 30 years, a plan to which Governor Chris Christie and the general assembly had agreed in 2017; raising taxes (ostensibly, for now, preponderantly on wealthier taxpayers); and the already-referenced transfer of additional authority, without responsibility, to government-worker unions. None of these proposals, though, are even real patches—the type that hold things together for a little while until some permanent solution can be reached. Rather, they are either essentially cosmetic (which is the best possible face to put on the lottery-revenue dedication) or they are actively harmful, like the other two proposals. They are political expedients that obscure the problem and deter its genuine resolution for as long as possible. And each of them demonstrates a fundamental, structural flaw in New Jersey's government-employee benefit system that the state needs to confront—but that these initiatives not only ignore but also exacerbate.

This paper will consider the possibility of New Jersey's imposing a "millionaires' surtax" on its 17,000 to 20,000 or so highest-income-generating families and will conclude that the likely effect of such a tax will be to exacerbate a capital and income flight from New Jersey that appears already to have begun. This flight threatens to set off a vicious spiral into economic decay that will do little to pay off the state's pension promises while greatly injuring the state's

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[22] *See, e.g.*, Shannon Pettypiece, *Trump Signs $1.5 Trillion Tax Cut in First Major Legislative Win*, BLOOMBERG.COM (Dec. 22, 2017), https://www.bloomberg.com/news/articles/2017-12-22/trump-signs-1-5-trillion-tax-cut-in-first-major-legislative-win.

[23] Howard Gleckman, *What the Tax Bill's Curbs on the SALT Deduction Would Mean for Itemizers*, FORBES (Dec. 21, 2017).

financial condition. It will look at the recent transfer of additional control over pension investments, accounting, and benefits to the state's uniformed government-employee unions and will determine that this move will only deepen a serious and crippling problem of New Jersey's pension governance—that government-employee interests are already significantly overrepresented in pension decision-making, while the interests of economy and the protection of taxpayers and the private sector are underrepresented.

This paper will review the recent dedication of state lottery funds to pension funding and conclude that, because the dedicated funds were not replaced by other revenue streams or spending cuts, the change is effectively cosmetic and possibly even obscurantist, rather than meaningfully effective. New Jersey faces no real choice but to begin to revise and reduce some of its pension promises; it would be well for the state to act quickly, as further delay only increases the likelihood of more pervasive and less equitable cuts later on. Suggested limitations on pension promises include switching from defined-benefit to defined-contribution pension benefits for work not yet performed (by both current and future employees), installation of payment caps on the largest pension payments, and related cost-cutting measures—all designed with both affordability and equity to all parties in mind.

1. The Millionaires' Surtax, General Tax Increases, and the Vicious Cycle

New Jerseyans appear conflicted about how to respond to this wave of pension-funding obligations. In an early 2017 poll by Quinnipiac University, half of the state's voters approved of raising taxes to—as the pollsters rather opaquely put the question—"fix public employee pensions."[24] Two-thirds of those voters, though, objected to across-the-board tax increases for this purpose.[25] Rather, a slightly higher number supported raising taxes on residents earning more than $1 million a year.[26] This millionaires' tax, proposed by State Senate president Stephen Sweeney in 2015, would have targeted 17,000 New Jersey families, ostensibly to raise an additional $675 million per year.[27] A more recent proposal by Governor Murphy would go further, raising the highest rate to 10.75 percent—the third-highest rate in the country.[28]

One way to make sense of these numbers is this: many New Jerseyans are in favor of *other* taxpayers—namely the highest-earning few thousand—paying more to fund pension promises but are unwilling to pay more themselves.[29] The poll results themselves do not allow this interpretation to be tested; the pollsters failed to ask how many of the voters questioned were themselves millionaires who would be subject to the surtax (though we can reliably presume that the number was fairly small, if the survey was random).[30]

This is a shame, as the question is vital. If the Quinnipiac poll fundamentally demonstrated that most New Jerseyans are not themselves willing to pay materially higher taxes to fund the state's pension promises to current workers and retirees, then the state legislature faces a profound and fundamental crisis. If the 17,000-odd families that would be targeted by the

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[24] *See* Samantha Marcus, *N.J. Voters Would Raise Taxes on the Rich to Fund Public Worker Pensions, Poll Finds*, NJ.COM (Mar. 21, 2017), http://www.nj.com/politics/index.ssf/2017/03/poll_finds_nj_voters_would_raise_taxes_on_the_rich.html.

[25] *See id.*

[26] *See id.*

[27] *See id.* The tax is popularly referred to as a "millionaires'" tax even though the term millionaire usually refers to those who own more than a million monetary units (e.g., dollars, pounds), rather than to those who earn more than a million of those units per year. *See, e.g.*, *Millionaire Definition,* MERRIAM-WEBSTER.COM, https://www.merriam-webster.com/dictionary/millionaire (last visited June 13, 2018).

[28] *See, e.g.*, James Nash & Dustin Racioppi, *Murphy Wants $1.6 Billion in New Taxes to Fund Schools, Transit*, NORTHJERSEY.COM (Mar. 13, 2018), https://www.northjersey.com/story/news/new-jersey/2018/03/13/nj-phil-murphy-tax-increase/418479002/.

[29] As Senator Russell B. Long (son of Huey P.) used to put it, "Don't tax you, don't tax me; tax that man behind the tree." John H. Cushman Jr., *Russell B. Long, 84, Senator Who Influenced Tax Laws*, N.Y. TIMES (May 11, 2003) (obituary). *See also* Nash & Racioppi, *supra* note 28 ("Murphy and his aides said . . . that higher taxes on millionaires is an idea broadly popular among those who don't have to pay it.").

[30] *See* Marcus, *supra* note 24.

surtax are not willing to pay it, they—or at least many of them—are free to decamp to states that tax income less heavily and that have lower taxes in general.

These families are spoiled for opportunity. New Jersey has one of the highest state income-tax rates in the country already,[31] as well as one of the highest overall state tax burdens,[32] making most states relatively attractive destinations even before the addition of a millionaires' surtax.[33] New Jersey, though wealthy, is not particularly large and has many neighbors, making a move more feasible for many New Jersey families than would be the case in many other American locales. States with no income tax and warmer weather than New Jersey, such as Florida and Texas, also appear to be popular destinations for outgoing New Jerseyans.[34] And of course, the families that would be affected by any millionaires' tax would by definition constitute the highest earners in the state—those in the best position to pay relocation costs and to recoup, and more than recoup, those costs in future tax savings.

If New Jersey's high earners (or a substantial number of them) *are* willing to move rather than pay the proposed surtax (or pay materially higher taxes generally), a series of potential consequences follows. First, as some of the targeted families decamp, the amount expected to be recouped from the surtax itself falls, because fewer families will be available to pay it. (If a tax on 17,000 families is expected to bring in an additional $675 million per year, then the average surtaxed family in New Jersey is expected to contribute an additional $40,000 per year [approximately]. Should only 1,000 of those 17,000 choose to move rather than pay, the

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[31] *See supra* note 3.
[32] *Id*.
[33] Pennsylvania and New York, to which New Jersey is already losing significant numbers of relatively young and affluent citizens, have personal income-tax rates of 3.07 percent (flat) and 8.82 percent, respectively, and property-tax rates of 2.95 percent and 4.6 percent, respectively, to New Jersey's 5.4 percent. *See* Lilley, *supra* note 3 at 9–10.
[34] *See, e.g.*, Jeff Goldman, *People Are Fleeing N.J. Faster Than Any Other State, Moving Company Says,* NJ.COM (Jan. 5, 2015), http://www.nj.com/news/index.ssf/2015/01/people_are_fleeing_nj_faster_than_any_other_state_moving_company_says.html.

expected surtax revenues would fall by $40 million annually.[35]) Meanwhile, the state will also lose all of the other tax revenues—income, sales, property, and other—contributed by those high-earning families, reducing net state income and requiring some portion of the surtax raised by the millionaires' tax to be used to replace the net revenues lost.

Not many of New Jersey's highest earners have to move out of state for the surtax to end up producing far less net revenue than expected. The result is that if the state remains committed to meeting its pension-funding crisis by increasing taxes rather than decreasing (at least some) benefits, then taxes will have to be raised on a less wealthy tranche of families—perhaps those earning over $500,000 per year.[36] Yet some of these families will be unwilling to pay the surtax as well and will themselves move away. So the process will continue—and will be magnified because of the growth lost to the state as families or companies that might otherwise have moved to New Jersey elect to move to a different state or to stay where they are.

This process is referred to as a vicious cycle: a cycle because of its repeating quality; vicious because its results are so dire. Once vicious cycles have begun, they tend to continue until they burn or tire themselves out. The way this particular vicious cycle would burn itself out would be by expanding the surtax to include more and more families who earn less and less income every year, with a certain number of families affected each year (or realizing that they

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[35] Research suggests that an even larger effect should be expected. *See, e.g.*, Pavel A. Yakovlev, *State Economic Prosperity and Taxation* (Mercatus Ctr. at Geo. Mason Univ., Working Paper, July 10, 2014) (showing that higher marginal state taxes reduce gross state product growth by nearly double the size of the tax increase, with increasing progressivity of tax rates working a smaller decrease in growth; increased total state taxation leads to outmigration).

[36] New Jersey is particularly susceptible to a vicious cycle of the sort described above because its income tax structure is already so progressive. Already, for instance, the top 10 percent of wage earners pay 72 percent of the state income tax. *See* Lilley, *supra* note 3 (citing Andrew Sidamon-Eristoff, *Opinion: When Not Losing Is Winning—Competition's Impact on NJ's Tax Policies*, NJSPOTLIGHT.COM (Mar. 29, 2016), https://www.njspotlight.com/stories/16/03/27/opinion-when-not-losing-is-winning-the-impact-of-competition-on-nj-s-tax-policies/). The top 1 percent of taxpayers pay one-third or more of the total take. Robert Frank, *One Top Taxpayer Moved, and New Jersey Shuddered*, N.Y. TIMES (Apr. 30, 2016). This means that if only one in 10 of these top earners were to leave for lower-tax jurisdictions, the result would be a 1 percent loss of population—but a 7 percent or greater loss of income tax revenue alone. Only a couple thousand of the famed 1 percent would have to depart to blow the same hole in the state's finances and utterly cancel out the expected revenue increase from a millionaires' tax.

will soon be affected) moving to lower-tax jurisdictions. Finally, everyone who could be surtaxed would be surtaxed, and yet the unfunded pension promises would remain unfunded—with no possible means remaining for the state to fund them. Even if this cycle were to "tire" before it burned out, it would leave the state poorer by the tax revenues and innovative spirits of all the taxpaying families that had moved away or had chosen to move to (or stay in) a state other than New Jersey. In other words, once a spiral of this type kicks off, the best possible outcome is permanently lower growth and diminished prospects.

One potential way to avoid a vicious tax-burden cycle would be to fund the pension promises by cutting spending on other government-provided services. In one sense, this is merely a different aspect of the same danger, as families also face increased incentive to leave New Jersey (and others *not* to come) if their taxes remain at the same level but their children's schools deteriorate, their neighborhoods grow less safe, the state's bureaucracy becomes additionally inefficient, and so on. Another complication arising in New Jersey is that most of the state's budget is (as noted above) mandated spending.[37]

The common term to describe entities that face more obligations than they have resources is insolvency. Should the state's political branches set off a vicious cycle of this sort, insolvency will follow almost inevitably.

Of course, vicious cycles of this sort are not common occurrences. Moving is expensive, time consuming, frustrating, and, practically, difficult and emotionally fraught. But the cycles do happen and currently appear to be unwinding in Puerto Rico and in Chicago specifically and

[37] *See supra* p. 4.

perhaps in Illinois generally (and in response to conditions that are in many ways very similar to those now besetting New Jersey).[38]

There is some evidence that a vicious cycle has already begun in New Jersey, even without imposition of a millionaires' tax. For more than a decade, New Jersey has lost more citizens to other states than almost any other state.[39] While its absolute population has remained fairly stable because of immigration from outside of the country, the native-born citizens it is losing to other states are on average far wealthier than either the foreign immigrants or the average remaining New Jersey population.[40] Meanwhile, taxpayers who remain in New Jersey express more eagerness to leave than those in just about any other state.[41]

In fact, the emigration of just one single wealthy citizen from New Jersey, who took his tax dollars with him, proved enough to make a deep dent in the state's budget projections. Early in 2016 David Tepper, a hedge-fund billionaire, moved to Florida, which has no state income tax—thereby saving himself nearly 9 percent a year in income taxes alone. His relocation simultaneously cost New Jersey just as much. Given that Tepper appears to have earned more than $6 billion in the four years preceding his move, this single migration cut the state's revenues by about $150 million per year.[42] (Note that if the original proposed millionaires' surtax were to trigger just four such relocations, the tax would end up causing a net decrease in state revenues; the same effect would be achieved if only 40 families earning one-tenth as much as Tepper behaved accordingly.)

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[38] *See, e.g.*, Scott Andrew Shepard, *The Lead Lemming: Illinois on the Pension-Crisis Brink*, 14 J. L. PUB. POL'Y 151 (2018).
[39] *See, e.g.*, Lilley, *supra* note 3, at 10–11 (summarizing data from the Cato Institute, the American Community Survey, and United Van Lines); Steven Malanga, *Budget Balloon*, CITY J. (Aug. 25, 2017) (citing study by Boston College's Center on Wealth and Philanthropy noting $70 billion net wealth migration out of New Jersey from 2004 to 2008); Young, *supra* note 7.
[40] *See* Lilley, *supra* note 3.
[41] *See, e.g.*, Malanga, *supra* note 39 (citing various polls to suggest that nearly half of New Jerseyans would like to move out of state, and that half of those who want to leave are motivated by the state's already high taxes).
[42] *See* Frank, *supra* note 36.

The threat to the state's finances is so great that the state's budget director made a special point of warning the state senate's finance committee about the development. Concerns about the effects of future tax flight have become strong enough that the state has begun to develop plans for monitoring the state's highest earners to seek out early intelligence of their possible departure and to ensure against any attempts to protect their assets while they remain citizens of New Jersey.[43] The state's public officials have perhaps incompletely comprehended the potential effects flowing from the imposition of an additional millionaires' surtax combined with heightened scrutiny of millionaires' financial dealings and personal behavior.

Meanwhile, the state's growth rates have begun to fall below those of its neighbors in almost every category.[44] Of states in New Jersey's neighborhood, only Connecticut has, in recent years, put up worse numbers.[45] Both states are careening toward disaster.[46]

A related vicious cycle seems to have gathered significant momentum in the concomitant arena of government-funding costs. New Jersey's credit rating has been reduced 11 times in the last eight years. (Two of the major credit-rating agencies have decreased the rating four times; the third had reduced it three times.[47]) Every time the credit rating sinks, the state's running costs rise with no concomitant gain to the state's services. In other words, taxes must ultimately rise to no benefit. This works to accelerate the taxpayer-flight process and increase the danger of a vicious cycle and insolvency. The concern is particularly pressing in New Jersey, one of the most

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[43] *See id.*
[44] *See, e.g.*, Lilley, *supra* note 3, at 4; Young, *supra* note 36 (NJ job growth expected to be half that of national average for next decade).
[45] *See, e.g.*, Eide, *supra* note 16.
[46] *Id.*
[47] Salvador Rizzo, *N.J. Credit Rating Cut for 11th Time uUnder Christie*, NORTHJERSEY.COM (Mar. 27, 2017), https://www.northjersey.com/story/news/new-jersey/2017/03/27/nj-credit-rating-cut-11th-time-under-christie/99708996/.

deeply indebted states in the United States.[48] It inspires no confidence that New Jersey's credit rating has fallen to the lowest of any state except Illinois.

The recent federal tax law adds to the concerns that a vicious cycle of tax flight might be instigated or enlarged. That legislation caps federal deductions of taxes paid to state and local governments at $10,000.[49] This means that not only would the tax deduction not apply to any additional levies occasioned by a millionaires' tax, but many New Jersey taxpayers who make quite a bit less than a million dollars are going to see significant tax increases in 2018 even without any new state taxes being levied.

New Jersey's new governor, Phil Murphy, chaired a committee that attempted unsuccessfully to solve the pension problem in 2005.[50] He has acknowledged that the problem has grown significantly since then but has promised to honor all current pension promises.[51] His plans for funding this guarantee were, during the 2017 gubernatorial campaign, to adopt and extend Sweeney's plans. He calls for an increase in the top income-tax rate to 10.75 percent—a $300 billion per year increase in business taxes—and the legalization and taxation of marijuana.[52] He has not yet addressed the concern that even if these taxes were all passed, even if they brought in as much additional revenue as anticipated (all without setting off or accelerating

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[48] *See, e.g.*, Norcross & Gonzalez, *supra* note 2, at 41; Truth in Accounting, *New Jersey Taxpayer Burden Highest in Nation*, *in* FINANCIAL STATE OF THE STATES 2016 128–29 (Sept. 2017).
[49] *See supra* note 23.
[50] *See* Mark Lagerkvist, *The Ticking Time Bomb Faced by Next NJ Governor*, WNYC.COM (Oct. 10, 2017), https://www.wnyc.org/story/ticking-time-bomb-faced-next-nj-governor/.
[51] *See id*.
[52] Steven Malanga, *Budget Balloon*, CITY J. (Aug. 25, 2017). It may highlight the despair—and desperate wishes of the states most critically endangered by their pension obligations—that so many of them are looking to marijuana taxes as almost magical revenue generators that can print money to throw at their funding problems. *See, e.g., id.*; Chris Williams, *GOP Leader Still Believes in Marijuana as Pension Solution*, WHAS11.COM (Nov. 15, 2017), https://www.whas11.com/article/news/politics/gop-leader-still-believes-in-marijuana-as-pension-solution /492133533; Patrick McGreevy, *High Taxes on Legal Pot in California Could Mean Black Market Will Thrive*, L.A. TIMES (Oct. 30, 2017). As the California case illustrates, however, marijuana taxes, while not insubstantial, are limited. Significant production, transportation, and sale facilities and networks already exist for pot and set a very real market price for the product, even if it is a black market price. Taxes that force the price of legal marijuana much higher than the existing black market prices will keep most purchasers in the black—rather than the taxed—market. This caps fairly firmly the amount that can be raised by taxing legal marijuana. *See, e.g.*, McGreevy.

the tax-flight cycle in New Jersey), and even if every penny from these revenue increases were dedicated to retiree-benefit (pension and healthcare) funding, they would fail—by a wide margin—to cover the pension-funding shortfall expected by 2023.[53]

If New Jersey has not begun to rotate through the vicious cycle, it may well expect to commence soon. If the process has already begun, it will pick up speed. Every additional cycle will compound the depth and breadth of the state's crisis while decreasing the assets that will be available to the state when it finally faces economic reality.

2. Underrepresenting Taxpayer Interests at the Negotiating Table

In 2018, the general assembly passed—nearly unanimously—an act transferring control of pension funding and pension policy for uniformed state workers (police officers and firefighters, primarily) into the hands of those workers' union officials, by establishing a policy-making committee for those pensions with a permanent majority of union officials.[54] This committee will be responsible for making pension-fund investment decisions and will have the power to change the level of uniformed-worker benefits and their relative responsibility for pension-fund contributions.[55]

Government-employee union representatives obviously have every incentive to increase benefits for their represented employees while minimizing contributions by those members. In a private setting, this impetus would be governed and restrained by economic necessity; the overriding goal of a pension plan's control committee would necessarily be to keep the pension

[53] *See supra* pp. 6–7.
[54] *See, e.g.*, Andrew Seidman, *Police, Firefighters Would Control Own Pension Plan Under N.J. Bill*, PHILLY.COM (Mar. 23, 2017), http://www.philly.com/philly/news/politics/Police-firefighters-control-own-pension-plan-under-NJ-bill-.html; Samantha Marcus, *Pension Fund May Soon Be Turned Over to Police, Firefighters*, NJ.COM (Mar. 15, 2017), http://www.nj.com/politics/index.ssf/2017/03/nj_senate_passes_bill_turning_pension_fund_over_to.html. The page including the legislation appears here.
[55] *See* Seidman, *supra* note 54; Marcus, *supra* note 54.

fund solvent over the long term—a goal that would necessarily limit the committee's impulses toward generosity.

That natural check will not apply to this union-dominated committee, though. While it has been granted the authority to make pension-fund investments and to alter (which, given the committee's composition, means "to raise") government-worker benefits, the committee faces no adverse incentives. Rather, if it invests poorly, or increases benefits or reduces contributions recklessly, the state's taxpayers are still entirely on the hook to make up any difference.

This is a mistake. Not only does it leave the committee unconstrained to act on its natural predisposition to increase benefits and decrease employee contributions, but it also creates incentives for the committee to make inappropriately risky investments. Any windfall benefits deriving from the dangerous investment risks taken will redound, under the committee's ministrations, to the union members' benefit, while any "windfall losses" will be laid at the ever more debt-burdened feet of the taxpayers.

Even before this enactment, New Jersey pension law has been studded with features that partake—to varying degrees, if not comprehensively—of this serious incentive mismatch and failure to meaningfully represent the interests of New Jersey's private-sector taxpayers. Already, the structures of collective bargaining overrepresent government workers at the expense of taxpayers—overrepresentation that has fueled the large increases in government-employee pension benefits since the adoption of government-employee unionization throughout the country.[56]

[56] *See, e.g.*, Brigham R. Frandsen & Michael Webb, *Public Employee Pensions & Collective Bargaining Rights: Evidence from State & Local Government Finances* 3 (Hutchins Ctr., Working Paper No. 35, Oct. 2017) ("[C]ollective bargaining requirements significantly and substantially increase government contributions to pensions, while reducing employee contributions.").

Consider, for instance, the 2011 New Jersey Pension and Health Benefit Reform Law.[57] The law was a bipartisan effort at curbing the already-explosive growth in pension liabilities. The reforms increased employees' pension contributions from 5.5 percent to 6.5 percent of salary immediately, with contributions rising to 7.5 percent over the following seven years.[58] It also created a fifth tier of reduced benefits for new hires and suspended cost-of-living increases for all retirees until funding ratios improved significantly.[59] Sweeney's support of the measure earned him the undying and deep-pocketed enmity of the New Jersey Education Association (NJEA)—the public teachers' union that is also the big-footed lobbying powerhouse in the state.[60] The law increased employee contributions to the pension fund but also included a provision that ultimately undercut the value of that increased contribution obligation. The law is a more constrained version of the power-without-consequences provision that was just enacted. Under this provision, once various retirement systems (i.e., pension funds) achieved a "target-funded ratio" of 75 percent, the governor was instructed to establish pension-planning committees for those funds. The committees, consisting half of government-employee union representatives and half of appointees meant to represent public employers, were empowered to reinstate cost-of-living increases, decrease employee contributions, and otherwise increase government-worker benefits.

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[57] *See New Jersey Division of Pensions & Benefits, Pension and Health Benefits Reform, Pension Reform Provisions*, NJ.GOV, http://www.nj.gov/treasury/pensions/reform-2011.shtml.
[58] *See id*.
[59] *See id.*
[60] *See, e.g.*, Susan Deile, *Letter: Long-Term Fix Needed for State Pension*, NORTHJERSEY.COM (Nov. 16, 2017), https://www.northjersey.com/story/opinion/readers/2017/11/16/letter-long-term-fix-needed-state-pension /867791001/ (An NJEA member attacks Sweeney in a letter to the editor for his support of the 2011 reform act and for failing to get onto the ballot in New Jersey a constitutional amendment that would have guaranteed full payment of all of New Jersey's pension promises, dropping the state into exactly the impasse that faces Illinois.); Brent Johnson, *Teachers' Union Battle Against Top Democrat Is Costing a Fortune*, NJ.COM (Nov. 3, 2017), http://www.nj.com/politics/index.ssf/2017/11/sweeney_vs_njea_battle_sparks_historic_spending.html (NJEA targeted Sweeney in 2017 election, making the race the most expensive general-assembly race in state history); Lilley, *supra* note 8.

In two important ways, these committees are more constrained, and thus less dangerous to taxpayer interests and state solvency, than the uniformed-employee control committee now instituted. First, the committees were designed ostensibly to include as one-half of their membership representatives of taxpayer interests, with the other half representing the unions. In other words, the committees would not be—structurally and necessarily—controlled by a majority of union officials.[61] Second, the committees faced some restraint on their generosity: they could increase benefits only once pension assets reached the level of 75 percent funded, and they could do so only in ways that would leave funding above 75 percent.[62]

Despite these topical differences, however, vast arenas for mischief nevertheless remained built into these committees. For instance, the balance on the committees between representatives of the unions and those of the taxpayers could never arise above the notional. In every instance, the government-employee unions may appoint half of the committee. The unions have a narrow and nonconflicted interest: to maximize the benefits flowing to their members while minimizing the contributions that those members have to make to the solvency of the pension funds. The unions have only that job and that interest. Half of the votes on the committee, then, will always lean toward expanding pension benefits for union members and thus expanding costs to taxpayers.

Putatively sitting across the table from them, meanwhile, are an equal number of committee members assigned to represent taxpayers' interests. This representation of interest, though, is far more complicated than the one on the other side of the table. Taxpayers do not have the same clear and undivided interest that the employee unions do. Some taxpayers are themselves government employees and so probably prefer that everyone's taxes rise to some

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[61] *See supra* note 57.
[62] *See id.*

degree so that their benefits can be increased a relatively large amount. Some taxpayers are uninformed about or uninterested in pension policy. Some would not mind paying more taxes to benefit government employees—even though they are not themselves public employees—or have been convinced by various politicians that someone else will end up paying the taxes, and not them. So the taxpayers do not speak with one voice.

Even if taxpayers were to speak unanimously, they could still speak only through their representatives. Those representatives can be expected to represent the true antithesis to the government-union interest—maximizing contributions and minimizing benefits, thus minimizing taxpayer obligations (i.e., making them the equivalent of representatives of a private employer and therefore a coherent adversary in the sort of one-on-one, face-to-face negotiations that are established by these committees)—but only if the governor, who assigns the taxpayer representatives, is both programmatically opposed to increases in pension obligations and uninfluenced by government-employee union contributions. In practice, in New Jersey, this means never. As has been considered, the public-employee unions—especially the teachers' union—are both powerful and strategic; they permit no Democratic Party divergence from strict support for the union position and have sometimes thrown their weight behind Republicans to punish straying Democrats—sometimes to great effect.[63] So while in New Jersey a Democratic Party victory—and particularly an undivided Democratic Party government, as has recently been installed—ensures deep political-branch attachment to union interests, no New Jersey executive can dare stray too far in opposition to those interests. The practical effect is that an "evenly divided" control committee is really, unavoidably, one already stacked in favor of union interests against taxpayer interests.

[63] *See* Lilley, *supra* note 8.

The final potential conflict of interest may be the most adverse to fiscal responsibility and genuine representation of taxpayer interests. Though assigned to represent taxpayers, any committee members who are themselves government employees simply cannot unreservedly represent the taxpayer interest, as they themselves will profit if the government-worker unions against whom they argue win the negotiations. If all of the governor's appointees on the board are government employees, then no one in the room—no member of the committee—wholly and without conflict represents the taxpayer's expense-minimizing position. This structure cannot be expected to do justice to New Jersey's taxpayers, and it manifestly has not.

As a result, these committees can be expected to favor increased benefits or decreased contributions any time a conclusion of 75 percent funding can be reached. They—and the political branches generally, especially given the current government configuration—can also be counted on to agree that the 75 percent funding has been reached quite generously. One method of overestimating the funding ratio has already been considered: the unjustifiably generous discount rate that the state uses to estimate future returns on current capital.[64] Similar sympathetic valuations of the expected costs of benefit increases or contribution reductions can likewise reduce the efficacy of this 75 percent funding minimum. Perhaps most dangerous are the artificial budgeting gimmicks—the most extravagant of which may well be the lottery-revenues dedication of 2017, considered just below—that have for so long characterized and distorted New Jersey's budgeting process in addition to endangering its long-term solvency.[65]

Meanwhile, a 75 percent funding target itself hardly sets a financially responsible threshold. Even in states that have otherwise achieved general financial stability, responsible

[64] While the Christie administration had scheduled the discount rate to fall in 2018 from 7.65 percent to 7 percent, the Murphy administration immediately raised the discount rate to 7.5 percent again, with promises to begin reducing again soon. *See, e.g.*, Coen, *supra* note 14.

[65] *See* Norcross & Sautet, *supra* note 6, at 17–38.

parties should not entertain sticky (i.e., hard to withdraw, once granted) benefit increases until the current promises have been fully (i.e., 100 percent) funded. Even then, the state should agree to increases only if a number of other factors obtain. The state should ensure that full funding is stable and protected against the next inevitable downturn, rather than the mere result of a short-term high point on the business cycle. It should block any increases until it has achieved full funding, using a theoretically and historically appropriate discount rate. It should move only if the state's budget is not already strained to breaking and its taxpayers not already pushed to the wall, so that any temporary miscalculations about the actual funding level of the pension programs or about the cost of the proposed benefit increases will not result in crisis. Finally, it must design any benefit increases so that its bounty is contingent; these benefit increases should continue only so long as all of the assumptions and presumptions that underlie its grant remain in place. Should funding slip below the necessary threshold, for whatever reason, the benefit increases ought immediately to decrease as necessary to restore full funding and stability. The 2011 control-committee provisions meet none of these standards.

3. The New Jersey Lottery Dedication and Alternative Income Streams

In 2017, Governor Christie and the general assembly agreed to dedicate the proceeds from the New Jersey state lottery, currently running at about $1 billion a year, to partial fulfillment of pension obligations for the next 30 years.[66]

This move was sold as an essentially costless way of firming up pension financing without cutting benefit promises for any worker.[67] The governor ensured the public that investors

[66] *See, e.g.*, Samantha Marcus, *Christie May Not Like What Wall Street Just Said About His Plan to Ease Pension Pain*, NJ.COM (Aug. 16, 2017), http://www.nj.com/politics/index.ssf/2017/08/lottery-pension_plan_doesnt_ease_njs_pension_pain.html.

and rating agencies would eagerly endorse the move, thus reducing the costs of borrowing for the state and improving its overall financial position.[68]

In fact, none of this happened.[69] None of the credit agencies retracted any of their reductions to New Jersey's creditworthiness; in fact, the kindest interpretation of the move by the markets was to find it "'slightly credit positive,' as it 'remove[d] the prospect of a complete pension contribution holiday going forward.'"[70] Most analysts thought the exercise essentially meaningless.[71]

Given the content of the lottery-revenue dedication, "meaningless" is the best interpretation available. While it does remove the prospect of a complete pension-contribution holiday *if* the provision is not suspended for any year in the next 30 years, a suspension would require nothing more than a provision in a budget agreement. The state has already demonstrated its willingness to suspend its pension-funding laws in just this way. In 2010, Governor Christie agreed with the legislature to begin addressing the state's accumulated pension underfunding, but only eventually. The plan called for the state to contribute one-seventh of the annualized (over 30 years) funding deficit (or 1/210 of the total unfunded liability), two-sevenths in 2012, and so forth. In other words, not until 2018 did the state intend to fund a full one-thirtieth of the debt and so begin getting the underfunding slowly under control.[72] Since 2014, however, the state has given up on even this gradual effort and has suspended portions of its scheduled repayment

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[67] *See id.*; John Reitmeyer, *Gov Touts Lottery as Answer to NJ's Pension Problems, but Critics Deride Plan*, NJSPOTLIGHT.COM (July 6, 2017), http://www.njspotlight.com/stories/17/07/05/christie-touts-lottery-transfer-as-answer-to-state-s-pension-problems-but-critics-deride-plan/.
[68] *See id.*; Liz Farmer, *States Get Creative on Pension Funding*, GOVERNING (July 19, 2017).
[69] *See, e.g.*, Marcus, *supra* note 66.
[70] *Id*. (quoting Moody's Investors Service, which also asserted in a report reviewing the pension-revenue dedication that, overall, it did "not alter the burden of pensions on the state's credit profile").
[71] *See id.*; Farmer, *States Get Creative*, *supra* note 68.
[72] *See, e.g.*, Jarrett Renshaw, *Christie's Overhaul May Not Save N.J. Pension System*, [NEWARK N.J.] STAR-LEDGER (Oct. 23, 2011).

obligations.[73] Dedicating the lottery profits to pension funding could have had a significant positive value if, say, the proceeds had been dedicated to paying down the state's unfunded pension debt more quickly than has been required under the amortization schedule, while the state still credibly committed to full annual funding of actual normal costs and the already-scheduled reductions in amassed underfunding. In light of its failure, year after year, to even fully fund the latter costs, the move could even have been meaningful if it had been used along with other contributions from state revenue collections to fund these already-established obligations.

This latter accomplishment would have required the state to increase other revenues or decrease other spending enough so that it had the funds available to honor its scheduled pledge. It would also have required the state to increase other revenues or decrease other spending by enough to replace or eliminate the bills that the lottery had been paying before its dedication to pension funding.

The state did none of this. Rather, it just shifted the pocket from which it pulled the money for the (partial) payments of normal costs and amortized underfunding reductions that it already intended to make.[74] It did not add to its anticipated funding levels, which still lag far below its 2011 statutory promise of full funding[75]—because, as we have seen, the state likely cannot afford to pay normal costs plus actuarially appropriate reductions of previous underfunding while remaining a going concern.[76] It did not make any attempt at paying more than the normal costs and the already-required amortized back payments each year. And, most importantly, it made no new provisions for additional revenue or decreased spending to make up

[73] *See* Reitmeyer, *supra* note 67.
[74] *See* Allan Sloan, *Why Gov. Chris Christie's Big Plan to Shore Up N.J. Pensions Is All Wet*, WASH. POST (July 14, 2017).
[75] *See, e.g.*, Reitmeyer, *supra* note 13.
[76] *See infra* pp. 5–7.

for the shifted lottery revenues.[77] The lottery dedication merely robbed Peter to (partially) pay Paul. Its financial position was not changed at all; the debts and deficits are just in Peter's name now.

Debt markets were not fooled—or impressed. But even this neutral, "merely cosmetic" evaluation of the lottery-revenue dedication may be overly optimistic. The funding dedication may materially worsen the state's position for two reasons. First, even though the move does nothing to alter the state's overall financial condition, it has allowed the state to claim that the market value of the lottery receipts over the next 30 years is an asset of the pension funds—one that can be used to boost the headline figures about how funded the pension accounts are (or, more correctly, to reduce the "book value" of the state's pension underfunding).[78]

This increase in the notional book value of the funds has two effects. First, because the value of the next 30 years of lottery revenues will be highest in early years of that period,[79] this change in notional value will give the state cover to continue, and perhaps even to increase, its deficiencies in paying even the annual normal costs plus amortized back payments of its pension promises. Evidence so far suggests that this was an intended consequence of the lottery-fund diversion—one that is already being taken advantage of.[80]

The second effect of the increased book value of total funding—described in greater detail above—is that without doing anything to solve the pension-funding crisis in New Jersey, it puts funds closer to the 75 percent notional-funding trigger that would allow the pension oversight boards actually to increase government-worker pension and healthcare benefits in

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[77] *See* Reitmeyer, *supra* note 67; Farmer, *supra* note 68.
[78] *See* Reitmeyer, supra note 67 (the book value of the pension funds' funded status increased from 45 percent to nearly 60 percent as a result of the revenue dedication); Marcus, *supra* note 66; Farmer, *supra* note 68 (quoting Municipal Market Analytics' Matt Fabian: "We believe that, at best, this transaction delays honestly confronting the pension liability problem.").
[79] *See, e.g.*, Sloan, *supra* note 74.
[80] *See id*.; Reitmeyer, *supra* note 67.

coming years, such as by reinstating the cost-of-living adjustment or otherwise increasing retirement benefits or decreasing worker contributions.[81] This presents a possibility worth monitoring, given the natural conflicts of interest built into these boards and the urgent need to reduce some classes of net benefit for some workers and retirees.[82]

The danger is enhanced because, when estimating the additional revenue that the lottery proceeds will bring to pension funding (and thus the amount by which the dedication increases the pension-funding level), the state has used the still-inflated discount rate of 7.5 percent.[83] A more realistic rate would result in the cosmetic effect of the dedication decreasing significantly.[84] Even assuming that the inflated discount rate were realistic, lottery revenues have declined a bit in recent years but are projected by the state to grow consistently in coming years.[85]

In short, the dedication of the lottery proceeds in New Jersey for 30 years to pension funding was at best an empty, cosmetic gesture. At worst, it facilitates additional underfunding by the state and raises the risk of further unaffordable retirement-benefit increases—increases that, once granted, have proven immensely difficult to withdraw.

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[81] *See infra* p. 21.

[82] Broader evidence suggests that this concern is neither limited to New Jersey nor trivial. Thad Calabrese concludes that dedicating revenue streams to pension funding tends to result, for reasons consistent with those that have characterized New Jersey's recent efforts, in benefit increases and in government claims of sounder funding unsupported by any real improvement in funding. *See* Thad Calabrese, *The Use of Locally Imposed Selective Taxes to Fund Public Pension Liabilities*, *in* FOR YOUR OWN GOOD: TAXES, PATERNALISM AND FISCAL DISCRIMINATION IN THE TWENTY-FIRST CENTURY 263 (Adam Hoffer and Todd Nesbit, ed., 2018).

[83] The Christie administration attempted to lower the rate to 7 percent—effective upon the instillation of Christie's successor, but the Murphy team reversed the decision and raised the rate back to 7.5 percent. *See* Coen, *supra* note 14.

[84] *See, e.g.*, Bob Williams, *Gambling with Lottery Revenue: The Faux New Jersey Pension Reform*, HUFFINGTON POST (July 31, 2017), https://www.huffingtonpost.com/entry/gambling-with-lottery-revenue-the-faux-new-jersey_us_597f4eace4b09982b737665b.

[85] *See, e.g.*, Daniel Takash & Anthony Randazzo, *Shifting New Jersey Lottery to Pension Is a Gamble*, REASON FOUNDATION: COMMENTARY (May 31, 2017), https://reason.org/commentary/shifting-new-jersey-lottery-to-pens/; Farmer, *supra* note 68 (quoting S&P Global Ratings analyst David Hitchcock for the proposition that "the state runs the risk of assuming its assets 'are better than what they really are'").

4. The Painful but Necessary Reforms to Come

Disinterested parties generally agree that New Jersey will be extremely hard pressed to fulfill the pension promises it has already made, even to the employees already covered. Nevertheless, the new administration appears set to continue on the current path for as long as it can. Delaying the reckoning will not soften it, however; it will only increase the likelihood of a still greater crash a bit farther down the road.

Good—if incomplete—proposals for real reform abound. New Jersey should, for instance, follow its neighbor across the Delaware River in moving new workers from the open obligations of current defined-benefit pension plans to defined-contribution 401(k) plans of the type that long ago became the norm in the private sector and the federal government. Because the taxpayers' inputs are defined in advance, such plans allow for coherent planning and funding of the sort that is simply impossible under defined-benefit plans. New Jersey will almost surely need to go further than did Pennsylvania's recent reforms, though. In its 2017 legislation, the Commonwealth made defined-contribution plans a partial option for current nonuniformed employees and a full option for new employees.[86]

New Jersey's funding deficit will likely require it to take broader action. It should, for instance, move all current workers—not just new hires—to defined-contribution plans for all work not yet performed by those employees after the date of the relevant legislation. Even this broader legislation will not address the already-accrued pension promises that, as the state itself has recently recognized, are unmeetable. It would, however, at least stabilize and cap any new obligations at—presumably—a manageable amount. It would also ensure that similarly situated employees accrue the same benefits for the same work done at the same time. Anything else does

[86] James Comtois, *Pennsylvania Governor Signs Pension Reform Bill*, PENSIONS & INVESTMENTS (June 12, 2017).

an obvious injustice and, given the significantly different demographics between older and younger workers, runs the risk of violating civil rights law. This would be a good first step.

And yet, it can only be a first step. Because the previously made promises have already grown unpayable, they will likely have to be trimmed back. The state probably cannot avoid this harsh and dreary necessity. If it acts soon, it may minimize the reductions and the pain to the neediest workers and retirees by targeting cuts carefully. If it waits until it has triggered a vicious cycle of taxpayer flight or it has otherwise narrowed its remaining options, the state will oblige itself to take more drastic and less equitable steps.

New Jersey enjoys—compared to Illinois and some of its fellow deep-crisis states—one advantage in its efforts to trim already-accrued pension promises. Some of these states, including Illinois, have tied themselves in merciless constitutional and legal knots that—according to their state supreme courts—forbid them to reduce any benefits for current workers, whenever those benefits are or were earned. New Jersey, despite the best efforts of the NJEA,[87] lacks any such confusion. The New Jersey Supreme Court has held as recently as 2015 that

> each year's appropriations act will reflect the present legislative and executive judgment as to the budgetary priority of this pressing need for which those branches will be answerable to the public and to the financial marketplace. It is not the place of this Court to dictate that judgment, for the Constitution has left such budgetary and political questions to the other two branches.[88]

In New Jersey, then, the only bars to comprehensive pension reform—i.e., reform to bring benefit promises in line with financial possibility and voter tolerance—are statutory. And what statute grants, later statutes can withdraw.

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[87] Ryan Hutchins, *With Collapse of Pension Amendment, NJEA Dives into Dem Politics,* POLITICO: NEW JERSEY (Aug. 8, 2016), https://www.politico.com/states/new-jersey/story/2016/08/with-pensions-amendment-collapse-njea-dives-into-dem-politics-104586.

[88] Burgos v. New Jersey, 118 A.3d 270, 275 (N.J. 2015). *See also* Spina v. Consol. Police & Firemen's Pension Fund Comm'n, 197 A.2d 169, 176 (1964) (pension promises neither a gratuity nor an enforceable contractual right. "We think it more accurate to acknowledge the inadequacy of the contractual concept.").

The state must focus on two considerations when reducing benefits that have already been promised for work that has already been performed. Those considerations are equity and misfeasance (whether intentional or unintended but structural) arising from conflicts of interest and inappropriate union-favoring bargaining procedures established by past pension and benefit laws. The two considerations will often interrelate: overly generous pension benefits that take clear advantage of taxpayer funding will often provide the clearest evidence that past bargaining processes were wrongly skewed in favor of certain government employees, so that adjusting for equity will effectively correct—as far as is still possible—for any such negotiating imbalances. Equitable considerations, then, are considered first below.

When contemplating reducing benefits for work already completed, the highest consideration must be equity. Equity demands above all that elderly and infirm individuals, who have already served a career in government work, not be impoverished. On the other hand, equity forbids the state, in close negotiations with government-employee unions, to impoverish New Jersey's taxpayers, to denude those taxpayers of government-provided services, or to dissolve the state as a functioning concern as a result of taxpayer flight or outright insolvency, in order to fund extravagant government-employee pensions—pensions that will in very many cases far exceed those that private-sector taxpayers can ever hope to accumulate.

These competing considerations counsel for adopting comprehensive pension limitations and reductions that first cut across accidents of negotiation or other contingent circumstances to ensure that savings arise in the fairest ways possible. One reform might be to cap all pension benefits for all current and future retirees collecting under the defined-benefit formula at some absolute figure. This could be a fixed number, such as $125,000 per year (as New Jersey has a particularly high relative cost of living), perhaps then adjusted for inflation or cost-of-living considerations. The cap could also take the form of a formula, such as twice the average cost of living in the state for each relevant payment year. In either case, the cap could be prorated for workers who spent only part of their careers working for the state of New Jersey or its municipalities.

A more sophisticated version of either of these caps could float depending upon what might be required to allow the state to fully fund the normal costs of its pension obligations for a given year, while making that year's actuarially appropriate contribution to paying down the pension-fund deficit that has accumulated for past years. The disadvantage of the floating-cap proposal is that it would leave pension beneficiaries relatively unsure of their income for future years, though of course they could always use the floor of the range as their expectation for planning purposes, treating the rest in any year as windfall.

This cap, however constituted, would at a stroke save the taxpayers from funding the state's greatest extravagances while simultaneously placing the first burden for bringing the pension program back into balance on parties most able to assume it.

In addition to this overall cap, the state might institute additional savings. It might add a further limit, capping any government employees or retirees at an annual pension limit equal to—at most, and independent of accumulated sick days, vacation days, or overtime pay—an average of their annual pay in each of their last, say, three years of work. This secondary cap would stop employees from making more in retirement than they did while they were working—a cap that wholly meshes with considerations of equity. The limitations arise to minimize the effects of "pension spiking," a practice of including in a final year's salary the cash-out value of that employee's unused vacation and other leave or significant overtime payments—all of which inappropriately inflate the final salary figure upon which pension benefits are based. (Of course, spiking could also be forbidden explicitly by statute.) This secondary cap could also be indexed to inflation. Additional savings could be achieved by subtracting from each year's pension ceiling the amount that pensioners will earn in Social Security benefits for that year, thus more tightly binding their pension income to their actual, uninflated final years' earnings and avoiding unaffordable overgenerosity of payment.

These twin caps would ensure that any savings achieved by decreasing previously promised benefits for previously accomplished work would occur carefully and fairly, with firm guarantees that no employees who had dedicated a career to government work and who had not gamed the system would find themselves living in penury—or, in fact, in conditions any worse than any honest employee could reasonably expect. A secondary advantage of these caps is the work they do to diminish benefits flowing to bad-faith employee behaviors without having to undertake massive individualized investigations or even to impute bad faith to almost any present or retired government employees. They achieve this effect by curbing the benefits that would otherwise have flowed to those who had gamed the system for their own benefit or had taken advantage of gaming opportunities established on their behalf (as by pension spiking or by collecting significant pension benefits from more than one position) merely as a by-product of doing equity.

These caps might contain additional provisions expressly designed to catch as many fishy situations as possible—for example, by setting the second, salary-specific cap at the maximum amount made by any given employee to the one highest-paid eligible position, to eliminate the problem of double-dipping. The state might also forbid any pension benefits to be paid out to employees who are still earning full-time government salaries in New Jersey to stop the fairly pervasive practice of employees working the required number of years at one position, earning a pension and "retiring," and then taking a separate government position for the rest of their working careers, allowing them to collect pension benefits before they had really retired from state work and to milk inordinately generous annual public support from heavily burdened taxpayers.[89] The state might adopt other rules—independent of the comprehensive caps—aimed at radically reducing or stripping away pensions from those reliably proven to have acted by fraud or collusion. By and large, though, equitably and thoughtfully devised pension-compensation caps will do the work of justice—unwinding the worst abuses enacted under what can at best be characterized as a deeply conflicted policy-development system. This system is fraught with disproportionate union representation and thoroughgoing agency problems—largely as a by-product of achieving equity for pension beneficiaries and taxpayers alike, while returning the state—at least as regards pension funding—to some sort of financial stability.

5. Conclusion

New Jersey faces an immediate and dire pension crisis. Over decades, it has mismanaged its pension policy and funding in myriad ways, such that it is extremely unlikely to be able to meet the promises it has already made to retirees and current workers for work already performed, much less extend these promises to work not yet performed or employees not yet hired. As a result, the state will likely have to move all workers to defined-contribution pensions for work not yet performed and make careful reductions in already-promised benefits

[89] *See, e.g.*, "Burypensions," *$1 Billion to NJ Double-Dippers*, BURYPENSIONS BLOG (Aug. 17, 2017), https://burypensions.wordpress.com/2017/08/17/1-billion-to-nj-double-dippers/ (listing current and former government workers who either collect two or more pensions from the state or who collect a pension while continuing to draw a salary from the state. The article claims that should double-dipping be outlawed, the state would save nearly $600 million in salaries not paid and over $400 billion in pensions unpaid each year. The article itself, however, notes that the analysis undertaken by the authors is rough, and the authors do not seem to account for the fact that some retirees, if not permitted to collect pension benefits and salary at the same time, would elect to resign from their jobs in order to collect their pensions, meaning that others would have to be hired at some unspecified expense to fill those positions, thus decreasing the savings to be achieved by eliminating these double-dipping opportunities. Nevertheless, the author's conclusion that this practice is flawed and should be corrected by any comprehensive reform efforts is sound.).

to some classes of beneficiaries—namely, those best able to absorb the reductions and those who would otherwise have enjoyed, at taxpayer expense, pension benefits greater than the best normal salaries they had ever earned.

These unpleasant tasks likely cannot be avoided. They can be delayed for somewhat longer, but delay will likely increase the costs of reform while rendering the eventual cuts less equitable. Further tax increases on the already-groaning taxpayers of New Jersey are likely to slow the state's economy further while setting off further waves of taxpayer flight to less heavily taxed (and better governed) jurisdictions. The lottery-revenue dedication (to the extent that it is not a meaningless gesture) actively threatens to stimulate a last round of pension-benefit increases, thereby compounding the eventual pain when cuts can no longer be avoided. And any moves to put even more pension-policy authority in the hands of already overrepresented government-employee unions represent a dereliction of fiduciary duty on the part of elected government officials and should perhaps be deemed an effective, even if not technically a legal, fraud and collusion against the people of New Jersey.

The state's political branches must face their hard task. They must seriously consider comprehensive pension reform, applicable to the whole of the government-employee pension system. The state's political branches, and New Jersey, have no time to lose.