POLICY BRIEF

By Ralph Benko
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Legal Authority to Adjust State Pension Plans

Exorbitant retirement benefits are threatening the ability of states and municipalities to deliver essential government services, and, in up to 20 states and hundreds of municipalities, are threatening their very solvency.

States and municipalities struggle with a trillion, or even multi-trillion, dollar crisis of unfunded public employee retirement benefit obligations. As the *Wall Street Journal's* David Wessel] says, "Bankruptcy is a last resort. To avoid it, state and local governments need an alternative that is less unappealing. They don't have one yet."[1]

Fortunately, they do have an appealing alternative as is becoming definitively clear.

There is growing bi-partisan recognition that exorbitant retirement benefits granted to civil service unions are threatening the ability of states and cities to provide essential services without implementing job-destroying tax increases. Indeed, even former San Francisco Mayor and State Assembly Speaker Willie Brown (D), a staunch public union supporter, recognizes that lucrative defined benefit pension plans are unsustainable. John Fund writes about a column Willie Brown authored for the *San Francisco Chronicle* in which Brown lamented that civil service was out of control.

> "The deal used to be that civil servants were paid less than private sector workers in exchange for an understanding that they had job security for life. But we politicians — pushed by our friends in labor — gradually expanded pay and benefits … while keeping the job protections and layering on incredibly generous retirement packages." Brown later told Fund, "When I was Speaker I was in charge of passing spending. When I became mayor I was in charge of paying for that spending. It was a wake-up call."[2]

Fortunately, a more appealing remedy than bankruptcy exists. It is contained in two U.S. Supreme Court cases, *Energy Reserves Group v. Kansas Power & Light* and *United States Trust Company of New York v. New Jersey*. States and, with state authority, municipalities, can unilaterally reduce excess retirement benefits under circumstances now widely prevailing. There is a widespread misunderstanding in many states that the U.S. Constitution prohibits these adjustments, but there is no such prohibition.

A story published earlier this year by The Pew Center on the States confirmed that legislators' belief that retirement benefits cannot be modified is only an assumption. "It is uncertain in many states what the constitutional protections are because they haven't been tested or at least thoroughly tested in the courts," says Ron Snell, director of state services at the National Conference of State Legislatures. "But state legislators have assumed the protections to be quite strong."[3] This assumption that there is constitutional prohibition against benefit modification is a misunderstanding. Case precedent is clear that, under circumstances currently prevailing in many places, retirement benefits may be reduced.

The U.S. Supreme Court's interpretation of the U.S. Constitution lays out the rules by which states may modify their contractual obligations. The clear language of the governing cases present as directly applicable to the situation at hand. The cases give clear guidance. (Legal Citations may be found on page 3.)

There are scores of state and lower federal court cases holding against attempts to modify vested pension benefits. Upon examination, few, if any, of these cases were brought on the grounds set forth as applicable by the U.S. Supreme Court. Accordingly, these state and lower court cases are irrelevant to the current circumstances. They were special, very narrow, cases that did not spring from legislative action to remedy a broad and general social or economic problem.

The governing law may be summarized as follows:

> *A state may impair a contractual right if it has a significant and legitimate public purpose such as remedying a broad and general social or economic problem, such as elimination of unforeseen windfall profits. A state may do so as an exercise of its police power. A contractual impairment may be constitutional if it is reasonable and necessary to serve an important public purpose.*

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1 Wall Street Journal, "Local Debts Defy Easy Solution", published September 23, 2010 and available at http://online.wsj.com/article/SB10001424052748704814204575507842266619222.html

2 Wall Street Journal, "Willie Brown Repents", published July 9, 2010 and available at http://www.flashreport.org/blog0a.php?postID=20100709132035 47&authID=2005081622025042

3 Stateline, The Pew Center on the States, "Activists seek new tactics to break old pension deals," published January 7, 2011 and available at http://www.stateline.org/live/printable/story?contentId=540089

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When a state reduces an obligation, the courts will inquire as to whether the adjustment of "the rights and responsibilities of contracting parties is based upon reasonable conditions and is of a character appropriate to the public purpose justifying the legislation's adoption. Courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure."

When a state impairs its own contractual obligations (as is the case with retirement benefits promises) the courts and certain other material factors come into play. The courts will hold the state to a somewhat higher standard of scrutiny as to the policy's necessity and reasonableness. Therefore, a prospering state with a well-funded retirement plan could not arbitrarily cut promised benefits. But a state struggling to the point of eliminating essential services or facing insolvency certainly may, under the law, modify existing retirement benefits.

Furthermore, it is entirely settled law that one legislature may not abridge the powers of a succeeding legislature and cannot bargain away the police power of a state. So, in addition to the realistic reading of the contracts clause itself, and as recognized by the Supreme Court, an independent doctrine holds that the Constitution's contract clause does not require a state to adhere to a contract that surrenders an essential attribute of sovereignty.

The classic doctrine that one legislature cannot abridge the powers of a succeeding legislature nor bargain away its police power permits states to reduce their public employee pension obligations under the circumstances now besetting many states.

The law does not permit a state to impair its contractual obligations arbitrarily or with impunity. The courts will look into whether a proposed impairment is reasonable and necessary to "serve an important public purpose". Modifying existing pension benefits because the cost of providing them threatens a state or municipality's ability to provide essential services or precipitating insolvency certainly rises to the standard of "remedying a broad and general social or economic problem."

According to several well accepted doctrines and the clear holdings of the United States Supreme Court, if a state or, with a state's authority, a municipality finds itself confronting a severe fiscal challenge based on exorbitant retirement pension obligations it is well within its inherent police powers to reduce its obligations to a reasonable level.

The courts will not rubber-stamp an arbitrary decision. Yet it is conceptually impossible to imagine a court finding that a reduction of such benefits to private sector levels for retirees of comparable circumstances to be 'unreasonable,' especially when the cost of providing those benefits threatens the ability to provide essential services. Evidence of reasonableness and necessity of such reductions includes:

1. extensive studies by respected nonpartisan institutes;
2. reports from respected media sources from across the political spectrum;
3. critiques by elected officials nationwide, both liberal and conservative, Democrat and Republican, of unjustifiably extravagant retirement benefits;
4. the documented growing inability of states and municipalities burdened by the cost of these retirement benefits to provide essential government services or maintain solvency.

Taken together, these factors are highly persuasive that it is reasonable and necessary to adjust certain states' and municipalities' pension obligations to the median level of private sector comparable positions.

The power to unilaterally, though reasonably, reduce benefits provides a great deal more latitude for officials than many knew they had. By taking this power into account, the executive branch officials and legislators in many states will find themselves positioned with many new options that they had not realized were available. Recognizing that, public officials simply may choose to reduce benefits of public workers to demonstrably reasonable levels. Or perhaps it will prove to be more politically palatable to set up a special commission to assess and implement the appropriate cuts. Alternatively, this newfound power might open a means by which to persuade state workers to accept solutions such as buyouts that will allow for a generally acceptable reduction of benefits. A good faith demonstration is all a state needs to reduce retirement benefits. This is simply done by showing they are implementing a remedy to a general economic problem and that such reductions are necessary and reasonable.

Legal Citations

Following are key, verbatim excerpts from the two authoritative governing U.S. Supreme Court cases interpreting the U.S. Constitution's contracts clause: *Energy Reserves Group v. Kansas Power & Light* 459 U. S. 400 (1983) and *United States Trust Company of New York v. New Jersey* 431 U.S. 1 (1977).

Energy Reserves Group v. Kansas Power and Light

The threshold inquiry is "whether the state law has, in fact, operated as a substantial impairment of a contractual relationship." *Allied Structural Steel Co. … See United States Trust Co. …* The severity of the impairment is said to increase the level of scrutiny to which the legislation will be subjected. *Allied Structural Steel Co. …* Total destruction of contractual expectations is not necessary for a finding of substantial impairment. *United States Trust Co. …* On the other hand, state regulation that restricts a party to gains it reasonably expected from the contract does not necessarily constitute a substantial impairment. In determining the extent of the impairment, we are to consider whether the industry the complaining party has entered has been regulated in the past. *Allied Structural Steel Co. …* ("When he purchased into an enterprise already regulated in the particular to which he now objects, he purchased subject to further legislation upon the same topic"). The Court long ago observed: "One whose rights, such as they are, are subject to state restriction, cannot remove them from the power of the State by making a contract about them." *Hudson Water Co. v. McCarter …*

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If the state regulation constitutes a substantial impairment, the State, in justification, must have a significant and legitimate public purpose behind the regulation, *United States Trust Co. …* such as the remedying of a broad and general social or economic problem. *Allied Structural Steel Co …* Furthermore, since Blaisdell, the Court has indicated that the public purpose need not be addressed to an emergency or temporary situation. *United States Trust Co. …* One legitimate state interest is the elimination of unforeseen windfall profits. *United States Trust Co. …* The requirement of a legitimate public purpose guarantees that the State is exercising its police power, rather than providing a benefit to special interests.

Once a legitimate public purpose has been identified, the next inquiry is whether the adjustment of "the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying [the legislation's] adoption." *United States Trust Co. …* Unless the State itself is a contracting party … "[a]s is customary in reviewing … economic and social regulation … courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure …"

For a State to impair its own contractual obligation, a somewhat more stringent test must be met, as set forth in *United States Trust Company of New York v. New Jersey*:

> Although the Contract Clause appears literally to proscribe "any" impairment, this Court observed in Blaisdell that "the prohibition is not an absolute one and is not to be read with literal exactness like a mathematical formula."
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> … an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose.

United States Trust Co. of New York v. New Jersey

Although the Contract Clause appears literally to proscribe "any" impairment, this Court observed in Blaisdell that "the prohibition is not an absolute one and is not to be read with literal exactness like a mathematical formula." Thus, a finding that there has been a technical impairment is merely a preliminary step in resolving the more difficult question whether that impairment is permitted under the Constitution. In the instant case, as in Blaisdell, we must attempt to reconcile the strictures of the Contract Clause with the "essential attributes of sovereign power," necessarily reserved by the States to safeguard the welfare of their citizens …

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Yet private contracts are not subject to unlimited modification under the police power. The Court in Blaisdell recognized that laws intended to regulate existing contractual relationships must serve a legitimate public purpose … A State could not "adopt as its policy the repudiation of debts or the destruction of contracts or the denial of means to enforce them." Legislation adjusting the rights and responsibilities of contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption … As is customary in reviewing economic and social regulation, however, courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure. *East New York Savings Bank v.Hahn …*

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When a State impairs the obligation of its own contract, the reserved powers doctrine has a different basis. The initial inquiry concerns the ability of the State to enter into an agreement that limits its power to act in the future. As early as *Fletcher v. Peck*, the Court considered the argument that "one legislature cannot abridge the powers of a succeeding legislature." It is often stated that "the legislature cannot bargain away the police power of a State." *Stone v. Mississippi* … This doctrine requires a determination of the State's power to create irrevocable contract rights in the first place, rather than an inquiry into the purpose or reasonableness of the subsequent impairment. In short, the Contract Clause does not require a State to adhere to a contract that surrenders an essential attribute of its sovereignty.

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The Contract Clause is not an absolute bar to subsequent modification of a State's own financial obligations. As with laws impairing the obligations of private contracts**,** an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose. In applying this standard, however, complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake. A governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.

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