A PUBLIC PENSIONS BAILOUT: ECONOMICS AND LAW

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Abstract

In several states, public pension plans are at risk of insolvency within a decade. These risks are significant, and the solutions currently contemplated are likely to fall short of what is necessary to contain the problem. If public pension plans do become insolvent, it seems likely the federal government will bail them out. This Article proposes that the federal government prepare for the prospect of federal financial support of public pension plans by instituting an optional regulatory regime for public pensions. If a state elects not to participate, its public pension plans would be ineligible for federal financial support. In states that do elect to participate, public plans would be eligible for federal financial support in the event of severe financial distress. All public plans in these states would be subject to a federal regulatory regime similar to ERISA, including minimum funding requirements. Congress could also authorize sponsors of regulated plans to revise existing employees' retirement benefits with respect to future services, an option that is available to private employers. This flexibility would allow for much more significant pension reforms on the state and local level since in many states pension reforms can only alter the benefits of new hires.

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Introduction

The monetary rewards from a career as a public school teacher, police officer, or firefighter can be very respectable, but the financial upside is usually limited. The traditional compensation for these positions includes the satisfactions of public service, a degree of job security beyond what the private sector offers, and relatively comfortable retirement benefits. In some jurisdictions, however, inadequate funding has placed the pension benefits of public employees in real jeopardy. Since the time horizon for pension obligations is very long, unsound pension financing can persist for decades before the scheme collapses. Now a significant number of state and local government pension funds are approaching insolvency.[1]

Often enough, public pension fund insolvencies are likely to be followed by defaults on payments to beneficiaries. Retired teachers, police officers, and other government employees will not receive their retirement benefits on schedule. The prelude is underway. Underfunded pension plans have already played a central role in

1. Alicia H. Munnell et al., Ctr. for Research at Bos. Coll., *Can State and Local Pensions Muddle Through?*, 15 St. & Loc. Pension Plans 1, 3 (2011), http://crr.bc.edu/wp-content/uploads/2011/03/slp_15.pdf; Joshua D. Rauh, *Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities*, 62 Nat'l Tax J. 585 (2010), *available at* http://ntj.tax.org/wwtax/ntjrec.nsf/FB6C0589369AA873852577A8003FB784/$FILE/Article%2008_Rauh.pdf.

the bankruptcy filings of Detroit, Michigan;[2] Stockton, California;[3] and Central Falls, Rhode Island.[4] In Detroit, for example, the proposed restructuring of the city's debt contemplates "significant cuts in accrued, vested pension amounts for both active and currently retired persons."[5] Other municipalities are also edging closer to financial distress due to underfunded pensions.[6] For example, according to the *New York Times*, "The pension fund for retired Chicago teachers stands at risk of collapse."[7] The mayor of Chicago estimates that meeting the city's pension obligations would require more than doubling existing property taxes.[8]

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2. *See* City of Detroit Bankruptcy Filing for the U.S. Bankruptcy Court of the Eastern District of Michigan, Case 13-53846, http://www.mieb.uscourts.gov/apps/detroit/DetroitBK.cfm.

3. *See* City of Stockton Bankruptcy Court Filings 2014, http://www.stocktongov.com/government/departments/manager/bankruptcy/bkCourtFilings14.html.

4. *See* City of Central Falls Bankruptcy Plan, http://centralfallsri.us/wp-content/themes/2012CF/assets/FinancialInfo/BankruptcyPlan/ExhibitE-RestructuredBenefit.pdf.

5. CITY OF DETROIT, OFFICE OF THE EMERGENCY MANAGER, PROPOSAL FOR CREDITORS 109 (June 14, 2013), http://www.freep.com/assets/freep/pdf/C4206913614.pdf; *see also* Alana Semuels, *Detroit Bankruptcy Plan Includes Deep Pension Cuts*, L.A. TIMES, February 22, 2014, http://www.latimes.com/nation/la-na-detroit-bankruptcy-20140222,0,3941443.story.html ("In the plan, which probably will be amended in the weeks ahead, police, firefighters and those departments' retirees will take a 10% cut to their current pension payment. The pensions of all other city employees and retirees will be cut more than three times as much: 34%. Neither group will receive cost of living adjustments in the future."); Plan of Adjustment of Debt of City of Detroit at 30-32, *In re* Detroit, Michigan (Feb. 21, 2014) (No. 13-53846), *available at* http://www.mieb.uscourts.gov/sites/default/files/detroit/docket2708.pdf; Disclosure Statement with respect to Plan for the Adjustment of Debts of the City of Detroit, at 4-8, *In re* Detroit, Michigan (Feb. 21, 2014) (No. 13-53846), *available at* http://www.detroitmi.gov/Portals/0/docs/EM/Bankruptcy%20Information/Disclosure%20Statement%20_Plan%20for%20the%20Adjustment%20of%20Debts%20of%20the%20City%20of%20Detroit.pdf. .

6. *See* Monica Davey & Mary Williams Walsh, *Chicago Sees Pension Crisis Drawing Near*, N.Y. TIMES, Aug. 6, 2013, http://www.nytimes.com/2013/08/06/us/chicago-sees-pension-crisis-drawing-near.html?pagewanted=all"&_r=0.

7. *Id.*

8. Recent Illinois legislation reduces cost of living allowances applied to the benefits of certain Chicago public employees (other than public safety workers), requires increased contributions from these employees, would divert state revenue sharing payments from the city to its pension funds if pension funding targets are not met, and authorizes Chicago to temporarily impose higher fees on telephone land lines and cell phone service until the local election cycle is completed. Pub. Act 98-0641, effective June 6, 2014, http://chicagotonight.wttw.com/sites/default/files/article/file-attachments/SB1922.pdf#overlay-context=2014/06/10/funding-chicagos-pensions, Pub. Act 98-0634, effective June 6, 2014, http://www.ilga.gov/legislation/publicacts/98/098-0634.htm. The legislation is expected to be challenged on the grounds that the Illinois constitution does not permit reductions in the benefits of current or retired employees. *See also Rahmbo's Toughest Mission: Can Rahm Emmanuel Save Chicago from Financial Calamity?*, ECONOMIST, Jun. 14, 2014, *available at* http://www.economist.com/news/united-states/21604165-can-rahm-emanuel-save-chicago-financial-calamity-rahmbos-toughest-mission; Sophia Tareen, *Gov. Quinn Signs Partial Pension Overhaul*, AP, Jun. 9, 2014, http://bigstory.ap.org/article/quinn-decide-monday-chicago-pension-overhaul; Tom Aaron, *Illinois Supreme Court Casts Doubt on Recent State and Local Pension Reform Efforts, a*

The problem is not confined to the municipal level. Using optimistic projections of the short-term returns that public pension plans will earn, Joshua Rauh recently estimated that as many as a dozen underfunded state pension plans might exhaust their reserves over the next ten years, starting with Illinois in 2018, then Connecticut, Indiana, and New Jersey in 2019.[9] That would be a very serious problem for a pension plan: it's not like running out of gas on the way to work in the morning, it's closer to running out of jet fuel on a transatlantic flight.

Once a pension plan exhausts its reserves, it faces the same dilemma year after year simply to stay even: attempting to fund current retiree benefits out of cash flow while still setting aside adequate funds for the accruing benefits of current employees. Yet a pension plan in this predicament will have failed to satisfy even the latter obligation for significant periods of time. For example, in order to prevent defaults on the pension obligations to retired state employees, state revenues might have to increase by twenty percent in Indiana and by thirty-five percent in Illinois and New Jersey. Colorado, which could see its pension reserves exhausted by 2022, would at that point require potential tax increases of over fifty percent to avoid defaulting on its pension obligations.[10] These revenue demands would not be temporary. Additionally, the financial burden could be significantly higher for states with plans that fail to achieve their targeted investment returns. If governments are unable to sufficiently reduce their budgets or increase taxes in a timely manner, large numbers of former employees, including teachers and police officers, might face grave financial difficulties.

Many state and local officials continue to deny that public pensions are at risk.[11] Additionally, from time to time members of Congress insist that there is no possibility of a federal bailout of

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Credit Negative, U.S. Pub. Fin. Wkly. Credit Outlook, Jul. 10, 2014, at 4, https://docs.google.com/file/d/0B4Bi-iePG1O6NEhWYy1VY0NoOVU/edit?pli=1.

9. Rauh, *supra* note 1, at 596; *cf.* Charles Gasparino, *Morgan's Big Secret: The Coming Muni Bond Crisis*, N.Y. Post, Jun. 17, 2012, http://nypost.com/2012/06/18/morgans-big-secret/ ("In New York, for example, JP Morgan said state officials would have to immediately cut spending by 12.3 percent or raise taxes on everyone by 7.4 percent. And [they would have to] make these tax hikes and budget cuts permanent for the next two decades to fully fund public-employee pensions. New Jersey faces an even bigger hole. Even after [Governor] Christie's reforms, it would still have to cut spending 30.8 percent or raise taxes another 17.2 percent, keeping them in place for two decades, to solve the problem.").

10. These projected revenue increases are based on the ratio of annual pension benefits to state revenues in 2008. The projections assume that states will not divert revenues allocable to current employees' benefits to fund retired workers' benefits. Rauh, *supra* note 1, at 596.

11. *See* discussion *infra* Part I.A.3.

public pension plans.[12] So far, these positions have been costless to maintain. Therefore, they mean very little. When the prospect of pension defaults spreads beyond a few moderately-sized cities and begins to threaten a number of state plans, the political dynamics of the issue will shift. Unequivocal rejections of a federal role in this area will give way to the real possibility of a federal bailout of severely underfunded public pension plans.

A federal bailout of public plans will be controversial, but, in the end, some sort of federal financial support is likely. The numerous recent bailouts of banks and manufacturers[13] might be distinguishable, technically,[14] but politically the incongruity could be hard to explain away. Furthermore, the federal government already insures private sector pension benefits;[15] should payments to retired public employees come up short, the case for treating public plans differently than private sector plans will deteriorate. The federal government may be able to tolerate a few isolated public pension plans defaults—just as it permitted Lehman Brothers to fail in

12. *See, e.g.*, Press Release, Senator Tom Coburn, Burr, Coburn, Thune Introduce Public Employee Pension Transparency Act (Apr. 23, 2013), http://www.coburn.senate.gov/public/index.cfm/2013/4/burr-coburn-thune-introduce-public-employee-pension-transparency-act; *cf.* JOINT ECONOMIC COMMITTEE, REPUBLICAN STAFF COMMENTARY, *The Pending State Pensions Crisis* 9, http://www.jec.senate.gov/republicans/public/?a=Files.Serve&File_id=6bdeeee9-4560-4904-bb2e-73cea6de06ab.

13. *See, e.g.*, Adam J. Levitin, *In Defense of Bailouts*, 99 GEO L.J. 435, 437 (2011); J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. REG. 283, 294–295 (2010); Cheryl Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 156–59 (2010). Daniel E. Teclaw, *U.S. Government Cost to Resolve and Relaunch Fannie Mae and Freddie Mac Could Approach $700 Billion*, STANDARD & POOR'S (Nov. 4, 2010, 9:42 PM), http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245235044878 ("Standard & Poor's estimates that the ultimate taxpayer cost to resolve Fannie Mae and Freddie Mac could reach $280 billion . . . . That $280 billion, however, could swell to $685 billion, by our estimate, with the establishment of a new entity to replace Fannie and Freddie that the government would initially capitalize."). *See also* Bailout Recipients, PROPUBLICA, http://projects.propublica.org/bailout/list (last updated Aug. 12, 2014); The Bailout: Initiatives and Programs, PROPUBLICA, http://projects.propublica.org/bailout/programs (last visited Aug. 26, 2014).

14. David Skeel contends that "[b]ailouts are most defensible if the issue is liquidity—a temporary crisis in funding—rather than insolvency" and that while recently bailed out banks were primarily threatened by illiquidity, the financial difficulties of state and local governments are not predominantly related to liquidity. David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 704–05 (2012).

15. *See, e.g.*, DOUGLAS HOLTZ-EAKIN, THE PENSION BENEFIT GUARANTY CORPORATION: FINANCIAL CONDITION, POTENTIAL RISKS AND POLICY OPTIONS (June 15, 2005), http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/64xx/doc6426/06-15-pbgc.pdf ("As a practical matter, however, the public probably views the pension insurance system as carrying an implicit federal guarantee. Consequently, many observers expect that if PBGC became insolvent, the Congress would feel compelled to provide direct assistance from general revenues.").

2008[16]—but a series of failures spread throughout the nation would be another matter entirely. The time is ripe to consider an effective framework for federal intervention.

It is true that many state and local governments have already instituted some reforms of their employee pension plans. For the most part, however, these reforms have been directed at the benefits provided to new hires,[17] while the looming crisis is driven by the benefits of current and retired public employees. Those benefits have typically been immune from reform, and, as a result, the reforms currently being imposed are unlikely to significantly reduce the prospect of public pension plan defaults in the near future.[18] Only the federal government has sufficient financial resources and legal authority to assure that the most seriously underfunded public pension plans do not default. A federal program could authorize the sponsors of its regulated plans to revise their existing employees' benefits with respect to future services. This is an option that private employers have always possessed, but one that is denied to public employers in many states.[19] The flexibility to adjust the retirement benefits of existing public employees in this way would permit more significant reforms at the state and local level.

This Article proposes that the federal government accept that it may be called upon to provide financial aid to several sizable public pension funds and act to meet the crisis on its own terms. The sooner the federal government confronts the matter, the more effectively it can contain the crisis—and the cost to the Treasury. The financial burden of federal support will be substantial, but the expense will only represent costs that, inevitably, someone must bear.

If it were clear that the costs of underfunded public plans could be distributed among only the taxpayers of the sponsoring jurisdictions, then the case for a federal role would be weaker. Unfortunately, it appears that in many cases the alternative distributees, at least in the short run, are United States taxpayers versus

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16. *See, e.g.*, Financial Crisis Inquiry Commission, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States 343 (Jan. 2011), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf ("The inconsistency of federal government decisions in not rescuing Lehman after having rescued Bear Stearns and the GSEs [Fannie Mae and Freddie Mac—government sponsored entities], and immediately before rescuing AIG, added to uncertainty and panic in the financial markets.").

17. *See* Part I.B (Public Sector Pensions).

18. *Cf.* Rick Lyman & Mary Williams Walsh, *Efforts to Rein in Public-Sector Pension Costs are Falling Short, Experts Say*, N.Y. Times, Feb. 24, 2014, http://nyti.ms/1pkgvnb ("[P]ension experts say that while some [state pension reforms] have whittled state shortfalls . . . none have come close to closing their pension gaps quickly enough to keep pace with a rapidly aging—and retiring—public work force.").

19. *See* Part I.B.2 (Legal Status of Public Employee Pension Benefits).

retired public servants. If there are villains in the public pensions crisis—negligent or cynical public officials or their constituents—standing by while public pensions default is unlikely to punish them.

Federal aid for troubled public pension plans must come with strings. This is essential both financially and politically. The federal government should condition eligibility for federal support on a state's consent to federal regulation of all of the state's public pension plans, local as well as state. Federal regulation of public plans would resemble the federal regulation of private pension plans and would include minimum funding requirements similar to those imposed on private sector plans. In line with federalism principles, a state could opt out of federal oversight, but then public plans in that state would be ineligible for federal financial assistance.

Public pension plans may weather the next decade or so without the need for federal support. At that point, however, the financial condition of many public plans could be more precarious than it is today. Even if a fiscal emergency lies somewhat further down the road, federal involvement can provide a framework for more significant progress in strengthening the balance sheets of public pension funds.

I. Employee Pensions in the Public and Private Sectors

Most full-time jobs in the United States offer a retirement plan.[20] There are two principal types of pensions: defined benefit plans and defined contribution plans. For either type of plan, an employer contributes to a fund or trust on behalf of an employee, with the expectation that the employee will not receive benefits from the arrangement until retirement or at least until the employee stops working for that employer.

In a typical defined contribution plan, an employer contributes money to an individual account held by a financial institution. The funds in the account are invested in stocks, bonds, and other assets, sometimes on behalf of the employee according to established guidelines, sometimes at the direction of the employee, with deductions taken out for administrative expenses as well as investment losses. For a defined contribution plan, the balance in the employee's account at (and after) retirement determines the benefits.

20. Bureau of Labor Stat., *News Release: Employee Benefits in the United States* (Mar. 2014), http://www.bls.gov/news.release/pdf/ebs2.pdf.

The plan sponsor is responsible for making specified annual contributions—typically proportional to an employee's annual wages or salary, or based on the success of the business—but the sponsor is not exposed to the risk of poor performance by the plan's investments. In defined contribution plans, strong investment performance means higher retirement benefits, and lower returns result in smaller pensions.

A typical defined benefit pension plan provides an employee an annual payment at retirement that is based upon the number of years the employee works for the employer and the employee's average salary over several years immediately before retirement. For example, the payment might be calculated by using two percent of the product of years worked times average salary for five years before retirement. Although the employer usually sets money aside and invests it to support its future pension commitments, defined benefit pension payments are not tied to the performance of the pension fund's investments. Accordingly, while the employee bears the risk of poor investment performance in a defined contribution plan, the employer bears the risk in a defined benefit plan. Because determining the adequately of a defined benefit plan's funding can be more difficult, at least in the short run, the risk of underfunded employee pensions is largely confined to this type of plan.[21]

The trend in the private sector is to move away from providing defined benefit pensions and to offer employees defined contribution pensions instead.[22] Some of the shift has been attributed to the way in which the federal government regulates private sector plans.[23] Private sector employee pension plans are regulated by the Internal Revenue Service and the Department of Labor under the Employee Retirement Income Security Act of 1974 (ERISA).[24] ERISA requires pension plans to make regular reports on their financial condition and imposes funding standards, such as requiring private sector defined benefit plans to fully fund the retirement benefits employees accrue.[25] ERISA also established a federal

21. Although the problem of underfunding is not limited to public sector plans, *see, e.g.*, McGraw-Hill Financial, S&P 500 2012 Pensions and Other Post Employment Benefits (OPEB): The Final Frontier 9 (2013), http://www.spindices.com/documents/research/sp-500-2012-pensions-and-opeb-201307.pdf, the issue of underfunded private sector plans is beyond the scope of this paper.

22. *See* U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, PRIVATE PENSION PLAN BULLETIN, HISTORICAL TABLES AND GRAPHS, 1–2 (2011 Data Release Version 1.0 June 2013), http://www.dol.gov/ebsa/pdf/historicaltables.pdf.

23. Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 471 (2004).

24. Pub. L. 93–406, 88 Stat. 829 (codified as amended in scattered sections of 26 and 29 U.S.C.).

25. 26 U.S.C. §§ 412, 430 (2012).

agency, the Pension Benefit Guaranty Corporation (PBGC), within the Department of Labor, to insure the benefits of private plans.[26] The PBGC charges an insurance premium[27] to private employers with pension plans and pays benefits[28] to retired employees if a plan defaults.

A. *Public Sector Pensions*

1. Introduction

State and local government pensions are generally defined benefit pensions that require some contribution by the employee.[29] (Generally, the benefit payments include an inflation adjustment—a cost of living allowance, or COLA.) For defined benefit plans, the retirement benefit does not depend on the investment returns of the pension fund. For example, an Illinois public school teacher would be required to contribute 9.4% of gross earnings toward retirement.[30] Under current law, an Illinois public school teacher who began teaching in 2001 and retires at age sixty, after teaching thirty years, would receive a benefit equal to approximately two-thirds of the teacher's average salary over the last four years of teaching. If that average (late career) salary were $100,000, say, then the pension would be $66,000. This represents a credit of 2.2% for each year of service, applied to the average salary at the end of the teacher's career.[31] Generally, the annual benefit is increased by 3% each year as an inflation adjustment, so here the benefit would be about $68,000 the next year, $70,000 the following year, and so

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26. 29 U.S.C. § 1302 (2012).

27. *See* PENSION BENEFIT GUAR. CORP., *Premium Rates*, http://www.pbgc.gov/prac/prem/premium-rates.html.

28. *See* PENSION BENEFIT GUAR. CORP., *Guaranteed Benefits*, http://www.pbgc.gov/wr/benefits/guaranteed-benefits.html.

29. U.S. GOVERNMENTAL ACCOUNTABILITY OFFICE, GAO-08-983T, STATE AND LOCAL GOVERNMENT PENSION PLANS, CURRENT STRUCTURE AND FUNDED STATUS, STATEMENT OF BARBARA D. BOVBJERG, DIRECTOR EDUCATION, WORKFORCE, AND INCOME SECURITY 2, 4 (July 10, 2008), http://www.gao.gov/new.items/d08983t.pdf; CONG. BUDGET OFFICE, THE UNDERFUNDING OF STATE AND LOCAL PENSION PLANS 2–3 (May 2011), http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12084/05-04-pensions.pdf.

30. TRS, ONLINE MEMBER GUIDE, TEACHERS RETIREMENT SYSTEM OF THE STATE OF ILLINOIS 11 (August 2009), http://www.ediillinois.org/ppa/docs/00/00/00/02/33/94/20100106210355_guide.pdf.

31. *Id.* at 24; 40 ILL. COMP. STAT. 5/16-133 (2012), http://www.ilga.gov/legislation/ilcs/fulltext.asp?DocName=004000050K16-133. ($66,000 = $100,000× 30× 0.02.) Recently enacted Illinois pension reforms, Illinois Pub. Act 98-599, which largely targets the benefits of new employees as well as the cost of living increases for benefits of most employees, does not significantly alter these terms.

on.[32] Typically, an Illinois public school teacher would be outside the federal social security system;[33] neither the employer nor the employee would pay the annual 6.2% tax on the employee's salary,[34] and the employee would not be eligible for social security retirement benefits.

The structure of the Illinois system is fairly representative of most state and local government pensions,[35] although the level of benefits varies from plan to plan and the majority of state and local government employees do participate in the social security system.[36] (Defined benefit pension plans for police and firefighters have similar features, although they differ in some respects because public safety careers are normally shorter.[37]) In general, in the public sector, annual retirement payments in defined benefit pension plans are determined according to the following formula:[38]

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32. *See* 40 Ill. Comp. Stat. 5/16-133.1(a)(3) (2012). In some cases, the annual benefit increases described in the text would be reduced under recently enacted pension reforms. Ill. Pub. Act 98-599, effective July 1, 2014, enacted December 5, 2013; 40 Ill. Comp. Stat. 5/16-133.1(a-1), (a-2) (2012), http://www.ilga.gov/legislation/publicacts/98/PDF/098-0599.pdf. At the time of this writing, the Illinois pension reforms have been stayed, http://www.surs.com/pdfs/news/Restraining_Order_and_Preliminary_Injunction.pdf. *See also* Associated Press, *Illinois: Judge Halts Pension Overhaul*, N.Y. Times, May 14, 2014, at A17 (temporary stay), http://nyti.ms/1sPSYvd.

33. 26 U.S.C. § 3121(b)(7) (2006); 40 Ill. Comp. Stat. 5/21-103 (2012); *see also* U.S. Governmental Accountability Office, GAO-08-983T, Social Security, Issues Regarding the Coverage of Public Employees, Statement of Barbara D. Bovbjerg, Director Education, Workforce, and Income Security 3–4 (Nov. 6, 2007), http://www.gao.gov/assets/120/118512.pdf.

34. 26 U.S.C. §§ 3101(a), 3111(a) (2006).

35. Because, for the most part, pension plans reforms do not alter the benefits of existing public workers, this § I.A.1 describes the typical characteristics of the plans of current employees and retirees of public pension plans. Section I.B surveys recent legislative revisions, which largely impact only new hires.

36. *See* Robert L. Clark et al., *The Evolution of Public Pension Plans*, *in* The Future of Public Employee Retirement Systems 241 (Olivia S. Mitchell & Gary Anderson eds., 2009). The variation in coverage of state and local government employees by Social Security is discussed in U.S. Governmental Accountability Office, GAO-08-983T, Social Security, Issues Regarding the Coverage of Public Employees, Statement of Barbara D. Bovbjerg, Director Education, Workforce, and Income Security 3 (Nov. 6, 2007) ("[A]bout one-fourth of public employees are not covered by Social Security for various historical reasons.").

37. *See* Wisconsin Legislative Council, 2008 Comparative study of Major Public Employee Retirement Systems 12–13 (May 2010), http://legis.wisconsin.gov/lc/publications/crs/2008_retirement.pdf; Olivia S. Mitchell et al., *Developments in State and Local Pension Plans*, in Pensions for the Public Sector, 15, 21–22 (Olivia S. Mitchell & E. Hustead eds., 2000).

38. *See* Wisconsin Legislative Council, 2010 Comparative study of Major Public Employee Retirement Systems 24 (Dec. 2011), http://legis.wisconsin.gov/lc/publications/crs/2010_retirement.pdf; David Rajnes, Employee Benefits Research Institute, State and Local Retirement Plans: Innovation and Renovation (July 2001), at 17, http://www.ebri.org/pdf/briefspdf/0701ib.pdf.

Terminal Compensation × Years Employed × Multiplier

Terminal Compensation is typically the average compensation over the employee's three most highly compensated years; a five-year average is also common.[39] *Years Employed* is the total number of years of the employee's service for the government employer. The *Multiplier* is the rate at which benefits accrue per year of service. A recent survey found that multipliers were usually in the range between 1.7% and 2.1%. The multiplier tends to be higher for jurisdictions in which the government employees are outside Social Security, with an average of 2.2% as opposed to 1.95%.[40] While in the public sector defined benefit pension plans provide for employee contributions, in practice, the employer often assumes the obligation.[41] Apart from police and firefighters, plans typically allow for retirement with full benefits after age fifty-five with thirty years of service. Frequently, employees have an option for early retirement, which usually comes with an adjustment to the benefits formula. Vesting generally occurs at five years or fewer of employment, although some plans require up to ten years of service; a couple of plans provide for immediate vesting.[42]

State and local government pension plans usually adjust benefits to account for inflation. Many determine the adjustment based on the Consumer Price Index. For example, Massachusetts provides for up to a three percent cost of living adjustment on the first

39. *See* WISCONSIN LEGISLATIVE COUNCIL, 2010 COMPARATIVE STUDY OF MAJOR PUBLIC EMPLOYEE RETIREMENT SYSTEMS 27–29 (Dec. 2011), http://legis.wisconsin.gov/lc/publications/crs/2010_retirement.pdf.

40. *See id.* at 24–25 (suggesting that 1.95% average multiplier for plans in which employees are covered by Social Security "may be somewhat misleadingly low because a number of plans increase their multiplier rates following a certain number of years in service; generally 15, 25 or 30 years.").

41. *See* WISCONSIN LEGISLATIVE COUNCIL, 2008 COMPARATIVE STUDY OF MAJOR PUBLIC EMPLOYEE RETIREMENT SYSTEMS 19 (May 2010), http://legis.wisconsin.gov/lc/publications/crs/2008_retirement.pdf. There are, for example, tax advantages to providing incremental employee compensation in this form instead of via straight salary. *See id.*; *cf.* 26 U.S.C. § 414(h) (2006) (specifying that such contributions "shall not be treated as having been made by the employer if it is designated as an employee contribution."); CALIFORNIA LEGISLATIVE ANALYST'S OFFICE, STATE "PICKUP" OF EMPLOYEE RETIREMENT CONTRIBUTIONS 1 (Jan. 1985) ("The pickup program, however, is accomplished not through additional employer expenditures, but by manipulating the employee's salary on paper."), http://www.lao.ca.gov/reports/1985/01_85_state_pickup_of_employee_retirement_contributions.pdf; *see, e.g.*, CITY CLUB OF PORTLAND, OREGON PERS: BURDENED BY THE PAST, POISED FOR THE FUTURE 10 (May 27, 2011), http://research.pdxcityclub.org/sites/default/files/reports/PERS_2011_0.pdf ("[T]oday approximately 70% of employees receive the pick-up [of the six percent employee contribution to the Oregon Public Employee Retirement System].").

42. *See* WISCONSIN LEGISLATIVE COUNCIL, 2008 COMPARATIVE STUDY OF MAJOR PUBLIC EMPLOYEE RETIREMENT SYSTEMS 20–24 (May 2010), http://legis.wisconsin.gov/lc/publications/crs/2008_retirement.pdf.

$12,000 of benefits, setting a ceiling of $360.[43] New Jersey's adjustment is sixty percent of the Consumer Price Index (CPI).[44] Illinois and a few other states simply increase benefits for most employees by three percent each year, independent of the actual rate of inflation.[45]

For the most part, public sector plans fall outside the scope of federal supervision. In the 1970s, the immediate problems stimulating ERISA involved insolvent private sector defined benefit plans, and there was concern that federal oversight of public sector plans would offend federalism principles.[46] Public sector plans are not currently subject to federal minimum funding requirements.[47] Public plans tend to follow the standards established by the Government Accounting Standards Board (GASB). GASB promulgates accounting guidelines for state and local governments. Although GASB is not a regulatory body, does not conduct investigations, and does not have enforcement authority, its standards are influential. In some cases, compliance with GASB rules is mandated by state law or effectively compelled by financial markets that invest in public debt. Since 1994, GASB guidelines have required public pension plans to provide regular reports on their financial condition and have specified the relevant accounting principles for these reports. GASB's standards, however, are significantly looser than those that ERISA imposes on private sector plans.[48]

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43. Final Report of The Special Commission to Study the Massachusetts Contributory Retirement Systems 4 (Oct. 7, 2009), http://economics.mit.edu/files/4598.

44. N.J. Dep't Treasury, Members Handbook, Public Employees' Retirement System 30 (March 2011). The state uses the CPI for urban wage earners and clerical workers (CPI-W).

45. *See* Wisconsin Legislative Council, 2008 Comparative study of Major Public Employee Retirement Systems 34–35 (May 2010), http://legis.wisconsin.gov/lc/publications/crs/2008_retirement.pdf; *see also* Arkansas Public Employees Retirement System, Contributory, Members Handbook 37 (2009); Teachers Retirement System of Illinois, Essential Facts About TRS 3 (June 2011) (Tier 1 only). As of 2011, new employees are assigned to the Tier II plan. "Changes from the 'Tier I' pension law include raising the minimum age to draw a retirement benefit to age 67 with 10 years of service, imposing a limit on the amount of salary that may be used to calculate retirement benefits, and limiting cost-of-living annuity adjustments to the lesser of three percent or 1/2 of the annual increase in the Consumer Price Index, not compounded. The retirement formula is unchanged." *Id.* at 2. A three percent COLA also applies to retired employee beneficiaries of the Florida Retirement System. However, current Florida employees will not be eligible for a cost of living adjustment with respect to service after July 1, 2011. Fla. Stat. § 121.101 (2011). Florida law provides for restoration of the flat three percent COLA in 2016 "[s]ubject to the availability of funding and the Legislature enacting sufficient employer contributions specifically for the purpose of [restoring the 3 percent] cost-of-living adjustment." Fla. Stat. § 121.101(5) (2011).

46. *See* discussion *infra* Part III.C.

47. 29 U.S.C. §§ 3(32), 4(b)(1) (2012); 26 U.S.C. § 412(e)(2)(C) (2006).

48. U.S. Governmental Accountability Office, GAO-07-1156, State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections and

2. Legal Status of Public Employee Pension Benefits

In most cases, the level of pension benefits and the terms of state or local government pension plans are very real, legally binding commitments.[49] But the extent of protection varies by jurisdiction. In the private sector, the rule is that accrued benefits can be forfeited only before they vest.[50] For example, a private sector employee might earn $100,000 straight salary and accrue $2000 toward a pension annually. Then, after three years on the job, the employee would have accrued $6000 in annual retirement benefits. If the benefits have not yet vested and the employee changes jobs, then the employee loses the accrued retirement benefits.[51] If the benefits had vested, then the employee would have the right to receive the benefits, under the terms of the plan—which might mean that the employee would have to wait until retirement to access the money.[52] This guarantee extends to virtually all public pension plans,[53] although for public plans benefits may not vest for some time.[54]

In a number of states, the protections government employees receive are significantly stronger than the security guaranteed to vested pension benefits under ERISA. With respect to services an employee has not yet rendered, a private sector employer may reduce the rate at which pension benefits accrue or even eliminate

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FISCAL OUTLOOK FOR FUNDING FUTURE COSTS 8 (Sept. 2007), http://www.gpo.gov/fdsys/pkg/GAOREPORTS-GAO-07-1156/pdf/GAOREPORTS-GAO-07-1156.pdf; J. Fred Gierz & Leslie E. Papke, *Public Pension Plans: Myths and Realities for State Budgets*, 60 Nat'l Tax J. 305, 317 (2007), http://www.ntanet.org/NTJ/60/2/ntj-v60n02p305-23-public-pension-plans-myths.pdf.

49. *See, e.g.*, Parker v. Wakelin, 123 F.3d 1, 6–7 (1st Cir. 1997); Legislature v. Eu, 816 P.2d 1309, 1333 (Cal. 1991); Peterson v. Fire & Police Pension Ass'n, 759 P.2d 720, 724 (Colo. 1988); Oregon State Police Officers' Assoc. v. Oregon, 918 P.2d 765, 773 (Or. 1996); Spiller v. State, 627 A.2d 513, 517 n.12 (Me. 1993).

50. 29 U.S.C. § 203(a) (2012); 29 U.S.C. § 1053(a) (2012); 26 U.S.C. § 411(a) (2006); Alessi v. Raybestos-Manhattan, Inc., 451 U.S. 504, 510 (1981); Modzelewski v. Resolution Trust Corp., 14 F.3d 1374, 1378 (9th Cir. 1994).

51. Sutton v. Weirton Steel, 724 F2d 406, 410 (4th Cir. 1983).

52. Chambless v. Masters, Mates & Pilots Pension Plan, 772 F.2d 1032, 1041 (2d Cir. 1985).

53. 26 U.S.C. § 411(e); 26 U.S.C. § 401(a)(7)(1974); Mary Beth Braitman & Terry A.M. Mumford, *Legal Advisory Report*, *in* REPORT OF THE COMMISSION ON THE DESIGN AND FUNDING OF RETIREMENT AND RETIREE HEALTH BENEFITS PLANS FOR STATE EMPLOYEES AND TEACHERS 5, App. A (Vt. Dec. 2009); Amy B Monahan, *Public Pension Plan Reform: The Legal Framework*, EDUC. FIN. & POLICY 617, 638–40 (2010).

54. Clark et al., *supra* note 36, at 248–50, 263—65; *see, e.g.*, City of East Point v. Seagraves, 524 S.E.2d 755, 757 (Ga. App. 1999); Alldredge v. Okla. Firefighters Pension & Retirement Bd., 816 P.2d 580, 582 (Okla. App. 1991) (vesting of benefits of firefighters employed before 1981 occurred at retirement); Spiller v. State, 627 A.2d 513, 516 (Me. 1993); McGrath v. R.I. Retirement Bd, 88 F3d 12, 17 (1st Cir 1996).

further accruals.[55] In contrast, in a significant number of states, a government sponsor of a pension plan is bound to the terms existing on the date an employee begins work or enters the plan; any adjustments detrimental to current employees must be offset by beneficial adjustments. In a sense, at some point, public employees may become vested in a plan's terms as well as their accrued benefits. For convenience, the Article will refer to this type of legal protection for a public pension as *term vesting*.

For example, suppose that an employee starts working in 2012 for an employer whose only retirement plan is a conventional defined benefit plan, with Terminal Compensation defined as an employee's average annual compensation over the final three years of employment and with a multiplier of two percent. An employee working for thirty years and earning $100,000 in each of the three years before retirement would receive $60,000 per year in retirement. If the vesting period for the 2012 plan is five years, then an employee who stopped working for this employer in 2015 would not receive any pension from the employer's plan, but a worker who worked for five years at an annual salary of $50,000, would be entitled to a pension at retirement of $10,000 per year. If the employer were a private employer subject to ERISA, the employer could terminate the pension plan in 2017, for example, and cease to offer any retirement plan. An employee who worked for this employer until 2042 would be entitled to a pension at retirement based on five years of service, not the thirty years that the employee would have been entitled to apply if the terms of the 2012 plan had remained in force.

If the 2012 plan were a public plan, however, then in many jurisdictions not only would the government employer be prohibited from ceasing to offer an existing employee a pension plan after 2017, the employer would be prohibited from substituting a defined contribution plan for the defined benefit plan at that point. With respect to a public-sector employee hired in 2012, in 2017 the public employer could not even reduce the multiplier applied to 2018 and beyond—unless the terms could be shown to be at least as generous as the terms of the 2012 plan.[56] In these jurisdictions,

55. *See* 26 C.F.R. § 1.411(d)-3(a)(3). (4) (2006); 29 U.S.C. § 4041(b) (2012); Herman v. Cent. States, Se. & Sw. Areas Pension Fund, 423 F.3d 684, 691 (7th Cir. 2005). There are notice requirements if a plan amendment reduces future benefit accruals. ERISA § 204(h), 29 U.S.C. § 1054(h) (2012).

56. Hammond v. Hoffbeck, 627 P.2d 1052, 1057 (Alaska 1981); Thurston v. Judges Ret. Plan, 876 P.2d 545, 548 (Ariz. 1994); Legislature v. Eu, 816 P.2d 1309, 1333 (Cal. 1991) ("[O]n commencing to serve the state the officer thereupon acquires a vested right to earn, through continued service, additional pension benefits in an amount reasonably comparable

however, public employers need not provide new employees pensions at all, and, if they do, the new employees' benefits can be less generous than those provided to existing employees.

Among those states with term vesting, the legal basis for the rule varies. A number of state constitutions contain provisions directly addressing the status of public employee retirement benefits. For example, the New York State Constitution provides: "After 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."[57] The Arizona and Illinois constitutions contain similar language.[58] In Alaska, Hawaii, Louisiana, and Michigan, the provisions use the same language, except that they specify that "*accrued* benefits . . . shall not be diminished or impaired."[59] The courts of Alaska, Arizona, Illinois and New York have construed their respective constitutional provisions as entailing term vesting, in some cases relying on the legislative history of the clause.[60]

In the remainder of the term-vesting states, the requirement of term vesting is derived from federal or state constitutional contract protections.[61] In these cases, many state courts appear to base their construction on the public policy consideration that acceptance of public employment limits an employee's future employment options to such an extent that prospective employees would expect

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to those available when he or she first took office."); Betts v. Bd. of Admin., 582 P.2d 614, 617 (Cal. 1978); Kraus v. Bd. of Trustees, 390 N.E.2d 1281, 1289 (Ill. App. 1979); Singer v. Topeka, 607 P.2d 467 (Kan. 1980); Madden v. Contributory Ret. Appeal Bd., 729 N.E.2d 1095, 1098 (Mass. 2000); Calabro v. City of Omaha, 531 N.W.2d 541, 551 (Neb. 1995); Pub. Emp. Ret. Bd. v. Washoe Cnty., 615 P.2d 972, 974-75 (Nev. 1980); Birnbaum v. N.Y. State Teachers Ret. Sys., 152 N.E.2d 241, 245 (N.Y. 1958); Civil Serv. Emps. Ass'n v. Regan, 525 N.E.2d 1, 3 (N.Y. 1988); Or. State Police Officers' Ass'n. v Oregon, 918 P.2d 765, 779 (Or. 1996); *cf. id.* at 775; Bowles v. Wash. Dep't of Ret. Sys., 847 P.2d 440, 446 (Wash. 1993); Dorward v ILWU-PMA Pension Plan, 452 P.2d 258, 262 (Wash. 1969). *See also* Alicia H. Munnell & Laura Quinby, Ctr. for Research at Bos. Coll., *Legal Constraints on Changes in State and Local Pensions*, 25 ST. & LOC. PENSION PLANS 1, 2 (2012), http://crr.bc.edu/wp-content/uploads/2012/08/slp_25.pdf.

57. N.Y. Const. art. V, §7.

58. Ariz. Const. art. 12, § 7; Ill. Const. art. 13, § 5.

59. Ark. Const. art. 12, § 7; Haw. Const. art. 16, § 2; La. Const. art 10, § 29; Mich. Const. art. 9, § 19 (emphasis added). The Constitution of Texas also contains protections for "accrued pension benefits." Tex. Const. art. 16, § 66.

60. *Hammond*, 627 P.2d at 1057; Sheffield v. Alaska Pub. Emps.' Ass'n, 732 P.2d 1083, 1087 (Alaska 1983); *Thurston*, 876 P.2d at 548; *Kraus*, 390 N.E.2d at 1289; *Birnbaum*, 152 N.E.2d at 245.

61. *E.g.*, "No State shall . . . pass . . . Law impairing the Obligation of Contracts" U.S. Const. art. I, § 10. This is the federal Contract Clause. Its inclusion in our great charter appears to be connected to the practice of some States, when we were but a Confederation, of requiring creditors to accept nominal consideration in satisfaction of debts. *See* Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122, 199 (1819).

the benefits of term vesting before embarking on such a career.[62] For example, the Nebraska Supreme Court explains the basis of the term-vesting principle as follows:

> [W]e recognize that the availability of and security afforded by a pension plan may draw employees into government service. . . . Firefighters who accepted employment with the City of Omaha after the implementation of the [benefit provision] reasonably expected to receive the [benefit] if they remained in public employment, and that expectation provided a powerful incentive to remain working for the city. [New employees] would have no such expectation and would not be entitled to the [benefit].[63]

In the Nebraska cases, the court does not acknowledge that private employers attract employees without committing to maintain the terms of a pension throughout an employee's tenure. The courts may regard it as self-evident that pensions have been a more significant feature of compensation in the public sector than in the private sector.[64] Perhaps it is also plausible that labor markets for public school teachers and public safety workers differ systematically from those for generic private sector jobs.[65]

Although there is some diversity among the states regarding current government employees' pension security, generally the legal rights of retirees to pension benefits is firmly established, with perhaps some uncertainty at the margins with respect to various cost of living adjustments.[66] In the event that a government pension plan

62. Kern v. Long Beach, 179 P.2d 799, 803 (Cal. 1947); *Public Empls.' Ret. Bd.*, 615 P.2nd at 974; *Dorward*, 452 P.2d at 261 ("The worker loses job mobility and possible wage increases, but gains pension rights. The employer gains employment stability because he can attract more competent employees and avoid labor turnover."); *Or. State Police Officers Ass'n*, 918 P.2d at 776.

63. Calabro v. Omaha, 531 N.W.2d 541, 551 (Neb. 1995).

64. *See* Smith v. Bd. of Trustees La. State Emps.' Ret. Sys., 851 So.2d 1100, 1117–18 (La. 2003) ("Because of the lower pay that inevitably comes with public service, the benefits offered through state pension plans are undoubtedly one of the primary reasons state governments can attract and retain better employees."); Christensen v. Minneapolis Mun. Emp. Retirement Bd., 331 N.W.2d 740, 747 (Minn. 1983); *see also* Bernard Jump Jr., *Public Employment, Collective Bargaining, and Employee Wages and Pensions*, *in* State and Local Government and Financial Management 78 (Catherine Spain ed., 1978).

65. *Cf.* Maury Gittleman & Brooks Pierce, *Compensation for State and Local Government Workers*, 26 J. Econ. Perspectives 217, 224 (2012) ("It seems plausible that public sector workers demand a compensation package skewed more towards benefits."), http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.26.1.217.

66. Alicia H. Munnell & Laura Quinby, *Legal Constraints on Changes in State and Local Pensions*, 25 St. & Loc. Pension Plans 1, 3 (2012); Bartlett v. Cameron, 316 P.3d 889, 895–96

defaulted on its pension obligations to retired employees, the retirees could demand compensation through state court proceedings. Whether the retirees could actually obtain money on a timely basis, however, is much less clear. There is a significant risk that, if a substantial number government pension plans default, in many cases retirees will have great difficulty in extracting compensation from their former government employers through litigation, at least in the short-run.

3. Financial Status of Public Pension Funds

The state and local retirement funds of many jurisdictions are financially sound, but, in other jurisdictions, more than a few funds are edging toward the precipice. Joshua Rauh projects that pension plans in over ten states will exhaust their funds by 2022, unless they divert contributions from current employees to fund retiree benefits—a maneuver that may delay a reckoning but sow the seeds of a more dramatic collapse later on.[67] Using the same assumption of no diversions, the Center for Retirement Research at Boston College (Boston College CRR) estimates that public pension plans in almost half of the states will become insolvent, although the study considers it more "realistic" to assume that plans in distress will use whatever money they can get their hands on to pay retirees' benefits.[68] Even so, these authors identify seven public plans that are unlikely to "muddle through."[69]

State and local government officials nevertheless continue to maintain that "[p]ublic pension plans are not in crisis."[70] Recently, a coalition of public officials asserted that "state and local government retirement systems do not require, nor are they seeking, Federal financial assistance."[71] As with many important issues in the

(N.M. 2013) (citing cases and holding that "any future cost-of-living adjustment to a retirement benefit is merely a year-to-year expectation that, until paid, does not create a property right under the Constitution"); Justus v. State, No. 12SC906, 2013 WL 4008216 (Colo. Aug. 5, 2013) (scheduling oral argument re question).

67. *See* Rauh, *supra* note 1, at 593.

68. Munnell et al., *supra* note 1, at 10–11.

69. *Id.* at 3.

70. NAT'L CONFERENCE OF STATE LEGISLATURES, FACTS ON STATE AND LOCAL GOVERNMENT PENSIONS (2011), http://www.ilretirementsecurity.org/admin/reports/files/PublicPensionFactSheet110125.pdf.

71. *Id. See* NATIONAL GOVERNORS ASSOCIATION ET AL., FACTS YOUR SHOULD KNOW 3 (2013) http://www.nasra.org/resources/2013%20Facts%20You%20Should%20Know.pdf; NAT'L CONFERENCE OF STATE LEGISLATURES ET AL., 2014 FACTS: STATE AND MUNICIPAL BANKRUPTCY, MUNICIPAL BONDS, STATE AND LOCAL PENSIONS (2014), http://www.nasra.org/files/JointPublications/FactsYouShouldKnow.pdf.

realm of political economy, much of the controversy concerns discount rates.

The accounting methods that public pension plans use themselves indicate that the plans have an aggregate deficit of $971 million, with financial assets of $2.7 trillion offset by liabilities of $3.6 trillion.[72] Economists estimate a deficit that is several times larger. According to Robert Novy-Marx and Joshua Rauh, the deficit was at least $2.5 trillion as of June 2009; by another measure, the deficit stood at $3.39 trillion.[73] In another study, using 2012 data, the Boston College CRR estimates that the deficit is at least $2.7 trillion.[74] The economists' estimates correspond to a funding ratio of about fifty percent, in contrast to the plans' reported funding levels, which would mean that plans were about three-quarters funded. The ratings agency Moody's recently adjusted its methodology for determining the funding status of public pensions, producing a dramatically higher estimated deficit. Under Moody's revised approach, the total "adjusted net pension liability" of the public pension plans that it analyzed comes to about $2 trillion for fiscal year 2011.[75]

The pronounced disparity between public pension plans' reported deficits and economists' estimates stems largely from the different discount rates used to project plan liabilities. Although in practice these projections require accounting for benefits spread out over decades, the importance of the choice of the discount rate

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72. Nat'l Ass'n of State Retirement Administrators, Public Fund Scorecard (May 30, 2014) (summary of findings for fiscal year 2011), http://www.publicfundsurvey.org/publicfundsurvey/scorecard.asp.

73. Robert Novy-Marx & Joshua D. Rauh, *Policy Options for State Pension Systems and their Impact on Plan Liabilities*, 10 J. Pension Econ. & Fin. 173, 181 (2011).

74. Alicia H. Munnell et al., Ctr. for Research at Bos. Coll., *The Funding of State and Local Pensions: 2012–2016*, 32 St. & Loc. Pension Plans, 1, 4 (2013), http://crr.bc.edu/wp-content/uploads/2013/07/slp_32-508.pdf. In a November 2013 paper, Novy-Marx and Rauh suggest, "Unfunded pension obligations at the state and local level . . . probably top $4 trillion today." Robert Novy-Marx & Joshua Rauh, Linking Benefits to Investment Performance in US Public Pension Systems (Nov. 25, 2013), http://www.stanford.edu/~rauh/research/NMRPLAANov2013.pdf.

75. Moody's Investor Service, Request for Comment: Adjustments to U.S. State and Local Government Reported Pension Data (July 2, 2012), http://s3.documentcloud.org/documents/686623/moodys-pensions-final-adjustments-sc.pdf ("The proposed adjustments described in this Request for Comment would nearly triple fiscal 2010 reported unfunded actuarial accrued liability ("UAAL") for the 50 states and our rated local governments, increasing UAAL to $2.2 trillion from $766 billion."); Moody's Investor Service, Adjustments to U.S. State and Local Government Reported Pension Data (Apr. 17, 2013), http://gfoa.org/downloads/MoodysAdjustmentsApril2013.pdf; Moody's Investor Service, Adjusted Pension Liability Medians for U.S. States, (June 27, 2013), http://www.washingtonpost.com/r/2010-2019/WashingtonPost/2013/06/27/National-Economy/Graphics/Moodys_State_Pension_Liability_Medians.pdf.

can be illustrated by an example involving a single projected payment many years away.

Suppose that benefit obligations are estimated to be $4 trillion in twenty years. At a discount rate of eight percent, the present value of that liability equals about $858 billion:

$$\frac{\$4 \text{ trillion}}{1.08^{20}} \approx \$858 \text{ billion.}$$

At a discount rate of four percent, the present value of the liability is about $1.83 trillion:

$$\frac{\$4 \text{ trillion}}{1.08^{20}} \approx \$858 \text{ billion.}$$

The latter discount rate produces a liability that is about twice as large.[76]

The reported liabilities and deficits of public pension plans are generally based on a discount rate in the neighborhood of eight percent, an estimate of the rate of return a plan will accrue on its investment assets. Organizations representing public plans justify a rate in that range by emphasizing that "for the most part, the expected returns used by public plans accurately reflect the long-term historical rates of return."[77] The majority of public pension plans' investments are in equities.[78] The proportion of investments allocated to stocks has grown over time and is significantly larger than for private sector defined benefit plans.[79] Equity investments tend to have notably higher average returns and greater risk.[80]

In contrast, economists' estimates of public plan liabilities use substantially lower discount rates. Novy-Marx and Rauh's estimates are based on Treasury rates that range from 0.2% to 2.5% over the

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76. At discount rate r, the present value (PV) of an amount X in one year is given by the formula PV = X/(1+r); at the same discount rate, the present value of X in n years is given by PV = X/(1+r)^n. For example, at a discount rate of ten percent, the present value of $55 in one year is $55/1.1 = $50.

77. NAT'L CONFERENCE OF PUBLIC EMP. RET. SYS., THE ADVANTAGES OF USING CONVENTIONAL ACTUARIAL APPROACHES FOR VALUING PUBLIC PENSION PLANS 5 (Nov. 2008), http://www.ncpers.org/files/ResearchSeriesIII.pdf.

78. *State Public Pension Investments Shift Over Past 30 Years*, The Pew Charitable Trusts & The Lauren and John Arnold Foundation 3 (June 2014), http://www.pewtrusts.org/~/media/Assets/2014/06/PensionInvestments06032014.pdf.

79. C.E. Weller & J. B. Wenger, *Prudent Investors: The Asset Allocation of Public Pension Plans*, 8 J. PENSION ECON. & FIN. 501–25 (2009).

80. The Pew Charitable Trusts & The Lauren and John Arnold Foundation, *supra* note 78, at 3–4.

first five years and from 3.5% to 4.3% from ten to thirty years.[81] The Boston College CRR study is based on a discount rate of five percent, which is derived from the yield of the thirty-year Treasury bond, adjusted upward by about twenty percent to account for the liquidity premium enjoyed by federal government debt.[82] The basis for the economists' approach is that public pension plan liabilities—beneficiaries' claims on their benefits—are fixed under the terms of the plans and governing state law. The appropriate discount rate for riskless claims is a riskless one.[83] From the perspective of financial economics, although the nature of a pension plan's liabilities may be relevant to determining the appropriate investment strategy for a plan, the composition of a pension plan's investment portfolio is not pertinent to determining the present value of the plan's liabilities.

As Novy-Marx emphasizes, under the accounting method sanctioned by GASB, a pension plan's measured liabilities and deficit could decrease if a plan simply discarded valuable fixed income assets from its portfolio, because doing so could increase the plan's projected average rate of return on its remaining assets.[84] According to economists Jeffrey Brown and David Wilcox,

> In most state and local plans, pension benefits are protected by constitutional, statutory, or common law guarantees. In many cases, these guarantees make the benefit promises to participants virtually free of risk. Finance theory is unambiguous that the discount rate used to value future pension obligations should reflect the riskiness of the liabilities.[85]

The economists' position is notable for lacking the hedging so common in their profession's pronouncements: "Discounting liabilities at an expected rate of return on assets in the plan runs entirely counter to the logic of financial economics: financial streams of payment should be discounted at a rate that reflects their risk."[86]

81. U.S. DEP'T OF THE TREASURY, INTEREST RATE HISTORIC YIELD DATA VISUALIZATION FOR JUNE 30, 2009, http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Historic-Yield-Data-Visualization.aspx; Novy-Marx & Rauh, *supra* note 73.

82. Munnell et al., *The Funding of State and Local Pensions*, *supra* note 74, at 4.

83. Jeffrey R. Brown & David W. Wilcox, *Discounting State and Local Pension Liabilities*, 99 AM. ECON. REV. 538, 538 (2009).

84. ROBERT NOVY-MARX, LOGICAL IMPLICATIONS OF GASB'S METHODOLOGY FOR VALUING PENSION LIABILITIES 3–5 (June 2012), http://rnm.simon.rochester.edu/research/LIoGMfVPL.pdf.

85. Brown & Wilcox, *supra* note 83, at 538.

86. Robert Novy-Marx & Joshua D. Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FIN. 1211, 1211 (2011).

The conviction of economists that pension plan deficits should be measured with a riskless discount rate has been endorsed by the accounting firm of Ernst and Young, the Congressional Budget Office, and a joint task force of the American Academy of Actuaries and the Society of Actuaries.[87] The actuaries' Pension Finance Task Force maintains that reporting pension liabilities based on expected return on assets tends to "mislead users, encourage unnecessarily generous compensation, discourage appropriate risk management of investments and encourage transactions that have no economic value."[88]

In the face of these disputes over the proper measure of public pension plan liabilities, GASB has largely rejected suggestions that it move its standards for public plans closer to those for private sector plans. GASB recently proposed revisions to its guidance that would theoretically call for some funds to value a portion of their pension liabilities using a discount rate closer to a risk-free rate of return: that is, "a tax-exempt, high-quality thirty-year municipal bond index rate."[89] In most cases, however, funds could continue to use the higher expected long-term rate of return on plan investments. According to the GASB proposal, the lower rate would only come into play when a plan's current assets and projected future assets are estimated to fall short of projected benefits; in that case, the new GASB standards call for a weighted average of the traditional rate and the municipal bond index rate.[90]

While the aggregate deficit for public plans is suggestive of the scale of the problem, the deficit is not distributed proportionately among jurisdictions or plans. Some government's plans are in much better shape than the aggregates would suggest, while the

87. AM. ACAD. OF ACTUARIES, RE: EXPOSURE DRAFT ON PENSION ACCOUNTING AND FIN. REPORTING BY EMP'RS 4 (Oct. 14 2001), http://www.actuary.org/files/publications/PPC_comments_GASB_PV_111017.pdf; CONG. BUDGET OFFICE, THE UNDERFUNDING OF STATE AND LOCAL PENSIONS 5 (May 2011) ("the fair value approach provides a more complete and transparent measure of the costs of pension obligations"); ERNST & YOUNG, RE: PROPOSED STATEMENT, "ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS—AN AMENDMENT OF GASB STATEMENT No. 27" 5 (Oct. 14, 2011) http://www.gasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175823114549&blobheader=application%2Fpdf ("It is our understanding that these promises have a low risk of default and as such should be discounted at a rate that has a similar low risk.").

88. AM. ACAD. OF ACTUARIES, RE: EXPOSURE DRAFT ON PENSION ACCOUNTING AND FIN. REPORTING BY EMPL'RS 10 (Oct. 14, 2001).

89. GOV'T ACCOUNTING STANDARDS BD., PENSION ACCOUNTING & FINANCIAL REPORTING (PROPOSED STATEMENT OF GASB: PLAIN LANGUAGE SUPPLEMENT) 6 (June 27, 2011), http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176158723597.

90. *Id.* at 6, 7.

fiscal condition of others is appreciably worse; it is the financial status of individual plans that will determine when a public pension crisis becomes an unavoidable item on the national agenda. Using somewhat artificial but instructive assumptions, Joshua Rauh estimates that pension plans in Illinois, Connecticut, Indiana, New Jersey, Hawaii, Louisiana, and Oklahoma will become insolvent by 2020 and that plans in six additional states will reach that stage by 2022.[91] Employing a similar methodology, researchers at the Boston College CRR estimate that pension plans in almost half the states will exhaust their funds within that period.[92] In each case, the projections are based on the plans' expected investment returns.

Both sets of projections assume that the plans will not fund immediate benefit obligations with respect to retirees out of funds contributed on behalf of current employees for their future benefits. This assumption may exaggerate the urgency of the situation from a purely practical perspective: if funds contributed for current workers' benefits are treated as available to pay retirees' pensions, then the Boston College CRR study finds that only six states' plans are at risk of insolvency over the next decade using a discount rate based on expected investment returns.[93] The Boston College CRR study finds another four states' plans at risk with a rate closer to a low-risk fixed income rate.[94] From a public policy perspective, however, the more dramatic projections are still significant. To the extent that government sponsors divert contributions on behalf of current workers to fund retired employees' benefits, the underlying financial vulnerability of a plan is amplified.

B. *Recent Public Pension Reforms*

As might be expected in a period of tightening government budgets, the current trend is to offer new hires pension plans that are less generous in several dimensions. Over the past ten to fifteen years, state pension reforms have been limited until very recently. For example, since 1997, new Michigan state employees have had only a defined contribution plan option.[95] New public school teachers in Michigan, who belong to the State's Public School Employees' Retirement System but work for local jurisdictions, continued to receive defined benefit pensions until 2010 when new

91. Rauh, *supra* note 1, at 596.
92. Munnell et al., *supra* note 1, at 8–11.
93. *Id.*
94. *Id.*
95. Mich. Act 487 (1996) (eff. March 1, 1997).

hires began participating in a hybrid defined benefit, defined contribution ("hybrid") plan.[96] Alaska closed its defined benefit pension plan to new hires as of July 1, 2006. Since then, new employees belong to a defined contribution plan.[97] As of January 1, 2009, new Georgia state employees belong to a hybrid plan rather than a defined benefit plan. In the new plan, the multiplier for the defined benefit program will be one percent, instead of two percent as in the previous defined benefit plans.[98]

Public employee pensions generally require contributions by employees as well as employers. Across the country, the level of contributions required from employees has been gradually increasing. Now most plans require employees to contribute more than five percent of their annual salary to support their plan.[99] Additionally, early retirement options have been delayed somewhat.[100]

Particularly in the past few years, as state and local governments have faced escalating financial pressure across the board,[101] the pace of pension reform at the state level has accelerated.[102] Traditionally, pension reforms have targeted new hires, leaving existing

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96. *See* Mich. Act 75 (2010) (eff. July 1, 2010); *see also* MICHIGAN PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM, COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR FISCAL YEAR ENDED SEPTEMBER 30, 2011 7 (2010).

97. SB FCCS 141(2D FCC), Ch 9 FSSLA 05 (Sept 15, 2005).

98. Emps. Ret. Sys. of Georgia, Old Plan, New Plan GSEPS Plan Guide 15, 17, 18 (2011); *see also* Alicia H. Munnell et al., Ctr. for Research at Bos. Coll., *A Role for Defined Contribution Plans in the Public Sector*, 16 ST. & LOC. PENSION PLANS 1, 4 (Apr. 2011), http://crr.bc.edu/wp-content/uploads/2011/04/slp_16-508.pdf.

99. *Compare* WISCONSIN LEGISLATIVE COUNCIL, 2002 COMPARATIVE STUDY OF MAJOR PUB. EMP. RET. SYS. 16 (Dec. 2003), http://legis.wisconsin.gov/lc/publications/crs/2002_retirement.pdf *with* WLC2010, at 18. Many public employers, however, elect to fund the amounts nominally required to be provided by their employees. CAROL V. CALHOUN, CYNTHIA L. MOORE & KEITH BRAINARD, GOV'TAL PLANS ANSWER BOOK 2–38 (2d ed. 2007). Such payments are not included in an employee's gross income for federal income tax purposes. 26 U.S.C. § 414(h)(2); Rev. Rule 77-462, 1977-2 CB 358.

100. The Wisconsin Legislative Council has been surveying various features of major public employee pension plans biennially for many years, and a comparison of the 2002 survey with the 2010 survey does not reveal substantial trends over that period beyond those noted in the text. *See also* WISCONSIN LEGISLATIVE COUNCIL, 2012 COMPARATIVE STUDY OF MAJOR PUBLIC EMPLOYEE RETIREMENT SYSTEMS 13, http://legis.wisconsin.gov/lc/publications/crs/2012_retirement.pdf. Comparative study ("Between the 2008 and 2010 Reports, 11 plans increased their early retirement provisions. Between the 2010 and 2012 Reports, 19 states increased their early retirement provisions.").

101. TRACY GORDON, STATE AND LOCAL FINANCES: WHERE WE'RE GOING, STATE TAX NOTES 339–46 (Jan. 31, 2011), *available at* http://www.brookings.edu/~/media/research/files/articles/2011/1/31%20state%20local%20finances%20gordon/0131_state_local_finances_gordon.pdf.

102. RONALD K. SNELL, STATE PENSION POLICY OPTIONS IN 2010 (Nat'l Conf. State Legs. Mar. 2010); RONALD K. SNELL, PENSIONS AND RETIREMENT PLAN ENACTMENTS IN 2011 STATE LEGISLATURES 2011 ENACTMENTS 1 [hereinafter SNELL, 2011 ENACTMENTS] ("[I]n all, 41 states enacted significant revisions to at least one state retirement plan in 2010 or 2011."); RONALD K. SNELL, PENSIONS AND RETIREMENT PLAN ENACTMENTS IN 2010 STATE LEGISLATURES (Nat'l

employees under the same regime that was in place when they were hired and creating tiers of employees subject to somewhat different benefit terms depending on date of hire.[103] Typically, later tiers enjoy less generous terms.[104] The most recent wave of revisions has generally preserved this pattern. When reforms impact existing employees, the modifications have been largely confined to controlling future COLAs and augmenting required employee contributions—with the exception of recent legislation in Rhode Island.[105]

In 2011, Rhode Island enacted legislation that substantially altered retirement benefits for public employees not eligible to retire before July 1, 2012.[106] As of July 1, 2012, a hybrid plan covers most

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Conf. State Legs. Nov. 23, 2010)[hereinafter Snell, 2010 Enactments], *available at* http://www.ncsl.org/Portals/1/Documents/employ/PensionReportNov23-2010.pdf; U.S. Governmental Accountability Office, GA0-12-322, State and Local Government Pension Plans: Economic Downturn Spurs Efforts to Address Costs and Sustainability (Mar. 2012).

103. *See, e.g.*, Rajnes, *supra* note 38, at 1, 10.

104. *See id.* Ronald K. Snell, State Pension Policy Options in 2010 (Nat'l Conf. State Legs. Mar. 2010); Snell, 2011 Enactments, *supra* note 102, at 1 ("[I]n all, 41 states enacted significant revisions to at least one state retirement plan in 2010 or 2011."); Ronald K. Snell, Pensions and Retirement Plan Enactments in 2010 State Legislatures (Nat'l Conf. State Legs. Nov. 23, 2010) [hereinafter Snell, 2010 Enactments]; Snell, 2012 Enactments; U.S. Governmental Accountability Office, State and Local Government Pension Plans: Economic Downturn Spurs Efforts to Address Costs and Sustainability (March 2012) (GAO-12-322).

105. Snell, 2011 Enactments, *supra* note 102, at 1–2. Recent legislation in a significant number of states requires larger employee contributions from existing employees; in a few states eligibility requirements have been revised for existing, non-vested employees and in three states legislation calls for reduced cost of living adjustments when existing employees retire, but only Rhode Island appears to have altered the retirement benefits committed to be paid to current employees. *Id.*; Rhode Island Retirement Security Act, S1111A (Nov. 18, 2011) (effective July 1, 2012). *See* Paul M. Secunda, *Constitutional Contracts Clause Challenges in Public Pension Litigation*, 28 Hofstra Lab. & Emp. L.J. 263, 276–77, 279–80 (2011) (describing proposed COLA adjustments impacting public employees in Colorado, Minnesota and South Dakota). *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, 1679–84 (2011); Whitney Cloud, Comment, *State Pension Deficits, the Recession, and a Modern View of the Contract Clause*, 129 Yale L.J. 2199, 2201–02 (2011). Illinois recently enacted legislation purporting to substantially reduce the state's public pensions deficit. Act of December 5, 2013, Ill. Pub. Act 98-599. The legislation, however, contains several legally vulnerable reductions in the benefits of existing and retired workers. Monique Garcia, *Illinois Pension Reform Fight Shifting to the Courtroom*, Chi. Trib., Dec. 4, 2013, http://articles.chicagotribune.com/2013-12-04/news/ct-met-illinois-pensions-met-1205-20131205_1_pension-bill-illinois-supreme-court-retirement-system.
(Conveniently, the legislation insulates the state judiciary from its effects). *See also Illinois: Judge Halts Pension Overhaul*, N.Y. Times, May 14, 2014, at A17 (temporary stay) http://nyti.ms/1sPSYvd. In any event, the financial impact of the pension reforms (according to the sponsors, about a $20 billion reduction in the deficit if sustained in full) is less impressive in terms of the state's actual unfunded liabilities, estimated by Moody's at $173 billion, as opposed to its reported shortfall of $100 billion. *See* Greg Hinz, *Illinois Pension Liability Drops, a Little,* Crain's Chi. Bus., Nov. 4, 2013 http://www.chicagobusiness.com/article/20131104/BLOGS02/131109955/illinois-pension-liability-finally-drops-a-little#.

106. R. I. Ret. Sec. Act, S-1111A (Nov. 18, 2011) (eff. Jul. 1, 2012).

Rhode Island state employees, included most existing employees. Under the new scaled-back defined benefit plan, the formula multiplier is generally capped at one percent for service years after the effective date.[107] Until recently, the multiplier for some senior employees had been as high as three percent.[108] The new legislation extends the final average salary period from three years to five years and increases age and service requirements. COLAs are also less generous under the new regime.[109]

In Utah, new state employees are no longer eligible for a defined benefit plan, as of July 1, 2011. They may choose a hybrid plan option or a defined contribution plan.[110] The multiplier for the defined benefit component is reduced from two percent to 1.5%, and the final average salary will be calculated over the employee's final five years of service, rather than the last three.

Aside from Rhode Island and Utah, however, the most recent wave of pension reforms has not targeted the defined benefit model. Over the 2010–2011 period, fourteen states increased the period over which terminal compensation is determined, normally from three years to five years.[111] Thirteen states increased the vesting period, typically from five or six years to eight to ten years.[112] Twenty-five states raised the age and years in service levels for retirement eligibility.[113] For example, in Missouri, the retirement age for new employees has increased from age sixty-two with five years' state employment to age sixty-seven with ten years' state employment.[114]

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107. *Id.*

108. *Id.* (The balance of the employee and employer contributions will be allocated to a defined contribution plan.) *Contra* WISCONSIN LEGISLATIVE COUNCIL, 2008 COMPARATIVE STUDY OF MAJOR PUBLIC EMPLOYEE RETIREMENT SYSTEMS 29 (three percent multiplier for years. 21–34, two percent for >34).

109. In response to legal challenges, Rhode Island and public employees have tentatively agreed to mitigate some aspects of the 2011 reforms. *See, e.g.*, Jennifer Levitz & John Kamp, *Rhode Island Officials, Unions Agree on Pension Fix*, WALL ST. J., Feb. 14, 2014. *See Outline of Terms for Settlement Agreement at* http://s3.documentcloud.org/documents/1018533/ex-b.pdf.

110. New Public Employees' Tier II Contributory Retirement Act, S.B. 63 (Utah 2010); *see also* Munnell et al., *supra* note 98, at 5.

111. *See* SNELL, 2011 ENACTMENTS, *supra* note 102, at 2; SNELL, 2010 ENACTMENTS, *supra* note 102, at 9–11, 16–-18. (Arizona, California, Illinois, Iowa, Louisiana, New Jersey, Virginia, Michigan).

112. SNELL, 2011 ENACTMENTS, *supra* note 102, at 2.

113. *Id.*; SNELL, 2010 ENACTMENTS, *supra* note 102, at 9–20; NATIONAL CONF. ON PUB. EMPLOYEE RET. SYS. & COBALT COMMUNITY RESEARCH, 2011 PUBLIC FUND STUDY 17 (June 2011).

114. Or, alternatively, retirement eligibility begins at age fifty-five with age and service summing to ninety, versus age forty-eight, with age and service summing eighty. *See* MISSOURI STATE EMPLOYEES' RETIREMENT SYSTEM, MISSOURI STATE EMPLOYEES' PLAN: 2011 GENERAL EMPLOYEES' RETIREMENT HANDBOOK 8 (2011).

Quite a few states have recently revised their plans' methods of providing cost of living adjustments downward.[115] For example, in 2011, legislation in New Jersey eliminated cost of living adjustments for existing and future retirees while leaving open the possibility of reinstatement should the funding status of the state's plan improve.[116] The hybrid plan for new Michigan teachers does not provide for a COLA.[117] COLA reductions in Colorado, Minnesota, and South Dakota—which affect existing and retired employees as well as new hires—have attracted legal challenges.[118] In each of these cases, the level of future COLAs turns in part on the funding level of the respective state's pension plan.[119] According to Boston College CRR's estimates, "A simple model suggests that eliminating a 2-percent compounded COLA reduces [a representative employee's] lifetime benefits by 15–17 percent . . . . Eliminating a 3-percent COLA on the same initial benefit reduces lifetime benefits by 22-25 percent."[120]

II. Difficulties with Current and Proposed Reforms

A. *Vindicating Public Employee Rights Through Litigation*

In the event that a public pension plan fails to satisfy its obligations to retired employees, the injured beneficiaries generally would be able to pursue conventional state law remedies. A judgment against a state or local government, however, is not a negotiable instrument. If a private sector defendant does not voluntarily tender payment, a judgment generally would be enforced

115. *See* Nat'l Educ. Ass'n, Characteristics of Large Public Education Pension Plans 41-50 (2010). *See also* Ronald K. Snell, *Pensions and Retirement Plans Enactments*, *in* 2011 State Legislatures, Nat'l Conference of State Legislatures 2, 7–9 (2011); Ronald K. Snell, *Pensions and Retirement Plans Enactments*, *in* 2010 State Legislatures, Nat'l Conference of State Legislatures 7–9 (2010).

116. *See* New Jersey Division of Pensions and Benefits, Cost-of-Living Adjustments (Feb. 2014), http://http://www.state.nj.us/treasury/pensions/pdf/factsheets/fact18.pdf.

117. *See* Michigan House Fiscal Agency, Legislative Analysis, Public School Retirement Revisions, A Summary of Senate Bill 1227 As Enacted 2 (June 2010), http://www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-1227-7.pdf.

118. *See, e.g.,* Reinke, *supra* note 105; Austin Applegate, Jormen Vallecillo, Katharine Cheng, States' Pensions: A Manageable Loner-Term Challenge 16–17, Barclay's Capital (May 18, 2011), http://www.readbag.com/nasra-resources-barclays1105; Cloud, *supra* note 105, at 2200–02; Mary Williams Walsh, *Two Rulings Find Cuts in Public Pensions Permissible*, N.Y. Times, July 1, 2011, at B1, http://www.nytimes.com/2011/07/01/business/01/pension.html.

119. *See* Snell, *supra* note 115, at 7–9.

120. Alicia H. Munnell, Jean-Pierre Aubry, Mark Cafarelli, Ctr. for Research at Bos. Coll., *COLA Cuts in State/Local Pensions*, 38 St. & Loc. Pension Plans 1, 3 (2014), http://crr.bc.edu/briefs/cola-cuts-in-statelocal-pensions.

against the defendant's property or by a garnishment of wages or other funds.[121] Yet these avenues are largely unavailable against a government.[122] In principle, a successful plaintiff, unable to foreclose on public property, could instead seek to compel a defaulting government—the government's officials—to raise taxes to enforce a judgment. Faced with a pension default, beneficiaries might follow this strategy.

It would not be unprecedented for a court to compel a government to raise taxes.[123] Federal courts have ordered local governments to raise property taxes in order to fund the costs of school desegregation judgments.[124] In the case of bond defaults, however, attempting to compel tax increases has not proved to be a particularly robust remedy in recent history.[125] In any event, the reliability of raising state or local taxes to increase revenue is uncertain in light of the ability of many residents to relocate. It is hardly a foregone conclusion that pension defaults would be cured

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121. *See, e.g.,* Gentile v. Ives, 303 A.2d 720, 721 (Conn. 1972); United States v. Harkin Builders, Inc., 45 F.3d 830, 833 (4th Cir. 1995). Prior to ERISA and the PBGC, these mechanisms were often futile in the case of insolvent pension funds because the sponsors were insolvent and had little in the way of income or assets. In the case of public pension plans, the lack of income or assets will typically not be a problem, particularly when the sponsor is a state government.

122. *See* Robert S. Amdursky & Clayton P. Gillette, Municipal Debt Finance Law § 5.4.3 (1992); *Gentile, supra* note 121, at 721; Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 648–50 (2010).

123. *See, e.g.,* Louisiana v. Pillsbury, 105 U.S. 278, 302 (1882) (remanding to Supreme Court of Louisiana to "direct the District Court to issue a *mandamus* to the city of New Orleans and its authorities, annually to levy and collect the tax of $650,000."); Bylinski v. City of Allen Park, 8 F. Supp. 2d 965 (E.D. Mich. 1998) ("[W]hen a federal court determines that a local municipality's actions violate a federal [statute] . . . the court may order a local government unit with taxing authority to levy taxes adequate to satisfy the municipality's debt obligations incurred in complying with federal law, even if the taxes exceed state constitutional and statutory limitations.").

124. *E.g.,* Missouri v Jenkins, 495 U.S. 33, 52, 56–57 (1990) ("[A] local government with taxing authority may be ordered to levy taxes in excess of the limit set by state statute where there is reason based in the Constitution for not observing the statutory limitation."); D. Bruce La Pierre, *Enforcement of Judgments Against States and Local Governments: Judicial Control over the Power to Tax*, 61 GEO. WASH. L. REV. 299 (1993).

125. CITY OF CLEVELAND, TEXAS, PRELIMINARY OFFICIAL STATEMENT DATED NOVEMBER 13, 2012: COMBINATION TAX AND REVENUE CERTIFICATES OF OBLIGATION, SERIES 2012A 12 ("A registered owner's only practical remedy, if a default occurs, is a mandamus or mandatory injunction proceeding to compel the City to levy, assess and collect an annual ad valorem tax . . . . However, the enforcement of such a remedy may be difficult and time consuming and a registered owner could be required to enforce such a remedy on a periodic basis."); COUNTY OF PRINCE WILLIAM, VIRGINIA, PRELIMINARY OFFICIAL STATEMENT DATED FEBRUARY 8, 2012: GENERAL OBLIGATION PUBLIC IMPROVEMENT BONDS, SERIES 2013 7 ("The mandamus remedy, however, may be impracticable and difficult to enforce."); *see generally* Kimhi, *supra* note 122, at 647.

by court-ordered taxation sufficient to eliminate pension fund deficits.[126] The outcome of litigation to fund pension plans by compelling state or local governments to raise revenue, or reduce spending, would be highly indeterminate. In the event of a pension default, retired public employees would, at best, face lengthy delays before receiving any satisfaction through existing legal remedies.

B. Drawbacks of Government Bankruptcy

Pension liabilities are not the sole source of financial exposure for state and local governments.[127] The Government Accountability Office projects that the state and local government sector will find it increasingly difficult to sustain the trend of its expenditures relative to projected revenues, largely on account of expected growth in Medicaid and employee health care costs and lagging increases in revenue.[128] A Pew Center on the States' study characterized California as on the "brink of insolvency" and classified Illinois, New Jersey, and several other states as "in fiscal peril."[129] This situation raises the possibility that some states, as well as some local governments, may be unable or unwilling to satisfy financial obligations generally, and has led to proposals for federal legislation permitting a state to declare bankruptcy.[130] The current Bankruptcy Code authorizes government bankruptcy only for certain subdivisions of a

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126. *See* Clayton P. Gillette, *What States Can Learn from Municipal Bankruptcy*, *in* When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis 103 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012). While there may be many residents who would find it difficult to move outside a municipality or state, such residents may not be, on average, the most promising source of tax revenue.

127. U.S. Governmental Accountability Office, State and Local Governments' Fiscal Outlook, GAO-12-523SP (Apr. 2012); Nat'l Ass'n of State Budget Officers, The Fiscal Survey of the States (2011); Pew Charitable Trusts, Beyond California: States in Fiscal Peril (Nov. 11, 2009); State Budget Crisis Task Force, Report of the State Budget Crisis Task Force 6 (July 2012) ("States have been grappling with their most serious financial crisis since the Great Depression.").

128. U.S. Governmental Accountability Office, State and Local Governments' Fiscal Outlook, GAO-12-523SP (Apr. 2012); *see also* Nat'l Ass'n of State Budget Officers, The Fiscal Survey of the States (2011).

129. Pew Charitable Trusts, Beyond California: States in Fiscal Peril 1, 2 (Nov. 11, 2009).

130. *E.g.*, David A. Skeel, Jr., *supra* note 14, at 680, 735; Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy*,*"* 59 UCLA L. Rev. 322, 331–35 (2011); Alan Fram, *House GOP Leader Says No Federal Bailout of States*, Associated Press, Jan. 24, 2011 ("Kate Dickens, spokesman for Sen. Mark Kirk, R-Ill., said Kirk believes Congress should give states the power to declare bankruptcy and avoid default and is talking to other lawmakers about potential legislation."). *But see* Sara Murray, *Rep. McHenry: Idea of State Bankruptcy Is Off the Table*, Wall St. J. Blogs (Apr. 13, 2011: 2:33 PM), http://blogs.wsj.com/washwire/2011/04/13/rep-mchenry-

state—generally referred to as municipal bankruptcy under Chapter 9 of the Bankruptcy Code—but not for an entire state.[131] This subsection considers whether bankruptcy, in its current form or expanded to include states, could be a viable solution to the problem of underfunded public pensions.

1. Municipal Bankruptcy

The conventional wisdom has been that public employee pensions are not restructured in bankruptcy, although several recent filings have challenged that position.[132] A municipal bankruptcy is—and a prospective state bankruptcy would be—something of a hybrid of consumer bankruptcy and a business reorganization. Municipal bankruptcy is formally known as the "Adjustment of Debts of a Municipality."[133] The Bankruptcy Code requires explicit state government authorization for a local government to proceed as a debtor in bankruptcy.[134] In about half the states—including Georgia, Indiana, Massachusetts, Oregon, Virginia, and Wisconsin—local governments lack this authorization.[135] In a number of other states, state law provides only limited authorization.[136] A

idea-of-state-bankruptcy-is-off-the-table ("Republicans have dismissed the idea of pushing legislation that would allow states to declare bankruptcy. 'We got pretty strong consensus that that was a bad idea,' Mr. McHenry said.").

131. 11 U.S.C. §§ 101(13), 101(40), 101(41), 109(a) (2012).

132. *See, e.g.,* Liz Farmer, *The "B" Word: Is the Stigma of Municipal Bankruptcy Going Away?*, GOVERNING, Mar. 2013, http://www.governing.com/topics/finance/gov-bword-stigma-municipal-bankruptcy-going-away.html; Mary Williams Walsh, *Creditors of Stockton Fight Over Pension Funding While in Bankruptcy*, N.Y. TIMES, Aug. 23, 2012, at B3, http://www.nytimes.com/2012/08/24/business/creditors-of-stockton-fight-city-over-pensions-while-in-bankruptcy.html ("Creditors of the city of Stockton, Calif., are mounting a challenge against a popular belief: that public workers' pensions are impervious to cutbacks even when a city goes bankrupt.").

133. 11 U.S.C. §§ 901-46 (2012).

134. 11 U.S.C. § 109(c)(2) (2012).

135. *See* W. Clark Watson et al., *Municipal Bankruptcy: A Guide for Public Finance Attorneys*, NAT'L ASS'N OF BOND LAWYERS, Oct. 2011, http://www.nabl.org/uploads/cms/documents/municipal_bankruptcy_a_guide_for_public_finance_attorneys.pdf; Alston & Bird, LLP, Municipal Assets in Distress (MAD) Task Force, Options for Dealing with Municipal Assets in Distress Aug. 2011, http://www.alston.com/files/docs/MAD-TaskForce.pdf [hereinafter Alston & Bird]; Caitlin Devitt, *Indiana Says No to Chapter 9*, BOND BUYER, May 3, 2011, http://www.bondbuyer.com/issues/120_84/indiana_chapter_nine-1026181-1.html.

136. *See* Watson et al., *supra* note 135; Alston & Bird, *supra* note 135; *see, e.g.,* R.I. Gen Laws § 45-9-7 (vesting authority in state-appointed receiver); Moreau v. Flanders, 15 A.3d 565 (R.I. 2011); Michigan Compiled Laws § 141.1222 (2007) (conditional on appointment and consent of emergency financial manager); *In re* Slocum Co. Drainage District, 336 BR 387 (Bankr. N.D. Ill. 2006) (authorization conditional on recommendation of Illinois financial planning and supervision commission or financial advisor). *See also* Chapman & Cutler, LLP, Chapter 9: The Last Resort for Financially Distressed Municipalities, in Primer on Municipal Debt Adjustment, at App. D (2012), http://www.afgi.org/resources/Bankruptcy_Primer.pdf.

municipality must be insolvent to be eligible for bankruptcy;[137] the definition of insolvency for municipal bankruptcy purposes is that the government is "(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts once they become due."[138]

A garden variety municipal bankruptcy involves a toll road authority, a water district, or a similar special-purpose district that may have borrowed substantial sums for a capital project, intending to service the debt through user fees or assessments that failed to raise as much money as expected.[139] In these cases, the principal creditors are usually bondholders who agree to a haircut,[140] presumably in consideration for placing the debtor in a position to focus on generating a reliable revenue stream to at least partially satisfy its creditors. This is similar to a reorganization pursuant to Chapter 11 of the Bankruptcy Code, since the local government's assets cannot be liquidated. Keeping a business operating is often a goal of a reorganization, although that is not guaranteed. (Unlike in Chapter 9, a business reorganization can be converted to a liquidation.) Therefore, the debtor in Chapter 9 or Chapter 11 typically seeks to reduce its debts to a manageable level going forward, eliminating most or all other claims through the power of the bankruptcy court to discharge debts.[141] The debtor proposes a plan specifying the extent to which it will honor, impair, or modify particular obligations.

Under Chapter 9 or Chapter 11, a successful plan does not have to obtain unanimous consent from creditors.[142] In the typical case, however, obtaining the approval of a bankruptcy court will require support from most creditors. Most creditors might support a plan, even though it reduces the nominal value of their claims, if they would not expect to do better otherwise. A plan of reorganization under Chapter 11, or a plan of adjustment under Chapter 9, will specify classes of creditor claims, and generally each class must then vote to approve the plan.[143] Although a successful plan does not

137. 11 U.S.C. § 109(c) (2012).

138. 11 U.S.C. § 101(32)(C) (2012).

139. *E.g., In re* Connector 2000 Ass'n, Inc., 447 BR 752 (Bankr. D. S.C. 2011); *In re* City of Colorado Springs Spring Creek Gen. Imp. Dist., 187 B.R. 683 (Bankr. D. Colo. 1995); In re Lake Grady Rd. & Bridge Dist., 119 B.R. 844 (Bankr. M.D. Fla. 1990) (special tax district).

140. *E.g., In re* Connector 2000 Ass'n, Inc., First Amended Plan for Adjustment of Debts (Bankr. D. S.C. 2011), *available at* http://www.southernconnector.com/Zbankruptcy.htm. *See* Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 359, 359 n.44 (2010).

141. *See* 11 U.S.C. §§ 1141(c)-(d), 944(b)(2) (2012).

142. 11 U.S.C. §§ 901(a), 1129(a)(3)-(4), 901(7)-(10) (2012).

143. *See* 11 U.S.C. § 1129(a)(8) (2012). The approval of a class whose claims are not discounted by the plan is not required. 11 U.S.C. § 1129(a)(8)(B).

require the approval of each class, the requirements for obtaining a bankruptcy court's approval of a plan favor obtaining assent from its major creditors.[144] So unless pension plan beneficiaries are on board, a local government will have difficulty adjusting its pension obligations through bankruptcy.

Severe levels of municipal financial distress have increased the pressure to obtain concessions from government pension plans through bankruptcy. To date, however, municipal bankruptcy has not yet proved a reliable means of obtaining relief from employee pension obligations. There seems to be only one instance of a municipality reducing pension obligation through bankruptcy. Recently, a bankruptcy court approved a plan that contained significant reductions to the benefits of retired employees of Central Falls, Rhode Island.[145] In that case, retirees apparently acquiesced to the plan in light of state legislation that might have reduced their priority in bankruptcy and Rhode Island's agreement to supplement the funds available to pay their benefits.[146] In other states, municipal pension beneficiaries would have less incentive to accept reductions in their benefits in bankruptcy.[147] For example, the California Public Employees Retirement System (CalPERS) maintains that under California law, obligations to retirees have priority over most other debts in municipal bankruptcy.[148] Whether or not the CalPERS' position is vindicated, it makes it unlikely consent will be

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144. *See, e.g.,* Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large Publicly Held Companies*, 139 U. PENN. L. REV. 125, 130 (1990); DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 231 (5th ed. 2010); Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 29 BUS. L. 441, 441, 453–54 (1984). The possibility of a plan without general creditor approval can serve as a significant motivation to gaining creditors' acceptance. Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 88 AM. BANKR. L.J. 663 (2009); Schwarcz, *supra* note 130, at 335 n.74 ("There does not appear to be any precedent in which municipalities resorted to cramdown under Chapter 9, nor are commentators in agreement on how such a cramdown would be applied.").

145. *See* Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES, Sept. 7, 2012, at A21, http://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html; Farmer, *supra* note 132; Nancy Kaffer & Stephen Henderson, *Police, Fire Pension Costs Could Crush Detroit, Study Shows*, DETROIT FREE PRESS, Feb. 26, 2013, at 1, http://www.freep.com/article/20130226/OPINION02/302260136/How-pension-costs-could-crush-Detroit.

146. *See Bankruptcy in Rhode Island: Improvident: Desperate Measures for Desperate Times*, ECONOMIST, May 5, 2012, http://www.economist.com/node/21554232.

147. *See, e.g.,* Kaffer & Henderson, *supra* note 145, at 1 (contrasting status of pension obligations in bankruptcy in Michigan and Rhode Island).

148. *See, e.g.*, Mary Williams Walsh, *Cuts for the Already Retired*, N.Y. TIMES, Dec. 19, 2011, at B1, http://www.nytimes.com/2011/12/20/business/pension-deal-in-rhode-isl+E95and-could-set-a-trend.html?pagewanted=all; Steven Church & James Nash, *Calpers Bankruptcy Strategy Pits Retirees vs. All Others*, BLOOMBERG, Dec. 12, 2012, http://www.bloomberg.com/news/2012-12-12/calpers-bankruptcy-strategy-pits-retirees-vs-all-others.html.

given anytime soon to a plan that reduces a California municipality's pension obligations.

When Stockton, California sought bankruptcy protection, the city did not propose to restructure its pension obligations. The city's other creditors, however, have objected to the city's position, and the outcome remains unsettled.[149] In contrast, the emergency manager of Detroit, Michigan has indicated that the city will seek to reduce its pension obligations through bankruptcy.[150] Here too, the outcome remains in doubt. Soon after Detroit filed its bankruptcy petition, several retired city workers and two of the city's retirement systems challenged the legality of the filing in state court under the Michigan Constitution.[151] That particular challenge, which has been transferred to the federal bankruptcy court,[152] is only the first of several lines of resistance by the retirement systems and their beneficiaries that Detroit must overcome. The city's success in addressing pension deficits through bankruptcy is neither inevitable nor predictable at this point.[153]

If either Detroit or Stockton eventually manages to lighten its pension burden via municipal bankruptcy, other municipalities—but only those in states that permit municipal bankruptcy—are likely to attempt to do the same. There is no guarantee of that the imitators will be successful. As discussed in Part II.B.2, below, outcomes in bankruptcy are inherently difficult to forecast. Further, a municipality's success would be at the expense of public employees, including retired workers on modest fixed incomes. Even if some bankruptcy courts can be persuaded that giving retirees a haircut is an appropriate result, such a solution may not become accepted as

149. *In re* City of Stockton, Cal., Opinion Regarding Chapter Nine Order of Relief (Bankr. E.D. Cal. 2013), at 14, 22, *available at* http://www.stocktongov.com/files/6_12_2013_Chapter9_OpinionJudgeChristopherKleinOpionChapter9Relief.pdf; *see also* Dale Kasler, *Stockton Bankruptcy Trial Yields No Hint on Cutting CalPERS Payments*, Sacramento Bee, June 4, 2014, http://www.sacbee.com/2014/06/04/6458016/lawyer-defends-stocktons-decision.html ("Arguments in the Stockton bankruptcy trial wrapped up Wednesday without an inkling from a judge on whether the city's flow of pension money to CalPERS can be curtailed to satisfy the demands of another creditor."; *cf.* Chris Megerian et al., *Stockton Bankruptcy Ruling Could Deal Blow to CalPERS, Public Pensions*, L.A. Times, Oct. 2, 2014, http://www.latimes.com/business/la-fi-stockton-bankruptcy-ruling-20141001-story.html.

150. *See* City of Detroit, Proposal for Creditors 56 (June 14, 2013), *available at* http://www.freep.com/assets/freep/pdf/C4206913614.pdf.

151. *E.g.*, Webster v. Michigan, No. 13-734-CZ (Cir. Ct., Ingham Co., July 19, 2013), *available at* http://www.freep.com/assets/freep/pdf/C4208749719.pdf.

152. *See* Bill Vlasic, *Federal Judge Halts Legal Challenges in Detroit Bankruptcy Case,* N.Y. Times (July 25, 2013), at A14, http://www.nytimes.com/2013/07/25/us/judge-clears-path-for-detroit-bankruptcy-case.html.

153. *Cf.* Mary Williams Walsh, *Detroit Rolls Out New Model: A Hybrid Pension Plan*, N.Y. Times, June 19, 2014, at A1, http://dealbook.nytimes.com/2014/06/18/detroit-rolls-out-new-model-a-hybrid-pension-plan/?smid=pl-share.

an attractive public policy as the consequences to beneficiaries become evident.

2. State Bankruptcy

In view of the considerable number of states facing financial stress, David Skeel proposes that eligibility for bankruptcy be extended to state governments. Skeel claims that through bankruptcy a "governor and his state could immediately chop the fat out of its contracts with unionized public employees."[154] In addition, the bankruptcy process would allow a state to "reduce its bond debt, which is nearly impossible to restructure outside of bankruptcy."[155] Skeel also asserts that state bankruptcy "could even permit a restructuring of the Cadillac pension benefits that states have promised to public employees."[156]

Skeel maintains that "[t]he ability to restructure [public employee] contracts is an essential component of an effective state bankruptcy framework." According to Skeel,

> In the current crisis . . . unsustainably generous public employee contracts have been a major component of most troubled states' woes. Lawmakers have considerable incentives to award generous contracts to state employees, both because state employees are an important voting block and because lawmakers themselves may be direct or indirect beneficiaries of the contracts.[157]

Skeel contends that state bankruptcy is preferable to direct federal financial support of struggling states. He recognizes that the federal government is the most likely source of funds for states declaring bankruptcy, but maintains that "the prospect of a bankruptcy restructuring would significantly reduce amount of funding needed as compared to a pure bailout."[158]

Under Skeel's scheme, a state's bankruptcy filing would initiate negotiations between the government and its creditors—bondholders, vendors, retired public employees entitled to benefits, etc.—to

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154. David Skeel, *A Bankruptcy Law—Not Bailouts—for the States*, WALL ST. J., Jan. 18, 2011, at A17.

155. *Id.*

156. *Id.*

157. David A. Skeel, Jr., *State Bankruptcy from the Ground Up, in* WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 198 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012).

158. *Id.* at 211.

establish an agreement on restructuring the state's obligations. He expects that an agreement, in addition to imposing losses on bondholders, would include significant wage and benefits reductions,[159] apparently a rare occurrence in a municipal bankruptcy.

Although some immediate manifestations of a public pension crisis have appeared on the local level, municipal bankruptcy could play at most a supporting role in addressing the problem of underfunded public plans. Many local governments are not authorized under state law to file under Chapter 9, and the greater share of unfunded public pension liabilities belongs to state plans. If the concept of state bankruptcy can overcome some formidable political resistance,[160] it could conceivably play a major role in confronting the problem across the country. As a solution to potential public pension plan defaults over the next decade, however, state bankruptcy would have several potential drawbacks:

- It may not be possible to determine a satisfactory plan.
- Outcomes would be unpredictable and could be inconsistent across jurisdictions.
- Bankruptcy courts lack the expertise to assess the sustainability of restructured pension plans.
- Public employees could be left with inadequate resources for retirement.

Most of the benefits that Skeel identifies from allowing states to restructure their debts in bankruptcy would come from altering states' behavior outside of bankruptcy: giving financially troubled states more leverage in negotiations with public employee unions and bondholders; and making it more difficult for states to defer funding employee pensions, to borrow irresponsibly, or to commit to unsustainable employee benefits. While these may be worthwhile objectives, the asserted benefits will do little to address the problem of already severely underfunded public pension plans. Given the precarious financial condition of a number of public pension plans, state bankruptcy cannot be counted on to simply discourage public pension plan defaults; it must be able to administer them reliably if a bankruptcy occurs.

159. *Id.* at 209.

160. *See e.g.,* Nat'l Governors Ass'n, NGA Statement Regarding Bankruptcy Proposals for States (Jan. 25, 2011), http://www.nga.org/cms/home/news-room/news-releases/page_2011/col2-content/main-content-list/nga-statement-regarding-bankrupt.html ("The mere existence of a law allowing states to declare bankruptcy only serves to increase interest rates, raise the costs of state government and create more volatility in financial markets.").

In an actual state bankruptcy, liquidation of the state would be off the table. In a business bankruptcy, creditors are motivated to devise a plan that dominates their returns from liquidating the debtor. Without a liquidation option, the prospects for creditor consensus on a plan to adjust the government's debts are uncertain.

Furthermore, it is important to recognize that, by the nature of bankruptcy, it is impossible to say with any confidence what implications state bankruptcy might have for a public pension plan crisis. Bankruptcy law is indeterminate and unpredictable in practice.[161] Therefore, significant inconsistencies in the treatment of pension plan beneficiaries are probably inevitable in different bankruptcy proceedings. If such inconsistencies do arise, they may not be recognized as having any appealing substantive policy rationales. They may also be politically awkward, creating pressure for a federal financial remedy outside of bankruptcy.

It is possible that, had state bankruptcy been an option over the past fifty years, public pensions would not be at risk today. Yet it is difficult to see how state bankruptcy would prevent the prospect of punishing losses to existing and retired public employees with respect to their retirement benefits. Given the inherent actuarial complexities of public pension plans, it also seems questionable that a bankruptcy court would be the appropriate forum for ensuring that a pension plan would remain on sound financial footing in the decades after its sponsor government emerged from bankruptcy.

Conceivably, over the long haul, the incentives from allowing state bankruptcy would encourage state governments to operate more efficiently. In the short run, however, state bankruptcy would not reduce the costs associated with public pension plan deficits. As opposed to a federal bailout, state bankruptcy would presumably lead to a different allocation of losses, but owing to the unpredictability of the bankruptcy process, it very unclear what that allocation would be.

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161. *See, e.g.*, Special Report of the Tribar Opinion Committee, *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 BUS. L. 717, App. 8-26 (1991) ("[O]pinions to nonclient third parties on bankruptcy law matters unavoidably have inherent limitations . . . . [that] exist primarily because of: the pervasive equity powers of bankruptcy courts; the overriding goal of reorganization to which other legal rights and policies may be subordinated; the potential relevance to the exercise of judicial discretion of future arising facts and circumstances; and the nature of the bankruptcy process.").

C. Subsidizing Borrowing

Joshua Rauh and Robert Novy-Marx suggest that the federal government address the problem of severely underfunded public pension plans by offering to subsidize state and local government debt that is dedicated to funding public pensions. In return for the subsidy, the government sponsor would have to stop offering defined benefit pension plans to new public employees.[162] Rauh and Novy-Marx, however, do not propose that the federal government guarantee such debt, nor do they consider whether jurisdictions with the most severely underfunded plans have the capacity to obtain and service enough debt to keep their pension plans afloat without federal guarantees. There is no reason to think that Rauh and Novy-Marx's proposal would require smaller contributions from the federal government if it were to provide the same level of security to beneficiaries of public plans.

In addition, Rauh and Novy-Marx's proposal would not adequately address the underfunded status of existing public pensions. Besides requiring the phaseout of defined benefit plans, they would mandate that states move toward full funding of their existing public plans: "The state must annually make exactly its actuarially required contribution (ARC) left over from the existing underfunded plans."[163] The ARC (Actuarially Required Contribution or Annual Required Contribution of a public pension plan) is a GASB concept consisting of two components: normal cost and an amortization contribution.[164] *Normal cost* represents the expense of benefits attributable to the service of employees during the current year, determined under the funding method used by the plan.[165] The *amortization contribution* is a partial payment against any unfunded liabilities attributable to employee services in past years, where the extent to which the plan is considered underfunded is determined according to the funding method chosen by the plan and the amortization of unfunded liabilities could generally extend over not more than thirty years.

162. "The state must close its defined benefit plans to new employees under a 'soft freeze' and agree not to start any new defined benefit plans for at least 30 years." Joshua Rauh & Robert Novy-Marx, *Pension Security Bonds: A New Plan to Address the State Pension Crisis*, (2010), *available at* http://kelloggfinance.files.wordpress.com/2010/05/plan-20100517-final-5pm1.pdf.

163. *Id.*

164. Governmental Accounting Standards Board, Statement 27: Accounting for Pensions by State and Local Government Employers (1994).

165. Charles L. Trowbridge, *Fundamentals of Pension Funding*, 4 Transactions of the Soc'y of Actuaries 17, 21 (1952), http://www.soa.org/library/research/transactions-of-society-of-actuaries/1949-59/1952/january/tsa52v4n83.aspx.

A public pension plan's choice of a funding method has been constrained by GASB standards.[166] As noted in Part II.B.1, however, GASB voluntary funding standards are significantly less demanding than the ERISA standards for private plans. So, in effect, Rauh and Novy-Marx's proposal would rely on GASB's less rigorous standards for determining whether a plan complies with their proposed funding mandate. In any event, effective June 15, 2014, GASB standards no longer include the ARC, which Rauh and Novy-Marx propose the federal government rely on to assess the adequacy of public plan's annual contributions.[167] GASB has actually retreated from its role in requiring plans to report the adequacy of their annual funding,[168] highlighting the need for significantly greater federal involvement than Rauh and Novy-Marx contemplate. In sum, Rauh and Novy-Marx do not consider whether their proposal is likely to be sufficient to address the underfunding of public pension funds or to cost less than any other approach, and their proposal would assess public plans' progress in moving toward full funding based on an unsatisfactory and now obsolete GASB standard.

Moreover, there are both political and constitutional difficulties with Rauh and Novy-Marx's proposed requirement that public plans cease offering defined benefit plans to new employees. A political drawback is that the federal government continues to allow private sector plans to offer defined benefits pensions and to guarantee the benefits of their beneficiaries. Rauh and Novy-Marx do not explain why defined benefit plans are acceptable in the private sector but not in the public sector.[169] Additionally, as discussed in Part III.C, the Supreme Court has been suspicious of federal regulation of States' affairs that is more restrictive than federal regulation of private sector affairs.

166. *Pension Funding: A Guide for Elected Officials*, National Governors Association et al. 3 (2013), http://www.nasra.org/files/JointPublications/PensionFundingGuide.pdf.

167. Rauh & Novy-Marx, *Pension Security Bonds*, *supra* note 162, at 2.

168. Munnell et al., *supra* note 74, at 6, http://crr.bc.edu/wp-content/uploads/2013/07/slp_32.pdf; GOVERNMENTAL ACCOUNTING STANDARDS BOARD, PENSION ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS: AN AMENDMENT OF GASB STATEMENT NO. 27 98 (2012) ("[GASB] does not believe that it would be appropriate to require disclosures about a standardized measure of the amount an employer would need to contribute to a pension plan each year . . . in order to reach projected objectives.").

169. ERISA has been cited as a factor in the decline in defined benefit pensions in the private sector. *See, e.g.*, Zelinsky, *supra* note 23, at 469–82, 504–06. Imposing funding rules and insurance premiums on defined benefit public plans may move the public sector in the same direction.

III. Federal Stabilization of Public Sector Pension Plans

A. *Reform: A Voluntary Federal Program Modeled On ERISA*

1. General Principles

It is not certain that the federal government will step in to aid the retired teachers, police officers, and firefighters who are beneficiaries of failing public pension plans. Nevertheless, it is sensible to prepare for that possibility. Timely action would allow the federal government to control the crisis and limit its ultimate financial exposure. As an intermediate step, the federal government should establish a mechanism to identify public pension plans at risk of insolvency and regularly monitor the state of their finances using ERISA's more rigorous actuarial standards.

No magic bullet exists that will eliminate the existing deficits of distressed public pension plans. A properly structured federal program, however, could both motivate and empower public pension plan sponsors to prevent further erosion in the financial condition of their plans. Failure to act promptly risks a much larger crisis down the road, and a larger, more widespread crisis will only intensify the pressure for federal action, at a greater cost. Assuming that the federal government will recognize that intervention is at least the lesser of evils, this Section describes a federal program that conditions federal financial support on acceptance of federal supervision.

A federal bailout of public pension plans might discourage state and local governments from adequately funding their plans, induce them to offer more generous benefits, and generally move the condition of public pension plan finances from bad to worse. So an essential prerequisite for federal financial support of a distressed public pension plan is the acceptance of federal oversight. Further, federal oversight must discourage actions that might lead to deterioration in a plan's financial condition. Accordingly, in order for any public pension plan in a state to receive federal support, the state should be required to affirmatively accept federal supervision of all of the state's government retirement plans, at both the state and local levels. States could opt out of federal regulation, but then no public pension plan in the state would be eligible for federal financial support. The federal oversight of public pension plans should be at least as rigorous as federal regulation of private sector retirement plans under ERISA. In particular:

- Plans must fully fund benefits accruing from the start of the federal program and move toward full funding for their legacy liabilities.[170]
- Plans must use actuarial standards comparable to the ones mandated for private plans, employing risk-free or low-risk discount rates in determining plan liabilities.[171]
- Plans would be charged insurance premiums[172] based on the riskiness of a plan's investment portfolio.
- Plans would be required to provide regular reports on their financial status.[173]

As discussed more fully in Part III.B, mandatory full funding is the key component of federal financial support for public pensions. In itself, however, a funding requirement will not protect the federal treasury unless the determination of a plan's financial status is regulated and takes into account the riskiness of plan assets.

The determination of the financial condition of a defined benefit pension plan depends on complex actuarial analysis. The results can vary substantially according to the method of projecting plan investment returns and the discount rate applied to plan liabilities. In order to prevent pension plan sponsors from choosing actuarial methods and parameters opportunistically to disguise financial difficulties, ERISA specifies the actuarial methods, mortality tables, and discount rates used to determine a private pension plan's financial condition.[174] In contrast, GASB accounting guidelines for public plans provide much more flexibility in the selection of actuarial assumptions.[175]

In the calculation of a private sector plan's liabilities, the Treasury chooses the discount rate according to current interest rates on investment grade corporate bonds.[176] Guidelines applicable to public pension plans sanction the use of "the long-term expected rate of return on pension plan investments."[177] As noted in Part

170. *Cf.* 26 U.S.C. § 430 (2006); 29 U.S.C. § 1083 (2012).

171. *Cf.* 26 U.S.C. § 430 (2006); 29 U.S.C. § 1083(h) (2012).

172. *Cf.* 29 U.S.C. §§ 1306-07 (2012); 29 U.S.C. § 1083(h) (2012).

173. *Cf.* 29 U.S.C. §§ 1021-25 (2012). *See* U.S. DEP'T OF LABOR, FORM 5500 ANNUAL RETURN/REPORT OF EMPLOYEE BENEFIT PLAN, http://www.dol.gov/ebsa/5500main.html.

174. U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2007 REVENUE PROPOSALS 76–80 (2006) http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2007.pdf; 26 U.S.C. § 430 (2006).

175. U.S. GOVERNMENTAL ACCOUNTABILITY OFFICE, *supra* note 48; MOODY'S INVESTOR SERVICE, *supra* note 75.

176. 26 U.S.C. § 430(h)(2) (2006).

177. *See* Brown & Wilcox, *supra* note 83, at 539; Governmental Accounting Standards Board, *supra* note 164.

I.B.3, this typically results in public plans using a rate in the neighborhood of eight percent.[178] The discount rate mandated for private plans depends on the duration of the plan's obligations and the prevailing yield curve, recently ranging from two percent, short term, to 6.5%, long term (that is, beyond twenty years).[179] A private pension plan with benefit commitments of $100 million concentrated twenty years out would have liabilities of about $35 million under ERISA standards while a public plan with similar obligations would likely report liabilities of only around $21 million. While recent revisions to GASB standards may represent a slight improvement in reporting standards for public plans, federal regulation of public plans should require them to apply actuarial assumptions at least as strict as those stipulated for private plans.

Significantly, underfunded public pension plans cannot be expected to move toward full funding over the next few years. If they could be fully funded in short order, then either they would have no need for federal support or they would have little incentive to accept federal regulation in exchange for federal aid. Initially, ERISA allowed sponsors of private sector defined benefit plans up to forty years to eliminate their deficits.[180] Under current law, underfunded private plans are generally allowed only seven years to do so.[181] Therefore, while government sponsors should be required to fully fund obligations arising from the period following the establishment of the federal program, they should be allowed to eliminate their unfunded liabilities over a span of several years.

178. CONG. BUDGET OFFICE, *supra* note 29, at 3–4.

179. INTERNAL REVENUE SERV., PART III—ADMINISTRATIVE, MISCELLANEOUS, AND PROCEDURAL: UPDATE FOR THE WEIGHTED AVERAGE INTEREST RATES, YIELD CURVES, AND SEGMENT RATES, Notice 2011-49, http://www.irs.gov/pub/irs-drop/n-11-49.pdf, The Moving Ahead for Progress in the 21st Century Act (MAP-21), Pub. L. No. 112-141, enacted July 6, 2012, 126 Stat. 405, § 40211, temporarily raised discount rates used to determine plan funding status, based on a twenty-five-year moving average of corporate bond rates, rather than current bond rates. *See* INTERNAL REVENUE SERV., PART III—ADMINISTRATIVE, MISCELLANEOUS, AND PROCEDURAL: UPDATE FOR THE WEIGHTED AVERAGE INTEREST RATES, YIELD CURVES, AND SEGMENT RATES, Notice 2013-46, http://www.irs.gov/pub/irs-drop/n-13-46.pdf/n-13-46.pdf. The effect of MAP-21 was to temporarily permit private plans to reduce their contributions to their pension plans, and, because contributions are deductible, the likelihood of reduced contributions and higher reported income permitted the legislation to be scored as raising federal revenue. The underlying policy of MAP-21 has been strongly criticized by the Pension Task Force of the American Academy of Actuaries and the Society of Actuaries as "materially distort[ing] pension plan measurement" and undermining the financial soundness of the PBGC. Gordon J. Latter, Chairperson of the Pension Finance Task Force, Re: Pension Funding Provisions of Recent Legislative Proposals (Apr. 17, 2014), http://www.actuary.org/files/PFTF_Ltr_MAP-21-Extension_April-17-2014.pdf. The procedure for determining private plan discount rates prior to MAP-21 is the appropriate model for public pension regulation.

180. Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 302, 88 Stat. 869–70 (current version at 29 U.S.C. § 1082(a) (2012)).

181. 29 U.S.C. § 1083(c) (2012).

Some severely underfunded public pensions may never be able to catch up, of course, and a portion of these will become insolvent, just as in the private sector.[182]

The reference date for full funding must be no later than the date on which this Article's proposed federal stabilization program is established, rather than, for example, the date a public pension plan applies for federal assistance. Otherwise, a government sponsor would lack an incentive to begin addressing a plan's underfunding until it was forced to seek financial assistance. In fact, the reference date for full funding might be set somewhat before the date that legislation is enacted: perhaps the date on which enabling legislation is introduced.

2. A Government Pension Benefit Guaranty Agency

If the federal government does step in to address the problem of distressed public pension plans, an operation resembling the PBGC will be necessary when an underfunded public pension plan does run out of money. The proposed entity might be called the Government Pension Benefit Guaranty Agency (GPBGA). While the PBGC so far has been able to operate without drawing on the general funds of the federal government by charging insurance premiums to private plans, the GPBGA would likely require substantial infusions of federal money immediately. In light of the financial difficulties PBGC has experienced, it seems advisable to establish a new entity to support and supervise public plans. If the federal government guarantees public pension plan obligations, it is essential that the insurance premiums take into account the riskiness of a plan's investment portfolio, something that the existing private sector pension guarantee program fails to do.[183]

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182. *See, e.g.,* Pension Benefit Guar. Corp., *PBGC to Assume Responsibility for Pension Benefits at Butzel Long*, July 3, 2013. According to the U.S. Department of Labor, during fiscal year 2014, the PBCG will administer over 4500 plans that it has taken over from sponsors, paying almost 900,000 retires about $6 billion in benefits in aggregate. U.S. DEP'T OF LABOR, FISCAL YEAR 2014 CONGRESSIONAL BUDGET JUSTIFICATION: PENSION BENEFIT GUARANTEE CORPORATION 13 (2013), http://www.dol.gov/dol/budget/2014/PDF/CBJ-2014-V2-02.pdf.

183. *See* Jeffrey R. Brown, *Guaranteed Trouble: The Economic Effects of the Pension Benefit Guaranty Corporation*, 22 J. ECON. PERSPECTIVES 177, 179, 179 n.3 (2008) http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.22.1.177; OFFICE OF MANAGEMENT AND BUDGET, FISCAL YEAR 2013 BUDGET OF THE U.S. GOVERNMENT 31 (Feb. 2012) http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/budget.pdf.

Under ERISA, the PBGC is authorized to terminate a private pension plan at the request of the plan administrator if, for example, the sponsor is bankrupt or insolvent.[184] The PBGC may initiate a plan termination if the plan cannot pay current benefits, if the agency determines that failure to terminate the plan threatens to "unreasonably" expose the PBGC trust fund to greater losses, or if the plan has not met the minimum ERISA funding standards.[185] When a plan is terminated, the PBGC obtains the plan's assets,[186] assumes responsibility for paying benefits to the terminated plan's beneficiaries,[187] and attempts to recover the plan's shortfall from the employer that sponsored the plan.[188]

Like the PBGC, the GPBGA should be given the authority to terminate distressed public pension plans under its jurisdiction. In most cases, neither bankruptcy nor insolvency of the employer would provoke termination, although for a few local jurisdictions municipal bankruptcy is conceivable.[189] Termination would be an option when a public plan has, or is close to having, insufficient funds to pay current benefits. Upon termination, the GPBGA would assume responsibility for paying the plan's beneficiaries and could obtain a claim on the government sponsor for the plan's unfunded liabilities. At the outset, at least, the federal government seems unlikely to foreclose the possibility of having state and local governments repay these funds. It is reasonable to suppose that the duration of any such debts would be measured in decades, whether or not a framework similar to that proposed in this Article is adopted.

The impetus for ERISA, which imposes extensive regulation on private pension plans and guarantees their benefits, came from a record of significant private pension plan defaults.[190] That sort of

184. 29 U.S.C. § 1342 (2012).

185. 29 U.S.C. § 1342(a) (2012).

186. 29 U.S.C. § 1342(d) (2012).

187. 29 U.S.C. § 1322 (2012).

188. *See, e.g.,* Pension Benefits Guar. Corp. v. Beverley, 404 F.3d 243 (4th Cir. 2005).

189. Under current law, bankruptcy is unlikely to play a significant role in resolving the problems of underfunded public pensions. States are not eligible for bankruptcy; recent proposals to change this, e.g., David A. Skeel, Jr., *supra* note 14, at 680, 735, seem to have lost momentum. *See* Sara Murray, *supra* note 130. In about half the states, including, for example, Georgia, Indiana, Massachusetts, Oregon, Virginia and Wisconsin, local governments are not authorized to file for municipal bankruptcy. In a number of other states, state law provides only limited authorization. *See* W. Clark Watson et al., *supra* note 135. The conventional wisdom has been that public employee pensions are not restructured in bankruptcy, although that position has been challenged recently. *See, e.g.,* Mary Williams Walsh, *supra* note 132. *See also* § II.B.

190. *See* James A. Wooten, The Employee Retirement Income Security Act of 1974: A Political History 79 (2004).

precedent is absent in the case of public pensions. The evidence described in Part I.B.3, however, suggests that it is time to prepare for a greater federal role with respect to state and local government employee pension plans. Presumably, the underfunding of numerous state and local pension plans will become an unavoidable item on the public policy agenda around the time that at least one sizeable plan no longer has sufficient assets to pay even the current benefits to retired beneficiaries and their survivors. The first time that occurs—if it does happen—it is possible that, through a combination of tax increases and expenditure cuts, the sponsoring jurisdiction will be able to raise sufficient funds to forestall a default. Yet the affected jurisdiction may face the same challenge each year, indefinitely, and conceivably it will not be politically feasible to meet that challenge indefinitely. Since many jurisdictions may be on the brink of similar adversity, it seems foreseeable that, at some point, sizeable defaults will occur absent federal intervention. While this hypothetical scenario suggests a possible role for the federal government in guaranteeing state and local employee pensions, it does not suggest that the most favorable form of intervention is to wait until such a crisis is at hand.

3. Treatment of Current Public Employees

A striking difference between private and public pension plans is that only in the case of many public plans are the terms of an employee's pension largely locked in from the date of hire. This makes it more difficult to align a public pension plan's benefit commitments with fiscal realities. In many states, public plans facing imminent financial distress are only able to adjust the benefits of new hires, although these employees will not make demands on the plan's cash flow for decades to come. In some cases, state courts have noted that rules barring impairments of the terms of existing employees' pensions might be qualified in the case of fiscal emergencies,[191] but this may require a state to wait until it is on the brink of a crisis before it can consider essential reforms to its public employee retirement plans.

Under its Spending Clause authority, Congress could permit public plans in participating states to revise the benefits of existing employees to the same extent that private plans may do so under ERISA. Such a revision would have no direct effect on the benefits

191. *See, e.g.*, Hammond v. Hoffbeck, 627 P.2d 1052, 1058 n.11 (Alaska 1981); Opinion of the Justices to the House of Representatives, 303 N.E.2d 320, 329 (Mass. 1973).

of already retired public employees or on the accrued benefits of existing workers. But it would allow, for example, a state or local government to substitute defined contribution plans for defined benefit plans for all its employees with respect to future services. This option would permit the federal government to reduce its level of oversight over the state or local government's retirement programs. Private employers have always had the option to make these kinds of changes to employee pensions, and there do not appear to be compelling economic or public policy arguments against allowing public employers to do so. As Amy Monahan observed, "How can individuals have a reasonable expectation of future benefit accruals if they cannot have a reasonable expectation regarding the factors that determine the amount of that benefit, such as salary level and length of employment?"[192] In other words, it does not seem credible to maintain that, at the time an employee is first hired, the employee could have relied on receiving a particular level of pension accruals for, say, the employee's tenth year of employment. A government employee generally has no basis to assume, at the time of hiring, that he will continue to be employed by the government in ten years or that he will receive a particular salary.

It is a somewhat different question whether federal law should (1) permit public plans in participating states to alter the future benefit accruals of public employees of long tenure or (2) simply permit (or perhaps require) the plans to, in the future, cease treating the benefit plans of their new hires as locked in for the remainder of the those employees' careers in public service. While the second option might seem more palatable in the abstract, it would probably prove to be a much less effective means of moving severely underfunded plans towards solvency. As a result, under the second alternative, some retired public employees might not receive their full benefits. In that case, the first option, while not ideal, may appear more attractive.

The first option may cause some current employees to receive less generous pensions than expected because their future service yields less generous retirement benefits, although conceivably higher future pay could compensate for reduced pension benefit accruals. The second option, however, may result in more plans becoming insolvent. That is likely to result in reduced benefits for some retired workers, and perhaps current workers, even if their

192. Monahan, *supra* note 53, at 641; *see also* Amy B. Monahan, *Statutes as Contracts?: The "California Rule" and Its Impact on Public Pension Reform*, 97 Iowa L. Rev. 1029, 1078–79 (2012).

benefits are federally guaranteed, if the program follows the ERISA model of insuring benefits only up to a fixed amount.[193]

4. Additional Considerations

A formal commitment of federal support in advance of actual public pension plan defaults might discourage public pension plans from putting their houses in order to the extent that they are able. By acting before defaults occur, however, the federal government can impose fiscal discipline and bring transparency to the financial status of public plans, thus obliging the plans' government sponsors to prevent any further deterioration in their plans' financial conditions. A properly structured recovery program for public pension plans would impose funding requirements from the moment a formal federal commitment is established, e.g., beginning on the date that the enabling legislation is introduced. These requirements would not only mandate that newly accruing pension obligations be fully funded, as measured by federal accounting and actuarial standards, they would also require that plans take steps to reduce any deficits at the time of the federal commitment.

Perhaps the most likely manner of federal support would be guarantees comparable to those provided to beneficiaries of private sector pension plans. Politically, it may be difficult to justify federal guarantees for private plans but not for public ones. Technically, as the director of the Congressional Budget Office has pointed out, the "PBGC is not backed by the full faith and credit of the U.S. government and has no authority to . . . call on general revenues to pay benefits."[194] But the PBGC is federal agency, and it is widely assumed that the federal government stands behind its commitments.[195]

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193. *See* Part III.A.4 below; *see also Pension Benefits Guar. Corp., PBGC Maximum Insurance Benefit Increases for 2014* (Nov. 6, 2013), http://www.pbgc.gov/news/press/releases/pr13-13.html (noting that maximum guaranteed benefit for sixty-five year old retiree is $59,318.16 and that a 2006 study found that fifteen percent of retirees compensated by PBCG do not have full amount of their benefits replaced).

194. *The Pension Benefit Guaranty Corporation: Financial Condition, Potential Risks and Policy Options: Hearing Before the S. Comm. on the Budget* 2 (2005) (statement of Douglas Holtz-Eakin, Director, Pension Benefit Guaranty Corporation) [hereinafter Holtz-Eakin Statement]; DOUGLAS J. ELLIOTT, A GUIDE TO THE PENSION BENEFIT GUARANTY CORPORATION 6 (May 20, 2009), http://www.brookings.edu/~/media/research/files/papers/2009/5/20%20pensions%20elliott/0520_pensions_elliott.pdf.

195. *See, e.g.*, Holtz-Eakin Statement, *supra* note 194; *cf. Examining the Challenges Facing PBGC and Defined Benefit Pension Plans, Before the Subcomm. on Health, Emp't, Labor and Pensions of the H. Comm. on Educ. and the Workforce* 5 (Feb. 2, 2012) (statement of Joshua Gotbaum, Director, Pension Benefit Guaranty Corporation), http://www.pbgc.gov/news/testimony/

Any bailout scheme requires a mechanism to distribute federal money. The PBGC has significant experience in administering a pension guarantee arrangement, but it has its own problems[196] and its own constituency. A new agency dedicated to supervising public plans could, in principle, avoid some of the structural problems embedded in the PBCG. When a public pension plan approaches insolvency, the Government Pension Benefit Guaranty Agency could terminate it, assume responsibility for paying the benefits accrued to that point and obtain financial claims against the government employer—whether a state (typically) or a local government. In that case, beneficiaries who have not yet retired would become members of a successor plan that would have to be fully funded going forward.

Without additional reforms on the federal level, it is likely that, for reasons described in Part I.B.2, under the laws of many states, current employees whose plans were terminated would accrue benefits under the successor plan on essentially the same terms as they enjoyed under the terminated plan. When these employees retired, the GPBCA would pay some of their benefits and the successor plan would pay some. A ceiling on the level of benefits guaranteed to a beneficiary would limit federal financial exposure and place beneficiaries of public plans on the same footing as those of private plans. (The PBGC generally guarantees only up to about $59,320 of annual benefits.)[197] To the extent that a portion of benefits under the terminated plan exceeds a ceiling on federal insurance, a beneficiary may be able to obtain additional funds through a state law claim against the sponsoring government employer of the terminated plans. In contrast to the mechanism used in the private pension scheme,[198] the GPBCA's claims against the state might only extend to guaranteed benefits; it would not necessarily pursue claims for amounts above a federal guarantee.

As an alternative to an agency modeled on the PBGC, money might be sent directly to jurisdictions themselves in the form of loans or grants, or a federal guarantee of pension bonds issued by

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page/tm020212.html [hereinafter Gotbaum Statement] ("Without the tools to set its financial house in order and to encourage responsible companies to keep their plans, PBGC[ ] may face, for the first time, the need for taxpayer funds.").

196. Gotbaum Statement, *supra* note 195 ("If PBGC's finances aren't reformed, the agency will eventually run out of money to pay benefits.").

197. *Public Benefits Guar. Corp.*, *supra* note 193; 29 U.S.C. § 1322(b)(3)(B) (2012). The ceiling is indexed for inflation.

198. 29 U.S.C. § 1362(b) (2012) (providing that "the liability to the corporation . . . shall be the total amount of the unfunded benefit liabilities . . . together with interest . . .").

government sponsors of troubled pension plans.[199] Under these approaches, possibly fewer public pension plans would be terminated. While terminating troubled government plans would be disruptive, it does provide a straightforward means of capping the annual amount of a beneficiary's guaranteed benefit, thus conserving federal funds for higher priorities. Terminating failing plans also sets a baseline to facilitate enforcing a full funding requirement for a jurisdiction's employee pensions. As is currently the case for private plans under ERISA, however, the GPBGA should have the discretion whether to terminate distressed public plans.

B. Economics of Federal Regulation of Public Pension Plans

At a high level of abstraction, no economic principle dictates that government liabilities should be fully funded.[200] It has been suggested that the primary rationale for requiring full funding of private pension plans under ERISA was the threat of inadequate resources when an insolvent business terminated a pension plan. In those circumstances, employee beneficiaries' claims would effectively be limited to the plans' assets at the time of termination.[201] Opponents of parallel funding mandates for government pension plans maintain that these concerns are absent in the case of public plans. For example, according to a report of a Pennsylvania legislative commission, "Full funding may be a necessary standard for a

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199. *E.g.*, Rauh & Novy-Marx, *supra* 162. Rauh and Novy-Marx would close public defined benefit plans to new employees.

200. *See* Stephen P. D'Arcy, James H. Dulebohn, Pyunsuk Oh, *Optimal Funding of State Employee Pension Systems*, 66 J. RISK & INS. 345, 347–49 (1999), http://business.illinois.edu/~sdarcy/papers/darcy.pdf; Henning Bohn, *Should Public Retirement Plans be Fully Funded?*, J. PENSION ECON. & FIN. 195, 195-219 (2011) http://journals.cambridge.org/action/displayAbstract?fromPage=online&aid=8255503; Dennis Epple & Katherine Shipper, *Municipal Pension Funding: A Theory and Some Evidence*, 37 PUB. CHOICE 179, 179–87 (1981); Michael Peskin, *Asset/Liability Management in the Public Sector*, *in* PENSIONS IN THE PUBLIC SECTOR 195–217 (Olivia S. Mitchell & Edwin C. Hustead eds., Univ. of Penn. Press 2001); Richard W. Johnson, *Pension Underfunding and Liberal Retirement Benefits Among State and Local Government Workers*, 50 NAT'L TAX J. 113, 113–42 (1997); Robert P. Inman, *Paying for Public Pensions: Now or Later?*, FED. RESERVE BANK PHILADELPHIA BUS. REV. 3, 3–12 (Nov. 1980), http://www.phil.frb.org/research-and-data/publications/business-review/1980/br80ndri.pdf; Edward E. Burrows, Fixing the Pension Plan Funding Rules, SOCIETY OF ACTUARIES (2003). Edward E. Burrows, Fixing the Pension Plan Funding Rules, SOCIETY OF ACTUARIES 2 (2003). ("[T]he *principal* objective of ERISA funding rules was the protection of workers in event of business failure. Many observers felt this was the only legitimate objective.").

201. JAMES A. WOOTEN, *supra* note 190, at 95–96, 126.

private plan, but it is not necessary for a public plan because a public entity can assume perpetual life."[202]

As a matter of economics, both public and private institutions could reasonably finance their pension obligations through debt, assuming that lenders were convinced that the borrower would be able to service it. Both public and private organizations fund capital expenditures via debt, and many start-up ventures even fund salaries and utility costs through capital markets. In the case of technology startups, costs such as salaries can be viewed as supporting the production of intangible assets that are projected to eventually support servicing the capital investments. If it is reasonable for a business to borrow to purchase assets, it should also be reasonable to borrow to produce them in-house.

For private enterprise, lenders may hesitate to support a pattern of borrowing for true operating costs. True operating costs, by definition, generate no security for investors. Most pension obligations are essentially operating expenses: they represent compensation for work already performed, although they also may increase the likelihood that an organization's investments in human capital are realized by encouraging longer tenure by employees.[203] Therefore, in general, investors would not have an incentive to fund a private firm's accrued pension obligations.

A government's taxing power, however, can provide investors with security even for funding operating expenses. At all levels of government, a degree of deficit spending might be beneficial if it is employed to smooth the level of taxation over time.[204] On the other hand, allowing pension plan deficits to rise until they reach unsustainable levels because of legislators' reluctance to raise present taxes is bad economics at any level of government. The extraordinary levels of taxation required when the option for additional deficit financing is exhausted is the opposite of tax smoothing. In other words, deficit spending can facilitate either more stable or more erratic taxation. Furthermore, as a matter of political economy, reliance on deficit spending may lead to more liberal

202. JOINT STATE GOV'T COMM'N OF THE GENERAL ASSEMBLY OF THE COMMONWEALTH OF PENNSYLVANIA, THE FUNDING AND BENEFIT STRUCTURE OF THE PENNSYLVANIA STATEWIDE RETIREMENT SYSTEMS: A REPORT WITH RECOMMENDATIONS 20 (2004), http://jsg.legis.state.pa.us/resources/documents/ftp/publications/2004-48-PENSIONS.pdf.

203. *See, e.g.,* Richard W. Johnson, *The Impact of Human Capital Investments on Pension Benefits*, 14 J. LABOR ECON. 520, 552–54 (1996); Edward P. Lazear, *Why Is There Mandatory Retirement?*, 87 J. POL. ECON. 1261, 1261–84 (1979); Alan L. Gustman et al., *The Role of Pensions in the Labor Market: A Survey of the Literature* 47 IND. LAB. REL. REV. 417 (1994); Brown, *supra* note 183, at 182.

204. D'Arcy, Dulebohn & Oh, *supra* note 200, at 353, 363; Inman, *supra* note 200, at 4; DAVID ROMER, ADVANCED MACROECONOMICS 541–45 (2d ed. 2001).

government spending by permitting the transfer of the costs from present to future taxpayers.[205]

States and local governments are not on quite the same footing as the national government with respect to unfunded liabilities because it is easier for residents to leave a local government than the national one in order to escape the consequences of the government's debts.[206] Still, while the considerations are not identical for different levels of government, there is no consensus in the economics literature that government pension plans should be fully funded at all times. In addition, it is often observed that, at the state and local level, it is not prudent to approach one hundred percent funding because it becomes more difficult politically to resist subsequent benefit increases, which would "in turn lead[ ] to increased costs and long run underfunding."[207]

The case for fully funding state and local plans becomes straightforward, however, to the extent that the federal government provides explicit or implicit guarantees for retiree benefits. The existence of a guarantee attenuates the motivation of the pension plan and its sponsor to prevent insolvency—the moral hazard problem endemic to insurance. When government obligations are guaranteed, there is a presumption in favor of full funding or an equivalent means of protecting the guarantor's interest.[208]

Under this Article's proposed regulatory framework, the assets of a public pension plan would provide the collateral for the federal government. So it is reasonable for the federal government to insist that participating plans both move toward full funding and immediately fund completely new benefit obligations from the time that the plans enter the program. In this context, the full funding requirement would also relieve state and local governments from the dilemma in which approaching one hundred percent funding triggers political pressure to grant more costly benefits, and tempts legislatures to devote the assets to other purposes or to suspend

205. *See* Inman, *supra* note 200, at 6–7; Alan J. Auerbach, Jagadeesh Gokhale, Laurence J. Kotlikoff, *Generational Accounting: A Meaningful Way to Evaluate Fiscal Policy*, 8 J. ECON. PERSPECTIVES 73 (1994), http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.8.1.73; James M. Buchanan, *The Balanced Budget Amendment: Clarifying the Arguments*, 90 PUB. CHOICE 117, 117–38 (1997).

206. *See* Inman, *supra* note 200, at 6.

207. Peskin, *supra* note 200; *see also* U.S. GOVERNMENTAL ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENT RETIREE BENEFITS: CURRENT FUNDED STATUS OF PENSION AND HEALTH BENEFITS, GAO-08-223 15–23 (2008), http://www.gao.gov/new.items/d08223.pdf.

208. *See generally* Zvi Bodie & Robert C. Merton, *Pension Benefit Guarantees in the United States: A Functional Analysis, in* THE FUTURE OF PENSIONS IN THE UNITED STATES (Ray Schmitt ed., 1993); Robert C. Merton & Zvi Bodie, *On the Management of Financial Guarantees*, 21 FIN. MGMT., 87, 87–109 (1992). *Cf.* George L. Priest, *The Government, The Market, and the Problem of Catastrophic Loss*, 12 J. RISK & UNCERTAINTY 219, 219–37 (1996).

contributions. When something approaching an eighty percent funding ratio could be perceived as fiscally prudent, amounts in excess of this threshold could be characterized as effectively a surplus and treated as such. With a higher mandatory ratio, this perverse incentive against achieving a more secure funding level should be eliminated.

In itself, a full funding requirement will not adequately limit the federal government's exposure, even with respect to the new pension obligations of participating plans. It also will be necessary to assess suitable risk-based premiums to discourage the program from becoming an endless drain on the Treasury even after the built-in losses attributable to the current predicament have been absorbed.[209]

The importance of charging a premium that is based on the risk of the plan's investments can be illustrated by a simplified example. Suppose that a pension plan is considering two alternative investment strategies, one of which consists of investing its funds entirely in federal securities (Portfolio *S*) and another which would allocate half of its funds to federal securities and half to stocks (Portfolio *R*). Suppose the real (adjusted for inflation) expected return of Portfolio *S* were three percent, reflecting a fifty percent chance that the real return would be 2.5% and a fifty percent chance that the real return would be 3.5%. Suppose that the expected return of Portfolio *R* were five percent, reflecting a twenty-five percent chance of a negative five percent real return, a fifty percent chance of a five percent real return and a twenty-five percent chance of a fifteen percent real return.[210] Suppose, further, that with a real return of less than one percent, the plan would be left with insufficient cash flow to satisfy all of its benefit obligations; the lower the return falls below one percent, the larger the guarantor's required contribution.

This example, although simplified, illustrates the problem presented by insurance premiums that do not adequately account for the riskiness of the insured's portfolio. Although the second portfolio, Portfolio *R*, is likely to have a higher return, it is the only one that threatens to require indemnification by the guarantor even if the value of the portfolio currently matches the value of plan liabilities. So the premium for Portfolio *R* should account for the guarantor's possible payout, as well as any administrative costs.

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209. *See* Merton & Bodie, *supra* note 208, at 98. *Cf.* Richard A. Ippolito, The Economics of Pension Insurance 88–91 (1989) (describing "Insurance Pricing Principles").

210. The standard deviation of the first portfolio would be 0.5%, and of the second, 7.1%.

From these considerations, it follows that the federal government should set premiums to account for (1) the extent of a public plan's underfunding attributable to the period since it became eligible for participation in the program and (2) the estimated volatility of plan assets over the interval to which the premium applies.[211] The federal government should be authorized to impose a supplemental premium if a plan significantly increases the riskiness of its investments after its premium is determined.

Given the existing level of underfunding of public pension plans, premiums set high enough to shield the federal government from a significant risk of loss as public pension-fund guarantor would certainly be very high,[212] probably high enough to discourage state participation. To the extent that states with severely underfunded public plans fail to participate, the federal government could be faced with the prospect of bailing out these plans anyway, without the opportunity to encourage more sound practices for the plans. So it is probably only feasible to protect the government from new losses, that is, losses attributable to the period after the inception of the federal program.

While it would be advisable to apply comprehensive federal regulation to public pension plans that may require federal support, ERISA is not an ideal model. The PBGC has never imposed a risk premium calibrated to the default risk of a pension plan; this undermines the financial stability of the PBGC, as well as the incentives of financially stable employers to continue to offer defined benefit plans.[213] The premiums that the PBGC charges plans are set by statute, and must be "uniform for all plans."[214] This and other deficiencies in the structure of the PBGC have resulted in a deficit of $36 billion for fiscal year 2013.[215]

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211. Bodie & Merton, *supra* note 208, at 216–17.

212. Merton & Bodie, *supra* note 208, at 98–99.

213. *See, e.g.,* OFFICE OF MANAGEMENT AND BUDGET, *supra* note 183, at 31 ("PBGC premiums are currently much lower than what a private financial institution would charge for insuring the same risk and are insufficient for PBGC to meet its long-term obligations."); *see generally* CONG. BUDGET OFFICE, THE RISK EXPOSURE OF THE PENSION BENEFIT GUARANTY CORPORATION 14 (Sept. 2005), http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/66xx/doc6646/09-15-pbgc.pdf.

214. 29 U.S.C. § 1306(a)(1) (2012).

215. *See* Pension Benefit Guar. Corp., *PBGC's Deficit Increases to $36 Billion As Multiemployer Risks Grow: Agency Continues to Excel in Customer Service*, Nov. 15, 2013, http://www.pbgc.gov/news/press/releases/pr13-14.html; U.S. GOVERNMENTAL ACCOUNTABILITY OFFICE, PENSION BENEFIT GUARANTY CORPORATION: ASSET MANAGEMENT NEEDS BETTER STEWARDSHIP, GAO-11-271 (2011), http://www.gao.gov/assets/330/320643.pdf; U.S. GOVERNMENTAL ACCOUNTABILITY OFFICE, PENSION BENEFIT GUARANTY CORPORATION: REDESIGNED PREMIUM STRUCTURE COULD BETTER ALIGN RATES WITH RISK FROM PLAN SPONSORS, GAO-13-58 (2012), http://www

In the President's proposed budget for fiscal year 2012, the White House proposed gradually giving the PBGC the authority to charge non-uniform premiums based on the differential risks of default posed by different pension plans. It has been estimated that without the use of risk-based premiums, the financially sustainable level of uniform premiums would be up to six times higher than those actually imposed by the PBGC currently.[216] If the federal government does not set plan premiums according to financial economics principles, then insured public plans should be required to fund above one hundred percent to account for the possibility of sharp drops in the value of plan assets.[217]

C. Federalism

A federal role in public sector pensions is bound to be controversial, not only because of the demands on the federal budget but also because it would involve the federal government in an area that is traditionally the States' domain. In ordinary times, the political obstacles alone would likely be the end of the matter. The prospect of cascading defaults of teachers' and public safety workers' pension plans, however, might make federal intervention politically feasible, even compelling. In the past, constitutional concerns have inhibited federal supervision of public pension plans. The federal program proposed in this Article, however, seems to be compatible with the principles of federalism under current constitutional doctrine.

When Congress developed the comprehensive regulatory structure for pensions in the 1970s under ERISA, federalism concerns played a role in limiting most elements of the regime to the private sector.[218] From 1975 through the mid-1980s, Congress considered a series of bills to apply reporting, disclosure, and fiduciary rules to public pension plans; none of these bills proposed significant regulation of public plan funding levels.[219] State and local officials have consistently and vigorously opposed this sort of oversight on the

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.gao.gov/assets/650/649838.pdf; Pension Benefit Guar. Corp., Annual Report (2012), http://www.pbgc.gov/documents/2012-annual-report.pdf.

216. *E.g.*, Cong. Budget Office, *supra* note 213, at 8. In other words, the current, uniform premiums charged to private pension plans are only one sixth as large as would be necessary to maintain the long-term solvency of the PBGC insurance scheme.

217. *See* Bodie & Merton, *supra* note 208, at 212–13.

218. *See, e.g.,* Roy v. Teachers Ins. & Annuity Ass'n, 878 F.2d 47, 49 (2d Cir. 1989).

219. Cong. Research Serv., Public Pension Plans: The Issues Raised over Control of Plan Assets (1990), *available at* http://babel.hathitrust.org/cgi/pt?id=pst.000016128316;view=1up;seq=1.

grounds that it "run[s] counter to a fundamental principle of American federalism, namely, that the states ought to be free to formulate their own employee compensation policies without being restrained by federal government regulations or mandates."[220]

In a 1980 report on proposals for federal regulation of public pension plans, the Advisory Commission on Intergovernmental Relations, a group composed predominantly of current or former state and local officials, rejected any degree of federal supervision. The Commission maintained, "There is no convincing evidence that the federal government has any compelling 'national interest' in regulating state and local public pension systems."[221] In hearings on the Public Employee Retirement Income Security Act of 1982 (PERISA), a representative of the National Governors Association testified that the organization was "absolutely opposed to this legislation being applied to the State governments," that the proposed legislation was "an unnecessary intrusion into State affairs," and that it was "probably unconstitutional."[222] In the end, none of the bills proposed in the wake of ERISA—whether styled as PERISA or the Public Employees Pension Plan Reporting and Accountability Act of 1984 (PEPPRA)—was enacted.[223]

Recently, Congress has shown renewed interest in federal oversight of public pension plans. The Public Employee Pension Transparency Act (PEPTA) would impose reporting requirements on state and local government plans, enforced by eliminating tax preferences for state and local bonds during periods when a government's plans were out of compliance.[224] The bill would require a plan sponsor to file an annual report with the Treasury describing the characteristics of plan participants and the plan's funding status, sponsor contributions, actuarial assumptions, and recent investment returns. It would mandate that the plan provide an estimate of its liabilities using a low risk interest rate, based on the yield curve on federal debt. The interest on the bonds of noncompliant jurisdictions, normally excluded from gross income, would become

220. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, STATE AND LOCAL PENSION SYSTEMS: FEDERAL REGULATORY ISSUES ii (1980).

221. *Id.* at 5.

222. *Public Employee Retirement Security Act of 1982: Hearings on H.R. 4928 and H.R. 4929 before the Subcomm. on Labor-Management Relations of the H. Comm. on Educ. and Labor*, 97th Cong., 2d Sess. 351 (1983), available at http://www.bookprep.com/read/mdp.39015031758 264.

223. CONG. RESEARCH SERV., *supra* note 219.

224. Public Employee Pension Transparency Act, S. 779, 113th Cong., 1st Sess. § 3(a) (Apr. 23, 2013) http://www.gpo.gov/fdsys/pkg/BILLS-113s779is/pdf/BILLS-113s779is.pdf.

taxable.[225] In its final section, the bill disclaims federal liability for any obligations of the covered government pension plans and emphasizes that it would not "alter existing funding standards for State and local government employee pension plans or . . . require Federal funding standards" for the plans.[226]

Imposing mandatory federal guidelines on all public pension plans might well be incompatible with federalism principles. In many states, public pension plans appear to be in relatively sound financial condition.[227] Across-the-board federal intervention is neither necessary nor politically viable; on the other hand, federalism is not offended when the price of federal financial support is acceptance of federal oversight. The federal government has an interest in promoting fiscal discipline and other policies that could mitigate federal exposure to public pension plan losses.

Although the meaning of federalism is not necessarily limited to legal formulas enforceable through litigation,[228] this Article's recommendations appear to be consistent with existing constitutional doctrine reflected in case law. Under the Spending Clause, Congress may attach conditions on the transfer of federal money to states when those terms might be beyond the authority of Congress to enforce if the subsidy were taken out of the equation.[229] Often the application of Spending Clause authority requires a state or local government to conform its laws with a federal program in order to qualify for the receipt of federal funds. For example, in *South Dakota v Dole*,[230] the Supreme Court held that a federal law that withheld five percent of a state's federal highway funds unless the state established twenty one as the minimum drinking age was valid under the Spending Clause "[e]ven if Congress might lack the power to impose a national minimum drinking age directly."[231]

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225. *Id.* The general exclusion of interest on state and local bonds from gross income is 26 U.S.C. § 103(a).

226. Public Employee Pension Transparency Act, S. 779, 113th Cong., 1st Sess. § 4 (Apr. 23, 2013) http://www.gpo.gov/fdsys/pkg/BILLS-113s779is/pdf/BILLS-113s779is.pdf.

227. Rauh, *supra* note 1, at 597; Alicia H. Munnell et al., *How Would GASB Proposals Affect State and Local Pension Reporting?*, 23 St. & Loc. Pension Plans 1, 11–14 (2011).

228. *See, e.g.*, Jonathan Rodden, *Market Discipline and U.S. Federalism*, *in* When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis 103 (Peter Conti-Brown & David A. Skeel, Jr., eds., 2012)

229. The Spending Clause permits Congress to "lay and collect Taxes, Duties, Imposts and Excises and provide for the common Defence and general Welfare of the United States." U.S. Const. art. I, § 8.

230. 483 U.S. 203 (1987).

231. 438 U.S. at 212; *see also* New York v. United States, 505 U.S. 144, 171-73 (1992); Kansas v. United States, 214 F.3d 1196 (10th Cir. 2000).

Although Congress could condition participation in a federal program on a state's express repeal of any conflicting state legislation, it does not appear necessary for the federal government to confirm that a jurisdiction's laws are entirely consistent with the federal program before disbursing funds to the jurisdiction. Should some aspect of a jurisdiction's law be inconsistent with a federal program after the jurisdiction has begun to participate in the program, the federal rule will prevail under the Supremacy Clause. There does not seem to be any principle preventing the federal government from either terminating further federal funding or seeking to recover previously spent federal money from the jurisdiction.

In *Ivanhoe Irrigation District v McCracken*,[232] the Supreme Court of California had refused to enforce contracts between state agencies and the federal government stipulating that water projects financed in part by federal funds would not be provided to "lands in excess of 160 acres in single ownership."[233] The California Supreme Court's decision was based on its determination that the contractual limitation, a prerequisite to federal funding, was incompatible with California law.[234] The Supreme Court reversed. The Court confirmed that the excess acreage restriction in the contracts was valid under "the power of the Congress to condition the use of federal funds, works and projects on compliance with reasonable requirements."[235] On this basis, it should be within federal power to require or permit participating states to undertake pension reforms that might conflict with certain state laws—even provisions of a state constitution.[236]

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232. 357 U.S. 275 (1958).

233. *Id.* at 285.

234. *Id.* at 290 (concluding that the California Court's decision rested on its determination that the acreage limitation would deprive the "people of the State and particularly those in the [irrigation] district[s] involved . . . of a right to the use of the water in the district."); *see also* California v. United States, 438 U.S. 645, 670–71 (1978); 357 U.S. at 285.

235. 357 U.S. 275, 291. Nat'l Fed. of Ind. Bus. v. Sebelius, 132 S. Ct. 2566 (2012), the Supreme Court decided that Congress could not authorize the President to terminate a State's existing level of Medicaid funding if the State elected not to participate in an expansion of the program. Slip op. at 2607 (Roberts, C.J.); *id.* at 2642 (Ginsburg, J.) (dissenting from this aspect of the judgment); *id.* at 2660–61 (joint dissent) (concurring in the judgment on this point). This result suggests that it might be prudent to include all the key elements of the regulatory framework in the enabling legislation, as federal sanctions for a state's noncompliance with subsequently imposed conditions might be restricted under principles articulated in the opinions invaliding the Medicaid expansion.

236. The circumstances under which a State has the power (under State law) to consent to participate in a federal program that would override certain State laws—say a provision of the State constitution—appears to be an unsettled question. A similar question arose in Detroit's bankruptcy filing: did Michigan have the power (under Michigan law) to authorize a municipal bankruptcy given that the bankruptcy court would have the ability (under federal

The Contract Clause of the federal Constitution[237] "limits the power of the States to modify their own contracts as well as to regulate those between private parties."[238] This clause does not restrict the federal government, however.[239] The Due Process Clause of the Fifth Amendment[240] may impose limits on the federal government that are analogous to the limits the Contract Clause imposes on the States, but these restrictions would not be as substantial.[241] Federal economic legislation that substantially impairs a private contract is presumed to be constitutional; it only violates due process if it is arbitrary and irrational.[242]

In a number of states, public pension plan beneficiaries would face the risk of receiving no benefits—or greatly diminished benefits—without federal intervention. Thus, a policy permitting public pension funds to strengthen their balance sheets and reduce their reliance on federal money, while bringing public employees' contractual pension rights in line with private sector workers', should not be characterized as arbitrary or irrational.

In recent decades, the Supreme Court has been solicitous of States' rights under the Tenth Amendment.[243] The Court has discouraged federal regulation that would "commandeer" state governments into enforcing federal mandates.[244] The Court has been more open, however, to regulation through generally applicable laws that affect individuals as well as states.[245]

The proposals of this Article would give states considerable latitude in determining the means of satisfying federal financial targets

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law) to imposes cuts on public employee pension benefits that otherwise would be inconsistent with the Michigan constitution. The Bankruptcy Court concluded that the pension protections of the Michigan constitution did not preclude Michigan from authorizing municipal bankruptcy. *See In re* Detroit, No. 13-53846, Opinion Regarding Eligibility (Bankr. E.D. Mich. Dec. 5, 2013), *available at* http://www.mieb.uscourts.gov/sites/default/files/detroit/docket1945.pdf.

237. "No State shall . . . pass . . . any Law impairing the Obligation of Contracts" U.S. Const. art. I, § 10.

238. United States Trust Co. v. New Jersey, 431 U.S. 1, 17 (1977).

239. Pension Benefit Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 732 n.9 (1984).

240. U.S. Const. amend. V (providing that no person shall be "deprived of life, liberty, or property, without due process of law.").

241. National R.R. Passenger Corp. v. Atchison Topeka & Santa Fe Ry. Co., 470 U.S. 451, 472 n.25 (1985) ("We have never held that the principles embodied in the Fifth Amendment's due process guarantee are coextensive with the prohibitions against state impairment of contracts under the Contract Clause, and . . . to the extent the standards differ, a less searching inquiry occurs in the review of federal economic legislation.").

242. *Id.* at 472, 476.

243. U.S. Const. amend. X ("The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States, or to the people.").

244. New York v. United States, 505 U.S. 144, 175 (1992); Printz v. United States, 521 U.S. 898, 933 (1997).

245. Reno v. Condon, 528 U.S. 141, 151 (2000).

and would not demand that states regulate in a particular fashion or enforce federal mandates—unlike Rauh and Novy-Marx's proposal to require public (but not private) plans to phase out defined benefit plans.[246] This Article's proposed regulation of state and local plans would not be substantially different from the regime applied to the private sector under ERISA.

CONCLUSION

There is a material risk that, within the next five to ten years, public pension plan defaults will become more than isolated occurrences. In the past few years, state and local governments have begun to reform their plans. However, because the benefits of existing public employees are largely insulated from modifications, it is unlikely that these reforms can prevent many of the potential defaults.

In the event that a government pension plan were to default on its pension obligations to retired employees, the retirees could demand compensation through state court proceedings. Whether the retirees could actually obtain money on a timely basis is much less clear. In many cases retirees may have great difficulty in extracting compensation from their former government employers through litigation, at least in the short run. Collecting a judgment against a government in fiscal distress could prove difficult and slow since the conventional means of enforcement, such as liens and garnishment, are largely unavailable.[247] For retirees, this short run may occupy a considerable part of the pertinent time horizon.

It is foreseeable that a series of public pension plan insolvencies will prove politically intolerable. Retired public servants would be sympathetic casualties, and public employees would be a reliable and politically effective constituency. Perhaps public pension plan insolvencies will prove economically intolerable as well. The threat of defaults by a state's public pension plans may undermine state government finances and that, in turn, could destabilize the market for other states' debt.

If there is to be a federal government intervention to prevent public pension defaults, then sooner is better. The political appeal of delay is clear enough: the necessary legislation will be expensive and controversial, while the benefits are hypothetical. The policy appeal of delay is that the prospect of federal aid will remove some

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246. *See* Part II.C.
247. *See Gentile*, *supra* note 121, at 282.

of the pressure on state and local governments to make sacrifices, e.g., to raise taxes, to cut popular programs, and to test the political and legal feasibility of reducing public employee benefits.

The cost of delay is the lost opportunity to contain the scale of the crisis. By acting before defaults occur, the federal government can impose fiscal discipline on underfunded pension plans that are potential candidates for financial support, restricting the growth of their deficits. Pressure on public pension sponsors to address existing deficits can be sustained by imposing realistic shortfall amortization obligations on public plans in participating states.[248] Delay gambles that, when defaults occur, governments will somehow manage to find the money to satisfy their pension obligations. If even a few jurisdictions fail this test, it will be difficult to avoid bailing out all of them, possibly at much greater expense than if intervention had come earlier.

248. *Compare* 29 U.S.C. § 1083(c) (2012).