

# OVERPROTECTING PUBLIC EMPLOYEE PENSIONS: THE CONTRACT CLAUSE AND THE CALIFORNIA RULE

*By Alexander Volokh*



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*Alexander Volokh*

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## Overprotecting Public Employee Pensions: The Contract Clause and the California Rule

Alexander Volokh\*

*The Contract Clause, which prohibits states from making laws impairing the obligation of contracts, is commonly used to challenge state and local public pension reform efforts. Courts in California, and in other states following California's example, follow a particularly strict rule: they hold not only that public employees are entitled to the pension they've accrued by their work so far, but also that they're entitled to keep earning a pension (as long they continue in their job) according to rules that are at least as generous. Thus, in states where the California rule applies, one can't constitutionally increase employee contribution rates or reduce cost-of-living allowances.*

*This rule is properly viewed either as an application of the federal Contract Clause, which usually defers to state law on the threshold question of whether there's a contract and what it covers, or as an application of a more generous state Contract Clause. Thus, there's nothing legally invalid about the California rule. But the rule is unsound as a policy matter, insofar as it locks governments and public employees into compensation structures different than what they would otherwise negotiate, and makes it harder for states to reform their pension systems.*

### I. THE PROBLEM

In 1996, Anne Arundel County, Maryland, modified its Police Service Retirement Plan.<sup>1</sup> The main change to the plan was that the maximum cost-of-living adjustment (COLA) would now be lower: while previously COLAs had been capped at 4%, they would now be capped at 2½% for benefits earned after the

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1 Howell v. Anne Arundel County, 14 F. Supp. 2d 752, 753 (D. Md. 1998).

bill's effective date.<sup>2</sup>

Police officers sued the county, asserting, among other claims, that the bill violated the U.S. Constitution's Contract Clause—"No State shall . . . pass any . . . Law impairing the Obligation of Contracts."<sup>3</sup> The district court agreed with the plaintiffs that "the retirement plans of state and local governments give rise to contractual rights within the scope of the Contract Clause,"<sup>4</sup> but denied that the Contract Clause was violated. The key aspect of the county's modification was that the COLA change was purely prospective; any benefits already earned would still be subject to COLAs calculated under the previous formula. And because the change didn't apply "retroactively to vested benefits," there was no impairment of contract rights.<sup>5</sup>

But that was Maryland. Consider an analogous case from California.<sup>6</sup> In 1982, charter amendment H in the city of Los Angeles placed a 3% cap on COLAs for police and firefighter pensions.<sup>7</sup> (COLAs had been introduced, with a 2% cap, in 1966; then the cap had been removed in 1971.)<sup>8</sup>

Police and firefighter unions challenged the amendment under the federal and California Contract Clauses.<sup>9</sup> The California Court of Appeal took the opposite approach from the Maryland district court: the COLA cap impaired the state's contractual obligations. That the cap was purely prospective was immaterial: "upon acceptance of public employment [one] acquire[s] a vested right to a pension *based on the system*

2 *Id.* at 753 & n.1. The bill also required the plan to pay its own expenses rather than having its administrative costs funded out of other county revenue, but the district court dismissed the challenge to this aspect in a footnote, *id.* at 753 & n.2, and this part of the challenge didn't play any role in the Contract Clause analysis.

3 U.S. CONST. art. I, § 10, cl. 1.

4 *Howell*, 14 F. Supp. 2d at 754 (quoting Defs.' Mem. Supp. Mot. Summ. J. at 7) (internal quotation marks omitted).

5 *Id.* at 755.

6 This case is also discussed at text accompanying *infra* notes 72–80.

7 *United Firefighters of L.A. City v. City of L.A.*, 259 Cal. Rptr. 65, 66 (Ct. App. 1989).

8 *Id.*

9 *See* CAL. CONST. art. I, § 9.

then in effect.”<sup>10</sup> (And if pension rules become more generous in the future, one then becomes entitled to the continuation of *those* more generous rules.)<sup>11</sup> Changing the COLAs *for the future* deprives employees of *currently* vested pension rights. Not that the COLAs can never be changed—contractual impairments can sometimes be justified—but the changes must be reasonable, meaning that they “must bear some material relation to the theory of a pension system and its successful operation,” and any disadvantages to the employees “should be accompanied by comparable new advantages.”<sup>12</sup> The court recognized Maryland’s approach<sup>13</sup> but noted that it was “contrary to California law.”<sup>14</sup>

This is the “California rule,” now adopted by twelve states (representing over a quarter of the U.S. by population).<sup>15</sup> As state and local governments seek to resolve their unfunded public pension problems,<sup>16</sup> the California rule, by freezing public-employee pension benefits in place, deprives governments of the flexibility to alter some of the future conditions of

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10 *United Firefighters*, 259 Cal. Rptr. at 66–67 (quoting *Miller v. State*, 557 P.2d 970, 975 (Cal. 1977)) (internal quotation marks omitted) (emphasis and alterations in original).

11 See text accompanying *infra* notes 115–120.

12 *United Firefighters*, 259 Cal. Rptr. at 67 (quoting *Miller*, 557 P.2d at 975 (quoting *Allen v. City of Long Beach*, 287 P.2d 765, 767 (Cal. 1955)) (internal quotation marks omitted)).

13 The approach in *Howell v. Anne Arundel County* had been previously used in *Maryland State Teachers Ass’n, Inc. v. Hughes*, 594 F. Supp. 1353 (D. Md. 1984).

14 *United Firefighters*, 259 Cal. Rptr. at 76.

15 These states are Alaska, Colorado, Idaho, Kansas, Massachusetts, Nebraska, Nevada, Oklahoma, Oregon, Pennsylvania, Vermont, and Washington. Amy B. Monahan, *Statutes as Contracts? The “California Rule” and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1071 (2012). Monahan’s article is an invaluable source on the California rule and goes into much greater detail than I do here. *But see id.* at 1071–75 (noting states that have adopted the California rule and then modified it, and states that have criticized the California rule); *id.* at 1082 (noting that not all these states have specifically ruled on the issue of future accruals).

16 See Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3, 10–16 (2013); Monahan, *supra* note 15, at 1034–36; Stuart Buck, *The Legal Ramifications of Public Pension Reform*, 17 TEX. REV. L. & POL. 25, 27 (2012).

public employment.<sup>17</sup>

If the government really promised its employees that its pension rules would be at least as generous for the duration of their employment, such a promise should be enforced<sup>18</sup>—governments can’t take property without paying just compensation, even in the face of a fiscal crisis;<sup>19</sup> why should they be able to do so with contract rights? But there is no such explicit promise. And guaranteeing particular pension rules is a strange thing to suppose governments have implicitly promised, given that they don’t promise other, more important prospective benefits: one’s tenure in one’s job, one’s future salary, or any other aspects of compensation. The State of California is free to repeal any civil service laws or other protections it may have for government employment; the Constitution isn’t implicated.<sup>20</sup> It may fire entire departments and slash public-sector salaries, if it so chooses.<sup>21</sup> But God forbid it chooses to lower COLAs: that’s unconstitutional.

This paper proceeds as follows: In Part II, I summarize basic Contract Clause doctrine. In Part III, I lay out the California rule. In Part IV, I explore whether the rule is consistent with the federal Constitution. In Part V, I critique the rule on policy grounds. Finally, in Part VI, I discuss possible fixes.

## II. THE RISE AND FALL AND RISE OF THE CONTRACT CLAUSE

In the original Constitution, before the adoption of the Bill of Rights, the Contract Clause was one of

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17 There are other legal constraints on pension reform, including the Takings Clause and state balanced budget requirements, *see* Beermann, *supra* note 16, at 31–67, but these are beyond the scope of this paper.

18 See Monahan, *supra* note 15, at 1077.

19 See U.S. CONST. amend. V; *Chi., Burlington & Quincy R.R. v. Chicago*, 166 U.S. 226, 235–41 (1897).

20 At most, firing individual employees will require certain procedures under the Due Process Clause. *See generally* *Goldberg v. Kelly*, 397 U.S. 254 (1970); *Bd. of Regents of State Colls. v. Roth*, 408 U.S. 564 (1972); *Mathews v. Eldridge*, 424 U.S. 319 (1976).

21 The Due Process Clause isn’t implicated by such non-individualized action. *See Bi-Metallic Inv. Co. v. State Bd. of Equalization*, 239 U.S. 441 (1915).

the few provisions to apply against states, together with such rules as the prohibition against states' entering into treaties, coining money, or passing bills of attainder and ex post facto laws. During the 19th century, it "was the most litigated provision in the Constitution and was the chief restriction on state authority."<sup>22</sup> The Marshall Court applied the clause "to tax-exemption agreements, grants of corporate charters, land grants, agreements between states, and state insolvency laws. In so doing the Court affirmed the sanctity of contracts and encouraged the rise of a market economy."<sup>23</sup>

Things are different now, as different as California is from Maryland. Starting in the mid-to-late 19th century, the Supreme Court made it easier for governments to abrogate their own contracts via eminent domain or the police power;<sup>24</sup> and in the early 20th century, the Supreme Court likewise retreated from aggressive protection of private contracts.<sup>25</sup> In 1934, the Court gave the Clause a "near-fatal punch"<sup>26</sup> when it upheld a state's two-year mortgage foreclosure moratorium in *Home Building & Loan Ass'n v. Blaisdell*.<sup>27</sup>

But the Clause isn't dead yet: in 1977, in *U.S. Trust Co. v. New York v. New Jersey*,<sup>28</sup> the Supreme Court reaffirmed that some limits remain on state abrogation of contracts, and that in fact the limits are stricter when the state seeks to abrogate its *own* (public) contracts,

22 James W. Ely, Jr., *Whatever Happened to the Contract Clause?*, 4 CHARLESTON L. REV. 371, 371 (2010) (citing BENJAMIN FLETCHER WRIGHT, JR., *THE CONTRACT CLAUSE OF THE CONSTITUTION*, at xiii (1938)).

23 *Id.* at 374 (footnotes omitted) (citing *New Jersey v. Wilson*, 11 U.S. (7 Cranch) 164, 167 (1812); *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. (4 Wheat.) 518, 712 (1819); *Fletcher v. Peck*, 10 U.S. (6 Cranch) 87, 142–43 (1810); *Green v. Biddle*, 21 U.S. (8 Wheat.) 1, 107–08 (1823); *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 207–08 (1819)).

24 *Id.* at 380 (citing *West River Bridge Co. v. Dix*, 47 U.S. (6 How.) 507 (1848)); *id.* at 381–82 (citing *Stone v. Mississippi*, 101 U.S. 814 (1880); *Butchers' Union Slaughter-House & Live-Stock Landing Co. v. Crescent City Live-Stock Landing & Slaughter-House Co.*, 111 U.S. 746, 754 (1884)); *see also id.* at 385 (public trust doctrine).

25 *Id.* at 387–88.

26 *Id.* at 388.

27 290 U.S. 398 (1934).

28 431 U.S. 1 (1977).

since then its own "self-interest is at stake."<sup>29</sup> The current test is whether the challenged state law "substantial[ly] impair[s] a contractual relationship"<sup>30</sup> and whether the impairment is "reasonable and necessary to serve an important public purpose."<sup>31</sup>

So far, this is all federal law; but state law also shows up in Contract Clause analysis, in two ways. In the first place, most state constitutions have their own contract clauses, which are usually interpreted similarly to the federal Contract Clause;<sup>32</sup> California is one of them.<sup>33</sup>

In the second place, even in federal doctrine, state law plays a role in the threshold question of whether a contract exists. After all, to answer whether a state law substantially impairs a contractual relationship, one must first identify the contract<sup>34</sup> and what it covers. This turns out to be tricky when it comes to pensions. The government usually doesn't enter into explicit contracts on this point; rather, the legislature generally just enacts a statute defining pension benefits for public employees.<sup>35</sup> And according to the Supreme Court, a statute isn't treated as a contract unless "the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State."<sup>36</sup>

So do these pension statutes create contractual obligations? Do the language and circumstances evince the necessary intent? On this threshold question, federal doctrine defers to state law, within limits. Ultimately it's a question of federal law; otherwise, states—whether

29 *Id.* at 26.

30 *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244 (1978); *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411 (1983); *GM v. Romein*, 503 U.S. 181, 186 (1992).

31 *U.S. Trust Co.*, 431 U.S. at 25.

32 *See Buck*, *supra* note 16, at 47 & n.105; Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617, 621 n.7 (2010).

33 CAL. CONST. art. I, § 9.

34 *See Romein*, 503 U.S. at 186.

35 These statutes usually don't themselves state an intent to create a contract. *See Monahan*, *supra* note 32, at 620 n.6 (citing N.J. STAT. ANN. § 43:13–22.33 (2009) as a rare example of a statute that does state such an intent).

36 *U.S. Trust Co.*, 431 U.S. at 17 n.14.

their legislatures or their courts—could define contract rights out of existence, making the Contract Clause “a dead letter.”<sup>37</sup> Federal courts’ willingness to use their own independent judgment also extends in the other direction, denying protection to arrangements that fall short of contracts even if a state court is willing to call them contracts.<sup>38</sup> But within these broad bounds, federal courts “accord special consideration and great weight to the views” of state supreme courts, and thus will usually accept state law determinations of whether a contract has been formed.<sup>39</sup>

Thus, in *Dodge v. Board of Education of City of Chicago*,<sup>40</sup> the Supreme Court examined the language of an Illinois statute granting public teachers pension benefits and concluded that the statute didn’t create a contract, but this was against the background of longstanding caselaw of the Illinois Supreme Court.<sup>41</sup> *Dodge* needn’t be read as supporting the traditional view that pensions are gratuities, revocable at will and not subject to the Contracts Clause:<sup>42</sup> all it shows is that this

37 *Indiana ex rel. Anderson v. Brand*, 303 U.S. 95, 100 (1938).

38 See *U.S. Mortgage Co. v. Matthews*, 293 U.S. 232 (1934); *Muni. Investors v. Birmingham*, 316 U.S. 153 (1942); Henry Paul Monaghan, *Supreme Court Review of State-Court Determinations of State Law in Constitutional Cases*, 103 COLUM. L. REV. 1919, 1940 & n.82 (2003) (“Under current doctrine, a state court cannot enlarge the range of interests embraced by the Contract Clause simply by recognizing an arrangement as a ‘contract’ as a matter of state substantive law.” (citing *Garrison v. City of N.Y.*, 88 U.S. (21 Wall.) 196, 203 (1874) (“It may be doubted whether a judgment not founded upon an agreement, express or implied, is a contract within the meaning of the constitutional prohibition.”))); Henry Paul Monaghan, *Of Liberty and Property*, 62 CORNELL L. REV. 405, 436 n.201 (1977); RICHARD H. FALLON, JR., ET AL., *HART AND WECHSLER’S THE FEDERAL COURTS AND THE FEDERAL SYSTEM* 530 (5th ed. 2003).

39 See *Brand*, 303 U.S. at 100–01; *Appleby v. City of New York*, 271 U.S. 364, 379–80 (1926); *Dodge v. Bd. of Educ. of City of Chi.*, 302 U.S. 74, 79 (1937); *Higginbotham v. City of Baton Rouge*, 306 U.S. 535, 538–39 (1939); *GM v. Romein*, 503 U.S. 181, 187 (1992); see also *Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Jr. Univ.*, 489 U.S. 468, 482–83 (1989) (Brennan, J., dissenting).

40 302 U.S. 74 (1937).

41 *Id.* at 79–80.

42 See, e.g., *id.* at 79; *Pennie v. Reis*, 132 U.S. 464 (1889); *Eddy v. Morgan*, 75 N.E. 174, 178 (Ill. 1905) (“A pension is a bounty springing from the graciousness and appreciation of sovereignty.

was the state of Illinois law in 1937. Since most states have now held that public pensions are contractually protected,<sup>43</sup> courts would now defer to state law in those states and grant federal Contract Clause protection, even with *Dodge* still on the books.<sup>44</sup>

The California rule should be understood in this context. It might represent a state-law rule of contract recognition—when does a statute create a contractual obligation?—which may be within the bounds of deference for purposes of federal Contract Clause doctrine. Prospective changes to employment conditions may not usually implicate the federal Contract Clause, but that’s because state law usually says so, and California law on pensions is a limited exception.<sup>45</sup> Or, to the extent the California rule is out of federal bounds, it could be interpreted as part of California’s own Contract Clause doctrine, which is more protective of public employee pensions than the federal doctrine.

But before trying to resolve the question, let’s look at what exactly California courts say about public employee pensions.

### III. PROSPECTIVE CHANGES AND THE CALIFORNIA RULE

The California rule was created in 1955, when the California Supreme Court considered a challenge to a 1951 city charter amendment in *Allen v. City of Long Beach*.<sup>46</sup> The amendment raised the amount of employees’ retirement contributions from 2% to 10%. It changed the pension from a fluctuating amount (based on the salary attached to the retiree’s previous

It may be given or withheld at the pleasure of a sovereign power.”); Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 994–1003 (1977).

43 See Monahan, *supra* note 32, at 620–34.

44 See, e.g., *Larsen v. Senate of the Commonwealth of Pa.*, 154 F.3d 82, 90 n.11 (3d Cir. 1998).

45 Monahan cites *Ass’n of Surrogates & Supreme Court Reporters v. New York*, 940 F.2d 766 (2d Cir. 1991), as an example of a case holding that a prospective change did impair a contract. Monahan, *supra* note 15, at 1042 & n.81. But this, too, seems to be an example of a federal court deferring to a state high court’s determination. See *Ass’n of Surrogates*, 940 F.2d at 770–71.

46 287 P.2d 765 (Cal. 1955).

position at the moment pension payments are made) to a fixed amount (based on the retiree's salary around the time of his retirement). And it required extra contributions from employees who had returned from military service.<sup>47</sup>

The Court held that the amendment unconstitutionally impaired the contract rights of the employees who were adversely affected. In doing so, it stated a test that would be often repeated in public employee pension cases:

An employee's vested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. Such modifications must be reasonable . . . . To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.<sup>48</sup>

In this case, there were no comparable new advantages, nor was there any evidence that the changes were related to the integrity of the pension system.<sup>49</sup>

The increase in contributions from 2% to 10% was purely prospective, so—though the Court didn't say so explicitly—California doctrine protects not only pension amounts already accrued but also the right to earn pension benefits on terms no worse than those in effect at the time one was hired.

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47 *Id.* at 766–67. The ground of the challenge—whether it was under the federal or state contract clause, or even that it was a constitutional challenge—wasn't specified in the opinion.

48 *Id.* at 767 (citing *Wallace v. City of Fresno*, 265 P.2d 884, 887 (Cal. 1954); *Packer v. Bd. of Retirement*, 217 P.2d 660, 662, 664–65 (Cal. 1950); *Kern v. City of Long Beach*, 179 P.2d 799, 803 (Cal. 1947)). For an example of a case where the presence of comparable new advantages saved the modifications from unconstitutionality, see *City of Downey v. Board of Administration*, 121 Cal. Rptr. 295, 303–04 (Ct. App. 1975) (detrimental rise in contribution rates balanced by advantageous increase in pension amount).

49 *Allen*, 287 P.2d at 767.

This rule remains in effect: as the California Supreme Court has since summarized, “By entering public service an employee obtains a vested contractual right to earn a pension on terms substantially equivalent to those then offered by the employer.”<sup>50</sup> In other words, one has “the primary right to *receive* any vested pension benefits upon retirement, as well as the collateral right to *earn* future pension benefits through continued service, on terms substantially equivalent to those then offered.”<sup>51</sup> The doctrine that “future pension benefits vest as they are *proratedly earned*”—which we've seen in Maryland<sup>52</sup>—is emphatically *not* the law in California.<sup>53</sup>

Similarly:

- In *Abbott v. City of San Diego*,<sup>54</sup> the San Diego city charter was amended to increase police and firefighters' contributions from 6% to 8%, among other changes.<sup>55</sup> The California Court of Appeal held, on an *Allen*-like logic, that these prospective increases were unconstitutional<sup>56</sup> because they weren't accompanied by commensurate benefits.<sup>57</sup>
- In *Wisley v. City of San Diego*,<sup>58</sup> the San Diego city charter was amended over a period of years to increase employee pension contributions from 1% to 2%, then 4%, then 8%.<sup>59</sup> This was similarly struck down as unconstitutional<sup>60</sup> because it was not

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50 *Carman v. Alvord*, 644 P.2d 192, 195 (Cal. 1982).

51 *Legislature v. Eu*, 816 P.2d 1309, 1331 (Cal. 1991).

52 See text accompanying *supra* notes 1–5.

53 *United Firefighters of L.A. City v. City of L.A.*, 259 Cal. Rptr. 65, 76 (Ct. App. 1989) (citing *Md. State Teachers Ass'n, Inc. v. Hughes*, 594 F. Supp. 1353, 1362–63 (D. Md. 1984)).

54 332 P.2d 324 (Cal. Ct. App. 1958).

55 *Id.* at 327.

56 The case didn't say whether the analysis was under the state or federal constitution.

57 *Abbott*, 332 P.2d at 329–30.

58 10 Cal. Rptr. 765 (Ct. App. 1961).

59 *Id.* at 766.

60 The case didn't say whether the analysis was under the state or federal constitution.



accompanied by commensurate benefits.<sup>61</sup>

- And in *City of Downey v. Board of Administration*,<sup>62</sup> the Court of Appeal examined a similar increase in employee contributions, and ruled that these prospective increases were *constitutional* because, in this case, they were accompanied by benefits—an increase in overall retirement benefits.<sup>63</sup>

The same logic applies to other prospective changes, like cost-of-living adjustments to pension benefits to be earned from future service. In *Pasadena Police Officers Ass'n v. City of Pasadena*,<sup>64</sup> the California Court of Appeal considered a challenge to a 1981 charter amendment placing a 2% cap on the rate of increase of police and firefighters' cost of living allowance.<sup>65</sup> An unlimited COLA had been introduced for all retirees (past and future) in 1969;<sup>66</sup> employees who had retired since 1969 were exempted from the 1981 cap, but those who had retired before 1969 weren't. Active employees could choose an option that, in essence, amounted to making the cap prospective only.<sup>67</sup> The court held that the amendment unconstitutionally impaired the contract rights of both active employees and pre-1969 retirees.

As to active employees, the court had little trouble finding, based on *Allen*,<sup>68</sup> that the cap was unconstitutional because it reduced the pension that would be earned under the previous rules—both what

had already been earned and what would be earned later—and was not accompanied by any comparable new advantages.<sup>69</sup>

As to the pre-1969 retirees, it's true that they worked their entire career with no expectation of a COLA, which was only introduced in 1969. "Thus, they had no vested contractual right, based on *the contract in effect during their employment*, to continuation of the COLA benefit."<sup>70</sup> But the retirees formed a new contract with the state in 1969 when they elected to switch to pensions with COLAs; and the 1981 amendments impaired this new contract.<sup>71</sup>

Substantially the same issue came up several years later, in *United Firefighters of Los Angeles City v. City of Los Angeles*,<sup>72</sup> the case discussed in the Introduction.<sup>73</sup> In that case, the California Court of Appeal considered a challenge under the state and federal contract clauses to charter amendment H, a 1982 amendment to the L.A. city charter that placed a 3% cap on (previously uncapped) cost-of-living adjustments to police and firefighters' pension benefits.<sup>74</sup> The amendment operated only prospectively, "to future years of service credited toward retirement."<sup>75</sup> Unsurprisingly, given *Allen* and *Pasadena Police Officers*, the court held that the amendment unconstitutionally impaired the plaintiffs' "vested contractual pension rights."<sup>76</sup> In the court's view, the COLA cap had no relation to the goals of a pension system (it reduced retirees' economic security rather than enhancing it);<sup>77</sup> any unsustainability in the

61 *Wisley*, 10 Cal. Rptr. at 767–68.

62 121 Cal. Rptr. 295 (Ct. App. 1975).

63 *Id.* at 303.

64 195 Cal. Rptr. 339 (Ct. App. 1983).

65 *Id.* at 341–42. Whether the challenge was under the federal or state contract clause wasn't specified in the opinion.

66 *Id.* at 341. Pre-1969 retirees had to make a formal election in 1969 to be governed by the COLA system, but virtually all such retirees did so. *See id.* at 345 & n.5.

67 *Id.* at 341–42. One of the options that active employees could choose to "cease contributing to the System and . . . receive an unlimited COLA on a portion of [their] pension calculated by the ratio of [their] years of service [before 1981] to [their] total years of service." *Id.* at 341.

68 *Id.* at 342 (citing *Allen v. City of Long Beach*, 287 P.2d 765, 767 (Cal. 1955)).

69 *Id.* (citing *Allen*, 287 P.2d at 767; *Abbott v. City of L.A.*, 326 P.2d 484, 489 (Cal. 1958); *Miller*, 557 P.2d at 975; *Betts*, 582 P.2d at 617; *Allen v. Bd. of Admin.*, 665 P.2d 534, 538 (Cal. 1983)); *see also id.* at 342 n.2 ("Defendants do point out that . . . the employee makes no COLA contributions from future salary, but do not claim this can compensate for the loss of a fully adjustable pension.").

70 *Id.* at 346 (citing *Olson v. Cory*, 636 P.2d 532, 538 (Cal. 1980)).

71 *Id.*

72 259 Cal. Rptr. 65 (Ct. App. 1989).

73 *See* text accompanying *supra* notes 7–14.

74 *United Firefighters*, 259 Cal. Rptr. at 66.

75 *Id.*

76 *Id.*

77 *Id.* at 74.

pension system came from the government's history of underfunding rather than from the recent history of high inflation rates;<sup>78</sup> and the city's desire to "enhance [its] ability to predict and plan for long-range . . . budgeting and financing" could also be fulfilled by, for instance, levying "a separate ad valorem property tax specifically to meet the pension system funding requirements."<sup>79</sup> Thus, the city couldn't show that its modifications were reasonable; nor could it show comparable new advantages, since the change to the pension system was merely disadvantageous on its face.<sup>80</sup>

And what goes for increases in contribution rates and limitations in cost-of-living adjustments naturally goes just as well for the outright elimination of the pension system. In *Legislature v. Eu*,<sup>81</sup> the California Supreme Court considered a challenge<sup>82</sup> to Proposition 140, "The Political Reform Act of 1990,"<sup>83</sup> a California constitutional amendment<sup>84</sup> adopted by initiative. The amendment, among other things, ended the accrual of any pension or retirement benefits (aside from Social Security) for any state legislators serving after its effective date.<sup>85</sup> As to legislators first taking office after the effective date of the amendment, the court found no constitutional violation, since these legislators had "acquired no vested or protectable right to a continuation of the pension system in operation prior to their employment."<sup>86</sup> However, as to incumbent

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78 *Id.* at 73–74.

79 *Id.* at 75.

80 *Id.* at 67.

81 816 P.2d 1309 (Cal. 1991).

82 The opinion stated that the challenge was under the federal constitution, *id.* at 1330 ("Finally, petitioners maintain that Proposition 140's limitations on the pension rights of incumbent legislators is unconstitutional as an invalid impairment of contract under the federal Constitution."), but then its holding seemed to rest on both the federal and state constitutions, *id.* at 1331 ("Petitioners find ample support for their position in California cases confirming that both the federal and state contract clauses protect the vested pension rights of public officers and employees from unreasonable impairment.").

83 *Id.* at 1312.

84 *Id.* at 1314.

85 *Id.*

86 *Id.* at 1335.

legislators, the court found that the pension restrictions violated the federal Contract Clause.<sup>87</sup> The reduction in benefits wasn't matched by any "comparable new advantages,"<sup>88</sup> since the pension system was entirely terminated going forward.

#### IV. IS THIS CONSISTENT WITH THE U.S. CONSTITUTION?

Let's go back to our previous question: are state pension statutes properly treated as contracts?<sup>89</sup> Recall the federal doctrine: a statute isn't treated as a contract unless "the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State."<sup>90</sup> Some cases express this even more strongly: the state's intent to contract must be "expressed in terms too plain to be mistaken."<sup>91</sup>

Generally, this language is absent, so there's no contract, just a revocable benefit.<sup>92</sup> Thus, if a state had a Social Security-like scheme, it should be able to abolish it without running afoul of the Contract Clause,<sup>93</sup> and the same is true of the future existence of current government jobs and the level of government salaries.<sup>94</sup> If one could find explicit language promising people such benefits, that would be one thing; but absent such

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87 *Id.*

88 *Id.* at 1332 (citing *Olson v. Cory*, 636 P.2d 532, 537 (Cal. 1980); *Betts v. Bd. of Admin.*, 582 P.2d 614, 617 (Cal. 1978); *Allen v. City of Long Beach*, 287 P.2d 765, 767 (Cal. 1955)).

89 See text accompanying *supra* notes 34–44.

90 *U.S. Trust Co.*, 431 U.S. at 17 n.14.

91 See, e.g., *United States v. Winstar Corp.*, 518 U.S. 839, 875 (quoting *Jefferson Branch Bank v. Skelly*, 66 U.S. (1 Black) 436, 446 (1861)) (internal quotation marks omitted).

92 See *supra* note 35.

93 See, e.g., *Richardson v. Belcher*, 404 U.S. 78, 80 (1971); *Bowen v. Pub. Agencies Opposed to Soc. Sec. Entrapment*, 477 U.S. 41, 55 (1986). Of course, there may be procedural due process obstacles to withdrawing Social Security benefits, see *Goldberg v. Kelly*, 397 U.S. 254 (1970); *Bd. of Regents of State Colls. v. Roth*, 408 U.S. 564 (1972); *Mathews v. Eldridge*, 424 U.S. 319 (1976), but not if the program is slashed wholesale, see *Bi-Metallic Inv. Co. v. State Bd. of Equalization*, 239 U.S. 441 (1915).

94 *Dodge v. Bd. of Educ. of City of Chi.*, 302 U.S. 74, 78–79 (1937).

language, freezing the benefits in place constitutionally would deprive the state government of flexibility and prevent it from structuring its operations as it sees fit.

Some California cases do examine the language of statutes to find such an intent, but this isn't the norm.<sup>95</sup> Should the California courts' determination that pension obligations are contractual receive federal deference<sup>96</sup> for Contract Clause purposes?<sup>97</sup>

As to the basic question of whether a contract exists—as opposed to the pension's just being an entirely revocable gratuity—the answer seems fairly easy (though some places do come out the other way<sup>98</sup>). It makes good sense to defer to California's doctrine that pension statutes form a contract—even without analyzing the language of the statute—because pensions are a form of deferred compensation. Government employees take their jobs in reliance on the full compensation package, from current salary to fringe benefits to pensions. The statute itself isn't an offer—you can't just get a government job by accepting. Nor does it form a unilateral contract—you can't accept by showing up and working. Rather, once one goes through the traditional job offer and acceptance process, the statute defining the benefits, like an employee handbook, forms part of the terms of the deal. Thus, “the circumstances” of the statutory enactment “evinced a legislative intent” to be bound.<sup>99</sup> Perhaps one might even say the intent is unmistakable, even though it's entirely implicit.<sup>100</sup>

95 See, e.g., *Claypool v. Wilson*, 6 Cal. Rptr. 2d 77, 91 (Ct. App. 1992); *Ret. Employees Ass'n of Orange County, Inc. v. Cnty. Of Orange*, 266 P.3d 287 (Cal. 2011); *Sonoma Cnty. Ass'n of Ret. Employees v. Sonoma Cnty.*, 708 F.3d 1109 (9th Cir. 2013) (applying the *Orange County* reasoning). The Ninth Circuit has criticized a California case for not engaging in an analysis of legislative intent. See *San Diego Police Officers' Ass'n v. San Diego City Employees' Retmt. Sys.*, 568 F.3d 725, 740 (9th Cir. 2009) (citing *Cal. League of City Employee Ass'ns v. Palos Verdes Library Dist.*, 150 Cal. Rptr. 739 (Ct. App. 1978)).

96 See text accompanying *supra* note 39.

97 Cf. *Monahan*, *supra* note 15, at 1070.

98 See, e.g., *Parker v. Wakelin*, 123 F.3d 1 (1st Cir. 1997); *Beermann*, *supra* note 16, at 52–53.

99 See text accompanying *supra* note 90.

100 See *Beermann*, *supra* note 16, at 51 (“In employment situations, perhaps the presumption should be flipped—it ought to be presumed that promises made based on employment are

We can safely conclude that a contract not only exists but also covers at least the services performed so far. The government owes the employee for whatever work has been completed. Overdue salaries are owed, as is accrued vacation time . . . and the pension one has accrued so far.<sup>101</sup> This much should clearly be within the bounds of federal deference.<sup>102</sup>

What about the more extensive rights protected by the California rule—the “collateral right to *earn* future pension benefits through continued service, on terms substantially equivalent to those offered” when one was hired?<sup>103</sup> I argue below<sup>104</sup> that this rule is a bad idea. But it should probably still be within the bounds of federal deference. Nothing prevents a government from explicitly promising crazy benefits to its employees, and the idea that one is entitled to the continuation of current pension rules is hardly the craziest of ideas, since it's plausible that one could rely on it in planning one's future career and foregoing investment in other lines of work. In that sense, perhaps *any* state judicial doctrine defining the terms and conditions of employment deserves federal deference.

Or one could adopt a slightly more moderate view. It's true that pensions are given a treatment that other benefits don't get—so, on a blank slate, it's not clear why anyone would think he was entitled to have such terms preserved for the future. But even if few would have thought that was the deal in 1955, everyone could reasonably interpret that to be the deal today in jurisdictions where the California rule is in effect. So even if the California rule would have been outside the bounds of federal deference when *Allen v. City of Long Beach* was decided,<sup>105</sup> it may be within the intended to be contractual.”).

101 See *Buck*, *supra* note 16, at 63.

102 Note that there's leeway over how to define “the pension accrued so far,” though the specific details are beyond the scope of this paper. See, e.g., *Buck*, *supra* note 16, at 35–36 (discussing different definitions of accrual); *id.* at 67–91. One major issue is long vesting periods in public employment. See *Monahan*, *supra* note 15, at 1079–82 (arguing that the real problem is long vesting periods); *Buck*, *supra* note 16, at 45–46.

103 *Legislature v. Eu*, 816 P.2d 1309, 1331 (Cal. 1991).

104 See *infra* Part V.

105 See text accompanying *supra* notes 56–59.

bounds of deference today. On this view, perhaps any judicial doctrine defining the terms and conditions of employment, even if wrong at first, becomes worthy of federal deference after enough time has passed (perhaps when the time for certiorari has expired).

But ultimately, how we resolve this question isn't that important, because California has its own Contract Clause,<sup>106</sup> and nothing stops California constitutional law from being more protective of pensions than federal constitutional law. (The rule about "comparable new advantages," which isn't a matter of contract interpretation on which federal doctrine defers to state law, is perhaps an example of a doctrine that derives from state constitutional law.)<sup>107</sup>

It's true that California cases are often sloppy about the exact basis of their Contract Clause rulings. Some cases don't bother mentioning that the question is one of constitutional law;<sup>108</sup> some don't say which constitutional provision they're addressing;<sup>109</sup> some only mention the federal Constitution;<sup>110</sup> and some cite the federal and California rules simultaneously.<sup>111</sup> One of the seminal California cases, *Kern v. City of Long Beach*,<sup>112</sup> mentions the words "Constitution" and "constitutionally" without saying which constitution is meant, but it does specifically cite the California constitution in a different context,<sup>113</sup> and also cites

some federal Contract Clause cases.<sup>114</sup> But behind this sloppiness, it's possible that, implicitly, any holding that's stricter than required by the federal Contract Clause is actually a holding of state constitutional law. If push came to shove, California courts could always clarify that their special willingness to find a contractual relationship, as well as the super-protective rule regarding what the contract covers, comes from California's own clause.

## V. THE TROUBLE WITH FREEZING PENSION RULES

If the legality of the California rule isn't the problem, what remains is pure policy. The main problem with the California rule is that it distorts the mix between pensions, on the one hand, and salaries (and all other benefits) on the other. It gives some employees a different compensation package than they'd otherwise prefer, and it makes it harder for states with unfunded pension issues to put their finances in order.

The *Pasadena Police Officers* court's holdings show clearly the ratchet effect of the California rule. California caselaw holds that "a public employee's pension constitutes an element of compensation and that the right to pension benefits vests upon the acceptance of employment even though the right to immediate payment of a full pension may not mature until certain conditions are satisfied."<sup>115</sup> Unlike all other terms of public employment, which "are wholly a matter of statute" and don't "ripen into obligations" protected by the state and federal contract clauses until the moment of performance, "deferred compensation in the form of pension rights has the status of a contractual obligation from the moment one accepts public employment."<sup>116</sup>

This "vest[ing]" or "contractual obligation"

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106 CAL. CONST. art. I, § 9.

107 For an example of an opinion not using such an approach, see *Md. State Teachers Ass'n, Inc. v. Hughes*, 594 F. Supp. 1353, 1362–63 (D. Md. 1984).

108 See, e.g., *Allen v. City of Long Beach*, 287 P.2d 765 (Cal. 1955) (not containing the text "constitution" or "clause").

109 See, e.g., *Pasadena Police Officers Ass'n v. City of Pasadena*, 195 Cal. Rptr. 339, 344, 346, 347 (mentioning the words "constitution" and "constitutionally" without mentioning which constitution applied).

110 See, e.g., *Miller v. State*, 557 P.2d 970, 972 (Cal. 1977).

111 See, e.g., *United Firefighters of L.A. City v. City of L.A.*, 259 Cal. Rptr. 65, 66 (Ct. App. 1989); *San Bernardino Public Employees Ass'n v. City of Fontana*, 79 Cal. Rptr. 2d 634, 638 (Ct. App. 1998); *Legislature v. Eu*, 816 P.2d 1309, 1331 (Cal. 1991).

112 179 P.2d 799 (Cal. 1947).

113 *Id.* at 801.

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114 *Id.* at 800.

115 *Pasadena Police Officers Ass'n v. City of Pasadena*, 195 Cal. Rptr. 339, 342 (Ct. App. 1983) (citing *Miller v. State*, 557 P.2d 970, 974 (Cal. 1977); *Betts v. Bd. of Admin.*, 582 P.2d 614, 617 (Cal. 1978); *Kern v. City of Long Beach*, 179 P.2d 799, 803 (Cal. 1947); *Dryden v. Bd. of Pension Comm'rs*, 59 P.2d 104, 107 (Cal. 1936)).

116 *United Firefighters of L.A. v. City of L.A.*, 259 Cal. Rptr. 65, 69 (Ct. App. 1989) (citing *Miller*, 557 P.2d at 973–74, 976; *Longshore v. County of Ventura*, 598 P.2d 866, 871 (Cal. 1979)).

language, by itself, doesn't tell us what rights vest—for all we know, the right that vests and is protected by the contract might be nothing more than the right to earn whatever pension has been accrued by the work done so far, which starts at 0 when employment is accepted and hopefully rises over time.<sup>117</sup> But the *Allen* language quoted above forecloses that interpretation: the right that vests is the right to continue earning as long as one is employed on the terms that applied when one accepted the job.

The pre-1969 retirees holding shows what's already obvious: that one can also acquire a (vested) right to new and more generous terms that one agrees to later. If this is so, then continuing to work (even without an explicit election) means that one accepts any new and more generous terms that may come into effect over time.<sup>118</sup> If the contribution rate had started at 3% at some point and then been reduced to 2%, the public employees would have accepted the more generous regime by performing services under that regime, and the city would then be precluded from raising the rate back to 3%. So *Allen* and its progeny show that one even has the right to continue to earn pension benefits on terms no worse than the most generous terms in effect at any time during one's employment.

But consider what isn't protected. Salaries of public officials aren't protected by the Contract Clause, even if a salary reduction will have an indirect effect on the amount of one's pension.<sup>119</sup> Existing statutory cost-of-living increases to *salaries* can be revoked as to future contractual terms,<sup>120</sup> but existing cost-of-living increases to *pensions* can't. Tenure in office isn't protected either, though of course statutes could provide protections

117 "Vesting" is an ambiguous term in the pension cases; some cases treat it as just meaning "contractual" while others don't. See Buck, *supra* note 16, at 38.

118 Betts v. Bd. of Admin., 582 P.2d 614, 619 (Cal. 1978); Olson v. Cory, 636 P.2d 532, 537 (Cal. 1980); United Firefighters of L.A. v. City of L.A., 259 Cal. Rptr. 65, 67 n.3 (Ct. App. 1989); Abbott v. City of San Diego, 332 P.2d 324, 329 (Cal. Ct. App. 1958) (citing Abbott v. City of L.A., 326 P.2d 484, 490 (Cal. 1958)); Glaeser v. City of Berkeley, 307 P.2d 61, 63–64 (Cal. Ct. App. 1957).

119 See San Diego Police Officers' Ass'n v. San Diego City Employees' Retmt. Sys., 568 F.3d 725, 737–38 (9th Cir. 2009).

120 Olson, 636 P.2d at 540.

(like civil service laws) beyond what's constitutionally required.<sup>121</sup> Thus, in *Miller v. State*,<sup>122</sup> the California Supreme Court held that the state could validly reduce the mandatory retirement age from 70 to 67.<sup>123</sup> (This had the effect of limiting an employee's pension, since he could no longer work and accumulate benefits for the extra three years, but this sort of limitation was lawful:<sup>124</sup> recall that, though pension rights vest on day one, "the right to immediate payment of a full pension may not mature until certain conditions are satisfied."<sup>125</sup>)

Only the pension rules that apply to employees have a special status.<sup>126</sup> But this seems strange: the conditions of any job include present compensation, future compensation, job security, and all sorts of other dimensions like the difficulty of the workload, the quality of the health plan, the generosity of vacation allowances, or the availability of parking. Employees take their compensation in a combination of all of these components. Why privilege pensions over everything else—holding that, on being hired, one acquires a vested right to the continuation of pension rules, but not a vested right in the future state of anything else?

First, let's take a step back and examine why there are fringe benefits at all. It's reasonable to believe that employees pay for any benefits they receive in the form of lower wages,<sup>127</sup> and not every employee will

121 And if state law protects certain aspects of the employment relationship, those aspects can become "property" interests protected by the Due Process Clause. See cases cited *supra* note 20.

122 557 P.2d 970 (Cal. 1977).

123 *Id.* at 973–74.

124 *Id.* at 974–75.

125 *Id.* at 974; Pasadena Police Officers Ass'n v. City of Pasadena, 195 Cal. Rptr. 339, 342 (Ct. App. 1983) (citing *Miller*; Betts v. Bd. of Admin., 582 P.2d 614, 617 (Cal. 1978); Kern v. City of Long Beach, 179 P.2d 799, 803 (Cal. 1947); Dryden v. Bd. of Pension Comm'rs, 59 P.2d 104, 107 (Cal. 1936)). Longevity-based benefits are also discussed in San Diego Police Officers' Ass'n v. San Diego City Employees' Retmt. Sys., 568 F.3d 725, 739–40 (9th Cir. 2009).

126 Even the *employer's* share of pension contributions is unprotected. See *San Diego Police Officers' Ass'n*, 568 F.3d at 738–39.

127 See generally Sherwin Rosen, *The Theory of Equalizing Differences*, 1 HANDBOOK OF LABOR ECONOMICS 641 (Orley

particularly value every benefit offered. So why don't employees take everything in cash and buy the benefits themselves? Why don't employees find their own parking, pay for their own food, buy their own health insurance, invest in their own IRAs?

The most basic reason for employers to provide some benefits is that the benefit can't be bought elsewhere, firms differ in their cost of providing the benefit, and workers differ in how much they value the benefit. For instance, any job comes with a particular risk of injury; one can't separate the risk of injury from the job itself; firms might be able to reduce the greatest risks at relatively low cost; and employees might place a relatively high value on that risk reduction. A firm will thus profit by reducing the risk and extracting some of the value of the risk reduction from the employee; equilibrium occurs when the firm's cost from reducing an additional risk equals an employee's benefit from that additional risk reduction. To top it off, workers differ in how risk-averse they are, so a sorting process will occur, where the most risk-tolerant workers gravitate to the riskiest jobs and the most risk-averse workers tend to choose the safest jobs.<sup>128</sup> The same goes for fringe benefits like putting high-ranking employees in corner offices, or providing generous vacation allowances.

Sometimes a benefit can be separated from a job—health insurance and pensions are two examples. It still makes sense for an employer to offer the benefit if he can do so more cheaply than the employee can. Individual health insurance plans are more expensive than employer-provided health insurance because of adverse selection. Buying insurance is a signal that one expects to use the insurance, so insurance companies selling individual health plans can count on having to reimburse a lot of medical expenses—and price their premiums accordingly, which leads to high-priced insurance for the sick and widespread non-participation

by the healthy.<sup>129</sup> But one doesn't usually choose one's workplace primarily for insurance reasons, so an insurer covering a whole workplace can expect a less biased sample of workers—not a random cross-section of society, since the particular workplace will attract a particular type of person, but at least a sample that isn't as biased toward the sick. Premiums will thus tend to be lower in employer-provided health plans because of the reduced adverse selection problem.<sup>130</sup>

Pensions may also exhibit this effect, at least if they're defined-benefit rather than defined-contribution pensions. Defined-contribution pensions could be just as well bought on the open market,<sup>131</sup> since they're essentially just investment accounts that earn whatever they earn. But with defined-benefit pensions, which are more common in the public sector,<sup>132</sup> the financial risk is borne by the pension provider. Here, too, individuals are more likely to buy their own defined-benefit pension (i.e., an annuity) if they expect to live longer, which again leads to high prices for those who expect to live longer and widespread non-participation by those who don't.<sup>133</sup>

Another major driver of employer-provided benefits is tax preferences. Whatever can be characterized as, say, a “no-additional-cost service” (such as free plane trips for airline employees when seats are available) or a “working condition fringe” (such as office space) or a “qualified transportation fringe” (such as on-site parking) doesn't

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129 See generally Obamacare.

130 See TIMOTHY S. JOST, *HEALTH CARE AT RISK: A CRITIQUE OF THE CONSUMER-DRIVEN MOVEMENT* 55 (2007); David S. Caroline, *Employer Health-Care Mandates: The Wrong Answer to the Wrong Question*, 11 U. PA. J. BUS. L. 427, 436 (2009); Sherry A. Glied & Phyllis C. Borzi, *The Current State of Employment-Based Health Coverage*, 32 J.L. MED. & ETHICS 404, 407 (2004).

131 Ignoring the tax treatment issues; see text accompanying *infra* notes 134–139.

132 See Alicia H. Munnell et al., *Why Have Defined Benefit Plans Survived in the Public Sector?* (Ctr. for Retirement Res. at Boston Coll., State and Local Pension Plans, no. 2, Dec. 2007); Buck, *supra* note 16, at 43–47.

133 See, e.g., Zvi Bodie et al., *Defined Benefit Versus Defined Contribution Plans: What Are the Real Trade-Offs?*, in PENSIONS IN THE U.S. ECONOMY 139, 148–49 (Zvi Bodie et al. eds., 1988); Amy Finkelstein & James Poterba, *Selection Effects in the United Kingdom Individual Annuities Market*, 112 ECON. J. 28 (2002).

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C. Ashenfelter & Richard Layard eds., 1986); RONALD G. EHRENBERG & ROBERT S. SMITH, *MODERN LABOR ECONOMICS: THEORY AND PUBLIC POLICY* 251–84 (7th ed. 2000); Price V. Fishback & Shawn Everett Kantor, *Did Workers Pay for the Passage of Workers' Compensation Laws?*, 110 Q.J. ECON. 713 (1995).

128 See Rosen, *supra* note 127, at 644–58; EHRENBERG & SMITH, *supra* note 127, at 251–74.

count as gross income to the employee;<sup>134</sup> neither do employer contributions to health plans.<sup>135</sup> If the employee had to pay for these benefits himself, some (like parking<sup>136</sup> or air travel) wouldn't be deductible at all; some (like trade or business expenses<sup>137</sup>) would only be deductible to the extent that total miscellaneous aggregate deductions exceeded 2% of adjusted gross income;<sup>138</sup> and health insurance premiums paid outside of an employer-provided plan would only be deductible to the extent they exceeded 10% of adjusted gross income.<sup>139</sup> Under these circumstances, small wonder that employees and employers choose to structure their compensation to include some employer-provided benefits. The tax advantages magnify the pre-existing advantages to employer provision of health benefits and pensions discussed above.<sup>140</sup>

All these factors lead to some equilibrium mix between salary and other benefits. The California rule, under which pension rules are protected but salary, job tenure, and other benefits aren't, means that when the terms of a government job become less generous because of market or fiscal pressures, it's salaries and other benefits that must take the hit; governments have little ability to adjust pensions for existing employees, since they must offer comparable new advantages to soften the blow. Not all employees would prefer this arrangement; plausibly, some might prefer less of a decrease in salary in exchange for some decrease in the generosity of their

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134 I.R.C. § 132; *see also id.* § 132(f)(2)(B) (limitation on exclusion for qualified parking).

135 *Id.* § 106(a); employee contributions to "cafeteria plans" are likewise excluded under *id.* § 125.

136 *See* Treas. Reg. § 1.162-2(e) ("Commuters' fares" not deductible).

137 I.R.C. § 162(a).

138 *Id.* § 67(a).

139 *Id.* § 213(a), (d)(1)(D).

140 These tax effects may be substantial. For the case of health insurance, *see* Jonathan Gruber, *The Impact of the Tax System on Health Insurance Coverage*, 1 INT'L J. HEALTH CARE FIN. & ECON. 293 (2001); Jonathan Gruber & Michael Lettau, *How Elastic Is the Firm's Demand for Health Insurance?*, 88 J. PUB. ECON. 1273 (2004). *But see* Robert W. Turner, *Taxes and the Number of Fringe Benefits Offered*, 33 J. PUB. ECON. 41 (1987) (arguing that tax rates have a small effect on fringe benefits).

future pension earnings. (Surely it depends how poor they are now, and how long they expect to live. Those with shorter life expectancies—men, the less-educated, the poor, minorities, and those in bad health—suffer the most from policies that protect pensions at the expense of current salaries.<sup>141</sup>) While some of this extra pain will fall on public employees, some will fall on taxpayers, and some of the pain of taxpayers may result in trimming various state government services (e.g., police, fire, garbage collection, DMV, schools). The California rule thus makes reductions in government compensation either more painful for employees or more expensive to taxpayers than they would be if pension terms could adjust together with salaries and other benefits.

This is the static effect of the California rule, but it's also worthwhile to consider some possible incentive effects of this rule going forward. Even when the terms of a job become *more* advantageous, governments may hesitate before offering more generous pension rules, since that generosity will become a liability in hard times.<sup>142</sup> Thus, whether the job market becomes better or worse for public employees, the California rule could hinder employers from offering wage/benefit packages that employees prefer. A private employer faced with this regime might just offer stingy pension benefits from the start, since benefits, once granted, are protected from reduction.

But of course we're not talking about private employers. The California rule applies only to public employees, and it's known that public-sector compensation packages are *more heavily* weighted

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141 *See* HILARY WALDRON, TRENDS IN MORTALITY DIFFERENTIALS AND LIFE EXPECTANCY FOR MALE SOCIAL SECURITY-COVERED WORKERS, BY AVERAGE RELATIVE EARNINGS (U.S. Soc. Sec. Admin., Office of Res., Eval., & Stats., Working Paper No. 108) (wealthier people have longer life expectancies); NAT'L CTR. FOR HEALTH STATS., HEALTH, UNITED STATES, 2011, at 37 fig.32 (showing lower life expectancy at age 25 for lower-educated people, and lower life expectancy at age 25 for men than for women); NAT'L CTR. FOR HEALTH STATS., HEALTH, UNITED STATES, 2012, at 76–77 tbl.18 (showing lower life expectancy for blacks than for whites).

142 *Cf.* *Goldberg v. Kelly*, 397 U.S. 254, 271–79 (1970) (Black, J., dissenting) (expressing a concern that making benefits harder to withdraw will make governments more stingy about granting them in the first place).

toward pension benefits than are their private-sector counterparts.<sup>143</sup> So the analysis is incomplete unless we bring in the public-choice considerations that make public employers act differently than private employers.<sup>144</sup> The heavy weighting of public employee compensation toward pensions is probably because of a countervailing force: governments, free from the ERISA regulations that govern private employers,<sup>145</sup> find it easier to promise generous pensions and then underfund them, leaving future generations to pick up

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143 See, e.g., Richard B. Freeman, *Unionism Comes to the Public Sector*, 24 J. ECON. LIT. 41, 43, 59 & tbl.10 (1986); Robert G. Gregory, *Recent Developments in Public Sector Labor Markets*, 3C HANDBOOK OF LABOR ECONOMICS 3573, 3599–3600 (Orley C. Ashenfelter & David Card eds., 1999); KEITH A. BENDER & JOHN S. HEYWOOD, OUT OF BALANCE: COMPARING PUBLIC AND PRIVATE SECTOR COMPENSATION OVER 20 YEARS, at 3 (Ctr. for State & Local Gov’t Excellence & Nat’l Inst. on Retirement Sec., Apr. 2010), [http://slge.org/wp-content/uploads/2011/12/Out-of-Balance\\_FINAL-REPORT\\_10-183.pdf](http://slge.org/wp-content/uploads/2011/12/Out-of-Balance_FINAL-REPORT_10-183.pdf) (“Benefits (e.g., pensions) comprise a greater share of employee compensation in the public sector.”); *id.* at 14–16; Beermann, *supra* note 16, at 16–26; *Are State and Local Government Employees Paid Too Much?*, N.Y. TIMES, Mar. 6, 2011, <http://www.nytimes.com/interactive/2011/03/06/us/public-private-employees.html>; Adam Summers, *Comparing Private Sector and Government Worker Salaries*, REASON FOUND., May 10, 2010, <http://reason.org/news/show/public-sector-private-sector-salary>.

144 See Ronald G. Ehrenberg & Joshua L. Schwartz, *Public-Sector Labor Markets*, in 2 HANDBOOK OF LABOR ECONOMICS 1219, 1219 (Orley C. Ashenfelter & Richard Layard eds., 1986) (“[P]rofit maximization is unlikely to be an objective of governmental units.”); *id.* at 1258; Gregory, *supra* note 143, at 3586–87. Richard Freeman writes:

A fundamental difference between public and private sector collective bargaining is that public sector unions, more so than private sector unions, can influence the employer behavior through the political process. The principal reason for this is that public sector employees help elect both the executive and legislative branches of government and thus play a role in determining the agenda for those facing them at the bargaining table. Private sector unions, while they can affect demand for labor through “union-label” campaigns or through governmental regulations . . . , do not in general help elect the board of directors of companies or top management.

Freeman, *supra* note 143, at 42.

145 See Buck, *supra* note 16, at 39–43; 29 U.S.C. § 1003(b)(1) (exempting “governmental plan[s]” from ERISA).

the bill.<sup>146</sup> Underfunded public employee pensions are thus a form of deficit spending.

If public pension policy is largely driven by an agency problem among public employers, the California rule may have a very different effect than I noted above. Rather than depressing pensions because, once granted, they’re harder to withdraw, the California rule could actually increase pensions. Perhaps the fact that pensions are protected actually makes it easier for governments to credibly promise generous pensions to their employees, knowing that (outside of a cataclysmic event like municipal bankruptcy<sup>147</sup>) later generations won’t be able to undo the terms. The California rule might thus exacerbate the deficit-spending-like bias toward generous pensions that would already exist.

There may be certain theoretic advantages to having a pension-heavy regime, though they run into problems in practice.

- First, underfunded employer-provided pensions are obviously cheaper than fully funded ones. Public employees would prefer getting these sorts of generous pensions through their workplace than getting a greater cash salary instead and buying a pension on the market, since private pensions would have to be adequately funded. Of course, all this is *provided the pensions are ultimately funded* through future taxes. Modern-day municipal bankruptcies, though, show that such funding won’t always be forthcoming.<sup>148</sup> Moreover, even if this sort of deficit pension funding is a win-win proposition for public employers and employees, it may no longer be optimal once the larger society (i.e., taxpayers) is added to the mix.
- Second, this sort of deficit spending may be

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146 See Freeman, *supra* note 143, at 58; Ehrenberg & Schwartz, *supra* note 144, at 1230; Beermann, *supra* note 16, at 26–31; Buck, *supra* note 16, at 45.

147 See, e.g., DAVID A. SKEEL, JR., CAN PENSIONS BE RESTRUCTURED IN (DETROIT’S) MUNICIPAL BANKRUPTCY? (Fed. Soc. White Paper, Oct. 2013); Joanne Lau, *Modifying or Terminating Pension Plans Through Chapter 9 Bankruptcies with a Focus on California*, 40 FORDHAM URB. L.J. 1975 (2013).

148 See *supra* note 147.



macroeconomically useful in recessionary times, from a Keynesian perspective. On the other hand, borrowing money from future taxpayers by underfunding current pensions is less transparent than traditional borrowing. And the time when the bills will come due and taxes will have to be raised—once these employees retire—won't generally be correlated with expansions (which is when Keynesian theory advises that tax hikes are optimal).

- Third, if, as behavioral economists argue, people don't save for their retirement as much as they'd like, introducing a bias in favor of more generous pensions may be welfare-improving even if the salary/pension mix is different than the mix that employers and employees would negotiate on their own. Even if this is true, though, providing more generous pension benefits won't be optimal for all types of workers. The primary losers will be those who value future benefits the least—as noted above, that means those with lower life expectancies, for instance men, the less-educated, the poor, minorities, and those in bad health.<sup>149</sup> The losers will also include those who plan optimally and don't need the extra nudge.

The inability to adjust pensions for existing employees may also lead to a bias in favor of replacing existing employees with new ones or encouraging existing employees to leave, though that tendency will probably be mitigated by whatever employment protections public employees have by statute or collective bargaining agreement.

## VI. POSSIBLE FIXES

In short, the California rule distorts what the salary/pension mix would otherwise be, given employer and employee preferences, and given the tax code as it is. Because underfunded pensions are a popular form of deficit spending, public employee compensation may already be too pension-heavy, and the rule makes it

<sup>149</sup> See *supra* note 141 and accompanying text.

more so by freezing pensions in times of retrenchment. The incentive effects of the rule, given the political economy of government employment, may well exacerbate this tendency. And the possible theoretical reasons for preferring a pension-heavy mix don't go very far in justifying this particular distortion.

How much leeway to modify public pensions does a “fiscal emergency” offer? Not much. As the *Allen* rule says,<sup>150</sup> one can modify pension rights before retirement for the sake of flexibility in light of changed conditions, but the changes must be reasonable, which means *both* that they need to have a relation to pension theory *and* must compensate for disadvantages with comparable advantages. Clearly, merely reciting the need to shore up pensions is insufficient,<sup>151</sup> and arguments in favor of COLA caps that “the ‘integrity’ of the pension system is strengthened when it can be determined with certainty what the obligations of the system are” likewise are insufficient.<sup>152</sup>

In *United Firefighters*, the Court of Appeal rejected the contention that the modifications were necessary to preserve the soundness of the system because it held that the fiscal crisis was caused by the government's own conduct in inadequately funding the system:<sup>153</sup> “a public entity cannot justify the impairment of its contractual obligations on the basis of the existence of a fiscal crisis created by its own voluntary conduct.”<sup>154</sup> The same may even be true when the crisis is created not by government officials but by a tax-limiting voter initiative like Proposition 13.<sup>155</sup>

And even if the modifications are justified by sound pension theory, this doesn't prevent the government from having to offer compensating advantages. So the ability to modify pensions seems to be of little help in resolving a fiscal crisis.

<sup>150</sup> See text accompanying *supra* note 48.

<sup>151</sup> See, e.g., *Olson v. Cory*, 636 P.2d 532, 539 (Cal. 1980).

<sup>152</sup> *Glaeser v. City of Berkeley*, 307 P.2d 61, 64 (Cal. Ct. App. 1957).

<sup>153</sup> *United Firefighters of L.A. City v. City of L.A.*, 259 Cal. Rptr. 65, 73–74 (Ct. App. 1989).

<sup>154</sup> *Id.* at 74 (citing *Sonoma Cnty. Org. of Pub. Employees v. Cnty. of Sonoma*, 591 P.2d 1, 10 (Cal. 1979)).

<sup>155</sup> *Id.* at 75; see also *Sonoma Cnty.*, 591 P.2d at 10 (noting the issue but not deciding it).

Moreover, the California rule probably doesn't conflict with the federal Constitution—it's a state rule for finding contracts in statutes that merits federal deference. Even if it doesn't merit federal deference, it represents a valid rule of California constitutional law, which California courts would explicitly adopt as a matter of state law if pressed. So we shouldn't look to the U.S. Supreme Court to fix it.

So, what fixes are available?

1. *A flexible definition of benefits.* One possibility would be to expressly reserve flexibility in the statutory definition of pension benefits.<sup>156</sup> For instance, in *International Ass'n of Firefighters v. City of San Diego*,<sup>157</sup> the San Diego charter provided that employee and city contributions to the retirement fund would be "computed upon the basis of actuarial advice designed to estimate the funding needed to accrue a guaranteed retirement allowance upon retirement."<sup>158</sup> Because the actuarial advice provision was part of employees' vested rights from the start, changes in contribution rights based on this advice—far from *impairing* anyone's rights—were in fact made *pursuant to* the employees' rights.<sup>159</sup>

Similarly, in *Pasadena Police Officers*, the Pasadena charter, which set contribution rates according to actuarial assumptions, was amended to alter those assumptions.<sup>160</sup> That amendment didn't violate any vested contract rights, since conformity with actuarial assumptions had been made a condition of pension contributions from the start.<sup>161</sup>

2. *Short-term contracts.* Perhaps providing benefits by the terms of short-term contracts (rather than by statute) could preserve government flexibility to modify pension terms prospectively. If pension terms are enshrined in memoranda of understanding—perhaps the result of collective bargaining with public-employee

unions<sup>162</sup>—that expire at a certain time, it seems hard to argue that the employees have acquired any vested right to compensation, benefits, pensions, or anything else beyond the term provided. The relevant governmental unit would then be able to alter pension terms in subsequent memoranda.<sup>163</sup>

But this theory (while sound for salary and other benefits<sup>164</sup>) might be on shaky ground in the case of pensions. In *Legislature v. Eu*, the California Supreme Court held that, in the case of legislators, the right to earn pension rights on the same terms begins when the legislators first begin their service, even though legislative terms may have begun and ended since then.<sup>165</sup> Similarly, a superior court judge remains entitled to earn pension rights on the same terms even if he is then appointed to the court of appeal: "The coach ticket punched in the 1964 appointment to the superior court continued to be good for passage in the parlor car of the court of appeal. His retirement destination was the same."<sup>166</sup>

Perhaps these cases can be distinguished because the legislators' and judges' benefits were provided by a non-sunsetting statute, and perhaps one can acquire a vested interest in the continuation of rules provided by a publicly available, non-sunsetting statute but not by a memorandum of understanding that expires by its own terms and that may not even have been renegotiated yet. But the coach ticket-parlor car metaphor quoted above suggests that the only thing that matters is that the employee remains in the same retirement system.

3. *State constitutional amendment.* Another possibility would be a state constitutional amendment abolishing the California rule and establishing that pension statutes only entitle the employee to that portion of the pension accrued so far. Given past California caselaw, this would probably itself count as a law impairing the obligation of contracts, so (like a

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156 See *Glaeser*, 307 P.2d at 64.

157 667 P.2d 675 (Cal. 1983).

158 *Id.* at 676.

159 *Id.* at 680–81.

160 *Pasadena Police Officers' Ass'n v. City of Pasadena*, 195 Cal. Rptr. 339, 347–48 (Ct. App. 1983).

161 *Id.* at 348–49.

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162 See Monahan, *supra* note 15, at 1037 n.39.

163 Cf. *San Bernardino Public Employees Ass'n v. City of Fontana*, 79 Cal. Rptr. 2d 634, 637, 639 (Ct. App. 1998); *Olson v. Cory*, 636 P.2d 532, 540 (Cal. 1980).

164 Which is where the cases cited *supra* note 163 arose.

165 816 P.2d 1309, 1332–33 (Cal. 1991).

166 *In re Marriage of Alarcon*, 196 Cal. Rptr. 887, 892 (Ct. App. 1983).

statute) it would be valid only for employees hired after the date of the amendment.

4. *Changing state caselaw.* Another, more long-term, possibility would be to alter the California rule by a pattern of anti-California-rule appointments to the state supreme court. While a reversal of the California rule through caselaw looks similar to a reversal by constitutional amendment, the caselaw route seems more likely to be viewed as an acceptable adjustment of the definition of contractual rights, and (always provided the court stays within the federal-law deference zone)<sup>167</sup> less likely to be seen as an (unconstitutional) impairment of contracts.<sup>168</sup> Though the idea that judicial decisions could impair contracts once had some currency,<sup>169</sup> in modern times “no court has shown any interest in reviving the idea.”<sup>170</sup> Thus, an appellate court in Massachusetts has allowed detrimental changes without comparable new advantages,<sup>171</sup> and this doesn’t

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167 See text accompanying *supra* notes 37–45. *Indiana ex rel. Anderson v. Brand*, 303 U.S. 95 (1938), is probably best read as an example of a later judicial interpretation falling outside the deference zone. See *id.* at 107 (“We think the [state court’s] decision in this case runs counter to the policy evinced by the act of 1927, to its explicit mandate and to earlier decisions construing its provisions.”).

168 The question of judicial redefinition of contracts is similar to the unresolved question of “judicial takings”—whether a change in property caselaw can result in a “taking” of property that violates the Takings Clause, see *Stop the Beach Renourishment, Inc. v. Fla. Dep’t of Env. Prot.*, 560 U.S. 702 (2010). See generally Barton H. Thompson, Jr., *The History of the Judicial Impairment “Doctrine” and Its Lessons for the Contract Clause*, 44 STAN. L. REV. 1373 (1992).

169 See Thompson, *supra* note 168, at 1391–1417 (discussing the judicial impairment doctrine in the 19th century); Monaghan, *supra* note 38, at 1976–83; *Gelpcke v. City of Dubuque*, 68 U.S. (1 Wall.) 175 (1863) (holding, in a municipal bond case, that bonds are governed by the state law in effect when the bonds were issued, not later caselaw).

170 Thompson, *supra* note 168, at 1451.

171 See *Dullea v. Mass. Bay Transp. Auth.*, 421 N.E.2d 1228, 1235–36 (Mass. App. Ct. 1981); Monahan, *supra* note 15, at 1071–72. Monahan also cites cases in Oregon and Colorado that modified the California rule, *id.* at 1072–74. The Oregon case, *Hughes v. State*, 838 P.2d 1018, 1033–34 (Or. 1992), dealt with the repeal of statute granting a tax exemption on “accrued or accruing” pension benefits. The Oregon Supreme Court held that the tax exemption was a contractual benefit that couldn’t be withdrawn, but that the statute didn’t promise the exemption for

seem to have been challenged as a judicial impairment of the state’s contract obligations.

5. *Privatization.* Another possibility—which alleviates the problem but doesn’t solve it structurally—is to pursue privatization and outsourcing. Firing state employees is constitutional, and providing pensions and retirement plans for the contractors’ employees will be left to the private employers. Those private pensions, if offered, will have to be ERISA-compliant,<sup>172</sup> which alleviates problems of underfunding; and in any event, the state won’t be on the hook for anything beyond the current contract price.

These are all possibilities for treating pension benefits just like other aspects of compensation: as something earned over time and not guaranteed for the future. In addition to being more rational as a public-employee compensation policy, abandoning the California rule would also give governmental units in California, and wherever else the rule has been adopted, flexibility to deal with changing circumstances.

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benefits yet to be earned; so as to future benefits, withdrawing the tax exemption didn’t impair the contractual obligation. I’m not sure that this is a true retreat from the California rule—conceivably, even California courts could decline to recognize a promise if the statutory language were clear enough. The Colorado lower-court case, *Justus v. State*, No. 2010-CV-1589 (Colo. Dist. Ct. June 29, 2011), has now been reversed, 2012 WL 4829545 (Colo. App. Oct. 11, 2012), and cert. has been granted by the Colorado Supreme Court, 2013 WL 4008216 (Colo. Aug. 5, 2013).

172 See Buck, *supra* note 16, at 39–43.



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