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Unfunded employee pension obligations will present a serious fiscal problem to state and local governments in the not too distant future. This article takes a looks at the causes and potential cures for the public pension mess, mainly through the lens of legal doctrines that limit public employers' ability to avoid obligations. As far as the causes are concerned, this article examines the political environment within which public pension promises are made and funded, as an attempt to understand how this occurred. The article then turns to ask if states could implement meaningful reforms without violating either state or federal law. In particular, the article looks at state balanced budget requirements, state constitutional provisions regarding public employee pensions, and federal constitutional law, and asks whether states could significantly reduce their pension promises to public employees without violating the law. The entire analysis must also be informed by the concerns of the employees and retirees whose perhaps sole source of retirement income would be reduced by changes in benefit levels. The article concludes with remarks placing the matter in that context, raising the possibility of a bailout to ameliorate the possibly disastrous consequences of reform to public employees and retirees.

The Public Pension Crisis

Jack M. Beermann*

The first decade of the new millennium was a difficult one for state and local government finances, and the second decade has started out even worse. In addition to the difficulty governments at all levels are experiencing in trying to maintain services without raising taxes, some analysts claim that many state and local governments are sitting on a fiscal time bomb; — underfunded public employee pension and health care liabilities[1] that threaten to destroy the fiscal well-being of many state and local governments. Some accounts predict that absent significant benefits reductions (which may not be legally feasible), state and local governments will soon be devoting an untenably large portion of their budgets to making pension payments and satisfying other obligations to retired workers.

Unfunded liabilities are possible because government pensions are still largely defined benefit plans, and the law generally does not require full advance funding of the projected costs of accrued benefits. In a defined benefit plan, an employee is promised a specific dollar amount of retirement benefits, usually based on the employee's final salary. These promises are often accompanied by promises of lifetime government-financed health care, without regard to the cost to the public employer. Although states operate under balanced budget requirements, it turns out

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[1] This article focuses primarily on unfunded pension liabilities. State and local governments also have substantial unfunded health care liabilities, and a few distinct aspects of that problem are highlighted in this article.

that underfunding pension obligations does not violate these state law requirements. Thus, current taxpayers are able to push off pension and other promises to retirees to future generations of taxpayers.

Private industry has moved away from defined benefit plans toward contribution plans, under which employers contribute a fixed amount to an employee's retirement plan and the employee receives retirement benefits based on the performance of the investments purchased with the contributions. The advantage of a contribution plan to employers is obvious—certainty. Once an employer makes the contributions required under the plan, there is no chance that actuarial miscalculations or market downturns will require additional contributions in the future. The employee, not the employer, bears the risk of a market downturn or inflation that might reduce the value of the pension.

Defined contribution plans also have some advantages for employees. First, employees may gain control over their funds and have the power to direct investments to their preferred level of risk. Second, employees' retirement funds are not subject to the solvency of the employer. There is no opportunity for employers to manipulate contribution levels. Further, once the employer's money is deposited into the account, the employer cannot raid the fund or take any other action that would prejudice the employees' ownership of the fund.[2]

While most public employers and employees in the United States set aside money each year to fund future projected pension obligations, many public pension plans are seriously

[2] This is not to say that private contribution retirement plans are risk free, but federal regulation under ERISA prevents private companies from failing to make required payments. Employees may suffer if their plan is terminated due to the insolvency of the employer or the inability or unwillingness of the employer to continue to contribute, but past contributions are largely safe in private plans.

underfunded either intentionally or due to unrealistic assumptions concerning investment performance and the amount that will be owed over time. This means that unless contributions are increased substantially, future pension payments to retired government workers will be made, at least in part, from current revenues. The problem is thought to be so serious that some local governments may be effectively insolvent. Retirees face the risk of reduced pension payments and current employees face the risk of receiving less generous retirement benefits than the promises that they have been depending upon.

In the private sector, ERISA[3] and programs administered by the Pension Benefit Guaranty Corporation provide a mechanism to deal with insolvent pension plans and the outstanding pension obligations of bankrupt private firms.[4] The financial consequences of pension plan insolvency to private companies and their employees may be disastrous, but ultimately they can be resolved in an orderly manner without forcing the company to pay all of its obligations. State and local governments have fewer options. State law and the Contract Clause of the United States Constitution may make it impossible for states to enact meaningful pension reform or simply discharge obligations that are too difficult to meet. Even if a state is insolvent, the federal Constitution may demand complete payment of all pension obligations. Bankruptcy may be an option for municipalities, but that is a very drastic step, not open to all municipalities, and is not available to the states themselves.

[3] Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461. ERISA makes underfunding of private pension liabilities unlawful.
[4] For a suggestion that ERISA be extended to state and local pensions, see Jon G. Miller, *Is Your Client's Government Pension Safe?: Making the Case for Federal Regulation*, 2 ELDER L.J. 121 (1994).

Even if everyone agreed that the best option would be to move away from defined benefit plans to defined contribution plans, implementing this change could be difficult because of the magnitude of unfunded liabilities. If paying current retirees' benefits depends on contributions from active government employees and current tax revenues, it may be impossible to move current employees to contribution plans without magnifying the crisis beyond manageability.

The public pension crisis raises three separate concerns. The first involves the potential fiscal disaster that some predict will occur years from now, when public employers are required to pay the pension benefits they have been promising to public employees for many years. The second concern is the reduction in government services that may be necessary to make these payments, which could lead to great taxpayer dissatisfaction and political instability. The third concern involves the consequences to public employees and retirees, especially those who did not participate in Social Security, who could be left with insufficient assets for a decent retirement.

Underfunding public pensions is in substance, if not in form, an example of deficit spending in which current taxpayers enjoy the benefits of government services while pushing off some of the costs to future taxpayers. It's a double whammy for those future taxpayers— they will not only be required to pay for the consumption of prior generations, but will also receive reduced government services as state and local governments allocate funds to pensions and health care for retired workers rather than services for current taxpayers

It should be noted that some analysts deny that there is a crisis in public pension costs looming just over the horizon. In their view, the total unfunded pension and health care liability of state and local governments is relatively small when compared to the overall revenues of state and local government. They also point out that average pension earned by retired government workers is small—under $20,000 per year. On this view, the "pension" crisis is an effort by conservative political forces to undermine public employee unions whose members tend to support liberal politicians and views.

Although the matter is not free from doubt, this article proceeds on the assumption that there is at least some truth to the conclusion reached by many, that pension obligations will present a serious fiscal problem in the not too distant future. This article takes a looks at the causes and potential cures for the public pension mess, mainly through the lens of legal doctrines that limit public employers' ability to avoid obligations. As far as the causes are concerned, this article examines the political environment within which public pension promises are made and funded, as an attempt to understand how this occurred. The first issue here is whether the promises governments have made to public employees are extravagant in light of their pay, benefits, job security and opportunities for advancement of state and local government workers as compared to workers in private industry. The article then turns to ask if states could implement meaningful reforms without violating either state or federal law. In particular, the article looks at state balanced budget requirements, state constitutional provisions regarding public employee pensions, and federal constitutional law, and asks whether states could significantly reduce their pension promises to public employees without violating the law. The entire analysis must also be informed by the concerns of the employees and retirees whose perhaps sole source of retirement income would be reduced by changes in benefit levels. The article concludes with remarks placing the matter in that context, raising the possibility of a bailout to ameliorate the possibly disastrous consequences of reform to public employees and retirees.

I. The political economy of public pensions

There are at least three separate issues regarding the political economy of public pension funding. First is the basic question of whether unfunded retirement promises to government workers constitute a fiscal crisis or whether the issue has been created as a means of attacking public employee unions or generally attempting to reduce compensation to public workers.[5] The second issue concerns the nature of retirement promises to government workers: i.e., are the promises excessive and subject to manipulation and abuse, or are they simply part of a perhaps generous, but reasonable overall, compensation package? The final issue is, assuming that public employee retirement benefits are excessive or subject to abuse, how did this happen: i.e., why would elected officials provide excessive retirement benefits to government employees?

A. How Large is the Potential Fiscal Problem?

[5] Attention to the underfunding of public pensions is not new. An early hint at the forthcoming crisis was a 1976 Harvard Law Review note discussing potential problems that might arise regarding public pensions in difficult fiscal times, such as altering the eligibility and benefits rules and moving investments into state securities. *See* Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992 (1976). In 1978, the Pension Task Force Report on Public Employee Retirement Systems (1978) estimated state and local unfunded pensions liabilities at $150 to $175 billion. A 1979 report to Congress by the Comptroller General characterized the underfunding of state and local pensions as a national problem. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, HRD-79-66, FUNDING OF STATE AND LOCAL PENSION PLANS: A NATIONAL PROBLEM (1979). This report noted that most of the pension funds it analyzed were underfunded using ERISA standards. *Id.* at 19. A 1981 article in the journal Public Choice posited two explanations for continued growth in unfunded pension liabilities: Increased income of municipal employees made deferred compensation more attractive to the employees and demand for public services due to baby boomers going to public schools grew faster than the tax base, which made deferred compensation attractive to governments. *See* Dennis Epple & Katherine Schipper, *Municipal Pension Funding: A Theory and Some Evidence*, 37 PUBLIC CHOICE 141, 170 (1981).

The public pension crisis is all over the news. Analysts refer to unfunded pension obligations as a ticking fiscal time bomb likely to cause serious problems in the future.[6] California is the state with the largest unfunded pension obligations, and recent reports predict that without significant, immediate reform, public services in California will face drastic cuts as more and more of the state's budget is devoted to making pension payments. Others dispute this and argue that pension obligations constitute a relatively small portion of state budgets and should be manageable over time. Which view is more accurate?

Those claiming that there is a public pension funding crisis seriously outnumber those making the contrary claim that pension debt is manageable. One study reported that unfunded obligations to public school teachers alone have been stated to total $332 billion, but the study's own calculations put the figure at $933 billion or nearly a trillion dollars.[7] The PEW center estimates are on the lower end, with a total of $1.38 trillion estimated to be underfunded for both pensions and retiree health care benefits, for all state and local employees.[8] A report by the Little Hoover Commission, a bi-partisan state oversight agency, estimates the unfunded liabilities of California's 10 largest public pension plans (of a total of 87 studied) at $240 billion, and predicts that large cities in California will soon be devoting one-third of their operating

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[6] Problems with funding of public pensions are not confined to the United States. Many nations have underfunded public employee pension plans. Some are completely or partly "pay as you go" which means by design, no funds are set aside to pay future pension obligations—all benefits are paid out of the current budget. *See generally* Eduard Ponds, Clara Severinson & Juan Yermo, *Funding in Public Sector Pension Plans-International Evidence* (Nat'l Bureau of Econ. Research, Working Paper No. 17082 (2011)).

[7] *See* JOSH BARRO & STUART BUCK, FOUND. FOR EDUC. CHOICE OF THE MANHATTAN INST. REPORT FOR POLICY RESEARCH, UNDERFUNDED TEACHER PENSION PLANS: IT'S WORSE THAN YOU THINK (2010) (claiming $933 billion shortfall in teacher pension funding).

[8] *The Widening Gap Update*, PEW CENTER ON THE STATES, June 2012, *available at* http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Retirement_security/Widening%20Gap%20Brief%20Update_webREV.pdf. *See also Promises with a Price: Public Sector Retirement Benefits*, PEW CENTER ON THE STATES, (2005), *available at* http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/State_policy/pension_report.pdf. This is an excellent comprehensive report on the finances of state retirement promises.

budgets to pension payments.[9] Another study concludes that to achieve full funding, government contributions to employee retirement, including social security and pensions, will have to increase by 250%, representing 14.1% of total revenues.[10] A Mercatus Center study has estimated the national gap to be approximately $3 trillion,[11] as does a 2012 report by a group chaired by former New York Lieutenant Governor Richard Ravitch and former Federal Reserve Board Chair Paul Volcker.[12] A new study, published in July, 2012, comes to this startling conclusion: "the average public employee pension plan in the United States is only around 41 percent funded while total unfunded liabilities as of 2011 are roughly $4.6 trillion."[13] Another analysis, by an economist at the Center for Economic Policy and Research, estimates the

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9 LITTLE HOOVER COMMISSION, PUBLIC PENSIONS FOR RETIREMENT SECURITY 3 (2011).

10 Robert Novy-Marx & Joshua D. Rauh, The Revenue Demands of Public Employee Pension Promises 1 (Simon School Working Paper No. FR 11-21, June 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1973668. This conclusion depends on important assumptions concerning investment performance and the effect that revenue shifts and increased taxes would have on the stability of the tax base.

11 *See* Eileen Norcross & Andrew Biggs, *The crisis in public sector pension plans: a blueprint for reform in New Jersey* 1 (Mercatus Center, Working Paper No. 10-31, 2010). One problem is that there is no uniform standard for reporting the level of pension ("Using methods that are required for private sector pensions, which value pension liabilities according to likelihood of payment rather than the return expected on pension assets, total liabilities amount to $5.2 trillion and the unfunded liability rises to $3 trillion."). For a proposal to create a uniform standard for reporting pension funding, see Daniel J. Kaspar, *Defined Benefits, Undefined Costs: Moving Toward a More Transparent Accounting of State Public Employee Pension Plans,* 3 W. & M. POL'Y REV 1 (2011), *available at* http://ssrn.com/abstract=1926234.

12 REPORT OF THE STATE BUDGET CRISIS TASK FORCE 2, 34-35 (2012), *available at* http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf. This report provides a comprehensive look at state finances, including structural problems it concludes were exposed during the economic recession beginning in 2008. Increased Medicaid spending and potential reductions in federal grants are cited as primary contributors to current state fiscal problems. It arrives at its $3 trillion estimate of underfunding by using a lower discount rate than the 8 percent rate of return commonly used by pension plans to estimate the amount current funds will cover in future liabilities. It also estimates unfunded medical care promises as "likely to be well above $1 trillion." *Id.* at 43. And the report notes that governments rarely set aside anything in advance to meet those promises. *Id.*

13 ANDREW G. BIGGS, STATE BUDGET SOLUTIONS, PUBLIC SECTOR PENSIONS: HOW WELL FUNDED ARE THEY REALLY (2012), *available at* http://www.statebudgetsolutions.org/doclib/20120716_PensionFinancingUpdate.pdf. This study also observes that the funding problem has gotten much worse relatively recently: "According to standard actuarial accounting, the average public pension has fallen to around 75 percent in 2011, versus 103 percent in 2000." *Id.*

shortfall at $647 billion, using traditional rates of return for pension fund assets.[14] This is a significant shortfall, but much lower than the $3 or $4 trillion figures used by others.

To put the magnitude of underfunding in perspective, the federal government's total debt as of March, 2012, is approximately $16.5 trillion[15] as compared to $3.8 trillion in annual spending, while total state and local spending per year is approximately $2.9 trillion with an estimated $2.6 trillion total debt.[16] It is unclear whether this estimate of state and local debt includes unfunded pension liabilities. Assuming it doesn't, counting $3 trillion in unfunded pension liability and $1 trillion in unfunded retiree health care benefits promises would put the total state and local debt at approximately $6.5 trillion, or about 2.5 years of total spending, while the federal government's debt equals more than 4 years of total federal spending. Websites like pensiontsunami.com (devoted to California's pension issues) exemplify the near-consensus that pension obligations are a ticking fiscal time bomb for state and local governments.[17]

The contrary view—that there is no public pension funding crisis—is best exemplified by an article published on the Huffington Post titled, "An Overblown 'Crisis' For State Pension Funds"[18] and Monique Morrissey's study titled "Discounting Public Pensions: Reports of

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[14] DEAN BAKER, CTR. FOR ECON. AND POLICY RESEARCH, THE ORIGINS AND SEVERITY OF THE PUBLIC PENSION CRISIS (2011), *available at* www.cepr.net/documents/publications/pensions-2011-02.pdf.
[15] For a current estimate of the national debt of the United State, see U.S. NATIONAL DEBT CLOCK, http://www.brillig.com/debt_clock/.
[16] Unless otherwise indicated, the figures in this paragraph are drawn from U.S. GOVERNMENT SPENDING, http://www.usgovernmentspending.com/.
[17] Another example of an analysis claiming that there is a crisis is a 2010 report by Taxpayers for Wilson. HARRY J. WILSON, PUBLIC PENSIONS: AVERTING NEW YORK'S LOOMING TAX CATASTROPHE,(2010), *available at* http://wilsonfornewyork.com/white_papers. This report was issued by the campaign of a candidate, Harry Wilson, for New York State Comptroller. Wilson lost the election.
[18] Zach Carter, *An Overblown "Crisis" For State Pension Funds*, HUFFINGTON POST, Mar. 7, 2011, *available at* http://www.huffingtonpost.com/2011/03/07/state-pension-plans_n_829112.html.

Trillions in Shortfalls Ignore Expected Returns on Assets."[19] These articles claim that state and local pension obligations are manageable, and that the contrary view is based on conservative analysts using low projected rates of return on pension fund assets to make the funding gap look larger than it actually is. Morrissey's study claims that to meet the actual shortfalls, state and local governments would have to increase their pension funding from 4 percent of their budgets to 5 percent, a significant but manageable increase. While many studies attack state and local pension funds for justifying low current contributions by predicting an 8 percent return on investments, Morrissey claims that 8 percent is historically accurate and more realistic than the much lower Treasury Bill rate used by those claiming that a crisis exists.

A particularly comprehensive study claiming that unfunded pension liabilities do not present a severe problem was published in 2007 by the Government Accountability Office, the research arm of Congress.[20] That study found that "the additional contributions that state and local governments will need to make in future years to fully fund their pensions on an ongoing basis are only slightly higher than the current contribution rate."[21] Specifically, the study found that "contribution rates would need to rise to 9.3 percent of salaries, less than a half percent more than the 9.0 percent contribution rate in 2006."[22] The GAO report was much more concerned with health care costs because many governments do not set aside anything to fund health care

[19] MONIQUE MORRISSEY, ECON. POLICY INST., DISCOUNTING PUBLIC PENSIONS: REPORTS OF TRILLIONS IN SHORTFALLS IGNORE EXPECTED RETURNS ON ASSETS *(*2011).
[20] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-1156,STATE AND LOCAL GOVERNMENT RETIREE BENEFITS: CURRENT STATUS OF BENEFIT STRUCTURES, PROTECTIONS, AND FISCAL OUTLOOK FOR FUNDING FUTURE COSTS (2007).
[21] *Id.* at 27.
[22] *Id.* This study was conducted before the financial crisis and recession that began in 2008, so it is unclear if these calculations are still accurate. A slightly more recent study of funding status of state and local government retiree benefits is U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-223, STATE AND LOCAL GOVERNMENT RETIREE BENEFITS: CURRENT FUNDED STATUS OF PENSION AND HEALTH BENEFITS (2008).

promises, and if health care costs continue to rise, it may be difficult for the promises to be fulfilled.[23]

The Huffington Post article reveals the political nature of this dispute. The article characterizes the Economic Policy Institute, which concludes that there is no serious problem, as "partly funded by unions," and attacks the Mercatus study as unreliable at least partly because the Mercatus Center is funded by the Koch brothers, well-known conservative activists. Morrissey points out that the same conservatives who use the low Treasury bill rate as the expected return on pension fund assets touted privatization of Social Security accounts on the basis of much higher returns in the stock market.

My sense is that while there may be some exaggeration out there, the pension funding crisis is real. In a detailed review of public pension financing, Jonathan Forman makes a convincing case that there is a funding problem.[24] As Forman explains,

> [b]ecause governments tolerate an 80% funding level and use actuarial valuations instead of market valuations, public pensions are almost guaranteed to be underfunded. Public sector workers tend to get larger pensions as a result, but much of the cost of those larger pensions is pushed onto future generations of taxpayers.[25]

[23] Another report concludes that while in 2010, 3.8 percent of state and local budgets were devoted to paying pension costs, that figure would rise to somewhere between 5 and 12.5 percent, depending on the health of the plan and investment outcomes. *See* ALICIA H. MUNNELL, JEAN-PIERRE AUBRY & LAURA QUINBY, CTR. FOR RET. RESEARCH, THE IMPACT OF PUBLIC PENSIONS ON STATE AND LOCAL BUDGETS (2010). Some states would have more serious problems however. For example, the authors predict that Illinois, a state with severe underfunding of pension plans, may have to devote approximately 17 percent of its state budget to meet all of its pension obligations. *See id.* at 6, fig. 9.

[24] Jonathan B. Forman, *Funding Public Pension Plans*, 42 J. MARSHALL L. REV. 837 (2009).

[25] *Id.* at 860. Forman explains that "bad things happen" when pension funds are fully funded because employees often successfully lobby for increased pension benefits and legislatures reduce payments or take funding "holidays" to use the money for other purposes. Surprisingly, Forman nevertheless calls for full current funding but proposes a more radical restructuring for future government employees that would either eliminate the traditional method of calculating pension payments based on the highest salary or replace benefit plans with contribution plans.

The 2012 analysis by a group led by Paul Volker, with distinguished members such as Alice Rivlin, Nicolas Brady, and George Shultz, concludes that unfunded pension and retiree health care liabilities are significant and absent serious reform, will contribute to future fiscal problems.[26] The amount of time and energy being devoted to raising alarms about the fiscal consequences of promises to retirees by responsible groups seems out of proportion if the purpose is to mount an indirect attack on public employee unions and public collective bargaining. While some politicians may have used this pension issue as a basis for attacking public employee unions, there seems to be genuine concern over future pension funding from a diverse array of observers, including the New York Times which does not generally carry the flag for conservative causes.

The situation with health care promises to retirees may be even worse than the pension problem because fewer state and local government entities have set aside any funds to pay for those expenses. Coupled with serious inflation in the cost of health care and health insurance, the failure to set aside funds to pay for this may prove disastrous as more workers retire.

B. Are Public Pension Promises Excessive or Abusive?

While the point is subject to dispute, let's assume that unfunded promises to current and future retirees constitute a significant fiscal problem for state and local governments. The next set of questions involves whether excessive promises of retirement benefits have been made to public employees and whether public pension plans are subject to abuse.

[26] REPORT OF THE STATE BUDGET CRISIS TASK FORCE, *supra* note x. For an analysis of the likely consequences to retiree health care benefits, see Richard Kaplan, Nicholas Powers & Jordan Zucker, *Retirees at Risk: The Precarious Promise of Post-Employment Health Benefits*, 9 YALE J. HEALTH POL'Y L. & ETHICS 287 (2009).

The defense of defined benefit public pensions often begins by pointing out that the average government employee pension is less than $20,000 per year, which certainly does not sound excessive. It is not clear, however, whether this is a meaningful figure. There are many government pension recipients who worked for the government just long enough to qualify, and who thus receive very small pensions. What really needs to be examined is the pension available to the government employee who makes a career in government service, how that fits into the overall compensation package for government employees, and how public retirement benefits compare to the retirement benefits available to private sector employees.

One possibility that should be dismissed is to make a direct comparison between public sector pensions and federal Social Security retirement benefits. One could imagine comparing contributions and benefits and ask whether public pension recipients are receiving overly generous benefits. There are two sets of reasons why this comparison is not apt. First, Social Security taxes pay for aspects of the program that go far beyond retirement benefits. In addition to retirement benefits, FICA pays for disability benefits, survivor benefits for spouses and children, a small death benefit, and potential benefits for multiple former spouses. Further, Social Security is fully portable between jobs. Second, public sector pensions are part of the state and local employees' compensation packages from their employer. In principle, the magnitude of their contributions to the fund is irrelevant to whether the pension promises are overly generous. When a person decides whether to accept government employment, and to remain in government employment when other opportunities arise, pensions and other post-employment benefits are undoubtedly part of the calculus. Current salary may be lower for government employees in the public sector than for workers in the private sector, and the public sector may offer fewer opportunities for advancement, especially for those without political connections. Greater job security, pensions and retiree health care promises may balance these factors out, so that overall the promises to retirees are not out of line. As a form of deferred compensation, public sector pensions may be perfectly reasonable.

Thus, even if it is true, as one study claims, that public pensions can be 4.5 times higher than social security benefits based on the same work history, this may not establish anything about the fairness of public pensions.[27] This possibility should also be tempered by the fact that social security recipients contribute less than many public pension recipients. Before recent stimulus measures, the combined employer-employee contribution to social security was 12.4% of the first $110,00 of income, while the combined contribution to public pensions in some jurisdictions may be closer to 20% or even more.[28] There may be states and localities in which employees are required to contribute much less, with the expectation that the government will fund retirement benefits, but again, the real question is whether the pension is reasonable as an element of compensation, not as a direct comparison with Social Security benefits.[29]

[27] It may also be the case the Social Security is underpaying based on contributions. For an argument that Social Security is a bad deal for current workers, see Jagadeesh Gokhale & Laurence J. Kotlikoff, Social Security's Treatment of Postwar Americans: How Bad Can It Get?, in The Distributional Effects of Social Security Reform, (Martin Feldstein, ed.), University of Chicago Press (2002).

[28] *See Social Security Benefits vs. Public Pensions*, CIV FI (May 8, 2010), http://civfi.com/2010/05/08/social-security-vs-public-pensions/. One report states that in Missouri, combined teacher and employer contributions have risen to 29% of salary in an attempt to accumulate sufficient equity to support promised pensions. See Robert Costrell, Michael Podgursky,and Christian Weller, "Fixing Teacher Pensions," Education Next, Fall 2011, pp. 60-69. http://educationnext.org/files/ednext_20114_forum.pdf. The authors advocate tying pension payments strictly to contributions and actual investment performance.

[29] It may be more useful to compare the replacement rate of public pensions with the replacement rate of private pensions. The replacement rate is the percentage of salary replaced by the pension. In 1985, a study calculated that the average worker retiring in 1984 at a $40,000 salary with 40 years of service received a pension replacing 32.3% of salary. See Donald Schmitt, Today's Pension Plans: How Much Do The Pay?, Monthly Labor Review December 1985 22, Table 5. These retirees would also receive Social Security benefits which would replace another portion of their salaries. Still, this is likely to be a lower replacement rate than what many public sector employees receive today.

This picture is complicated by disagreement over whether public sectors workers truly earn less in current and overall compensation than their private sector counterparts. In some circles, it is now widely thought that public sector workers earn greater total salary and benefits than comparable private sector workers. For example, the Bureau of Labor Statistics found that in December 2010, private sector workers earned approximately $28 per hour in total compensation, while their public sector counterparts at the state and local level earned approximately $40.[30]

Politicians have noticed this purported fact: Indiana Governor Mitch Daniels has described public sector workers as "a new privileged class in America,"[31] while former Minnesota Governor Tim Pawlenty stated: "It used to be that public employees were underpaid and over-benefited. Now they are over-benefited and overpaid compared to their private-sector counterparts."[32] It is unclear, however, whether this is due to gains by public employees or losses in the private sector, where defined benefit pension plans have virtually disappeared along with many high paying jobs.

As should be expected, it is also not clear whether the apparent compensation disparity between public and private sector employees is real. Views on this seem to fall out along similar political fault lines as whether the funding crisis is real or imagined. Some studies dispute the disparity theory by claiming that higher pay for government workers is attributable to age,

[30] BUREAU OF LABOR STATISTICS, EMPLOYER COSTS FOR EMPLOYEE COMPENSATION – DECEMBER 2010 1 (2011), *available at* http://www.bls.gov/news.release/archives/ecec_03092011.pdf.
[31] Ben Smith & Maggie Haberman, *Pols Turn on Labor Unions*, POLITICO, June 6, 2010, *available at* http://www.politico.com/news/stories/0610/38183.html.
[32] Joe Kimball, *Gov. Pawlenty: Public Employees Are "Over-Benefited and Overpaid"*, MINNNPOST.COM, Apr. 30, 2010, *available at* http://www.minnpost.com/politicalagenda/2010/04/30/17788/gov_pawlenty_public_employees_are_over-benefited_and_overpaid.

education, and skill level required for the jobs.[33] When one accounts for these and similar traits, it is argued that public sector workers are undercompensated relative to their private sector counterparts.[34] One 2010 study, by the Center for Economic and Policy Research, found a 4% wage "penalty" for public sector workers, taking into account wages and benefits, and controlling for age and education.[35]

There is no question that public employees as a group receive vastly higher defined benefit pension compensation than private employees, since most private employers have halted the practice. Many public employees, about one in four, are not in the Social Security system, which means that their state pension is their only source of employer and government support in old age. It would be grossly unfair to state employees if pension reform did not take into account the fact that they don't participate in the federal Social Security system. Comparing the raw numbers between private and public employee pension payments should take Social Security into account, especially since participating employers and employees both contribute to Social Security.

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[33] *See* Jeffrey Keefe, *Debunking the Myth of the Overcompensated Public Employee: The Evidence* 3 (Econ. Policy Inst., Briefing Paper No. 276, 2010) ("Prior research revels that education level is the single most important earnings predictor."); JOHN SCHMITT, CTR. FOR ECON. AND POLICY RES., THE WAGE PENALTY FOR STATE AND LOCAL GOVERNMENT EMPLOYEES 3 (2010); SYLVIA A. ALLEGRETTO & JEFFREY KEEFE, BERKELEY CTR. ON WAGES AND EMP'T DYNAMICS, THE TRUTH ABOUT PUBLIC EMPLOYEES IN CALIFORNIA: THEY ARE NEITHER OVERPAID NOR OVERCOMPENSATED 3 (2010) ("a re-estimated regression equation of total compensation (which includes wages and benefits) demonstrates that there is no significant difference in total compensation between full-time state and local employees and private-sector employees") (emphasis omitted); KEITH A. BENDER & JOHN S. HEYWOOD, NAT'L INST. ON RET. SEC., OUT OF BALANCE? COMPARING PUBLIC AND PRIVATE SECTOR COMPENSATION OVER 20 YEARS (2010) (concluding that on average state and local employees are underpaid when compared to private-sector workers by approximately 7 percent); Michael A. Miller, *The Public-Private Pay Debate: What Do the Data Show?* 119 MONTHLY LAB. REV. 19 (1996) (finding mixed results with lower level state and local workers earning more than their private counterparts but higher level workers earning more in the private sector than the public sector).
[34] Keefe, *supra* note x.
[35] Keefe, *supra* note x. Keefe's analysis has been attacked in, among others, CTR. FOR UNION FACTS, THE ECONOMIC POLICY INSTITUTE IS WRONG: PUBLIC EMPLOYEES ARE OVERPAID (no date), available at http://www.unionfacts.com/downloads/Public_Sector_UnionsBrief.pdf.

One author reports that in Wisconsin, which he characterizes as the eighth most generous state in terms of income replacement, the average retired worker receives a pension equal to 57% of their pre-retirement salary. [36] The full pension is paid after 35 years at age 57 for non-public safety employees. More comprehensively, a 1997 table reports average replacement rates for public employees without Social Security of about 62%,[37] but this may be lower than the replacement rate for current retirees, if reports that governments have sweetened pensions in recent years are true. This rate is more generous for most private employees receiving pensions but not to such a great extent when Social Security payments are included in the comparison.

As in many situations, the view that public employee pensions are excessive is supported by notorious instances of what is known as pension "spiking," in which employees take advantage of provisions in pension plans that allow them to increase their pension benefits, often as they prepare to retire. Public employee pensions are usually based on the employee's pay at the end of the career, often the average of the employee's last three or five years of government employment. Employees make efforts to increase their pay at the end of their careers to "spike" their pensions. Even if the methods employees use to spike their pensions are within the rules of the pension system, they seem illegitimate for the simple reason that pensions manipulated in this manner are not related to the employee's needs and legitimate expectations after retirement.

Here are a few examples of pension spiking. One way that pensions can be spiked is to add additional part-time work during the years when salary is used to calculate pension benefits.

[36] See Paul M. Secunda, Constitutional Contracts Clause Challenges in Public Pension Litigation, 28 Hofstra Lab. & Emp. L.J. 263, 273-74(2011).
[37] See Ann C. Foster, Public and Private Sector Defined Benefit Pensions: A Comparison, Compensation & Working Conditions, Summer 1997, at 41, available at http://www.bls.gov/opub/cwc/archive/summer1997art5.pdf

For example, in some jurisdictions, public high school teachers can teach evening courses at a community college and then count that pay in total salary for pension purposes. This apparently common practice among teachers in some areas can boost pension benefits significantly. In Massachusetts (and perhaps in other states) longevity clauses are included in public employees' collective bargaining agreements. The employee informs the employer either one or three years in advance that they plan to retire and under the agreement, their salary is boosted in recognition of their longevity. This also boosts their pension, which is the design of the contract. If the employee changes her mind and decides not to retire, she can simply pay the bonus back to the governmental unit. The amount and length of the bonus (usually either one or three years) is determined in unionized sectors in collective bargaining between the employee union and the governmental unit.

Another legally sanctioned form of pension spiking involves pension "buybacks" for various forms of service outside the pension system. Under a buyback program, an employee is allowed to pay a year's contribution to the system to purchase a year of service credit toward a state pension. Employee contributions are not sufficient to cover the increased costs to the pension system, so these buybacks are a good deal for the employee but not for taxpayers who will be required to make up the shortfall sometime in the future. For example, in 2008, Massachusetts enacted a provision allowing public school teachers to buy pension credit for years in the Peace Corps. Several other bills were proposed in the following year to expand buy back, in the midst of efforts to eliminate abuses such as counting volunteer service on government boards toward pension service; one day to one year of service provisions (which were used by outgoing legislators to receive an entire year of service credit for the first week of

January when their terms expired); and king for a day provisions, which allowed employees to be promoted for one day and then retire at a higher rate.[38] For example, school nurses sought to be allowed to buy pension credit for years in nursing before they entered a school system, and higher education teachers sought to be included in the Peace Corps buyback provision.

One of the most striking examples of legislative largesse in the pension area happened in Rhode Island in the 1980s. Rhode Island public school teachers had been covered by state pensions since 1936. As is generally true of public school teachers in the United States, Rhode Island public school teachers are highly unionized. In the 1980s, they lobbied for inclusion of their union's employees in the state pension plan despite the fact that they are not government employees. In 1987, the Rhode Island General Assembly obliged, and union employees were allowed join the teachers' pension plan, conditional on payments to buy years of creditable service. As a court later detailed:

> Inclusion in the state pension system was a great deal for the union employees.
>
> Bernard Singleton, for example, became a member of the Retirement System effective January 1, 1990 . . . and promptly purchased roughly 25 years of service credit for his prior union employment at a cost of $25,411.09. On July 28, 1990, several months later, at age 52, he took "early retirement" and immediately began to collect a pension of approximately $53,000 per year, with an expected lifetime benefit of about $750,000.[39]

The return on investment for these participants was beyond even Bernard Madoff's wildest dreams. "The district court later calculated the plaintiffs' total contribution to the Retirement

[38] A bill eliminating some of these abusive practices was passed and signed in 2009. *See* Act Providing Responsible Reforms in the Pension System, ch. 21, 2009 Mass. Laws (June 16, 2009). This law eliminated pension credit for volunteer service, the one day rule, under which one day of work counted for pension purposes as a full year of service, and it outlawed the practice of combining work from multiple government jobs to receive a higher pension. *See* Michael Levenson, *Key Measures Passed in Mass*., BOSTON GLOBE, Aug. 17, 2010, at 1.

[39] Nat'l Educ. Ass'n-Rhode Island *ex rel*. Scigulinsky v. Ret. Bd. of Rhode Island Employees' Ret. Sys.,, 172 F.3d 22, 24 (1st Cir. 1999).

System at $1,995,784, the present value of their projected pension benefits at about $11,430,579, and an average projected rate of return for the individual plaintiffs of approximately 1250 percent."[40] Once the details of this plan became generally known, the Rhode Island General Assembly repealed it and provided that no further benefits would be paid.[41] The United States Court of Appeals for the First Circuit upheld this repeal against attacks based on federal constitutional rights to continued benefits.[42]

There are notorious individual instances of pension spiking under which employees have boosted their pensions in ways that seem illegitimate. The most famous example in Massachusetts is William Bulger, who retired after 35 years in Massachusetts government, including 17 years as President of the State Senate, and 7 years as President of the University of Massachusetts. His retirement salary was approximately $300,000, entitling him to a lifetime pension of $179,000. In the last few years of his service as University President, the Board of Trustees added a housing allowance to his compensation, even though Bulger was living at his longtime home which he owned. When Bulger retired (under pressure over his relationship with his then-fugitive brother Whitey Bulger), he included the housing allowance as part of his salary for pension purposes, and the Massachusetts Supreme Judicial Court agreed, boosting the pension to $196,000 annually.[43]

Another Massachusetts example of pension spiking which provoked the above-mentioned reform efforts involved a public school teacher who added almost $3000 per year to her $26,000

[40] *Id.* at 24-25.
[41] *Id.* Participants were given a refund of their contributions in excess of the amount they had already received in benefits.
[42] Id.
[43] Bulger v. Contributory Ret. Appeal Bd., 447 Mass. 651 (2006)

pension by including years of volunteer service on the board of her city's public library.[44] The fact that she counted two years during which she failed to attend a single library board meeting made her case look even weaker than it would have had she been a dedicated volunteer board member. One State Representative[45] who spoke out in favor of closing this method of pension spiking, later included unpaid service on a local school board as part of his pension-eligible service, provoking cries of hypocrisy in a newspaper editorial. Finally, also in Massachusetts, is the example of an employee working two full-time government jobs and claiming two separate full pensions.[46] Even if pensions to public officials are generally not abusive, examples of abusive practices like those discussed above taint the entire system.

C. Why?

Assuming that there is a funding crisis and that public sector employees have been promised excessive or at least potentially abusive retirement benefits, including pensions and

[44] *See* Sean P. Murphy, *Ex-lawmaker's wife got pension boost: Credit given for Lynn library job*, BOSTON GLOBE, April, 19 2009. The article also reports that the teacher's ex-legislator husband also benefitted from generous pension provisions apparently designed just for him by the Massachusetts legislative leadership. "The carefully tailored provision, which did not mention Bassett by name, permitted him to collect his $41,000-a-year state pension even while working full time as the Essex Regional Retirement Board chairman and executive director, a job that currently pays him an estimated $123,000 a year." Ex-representative Bassett was fined $10,000 for engaging in private lobbying activity on government time using government facilities. *See* Paul Leighton, *Bassett fined $10,000*, SALEM NEWS (Oct. 21, 2011), http://www.salemnews.com/local/x2117288138/Bassett-fined-10-000/print. He had been fired the prior year year for deficient performance "after years of controversy over his high salary, lavish expense accounts, and exorbitant legal and consultant fees." *Id.* The pensions of both Bassetts apparently were boosted by legislative action crafted exclusively for them at both the city and state levels.

[45] *See* Edward Mason, *Pol OK'd pension reform, but then tried to cash in*, BOSTON HERALD (Sep. 30, 2009), http://bostonherald.com/news/politics/view/20090930pol_okd_pension_reform_but_then_tried_to_cash_in. This particular state representative had been in the news for an "arrest in 2004 for drunken driving, gross lewdness and disorderly conduct, and his $17,000 fine in 2007 and $10,000 in 2004 for violating Massachusetts campaign finance law." *Id.*

[46] *See* Matt Carroll, *Ex-officer is cleared on fraud charges*, BOSTON GLOBE, June 15, 2007, at 6 ("Lincoln was collecting a $139,787 pension, based on his average pay for the last three years of his working career; it was the highest in Plymouth County history. . . . Sullivan, in his report, said the taxpayers of Plymouth County should find 'the Lincoln pension situation to be incredibly offensive,' noting that Lincoln worked only three years for the county but will be paid about $60,000 a year by [county] taxpayers for the rest of his life.")

health care, the final question for this part of the discussion is why did this happen. Why would politicians make such promises and underfund them?

To a certain extent, the pathology is typical of deficit spending by government.[47] Incumbents can gain political support by enacting programs favored by constituents without requiring taxpayers to currently pay the full cost of the programs. Taxes can remain low even as services expand. Taxpayers are happy to enjoy the value of current services and reelect politicians that provide them.

Deficit spending is not unambiguously bad. During poor economic times, its use as economic stimulus may help cushion the effects of recession and even spur economic growth. Too often, however, deficit spending seems to be intended more for political stimulus than economic stimulus. After record surpluses at the end of the Clinton administration, tax cuts and increased spending under George W. Bush put the federal budget in deficit, which has continued and been amplified during the Obama administration. Although the argument in favor of tax cuts is that they increase economic activity which leads to more tax revenue, it appears that tax increases during the Clinton years contributed to surpluses then, and tax cuts at the outset of the administration of George W. Bush contributed to deficits in every budget he signed. Deficit spending appears to be a powerful political stimulus.

Unfunded pension promises benefit politicians in two ways. First, as in all deficit spending, they allow for current officials to provide services without requiring taxpayers to pay

[47] *See* Darryl B. Simko, *Of Public Pensions, State Constitutional Contract Protection, and Fiscal Constraint*, 69 TEMPLE L. REV. 1059, 1061 (1996) (characterizing underfunded pensions as a form of deficit spending).

for them until much later, when they may be out of office.[48] Second, pension promises help politicians shore up support among government workers,[49] or at least avoid opposition from government workers which would be substantial if significant reductions in pension benefits were proposed.

Taxpayers go along with underfunding for several simple reasons. First, each taxpayer's share of the overall liability is likely to be relatively small, or at least appear to be small at the time the promises are made. The psychological tendency to discount long-term problems likely reinforces the impression of each taxpayer that the unfunded liability is not a problem for them. Second, information on the extent of unfunded liabilities is not readily available, and what information there is may be difficult to interpret. Taxpayers may simply not know that public employees have been promised overly generous pensions or that tax revenues are insufficient to fund them. This problem is aggravated by the use of overly optimistic projected rates of return on pension fund investments which help obfuscate the financial status of the funds. Third, some taxpayers may conclude that they are unlikely to be affected by the whole mess at the time the obligations come due. Taxpayers move, retire, and die, all of which would minimize or exclude them from the negative effects future taxpayers may suffer due to unfunded pension liabilities.[50]

Excessive or abusive pension promises also occur due to the nature of the relationship between government employees and elected officials, and policymakers' self-interest.

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[48] Joshua Rauh, *The Pension Bomb*, MILKEN INST. REV. 26, 28 (First Quarter 2011) cited in David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 692 (2012).

[49] Skeel, supra note x, at 691.

[50] Robert P. Inman, *"Municipal Pension Funding: A Theory and Some Evidence" by Dennis Epple and Katherine Schipper: A Comment*, 37 PUB. CHOICE 179, 180 (1981). *See also* Robert P. Inman, *Public Employee Pensions and the Local Labor Budget*, 19 J. PUB. ECON. 49, 50 (1982) (arguing that mobile taxpayers are likely to support deferring payment for current services until later at the expense of poorer, less mobile, residents).

Government employees are often among the most ardent supporters of incumbent politicians because such employees depend on politicians for their jobs, levels of pay, and working conditions.[51] In the age of patronage, the relationship between employees and elected officials was quite direct because virtually all government workers owed their jobs to some sort of connection to an elected official. But even in this era in which civil service is the dominant government employment system, patronage still exists at high levels and various pockets of government.[52] Further, even if only a small percentage of employees are in a close relationship with elected officials, whatever system of pay and benefits is created will normally be designed to cover everyone. In other words, the desire to be generous to “connected” employees contributes to excessive compensation for all employees. Finally, in some situations, officials have the power to shape policies governing their own pensions, which can also result in generous promises that include themselves and other public employees.

In the pension area, the effects of close relationships between politicians and employees can be quite direct. For example, in the case discussed above involving the employee in Plymouth County, Massachusetts, who worked two full time jobs and claimed two separate pensions, one of his employers, an elected County Sheriff, sat on the retirement board that

[51] *See* Skeel, *supra* note x.

[52] In Massachusetts, a scandal over patronage hiring at the state probation department has led to federal indictments of several officials including the former head of the department. It has been reported that federal prosecutors are investigating whether state legislators who “recommended” candidates to probation department jobs violated federal law in the process. Andreas Estes & Thomas Farragher, *Ex-probation chief, 2 aides indicted in hiring scandal: Accused of rigging selection process for job applicants*, BOSTON GLOBE, March 24, 2012, at 1; Andrea Estes & Scott Allen, *DiMasi facing a cancer diagnosis Ex-speaker's illness likely to be treated at prison medical center*, BOSTON GLOBE, May 19, 2012, at 1 (suggesting that the investigation includes looking into whether state legislators violated federal law).

approved one of the pensions. The employee had helped the Sheriff's election campaign.[53] There are thousands of similar relationships throughout state and local government that undoubtedly influence compensation decisions.[54] In short, before the recent spotlight that has shined on the pension issue, from one perspective, the entire system may have operated like an enormous conspiracy to capture as much of the taxpayers' money for retired workers as possible.

We now have two general ways of understanding why government employees might be overcompensated and why an important part of that compensation takes the form of unfunded pension obligations. There are also particulars concerning how unfunded pension promises developed that can illuminate this problem. Political scientists and economists began looking at this issue as long ago as the 1970s. One early view was that as government employment became more professionalized and wages increased, deferred compensation in the form of pensions became very attractive at the same time that taxpayers demanded increased services without really wanting to pay for them.[55] It also appears that at certain times, public employee unions

[53] "The pension system is the way it is because those who oversee it, the cops and firefighters who run the retirement boards, have it just the way they like it. As the inspector general notes, Lincoln was no accident. Former Plymouth County Sheriff Joseph McDonough, who hired Lincoln for this three-year victory lap at the jail, knew how the system worked. He is on the Plymouth County retirement board. Lincoln, not coincidentally, helped on McDonough's campaign in 2000." Steve Bailey, *Putting a Face on the Need to Reform*, BOSTON GLOBE, June 7, 2006, at D1.

[54] Another good illustration is the ability of the state teachers' union in Rhode Island to convince the legislature to allow employees of the union to buy into the state pension system, resulting in a 1250 percent return on investment. *See infra* note x.

[55] Dennis Epple & Katherine Schipper, *Municipal Pension Funding: A Theory and Some Evidence*, 37 PUB. CHOICE 141, 170 (1981). Interestingly, Epple and Schipper suggest that public pension underfunding should decrease as the school-aged population of baby boomers declines.

placed a higher priority on current wages than on adequate funding of pension promises, even if this created some risk of nonpayment in the future.[56]

Two additional historical factors have contributed to the problem of pension funding. One factor is that in good economic times, governments have tended to increase all forms of employee compensation, including pension promises.[57] Assuming a general level of underfunding, a higher overall payroll is likely to produce a higher level of underfunding. Another factor is that in tight fiscal times, governments have foregone or reduced pension contributions and used the money to fund other services.[58] This is not surprising since constituents' demand for services may actually increase in periods when funds are tight due to economic downturn. State balanced budget requirements may contribute to this aspect of the problem: Because borrowing to meet operating expenses may not be available, underfunding pension obligations because a necessary tool to balance the budget without making drastic cuts to services.[59] These two dynamics, increased promises in boom times coupled with decreased funding in tough times, is a recipe for fiscal disaster.

In sum, unfunded pension and health care promises to retirees are, in a sense, the state and local version of the federal deficit. Politicians have twin incentives at work: To defer payment for current services to future generations of taxpayers, and to reward loyal supporters in the ranks of government workers with handsome compensation packages including generous

[56] Olivia S. Mitchell & Robert S. Smith, *Pension Funding in the Public Sector*, 76 REV. ECON. & STAT. 278, 282-83 (1994). Public employee unions have challenged underfunding as violating their contractual or constitutional rights, apparently out of concern that if the system is underfunded, their pensions might not be paid in full.
[57] *See* REPORT OF THE STATE BUDGET CRISIS TASK FORCE, *supra* note x, at 40-41.
[58] *See* Barbara A. Chaney, Paul A. Copley & Mary S. Stone, *The Effect of Fiscal Stress and Balanced Budget Requirements on the Funding and Measurement of State Pension Obligations*, 21 J. ACCOUNTING & PUB. POL'Y 287, 293 (2002).
[59] *See generally* Chaney et al., *supra* note x.

retirement benefits. Even if most government workers are of little concern to politicians, the desire to reward the connected few (and often themselves) contributes to the phenomenon of all boats rising together. Even legislators themselves may need to establish an attractive pension system for all government workers to justify their own generous post-service compensation. Taxpayers may now be waking up, but as we shall see in the discussion of legal constraints on pension reform, it may be too late to avoid severe fiscal hardship.

II. State Law Constraints on Underfunding Pension Liabilities and Pension Reform.

Recent and continuing fiscal difficulties in many state and local government entities have inspired searches for ways to save money. Pensions are an obvious candidate, but even if state legislatures were determined to reduce pension promises, state contract law and state constitutional law designed to protect the legitimate expectations of state and local employees may stand in the way. In this part of the article, I look at three state law issues concerning pension reform: the effects of state balanced budget requirements on pension funding, state law constraints on underfunding pension contributions; and state contract and constitutional law constraints on reducing pension benefits or promises to workers not yet retired. As we shall see, state law can pose significant impediments to pension reform.

A. State Balanced Budget Requirements and Pension Plan Funding

In debates over fiscal policy, the fact that balanced budget requirements exist in nearly every state[60] is held up as evidence that the federal government could and should follow suit and

[60] State balanced budget requirements arise from constitutional provisions, statutory provisions and in a few cases from court decisions interpreting financial provisions of state constitutions. *See* NAT'L CONFERENCE OF STATE LEGISLATURES, NCSL FISCAL BRIEF: STATE BALANCED BUDGET PROVISIONS 8 (2010), *available at*

balance its budget. This has been a cornerstone of the Tea Party movement, and during 2011's controversy over extending the federal government's debt limits, there was a proposal to condition the extension on Congress voting for a balanced budget amendment to the federal Constitution. As we have seen, however, the magnitude of unfunded state pension and health care promises shows that states are not nearly as constrained as might appear from the existence of balanced budget requirements. This raises questions of whether the failure to fund pension obligations constitutes unlawful deficit spending, and whether such a violation would justify renunciation of some portion of unfunded obligations.

The simple answer is that state failure to fund pension liabilities is not considered a violation of state balanced budget requirements. Further, in some states, competing constitutional requirements prohibiting diminution of pension promises mean that the weight of state constitutional law is more strongly on the side of what is, in effect, deficit spending, than it is on the side of fiscal constraint.

The first thing to understand about state balanced budget requirements is that they are quite diverse and impose varying levels of fiscal discipline. One important fact is that state balanced budget requirements normally affect only state operating budgets, not capital or long-term debt obligations.[61] This means that states are free to finance capital projects with long-

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http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf (citing NAT'L ASS'N OF STATE BUDGET OFFICERS, BUDGET PROCESSES IN THE STATES 40 (2008)). For a general look at the effect of balanced budget requirements, see Yilin Hou & Daniel L. Smith, *Do State Balanced Budget Requirements Matter? Testing Two Explanatory Frameworks*, 145 PUBLIC CHOICE 57 (2009). This study concludes that balanced budget requirements have effects on the government and that the evidence is inconclusive on whether there is a difference in effects between constitutional and statutory balanced budget requirements. *See also* James M. Poterba, *Balanced Budget Rules and Fiscal Policy: Evidence from the States*, 48 NAT'L TAX J. 329 (1995).

[61] NAT'L CONFERENCE OF STATE LEGISLATURES, NCSL FISCAL BRIEF: STATE BALANCED BUDGET PROVISIONS 7 (2010), *available at* http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf. For a general

term debt, which is sensible fiscal policy because current taxpayers might be unwilling to fully finance projects with long-term benefits. Interest payments on long-term debt would presumably be included in the operating budget which must be balanced each year, but there is no prohibition on incurring long term debt. However, state constitutions often contain stringent limits on the use of debt financing. Thus, the exclusion of long-term debt from balanced budget requirements does not necessarily release states from the fiscal constraints under which they would otherwise operate.

The Association of State Budget Officers reports that state balanced budget requirements generally take three forms, with many states operating under two or even all three of the requirements. 1) The governor's proposed budget must be balanced; 2) The enacted budget must be balanced; and 3) No deficit can be carried forward from one fiscal period into the next.[62] Further, some states require that the governor sign a balanced budget.[63] State constitutions and statutes do not always explicitly require these steps, but courts have read them to exist.

State balanced budget provisions also vary in the availability of enforcement mechanisms. [64] In a very few states, mandatory spending reductions are required if expenditures would otherwise exceed revenue. Some states provide for criminal punishment of officials who authorize deficit spending. In other states, governors monitor expenditures and are required to make cuts during the fiscal year to ensure that the budget remains in balance. Some states may

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look at state balanced budget requirements, see U.S. GEN. ACCOUNTING OFFICE, BALANCED BUDGET REQUIREMENTS: STATE EXPERIENCES AND IMPLICATIONS FOR THE FEDERAL GOVERNMENT (1993).

[62] NAT'L ASS'N OF STATE BUDGET OFFICERS, BUDGET PROCESSES IN THE STATES 40 (2008), *available at* http://nasbo.org/LinkClick.aspx?fileticket=AaAKTnjgucg=&tabid=80 cited in NAT'L CONFERENCE OF STATE LEGISLATURES, NCSL FISCAL BRIEF: STATE BALANCED BUDGET PROVISIONS 2-3 (2010), *available at* http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf.

[63] NAT'L CONFERENCE OF STATE LEGISLATURES, *supra* note x, at 5.

[64] NAT'L CONFERENCE OF STATE LEGISLATURES, *supra* note x.

also simply prohibit the paying of bills if funds have run out. Some states are more liberal, allowing borrowing at the end of the fiscal year to satisfy outstanding obligations. The overriding factor may be the political culture of state government. Even in states with uncertain enforcement, operating budgets remain balanced because the political costs of running an illegal deficit would simply be too high.

Ironically, state balanced budget requirements are negatively correlated with pension funding to full actuarial standards.[65] In other words, states with strict balanced budget requirements are less likely than other states to fully fund their projected future pension obligations. The reason for this may be simple: When balanced budget requirements are likely to be strictly enforced, expenditures are moved to areas that do not constitute deficit spending. Because pension promises are an off-budget method of providing compensation to state employees for current services, the larger the share that can be paid in the form of deferred compensation, the more services government can provide out of current revenue. Further, in tight fiscal times, the tendency for state governments to reduce or suspend pension funding for one or more years[66] to avoid serious cuts to current services, can aggravate pension fund deficits during bad economic times when stock market downturns reduce pension fund investment values and state tax revenue declines.[67]

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[65] *See* Chaney et al, *supra* note x, at 307.

[66] *See* REPORT OF THE STATE BUDGET CRISIS TASK FORCE, *supra* note x, at 37-38. The Report contains a detailed discussion of state and local underpayment of projected pension liabilities and reform efforts that may make it more difficult in some states for government entities to continue underpaying. This, in turn, would lead to more stress on already tight state and local budgets. *See id.* at 40-41.

[67] THAD CALABRESE, SOC'Y OF ACTUARIES, PUBLIC PENSIONS, PUBLIC BUDGETS, AND THE RISKS OF PENSION OBLIGATION BONDS, 3 (2010), *available at* http://www.soa.org/library/monographs/retirement-systems/public-pension-finance/2010/june/mono-2010-mrs10-calabrese.pdf.

The relative freedom of states to determine their own discount rates also contributes to the general underfunding of pension obligations. States can tinker with pension growth forecasts and discount rates to make it appear that they are funding future obligations adequately or creating only a relatively small funding gap when they decrease their contributions to bridge budget gaps.[68] These temporary budget fixes contribute to cumulative problems, since later budgets do not make up for the earlier gap in funding. States may also issue pension obligation bonds to meet required annual contribution requirements, but this move passes the cost on to future generations of taxpayers who must pay the bonds and may also need additional funds to make up for underfunding due to inflated discount rates.[69] Thus, the short-term nature of state budgeting and the inapplicability of "balanced budget" requirements conspire to create a long-term mess of underfunded pension obligations.

This should be discouraging to those who champion balanced budget requirements as devices to bring fiscal constraint to government. Underfunding future pension obligations shares many of the vices of deficit spending and is different from long-term borrowing for capital projects, because pension promises are more like operating expenses than capital borrowing. While deficit spending may make sense when economic stimulus is desired, for programs that do not promise to grow the economy for the future, it is a simple inter-generational wealth transfer, with current taxpayers pushing off the expense of providing current government services to future taxpayers. For the most part, pension promises fall into this category. Generous, secure

[68] *Id.* States have more leeway than private entities to alter their discount rates because they generally follow the pension standards set by the Governmental Accounting Standards Board rather than the market-based standards established by the Financial Accounting Standards Board. *See also* JOSH BARRO & STUART BUCK, MANHATTAN INST., UNDERFUNDED TEACHER PENSION PLANS: IT'S WORSE THAN YOU THINK (2010), *available at* http://www.manhattan-institute.org/pdf/cr_61.pdf.
[69] Calabrese, *supra* note x, at 7–11.

pension promises allow government employers to pay their employees less in current cash compensation. Underfunding pension obligations means that future taxpayers will essentially pay the bill for services provided in the past without any current benefit, such as a building, park, or highway, that is still being used while bond payments are made. An effective state balanced budget requirement would thus include advance funding (under realistic projections and discount rates) of pension and retiree health care promises to public employees as part of the current operating expenses required, under state law, to be part of a balanced budget.

B. State Law Limitations on Pension Reform[70]

1. Pension Flexibility under State Law

In many states, the weight of constitutional law is with state employees rather than the taxpaying public.[71] In a comprehensive review of state pension plan protections, Amy Monahan has demonstrated that many states protect pension plan participants from significant modifications to their plans, under both constitutional and contract law theories.[72] In another article, Monahan reports that "courts in California and the twelve other states that have adopted California's precedent have held not only that state retirement statutes create contracts, but that

[70] Although state statutory and constitutional protections of public pensions are distinct from federal law, except perhaps in states with very specific constitutional protections for pension promises, the considerations state judges use to decide whether to protect pensions under state law are very similar to the considerations they use to determine whether a reform violates the federal Contracts Clause. Generally, once a state court finds that an employee has a contractual right to a feature of a pension plan, the court finds a violation of either state pension provisions or federal constitutional law.

[71] For a general discussion of the legal status of public pension reform, see David L. Gregory, *The Problematic Status of Employee Compensation and Retiree Pension Security: Resisting the State, Reforming the Corporation*, 5 B.U. PUB. INT. L.J. 37 (1995).

[72] Amy Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617 (2010).

they do so as of the first day of employment."[73] Jonathan Forman concludes that state law places serious constraints on pension reform with regard to existing workers: "Through state constitutional provisions and court interpretations of property and contract rights, most states essentially guarantee that their public workers will get the pensions that they were promised when they were hired."[74]

Some state constitutions contain provisions that explicitly prohibit the state from reducing pension payments or pension promises to state employees. For example, the New York Constitution provides that "[a]fter July first, nineteen hundred forty, membership in any pension or retirement system of the state or of a civil division thereof shall be a contractual relationship, the benefits of which shall not be diminished or impaired."[75] This has been interpreted to protect the level of benefits promised as of the date that the employee became eligible to participate in the pension plan.[76] Similarly, the Michigan constitution provides that "[t]he accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby."[77] States with provisions like these may be unable to reduce pension payments or promises to state workers even if the magnitude and nature of pension promises is in serious tension with state balanced budget requirements. It should also be noted that many state courts use the federal

[73] Amy B. Monahan, Statutes as Contracts? The "California Rule" and its Impact on Public Pension Reform, 97 Iowa L. Rev. 1029, 1032 (2012). Monahan is highly critical of this line of cases, finding it to be inconsistent with more general legal principles concerning flexibility in government regulatory programs. This is discussed further infra at x.
[74] Forman, *supra* note x, at 866.
[75] N.Y. CONST. art. V, § 7.
[76] *See* Kleinfeldt v. New York City Emp. Ret. Sys., 36 N.Y.2d 95, 101-102 (1975); McCaffrey v. Bd. of Ed. of E. Meadow Union Free Sch. Dist., 48 A.D.2d 853 (N.Y. App. Div. 1975).
[77] MICH. CONST., art. IX, § 19.

Contract Clause to protect pension promises, finding first, a contractual relationship under state law, and then protecting employee rights under federal constitutional law.[78]

Most states recognize that public pension rights vest at some point, after which the state is precluded from amending the contractual promises. The most common point at which rights are solidified under state law is when an employee satisfies the requirements for grant of the pension, commonly referred to as "vesting," which usually occurs at some point after the onset of employment and before retirement.[79] Some states' law is even more favorable toward employees, recognizing pension rights from the onset of government employment. Courts in these states reason that "by accepting the job and continuing work, the employee has accepted

[78] *See, e.g.*, Oregon State Police Officers' Ass'n v. State, 323 Or. 356 (1996) (state constitutional amendments altering employee contribution amounts, prohibiting guaranteed rates of return on pension funds and prohibiting inclusion of unused sick leave in pension calculations violated Contract Clause rights of employees); Singer v. City of Topeka, 227 Kan. 356 (1980) (changes in retirement benefits promises violated contractually protected rights and therefore violated federal Contract Clause).

[79] Many decisions recognize vested rights in dicta while denying claims brought by employees who sue over pension reform before they are actually eligible to retire. *See, e.g.*, Petras v. State Bd. of Pension Trustees, 464 A.2d 894, 896 (Del. 1983) (a teacher possessed no contractual right to receive credit for time spent teaching in other states because the teacher's pension rights had not yet vested when the state legislature amended its credit policy); Baker v. Oklahoma Firefighters Pension & Ret. Sys., 718 P.2d 348, 353 (Okla. 1986) (only those firefighters and police officers "who had retired or who could have retired and become eligible for payment of pension benefits" possessed pension rights that the state legislature could not detrimentally change with subsequent legislation). For similar holdings, *see also* Bd. of Trustees v. Cary, 373 So.2d 841, 842-43 (Ala. 1979); Pyle v. Webb, 489 S.W.2d 796, 798 (1973); Police Pension & Relief Bd. v. McPhail, 338 P.2d 694, 700 (Colo. 1959) ("Until an employee has earned his retirement pay, or until the time arrives when he may retire, his retirement pay is but an inchoate right . . . ." (citation omitted)); City of Jacksonville Beach v. State *ex rel.* O'Donald, 151 So.2d 430, 431-32 (Fla. 1963); Hickey v. Pension Bd., 106 A.2d 233, 236 (Pa. 1954); Ellis v. Utah State Ret. Bd., 757 P.2d, 882, 886 (Utah 1988); Leonard v. City of Seattle, 503 P.2d 741, 746 (Wash. 1972) (en banc) (explaining that "[e]ven before ripening finally, and during the years of its accrual, it was more than an expectancy and more than an enforceable promise or a contract; it gave him steadily accruing rights in and to the pension fund itself"); Campbell v. Michigan Judges Ret. Bd., 143 N.W.2d 755, 756-58 (Mich. 1966) (concerning voluntary pension contributions); *but see* Brown v. City of Highland Park, 30 N.W.2d 798, 800 (Mich. 1948) (asserting that where public employee membership in pension systems is mandatory, the accompanying pension benefits are not a part of the contract of employment and can be amended by the legislature).

the State's offer of retirement benefits, and the State may not impair or abrogate that contract without offering consideration and obtaining the consent of the employee."[80]

Some states take a reliance interest approach to the question of whether an employee has a vested right to pension benefits that is protected under constitutional or contractual principles.[81] For example, the West Virginia Supreme Court has reasoned:

> When considering the constitutionality of legislative amendments to pension plans, an employee's eligibility for a pension does not determine whether he or she has vested contract rights. Instead, the determination of an employee's vested contract rights concerns whether the employee has sufficient years of service in the system that he or she can be considered to have relied substantially to his or her detriment on the existing pension benefits and contribution schedules.[82]

With sufficient length of service, reliance is presumed,[83] but only on those provisions that are in effect during the lengthy service.

This approach to determining whether the state may alter pension benefits requires that the court determine in each case whether the employee has relied on the particular provision that has been altered, especially with regard to provisions that were not in effect during the entire period of employment. For example, in 1988, the West Virginia legislature amended that state's public pension statute to include lump-sum payments for unused vacation time in retiring employees' final salary for pension calculations.[84] Apparently many employees took early retirement shortly after the amendment passed so they could take advantage of this method of increasing their pension payments. Then, in 1989, the legislature repealed the provision. When

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[80] Proska v. Arizona State Sch. for the Deaf & Blind, 74 P.3d 939, 942 (Ariz. 2003).
[81] For an argument that reliance should be the key issue in Contract Clause jurisprudence, see Robert A. Graham, Note, *The Constitution, The Legislature, and Unfair Surprise: Toward A Reliance-Based Approach to the Contract Clause*, 92 MICH. L. REV. 398 (1993).
[82] Booth v. Sims, 193 W. Va. 323, 337 (1995).
[83] *Id.* at 340.
[84] Myers v. W. Virginia Consol. Pub. Ret. Bd., 226 W.Va. 738 (2010).

Donald Adams retired in 1996, he sought to have a lump sum payment for his unused vacation time included in his final salary for pension purposes even though the provision allowing this had been repealed in 1989.[85] The trial court dismissed Adams's claim, but the West Virginia Supreme Court ruled that Adams was entitled to an opportunity to prove his allegation

> that in 1988 he made a decision to continue his employment with the State in reliance upon the 1988 version of [the retirement statute], and expected that he would be able to add his accrued but unpaid leave to his final average salary when he retired, and would thereby receive an increased monthly retirement benefit.[86]

Without specific evidence of reliance, the particular pension benefit would not be vested and the state would be able to eliminate or modify it. For example, when Rodney Myers and another employee retired in the late 1990s, they also sought to have lump sum payments for unused vacation time included in their final salaries on the basis that they relied on the 1988 provision by remaining employed by the state for ten years after the 1988 amendment was adopted. The West Virginia Supreme Court denied the claim, concluding that reliance on a provision that was in effect for only one year cannot be presumed and;

> neither [plaintiff] presented any specific evidence indicating that they relied to their detriment on this specific provision. [N]either of the Appellees in this case was eligible to retire during the year this benefit was in effect and, thus, . . . neither of the Appellees could have based any retirement decision on the promise contained in the 1988 amendment. Indeed, neither Appellee introduced any evidence to show that he made any decision whatsoever on the basis of that particular promised benefit.[87]

Although, as Monahan reports, California protects pension promises from the first day of employment, some California decisions take a nuanced view of reliance, balancing employees' interest in pension benefits against the state's need for flexibility and control. The California

[85] Adams v. Ireland, 207 W.Va. 1 (1999)
[86] *Id.* at 5.
[87] *Myers*, 226 W.Va. at 750-51.

Supreme Court has stated that "[t]he employee does not obtain, prior to retirement, any absolute right to fixed or specific benefits, but only to a 'substantial or reasonable pension.'"[88] It is unclear, however, how far this apparent flexibility goes, because California cases also state that normally any reduction in pension benefits must be compensated for by other aspects of the reform provisions.[89] Further, there are California cases that appear to mechanically enforce provisions of pension laws in effect during employment, even when that results in what may be seen as abusive double-increases in benefits.[90]

In addition to the contract-based protections employees enjoy, labor law may provide another layer of protection. State and local governments may not be able to unilaterally alter pension benefits for employees in bargaining units engaged in collective bargaining. Because retiree benefits are often specified in collective bargaining agreements, any unilateral attempt to alter them may be considered a breach of contract, no matter how weighty the government interest behind the need for reform.[91] Thus, for unionized sectors, reform may depend on successful collective bargaining.

In some states, the law goes further than protecting benefits levels and also protects funding levels, requiring an actuarially adequate level of annual contributions to pension funds.[92]

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[88] Betts v. Bd. of Admin., 21 Cal.3d 859, 873 (1968) (quoting Wallace v. City of Fresno, 42 Cal.2d 180, 183 (1954).
[89] Allen v. City of Long Beach, 45 Cal.2d 128, 131(1955)) ("changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.") (emphasis supplied). Because of relatively strict application of this requirement, Monahan views the California decisions as much more favorable to employees than the language from Betts might imply. See Monahan, Statutes as Contracts?, supra note x at 1062-64.
[90] *Betts*, 21 Cal.3d at 867 ("We fully recognize that the effect of our holding is that petitioner thereby receives the benefit of a double increment of increase, a troubling result. We can only observe that the Legislature must have intended to provide such benefits to constitutional officers serving between 1963 and 1974 because it left in effect both of the formulae during that 11-year period.").
[91] *See* City of Philadelphia v. District Council 33, 598 A.2d 256, 259-60 (Pa. 1991) (city imposition of new pension scheme breached collective bargaining agreement and possibly unconstitutionally impaired contract).
[92] For a discussion of cases involving funding levels, see Simko, *supra* note x, at 1065-79.

For example, in elaborating on state statutes that create contractual guarantees in pension benefits to public employees, the North Carolina Appeals Court stated, "it is clear that Plaintiffs had a contractual right to the funding of the Retirement System in an actuarially sound manner. Therefore, we hold that the right to have the Retirement System funded in an actuarially sound manner is a term or condition included in Plaintiffs' retirement contracts."[93] The North Carolina court cited decisions from several other jurisdictions for the proposition that actuarially sound funding can be a contractually protected term of a pension program.[94]

Other states recognize that the legislature should have discretion over funding decisions and protect only the ultimate pension payments and not the funding of pension funds. For example, in Illinois, pension participants and funds themselves challenged a statute that changed the method of calculating government contributions to pension funds. They argued that the new statute violated the Illinois Constitution's pension protection provision: "Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[95] The Illinois Supreme Court held that this provision relates only to benefits and not to the "politically sensitive area of pension funding."[96]

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[93] Stone v. State, 191 N.C. App. 402, 414 (N.C. App. 2008).

[94] *See id.* at 415 (citing Municipality of Anchorage v. Gallion, 944 P.2d 436 (Alaska 1997)); Dadisman v. Moore, 181 W. Va. 779 (1988); Valdes v. Cory, 139 Cal. App.3d 773 (1983); Sgaglione v. Levitt, 37 N.Y.2d 507 (1975); Weaver v. Evans, 80 Wash.2d 461 (1972); Dombrowski v. City of Philadelphia, 431 Pa. 199 (1968); State Teachers' Ret. Bd. v. Giessel, 12 Wis.2d 5 (1960). Any attempt to move to actuarially adequate funding may be impossible or extremely difficult for many states. *See* PEW study, *supra* note x, at 48-52.

[95] ILL. CONST., art. XIII, § 5.

[96] McNamee v. State, 173 Ill.2d 433, 440 (1996). *See also* People *ex rel*. Illinois Fed'n of Teachers v. Lindberg, 60 Ill.2d 266 (1975). The court cited cases in which it had invalidated legislation that reduced pension benefits, but declined to follow a New York case that protected funding levels. *See McNamee*, 173 Ill.2d at 445, (citing Felt v. Bd. of Trustees of Judges Ret. Sys., 107 Ill.2d 158 (1985)); Buddell v. Bd. of Trustees, State Univ. Ret. Sys. of Illinois, 118 Ill.2d 99 (1987). The plaintiffs had urged the court to follow *McDermott v. Regan*, 82 N.Y.2d 354

Judicial insistence on adequate funding would prevent some of the most serious missteps that have contributed to the funding crisis.[97] It would reduce the tendency of states to use pension obligations as a form of deficit spending, pushing off payment for current services onto future taxpayers. Underfunding of pension funds is sometimes systematic, as when states use unrealistic projected rates of return on pension funds to justify underfunding; and sometimes it is episodic, as when states decide to cut pension contributions to balance the state budget during difficult fiscal times.[98] While legitimate questions can be raised over whether the courts should prevent the government from allocating funds as it sees fit, judicial compulsion in this context maybe the least of several potential evils.

It should not be surprising that the law in many states is very protective of public employees' and retirees' pension expectations. For the most part, the employees have traditional contract principles on their side, and in the typical case, they have legitimately relied on their

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(1993), in which the New York Court of Appeals had invalidated a provision removing the New York Comptroller's power to require actuarially adequate contributions to pension funds. *See also* Jones v. Bd. of Trustees of Kentucky Ret. Sys., 910 S.W.2d 710 (Ky. 1995) (state legislature had power to amend method of calculating public employer contribution to retirement fund without unconstitutionally impairing contracts).

[97] Some full funding requirements may go too far. The United States Postal Service is legally required to fund its pension and retiree health care obligations in advance. This has proven to be a hardship to the Postal Service, and due to its general downturn in business, it is likely to fail to make its advance health care payments for 2011 and 2012. *See* Ron Nixon, *Postal Service Set to Default on Billions in Health Fund Payments*, N.Y. TIMES, July 18, 2012; Hope Yen, *Postal service to default on $11.1b bill*, ASSOCIATED PRESS, July 31, 2012.

[98] For example, the challenge in *Stone v. State* resulted from an executive order issued by the North Carolina's governor diverting pension contributions to balance the budget. *See* Stone v. State, 191 N.C. App. 402, 414 (N.C. App. 2008). It appears common that in difficult fiscal times, pension contributions are reduced. From the perspective of the government employee, using underfunding as a reason for cutting benefits may appear to be manipulative. Legislators promise generous pension benefits knowing they will underfund them and be able to use the underfunding later as an excuse for reform. This conspiracy theory may be far-fetched in the amount of the advance planning it entails, but it may not seem so to the public employee suffering cuts to promised benefits. Zach Carter's Huffington Post article accuses conservative state governors of creating the pension funding crisis to finance tax cuts and justify pension reductions to state workers. *See* Carter, *supra* note x. Regarding New Jersey, Carter reports that "During the 1990s, under Gov. Christine Todd Whitman (R), the state slashed its annual pension contributions in order to finance a slate of tax cuts, and didn't begin seriously boosting those contributions until 2007. . . . Last year, Gov. Chris Christie (R) took a page from Whitman's playbook, forgoing the $3 billion annual state contribution to the pension plan while pushing $1 billion in tax cuts for the state's wealthiest citizens."

employers' retirement promises. These state courts recognize that it would be grossly unfair to employees if their retirement savings were subject to the political and fiscal winds that might lead state and local legislative bodies to make significant cuts to their pensions.[99]

III. Federal constitutional law constraints on state pension reform

Assuming that state law allows it, the next issue to explore concerns federal constitutional constraints on state pension reform. The primary federal constitutional provision that restrains states here is the Contract Clause, which prohibits states from passing "any . . . Law impairing the Obligation of Contracts."[100] Additionally, the Takings Clause may limit states' ability to reduce pension payments to some state workers.

A. The Contract Clause and Pension Reform

There has been a good deal of litigation in both state and federal courts concerning the application of the Contract Clause to state pension reform.[101] It was understood from very early

[99] A recent report released by the Center for Retirement Research at Boston College argues for a sharp distinction between benefits earned for past service and benefits expected based on future service. See Alicia H. Munnell and Laura Quinby, Legal Constraints on Changes in State and Local Pensions (2012), available at http://crr.bc.edu/wp-content/uploads/2012/08/slp_25.pdf. Their main argument in favor of flexibility is that public pension benefits should be subject to the same economic considerations as private pensions. See id. at 3. In general, private companies can reduce pension promises prospectively, i.e. while pension promises based on past service may not be reduced, pension promises based on future service can be reduced along with other elements of future compensation. The authors of the report recognize that in some states, this would require a constitutional amendment. Id. Munnell and Quinby's treatment is more balanced than that of some analysts who do not seem to recognize the legitimate reliance interests government workers have in their pension benefits.

[100] U.S. CONST. art. 1, § 10.

[101] Early Supreme Court decisions on this subject are not favorable to pension plan participants' claims. In 1889, the Court characterized public pensions as gratuities that could be withdrawn at any time. Pennie v. Reis, 132 U.S. 464 (1889). Later, the Court held that a new statute reducing payments under a prior statute to those already receiving their pensions did not violate the Contract Clause. *See* Dodge v. Bd. of Educ. of City of Chicago, 302 U.S. 74, 81 (1937). Neither of these cases has been overruled, and in fact *Dodge* was cited with approval as recently as 1985. However, due to the significant changes to the law governing constitutional protection of state benefits over the last 50 years, it would be unwise to treat the issues addressed in this article as settled by those decisions. *See* Note, 90 Harv. L. Rev., *supra* note x, at 996.

on that the Contract Clause applied both to state laws impairing private contracts and state laws impairing the obligation of the state's own contracts.[102] However, in the early cases, the Supreme Court refused to protect legislative pension promises under the Due Process Clause[103] or the Contract Clause.[104] In neither case, however, did the Court categorically rule out protecting the pension promises. In the later of the cases, which more closely resembles the current approach under the Contract Clause, the Court found no contractual right based largely on decisions of the particular state supreme court finding that the legislation in question was not intended to preclude subsequent revision of the plan involved.

Although at one time it might have seemed that the primary focus of the Contract Clause was on state regulation of private contracts, more recently, recognizing the potential for state and local governments to use their sovereign immunity to take advantage of contractual partners, the Supreme Court has stated that the Contract Clause applies more strictly to States' contracts than to private contracts.[105] The First Circuit has observed stricter scrutiny of impairments to the state's own contracts can be attributed to the fact that "'the State's self-interest is at stake.'"[106]

The Contracts Clause, however, is not understood today as an absolute bar on laws altering state pension obligations (and other state promises).[107] Rather, the standard that has

[102] *See* Fletcher v. Peck, 10 U.S. 87, 138 (1810).
[103] Penne v. Reis, 132 U.S. 464 (1889) (abolition of pension plan and transfer of funds deducted from employees' paychecks to other purposes does not violate pension plan beneficiaries' due process rights).
[104] Dodge v. Bd. of Educ. of City of Chicago, 302 U.S. 74 (1937).
[105] U.S. Trust Co. of New York v. New Jersey, 431 U.S. 1 (1977).
[106] Parker v. Wakelin, 123 F.3d 1, 5 (1st Cir. 1997) (quoting U.S. Trust Co. of New York, 431 U.S. at 26).
[107] See U.S. Trust Co. of New York, 431 U.S. at 25 (footnote omitted) ("The Contract Clause is not an absolute bar to subsequent modification of a State's own financial obligations. As with laws impairing the obligations of private contracts, an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose."). It may be that under the original understanding of the Contract Clause, all retrospective modifications of contractual obligations would be considered unconstitutional. See Douglas W. Kmiec & John O. McGinnis, The

developed in the federal courts to decide whether pension reform violates the Contracts Clause has two elements: 1) does the change in state law result in a "substantial impairment of a contractual relationship,"[108] and if so, 2) is this impairment justified as "'reasonable and necessary to serve an important public purpose'"?[109] Thus, there must be both a contractual relationship and a substantial impairment, and even when that is present, an important public purpose is sufficient to uphold the impairment.[110]

The second element, allowing impairment to be justified as "reasonable and necessary to serve an important public purpose," reads like a form of intermediate scrutiny. The state law must be more than merely rationally believed to serve a legitimate purpose, which would be the test under the lowest level of constitutional scrutiny.

The first element, whether there has been a substantial impairment of a contractual relationship, can itself be divided into three separate inquiries: first, whether a contractual relationship exists; second, whether any such relationship has been impaired; and third, whether any impairment is substantial. [111]

When determining whether a protected contractual relationship exists, courts are very sensitive to states' interest in remaining flexible and retaining their full regulatory authority. This judicial instinct in the United States dates back at least to the famous *Charles River Bridge*

Contract Clause: A Return to the Original Understanding,14 HASTINGS CONST. L.Q. 525 (1987). However, as the authors point out, the Clause is not so understood by the Supreme Court today.

[108] Parker v. Wakelin, 123 F.3d 1, 5 (1st Cir. 1997) (internal quotation mark omitted) (quoting Gen. Motors Corp. v. Romein, 503 U.S. 181, 186 (1992)).

[109] Id. (quoting U.S. Trust Co. of New York, 431 U.S. at 25); *see also* Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411-12 (1983). Some courts have discussed this test as having three prongs. *See, e.g.*, McGrath v. Rhode Island Ret. Bd., 88 F.3d 12, 16 (1st Cir. 1996).

[110] For a detailed examination of Contract Clause protection of public pensions, see Monahan, *supra* note x.

[111] *Gen. Motors Corp.*, 503 U.S. at 186.

case[112] in which the Supreme Court held that a company operating a toll bridge under a state charter could not prevent the state from chartering another bridge which, when its tolls expired a few years after opening, would drive the first bridge out of business. In the course of determining that the Charles River Bridge operators did not have an exclusive franchise over river crossings in the area, the Court expressed concern that a contrary finding would prevent state governments from acting in the public interest. As Chief Justice Taney stated in his opinion for the Court rejecting an implied intention of the state to create a binding exclusive contract;

> still less will it be found, where sovereign rights are concerned, and where the interests of a whole community would be deeply affected by such an implication. It would, indeed, be a strong exertion of judicial power, acting upon its own views of what justice required, and the parties ought to have done, to raise, by a sort of judicial coercion, an implied contract[.]

Early cases refusing to recognize vested rights in pension payments clearly rested their analysis on the need to preserve regulatory flexibility over pension payments to retired state workers. Just as Congress remains free to adjust the Social Security program by increasing the retirement age, delaying or reducing cost of living allowances, increasing payroll tax deductions, imposing income tax on benefits payments and even reducing benefits payments, the Supreme Court has recognized state flexibility in pension terms. As the Court stated very clearly in 1985, the presumption against finding a contractual obligation in pension promises

> is grounded in the elementary proposition that the principal function of a legislature is not to make contracts, but to make laws that establish the policy of the state. Indiana ex rel. Anderson v. Brand, 303 U.S. 95, 104-105 (1938). Policies, unlike contracts, are inherently subject to revision and repeal, and to construe laws as contracts when the

[112] Proprietors of Charles River Bridge v. Proprietors of Warren Bridge, 36 U.S. 420 (1837).

> obligation is not clearly and unequivocally expressed would be to limit drastically the essential powers of a legislative body. Indeed, "'[t]he continued existence of a government would be of no great value, if by implications and presumptions, it was disarmed of the powers necessary to accomplish the ends of its creation.'" Keefe v. Clark, 322 U.S. 393, 397 (1944) (quoting Charles River Bridge v. Warren Bridge, 36 U.S. (11 Pet.) 420, 548 (1837)). Thus, the party asserting the creation of a contract must overcome this well-founded presumption, Dodge, supra, 302 U.S., at 79, and we proceed cautiously both in identifying a contract within the language of a regulatory statute and in defining the contours of any contractual obligation.[113]

In light of these concerns, the courts have developed a strong clear statement principle for determining whether a contractual relationship with the state exists.[114] The standard in this area has been referred to as the "unmistakeability doctrine,"[115] requiring that the state's intent to be contractually bound be "'expressed in terms too plain to be mistaken.'"[116] The purposes of the unmistakeability doctrine are to preserve state flexibility in the exercise of sovereign power and

[113] Nat'l R.R. Passenger Corp. v. Atchison Topeka & Santa Fe Ry. Co. 470 U.S. 451 (1985).

[114] A related doctrine, the "sovereign acts doctrine" protects similar interests. As explained by Joshua Schwartz:

> These doctrines preserve the government's ability to respond effectively to changed circumstances that call for a policy response without undue inhibition because of the collateral effects such a response may have upon subsisting government contracts. At the same time, these rules of law should be framed so as to provide appropriate protection to the reliance and expectation interests of the government's contractual partners. Indeed, the government shares a long-range interest in achieving a legal regime in which the risks borne by its contractors do not stand as a barrier to entry into a competitive market for government contracts. Finally, in striking a balance between governmental and contractors' interests, the sovereign acts and unmistakability doctrines must also maintain the constitutional separation of powers among the branches of the federal government.

Joshua I. Schwartz, *Liability for Sovereign Acts: Congruence and Exceptionalism in. Government Contracts Law*, 64 GEO. WASH. L. REV. 633 (1996)

[115] *See Parker*, 123 F.3d at 5.

[116] *Id.* at 5 (quoting United States v. Winstar Corp, 518 U.S. 839, 875 (1996)).

to avoid the difficult constitutional questions that arise if a contractual obligation is found.[117] Due to the strong presumption against finding a contractual obligation, there are no clear standards governing the determination.[118] Rather, all of the facts and circumstances surrounding each alleged contract must be closely examined to determine whether the state legislature intended to create a contractual relationship.[119]

It is not altogether clear that the analogy between public pension benefits and cases like *Charles River Bridge* and even Social Security reform legislation is apt. Unlike the typical regulatory program, pension benefits are earned through government employment and, especially with regard to past services, are compensation for work already performed. In employment situations, perhaps the presumption should be flipped—it ought to be presumed that promises made based on employment are intended to be contractual. Otherwise, state and local employers would be free to take advantage of employees in exactly the way that the Contract Clause, as applied to government's own contracts, is supposed to prevent. Further, allowing state and local governments complete freedom to alter employee benefits retroactively could hamper public

[117] *See* United States v. Winstar Corp., 518 U.S. 839, 871-91 (1996). Justice Souter's plurality opinion in *Winstar* relied upon the purposes of the unmistakeability doctrine to argue that the strength of the doctrine should be calibrated to reflect the extent to which a particular contract limits sovereign powers. Contracts that would limit important powers such as the taxing power should be subject to a strict unmistakeability doctrine while "humdrum supply contracts" should not. *Id.* at 880. For a look at the implications of *Winstar*, see Joshua I. Schwartz, *The Status of the Sovereign Acts Doctrine and Unmistakeability Doctrines in the Wake of Winstar: An Interim Report*, 51 ALABAMA L. REV. 1177 (2000).

[118] The high bar to finding a contractual obligation stands in contrast to the relatively easier time government workers and government benefits recipients have in establishing property interests in their jobs or benefits. Under the test developed under Board of Regents v. Roth, 408 U.S. 564 (1972), government benefits and employment are considered property under federal law whenever ascertainable standards govern their award and termination. Accrued pension benefits are almost certainly property under federal law, despite outdated decisions such as Pennie v. Reis, 132 U.S. 464 (1889) which characterize public pensions as mere gratuities. A finding that a pension promise is property would not, however, prevent the government from legislatively removing protections or depriving the employee of benefits for legal cause following a constitutionally adequate process. This may explain why the Court has made it more difficult to find a contractual obligation than a property interest. The Contract Clause provides substantive protection to the contractual interest, which means regardless of the procedure, it cannot be taken away. By contrast, due process prohibits only deprivations accomplished without due process of law.

[119] *See Parker*, 123 F.3d at 4.

employers' ability to attract high quality employees or reduce employers' flexibility regarding the timing of pay and benefits if employees refuse to accept insecure promises of deferred compensation. With regard to Social Security, even though benefits are based on contributions, the case for allowing reform is still much stronger than in the government employment situation. People are likely to understand that Social Security is a government benefits program subject to legislative change.

The high bar against finding a contractual obligation in pension contracts is illustrated by the First Circuit's decision in *Parker v. Wakelin*, a case involving statutory amendments to Maine's public employee retirement laws. The amendments, enacted in 1993, made several changes to the pension system that were unfavorable to employees. Some of the changes applied to all employees while others applied only to those employees with less than ten years of creditable service. The changes that affected all employees included an increase in the required employee contribution to the pension plan (from 6.5 percent to 7.65 percent), a cap on salary increases that may be used in calculating pension benefits, and a six-month delay in a retiree's first cost of living increase. For employees with less than ten years of service, the minimum full pension retirement age was increased from 60 to 62, the penalty for retiring early was increased from 2.25 percent of the pension benefit to 6 percent of the pension benefit for each year before age 62, and the ability of employees to include unused sick and vacation pay in calculating pension benefits was eliminated.[120]

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[120] *See Parker*, 123 F.3d at 3 nn. 3&4, discussing 5 M.R.S.A. §§ 17001(13)(B), 17001-B, 17701(13)(C), 17851(1-A) & (2-A), 17852(3-A) and 17806(3).

While many state courts treat pension promises as unilateral contracts that are entered into when the employee begins working,[121] the First Circuit explicitly rejected a blanket rule treating all pensions that way. Instead it chose to closely analyze Maine law to determine whether the State of Maine intended to bind itself to the pension promises made to employees as embodied in the statutory provisions as they existed before the amendments.[122] The most significant indication of contractual intent on the part of the Maine legislature was a statute enacted in 1975 which states:

> No amendment to this chapter shall cause any reduction in the amount of benefits which would be due to the member based on creditable service, compensation, employee contributions and the provisions of this chapter on the date immediately preceding the effective date of such amendment.[123]

This is a typical provision found in state law to protect public employee pensions. The question is whether it satisfies the unmistakeability doctrine's standard for finding intent to create a binding contract to maintain pension benefits as of the date a public employee was hired, i.e., whether it creates a contractual obligation.

In *Parker*, the district court had found that no changes could be made to the potential benefits of Maine employees with enough service to retire before the changes took effect, but that the benefits of employees with some service but not enough to retire could be reduced. The court of appeals viewed the question as turning on the meaning of the word "due" in the 1975

[121] *See, e.g.*, Ass'n of Pennsylvania State Coll. & Univ. Faculties v. State Sys. of Higher Educ., 505 Pa. 369 (1984); Halpin v. Nebraska State Patrolmen's Ret. Sys., 211 Neb. 892 (1982) (alteration in pension calculation method violated Contract Clause); Yeazell v. Copins, 98 Az. 109 (1965) (finding contractual obligation in legislative terms in effect at time employee entered employment).

[122] The Third Circuit has held that even in Pennsylvania where the state courts view pension promises as contractual, no contractual right exists if the pension plan explicitly provides that administrators have the power to make alterations to the plan. *See* Transp. Workers Union of Am., Local 290 By & Through Fabio v. Se. Pennsylvania Transp. Auth., 145 F.3d 619 (3d Cir. 1998)

[123] P.L. 1975, ch. 622, § 6, codified at 5 M.R.S.A. § 17801.

statute quoted above. If "due" means what *would* be payable if the employee retired, then the promise was contractual and the state could not alter the terms of the pension plan. If, however, the word "due" refers to amounts actually due and owing, then only retired employees already receiving pension payments are protected because no amounts are "due" to an employee who has not already retired.

Based in part on the reasoning of the Maine Supreme Court in an earlier case involving pension reform,[124] the First Circuit held that the 1975 statute was not sufficient to create a contractual obligation in favor of any employee who had not yet retired, even if the employee was eligible to retire but had not yet done so. In the earlier case, the Maine Supreme Judicial Court rejected the notion that pension terms become binding contractual promises at the moment of employment.[125] The First Circuit reasoned that this indicates that the word "due" in the 1975 statue does not refer to pension terms in effect at the time of employment. However, the court recognized that this does not resolve the question whether pension terms might be "due" once an employee has sufficient creditable service, and is old enough, to retire. For the First Circuit, in light of the Maine court's understanding of the word "due", the unmistakeability doctrine tipped the scales against finding a contractual obligation to employees who were eligible to retire.[126] Thus, all of the 1993 pension reforms could be applied to all non-retired Maine employees without violating the Contract Clause. This is a relatively narrow understanding of the Contract Clause's protection of government pension promises.

[124] Spiller v. State, 627 A.2d 513 (Me. 1993).
[125] *Id.*
[126] If, in a subsequent case, the Maine Supreme Judicial Court holds that the 1975 statute prohibits pension plan changes that alter the benefits that would be paid to employees already eligible to retire, the First Circuit's conclusion would be subject to revision. However, a case subsequent to such a determination by the Maine court is unlikely to arise in federal court because the state courts would have already prohibited the changes to the pension plan that might violate the Contract Clause.

A finding that a contractual right in pension benefits exists does not mean that pension reform measures are automatically unconstitutional. As mentioned above, the Contract Clause prohibits only substantial impairments,[127] (and, as discussed below, allows substantial impairments if they are "reasonable and necessary to serve an important public purpose."[128]) There is no clear line in the caselaw between substantial and insubstantial impairments.[129] The central inquiry appears to be whether the complaining party actually relied on the altered term or terms. As one court put it:

> In determining whether an impairment is substantial and so not "permitted under the Constitution," of greatest concern appears to be the contracting parties' actual reliance on the abridged contractual term. Specifically, the Supreme Court has examined contracts to determine whether the abridged right is one that was "reasonably relied" on by the complaining party, . . . or one that "substantially induced" that party "to enter into the contract."[130]

For example, in a case involving an alleged impairment of municipal bonds issued by a water utility, the bondholders complained that their Contract Clause rights were violated when the water utility was no longer legally entitled to place a lien on property based on a default by a tenant.[131] When the bonds were issued, default by a tenant allowed the utility to place a lien on the land even if the owner had not contracted for service. This increased the likelihood of payment after default. The court concluded that a loss of the ability to place a lien on the landlord's property after default by a tenant was not a substantial impairment of the contract:

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[127] Gen. Motors Corp. v. Romein, 503 U.S. 181, 186 (1992).
[128] Parker v. Wakelin, 123 F.3d 1, 5 (1st Cir. 1997) (quoting U.S. Trust Co. of New York v. New Jersey, 431 U.S. 1, 25 (1977)); *see also* Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411-12 (1983).
[129] *See* Baltimore Teachers Union, Am. Fed'n of Teachers Local 340, AFL-CIO v. Mayor & City Council of Baltimore, 6 F.3d 1012, 1017 (4th Cir. 1993) (the "Supreme Court has provided little specific guidance as to what constitutes a 'substantial' contract impairment.").
[130] City of Charleston v. Pub. Serv. Comm'n of W. Virginia, 57 F.3d 385, 392 (4th Cir. 1995) (quoting Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 246 (1978); City of El Paso v. Simmons, 379 U.S. 497, 514 (1965)).
[131] City of Charleston v. Pub. Serv. Comm'n of W. Virginia, 57 F.3d 385 (4th Cir. 1995).

> The bond contracts themselves contain express acknowledgements that the parties' rights were subject to legislative regulation; there was a long established precedent of extensive state regulation of public utilities; the contracts were not abolished but merely modified; and the abridged right is, by its nature, not one central to the parties' undertaking.[132]

Another factor that is relevant to whether there is a substantial impairment of a contract under the Contract Clause is whether the law has provided alternative benefits to the party whose rights have allegedly been impaired. (As discussed above, this is also an important factor in some states for satisfying state law restrictions on pension modification.) Rather than isolate the individual elements in the contractual agreement, courts holistically ask whether the parties' overall situation has been made significantly worse. For example, in the case involving the bondholders discussed above, in the year before the bondholders lost the right to place liens on landlords' property, they gained the right, under state law, to terminate water service for nonpayment. The court held that the addition of this very effective remedy for nonpayment meant that overall, there was not a substantial impairment of the bondholders' contractual rights.[133] In the pension reform area, this flexibility can be important as governments struggle to reduce their costs without harming employees who depend on the benefits.

Amy Monahan concludes from her examination of the caselaw that in general, changes to the level of benefits and changes that affect the rights and responsibilities of employers are held to be substantial impairments. In her view, except perhaps in extraordinary circumstances, changing the method for calculating benefits so that lower benefits are paid is likely to be found to be a substantial impairment of the contract. Monahan points out, however, that some states,

[132] *Id.*
[133] *Id.*

such as California, allow substantial pension reform as "reasonable and necessary" impairments before retirement because, in their understanding of state law, employees have a right to a "substantial or reasonable pension" but not to a specific level of benefits.[134]

Despite this recognition that California courts have allowed substantial pension reform as reasonable and necessary, Monahan is highly critical of California's general approach to pension reform, an approach that she recognizes has been followed by at least a dozen more states. Monahan states that the California rule recognizing contractual rights in pension promises from the first day of employment is, for several reasons, "surprising":

> First, it runs contrary to the well-established legal presumption that statutes do not create contractual rights absent clear and unambiguous evidence that the legislature intended to bind itself. Second, courts interpreting the California Rule have held that the contract protects . . . the rate of future accrual. This interpretation is contrary to federal Contract Clause jurisprudence, which holds that prospective changes to a contract should not be considered unconstitutional impairments. Third, not only is this interpretation contrary to general contract theory, it also appears to create economic inefficiency, in that it fixes in place one part of an employee's compensation. . . . California courts have held that even though the state can terminate a worker, lower her salary, or reduce her other benefits, the state cannot decrease the worker's rate of pension accrual as long as she is employed. This framework can be welfare reducing. Given the option, an employee may prefer to accept lower future pension accruals in return for avoiding termination or a reduction in current compensation, but such deals are hard to accomplish in a system that

134 Monahan, *supra* note x, at 628 (citing Betts v. Bd. of Admin., 21 Cal. 3d 859 (1978)).

> protects the right to future accruals. It should also be noted that the protections the California Rule appears to offer are illusory, given that it simply forces a state that needs to reduce costs to do so in some area other than pension accruals--for example, through layoffs or salary reductions. Viewed holistically, the California Rule simply does not protect employees' economic interests, and in some cases the rule may even harm the interests of the very employees it is meant to protect.[135]

Monahan may be correct that California law is contrary to general legal principles and more protective of employees than federal Contract Clause jurisprudence, but I do not find California law "surprising." On her first point, there are good reasons to treat statutory promises to government employees different from promises contained in other regulatory statutes. Most people have multiple employment options at the outset and at various stages of their careers. Retirement promises form part of the inducement for individuals to choose and remain in government employment. While businesses may be in a similar situation and may suffer, as did the Charles River Bridge Company, when the regulatory rug is pulled out from under it, individuals have much less ability to diversify regulatory risk than businesses. Employees cannot be expected to save twice or three times for retirement or change jobs every so often so their retirement promises come from multiple employers. This recognition helps explain why federal law protects private pensions through the ERISA and the programs administered by the Pension Benefit Guaranty Corp. That the federal Contracts Clause may be less protective than state law is no reason for state law to change. Under familiar understandings of federalism, in

[135] Monahan, Statutes as Contracts, supra note x at 1032-33.

many situations, federal law should be lenient with regard to state law, especially when the state's own operations are involved, stepping in only in extreme cases.

As to Monahan's claim that protecting pension promises is inefficient because the optimal result may be reduced pension promises rather than layoffs that might be necessary to fund remaining employees' pensions, this is a dilemma that is familiar to anyone studying labor economics. As wages and benefits increase, employers may hire fewer employees, may fire existing employees and may replace employees with technology or workers in jurisdictions with lower salaries. Some unions have dealt with this problem by agreeing to lower wages and benefits for new employees while protecting the wages and benefits of incumbents. More fundamentally, although Monahan clearly understands that pension promises are a form of deferred compensation, her argument in favor of greater flexibility virtually ignores the ex ante perspective of the parties. At the time the contract was made, had the employees' known that their pension promises were subject to significant revision, they may not have accepted government employment or they may have demanded significantly higher current compensation. Normally, the security of contract enforcement is thought to increase efficiency, and Monahan does not refute that general tendency.

Monahan's strongest point is that protecting future accrual levels significantly reduces pension flexibility. If she is correct that public employees are "generally at-will employees, with no guaranteed period of employment,"[136] then it would make legal and practical sense to allow prospective changes to the terms of a contract that both parties could simply terminate at any time. At-will employees' reliance on future benefits may be viewed as unworthy of protection.

[136] See Monahan, Statutes as Contracts, supra note x at 1077.

However, there are reasons to doubt her premise. Government employees are highly unionized,[137] and are much more likely than private employees to have job security in the form of contractual or civil service protections. Further, advocates of prospective change should recognize that, for example, a 20 year government employee suddenly faced with significantly lower future accrual of retirement benefits may be seriously damaged economically by the change and may not be in a position to seek alternate employment or take some other action to ameliorate the effects of the change.[138]

Sometimes, pension reforms are touted as providing benefits to plan participants even if the predominant effect of reform is to reduce pension expenditures. At a basic level, current and future recipients benefit from any reform that brings a fund closer to full funding, because fund enhancement makes pension promises more secure. There are, however, two problems with generalizing from this possibility to a principle that any reform that enhances the assets of a pension fund survives Contract Clause scrutiny. First, this reasoning would allow serious detriment to some participants as long as most participants gain. While this might be appropriate in some contexts, for example if a reform reduces pension spiking by those at the high end of the benefits scale, it would not be appropriate to sacrifice lower end recipients who are heavily dependent on their benefits.[139] The financial health of the fund should not be shored up on the

[137] According to the Cato Institute, "In 2009, 39 percent of state and local workers were members of unions, which was more than five times the share in the private sector of 7 percent." See Chris D. Edwards, Public-Sector Unions, Cato Institute Reports No. 61 (March 2010).

[138] See Eric M. Madiar, Public Pension Benefits under Seige: Does State Law Facilitate or Block Recent Efforts to Cut the Pension Benefits of Public Servants, 27 ABA J. Lab. & Emp. L. 179, 194 (2012) (criticizing Monahan's conclusions for failing to recognize the reasonable expectations of pension plan participants).

[139] I do not mean to say that payments to those receiving the smallest pensions should be immune from reduction or other reform, such as reducing cost of living increases. The real question is economic dependency. Some retirees receiving small pensions barely worked for the government and just got over the eligibility bar with questionable creditable service, such as volunteer service on a local government board or commission. Other retirees receiving

backs of those who can least afford it. Second, using the financial health of pension funds as a justification for reforms that otherwise harm plan participants is illogical if the pension promises involved are viewed as contractual obligations in favor of recipients. Recipients gain nothing if under state law the plan must live up to the promises made regardless of the financial health of whatever fund has been established to marshal assets to make the payments. Reform under such circumstances benefits only the state budget, not pension plan participants.[140]

The final issue in a Contract Clause controversy examines the government interest advanced by the challenged reforms. Although the Contract Clause is phrased as an absolute prohibition on state laws impairing contracts, as noted, courts apply what appears to be akin to an intermediate level of constitutional scrutiny in Contract Clause cases, asking whether the challenged government acts are "reasonable and necessary to serve an important public purpose."[141] In the pension area, this standard may save reforms that are designed to combat abusive pension practices.[142] The question remains, however, whether a pure desire to save

small pensions are highly dependent on those benefits because they worked at relatively low paying government jobs for long periods and did not participate in federal Social Security during that time. It is thus difficult to design reforms based purely on the size of the pension.

[140] I leave to the side for now the possibility of bankruptcy, which might allow greater reductions. *See infra* at x.

[141] Parker v. Wakelin, 123 F.3d 1, 5 (1st Cir. 1997) (quoting U.S. Trust Co. of New York v. New Jersey, 431 U.S. 1, 25 (1977)); *see also* Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411-12 (1983). *Cf.* Craig v. Boren, 429 U.S. 190, 197 (1976) ("classifications by gender must serve important governmental objectives and must be substantially related to achievement of those objectives.").

[142] Courts seem open to reforms that curb abusive pension practices. For example, in *Madden v. Contributory Ret. Appeal Bd.*, 431 Mass. 697 (2000), the Massachusetts Supreme Judicial Court approved a decision by the Teachers' Retirement Board to close a loophole that would have allowed a part-time teacher to receive full-time credit for part-time service. However, the court disapproved of application of the new rule to part-time service before the rule was adopted. The Court stated that modifications in benefits are allowed if they are "reasonable and bear some material relationship to the theory of a pension system and its successful operation." *Id.* at 701.

money is sufficient to save a reform measure that operates only to reduce payments to retirees, increase contributions from retirees, or both.[143]

In general, it appears that courts rarely approve substantial impairments as supported by a sufficient government interest.[144] In support of pension reform, it might simply be argued that saving money is an important public purpose and thus, especially if obligations to retirees pose a fiscal crisis as some claim, reducing pension obligations is "reasonably necessary" to serve that interest. The problem is that this could be said about virtually any breach of contract by government—the government has decided that it would be better off not living up to its promises because, at a minimum, it saves resources. As the Supreme Court stated in a Contract Clause case not involving public pensions:

> Merely because the governmental actor believes that money can be better spent or should now be conserved does not provide a sufficient interest to impair the obligation of contract. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.[145]

There should therefore be some additional government interest behind pension reform. Such an interest might be in eliminating fraud or abusive pension practices that detract from equity among workers and result in unjustifiable benefits, i.e., benefits with no relation to the retirement income that the employee was relying on as part of government service.

[143] For an argument that budget difficulties and financial downturns should provide adequate reasons to allow states to modify their pension obligations, see Whitney Cloud, Comment, *State Pension Deficits, the Recession, and a Modern View of the Contracts Clause*, 120 YALE L.J. 2199 (2011). See also Gavin Reinke, Note, When a Promise Isn't A Promise: Public Employers' Ability to Alter Pension Plans of Retired Employees, 64 Vand. L. Rev. 1673, 1989-90 (2011) (arguing that saving money is legitimate government interest supporting pension reform against substantive due process challenge).

[144] Monahan, *supra* note x, at 631 ("The only public pension plan cases identified that found substantial impairments to be reasonable and necessary to serve an important public purpose were in cases where the court first held that no substantial impairment occurred.").

[145] U.S. Trust Co. of New York, 431 U.S. at 26.

It is unclear whether the government interest in saving money on pension expenses would be more acceptable if it were linked to a history of overly generous promises and abusive practices. The government should be viewed as having an interest in closing loopholes that allow abusive practices. In general, government has an interest in protecting the integrity and fairness of programs it administers. Courts should be more receptive to reforms that target practices that are regarded as abusive than to reforms that reduce benefits to employees who legitimately relied on them.

The propriety of considering the government's interest in saving money as the interest behind pension reform is also linked to the structure of the pension plan and state law on whether pension promises are strictly enforceable. If plan participants are legally entitled under state law to their promised payments regardless of whether the state has set aside sufficient funds to meet its obligations, it would seem that the simple interest in saving money should not be sufficient to support pension reform. Under such circumstances, to allow government's interest in saving money to support reducing benefits would essentially nullify the plan participants' legal rights without any compensatory benefit.

B. The Takings Clause and Pension Reform

Another possible constitutional constraint on pension reform is the Takings Clause, which prohibits government from taking property for public use without compensation. In litigation involving public pensions, it is common for claims under the Contract Clause and Takings Clause to be made together over the same reform, because under current understandings, government contractual promises may be considered property for constitutional purposes.[146] With regard to state and local reforms, the Takings Clause is unlikely to add much to claims under the Contract Clause because a participant's interest in pension promises is unlikely to be property unless it is found to be a contractual promise protected under the Contract Clause or state law pension doctrine.[147] It is theoretically possible, however, that a reform that does not violate the Contract Clause, because the government's action is reasonable and necessary to serve an important public purpose, violates the Takings Clause. This is because the government's justification for a taking is irrelevant—if it takes property even for the most important of purposes, it must pay compensation.

The takings claim is strongest with regard to benefits that have already been paid, and might also be relatively strong with regard to reforms that reduce pension payments to people already receiving them. In the Scigulinsky case, involving "evictions" of participants from a state pension plan, the First Circuit upheld legislation that halted public pension payments to private union employees. The legislation required the state to repay, with interest, these participants' contributions to the system insofar as they exceeded what the participants had received in payments. The court noted that "[p]ension payments actually made to retirees become their property and are protected against takings, even if and where the payments are

[146] See, e.g., San Diego Police Officers' Ass'n v. San Diego City Employees' Ret. Sys., 568 F.3d 725 (9th Cir. 2009) (plaintiffs allege that failure to fund pension plan adequately violated both the Contracts Clause and Takings Clause).

[147] Picard v. Members of Emp. Ret. Bd. of Providence, 275 F.3d 139, 144 (1st Cir. 2001) ("In evaluating whether a purported contract or property right is entitled to constitutional protection under the Takings Clause, Contract Clause, or Due Process Clause, this Court generally looks to state law as interpreted by the state's highest court."); Nat'l Educ. Ass'n-Rhode Island *ex rel*. Scigulinsky v. Ret. Bd. of Rhode Island Employees' Ret. Sys., 172 F.3d 22 (1st Cir. 1999) ("It would make nonsense of such rulings-and the clear intent requirement-to conclude that an expectancy insufficient to constitute an enforceable contract against the state could simply be renamed "property" and enforced as a promise through the back door under the Takings Clause.").

unquestionably a gift."[148] The law is less clear with regard to promises made to people who have already retired. Some courts view such benefits as vested and immune from reduction. . Other courts view such benefits as regulatory promises that are open to change, assuming state law does not clearly immunize them from revision. The same can be said of benefit promises to people eligible to retire at the time reforms are enacted. Some courts treat these as vested and immutable, but again, this depends largely on the terms of state law. Because of this connection to state law, the Takings Clause is likely to follow the Contract Clause in recognizing only those claims that involve unmistakeable contractual promises already protected from reduction under state law.

The possibility that a pension reform measure that satisfies Contract Clause scrutiny but nevertheless might require compensation under the Takings Clause implicates the thorny issue of the extent to which regulation under the state's police power that reduces the value of property can constitute a taking of that property requiring compensation. If each dollar of promised pension benefits is viewed as a separate property interest, then it would seem that any diminution would violate the Takings Clause. But if instead the property interest is viewed as the value of the pension as a whole, then reforms that preserve the bulk of expected benefits should not be problematic. In this article, I will not attempt to resolve the conceptual difficulties that plague regulatory takings doctrine.[149] It should be noted, however, that the application of regulatory takings analysis is highly uncertain in the public pension context because the property rights at

[148] Scigulinsky, 172 F.3d at 30.

[149] Regulatory takings doctrine has proven very lenient in terms of allowing changes in government regulation to cause substantial reductions in the value of private property without requiring compensation. However, the law is very strict when government requires the actual physical occupation of private property. It is difficult to fit reduction in pension benefits into this paradigm. On the one hand, if each dollar of expected benefits is considered a separate piece of property, then taking one away might be considered a taking. On the other hand, if the property interest is in a reasonable pension in light of work performed, then reforms may not appear to be prohibited takings.

issue are contractual and perhaps even regulatory, which makes it difficult to separate the terms of state law from the value of the property allegedly taken.

The reasons for the relative leniency of regulatory takings law apply in the context of pension reform. Regulatory takings law recognizes that adapting government policy to changed circumstances or new priorities would be impossible if every regulatory diminution in the value of a property interest requires compensation. Flexibility is even more important if it appears that pension promises are overly generous, subject to abuse by legislators and other officials handing out political favors and by employees using loopholes and tricks to spike their pensions. It is one thing for the government to breach a simple arms-length contract with a supplier of goods or services. It is quite another for government to attempt to reign in excessive pension promises made to secure the power of incumbent politicians at the expense of taxpayers. Just as the law does not generally recognize a reliance interest in a static regulatory environment, so too is it unlikely to recognize a reliance interest in a completely static public pension system. To the extent that courts apply the Takings Clause to pension reform, they are unlikely to rule against reforms except in the most extreme circumstances.

As noted, takings analysis is likely to mirror the analysis undertaken pursuant to state law pension protections and the Contract Clause. The Takings Clause may have independent bite in one potentially significant situation, i.e., when pension reform is undertaken pursuant to federal law, either because changes are being made to federal government pensions or because state pensions are adjusted pursuant to federal law, most notably federal bankruptcy law. The Contract Clause does not apply to the federal government and therefore federal changes to existing contractual relationships are scrutinized under the more lenient minimal scrutiny applied to substantive due process challenges to economic regulation.[150] If federal law allows or even requires the reduction of pension benefits to federal or state and local employees, the Takings Clause might be the most promising avenue for attacking the reform. In the current context, a key issue is whether a municipality can use federal bankruptcy law to discharge its pension obligations. As discussed below, the answer appears to be yes, and because the Contracts Clause does not apply to the federal government, the principal legal question becomes whether a discharge pursuant to bankruptcy law could be viewed as an uncompensated taking. This is discussed below.[151]

IV. Bankruptcy, Reduction of Pension Obligations, and Default[152]

Chapter 9 of the Bankruptcy Code allows for the "adjustment of debts of a municipality." In short, local government units can declare bankruptcy and have their debts adjusted under federal law. Municipalities may not employ federal bankruptcy law if the law of their state does not allow it.[153] In other words, local governments need state permission to declare bankruptcy. In theory, in states in which municipal bankruptcy is allowed, federal bankruptcy law could be employed by municipal governments to reduce or eliminate their pension obligations.[154]

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[150] See Pension Ben. Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 730 (1984) ("The retroactive aspects of legislation, as well as the prospective aspects, must meet the test of due process[.] [T]hat burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose.")
[151] See infra at x (concluding that takings principles are unlikely to prevent state and local governments from pursuing pension reform through bankruptcy or otherwise).
[152] I am indebted to Ted Orson, lawyer for the City of Central Falls, Rhode Island and the State of Rhode Island in the city's municipal bankruptcy proceedings for guiding me through Chapter 9 of the Bankruptcy Code and offering his perspective on the subject. For a theoretical overview of municipal bankruptcy, see Michael W. McConnell & Randall C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. Chi. L. Rev. 425 (1993).
[153] 11 U.S.C. § 109(c).
[154] The funded portion of future pension benefits might not be subject to adjustment in bankruptcy, but unfunded obligations might be subject to "discharge at less than full payment." Skeel, *supra* note x, at 692.

There are significant differences between municipal bankruptcy and bankruptcy of private entities. Most significantly, there is no provision for liquidation of municipal assets and termination of the existence of the municipality. It is thought that federal liquidation of a municipal government would be too great an intrusion into state authority.[155] Further, bankruptcy may not be used to restructure the municipal government because that too would interfere with state authority over municipalities.[156] Finally, there is no provision in federal law for states themselves to declare bankruptcy, and any such effort would be met with serious constitutional objections.

There are five statutory conditions[157] that must be met for municipalities to use Chapter 9 to adjust their finances. First, the municipality must be authorized under state law to be a debtor under Chapter 9.[158] Second, the debtor must actually be a municipality. For villages, cities, towns, counties and such, this is normally not a difficult condition to meet, but status as a municipality may be less clear for other government entities, such as water districts, school districts, and other special purpose agencies. Third, the debtor must be insolvent. "Insolvent" is defined in the Bankruptcy Code to mean either failing to pay debts or "unable to pay its debts as they become due."[159] In the case law, this is interpreted to mean not only that the municipality is running a deficit but also that it will be unable to pay its debts in the current or next fiscal

[155] The official website of the United States Courts describing municipal bankruptcy provisions makes this point. *See Municipality Bankruptcy*, USCOURTS.GOV, http://www.uscourts.gov/federalcourts/bankruptcy/bankruptcybasics/Chapter9.aspx.
[156] 11 U.S.C. §§ 903 & 904.
[157] These requirements are contained in § 109(c).
[158] The Allegheny Institute reports that as of 2010, nineteen states authorized their municipalities to employ federal bankruptcy. See Allegheny Institute, Issue Summary: Municipal Bankruptcy, http://www.alleghenyinstitute.org/government/munbankruptcy.html.
[159] 11 U.S.C. § 101(32).

year.[160] Fourth, the municipality must desire to make a plan to reorganize its debts. This precludes involuntary municipal bankruptcy. Fifth, the municipality must either obtain agreement from creditors holding a majority of claims, negotiate in good faith with creditors, show that negotiation would be impracticable, or reasonably believe that a creditor will obtain a preference absent bankruptcy. Usually, this fifth requirement results in negotiations with creditors before the municipality files.

Municipal bankruptcy allows for adjustment of pension liabilities to both retired workers and current workers who are paying into the retirement system. For current workers, their labor contracts are considered executory contracts under § 365 of the Bankruptcy Code, which is explicitly applicable to municipal bankruptcy.[161] Debtors are authorized by § 365 to reject their executory contracts. Thus, in the bankruptcy of Central Falls, Rhode Island, on the day the petition was filed, the city rejected all of the collective bargaining agreements and imposed new terms of employment, including new provisions relating to pensions.[162] Due to the special nature of collective bargaining agreements, rejection of municipal collective bargaining agreements is allowed only if the "balance of equities" favors rejection.[163] If this standard is met,

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[160] *See In re* City of Bridgeport 132 B.R. 85, 89 (Bankr. D. Conn. 1991). Apparently, a high percentage of municipal filings are rejected, as the City of Bridgeport's was, because the municipality is not legally insolvent.
[161] *See* 11 U.S.C. § 901 (incorporating 11 U.S.C. § 365 into Chapter 9 on Municipal Bankruptcy).
[162] Unless otherwise noted, all information concerning the Central Falls, Rhode Island, bankruptcy is drawn from a conversation with Ted Orson, bankruptcy attorney for the City and State of Rhode Island and from the Chapter 9 plan for the City filed with the Bankruptcy Court, available at http://www.rib.uscourts.gov/newhome/central_falls/CF479.asp.
[163] It should be noted that after the Supreme Court decided that it was not an unfair labor practice for a debtor to reject a collective bargaining agreement in *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513 (1984), Congress enacted special provisions regarding rejection of collective bargaining agreements. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333-92 (1984) (codified at 11 U.S.C. § 1113). Those provisions are not among those listed by Congress as applying to municipal bankruptcy, which means that rejection of municipal collective bargaining agreements is governed by Bildisco's "balance of equities" standard, which the Supreme Court determined was the most accurate reading of Congress's intent regarding the application of § 365 to collective bargaining agreements. Another difference between rejection under § 365 and rejection under § 1113 is

municipalities can reduce or eliminate pension and health care promises to current workers, and require them to contribute more toward the costs of both.

With regard to retired municipal workers already receiving pension benefits, the situation is simpler as a legal matter but more complicated as an equitable or political matter. Because retired employees have no substantial remaining contractual obligations to the municipality, their pension promises are no longer considered executory contracts.[164] Rather, under bankruptcy law, the obligation to make future pension and health care payments to retired workers is a simple debt of the debtor, and the creditors (retired workers) have only unsecured claims against the municipality. The claims are unsecured because workers do not have separate individual accounts into which their retirement contributions (and the employer's matching contributions) have been deposited. In fact, for municipalities with severe underfunding, benefits are often paid out of the contributions of current employees, and there is no segregation of the funds contributed by each worker and by the municipality itself on behalf of each worker.

This means that theoretically, retired workers could see their benefits subjected to severe restrictions. Given that many municipal workers have not participated in the federal Social Security system, this could cause serious hardship, basically placing retirees without other

that when a contract is rejected under § 365, the creditor has a claim for damages as an unsecured creditor for breach of contract. By contrast, the dominant view is that when rejection is accomplished under § 1113, the affected employees have no claim for damages because their rights have already been determined under federal bankruptcy law. For a discussion of the constitutionality of state and local rejection of collective bargaining agreements, see Ronald D. Wenkert, *Unilateral Modification of Collective Bargaining Agreements in Times of Fiscal Crisis and Bankruptcy: An Unconstitutional Impairment of Contract?*, 225 ED. L. REP. 1 (2007).

[164] The authoritative definition of "executory contract" in bankruptcy law was formulated by Vern Countryman in his article Executory Contracts in *Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). See also See Comment, Hannah Heck, Solving Insolvent Public Pensions: The Limitations of the Current Bankruptcy Option, 8 Emory Bankr. Dev. J. 89, 124 (2011) (concluding that pension obligations to retired workers are not executory contracts because retirees have no continuing contractual obligations). This comment also argues that any state law impediments to implementation of federal bankruptcy law in the public pension context (other than state refusal to allow its municipalities to use Chapter 9) would be preempted by federal law. See id. at 120-21.

savings into abject poverty. There have been so few municipal bankruptcies and even fewer in which pensions to current retirees are adjusted that there is no real precedent for how retirees ought to be treated. The proposed plan in the Central Falls, Rhode Island, bankruptcy, which cited pension and health care obligations to retirees as a major cause of insolvency, [165] would reduce most retirees' pension benefits by 55 percent, except that no retiree's pension would be reduced below $10,000 per year.[166] While these cuts may seem draconian, the plan treated retirees better than other unsecured creditors. Apparently, there was a strong feeling among those involved in the bankruptcy that it would have been inhumane to reduce retirees' benefits to the level they would get as unsecured creditors.

To some, it may still seem cruel to reduce pensions so much. Many of Central Falls' employees worked for the city for decades, always expecting that their pensions would be paid based on the formula established in their employment contracts. They relied on those funds in making important life choices such as whether to continue their city employment, whether to save or spend their salaries, whether to move, and whether to go back to school to train for a different profession. As discussed above, most pensions are not unreasonable when viewed in light of the employees' total compensation packages. A worker retiring at a $50,000 salary may see a $35,000 pension reduced to under $16,000, and may have increased health care costs. This is a serious hardship to the people involved and may be life changing for many of them. However, this is the pain caused in many situations of insolvency. Just as Bernard Madoff's clients were led to believe that their investments were worth much more than was true, the City

[165] *See* Mary Williams & Katie Zezima, *Small City, Big Debt Problems*, N.Y. TIMES, Aug. 1, 2011.
[166] *See* Plan for the Adjustment of Debts of City of Central Falls, Rhode Island, *In re* City of Cent. Falls, R.I., 468 B.R. 36 (Bankr. D.R.I. 2012) (No. 11-13105), *available at* http://www.rib.uscourts.gov/newhome/central_falls/116/116-1.pdf.

of Central Falls misled its employees. Apparently the City failed for years to make its actuarially required contributions on behalf of its employees. The money to pay retirees' pensions in full was simply not there. The question is whether the City or the State should be required to increase taxes or employ some other financial device to make good on these promises.

Given the lack of precedent, it remains to be seen whether other unsecured creditors will challenge favorable treatment to retirees in municipal bankruptcy as unfair to them, perhaps arguing that they will receive lower payouts on their claims as a result of the favorable treatment of pension claims. It also remains to be seen how federal bankruptcy courts will react to such claims. Congress could amend the Bankruptcy Code to deal with the problem, but federalism concerns counsel against it. Congress may not want to interfere with the local political considerations that are likely to affect the treatment of retirees in municipal bankruptcy. Some states have enacted legislation allowing state authorities to assume supervision over distressed municipalities. More specifically, in Central Falls, the retirees negotiated for a five year transition period during which their pension benefits would be reduced by only 25 percent. This was contingent on the state legislature providing funding during the transition period, which it did. Federal standards on the treatment of government retirees in bankruptcy might interfere with these local political efforts.

The Contract Clause of the federal Constitution is no bar to municipal bankruptcy for the simple reason that the Contract Clause does not apply to the federal government.[167] While the

[167] Federal laws affecting the obligation of contracts are evaluated under a less exacting due process standard. *See* Pension Ben. Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 733 (1984) ("to the extent that recent decisions of the Court have addressed the issue, we have contrasted the limitations imposed on States by the Contract Clause with the less searching standards imposed on economic legislation by the Due Process Clauses.").

first municipal bankruptcy law was found to violate the Contract Clause by allowing municipalities to violate their contracts,[168] this does not appear to be the current understanding. Later, the constitutionality of federal bankruptcy for municipal governments was upheld against challenges based on federal interference with state sovereignty and due process,[169] and it does not seem that a challenge based on the contractual or property rights of municipal creditors would succeed either.[170] Instead of relatively stringent Contract Clause scrutiny, federal interference with the obligation of contracts is judged under the deferential rational basis standard applied to economic regulation generally.[171]

Even in these difficult financial times, municipal bankruptcy has been very rare. Further, even if municipal bankruptcy became more common, it would have no effect on the large portion of unfunded retirement obligations owed by states to their current and retired workers. As noted, there is no provision for state governments to file for bankruptcy under federal law.[172] There is a question of whether it would be constitutional to amend federal law to allow states to file for adjustment of their finances in the same fashion as municipal governments. Professor Skeel notes that advocates of state bankruptcy do not find the constitutional objection to be serious if two conditions that already apply to municipal bankruptcy are met—filing must be voluntary, and bankruptcy must not interfere with governmental decision making.[173] He also notes that

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[168] Ashton v. Cameron County Water Imp. Dist. No. 1, 298 U.S. 513, 531 (1936). *See also* Skeel, *supra* note x, at 708.
[169] United States v. Bekins, 304 U.S. 27 (1938).
[170] *See id.* at 54.
[171] *Pension Ben. Guar, Corp.*, 467 U.S. at 728-31.
[172] For a discussion of the possibility of authorizing states to employ bankruptcy to restructure their debts, see Skeel, *supra* note x.
[173] *See id.* at 679.

these advocates view the constitutional permissibility of municipal bankruptcy as strong precedent for the constitutionality of state bankruptcy.

It is not absolutely clear that the approval of municipal bankruptcy is precedent for finding no constitutional difficulty with state bankruptcy. The status of municipal governments under federal law is inconsistent to say the least. Long ago, in refusing to intervene in a dispute concerning municipal boundaries and responsibility for municipal debts,[174] the Supreme Court stated as a basic principle that municipal governments exercise state governmental power and are created and organized purely for the convenience of the states. "Municipal corporations are political subdivisions of the state, created as convenient agencies for exercising such of the governmental powers of the state as may be entrusted to them."[175] In this light, if municipalities are simply state agencies, then the constitutionality of municipal bankruptcy should provide a strong precedent for the constitutionality of state bankruptcy.

There are, however, many ways in which municipal governments and state governments are treated differently under federal law. In the civil rights area, state governments, including state agencies, are immune from damages by virtue of the Eleventh Amendment and principles of sovereign immunity, while municipal governments are not. States are not "persons" subject to federal civil rights liability in state courts while municipal governments are. Given that the Contract Clause is directed explicitly at states –"No State shall . . . pass any . . . Law impairing the Obligation of Contracts"—perhaps state attempts to reduce their contractually binding pension obligations should be treated differently than similar actions by municipal governments.

[174] *See* Hunter v. Pittsburgh, 207 U.S. 161 (1907).
[175] *Id.* at 178.

The fact that municipalities are subject to state control may provide a basis for treating state and municipal governments differently with regard to the possibility of using bankruptcy law to adjust their debts. Unlike other debtors, states theoretically have the ability to raise whatever funds are necessary to pay their debts through taxation. Municipal governments may not have this ability because they are subject to state control. The state legislature could prevent a locality from raising sufficient funds to pay their debts by forbidding increased taxation or limiting revenue sources. Further, a geographically small municipal government is much more likely to run up against practical limits on its taxing ability than a large municipality or a state.

States, by contrast, lack funds only when the state's own government declines to raise them through sufficient taxes and fees. Lack of taxable wealth may limit the ability of states to raise revenue, but this is much more likely to be a local problem than a statewide problem. As a conceptual matter, unless taxation is at such a high level that there is simply no more wealth to tax, from the point of view of a creditor, state bankruptcy looks more like a political decision not to pay debts than a true state of insolvency.[176] However, this picture is somewhat incomplete. While it is true that state taxpayers in a state with underfunded pension liabilities are able to push off some of the costs of state services onto future taxpayers, it is difficult to blame those future taxpayers for resisting tax increases to pay for pension liabilities incurred in the past when they may not have been enjoying the benefits of the services provided in exchange for the unfunded pension promises. Similarly, it is not difficult to imagine that future federal taxpayers would

[176] Tax increases sufficient to meet all unfunded pension obligations may be economically disastrous and state taxpayers as a whole would be better off if states were allowed to reduce their obligations rather than raise taxes. High taxes can put a damper on economic activity and encourage business to move to lower tax states or countries. However, state bankruptcy to avoid pension obligations would exacerbate the unwillingness of state politicians to raise sufficient funds for pension obligations, which either results in hardship for workers relying on their pensions or imposes the cost of current labor on future generations of taxpayers.

resist tax increases to pay the $16 trillion in debt that the federal government has incurred in the last 12 years or so.

If bankruptcy is not available to states, does that mean that they are stuck with their pension and health care obligations to retired workers? Theoretically, the answer seems to be yes, as perhaps it ought to be given the interests of state retirees and employees. Default on pension obligations, or alterations beyond those allowed under Contract Clause jurisprudence, would violate the federal constitution and would also be contrary to the law in many, if not all, states. However, just because state action violates federal law does not guarantee an effective remedy. Surprisingly, whether states can be sued in federal court over alleged constitutional violations in pension reform is unclear.

Controversy over federal remedies for state contractual violations goes back to the beginnings of the republic. When the state of Georgia defaulted on its bonds after the Revolutionary War and the Supreme Court ruled in *Chisolm v. Georgia*[177] that Georgia could be sued in federal court by a nonresident for breach of contract, the state legislature considered and nearly passed a statute imposing the death penalty, "without benefit of clergy," on anyone attempting to enforce the judgment in the case.[178] The decision also provoked Congress and the states to pass and ratify the Eleventh Amendment to the Constitution,[179] which reversed the jurisdictional ruling in the *Chisolm* case. One hundred years later, the Supreme Court ruled that the Eleventh Amendment and principles of sovereign immunity precluded federal court

[177] Chisolm v. Georgia, 2 U.S. 419 (1793)
[178] See William A. Fletcher, A Historical Interpretation of the Eleventh Amendment: A Narrow Construction of an Affirmative Grant of Jurisdiction Rather Than a Prohibition against Jurisdiction, 35 Stan. L. Rev. 1033, 1058 (1983).
[179] U.S. Const. Amend. XI.

jurisdiction over a claim brought by a citizen of Louisiana alleging that the state violated the U.S. Constitution by defaulting on bonds issued in 1874.[180]

Thus, it appears that the federal cases establish that states cannot be sued for damages in federal court without their consent, even for actions that violate the Constitution of the United States.[181] However, under well-established principles, when state law violates the federal constitution, state officials can be sued in their official capacities for injunctive relief,[182] even if the injunction requires future payments from the state treasury.[183] This means that a state official could be ordered, on pain of contempt, to make future payments found to be constitutionally required, but the official could probably not be ordered to make past payments wrongfully withheld.[184] Thus, the conventional understanding seems to be that if state pension reform is found to violate the federal constitution, injunctive relief may be available in federal court to

[180] Hans v. Louisiana, 134 U.S. 1 (1890).
[181] It appears to be an open question whether states can avoid their Takings Clause obligation to pay compensation for takings of private property by interposing a sovereign immunity defense. A decision by the Supreme Court recognizing sovereign immunity from takings claims would be shocking. The Takings Clause appears to be a limit on sovereignty of both the federal government and state governments now that the Takings Clause applies to them under the Fourteenth Amendment. Perhaps Contracts Clause claims against states for breaching their own contracts should be thought of the same way. This depends, however, on the expansion of the Contract Clause to cover the state's own contracts, and state immunity from contract damages is not directly contrary to clear constitutional text the way that immunity from takings claims would be (again assuming the Takings Clause applies to the states through the Fourteenth Amendment).
[182] Ex Parte Young, 209 U.S. 123 (1908). The reach of Ex Parte Young is not completely clear. Other decisions from the same era seem to validate sovereign immunity in federal court from contract damages and from suits seeking specific performance of contracts between a state and private parties. See Louisiana v. Jumel, 107 U.S. 711 (1883); In re Ayers, 123 U.S. 443 (1887*);* Hagood v. Southern, 117 U.S. 52 (1886). Hagood was distinguished in Ex Parte Young as a case in which the state was the actual party in interest, which seems to be the case with regard to pension reform as well. See Ex Parte Young, 209 U.S. at 150.,
[183] See Edelman v. Jordan, 415 U.S. 651 (1974). See also Milliken v. Bradley, 433 U.S. 267 (1977).
[184] See Quern v. Jordan, 440 U.S. 332 (1979). Professor Skeel posits that "the officer could evade a mandamus action seeking to compel performance of the contract by simply resigning." Skeel, *supra* note x, at 686, but normally when the case is brought in the officer's official capacity, the new occupant of the resigned official's office is substituted, and the case continues without regard to the resignation of the officer. For example, Quern became the defendant in *Edelman v. Jordan* when he took Edelman's position in the state of Illinois. No doubt, state and local officials may sometimes succeed in avoiding liability, but it is not likely to be so simple as resigning once the official is ordered to comply with federal law in the future.

require responsible officials to make future payments and administer the program based on preexisting standards, but they could not be ordered to make up for past reductions in payments or other past violations.[185]

This conventional understanding of the line between permissible and impermissible federal relief against state officials is more complicated than it seems, because it is not entirely clear that injunctions requiring increases in future payments to meet constitutional obligations are allowed. Consider, for example, a recent decision by a federal district court in New Jersey holding that an attack on pension reforms in New Jersey is barred by the Eleventh Amendment.[186] The State of New Jersey passed legislation increasing employees' required contributions to state pension funds and suspending cost of living allowances for both current and future retirees.[187] The plaintiffs challenged these reforms as impairing the obligation of contracts, taking property without just compensation and as violating their due process rights. The court, in a thoughtful opinion, found federal jurisdiction barred because rather than challenging an ongoing violation of federal law, the plaintiffs were seeking a remedy for a past violation, namely the passage of the pension reform statute at issue.[188] Under this reasoning,

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[185] For an overview of the ways in which judicial decisions constrain state fiscal decisionmaking, see Kenneth T. Cuccinelli, II, E. Duncan Getchell, Jr., & Wesley G. Russell, Jr., Judicial Compulsion and the Public Fisc—A Historical Overview, 35 Harv. J.L. & Pub. Pol'y 525 (2012).
[186] See New Jersey Education Assoc, v. New Jersey, 2012 WL 715284 (D.N.J.).
[187] Id. at *1.
[188] The court structured the inquiry as follows: "[T]he question to be answered in this case is appropriately framed as determining whether Plaintiffs' requested relief is retroactive or prospective in nature. Therefore, at the heart of this Court's Eleventh Amendment analysis is the following question: was the enactment of Chapter 78 a single act that has continuing ill-effects or does the enforcement of Chapter 78 by the Executive Defendants amount to a continuous violation of the Plaintiffs' constitutional rights? . . . After examining the nature of Plaintiffs' claims, the Court has determined that the enactment of Chapter 78 was a single act that continues to have negative consequences for the Plaintiffs. As such, any redress sought by the Plaintiffs would be retroactive in nature and is therefore barred by the Eleventh Amendment." Id. at *4.

there is no federal remedy for a states' breach of contract even if the breach violates the Contracts Clause.[189]

The final substantive issue to be addressed is whether the Takings Clause provides protection against diminution of government pension obligations pursuant to bankruptcy, on the theory that pensions are property that may not be taken without just compensation. Takings analysis turns out not to be a promising avenue of attack for public pension plan participants seeking to avoid costly reform. In short, although the Supreme Court has made it clear that takings principles apply to bankruptcy's effects on property, [190] the Takings Clause is unlikely to provide protection for public pension recipients and government employees with accrued service toward pensions because bankruptcy and other reform does not deprive the pension plan participants of an interest in identifiable property.

Takings principles limit the ability of bankruptcy to destroy creditors' property interests including liens and security interests that creditors often hold in debtors' property.[191] It does not

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[189] See id. at * 5, citing *Va. Office of Prot. & Advocacy v. Stewart,* 131 S. Ct. 1632, 1639 (2011) ("Therefore, the relief requested by Plaintiffs is, in both substance and practical effect, a request for specific performance of the alleged pre-Chapter 78 contract existing between Plaintiffs and the State of New Jersey. Under controlling Supreme Court precedent, such relief is not permitted.")

[190] "The bankruptcy power is subject to the Fifth Amendment's prohibition against taking private property without compensation." United States v. Security Indus. Bank, 459 U.S. 70, 75, (1982). On the relationship between bankruptcy and takings principles, see James S. Rogers, The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause, 96 Harv. L. Rev. 973 (1983).

[191] See Security Indus. Bank, 459 U.S. at 78 (construing Bankruptcy Code not to authorize destruction of liens to avoid constitutional question whether destruction would be a taking requiring compensation.) The interaction between bankruptcy law and takings principles became an issue during the Great Depression when Congress enacted statutes providing for relief of bankrupt homeowners against mortgage foreclosure. See also Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 590 (1935) (finding bankruptcy law unconstitutional insofar as it authorized "the taking of substantive rights in specific property acquired by the" creditor, namely a mortgage held by a bank). But see Wright v. Vinton Branch of Mountain Trust Bank, 300 U.S. 440 (1937) (upholding amended provisions preserving mortgagees' interest while imposing a stay on foreclosure proceedings subject to the discretion of the federal court). For a more recent affirmation of the constitutionality of adjusting mortgagees' rights in bankruptcy, see Travelers Ins. Co. v. Bullington, 878 F.2d 354 (11th Cir. 1989).

protect purely contractual rights such as the details of pension promises made by governmental units to past and current employees. The whole point of bankruptcy is to adjust such unsecured obligations among the creditors so that no creditor or class of creditor gains an unfair share of the debtor's assets.[192] The analysis might be different if employees' and retirees' funds were held in segregated accounts for the benefit of each employee or retiree.[193] Absent an identifiable fund "owned" by the pension recipient or the employee, such as perhaps an annuity purchased in the name of the recipient or a brokerage account in the name of the recipient, the fact that state and local pension promises might be considered "property" for due process purposes does not mean that they are protected by the Takings Clause from rejection or reduction in bankruptcy.

However, even if there is no federal remedy available, state constitutional and statutory provisions, discussed above, may impose substantial impediments to state pension reform. As noted, many states prohibit diminution of pension benefits for both retired workers and workers currently employed. In such states, legislation or executive action purporting to reduce benefits may be declared null and void by state courts. In these states, and in light of the possibility of federal civil rights injunctive relief, federal bankruptcy law may be necessary to bring about meaningful pension reform in some states. However, as noted, most states do not allow their municipalities to employ bankruptcy to adjust their debts. Whether courts in those states would prevent reform even in dire financial circumstances, remains, perhaps, to be seen.

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[192] See In re Nolan, 232 F.3d 528, 534 n. 10 (6th Cir. 2000) ("Every bankruptcy involves a 'transfer' of private property from a creditor to a debtor, in the sense that a creditor is involuntarily deprived of a previously-vested, legally-enforceable debtor obligation to return borrowed creditor property. However, mere reconciliation of debts among private entities does not normally constitute taking private property for *public use*.") In municipal bankruptcy, the "public use" requirement might be met, but the adjustment of claims would still not constitute a "taking."

[193] Even if there were some separable property interest that could be claimed by each public pension plan participant, ordinarily the interest would be protected only to the extent of its value at the time of bankruptcy. See Skeel, supra note x at 698.

IV. Concluding observations

The public pension crisis, in part, is a state and local analog to the spiraling federal debt. Without significant reform, state and local governments will have to devote increasingly large portions of their limited revenues to fulfilling pension promises that may have been made decades before. We have already seen significant reductions in government services in states with high pension costs, such as California. That state, which once boasted of the most comprehensive and inexpensive higher education system in the nation, is now finding it impossible, for example, to continue to offer sufficient community college slots for all students. Pension costs are a major contributor to California's financial difficulties.

The pension funding crisis is different from other forms of deficit spending because the it involves obligations to individuals, i.e. current and former government employees. Most references to the "public pension crisis" are to the financial aspects of the problem. This masks the most important crisis, the human crisis. The vast majority of people receiving government pensions are not wealthy. If many pension plans follow the lead of Central Falls, Rhode Island, there will be a crushing financial blow to many pension recipients, especially those who never participated in the federal social security system. Most state and local pensions are relatively modest, and the workers and employers involved have contributed to their pensions the way that workers and employers in the private sector pay social security taxes and contribute to 401k accounts, often coupled with employer contributions.[194] These workers have structured their

[194] State and local employers and employees contribute, on average, a total of 18.5 percent of salary to public pension funds covering employees not participating in social security (10.5 percent for the employer and 8 percent for the employee.) Social security contributions for other workers total 12.4 percent, with employers and employees contributing 6.2 percent each. *See* ALICIA H. MUNNELL & MAURICIO SOTO, CENTER FOR STATE AND LOCAL

finances and made career and personal decisions in reliance on their pension expectations. Reforms that involve significant reductions in pension payouts or large increases in employee pension contributions may appear to be unfair to the majority of workers who have not engaged in any significant manipulation of their pension entitlements. Of course, when a private business goes into bankruptcy, many people's legitimate expectations are upset, even people who cannot afford the losses they are forced to bear.

In a sense, public pension recipients are in a similar position, but on the lower end of the economic scale, to the victims of Bernard Madoff's ponzi scheme. In many public pension funds, the level of contributions was established based on the expectation that the funds would earn 8 percent per year. While average returns over the last 20 years or so may be in that range, over the last decade the returns have been closer to 6 percent, with a 3.2 percent annual return over the past 5 years. In the fiscal year ending June 30th, the two largest California public pension funds earned 1 percent and 1.8 percent, while New York State's largest fund earned 6 percent in its fiscal year that ended in March, before significant market losses in the second quarter of 2012. If returns remain well below the 8 percent level usually relied upon, underfunding will only get worse, and pension fund participants' expectations will become more and more unrealistic.

Another analog to the Madoff scandal is that these workers were likely led to believe that their employers were contributing to the pension fund, in amounts sufficient to fund the promises that were being made. Just as Madoff's victims received fabricated statements indicating

GOVERNMENT EXCELLENCE, ISSUE BRIEF: STATE AND LOCAL PENSIONS ARE DIFFERENT FROM PRIVATE PLANS 4 (2007), *available at* http://crr.bc.edu/wp-content/uploads/2007/11/slp_1.pdf.

investment gains that did not exist, government workers were told what level of benefits they should expect, and that money was being set aside each month on their behalf.

The fairness of significant reductions in pension benefits depends on a variety of considerations, including the magnitude of the contributions made by retirees and employees to the retirement system; the degree to which pensions were spiked in ways not related to the true earnings of the employees; the degree to which employees accepted lower current wages in exchange for generous retirement benefits; and the other ways in which employees structured their finances and their personal and professional lives around their pension expectations. Employees may have rejected other employment opportunities such as moving into higher paying private sector jobs without pension benefits and they may have saved less for retirement in reliance on their pensions. These decisions are irrevocable for older workers and retirees who have insufficient (or no) remaining time in the work force to ameliorate the consequences of these decisions.

Reforms may seem less unfair if pension promises were unrealistically generous in light of contributions to pension funds and true rates of return on pension fund investments. Reduction in benefits may not seem unfair if contributions similar to or slightly higher than those made to social security resulted in pension promises two, three, or four times higher than social security benefits that would have been earned in that program.[195] If workers or their unions understood that their contributions were based on projected returns that were way out of line

[195] As noted above, public pension participants contribute somewhat more to their pension funds than the amounts required for participation in social security. *See supra* note x. Higher returns for public pension participants may be justified in part because those funds invest in the stock market, while social security funds are invested only in federal Treasury bills which earn a relatively low rate of return.

with the market, it might not seem unfair to make them bear some of the pain of the shortfall that has resulted, especially if government salaries are similar to or even higher than private sector salaries, as some analysts claim. However, this ignores the inducement aspect of pension promises, that state and local workers were induced to accept and remain in their jobs in part based on the pension promises that were continually made during their employment.

Reform may seem even less unfair when it is directed at activities that seem to fall into the general category of pension spiking. Insofar as pension benefit calculations are inflated by including overtime, secondary jobs, longevity pay, and artificial promotions, reducing benefits may seem perfectly fair. Public pensions should compensate employees fairly and provide economic security, they should not provide an opportunity to game the system. Of course, rules in many areas of law are subject to manipulation, but it is generally not viewed as unfair when reforms are directed at issues properly characterized as "loopholes."

The Massachusetts Supreme Judicial Court's statement that changes to pension plans are constitutional if they are "reasonable and bear some material relationship to the theory of a pension system and its successful operation," can help provide the basis for a general understanding of how the contractual underpinnings of contemporary pensions should be tempered to allow for reforms to abusive pension practices. Government pensions are designed to provide financial security, incentives to faithful long-term government service, and to perhaps make up for the lower salaries of government employees, while providing for the reduced economic needs for retired workers as compared to people still active in the work force. Under traditional, straightforward contract principles, employees can make a persuasive case that they should be able to take advantage of all of the features of the pension system in place during their employment. These could include provisions that enable pensions to be spiked based on second, part-time jobs, volunteer service, and longevity bonuses, designed simply to increase pensions. The Massachusetts court's comment encourages viewing pension reform from the perspective of the goals and nature of a pension system rather than as a simple contractual arrangement. Amounts earned through "gaming" the system are inconsistent with the theory of a pension system. No worker should have a legitimate expectation of a pension boosted by part-time work, end of career promotions, and longevity pay earned simply by informing the government employer that retirement is a year or more away.

The simple contractual view is inconsistent with contemporary application of the Contract Clause. Rather than simply disallow all retrospective modifications of the terms of both private and government contracts, the Supreme Court allows even substantial impairments of government contracts if they are supported by an important government interest. This contemporary standard rejects a simplistic contractual view of government-citizen contractual relations in favor of a more realistic view, imbued with policy and analysis of the legitimacy of private expectations.

In an odd sense, this is also theoretically consistent with the Supreme Court's recent, somewhat surprising decision invalidating the expansion of Medicaid under the Affordable Care Act.[196] In the Affordable Care Act, Congress specified that states must expand Medicaid eligibility on pain of the loss of all federal Medicaid funding, even for elements unrelated to the Affordable Care Act's expansion of the program. The Supreme Court rejected this provision on

[196] *See* Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566 (2012) (invalidating portions of Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 896 (Mar. 23, 2010)).

the ground that the states have established expansive subsidized health care programs for the poor in reliance on continued federal funding, and it would not be truly voluntary if states risked all of their funding by refusing to expand their programs to meet the Affordable Care Act's standards. On a purely contractual theory, the Court's decision makes no sense. The states have a clear and simple choice—provide Medicaid under the new law's standards or forego Medicaid funding for the future. This simplistic contractual perspective does not account for the expectations and networks of institutions that have grown up around federal Medicaid funding, which make it virtually inconceivable for any state to forego federal funding altogether. Similarly, if pension promises are viewed as the product of a corrupt or incompetent political system, then perhaps adjustments beyond those that would be tolerated on a strict contractarian view should be allowed.

Reforms targeting abuses should be allowed under any theory. Government employees may recognize that there are contractually-protected loopholes and devices that allow them to spike their pensions. They also probably understand, however, that they are taking advantage of technicalities that go beyond the spirit of the government pension program. A purely contractual view would not take this into account. The core of pensions based on a person's true long-term service and economic reliance should be protected, but contractual formalities should not prevent the closing of loopholes and the elimination of methods that allow pension spiking.

Fairness aside, if the financial situation of government pension funds does not improve, many state workers and retirees may suffer severe reductions in their pension benefits as public entities find it economically or politically impossible to meet their obligations to retired workers. Municipalities may reduce pension benefits through bankruptcy and states may unilaterally reduce benefits and use their unique positions as sovereign states to resist judicial remedies based on state or federal law. These possibilities may give pension plan participants strong incentives to negotiate over their pension benefits, perhaps resulting in the acceptance of significant reductions that are less painful than what would have otherwise occurred.

What might the future hold for the public pension systems? While reflecting on the relative impecunity of government pension recipients and their legitimate expectations based on years of contributions and service, it is worth considering whether public pensions should be bailed out the way that financial institutions have been bailed out in the past. According to the website propublica.com, 928 institutions have received more than $600 billion in federal bailout funds during the recent financial crisis. This includes nearly $200 billion to the quasi-governmental Fannie Mae and Freddie Mac, and nearly $70 billion to the insurance company, AIG. Other large institutions receiving billions of dollars in bailout funds include General Motors, Bank of America, and Citigroup.[197] There have been additional government bailouts in the United States, including the rescue of the City of New York in 1975, Chrysler Corp. in 1980, and the savings and loan industry in the late 1980s and early 1990s. Perhaps the federal government should step in, in a cooperative plan with the states, and provide funds, loans, and other financing to bail out underfunded public pension funds. If the government is willing to provide funds for mismanaged banks and insurance companies, why not for pension funds?

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[197] *See Bailout Recipients*, PROPUBLICA, http://projects.propublica.org/bailout/list.

One modest proposed bailout of state and local pension funds is for the federal government to guarantee pension obligation bonds issue by states.[198] Additional proposals in the same vein would provide federal guarantees or favorable tax treatment for such bonds on the condition that the state adopt certain austerity measures such as moving to defined contribution pension plans for new employees and fully funding existing defined benefit plans.[199] These proposals are designed to relieve some of the fiscal pressure on state and local governments while preserving employees' pensions.

There are many practical reasons to be cautious about bailing out public pension funds. The most obvious is that it would be very expensive: in the trillions of dollars especially if health care promises to retirees are included. It should be noted that according to the New York Times, the government's total commitment of loans and other investments in the recent financial bailout may total more than $12 trillion,[200] but still, in present circumstances, any request to spend trillions more would be greeted with great skepticism to say the least. Further, bailing out hundreds of public pension funds would be a difficult and complex undertaking with enormous moral hazard implications. Each of the hundreds of underfunded pension funds is underfunded to a different degree, and got there in its own way. Some funds were abusive, with extravagant promises and minimal contributions, while others simply suffered from lackluster investment performance perhaps owing to unrealistic, but good faith, predictions. Some large bureaucracy,

[198] See Debra Brubaker Burns, Note, Too Big to Fail and Too Big to Pay: States, Their Public-Pension Bills, and the Constitution, 39 Hastings Const. L.Q. 253, 276 (2011), citing Governor Pat Quinn, Illinois State Budget Fiscal Year 2012 29 (2012), available at http://www2.illinois.gov/budget/Documents/FY%202012/FY12_Operating_Budget.pdf and Dave McKinney, Top U.S. House Republican Rejects Federal Guarantee for Ill. Pensions, Chi. Sun-Times, Feb. 23, 2011, http:// www.suntimes.com/news/politics/3959464-418/top-u.s.-house-republican-rejects-federal-guarantee-for-ill.-pensions.
[199] See Burns, Note, supra note x at 276-77.
[200] *See Adding Up the Government's Total Bailout Tab*, N.Y. TIMES, Feb. 4, 2009, *available at* http://www.nytimes.com/interactive/2009/02/04/business/20090205-bailout-totals-graphic.html.

like the Resolution Trust Corporation of the savings and loan crisis, but much larger, would have to be created, and standards would have to be developed to guide the treatment of the funds based on numerous variables.

The moral hazard problem is also significant. In some states and localities, corruption has contributed significantly to extravagant pension promises. Unless serious consequences are attached to abusive behavior and effective controls are put in place, losses may continue after bailouts.[201] We have seen this in what seems, at this point, to be a regularly occurring cycle of bailouts directed at financial institutions. If state and local pension funds are too big to fail, their managers can continue with their untoward behavior, assured that the federal government will be there to pick up the pieces when things fall apart.

Despite all of this, the human case in favor of a bailout is compelling. The Rhode Island legislature recognized this when it appropriated funds to cushion the blow suffered by Central Falls retirees. The possibility of large numbers of retirees without sufficient pensions to stay out of poverty may not threaten to bring down the entire financial system, but it is a prospect that is contrary to the ideals established by the social security system, that the elderly should have sufficient resources to live out their remaining years with dignity. Of course, there are competing demands for every government dollar, and in an era with no appetite for tax increases, spending on the elderly may come out of funds that might have been devoted to education or health care for children and the poor. There are obviously no easy answers, but the possibility of

[201] For example, consider the multi-billion dollar trading losses suffered by JP Morgan Chase after it received (and paid back) $25 billion in federal bailout funds. *See Management shake-up at JPMorgan; Zames is COO*, WALL ST. J., July 27, 2012, *available at* http://online.wsj.com/article/AP13f79c4fe0694aa49fc0f09df5446b30.html.

a large scale bailout should at least be part of the conversation. Retirees are entitled to at least as much consideration as financial institutions and government bondholders.

Looking at the more distant future, steps ought to be taken to avoid the possibility of this happening again. Investment volatility and political considerations are likely to continue to threaten the financial viability of pension funds if they continue as currently structured. As of yet, there has been no large scale movement in government away from benefit plans toward 401k-style contribution plans. This may be due to a combination of worker resistance and the financial difficulty of making the transition when underfunded pension plans need continued contributions to move toward actuarial soundness.[202] In Massachusetts, for example, one element of pension reform is a long-term schedule for eliminating municipal pension underfunding by requiring higher municipal contributions until full funding is achieved 2025.[203] Assuming that no significant movement is made away from defined benefit plans toward contribution plans, reform is likely to include further attacks on pension spiking and a combination of reduced benefits and increased contributions from workers. More states may require their workers to join the federal social security program and then scale down the size of pensions accordingly. Health care benefits are likely to be cut by requiring greater contributions from retirees toward premiums, and by increasing co-pays and deductibles.

One final thought. The recent controversy over collective bargaining rights in Wisconsin and related events may lead some to believe that the public pension crisis is less about the

[202] One respected expert, and zealous advocate of requiring that pensions be based on actual contributions, concludes that the transition problem is manageable. See Robert M. Costrell, "GASB Won't Let Me": A False Objection to Pension Reform, Policy Perspective Published by The Laura and John Arnold Foundation (2012).

[203] MASS. GEN. LAWS ch. 32 § 22c. It appears that the Massachusetts legislature altered the schedule in reaction to the stock market and general financial downturn of 2008.

problem of chronic underfunding of pensions, and more about the slow but steady elimination of economic security for middle class workers in the United States. Public employment is the last bastion of unionized labor in the United States. Unionized workers tend to earn higher salaries and benefits and enjoy greater job security than their non-unionized counterparts. Perhaps because of this, many unionized jobs in the United States' private sector have disappeared, with manufacturing leading the way. Until now, relatively low level state and local employees have been able to remain in the middle class and have enjoyed economic security in retirement. Pension reform and elimination of collective bargaining rights could signal the end of that.[204] It may be only a matter of time before the twentieth century is viewed by public workers as the good old days.

[204] Pension reform advocate Robert Costrell blames collective bargaining for the high cost of teacher fringe benefits, including pension promises not based on teacher contributions to the pension fund. See Robert M. Costrell, Oh, To Be a Teacher in Wisconsin: How can fringe benefits cost nearly as much as a worker's salary? Answer: collective bargaining., The Wall Street Journal (Feb. 25, 2011).