Navigating the Legal Landscape for Public Pension Reform: Travel at Your Own Risk

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Meaningful reform of public pensions can happen in a number of ways: You can alter cost-of-living adjustments. You can reduce future benefits. Or you can raise the retirement age, to name just a few.

Before the 1970s, public pension reform along any of those lines would have been a snap compared with today. Back then, public pension plans were generally treated as gratuities, gifts from the state. Legally, they could be easily modified or terminated at any time (though politically might be another matter).

Those days are over. Today, nearly all states protect public pensions to varying degrees, working in a complicated legal environment. As a result, reform-minded policymakers have to tread carefully, treating each state as a separate case. By no means is public pension reform out of the question, but legal precedent in a given state determines what reforms are realistic there.

State by State

It is comparatively easy to modify pension plans in Texas, where they are still treated as gratuities. This is also true in Indiana and Montana, where employees are required to participate in pension plans.

Everywhere else, the law is far murkier. Legal experts describe the area of public pension law as "unsettled," which makes it difficult to spell out what reforms can be accomplished.

In at least 27 states, pension members' past and future accruals are protected, but to different degrees. (Past accruals are benefits for services already performed, and future accruals for benefits yet to be earned.) These varying degrees of protection complicate the task of modifying current members' pension plans.

These states treat public pension plans as contracts that must conform to constitutional, statutory, or common law (the last of these was developed through court decisions interpreting statutes or constitutions).

1

Past and Future Accruals Protected

Alabama	Kansas	North Dakota
Alaska	Kentucky	Oregon
Arizona	Massachusetts	Pennsylvania
California	Mississippi	South Carolina
Colorado	Montana	Tennessee
Delaware	Nebraska	Utah
Georgia	Nevada	Vermont
Idaho	New Hampshire	Washington
Illinois	New York	West Virginia

2

Past and Future Accruals Protected by Constitution

Alaska	Arizona	Illinois
	New York	

3

California Rule Followed

Alaska	Mississippi	Oklahoma
California	Nebraska	Vermont
Kansas	Nevada	Washington

4

Only Past Accruals Protected

Massachusetts	Ohio	Wyoming
New Mexico	Wisconsin	

(and possibly New Jersey)

At least four of these states base this protection on their own constitutions, which provide the strongest form of legal protection possible. The other 23 states base this protection on statutes or common law.

Under the contract approach, any modification to a public pension plan must be scrutinized under the Contracts Clause in the state and federal constitutions, which can set a high standard. The Clause prohibits states from passing legislation that substantially impairs an existing contract, but even a substantial impairment does not violate the Contracts Clause if it is reasonable and necessary to achieve an important public purpose.

The "reasonable" bar is not set high. A modification is deemed reasonable if it bears some material relation to an important public purpose. "Necessary" is another matter. To establish that a modification is necessary, the state must show that it could not achieve its intended outcome through either a less drastic measure or no action at all. This is a more difficult legal standard to satisfy; a financial crisis might be one of the few events providing a "necessary" motivation for reform, but this is untested in courts.

At least nine states follow the California Rule, an important variant of the contract approach. Adopted first in the California courts and then in other states, this rule provides contractual protection for both past and future accrued pension benefits from the time employment begins. In other words, public pensioners in states following the California Rule cannot have their benefits reduced at any point.

Of course, the California Rule has an exception: "Reasonable" changes, as defined by the courts, are allowed. A modification is considered reasonable if it "bear[s] some material relation to the theory of a pension system and its successful operation," and if any benefit reductions are offset by comparable increases. To complicate matters further, some states require a federal Contracts Clause analysis—in addition to the analysis provided in the California Rule—to determine whether the proposed modifications would deprive members of their contractual rights.

Different courts offer different opinions, of course.

For example, lower courts in Minnesota and Colorado recently upheld legislation that reduced cost-of-living-adjustments (COLAs) for public pensions. The Colorado Supreme Court had previously adopted the California Rule, but it did not rule on whether the COLA was a part of the contract. The lower court found that the COLA was not a part of the contract and therefore could be modified by the state legislature. In Minnesota, the court held that pensioners had no reasonable expectation of a particular COLA, and therefore the legislature could modify it.

This is an important issue—COLAS are expensive to fund, and reducing them would help public pensions close their funding gaps. In light of these recent opinions, other states may also find that COLAs are not part of the public pension contract. But these cases are not controlling; only higher courts can bind lower courts, and decisions in one state are not binding on others.

In states where only past accruals are protected, current plan members' future accruals can be modified. At least five of the states where only past accruals are protected, including Ohio, view public pension benefits not as contracts, but as members' property. Once members' rights in a public pension plan are considered property, they are entitled to protection under the U.S. Constitution's Due Process (Fifth and Fourteenth Amendments) and Takings (Fifth Amendment) clauses, and relevant state constitution equivalents. But this tends to work in favor of reformers. Employees' challenges to pension plan modifications on due process grounds and under the Takings Clause are usually unsuccessful. (Takings occur when the government seizes property, either physically or by inhibiting its use.)

The Future of Reform

Despite increases in public pension plans' unfunded liabilities, constraints on unilateral public pension modifications may make meaningful pension reform difficult or impossible. The most immediate cost savings would come from modifying retired members' pension plans, but this is usually prohibited. In many instances, it is also difficult to modify the terms for current employees. Modifying plans for only new hires may not provide all the financial relief that states and municipalities need today.

The bottom line is that the law is bound by considerations that are completely different from those reformers might have in mind. And that may be the ultimate legal lesson: If you want to help public pension plans close their funding gaps by reducing benefits, the law will probably work against you. ■

Recommended reading

Amy Monahan. 2010. "Public Pension Plan Reform: The Legal Framework." University of Minnesota Law School, *Legal Studies Research Paper Series*, Research Paper No. 10-13 (March). ***http://ssrn.com/abstract=1573864***