# THE IMPACT OF LAW ON THE STATE PENSION CRISIS

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*While some state and municipal pension plans have funds sufficient to meet obligations to retirees without imposing onerous obligations on current and future taxpayers, underfunding of plans in other states has reached disastrous proportions, raising the possibility of default on pension obligations, cuts in public services, steep tax increases, or some combination of the three. The substantial differential in pension funding might be attributed to divergent political pressures, different responses to uncertainty about investment returns, or other factors. Our examination of pension funding law in ten states—five with the best-funded plans and five with the worst-funded plans—highlights the role of legal structures in the financial health of state pension plans. First, timing of state law commitment to actuarial principles correlates with the current level of plan funding; those states that made pension promises before considering the actuarial implications of those promises continue to face an uphill struggle decades later. Second, state constitutional mandates—if enforced by the state judiciary—correlate positively with adequate pension funding. Third, pension funding is generally better in states whose statutes provide nonconstitutional institutional buffers between pensions and the rough-and-tumble of ordinary politics. Fourth, the provision of statutory mechanisms for retirement systems to enforce government obligations to contribution is strongly correlated with the health of state pension plans.*

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## I. INTRODUCTION

Many state and municipal pension plans are in crisis. Illinois is a poster child for that crisis.[1] According to the state's own figures, at the close of the 2017 fiscal year, Illinois' retirement systems had $129.5 billion in unfunded liabilities; only 37.6% of the state's retirement obligations were funded.[2] Illinois, however, is not alone. At the close of the 2016 fiscal year, Kentucky's primary pension plan for civilian state employees was only 16% funded.[3] New Jersey's

1. *See, e.g.*, Maria O'Brien Hylton, *Combating Moral Hazard: The Case for Rationalizing Public Employee Benefits*, 45 IND. L. REV. 413, 446 (2012) ("The pension situation in Illinois is by far the most absurd in the nation. Illinois appears on the bottom rung on every analysis of state debt.").

2. COMM'N ON GOV'T FORECASTING & ACCOUNTABILITY, ILL. STATE RETIREMENT SYSTEMS: FINANCIAL CONDITION AS OF JUNE 30, 2016, at i (2017), http://cgfa.ilga.gov/Upload/FinConditionILStateRetirementSysMar2017.pdf.

3. COMMONWEALTH OF KY., PENSION PERFORMANCE AND BEST PRACTICES ANALYSIS INTERIM REPORT #2: HISTORICAL AND CURRENT ASSESSMENT 2 (2017), https://pensions.ky.gov/Documents/2017%2005%2022%20-%20Report%202%20FINAL%205.22.17%20-%20Historical%20and%20Current%20Assessment.pdf.

pension plans have $90 billion in unfunded liabilities.[4] The Pew Center estimates that the aggregate unfunded liability of state pension plans exceeded $1.4 trillion dollars by the end of the 2016 fiscal year.[5] Other estimates are considerably higher.[6]

Funding of state and municipal pension plans directly affects the twenty million Americans covered by these plans.[7] But the consequences of underfunding affect a much broader range of Americans: future taxpayers may have to rescue underfunded plans,[8] and citizens may receive fewer services as an increasing share of state budgets is devoted to meeting retirement commitments.[9] Chronic underfunding of pension plans may generate draconian alternatives, such as default on pension obligations, dramatic cuts in public services, or raising taxes to levels that could provoke taxpayer

4. N.J. PENSION & HEALTH BENEFIT STUDY COMM'N, FINAL REPORT 1 (2017), https://www.scribd.com/document/366512602/Final-Report-New-Jersey-Pension-and-Health-Benefit-Study-Commission-Dec-6-2017.

5. PEW CHARITABLE TRS., THE STATE PENSION FUNDING GAP: 2016, at 2 (2018), http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/04/the-state-pension-funding-gap-2016#0-overview [hereinafter PEW PENSION FUNDING GAP 2016]. This represents an increase from $1.1 trillion in 2015. *See* PEW CHARITABLE TRS., THE STATE PENSION FUNDING GAP: 2015, at 1 (2017), http://www.pewtrusts.org/~/media/assets/2017/04/psrs_the_state_pension_funding_gap_2015.pdf [hereinafter PEW PENSION FUNDING GAP 2015].

6. *See* EILEEN NORCROSS & OLIVIA GONZALEZ, MERCATUS CTR. AT GEORGE MASON UNIV., THE PATH TO PUBLIC PENSION REFORM 2 (2017), https://www.mercatus.org/publications/path-public-pension-reform (noting a market value estimate of $3.41 trillion rather than the state-reported total of $1.19 trillion).

7. WILLIAN G. GALE & AARON KRUPKIN, BROOKINGS INST., FINANCING STATE AND LOCAL PENSION OBLIGATIONS: ISSUES AND OPTIONS 3 (2016), https://www.brookings.edu/wp-content/uploads/2016/07/Financing-State-and-Local-Pension-Obligations-Gale-Krupkin.pdf. It also bears noting that pension beneficiaries in thirteen states do not contribute to Social Security or state employment; they are therefore not entitled to Social Security benefits for their state service. *See* T. Leigh Anenson et al., *Reforming Public Pensions*, 33 YALE L. & POL'Y REV. 1, 31 (2014).

8. Anenson et al., *supra* note 7, at 37.

9. *Id.*

rebellion or flight.[10] In this sense, underfunding of pensions may constitute a "fiscal time bomb."[11]

At the municipal level, pension default has already become a reality: Detroit's bankruptcy resulted in a cut in pension benefits promised to retired workers.[12] In Rhode Island, Central Falls' bankruptcy resulted in pension benefits being cut by up to 55%.[13] Other municipalities have negotiated pension reductions to stave off potential default.[14]

At the state level, where bankruptcy is unlikely to be an option,[15] the default option is considerably more complex. Depending on the structure of government promises and the provisions of the state

10. In Kentucky, for example, the KERS nonhazardous pension funds will likely have to convert all of their assets into cash-to-pay benefits, and these funds will likely be fully depleted within the next five to seven years. *See* Attracta Mooney, *Kentucky, Home to the Worst-Funded Pension Fund in the US*, FIN. TIMES (June 10, 2016), https://www.ft.com/content/a1c5c5d6-2cc9-11e6-bf8d-26294ad519fc. At that point, the money to pay benefits would have to come from state coffers, which means either a significant tax increase or a reduction in the number of state employees and services as well as cuts to expenditures for security, education, infrastructure, and other services provided out of the funding from general revenues.

11. *See* Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3, 4 (2013).

12. *See In re* City of Detroit, 838 F.3d 792, 796 (6th Cir. 2016) (upholding a bankruptcy settlement that reduced pensions by 4.5% and eliminated the cost of living adjustments).

13. Hillary Russ, *Bankruptcy Saves Tiny Rhode Island City, but Leaves Scars*, REUTERS (Sept. 3, 2012, 8:10 PM), https://www.reuters.com/article/us-usa-rhodeisland-centralfalls-bankrupt/bankruptcy-saves-tiny-rhode-island-city-but-leaves-scars-idUSBRE88300220120904; *see also* Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES (Sept. 6, 2012), https://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html (discussing bankruptcy of Central Falls, Rhode Island, and its cut of local pension benefits).

14. The City of Houston, for instance, negotiated a deal with municipal workers that reduced pension benefits, but the deal was combined with a bond issue that infused the system with additional funding to increase solvency. *See* Mike Morris, *Houston Voters OK $1 Billion Measure to Bolster Police, City Workers Pension Funds*, HOUSTON CHRON. (Nov. 8, 2017, 9:26 A.M.), https://www.chron.com/news/politics/houston/article/Reforms-locked-in-as-Houston-voters-approve-1B-12339613.php (discussing passage of the bond issue as the last step in the negotiated settlement). Following the Central Falls, Rhode Island, bankruptcy, retirees in Providence agreed to reduce medical pension benefits by shifting to Medicare after they reached sixty-five. Dan McGowan, *Everything You Need to Know About Providence's Improving-But-Still-Shaky Finances*, WPRI.COM (Feb. 8, 2018, 1:12 PM), http://wpri.com/2018/02/08/everything-you-should-know-about-providences-improving-but-still-shaky-finances.

15. Although chapter nine of the bankruptcy code provides for municipal bankruptcies, the code makes no comparable provision for state bankruptcies. *See* 11 U.S.C. §§ 901–946 (2012). For a discussion of state bankruptcy as an option, see Hylton, *supra* note 1, at 458–61.

constitution, either state constitutional law[16] or the Federal Constitution's Contracts Clause[17] might require governments to honor pension obligations, regardless of the impact on local citizens.[18]

Underfunding of state and municipal plans is, in part, a product of uncertainty about how much money government entities must contribute and invest to fund obligations that will not come due for decades.[19] In the face of that uncertainty, state and local politicians have the political incentive to make overly optimistic assumptions about investment returns,[20] and those assumptions contribute substantially to underfunding.

In recent years, some states and municipalities have moved to eliminate that uncertainty (or, more accurately, shift it to state employees) by replacing traditional defined benefit plans with 401(k) plans[21] or cash balance plans,[22] at least with respect to new employees. Other states have reduced the level of budgetary risk by giving employees a choice between 401(k) plans and traditional plans, while making 401(k) the default plan for employees who fail to elect.[23] Still, other states have adopted hybrid plans, reducing the scope of the guaranteed benefits—hence the funding uncertainty.[24]

Uncertainty, however, is not the only cause of pension underfunding. A number of states have knowingly contributed less

16. *See, e.g.*, Jones v. Mun. Emps.' Annuity & Benefit Fund, 50 N.E.3d 596, 603 (Ill. 2016) (indicating that the state constitution's pension protection clause precludes legislative action reducing pension benefits); *see also* Hall v. Elected Officials' Ret. Plan, 383 P.3d 1107, 1113 (Ariz. 2016).

17. *See, e.g.*, Faulkenbury v. Teachers' & State Emps.' Ret. Sys. of N.C., 483 S.E.2d 422, 429 (N.C. 1997).

18. As Amy B. Monahan has recently demonstrated, even if state constitutions preclude reduction of retirement benefits, retirees might face considerable difficulty enforcing pension promises in court if legislatures refuse to appropriate the funds necessary to honor promises to retirees. *See* Amy B. Monahan, *When a Promise Is Not a Promise: Chicago-Style Pensions*, 64 UCLA L. REV. 356, 384–87 (2017).

19. *See* Amy B. Monahan, *State Fiscal Constitutions & The Law & Politics of Public Pensions*, 2015 U. ILL. L. REV. 117, 128 (2015).

20. *Id.*

21. *See, e.g.*, ALASKA STAT. § 14.25.320 (2018).

22. A cash balance plan mimics a defined contribution plan by guaranteeing the employee a lump sum account balance based on employee and employer contributions plus a stated rate of interest. Unlike a defined contribution plan, the employee owns no actual account; the employer assumes all funding and investment risk. *See* Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 499–500 (2004). For an example of a cash balance plan, see, e.g., KY. REV. STAT. ANN. § 16.583 (West 2018).

23. *See* FLA. STAT. § 121.4501(4)(b)(3) (2018). On the move towards defined contribution plans, see ALICIA H. MUNNELL ET AL., CTR. FOR ST. & LOC. GOV'T EXCELLENCE, DEFINED CONTRIBUTION PLANS IN THE PUBLIC SECTOR: AN UPDATE 3–6 (Apr. 2014), http://www.nasra.org/files/Topical%20Reports/Plan%20Design/Defined_Contribution_Plans_An_Update.pdf.

24. *See, e.g.*, VA. CODE ANN. § 51.1-169 (West 2018).

than necessary to keep pension plans funded on an actuarial basis, leaving funding problems for their successors.[25]

In the midst of the pension crisis, however, a number of states have maintained healthy plans that, by many measures, are nearly 100% funded.[26] Even in these states, pressures to control pension costs remain even though retirees and local officials can be confident that funds will be available to pay promised benefits.

Our focus is on a narrow but important question: does law matter? One hypothesis is that underfunding is all about politics, and that legal structures can do little or nothing to control the political incentive to prefer the interests of current voters over the interests of future taxpayers who may suffer the consequences of underfunded plans. Our study examines legal structures to see whether particular structures or legal constraints have been associated with greater or lesser success in avoiding pension underfunding.

We are not the first to consider the impact of legal structures on pension funding. Two extraordinarily valuable studies have preceded our own. Natalya Shnitser's empirical analysis of pension plan design found that a number of statutory and constitutional provisions correlate positively with a state's funding discipline.[27] Amy Monahan's study—focused on eight states in which state constitutional language requires pension funding—concludes that constitutional provisions themselves are not sufficient to ensure adequate pension funding.[28]

Although our study builds on the work of Professors Shnitser and Monahan, our approach is inductive. We focus on ten state pension plans—five of the best funded and five of the worst funded—and seek to identify legal structures in these states that shed light on the disparity in outcomes. Concentrating on ten states has allowed us to examine in greater detail the mechanics of the funding process, which has enabled us to identify features understandably difficult to examine in a study as broad as Professor Shnitser's.[29] One prominent example is the role of the judiciary in the funding process, an issue that would have been difficult for Professor Shnitser to code. Although Professor Monahan did focus on the role of the judiciary, her article limited itself to the states in which constitutional text

25. *See* FRANK RUSSEK, CONG. BUDGET OFF., THE UNDERFUNDING OF STATE AND LOCAL PENSION PLANS 3 (2011), https://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12084/05-04-pensions.pdf (noting the failure of states and localities to abide by their funding guidelines in times of budgetary stress).

26. *See* PEW PENSION FUNDING GAP 2016, *supra* note 5, at 2 (noting four states that were over 90% funded).

27. Natalya Shnitser, *Funding Discipline for U.S. Public Pension Plans: An Empirical Analysis of Institutional Design*, 100 IOWA L. REV. 663, 699 (2015).

28. Monahan, *supra* note 19, at 133–47.

29. Shnitser, *supra* note 27, at 665–66 (analyzing 110 state-administered public pension plans).

guaranteed pension funding,[30] while courts in some states have derived funding mandates from other constitutional provisions.[31]

We concede, as do Professors Shnitser and Monahan,[32] that proving causation in this area is nearly impossible, but we do identify some correlations that suggest that legal structures play a role in the financial health of state pension plans.[33] First, the timing of the state law commitment to actuarial principles correlates with the current level of plan funding; those states that made pension promises before considering the actuarial implications of those promises continue to face an uphill struggle decades later.[34] Second, state constitutional mandates—if enforced by the state judiciary—correlate positively with adequate pension funding. Third, pension funding is generally better in states whose statutes provide nonconstitutional institutional buffers between pensions and the rough-and-tumble of ordinary politics. Fourth, the provision of statutory mechanisms to enforce government obligations to contribute to retirement systems is strongly correlated with the health of state pension plans.

## II. BACKGROUND

### *A. Funding of State Plans*

Most states offer defined benefit plans to state employees.[35] Defined benefit plans promise employees specified retirement benefits upon retirement, generally based on salary and years of service.[36] The plans promise to pay the specified benefit without regard to the level of employee or employer contribution and without regard to the investment returns realized on those contributions.[37] Some states maintain a single defined benefit plan,[38] while most others have separately funded and managed plans for different categories of employees.[39] Teachers, police officers, and other

30. Monahan, *supra* note 19, at 134 (identifying criteria for inclusion in the study).

31. *See* discussion *infra* Subpart III.C.1.

32. Monahan, *supra* note 19, at 134–35 (noting the impossibility of accounting entirely for the "existing, endogenous features of the states themselves"); Shnitser, *supra* note 27, at 694 (noting "endogeneity as a possible concern").

33. *See* discussion *infra* Part III.

34. *See* discussion *infra* Subpart III.B.

35. *See* RUSSEK, *supra* note 25, at 2; RONALD SNELL, NAT'L CONFERENCE OF STATE LEGISLATURES, STATE CASH BALANCE, DEFINED CONTRIBUTION AND HYBRID RETIREMENT PLANS 1 (2012), http://www.ncsl.org/Portals/1/Documents/employ/State-DC-and-Hybrid-Plans-July2012.pdf.

36. RUSSEK, *supra* note 25, at 2; SNELL, *supra* note 35.

37. SNELL, *supra* note 35.

38. *See, e.g.*, WIS. STAT. § 40.20 (2018) (providing for consolidation of various retirement systems into the Wisconsin retirement system).

39. *See* Shnitser, *supra* note 27, at 667–68.

employees may participate in plans with different benefit structures.[40] Some municipal employees are covered by state pension plans; in other states, municipalities maintain their own separately funded plans for some or all municipal employees.[41]

Various studies track the financial health of state pension plans.[42] These studies use a variety of measures, the most common of which is the funding ratio: the value of the plan's assets divided by the plan's pension obligations.[43] Within each plan, the funding ratio may vary from year to year depending on a variety of factors, including the level of contribution, investment results, and changes in promised benefits.[44]

A plan's funding ratio incorporates a variety of contestable actuarial assumptions: at what age and at what salary will beneficiaries retire, how long will they live, and what investment returns will the pension fund generate.[45] The uncertainty surrounding these factors creates an opportunity for decisionmakers to adopt assumptions that make the funding ratio look more favorable, permitting fewer expenditures on pensions and more on current services that appeal to voters.[46] The appropriate rate of investment return for calculating the funding ratio is the subject of particular controversy.[47] In computing expected returns, states tend

40. *Id.*

41. *See generally* JEAN-PIERRE AUBRY ET AL., CTR. FOR RET. RESEARCH AT BOS. COLL., THE FUNDED STATUS OF LOCAL PENSIONS INCHES CLOSER TO STATES (2018), http://crr.bc.edu/wp-content/uploads/2018/01/slp58.pdf (discussing differences between state and local plans and including an appendix listing a variety of municipal pension plans).

42. *See, e.g.*, RACHEL BARKLEY, MORNINGSTAR, THE STATE OF STATE PENSION PLANS 2013: A DEEP DIVE INTO SHORTFALLS AND SURPLUSES (2013), http://etf.wi.gov/news/morningstar-report2013.pdf; SUSSAN S. CORSON ET AL., S&P GLOBAL RATINGS, U.S. STATE PENSIONS: WEAK MARKET RETURNS WILL CONTRIBUTE TO RISE IN EXPENSE 3–10 (Sept. 12, 2016), http://www.nasra.org/files/Topical%20Reports/Credit%20Effects/SPGlobalstates1609.pdf.

43. AM. ACAD. OF ACTUARIES, THE 80% PENSION FUNDING STANDARD MYTH 1 (2012), https://www.actuary.org/files/80_Percent_Funding_IB_071912.pdf [hereinafter THE 80% PENSION FUNDING STANDARD MYTH].

44. *Id.* at 2.

45. *See* Gang Chen & David S. T. Matkin, *Actuarial Inputs and the Valuation of Public Pension Liabilities and Contribution Requirements: A Simulation Approach* 4, 6–7 (Ctr. for Ret. Research at Bos. Coll., Working Paper No. 2017-4, 2017), http://crr.bc.edu/wp-content/uploads/2017/05/wp_2017-4-1.pdf.

46. *Id.* at 5.

47. Actuaries discount benefits based on the rate they expect the pension fund's portfolio will earn. *See* DONALD J. BOYD & YIMENG YIN, NELSON A. ROCKEFELLER INST. OF GOV'T, PUBLIC PENSION FUNDING PRACTICES: HOW THESE PRACTICES CAN LEAD TO SIGNIFICANT UNDERFUNDING OR SIGNIFICANT CONTRIBUTION INCREASES WHEN PLANS INVEST IN RISKY ASSETS 10–14 (2016), https://rockinst.org/wp-content/uploads/2018/02/2016-06-02-Pension_Funding_Practices.pdf. There is, however, debate over whether pensions should use lower

to use optimistic estimates that reduce the necessary contributions the state must make to pension funds.[48] Some believe that the appropriate rate should approach the much lower return rate on low-risk bond investments, given the near certainty that states will have to honor pension obligations.[49] Others disagree, concluding that the discount rate should reflect actual returns on investments the plans make, which are typically higher than the returns on low-risk bonds.[50]

Moreover, the funding ratio itself provides an incomplete measure of the plan's fiscal health.[51] A plan whose sponsor has financial strength will be better able to weather investment losses than a plan whose sponsor is unable to provide a safety net against investment losses.[52] A sponsor with a large payroll compared to its unfunded liability may be in less danger than a sponsor with a small payroll.[53] As incomplete and inaccurate as funding ratios may be as a measure of pension plan health, they remain a convenient yardstick for measuring the commitment of various states to provide adequate funding for state pensions.

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discount rates that reflect the certainty of future benefit payments. *See* Chen & Matkin, *supra* note 45, at 1.

48. *See* Chen & Matkin, *supra* note 45, at 5.

49. *See, e.g.*, Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSP. 191, 195 (2009); DONALD J. BOYD & PETER J. KIERNAN, NELSON A. ROCKEFELLER INST. OF GOV'T, STRENGTHENING THE SECURITY OF PUBLIC SECTOR DEFINED BENEFIT PLANS 7–9 (2014), http://www.californiacityfinance.com/BlinkenReport1401.pdf.

50. Public pensions hold more than half of their assets in equities and about 70% in risky assets. ALICIA H. MUNNELL ET AL., CTR. FOR RET. RESEARCH AT BOS. COLL., THE FUNDING OF STATE AND LOCAL PENSIONS: 2013-2017, at 1, 5 (2014), http://crr.bc.edu/wp-content/uploads/2014/06/slp_39.pdf; *see, e.g.*, Peter Mixon, *Estimating Future Costs at Public Pension Plans: Setting the Discount Rate*, PENSIONS & INV. (Apr. 29, 2015), http://www.pionline.com/article/20150429/ONLINE/150429853/estimating-future-costs-at-public-pension-plans-setting-the-discount-rate. For a general discussion of the alternatives, see RUSSEK, *supra* note 25, at 6–7.

51. The American Academy of Actuaries suggests that the soundness of a pension may also depend on the size of the pension obligation relative to the financial size of the plan sponsor, the financial health of the sponsor, the sponsor's funding policy, implementation of that policy, and the plan's investment strategy. THE 80% PENSION FUNDING STANDARD MYTH, *supra* note 43, at 2–3.

52. Mixon, *supra* note 50.

53. PEW CTR. ON THE STATES, THE TRILLION DOLLAR GAP: UNDERFUNDED STATE RETIREMENT SYSTEMS AND THE ROADS TO REFORM 53 (2010), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2010/trilliondollargapunderfundedstateretirementsystemsandtheroadstoreformpdf.pdf.

### *B. Why Prefund Pension Plans?*

Much of the literature on the crisis in state and local pension plans decries the underfunding of plans.[54] The underlying assumption is that pension plans should be prefunded, rather than operating on a pay-as-you-go basis.[55] That assumption merits exploration. The Employee Retirement Income Security Act of 1974 ("ERISA") requires prefunding of most private sector defined benefit plans.[56] Both history and logic provide support for that requirement. A private employer's promise to pay pension benefits is valuable only so long as the employer remains solvent. Congress enacted ERISA in part as a response to the lost pensions that resulted from the collapse of major employers.[57] Congress imposed the prefunding requirement to assure employees that their pension benefits would not be entirely dependent on their employer's solvency.[58]

By contrast, the nation's largest retirement plan—Federal Social Security—is not prefunded but operates on a pay-as-you-go basis.[59] Debate on the actuarial soundness of Social Security focuses not on

54. *See, e.g.*, Jeffrey Diebold et al., *Sweat the Small Stuff: Strategic Selection of Pension Policies Used to Defer Required Contributions*, 36 CONTEMP. ECON. POL'Y 505, 505–06 (2017); RICHARD W. JOHNSON ET AL., BROWN CTR. ON EDUC. POL'Y AT BROOKINGS, ARE PUBLIC PENSIONS KEEPING UP WITH THE TIMES? 19–20 (2013), https://www.brookings.edu/wp-content/uploads/2016/06/12-public-pensions-johnson-chingos-whitehurst.pdf.

55. *See* Jeffrey R. Brown et al., *The Economics of State and Local Pensions*, 10 J. PENSION ECON. & FIN. 161, 164 (2011).

56. *See* 29 U.S.C. § 1083(a)–(b) (2012).

57. For an account of one of the most notorious retirement plan collapses and its connection to ERISA, see generally James A. Wooten, *"The Most Glorious Story of Failure in the Business": The Studebaker-Packard Corporation and the Origins of ERISA*, 49 BUFF. L. REV. 683 (2001) (examining the history and termination of the Studebaker-Packard Corporation). For another account suggesting that the United Automobile Workers Union was fully aware of the risks associated with the Studebaker pension plan at the time of its negotiations with Studebaker, see JOHN H. LANGBEIN ET AL., PENSION AND EMPLOYEE BENEFIT LAW 81–82 (5th ed. 2010).

58. Pre-ERISA law imposed funding requirements as a prerequisite for obtaining corporate tax benefits, but it did not prevent an employer from maintaining an underfunded plan so long as the employer was willing to forego those tax benefits. *See* JAMES A. WOOTEN, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: A POLITICAL HISTORY 95–96 (2004). In practice, ERISA's prefunding requirement had an unintended consequence: it caused most private employers, over time, to abandon defined benefit plans in favor of defined contribution plans. *See* EMP. BENEFIT RESEARCH INST., THE WORLD OF PENSIONS TEN YEARS AFTER ERISA 5–6 (1984), https://www.ebri.org/docs/default-source/ebri-issue-brief/0984ib1.pdf?sfvrsn=a2c1292f_0. For an account of the decline of private sector defined benefit plans, see EDWARD A. ZELINSKY, THE ORIGINS OF THE OWNERSHIP SOCIETY: HOW THE DEFINED CONTRIBUTION PARADIGM CHANGED AMERICA 31–38 (2007).

59. *See* Martin Feldstein & Jeffrey B. Liebman, *Social Security* 5–7 (Nat'l Bureau of Econ. Research, Working Paper No. 8451, 2001).

the ratio between assets and liabilities of the so-called trust fund but instead on when the difference between benefits paid and payroll taxes collected will result in the fund's depletion.[60]

The primary reason for requiring prefunding of defined benefit plans—protecting retirees against insolvency—becomes less compelling when government is the employer. Government, unlike private employers, has the power to tax to fund the retirement benefits it has promised to its employees.[61] Nevertheless, prefunding of state pensions remains the preferred alternative[62] for several reasons.

First, state power to tax is not unlimited.[63] Because the population is mobile, a state whose tax burden becomes high relative to that of its neighbors risks losing those taxpayers in the best position to shoulder that burden.[64] A number of municipalities—most notably the City of Detroit—have already faced this problem, resulting in bankruptcy and cuts to pension benefits previously promised to city employees.[65]

Second, and perhaps most important, prefunding of pensions improves fiscal discipline by government officials.[66] A prefunding requirement forces officials to recognize the full cost of government employment rather than postponing payment until long after the benefits of that employment are realized.

Third, intergenerational equity concerns militate in favor of prefunding. Prefunding ensures that the tax burden associated with

60. *See* Soc. Sec. & Medicare Bds. of Trs., *A Summary of the 2018 Annual Reports*, SOC. SEC. ADMIN., https://www.ssa.gov/oact/trsum (last visited Feb. 25, 2019) (estimating depletion of combined trust funds in 2034).

61. *See* 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, 1705 (2011) (noting that state governments could fund pension liabilities by raising taxes).

62. *See* Jonathan Barry Forman, *Funding Public Pension Plans*, 42 J. MARSHALL L. REV. 837, 841–42 (2009).

63. *See* 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, 303–04 (1993) (discussing the various constraints on state taxation powers).

64. A recent study suggests that the fear of state-to-state migration by wealthy taxpayers may be overstated. Data suggests that top-income earners may be "embedded elites" who are reluctant to move from the places in which they have been successful, with a single exception: a tendency to move from higher-tax states to Florida. Cristobal Young et al., *Millionaire Migration and Taxation of the Elite: Evidence from Administrative Data*, 81 AM. SOC. REV. 421, 431–32 (2016).

65. *See In re* City of Detroit, 838 F.3d 792, 796, 798 (6th Cir. 2016) (upholding a bankruptcy settlement that reduced pensions by 4.5% and eliminated cost of living adjustments).

66. *See* Alicia H. Munnell et al., *Public Pension Funding in Practice* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 16442, 2010).

government services is borne by the generation that benefits from those services.[67] By contrast, a pay-as-you-go system requires a future generation to bear the costs of current services—a problem that becomes especially serious if officials provide generous retirement benefits to current employees in lieu of salaries that would have to be paid out of current tax dollars.[68]

Finally, funding pensions on a pay-as-you-go basis may be more expensive for taxpayers than prefunding those pensions, although there is room for debate on the issue. When plans are fully funded, today's tax dollars are used to generate investment returns, from which future pensions will ultimately be paid.[69] By contrast, if pensions are funded on a pay-as-you-go basis, today's taxpayers will have a lighter tax burden now, but future taxpayers will have to pay the bill when employees retire. If pension funds can generate a higher return on investments than taxpayers would realize on savings from lower current taxes—because of some combination of expertise, bargaining power over investment fees, and greater risk tolerance[70]—prefunding will ultimately reduce the total burden on taxpayers. On the other hand, if taxpayers are typically borrowers, and prefunding, by raising their current tax burden, causes them to borrow more on credit cards or car loans at interest rates exceeding the returns achieved by pension plans, prefunding would be more expensive than funding pensions on a pay-as-you-go basis.[71]

Although these concerns support prefunding state pensions, intergenerational equity concerns militate against immediate transformation of underfunded plans into fully funded plans. An immediate transformation would place all of the costs associated with a prior generation's profligacy on current taxpayers. To mitigate this problem, states could (and many do) amortize unfunded liability over a period of time—often thirty years—as a means of spreading the burden of restoring a pension plan to fully funded status.[72]

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67. *See* RUSSEK, *supra* note 25, at 9; BOYD & YIN, *supra* note 47, at 1.

68. *See Pay Now or Pay Later*, ECONOMIST (June 15, 2011), https://www.economist.com/free-exchange/2011/06/15/pay-now-or-pay-later.

69. *See* Richard H. Mattoon, *Issues Facing State and Local Government Pensions*, ECON. PERSPECTIVES 2, 4 (2007) (noting that investment returns are the largest source of revenue for most state pension plans).

70. *See* Paul J. Heald, *Mowing the Playing Field: Addressing Information Distortion and Asymmetry in the TRIPS Game*, 88 MINN. L. REV. 249, 307 (2003) (noting that governments often have more bargaining power than individuals or large businesses in contract negotiations).

71. *See* Henning Bohn, *Should Public Retirement Plans be Fully Funded?* 35 (Nat'l Bureau of Econ. Research, Working Paper No. 16409, 2010).

72. *See* DAVID KAUSCH & PAUL ZORN, GABRIEL ROEDER SMITH & CO., DEVELOPING A PENSION FUNDING POLICY FOR STATE AND LOCAL GOVERNMENTS 4–5 (2012) (discussing amortization methods for state and local government pension plans).

### C. The Politics of Pension Funding

Prefunding of pensions is more attractive as a matter of principle than as a matter of politics. As Professor Jack Beermann has observed, underfunding of pensions has the same attraction as deficit financing in general: it allows government officials to take credit for current services while deferring payment until they leave office.[73] Politicians may find it particularly attractive to make unfunded pension promises for two reasons: first, they, as office holders, may benefit from the pensions,[74] and second, government employees who do benefit from pensions are often an important voting and lobbying bloc.[75]

Conversely, no significant political force is likely to emerge as a pension watchdog. First, the ultimate costs of unfunded pensions are diffused among a large body of taxpayers, none of whom has an individual interest that compares to the interest of pension beneficiaries.[76] Second, pension underfunding is far from transparent. Uncovering questionable actuarial assumptions that underlie funding decisions is beyond the capacity of most citizens.[77]

Finally, even officials who are generally committed to adequate pension funding face another problem: the countercyclical nature of the need for pension funding. When the economy generates healthy investment returns, tax revenues tend to rise, making funds more readily available for pension funding.[78] But healthy investment returns reduce the need for pension funding, creating incentives for officials to spend tax revenues on other services.[79] Then, when investment returns and tax revenues fall, pension funding becomes more critical, but fiscal stress generates incentives to avoid pension funding obligations.[80]

### D. Disparities Among the States

Because our objective is to examine the correlation between the health of state pension plans and the legal structures that govern

73. *See* Beermann, *supra* note 11, at 27.

74. *See* David A. Skeel, Jr., *States of Bankruptcy*, 79 U. Chi. L. Rev. 677, 692 (2012).

75. *See* Beermann, *supra* note 11, at 27.

76. *See id.*

77. *See generally* Steven W. Thornburg & Kirsten M. Roberts, *Accounting, Politics, and Public Pensions*, CPA J. (May 2018), https://www.cpajournal.com/2018/05/18/accounting-politics-and-public-pensions/ (discussing the complexities and accuracy of actuarial assumptions underlying public pensions).

78. *See* Greg Mennis & Stephen Fehr, *States Turn to New Tool to Sustain Pension System Funding*, Pew Charitable Trs. (May 16, 2018), https://www.pewtrusts.org/en/research-and-analysis/articles/2018/05/16/states-turn-to-new-tool-to-sustain-pension-system-funding.

79. *Id.*

80. *Id.*

those plans, we had to separate healthy plans from unhealthy ones. Determining the funding level of pension plans is not an exact science. Overly optimistic actuarial assumptions can create the appearance of funding that does not match the reality.[81] In addition, the funding ratio of a plan varies over time, depending on investment results and contributions made to the plan.[82]

Moreover, the overall health of a state's pension plan may depend not only on the funding ratio but also on the relationship between the plan's unfunded liability and the state's population.[83] Unfunded liability per capita measures the tax burden each state resident would have to bear to bring the state's pension plan to the level of full funding.[84]

Discussion of a state's pension plan is itself an oversimplification. Many states have multiple plans covering different categories of employees, and often municipal employees are covered by municipal plans governed separately from plans maintained by the state.[85] In a number of states, there are significant differences in the funding ratios for different plans.[86]

By any measure, however, some state retirement systems are far healthier than others. In a recent study, Standard & Poors ("S&P") aggregated the plans maintained by each individual state and then compared the funding ratios across states.[87] The study revealed a range of funding ratios for fiscal year 2015 ranging from 104.1 in South Dakota to 37.4 in Kentucky.[88] Other studies have found

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81. *Id.*

82. *See, e.g.*, PEW PENSION FUNDING GAP 2016, *supra* note 5, at 11.

83. JEAN-PIERRE AUBRY & CAROLINE V. CRAWFORD, CTR. FOR RET. RES. AT BOS. COLL., DOES PUBLIC PENSION FUNDING AFFECT WHERE PEOPLE MOVE? 1 (2016), http://crr.bc.edu/wp-content/uploads/2016/10/slp_52.pdf.

84. BOB WILLIAMS ET AL., AM. LEGISLATIVE EXCH. COUNCIL, UNACCOUNTABLE AND UNAFFORDABLE 2016: UNFUNDED PUBLIC PENSION LIABILITIES NEAR $5.6 TRILLION 2 (2016), https://www.alec.org/publication/pensiondebt2016/.

85. The Public Plans Database provides data on 114 pension plans administered on the state level and sixty-six administered by local governments. *Downloadable Data*, PUB. PLANS DATA, http://publicplansdata.org/public-plans-database/download-full-data-set/ (last visited Feb. 25, 2019). The Database estimates that its sample covers 95% of public pension memberships and assets. *Id.*

86. In Kentucky, for instance, although all state plans are poorly funded, the Kentucky Employee Retirement System (KERS) had a funded ratio of 18.9%, while the Kentucky County Retirement System, covering different employees, has a funded ratio of 58.7%. *State Data: Kentucky*, PUB. PLANS DATA, http://publicplansdata.org/quick-facts/by-state/state/?state=KY (last visited Feb. 25, 2019).

87. CORSON ET AL., *supra* note 42, at 14–15.

88. *Id.* at 8. The S&P calculations were based on information reported by the Government Accounting Standards Board ("GASB") statements 67 and 68. *Id.* at 5.

similar disparities.[89] Because the pension plans in South Dakota and Wisconsin were more than fully funded, the unfunded pension liability per capita in fiscal year 2015 was below zero.[90] By contrast, in Illinois and New Jersey, the unfunded pension liability per capita exceeded $9,000.[91] That is, eliminating the unfunded liability of those plans through taxation would require tax payments of more than $9,000 for every adult and child living in the state.

TABLE: PENSION LIABILITIES AND RATIOS FOR SELECTED STATES

| State | Funded Ratio | Net Pension Liability per Capita ($) |
|---|---|---|
| Connecticut | 49.4 | 7,660 |
| Florida | 92.0 | 113 |
| Illinois | 40.2 | 9,078 |
| Kentucky | 37.4 | 7,046 |
| New Jersey | 37.8 | 10,468 |
| New York | 98.1 | 74 |
| North Carolina | 94.6 | 169 |
| Rhode Island | 55.5 | 3,051 |
| South Dakota | 104.1 | (109) |
| Wisconsin | 102.7 | (119) |

For purposes of this Study, we selected the five states whose plans are best funded and the five states whose plans are worst funded, as identified in the S&P study.[92] Other studies, often focused on different years, might have slightly different rankings, but in virtually every study, South Dakota, Wisconsin, New York, Florida, and North Carolina rank near the top, and Illinois, New Jersey, Connecticut, Kentucky, and Rhode Island rank near the bottom.[93] We have therefore focused our attention on these ten states.

89. *See, e.g.*, ALICIA H. MUNNELL & JEAN-PIERRE AUBRY, CTR. FOR RET. RESEARCH AT BOS. COLL., THE FUNDING OF STATE AND LOCAL PENSIONS: 2015-2020, 2–3 (2016) http://crr.bc.edu/wp-content/uploads/2016/06/slp_50-1.pdf.

90. CORSON ET AL., *supra* note 42, at 15.

91. *Id.* at 14–15.

92. The S&P rankings were based on funding ratio alone, but an examination of pension debt per capita reveals similar trends. The five "top" states had net pension liability per capita of under $200, while four of the five "bottom" states had net pension liability per capita of over $7,000. *Id.* The national median was $790, and the national average was $1,870. *Id.*

93. *See, e.g.*, PEW PENSION FUNDING GAP 2015, *supra* note 5, at 6–8 (South Dakota, Wisconsin, New York, and North Carolina are the four best-funded plans, and Florida is in the top ten; Kentucky, New Jersey, Illinois, and Connecticut are the four worst-funded plans, and Rhode Island is in the bottom ten); PEW PENSION FUNDING GAP 2016, *supra* note 5, Appendix B (Wisconsin South Dakota, and New York remain among the four best-funded plans;

## III. THE IMPACT OF LAW

### A. *Introduction*

In examining the impact of law on funding state retirement plans, we face a preliminary question: what counts as law? Law determines how state officials are elected or selected. So, in a sense, law is responsible for all decisions affecting retirement funding, including the selection of retirement fund investments, the actuarial assumptions about employee longevity and expected investment returns, and the decision to appropriate—or not appropriate—funds needed to meet statutory requirements.

Our focus is, however, narrower. We examine legal rules embodied in statutes, constitutional provisions, and court decisions governing retirement funding. A caveat is necessary: we do not pretend to have examined all legal rules that might affect plan funding. For instance, the shape of the state's limitations on state debt[94] or the structure of the collective bargaining process with state employees[95] could conceivably affect the adequacy of retirement funding. It would be impossible to design a study of all legal rules

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Kentucky, New Jersey, Illinois, and Connecticut remain the four worst-funded plans); BARKLEY, *supra* note 42, at 13–19 (Florida, New York, North Carolina, South Dakota, and Wisconsin are among the seven states with funding ratios exceeding 85%; Connecticut, Illinois, and Kentucky are the only states with funding ratios below 50%). The American Legislative Exchange Council, a group of conservative legislators that evaluated funding ratios using a risk-free rate of return, concluded that all states but Wisconsin had funding ratios below 50%, but they nevertheless concurred with the prevailing data analysis about which states were strongest and weakest. Michael Katz, *Report: Only One US State Pension has Funded Level Above 50%*, CHIEF INVESTMENT OFFICER (Dec. 29, 2017), https://www.ai-cio.com/news/report-one-us-state-pension-funded-level-50. Wisconsin, South Dakota, New York, and North Carolina were in the top five, while Connecticut, Kentucky, Illinois, and New Jersey were in the bottom five. *Id.*

94. Most states do not treat the obligation to pay retirement plan benefits as a state debt, but the New Jersey Supreme Court has held that a statutory obligation to provide future funding for those benefits would constitute a debt prohibited by the state constitution. *See* Burgos v. State, 118 A.3d 270, 275 (N.J. 2015); *see generally* Barbara A. Chaney et al., *The Effect of Fiscal Stress and Balanced Budget Requirements on the Funding and Measurement of State Pension Obligations*, 21 J. ACCT. & PUB. POL'Y 287 (2002) (finding that balanced budget amendments correlate with poor pension funding); Stewart E. Sterk & Elizabeth S. Goldman, *Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations*, 1991 WIS. L. REV. 1301 (1991) (discussing the variety of state court interpretations on debt limitations).

95. One could hypothesize that the right to strike has an effect on the benefits employees might obtain, which in turn might have an impact on the adequacy of retirement funding. For instance, New York's Taylor Law precludes strikes by public employees. N.Y. CIV. SERV. LAW §210 (McKinney 2018); *see* Hylton, *supra* note 1, at 472–82 (discussing the effect of collective bargaining on public pensions).

that could conceivably affect retirement plan funding. We believe we have concentrated on the legal rules most likely to be relevant to plan funding.

### *B. When Did Statutes Mandate Actuarial Funding?: The Legacy Cost Problem*

Imagine a state establishing a funded retirement system from scratch—at a time before the state has made any (or many) retirement promises to its employees. Funding the plan on an actuarially sound basis requires the state to ensure that, each year, some combination of state and employee contributions cover the normal cost of the retirement benefits employees earned in that year, which is the difference between the present value of the accrued benefits at the end of the year and the present value of those benefits at the end of the preceding year.[96] Over time, overly optimistic actuarial assumptions might require contributions to cover unfunded liability, but unless the assumptions are systematically overoptimistic, unfunded liability should not significantly increase the funding burden facing the state.[97]

By contrast, suppose the state has been making—but not funding—retirement promises to employees for decades, and the state later seeks to ensure that the plan is fully funded. The state now needs to ensure that contributions cover both normal costs and, over time, the unfunded liability created by the years during which the state made no contributions at all. Depending on the magnitude of the state's promises and the length of delay in funding those promises, the cost of bringing the plan to full funding requires a significant infusion of cash,[98] even if the state amortizes those costs over a long period of time.

As a result, one would expect state pension plans to be better funded in those states that imposed actuarial funding requirements before promising significant retirement benefits to employees. An examination of practices in the aforementioned ten states demonstrates that the states whose plans are fully funded enacted statutes requiring actuarially based funding at a relatively early stage.[99] Similarly, the states whose laws did not mandate actuarially

96. *See, e.g.*, William Farrimond & Duane L. Mayer, Actuarial Cost Methods, A Review 1 (3d ed. 1999) ("[T]he Normal Cost under any type of plan formula . . . is the difference in the Present Values of the Accrued Benefit from time t to (t + 1).").

97. *See* Chen & Matkin, *supra* note 45, at 4, 6–7.

98. *See* Pew Ctr. on the States, The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform 15, 18, 21 (2010), https://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2010/trillion dollargapunderfundedstateretirementsystemsandtheroadstoreformpdf.pdf (discussing the trillion-dollar gap and various solutions to closing that gap).

99. *See infra* pp. 122–24.

sound funding practices generally have underfunded plans.[100] But the correlation is not perfect; some states that mandated actuarial funding at an early stage nevertheless find themselves with seriously underfunded plans.[101]

Statutes in Wisconsin,[102] New York,[103] and North Carolina[104] have required that state pensions be funded on an actuarially sound basis for more than sixty years, well before the trend towards liberalization of state pension benefits that occurred beginning in the 1970s.[105] South Dakota's statutory requirement for actuarial soundness dates to 1974,[106] and Florida's requirement was introduced through a constitutional amendment enacted in 1976 as a direct response to the legislature's then-recent extension of benefits without providing for adequate funding.[107] South Dakota's statute required a report to the legislature and governor if the funding ratio fell below 90%,[108] while Florida enacted a statute guaranteeing that state contributions would be sufficient to cover all normal costs and to amortize unfunded liability.[109]

By contrast, during the same period, Connecticut and Rhode Island purported to embrace actuarial soundness in principle, but nevertheless they enacted statutes certain to increase unfunded liability, thereby creating a growing problem of legacy costs. The Connecticut statute directed the retirement commission to determine, on an actuarial basis, the normal contribution and unfunded liability.[110] But the statute provided that once the commission determined the contribution necessary to provide for normal cost, plus a forty-year amortization of unfunded liabilities, the state would be required to contribute only 30% of that amount in 1971, the year the statute was enacted.[111] It would only require 35% the following year, until fifteen years later, when the required contribution was to reach 100%.[112] The nearly inevitable result was a substantial

100. *See infra* pp. 122–24.
101. *See infra* pp. 122–24.
102. WIS. STAT. § 40.05 (2018).
103. N.Y. RETIRE. & SOC. SEC. LAW § 23 (McKinney 2015).
104. N.C. GEN. STAT. § 135-8 (2017).
105. *See, e.g.*, Tom Bryan, *The New Jersey Pension System*, *in* PENSIONS IN THE PUBLIC SECTOR 327, 330–31 (Olivia S. Mitchell & Edwin C. Hustead eds., 2001) (providing a compilation of pension liberalizations enacted in New Jersey alone from 1970 through 1992).
106. 1974 S.D. Sess. Laws ch. 35 § 75 95 (codified as amended at S.D. CODIFIED LAWS § 3–12–122 (2017)).
107. FLA. CONST. art. 10, § 14.
108. 1974 S.D. Sess. Laws ch. 35 § 75 95.
109. 1978 Fla. Laws 567 (codified as amended at FLA. STAT. § 112.63 (2018)).
110. CONN. GEN. STAT. § 5–156a (2018).
111. *Id.*
112. *Id.* Connecticut enacted a similar statute regarding the Teacher's Retirement System in 1979, directing the Teacher's Retirement System Board to

increase in unfunded liability during that fifteen-year period.[113] Rhode Island pursued a similar course in 1976, enacting a statute that would not require state contributions to meet even normal costs until 1985.[114] Subsequent Rhode Island statutes compounded the problem. In 1989, the legislature enacted a statute providing that the unfunded liability contribution would not increase at a rate higher than the inflation rate,[115] and, in 1994, the legislature retreated from even the pretense of actuarial soundness, enacting a statute that stated that "nothing shall preclude the state of Rhode Island from making its contribution to the unfunded liability in a manner deemed appropriate by the state of Rhode Island."[116]

Illinois did not even purport to place its pension plan on an actuarial basis until 1989.[117] Until that time, Illinois financed its plan on a pay-as-you-go basis, and state contributions did not even match the amounts paid out in benefits.[118] The 1989 legislation required the state to pay normal costs and to amortize unfunded liability over forty years, but, like Connecticut and Rhode Island,

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determine, on an actuarial basis, the normal cost and unfunded liability of the fund. 1979 Conn. Acts 609 (Reg. Sess.). But the statute provided for only 35% contribution in 1981 and only 40% the following year, with the required contribution reaching 100% fourteen years later in 1974. In 1985, the statute was amended to contract the time for full payment of the actuarially determined contribution rate from 1992 to 1994. 1985 Conn. Acts 1203 (Reg. Sess.) (as amended CONN. GEN. STAT. § 10–183z (2018)).

113. Jean-Pierre Aubry & Alicia H. Munnell, *Forensics and the Future of a Connecticut Pension Plan*, *State and Local Pension Plans*, CTR. FOR RETIREMENT RES. (Dec. 2015), http://crr.bc.edu/wp-content/uploads/2015/11/slp_46.pdf.

114. 1976 R.I. Pub. Laws 1369 (codified as amended at 36 R.I. GEN. LAWS § 36–10–2 (2011)). It bears noting that in 1936, Rhode Island had a statutory provision that required actuarially determined payments to make up for deficiencies in employee and other contributions. 18 R.I. GEN. LAWS § 18–5–3 (1938). In 1947, the statute was amended to require only sufficient funding for a period of ten years. R.I. GEN. LAWS § 5-2 (1947). A 1974 actuarial report on the Rhode Island Retirement System explained the certain dangers of continuing to underfund state pension liability, and the report identified a clear path forward for correcting the problem. A.A. WEINBERG, REPORT ON AN ACTUARIAL VALUATION OF THE SYSTEM AS OF JUNE 30, 1974 (1974). Instead of addressing the underfunding problem, however, the legislature passed the 1976 amendment, funding current service costs at 68% and funding interest on unfunded liability at only 25%, only reaching normal cost funding level in 1985. 1976 R.I. Pub. Laws 1369 (codified as amended at 36 R.I. GEN. LAWS § 36–10–2 (2011)).

115. 1989 R.I. Pub. Laws 330–31.

116. 1994 R.I. Pub. Laws 314.

117. 1989 Ill. Laws 2008, 2010.

118. *See* Eric M. Madiar, *Illinois Public Pension Reform: What's Past is Prologue*, 31 ILL. PUB. EMP. REL. REP. 1, 12–13 (2014) (noting that during the 1980s, the State often paid 60% of the value of the benefits paid out in contributions).

Illinois phased the requirement in over seven years.[119] Ultimately, the state did not make the statutorily required contributions.[120]

By the time Connecticut, Rhode Island, and Illinois were scheduled to contribute all normal costs and an amortized portion of unfunded liability, the cost of those contributions had become politically unpalatable, and the result in each state was further growth in unfunded liability.[121] Nevertheless, the disparity between well-funded plans and poorly funded plans cannot be explained entirely by the legacy costs resulting from late adoption of an actuarial foundation for pension funding. Kentucky and New Jersey, two of the worst-funded plans in the country,[122] required actuarially determined employer contributions two decades before Florida and South Dakota.[123] New Jersey's statute dates from 1954;[124] Kentucky's statute dates from 1956.[125] The experience in both states establishes that an early commitment to actuarially sound funding is not, by itself, sufficient to avoid severe underfunding. Kentucky's plans were reasonably well funded as recently as 2002.[126] Their deterioration was the result of a combination of actuarial back-loading, modified actuarial assumptions, weak investment returns, and the failure to make even the inadequate contributions necessary to comply with the flawed actuarial assumptions.[127] New Jersey's problems started earlier, with a 1992 revaluation of pension plan assets[128] that lowered the state's required contribution, a 1994 adjustment of actuarial funding methodology,[129] unwise investment decisions,[130] and a failure to make statutorily required contributions.[131]

119. 1989 Ill. Laws 2008.

120. Madiar, *supra* note 118, at 12–16.

121. *Compare* R.I. Pub. Laws 330–31, *with* Aubry & Munnell, *supra* note 113, *and* Madiar, *supra* note 118, at 14.

122. John Reitmeyer, *S&P Notes Progress but Ranks NJ's Among Worst-Funded Pension Systems*, NJ Spotlight (Nov. 1, 2018), https://www.njspotlight.com/stories/18/10/31/s-p-notes-progress-but-still-ranks-nj-among-worst-funded-public-pension-systems/.

123. 1956 Ky. Acts 191; 1954 N.J. Laws 488–89.

124. 1954 N.J. Laws 488–89.

125. 1956 Ky. Acts 184.

126. Commonwealth of Ky., *supra* note 3, at 56 (noting that in 2002 two of the state's plans were 100% and 90% funded).

127. *Id.* at 56–63.

128. 1992 N.J. Laws 534.

129. 1994 N.J. Laws 433.

130. *See* Hall Inst. of Pub. Pol'y, History and Future of New Jersey Pensions 4–5 (2009), https://www.nasra.org/files/State-Specific/New%20Jersey/NJ_inv.pdf.

131. *See* Burgos v. State, 118 A.3d 270, 301 (N.J. 2015) (Albin, J., dissenting) (noting that between 1997 and 2012, New Jersey had paid less than 10% of its statutorily required contributions).

### *C. Judicial Construction of State Constitutions*

#### *1. Constitutional Protection of Pension Funding*

In a previous study, Professor Monahan concluded that states whose constitutions provide clear and concrete guaranties of pension funding do not have materially better funding discipline than states without those guaranties.[132] Professor Monahan's focus was on constitutions whose language explicitly protects pension funding.[133] Rather than focusing on constitutional language, we have examined judicial interpretation of state constitutional provisions, including constitutions that do not explicitly mandate funding of pensions. Our conclusion is that when courts interpret constitutional provisions to preclude legislative interference with pension funding mandates, their decisions can have a significant impact on the adequacy of state pension funding.

New York's constitution does not expressly mandate actuarially sound pension contributions; instead, the constitution deems the state retirement system to be a "contractual relationship, the benefits of which shall not be diminished or impaired."[134] At the time the state constitutional provision was enacted, the State Comptroller, an elected official whose sole responsibilities relate to maintaining the state's fiscal integrity,[135] acted as the trustee of the state's retirement system.[136] As a result of a fiscal crisis in the 1970s, the New York legislature enacted a statute requiring the State Comptroller to invest a percentage of retirement plan assets in bonds issued by a financial intermediary created to help New York City stave off bankruptcy.[137] In *Sgaglione v. Levitt*,[138] the New York Court of Appeals held the statute invalid.[139] The *Sgaglione* court concluded that depriving the trustee of independent judgment to determine how retirement funds should be invested violated the state constitution's impairment clause.[140] The court indicated that although the impairment clause explicitly protects benefits, protection of the source of funding is "necessarily implied."[141] The Court of Appeals reaffirmed that conclusion two decades later when the legislature attempted to change the pension plan's funding method from the

132. Monahan, *supra* note 19, at 147.
133. *Id.* at 134.
134. N.Y. CONST. art. V, § 7.
135. *Id.* § 1.
136. *Id.*
137. New York State Financial Emergency Act for The City of New York, N.Y. UNCONSOL. LAW ch. 22 §14, (LexisNexis 2019).
138. 337 N.E.2d 592 (N.Y. 1975).
139. *Id.*
140. *Id.* at 594.
141. *Id.*

aggregate cost method to the projected unit cost method[142] and extended the state's "smoothing" method to a five-year period rather than a four-year period.[143] In *McDermott v. Regan*,[144] a unanimous Court of Appeals held that these mandates, which would have reduced the funding the State would have to contribute, deprived "the Comptroller of his personal responsibility to maintain 'the security of the sources of benefits' of the pension fund."[145]

Like New York's constitution, North Carolina's constitution does not expressly mandate actuarial funding.[146] Instead, it provides that neither the State, nor any state agency, officer, or public employee, may "use," apply, divert, or loan any part of the state's retirement funds for any purpose other than the retirement system's benefits.[147] Like the New York Court of Appeals, a North Carolina appellate court construed this provision to protect pension funds against legislative meddling.[148] However, when facing a budget deficit, the Governor of North Carolina issued an executive order placing state employer pension contributions in escrow so that the funds could be applied to address the deficit.[149] In *Stone v. State*,[150] a North Carolina Court of Appeals invalidated the order.[151] The court determined that both the Contract Clause of the United States Constitution, and North Carolina's constitutional limit on diversion of retirement plan assets, precluded payment of contributions into an escrow account and mandated that the funds be paid directly into the state's pension plans.[152]

These decisions are particularly significant because they are not abstract statements about the constitutional inviolability of the state's pension funds. In each case, the court responded to a concrete legislative effort to reduce pension funding in order to meet other budgetary needs by mandating payment to the pension fund.[153] Although it would be impossible to establish that these decisions are the primary cause for the relative health of the New York and North Carolina state pension plans, the decisions were, at the very least, a "but for" cause of adequate pension funding. Of course, in states like

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142. The change was from an aggregate cost method, which resulted in funding some benefits before they were accrued, to one where funding would only be applied when benefits were accrued.

143. McDermott v. Regan, 624 N.E.2d 985, 987 (N.Y. 1993).

144. *Id.* at 985.

145. *Id.* at 989.

146. *See generally* N.C. CONST. art. V (containing no explicit actuarial funding requirement).

147. *Id.* § 6, cl. 2.

148. Stone v. State, 664 S.E.2d 32, 40–42 (N.C. Ct. App. 2008).

149. N.C. Exec. Order No. 3, Budget Administration (Feb. 8, 2001).

150. *Stone*, 664 S.E.2d at 32.

151. *Id.*

152. *Id.*

153. *See id.*; *see also* Sgaglione v. Levitt, 337 N.E.2d 592, 595–96 (N.Y. 1975).

Wisconsin and South Dakota, where the legislatures consistently funded pension plans,[154] there was little reason for judicial challenge, and courts have played little role in maintaining adequate funding.[155]

By contrast, courts in three of the states with the worst-funded pension plans have explicitly rejected arguments that their state constitutions mandate state pension contributions. The supreme courts in New Jersey, Illinois, and Kentucky have held that their state legislatures have no, or at least limited, obligations to make contributions to fund their state pension systems.[156]

The New Jersey Supreme Court in *Burgos v. State*[157] held that the debt limitation clause in the New Jersey Constitution trumped the legislature's purported contract obligation to make the appropriations necessary to meet annual required contributions to the pension fund.[158] In 2011, the state legislature enacted a statute purporting to give retirement system members a contractual right to have the State make annual required contributions to the state retirement fund.[159] When, only three years later, the government invoked a revenue shortfall as the basis for failing to make the required contribution, plan members brought suit, invoking the Contract Clauses of the Federal and State Constitutions.[160] The court rejected the claim, finding that the legislature had "no authority to enact an enforceable and legally binding long term financial agreement" to fund the state pension plans.[161] Although *Burgos* itself was decided long after New Jersey's pension crisis had unfolded, earlier New Jersey decisions had demonstrated reluctance to bind government bodies to contractual obligations.[162]

The Illinois Constitution includes a pension protection clause modeled on a provision in the New York Constitution.[163] Unlike the

154. *See, e.g.*, *infra* notes 201, 237–45.

155. *See, e.g.*, PEW PENSION FUNDING GAP 2016, *supra* note 5, at Fig. 1 (detailing how both Wisconsin and South Dakota had "at least 90% of the assets needed to pay promised benefits[.]").

156. *See infra* notes 157–71 and accompanying text.

157. 118 A.3d 270 (N.J. 2015).

158. *Id.* at 274–76.

159. N.J. STAT. ANN. § 43:3C–9.5(c) (West 2018).

160. Hilary Russ, *NJ Governor Christie to Cut Pension Payments to Balance Budget*, REUTERS (May 20, 2014, 3:17 PM), https://www.reuters.com/article/us-usa-new-jersey-budget/nj-governor-christie-to-cut-pension-payments-to-balance-budget-idUSBREA4J0TW20140520.

161. *Burgos*, 118 A.3d at 275.

162. *See* Spina v. Consol. Police & Firemen's Pension Fund Comm'n, 197 A.2d 169, 171 (N.J. 1964) (holding no binding contract when the statute provided that a "governing body shall include in any tax levy a sum sufficient to meet the requirements of said fund.").

163. ILL. CONST. art. XIII, § 5. ("Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."); *see* ROBERT TILOVE,

New York Court of Appeals, however, the Illinois Supreme Court has held, in *People Ex. Rel. Sklodowski v. State*,[164] that "the pension protection clause creates enforceable contractual rights only to receive benefits, not control funding."[165] In that case, beneficiaries of various Illinois pension funds brought suit to require contributions at the level previously mandated by the State Pension Code.[166] The court rejected the claim, finding that the pension funding provisions were not part of the constitutional mandate.[167]

The Kentucky Constitution includes no pension protection clause,[168] and the state legislature never made a funding promise akin to the New Jersey legislature's 2011 promise, but Kentucky statutes did purport to make the promise of retirement benefits an "inviolable contract" with plan beneficiaries.[169] In 1992, after the governor and legislature changed the actuarial valuation method used by the state's retirement board to determine contributions, the retirement board challenged the legislature's right to interfere with its determination.[170] The Kentucky Supreme Court in *Jones v. Board of Kentucky Retirement Systems*[171] found that the change, which significantly reduced the state contributions to meet pension benefits costs, did not amount to a "substantial impairment" of the contract to ultimately pay retirement benefits.[172] Although at the time of the Kentucky decision, the state's pension plan was well funded,[173] the precedent set by the state's highest court was never again challenged.[174] In the years following this decision, the Kentucky legislature, seemingly emboldened by the decision in *Jones*, made

PUBLIC EMPLOYEE PENSION FUNDS 337 (1976) (concluding that the Illinois provision was copied almost verbatim from New York's constitution of 1938).

164. 695 N.E.2d 374 (Ill. 1998).

165. *Id.* at 378. The Illinois Supreme Court struck down a legislative reduction of pension benefits as a violation of the state constitution's pension protection clause. *In re* Pension Reform Litigation, 32 N.E.3d 1,4 (Ill. 2015).

166. *People ex. rel. Sklodowski*, 695 N.E.2d at 374.

167. *Id.* at 379.

168. *See generally* KY. CONST.

169. KY. REV. STAT. ANN. § 61.692 (West 2018).

170. Jones v. Board, 910 S.W.2d 710, 712 (Ky. 1995).

171. *Id.*

172. *Id.* at 716. In contrast to the New York Court of Appeal's decision in *McDermott*, the Court in *Jones* rejected the argument that the refusal to make the contributions recommended by the Retirement Systems Board and the modification of the valuation method for determining contributions violated Section 19 of the Kentucky Constitution—which prohibits "any law impairing the obligation of contract"—or the Contracts Clause in § 10 of the United States Constitution.

173. COMMONWEALTH OF KY., *supra* note 3, at 98.

174. For a discussion concerning litigation risk with respect to public pensions and protection clauses, see Kenneth T. Cuccinelli, E. Duncan Getchell, Jr., & Wesley G. Russell, Jr., *Judicial Compulsion and The Public Fisc – A Historical Overview*, 35 HARV. J. L. & PUB. POL'Y 525, 534–38 (2012).

underfunded contributions into the Kentucky State Retirement System year after year.[175]

The court decisions in New Jersey, Illinois, and Kentucky may not have caused underfunding of the state pension plans, but they did little to prevent that underfunding and may have emboldened legislatures bent on prioritizing other state programs. Like New York and North Carolina, these states lacked state constitutional provisions providing explicit protection for pension funding.[176] Unlike New York and North Carolina, courts in these states were unwilling to look to other constitutional provisions to mandate funding.[177] As always, one must be cautious about inferring causation from correlation, but in this case the correlation between judicial intervention and adequate funding is a strong one.

### 2. *Constitutional Protection of Pension Benefits*

Courts in some states, but not all, have held that pension benefits (as distinguished from pension *funding*) are protected as contractual rights under state constitutions, statutes, or the U.S. Constitution's Contracts Clause.[178] One might anticipate that the worst-funded pension plans would be in states where courts guarantee benefits but not the funding of those benefits. In those states, plan beneficiaries would have less incentive to advocate for adequate state funding, given that benefits would have to be paid in any event. Conversely, in states where pension benefits payments are not contractually protected, pension beneficiaries would have a greater incentive to lobby for increased funding, constitutional amendments, or statutory amendments to protect the benefits, because in the event of a significant shortfall in funding, the states might reduce or eliminate benefits or increase employee contributions.[179]

The data, however, provides only limited support for the hypothesis that benefit guarantees generate underfunding. Of the five states with troubled plans, only two—Illinois[180] and, arguably,

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175. *See* PEW CHARITABLE TRS., KENTUCKY'S SUCCESSFUL PUBLIC PENSION REFORM 1, 6 (2013), https://www.pewtrusts.org/-/media/legacy/uploadedfiles/pcs_assets/2013/20130927kentuckypensionreformbriefpdf.pdf (noting that Kentucky had failed to make required contributions for more than a decade).

176. People *ex rel.* Sklodowski v. State, 695 N.E.2d 374, 378 (Ill. 1998).

177. *See, e.g.*, *id.* at 379.

178. *Id.*

179. Patrick McGuinn, *Pension Politics: Public Employee Retirement System Reform in Four States*, BROWN CTR. ON EDUC. POL'Y AT BROOKINGS 1, 44 (Feb. 2014), https://www.brookings.edu/wp-content/uploads/2016/06/Pension-Politics_FINAL_225.pdf; MARK J. WARSHAWSKY & EILEEN NORCROSS, MERCATUS CTR. GEORGE MASON UNIV., UNDERFUNDED PENSIONS: THE EXPANDING AND ESCALATING CHALLENGE 1, 2 (2016), https://www.mercatus.org/system/files/mercatus-warshawsky-norcross-underfunded-pensions-v2.pdf.

180. *In re* Pension Reform Litig., 32 N.E.3d 1, 4 (Ill. 2015); *People* ex rel. *Skoldowski*, 695 N.E.2d at 374.

Kentucky[181]—embrace a strong theory of contract under which state employees are entitled to protection of their pension benefits. The supreme courts of the remaining states, Connecticut,[182] Rhode Island,[183] and New Jersey,[184] all seem to reject the notion of pension benefits as contractual rights and do not seem to provide any guarantee of payment of such benefits.

The Illinois Constitution expressly provides that membership in a state pension plan is an "enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[185] In analyzing the applicability of the constitutional mandate, the Supreme Court of Illinois in *People ex. Rel. Sklodowski v. State* affirmed that the constitutional provision protects the rights of employees to receive benefits; it simultaneously held that it created no rights to enforce adequate funding of those benefits, nor did it require even meeting the level of state contributions otherwise mandated by Illinois law to fund such benefits.[186] Similarly, the Kentucky Supreme Court has stated that Kentucky Retirement System members "have a contractual right" to the pension benefits they were promised on employment, and the State can take no action to reduce such benefits.[187] But just as in Illinois, the court found no corollary obligation to mandate funding for such benefits.[188]

In contrast to the Illinois and Kentucky decisions, courts in Connecticut, Rhode Island, and New Jersey have found that the legislature has no contractual obligation to pay promised pension benefits. The Connecticut Supreme Court, in considering a challenge to a legislative change to state pension eligibility requirements in *Pineman v. Oechslin*,[189] determined that the State Employees Retirement Act conferred "no contractual rights in the statutory pension plan."[190] The *Pineman* court's decision was premised on the view that the statutory pension benefits conferred by the State Employees Retirement Act merely create an "expectancy interest"[191] for state employees, which was "revocable at the will of the legislature."[192] The Rhode Island Supreme Court's analysis on this

181. Jones v. Bd. of Trs. of the Ky. Ret. Sys., 910 S.W.2d 710, 713 (Ky. 1995).
182. Pineman v. Oechslin, 488 A.2d 803, 809–10 (Conn. 1985).
183. Retired Adjunct Professors of the State of R.I. v. Almond, 690 A.2d 1342, 1345 (R.I. 1997).
184. Berg v. Christie, 137 A.3d 1143, 1147 (N.J. 2016).
185. ILL. CONST. art. XIII, § 5.
186. *People* ex rel. *Skoldowski*, 695 N.E.2d at 379.
187. Jones v. Bd. of Trs. of the Ky. Ret. Sys., 910 S.W.2d 710, 713 (Ky. 1995). The court's statement was dictum in a case holding that the legislature's failure to provide funding did not violate any constitutional mandate.
188. *People* ex rel. *Skoldowski*, 695 N.E.2d at 379.
189. 488 A.2d 803 (Conn. 1985).
190. *Id.* at 810.
191. *Id.* at 807.
192. *Id.*

point in *Retired Adjunct Professors of the State of Rhode Island v. Almond*[193] closely followed and cited *Pineman*, and it rejected the proposition that promised pension benefits rose to the level of contractual obligations.[194] In *Berg v. Christie*,[195] the Supreme Court of New Jersey similarly determined that even where the legislature granted a "non-forfeitable right to receive benefits as provided under the laws governing the retirement system,"[196] the legislature could suspend cost of living adjustments ("COLAs"), because the court found that the legislature did not provide a clear intent to confer a contractual right to those COLA increases.[197]

Evidence from these five states, taken alone, provides no support for the proposition that recognizing a contract right to benefits leads to underfunding of plans. However, none of the five states with healthy plans recognizes a constitutionally protected right to benefits without also providing for judicial enforcement of provisions that require funding of benefits.[198] Of the five states with the healthiest plans, New York[199] and North Carolina[200] are the only two that seem to provide a strong contract theory guaranteeing the payment of benefits, and, as we have seen, both of these states also enforce

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193. 690 A.2d 1342 (R.I. 1997).

194. *Id.* at 1345–46.

195. 137 A.3d 1143 (N.J. 2016).

196. N.J. STAT. ANN. § 43:3C–9.5(b) (West 2011).

197. *Berg*, 137 A.3d at 1155, 1158.

198. *See generally* Oladunni M. Ososami & Todd N. Tauzer, *For the Five Highest-Funded U.S. State Pension Plans, Being Proactive Keeps Liabilities Manageable*, S&P GLOBAL (Oct. 24, 2017), https://www.nctreasurer.com/ret/Active%20Employees/SPGlobalRatings_FiveHighestFundedStates1710.pdf (reviewing New York, North Carolina, Wisconsin, South Dakota, and Tennessee pension benefit plans).

199. New York enacts all new pension benefit legislation on a year-to-year basis and has done so since 1940 when New York's constitutional provision acknowledging the contractual nature of pension benefits first took effect. Despite the temporal limit imposed by the legislature, however, the Court of Appeals concluded that while "the legislature does not have to grant pension benefits, once it does, for however short a period, they may not be impaired by a limitation as to time in the statute creating them." Pub. Emps. Fed'n, AFL-CIO v. Cuomo, 467 N.E.2d 236, 240 (N.Y. 1984). In addressing the question of the State's constitutional obligations to pay pension benefits, the New York Court of Appeals determined that the legislature's limit of the right of state employees to withdraw their contributions from the state retirement system, in the event they were terminated before the completion of their ten-year vesting period, constituted an unconstitutional deprivation of the state employees' contractual right to such benefits. *Id.*

200. North Carolina's Supreme Court has held that once the legislature enacts laws that provide for certain retirement benefits for state and local employees who fulfill certain conditions, the promise of these benefits constitutes an offer by the government guaranteeing those benefits if the employees fulfill those conditions—i.e. creates an enforceable contract. Bailey v. State, 500 S.E.2d 54, 60 (N.C. 1998).

funding requirements.[201] Accordingly, just as in New York, North Carolina provides strong support for the enforcement of the obligation to pay pension benefits and fund them.

Florida, Wisconsin and South Dakota seem to permit legislative amendments that modify the statutory obligation to pay plan benefits. In the case of Florida, state law expressly provides that rights of state retirement system members "are of a contractual nature . . . . and shall not be abridged in any way,"[202] but despite this provision, the Supreme Court of Florida has determined that the legislature has the authority to prospectively alter retirement benefits by increasing employee contributions.[203] So too, in Wisconsin, benefits accrued under the state pension plan are deemed contractual rights that are not subject to abrogation; the legislature has the right to amend, repeal or enact any statutory change to the pension laws at any time.[204] While no recent South Dakota court has yet decided whether pension benefits are a contractually guaranteed obligation, a South Dakota statute explicitly provides that benefits are not contractual,[205] and a sixty-year-old South Dakota Supreme Court case indicated that pension benefits that have not yet accrued upon retirement "could be cancelled or revoked at the will of the legislature."[206]

Overall, then, the data from these states provide support, albeit on limited evidence, for one conclusion: constitutional protection of benefits, but not funding—the situation in Illinois and Kentucky—creates a significant risk of underfunding. Of the six states that provide no protection to either funding or benefits, half have well-funded plans and the other half do not—providing no evidence for any correlation. Finally, if a state recognizes a constitutional obligation to pay benefits and a corollary obligation to provide funding for the benefits, the risk of underfunding is minimal. Indeed, both New York and North Carolina courts have found that both obligations essentially go hand in hand,[207] and accordingly, both states have healthy funds.[208]

201. *See* Faulkenberry v. Teachers' and State Employees' Ret. Sys. of N.C., 483 S.E.2d 422, 429 (N.C. 1997); *Cuomo*, 467 N.E.2d at 240.

202. FLA. STAT. § 121.011(3)(d) (2018).

203. Scott v. Williams, 107 So. 3d 379, 388 (Fla. 2013).

204. WIS. STAT. § 40.19(1) (2018); State *ex rel.* Risch v. Bd. of Trs. of Policemen's Pension Fund, 98 N.W. 954, 956 (Wis. 1904).

205. S.D. CODIFIED LAWS § 3–12–122 (2018).

206. Tait v. Freeman, 57 N.W.2d 520, 522 (S.D. 1953).

207. Stone v. State, 664 S.E.2d 32, 40 (N.C. 2008); McDermott v. Regan, 624 N.E.2d 985, 989 (N.Y. 1993).

208. Ososami & Tauzer, *supra* note 199.

## *D. Structural Protections*

Especially in times of budgetary crisis, the political branches of state governments face significant pressure to subordinate pension funding to other pressing public needs.[209] The constitutional constraints discussed in the preceding Subpart can operate to constrain officials who might otherwise defer funding of pension commitments.[210] This Subpart examines structural mechanisms legislatures have developed to make it difficult for their successors to yield to the political pressure to divert money from pension funding.

In general, states with the healthiest plans have accorded power to intermediaries to constrain political pressures that reduce pension plan funding.[211] Of course, absent constitutional limits, the legislature retains the power to strip these intermediaries of authority or to override their determinations,[212] but there is some evidence, albeit not conclusive, that some of the political and structural obstacles to doing so have been moderately effective.

With the exception of New York's state retirement system, all of the retirement systems examined are managed by a retirement board.[213] New York's system, unique among the states, is managed by the elected State Comptroller.[214] One might hypothesize that the retirement board's independence from politics, and its duty to determine how much the State must contribute to the retirement fund, play a role in the health of the state's retirement plan.

Examining any individual structural protection in isolation can be misleading. Consider, first, the composition of the retirement system's board. In her empirical study, Professor Shnitser tested the hypothesis that a retirement board's independence from politics correlates positively with adequate funding of the state's retirement plan.[215] But, of course, if the board is powerless to set contribution rates, one would not expect the board's composition to be terribly significant. Moreover, determining the board's independence from politics is itself a daunting task, casting doubt on quantitative efforts to correlate independence with funding discipline. Not only do boards

209. TOM SGOUROS, HAAS INST. FAIR & INCLUSIVE SOC., UNIV. CAL. BERKELEY, FUNDING PUBLIC PENSIONS 4 (2017), http://haasinstitute.berkeley.edu/sites/default/files/funding_public_pensions_-_publish.pdf.

210. *See supra* Subpart III.C.I.

211. Alicia H. Munnell & Annika Sundin, *Investment Practices of State and Local Pension Funds: Implications for Social Security Reform*, *in* PENSIONS IN THE PUBLIC SECTOR 156 (Olivia S. Mitchell & Edwin C. Hustead eds., 2001).

212. *See, e.g.*, Monahan, *supra* note 19, at 150.

213. *See infra* pp. 134–37

214. N.Y. RETIRE. & SOC. SEC. LAW § 11 (McKinney 2018).

215. Shnitser, *supra* note 27, at 680–81, 696–700.

vary in the number of *ex officio* members,[216] but they vary significantly in the number and percentage of political appointees.[217] In addition, one might hypothesize that other elements of board composition, such as the number of employee or retiree representatives, might have an impact on funding discipline.[218]

Consider next the role of the retirement board, or the board's actuary, in determining the State's contribution rate. Professor Shnitser's study supports the hypothesis that contribution rates set by an actuary—and not by the state legislature—correlate positively with plan health.[219] But again, the difficulty in coding data involves difficult judgment calls that complicate quantitative study.[220] For example, how should Florida be treated when the State regularly resets contribution rates by statute, but the statutory rates are determined by an actuary?[221]

Assessing the significance of structural provisions is especially difficult in states like New York and North Carolina, where judicial interpretation of the state constitution provides an independent constraint on legislative funding decisions.[222] Nevertheless, in both New York and North Carolina, the constitutional protection is intertwined with institutional structure. In both states, courts have held that interference with a statutory structure violated a constitutional provision.[223] In New York, by statute, the State Comptroller has the authority to determine the amount necessary to

216. Professor Shnitser's study distinguished retirement boards with greater than 30% *ex officio* membership from those with 30% or fewer *ex officio* members. *Id.* at 698.

217. For instance, among states with healthy plans, North Carolina's Retirement Board is composed entirely of *ex officio* members and appointees of the governor and state legislature. N.C. GEN. STAT. ANN. § 135-6 (West 2018). South Dakota's Retirement Board includes no *ex officio* voting members and a single gubernatorial appointee. The remaining members are elected by various constituency groups. S.D. CODIFIED LAWS §§ 3-12-48, 3-12-49 (2018).

218. *See* Munnell, *supra* note 66, at 7, 10. The Munnell study ultimately concluded that the number of employees or retirees on a board had no effect on pension funding. *Id.* at 9. Another difficulty in categorization arises because state legislatures have changed the size and composition of retirement boards over time. *See, e.g.*, 40 ILL. COMP. STAT. ANN. § 5/14-134 (West 2018) (providing a change from seven trustees until 2006 to thirteen trustees after 2006); 36 R.I. GEN. LAWS § 36-8-4 (2018) (detailing that the 2006 change reduces *ex officio* membership and adds two members appointed by the state treasurer). Professor Shnitser dealt with this problem by focusing on ten specific years. Shnitser, *supra* note 27, at 692.

219. *Id.* at 698.

220. Professor Shnitser's article sets the basis for her own eminently reasonable coding decisions. *Id.* at 692–95.

221. *See* FLA. STAT. § 121.71 (2018).

222. *See* Campaign for Fiscal Equity v. State, 655 N.E.2d 661, 665 (N.Y. 1995); *see also* Leandro v. State, 488 S.E.2d 249, 256 (N.C. 1997).

223. *See* McCall v. State, 640 N.Y.S 347, 350 (N.Y. App. Div. 1996); *see also* Stone v. State, 664 S.E.2d 32, 37 (N.C. Ct. App. 2008).

meet the State's pension obligations[224] and the authority to ensure that state employers make the required contribution.[225] Although the Comptroller is an elected official, the Comptroller's limited agenda reduces the incentive to succumb to pressures to reduce pension funding in order to fund other government programs or to keep taxes low.[226] Moreover, as already noted, a 1993 decision by the New York Court of Appeals had held that the constitutional prohibition on impairment of pensions precluded the legislature from interfering with the Comptroller's statutory responsibility to preserve the security of the state pension funds.[227] Since that decision, when the state legislature has sought to permit amortization of potentially large pension contributions, it has prefaced the amortization provisions with the language "[i]f the comptroller, in his or her discretion, decides to permit amortization."[228]

In North Carolina, by statute, the retirement system's Board of Trustees selects an actuary and, based on the actuary's investigation and valuation, sets an employer retirement contribution rate.[229] Employers, including the state and state agencies,[230] must pay to the state pension fund the actuarially determined employer contribution rate.[231] The legislature does not directly make annual appropriations earmarked for retirement, and the state's required contribution rates are based on the actuary's calculations.[232] When, in 2001, the Governor sought to divert pension contributions for use in closing the State's budget deficit, a state appellate court held the effort violated the Federal Constitution's Contracts Clause because existing statutes created a contract right to have employer contributions reduced only upon certification of the actuary that the contributions were unnecessary to preserve actuarial soundness—a certification the actuary did not provide.[233]

The North Carolina experience demonstrates that giving a Board power to set rates is not, by itself, sufficient to overcome the political pressures facing governors and legislators. In North Carolina,

224. N.Y. RETIRE. & SOC. SEC. LAW § 16 (McKinney 2018).

225. *Id.* § 17.

226. DANIEL DISALVO, MANHATTAN INST., THE POLITICS OF PUBLIC PENSION BOARDS 7 (2018), https://www.manhattan-institute.org/html/politics-public-pension-boards-11446.html.

227. McDermott v. Regan, 624 N.E.2d 985, 988–89 (N.Y. 1993).

228. *See, e.g.*, N.Y. RETIRE. & SOC. SEC. LAW §§ 16-d, 17-c, 19-a(b).

229. N.C. GEN. STAT. ANN. §135-6(l–n) (West 2018) (detailing board appointment of actuary and actuary's duties).

230. *Id.* §135-1(11) (defining employers to include state and state agencies).

231. N.C. GEN. STAT. ANN. §135-8(d)(3a) (West 2017). The current statute reflects a 2017 amendment, but the prior statute also placed determination of the contribution rate in the actuary's hands. *See* 2017 N.C. SESS. LAWS 2017-129 (stricken language).

232. N.C. GEN. STAT. ANN. § 135-8(d)(3) (West 2017).

233. Stone v. State, 664 S.E.2d 32, 39–40 (N.C. Ct. App. 2008).

judicial enforcement was critical. Like North Carolina, Kentucky and New Jersey each have had statutes conferring on a retirement board of trustees, or the Board's chosen actuary, the power to set state contribution rates,[234] and in each state the political branches, unconstrained by judicial decision, have effectively overridden that power. In New Jersey, when fiscal difficulties hit, the legislature first changed the method for valuing retirement fund assets to reduce the state's contribution.[235] The legislature then issued bonds to fund the state's contribution[236] and ultimately stopped appropriating the statutorily required contribution.[237] In Kentucky, the legislature passed appropriation bills that included an express override of the statute, giving the retirement board authority to set contribution rates.[238] By contrast, in South Dakota, contribution rates are set by statute, not by the State's Board,[239] but the plan nevertheless remains fully funded.[240]

Wisconsin and South Dakota (the two well-funded states without constitutional protections)[241] share one structural feature: in each state, the legislature has established a bipartisan committee designed

234. KY. REV. STAT. ANN. § 61.565(3) (West 2018) (providing that contribution rates shall be determined by the retirement board on the basis of actuarial valuation); N.J. STAT. ANN. 43:15A–24 (West 2018), as amended through 1990, provided simply that the retirement system would certify the contribution necessary to cover normal cost plus amortized unfunded liability (over a period, not to exceed forty years, determined by the State Treasurer), and the State would pay that contribution. *See* 1990 N.J. Laws 21.

235. *See* 1992 N.J. Laws 573–76 ("Each employer shall make contributions equal to percentage of compensation of members in its employ as certified by the board of trustees based on annual actuarial valuations.").

236. *See* 1997 N.J. Laws 418–19.

237. *See* Ted Ballantine, *Chart: A History of New Jersey's Pension Payments*, PENSION360 (Oct. 9, 2014), http://pension360.org/chart-a-history-of-new-jerseys-pension-payments (providing a chart detailing the failure of New Jersey legislature to make annual required contributions).

238. *See* 2004 Ky. Acts 13 (limiting employer contribution rates for July 1, 2004 through June 30, 2006 "[n]otwithstanding KRS 61.565"); *see also* 2008 Ky. Acts 491 (showing the same for the period from July 1, 2008 through June 30, 2009).

239. S.D. CODIFIED LAWS § 3-12-71 (2018) (explaining that state employees who make contributions to the retirement system must have their contributions matched by the employer at specified rates).

240. S.D. RET. SYS., ANNUAL REPORT OF THE FUNDED STATUS OF THE SOUTH DAKOTA RETIREMENT SYSTEM TO THE GOVERNOR AND LEGISLATURE OF THE STATE OF SOUTH DAKOTA 1, 4 (Jan. 8, 2018), http://sdlegislature.gov/docs/budget/BoardPapers/2018/3%20-%20SDRS%20-%20Annual%20Report%20of%20Funded%20Status%20Jan2018.pdf.

241. Florida's constitution prohibits any increase in retirement benefits unless the governmental unit granting the benefit leads the increase; it requires "provision for the funding of the increase in benefits on a sound actuarial basis." FLA. CONST. art. X, § 14.

to serve as a filter for retirement legislation.[242] In each case, the committee's membership is not limited to elected representatives of a single house of the legislature. South Dakota's committee includes five members from each house,[243] while Wisconsin's committee also includes, among others, the Secretary of the Employee Trust Fund, the Commissioner of Insurance, and an Assistant Attorney General.[244] Wisconsin's statute authorizes the Board to establish contribution rates[245] and also provides that no legislation affecting the retirement system may be enacted without the bipartisan committee's written report, which must include an independent actuarial opinion.[246] South Dakota's statute does not preclude legislation without a report from the committee,[247] but over time, the Board and the standing Retirement Laws Committee have worked closely to implement benefit increases that did not threaten the system's actuarial soundness.[248]

By contrast, neither New Jersey nor Connecticut has a comparable statute insulating pension funding from the ordinary political process. Connecticut goes so far as to permit collective bargaining agreements to override the statutory requirement for actuarial funding[249] and has used that process in ways that contribute

242. S.D. CODIFIED LAWS § 2-6-12 (2018) (requiring that the committee "review all proposed legislation that affects public employee retirement in the state" but also requiring review by standing committees during the legislative session); WISC. STAT. ANN. §§ 13.50(1), (6)(a)–(b) (West 2018) (establishing the committee and precluding retirement legislation without a report from the committee).

243. S.D. CODIFIED LAWS § 2-6-9 (2018).

244. WIS. STAT. § 13.50(1) (2018) (providing for a committee composed of three legislators from each house, two from the majority party, and one from the minority party, plus the three officials discussed in the text and one member of the public designed to be a taxpayer representative).

245. *See id.* § 13.50(6)(a)–(b).

246. *See id.*

247. *See* S.D. CODIFIED LAWS § 2-6-12 (2018) (requiring only that the Retirement Laws Committee report to the legislature about the financial soundness of the retirement system).

248. *See generally* S.D. RET. SYS., HISTORICAL HIGHLIGHTS OF THE SOUTH DAKOTA RETIREMENT SYSTEM 1973-2008, https://nasrasite.qa.membershipsoftware.org/files/State-Specific/South%20Dakota/SDRShistory.pdf (last visited Feb. 25, 2019) (showing consistent improvements in benefits as well as the actuarial value of assets increasing from $141 million in 1974 to $5.67 billion in 2006).

249. *See* CONN. GEN. STAT. § 5-278(e) (2017) (mandating that the terms of a collective bargaining agreement prevail over "any general statute or special act, or regulations adopted by any state agency . . ."); *see also* § 5-278(f) (providing that collective bargaining negotiations concerning retirement system changes shall be conducted with a coalition representing "all state employees who are members of any designated employee organization"). The statute does require legislative approval of the collective bargaining agreement as a whole—but as part of the legislative process—and with time limits on legislative debate. *See* §

to underfunding.[250] Not until 2008 did Rhode Island enact a statute requiring the State Board to prepare "pension impact notes" to accompany legislation that would impact the state retirement system.[251] More recently, in 2013, Kentucky established a bicameral, bipartisan Public Pension Oversight Board[252] with the power to review and recommend changes to laws relating to the retirement system.[253] The Rhode Island and Kentucky enactments were not in place early enough to prevent the underfunding that had already developed in those states; instead they were enacted in response to the perceived crisis.[254]

Illinois presents the most serious challenge to the proposition that a bipartisan, bicameral committee with power to comment on retirement legislation acts as an effective check against inadequate funding. Like Wisconsin and South Dakota, Illinois has a statutorily created commission with bipartisan, bicameral representation and a responsibility to report on pension legislation.[255] Yet the Illinois pension system is in shambles.[256] The Illinois commission's agenda extends beyond pensions to a variety of other budgetary issues,[257] perhaps dissipating both the Commission's focus on pensions and the

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5-278(b)(1), (4)–(5). Connecticut has used the collective bargaining process to reduce State contributions on multiple occasions. *See* KEITH BRAINARD & ALEX BROWN, THE ANNUAL REQUIRED CONTRIBUTION EXPERIENCE OF STATE RETIREMENT PLANS, FY01 to FY 13, at 9 (2015).

250. *See* LEE HANSEN, OLR BACKGROUNDER: THE STATE EMPLOYEES RETIREMENT SYSTEM 7 (2016) (noting that the series of collective bargaining agreements allowed the State to originally underpay, but it caused the unfunded liability to substantially increase).

251. 36 R.I. GEN. LAWS § 36-10-39 (2018). Rhode Island previously required "fiscal impact notes," but did not require preparation by the retirement system. *See* 2008 R.I. Pub. Laws, Ch. 100, art. 23, § 2 (adding the requirement that the note be "prepared and paid for by the employees' retirement system of the state of Rhode Island").

252. *See* KY. REV. STAT. ANN. §§ 7A.200, 7A.220 (West 2018) (establishing the Public Pension Oversight Board and requiring it to be composed of nineteen members).

253. *Id.* § 7A.250.

254. *See, e.g.*, PEW CHARITABLE TRS., KENTUCKY'S SUCCESSFUL PUBLIC PENSION REFORM, *supra* note 175, at 1–5.

255. *See* 25 ILL. COMP. STAT. 130/3A-1 (2018) (giving the Commission on Government Forecasting and Accountability responsibility for preparing Pension Impact notes.); *see also* 130/1-5(a) (explaining that membership includes 6 members from each house, 3 from each party).

256. *See* TED DABROWSKI & JOHN KLINGNER, ILL. POL. INST., WHAT'S DRIVING ILLINOIS' $111 BILLION PENSION CRISIS: RETIREMENT AGES, COLAS, AND OUT-OF-SYNC PENSION PAYOUTS 1 (2016), https://files.illinoispolicy.org/wp-content/uploads/2016/04/Pension-papers_combined_4-8.compressed.pdf (showing that Illinois' state pension debt reached over $111 billion, and the system is an ongoing crisis that is not sustainable).

257. *See* 25 ILL. COMP. STAT. ANN. 155/2 (West 2010) (detailing the Commission's duties; preparation of Pension Impact Notes is number eleven on a list of fourteen duties).

deference the legislature might accord the Commission in any particular issue.[258] Moreover, because Illinois' pension plans have been underfunded since their inception,[259] the Commission could not play the same role as its counterparts in Wisconsin and South Dakota, ensuring that political pressures did not deplete a well-funded plan.

Ultimately, the evidence is inconclusive about the effectiveness of statutory structural protections as a safeguard for pension funding. When backed by judicially enforced constitutional limits, as in New York and North Carolina, structural separation of pension funding from ordinary legislative processes appears to be effective in maintaining well-funded plans. Even without judicial intervention, states that have created bipartisan, bicameral commissions devoted to pension issues appear to have been more successful in maintaining full funding than states without similar mechanisms. But causation is impossible to prove. The prudence that led those states to create structural protections for pension funds might also have led them to safeguard pensions even without those mechanisms.

### *E. Enforcement Mechanisms*

Despite widespread recognition that state legislatures have failed to make statutorily required contributions to state retirement funds,[260] the prior literature has largely ignored the impact of statutory mechanisms for enforcing government obligations to make retirement contributions.[261] Statutory enforcement mechanisms are, of course, subject to legislative repeal.[262] Nevertheless, our examination of the statutory recourse available to retirement systems when employers—the state, state agencies, or municipalities—fail to make statutorily required contributions reveals that default rules matter. States with well-funded plans tend to provide the retirement system with some combination of automatic appropriation, financial penalties, or judicial recourse when government employers fail to

258. During several periods, Illinois had a pension laws commission. In 1963, the legislature created a commission to study pension and benefit laws. 1963 Ill. Laws 727-28. That commission was abolished in 1984, and its functions transferred to the Illinois Economic and Fiscal Commission. 1984 Ill. Laws 1145-46, 1150-52. A 1995 statute transferred responsibility for pension impact notes from the Economic and Fiscal Commission to a newly created, bicameral, bipartisan Pension Laws Commission. 1995 Ill. Laws 1961. Eight years later, however, the legislature abolished the Pension Laws Commission and transferred responsibility for pension impact notes to the Commission on Government Forecasting and Accountability. *See* 2003 Ill. Laws 4560, 4563.

259. *See* Madiar, *supra* note 118, at 5, 15.

260. *See, e.g.*, Monahan, *supra* note 19, at 121.

261. *Id.* at 161 (discussing briefly how statutory enforcement of contribution is subject to repeal and is thus a weak method for enforcing contribution).

262. *See, e.g.*, WIS. STAT. ANN. § 40.19(1) (West 2012) (noting that the State reserved the right to amend or repeal the required statutory contributions).

make required contributions. By contrast, states with poorly funded plans tend to require affirmative legislative appropriation of statutorily required contributions, with no sanctions for failure to make the required appropriations. This research suggests that statutory enforcement mechanisms, even if they are never used, may have a deterrent effect that guards against underfunding.

First, consider how states appropriate funds for retirement contributions. In South Dakota, Wisconsin, North Carolina, and Florida—all states with healthy plans[263]—statutes require no direct legislative appropriation of retirement contributions.[264] Instead, employers—state agencies, state departments, or municipal entities—must contribute to the state retirement fund out of the legislative appropriations made to the employer or agency, or, out of other revenues.[265] Because there is no specific appropriation for retirement funding,[266] if the legislature seeks to reduce expenses during the budgetary process, it can do so by reducing overall funding for various agencies or departments, but it cannot merely forgo an appropriation of funds for retirement.[267]

By contrast, in each of the states with fiscally troubled plans, state contributions are and have been dependent on affirmative legislative appropriation of funds, with no statutory discussion of the consequences that follow from the legislature's failure to appropriate the funds. Illinois, Rhode Island, New Jersey, and Connecticut all have had statutes that explicitly obligate the legislature to make appropriations.[268] Kentucky did not enact a similar statute until 2013.[269] Until then, the Kentucky statute provided only that "[it] is the intent of the General Assembly" to begin phasing in actuarially required contribution rates.[270]

263. CORSON ET AL., *supra* note 42, at 6.

264. FLA. STAT. §121.061 (2018); N.C. GEN. STAT. §135-8 (2018); S.D. CODIFIED LAWS §3-12-71 (2018); WIS. STAT. §40.05 (2018).

265. FLA. STAT. ANN. §121.061(1); N.C. GEN. STAT. §135-8(b)(1) (2018); S.D. CODIFIED LAWS §3-12-71; WIS. STAT. §40.05(1)(b)(2) (2018).

266. FLA. STAT. §121.061; N.C. GEN. STAT. §135-8; S.D. CODIFIED LAWS §3-12-71; WIS. STAT. §40.05.

267. FLA. STAT. §121.061(2)(a); N.C. GEN. STAT. §135-8(f)(3); S.D. CODIFIED LAWS §3-12-74; WIS. STAT. §40.06(2)(c).

268. CONN. GEN. STAT. § 5-156a(a) (2018) ("The General Assembly shall review the commission's recommendations and certification and shall appropriate to the retirement fund . . . ."); 40 ILL. COMP. STAT. 5/14-131(a) (West 2018) ("The State shall make contributions to the system by appropriations . . . ."); N.J. STAT. ANN. § 43:15A-37 (West 2018) ("The Legislature shall make an appropriation sufficient to provide [for the state's obligations]."); 36 R.I. GEN. LAWS § 36-10-2(a) (2011) ("The State of Rhode Island shall make its contribution . . . by annually appropriating.").

269. KY. REV. STAT. ANN. § 61.565(5) (LexisNexis 2015); *see* 2013 Ky. Acts 670 (amending KY. REV. STAT. ANN. § 61.565).

270. *See* 2013 Ky. Acts 670–671 (strikeout indicating prior language).

Like the states with fiscally troubled plans, New York requires state appropriation of funds for the retirement system.[271] But a New York statute authorizes the State Comptroller to bring suit against any employer who fails to make a required payment.[272] It is not entirely clear whether the statute also applies to the state as an employer,[273] but another statute requires that once the legislature appropriates funds, the amount due from the state must be paid "from the state treasury on warrant of the Comptroller,"[274] an independently elected official who derives little political benefit from the use of retirement funds for other purposes.[275] Until an Illinois reform statute enacted in 2013,[276] none of the fiscally troubled states had a comparable statute.

Next, consider the sanctions imposed on employers who fail to make statutorily required contributions. South Dakota and North Carolina each impose statutory penalties on employers who fail to make statutorily required contributions.[277] In South Dakota, the penalty is 5% of the amount of the delinquent contribution.[278] In North Carolina, the penalty is 1% for every month of delinquency.[279] In both states, the statutory language appears to cover both the state itself and other governmental entities that participate in the retirement system.[280]

In Wisconsin and Florida, if any employer other than the state fails to make required payments, the retirement system can obtain payment by compelling the state to withhold funds otherwise due to the employer.[281] Florida statutes also authorize the retirement system administrator to file an action against a delinquent

271. N.Y. RETIRE. & SOC. SEC. LAW § 16(a) (McKinney 2018).

272. *Id.* § 17(e).

273. The statute defines "employer" to include the State of New York. *Id.* § 2(8). On the other hand, section 16 of the statute, entitled "Annual appropriation by state," appears directly applicable to the state's contributions, suggesting that section 17, entitled "Annual appropriation by participating employers," was designed to deal with employers other than the state. *Id.* §§ 16, 17.

274. *Id.* § 16(a). The statute does, however, require an appropriation by the legislature. *Id.* § 16(f).

275. N.Y. CONST. art. V., § 1 (McKinney 2006).

276. 40 ILL. COMP. STAT. 5/16-171 (West 2013).

277. N.C. GEN. STAT. ANN. § 135-8(f)(3) (West 2018); S.D. CODIFIED LAWS § 3-12-72 (2018).

278. S.D. CODIFIED LAWS § 3-12-72.

279. N.C. GEN. STAT. ANN. § 135-8(f)(3) (West 2018). The North Carolina statute authorizes the Board of Trustees to exempt employers from the penalty once every five years upon a showing of good cause, and it also authorizes the Board to require the state treasurer to withhold funds otherwise due to any delinquent employer. *Id.*

280. *See* N.C. GEN. STAT. ANN. § 135-1(11) (defining employer to include the state); S.D. CODIFIED LAWS § 3-12-47(33) (2018) (also defining "employer" to include the State of South Dakota).

281. FLA. STAT. § 121.061(2)(a) (2018); WIS. STAT. § 40.06(4)(a) (2018).

employer.[282] When the state is the delinquent employer, both Wisconsin and Florida have provisions for automatic payment without the need for legislative appropriation.[283] The Florida statute provides that if a state agency fails to make a required payment, the "amount due is hereby appropriated and shall be paid from the General Revenue Fund of the state."[284] Meanwhile, the Wisconsin statute authorizes the Department of Employee Trust Funds to submit a voucher to the State Department of Administration, "which shall immediately approve the voucher and within no more than 5 days . . . make payment" without going through its ordinary pre-audit procedures.[285] Finally, the New York statute, like the Florida statute, authorizes the state comptroller to sue delinquent employers.[286]

By contrast, until 2013, none of the states with fiscally troubled plans had statutes providing recourse to the retirement system board if the legislature fails to make the contributions required by statute.[287] As a result, the legislature can effectively act with impunity, without going through the process of actually repealing inconvenient statutes providing the board with enforcement powers.

Illinois took a step towards remedying this problem in 2013, when it amended its statute to give its Board the power to bring a mandamus action in the state supreme court, which can be used to compel the legislature to make the required contribution.[288] The statute explicitly waived the state's sovereign immunity,[289] eliminating what would otherwise constitute a bar to the mandamus action. Unfortunately, when the Illinois Supreme Court invalidated the 2013 statute because it violated the state constitution's pension protection clause, it invalidated the entire statute, and thus, by extension, the sovereign immunity waiver[290]—which would otherwise have strengthened pension protection.

Perhaps the existence of statutory enforcement mechanisms signals a strong *a priori* commitment to adequate pension funding, so

282. FLA. STAT. § 121.061(2)(c).
283. *Id.* § 121.061(3); WIS. STAT. § 40.06(4)(b).
284. FLA. STAT. § 121.061(3).
285. WIS. STAT. § 40.06(4)(b).
286. N.Y. RETIRE. & SOC. SEC. LAW § 17(e) (McKinney 2018).
287. *See infra* discussion pp. 145–46.
288. 40 ILL. COMP. STAT. ANN. 5/2-125(c) (West 2018); *see* 2013 Ill. Legis. Serv. 98-599 (West).
289. *See* FLA. STAT. § 121.061(3).
290. *In re* Pension Reform Litigation, 32 N.E.3d 1, 29–30 (Ill. 2015). In the absence of the statute, there is authority to suggest that the Illinois Supreme Court would not permit sovereign immunity to serve as a bar to a claim against the State for pension *benefits* once those benefits became due. *See* Jorgenson v. Blagojevich, 811 N.E.2d 652, 668–69 (compelling the State Comptroller to pay judges their constitutionally protected salaries even without legislative appropriation); *see also* Eric M. Madiar, *Is Welching on Public Pension Promises an Option for Illinois?*, 48 J. MARSHALL L. REV. 167, 289 (2014).

that the statutory mechanisms were superfluous—a "belt and suspenders" approach to funding adequacy. Nevertheless, the correlation between statutory enforcement mechanisms and adequate funding is a strong one,[291] making it difficult to discount adequate enforcement mechanisms as a potential cause for better pension funding.

### *F. Statutory Treatment of Unfunded Liability: Amortization and Smoothing Mechanisms*

To move towards full funding of pensions, state contributions must cover normal costs plus a share of unfunded liability.[292] Unfunded liability arises for a number of reasons: the state's past failure to make contributions, overly optimistic actuarial assumptions, or investment returns that failed to meet expectations.[293] Contributions towards unfunded liability are intended to increase the plan's funding ratio and improve the health of the plan.[294] How the state decides on the appropriate contribution towards its unfunded liability can have a long-term impact on the state's funding ratio.[295]

#### *1. Amortization*

##### a. Amortization Mechanisms

When a state has accumulated significant unfunded liability, eliminating that liability in a single year would generate a serious disruption in the state's finances.[296] Amortization of the liability over a longer period—perhaps as long as thirty or forty years—distributes the burden more evenly over time, albeit at a greater overall cost to taxpayers. Amortizing liability by making equal annual payments over a closed thirty- or forty-year period resembles the thirty-year fixed rate mortgage home buyers have traditionally used to finance their purchases.[297] The state makes the same payment each year until the liability is extinguished at the end of the period.

To reduce the size of initial state contributions, states have used two variations on the "closed period," "level dollar" amortization mechanism, defined below. The first variant substitutes a "percent of payroll" approach for the "level dollar" approach described in the

291. *See supra* Subpart III.C.1.
292. *See* BOYD & YIN, *supra* note 47, at 3–4.
293. *See* Madiar, *supra* note 291, at 169–70.
294. *See* Katherine Loughead, *How Well-Funded are Pension Plans in Your State?*, TAX FOUND. (May 17, 2018), https://taxfoundation.org/state-pensions-funding-2018/.
295. *See* Monahan, *supra* note 19, at 119–20.
296. *See id.*
297. For an argument that a thirty-year amortization period is excessively long with respect to public employees, see Hylton, *supra* note 1, at 432.

preceding paragraph.[298] Rather than contributing the same amount each year, the state's annual contribution is computed based on a percent of the payroll of members of the retirement plan.[299] The percent of payroll approach assumes that salaries of members will rise over time (presumably with inflation) and that the state's required contribution will increase over time at the same rate as salaries, resulting in a more equal allocation of pain to taxpayers.[300] The effect of the percent of payroll approach, however, is to backload the state's payments, easing the immediate burden on the state.[301]

As time passes, and the percent of payroll payments increases, states can seize upon the second variant on the thirty-year closed amortization approach: the state can treat the amortization period as "open" rather than "closed."[302] That is, the state can restart the amortization process over a new thirty-year period. This enables the state to make the smaller amortization payment the payroll method requires in its early years.[303]

Taken together, these two variations—the percent of payroll approach combined with an open amortization period—allow the state to achieve negative amortization.[304] Although the state purports to amortize its unfunded liability, in fact that liability continues to increase because the state's contributions do not cover the interest on the previous year's unfunded liability.[305] Moreover, so long as the state continues to use open periods, it will never actually pay off the unfunded liability.[306] The choice of amortization method, then, can have a significant impact on the state's funding ratio.

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298. *See* Boyd & Yin, *supra* note 47, at 5, 7.

299. *Id.* at 5.

300. Commonwealth of Ky., *supra* note 3, at 58.

301. *Id.*

302. For examples demonstrating the comparative operation of open and closed amortization periods, see Jeffrey Diebold, Vincent Reitano & Bruce McDonald, *Sweat the Small Stuff: Strategic Selection of Pension Policies Used to Defer Required Contributions*, 36 Contemp. Econ. Pol'y 1, 7–8 (2017).

303. *See id.*

304. *See* David Kausch & Paul Zorn, Developing a Pension Funding Policy for State and Local Governments 4–5 (2012).

305. *See* Boyd & Yin, *supra* note 47, at 8. Even without use of open period amortization, a level percent of payroll approach can generate negative amortization if the State's estimates of payroll growth are overly optimistic. For instance, in Kentucky, actuaries made a payroll growth rate assumption of 3.5 to 4.5% annually, but in fact, from 2005 to 2016, the size of the state's workforce dropped by 19.8%. As a result, the statutorily required contributions were smaller than necessary to maintain existing funding levels. *See* Commonwealth of Ky., *supra* note 3, at 58–60.

306. Boyd & Yin, *supra* note 47, at 5.

b. Statutory Treatment of Amortization

The variety of amortization techniques raises two questions. First, to what extent have states with healthy plans resisted use of open periods combined with a percentage of payroll approach? Second, to what extent has law in those states restrained officials from using these politically attractive alternatives?

Consider first the treatment of amortization in states with troubled plans. Until recent reforms, no states had statutes providing for level dollar amortization over a closed period. Rhode Island and Illinois effectively had no actuarially based funding system until 2001 and 2012, respectively, making any discussion of amortization methods largely irrelevant.[307] Connecticut did not mandate actuarial funding until roughly 1990,[308] and even after that date, its statutes did not mandate level dollar contribution,[309] nor did they mandate a closed amortization period.[310] Moreover, Connecticut's amortization provisions hardly operated as a statutory constraint in light of the Connecticut statute permitting a collective bargaining agreement to override any statutory contribution that would otherwise be mandated.[311] Kentucky and New Jersey have consistently had statutory amortization provisions in place;[312] neither mandated level dollar amortization, however, until a 2011 New Jersey statute mandated level dollar amortization.[313] Until 2018, New Jersey statutes authorized amortization over an open period.[314] Kentucky statutes have provided for a closed period,[315] but the legislature

307. *See* 2001 R.I. Pub. Laws Ch. 77, art. 18 (eliminating provision allowing the State to make whatever contributions it saw fit and requiring funding on an actuarial basis—albeit one providing for open thirty-year periods); 2010 Ill. Legis. Serv. P.A. 96-1497 (providing for actuarially based funding starting in 2012).

308. Connecticut statutes did not require the State to contribute 100% of payments necessary to amortize its teacher retirement plan until 1992, *see* CONN. GEN STAT. ANN. § 10-183z (West 2018), nor did it require 100% contribution towards the retirement system for other state employees until 1986, *see* § 5-156a.

309. *See* CONN. GEN. STAT. § 10-183b (2018) (defining amortization for purposes of retirement plan to require level percent of payroll); § 5-154 (defining amortization for purposes of teachers plan but not specifying any precise method).

310. *See id.* § 5-156a(b) (calling for payment of "normal cost plus full 40-year amortization from the beginning of such fiscal year"); *id.* § 10-183z (same for teachers' retirement system).

311. *Id.* § 5-278(e).

312. KY. REV. STAT. ANN. § 61.565 (West 2018); N.J. STAT. ANN. § 43:15A-24 (West 2018).

313. 2011 N.J. Sess. Law Serv. Ch. 78 (West) (adding level dollar requirement to §43:15A-24 and companion statutes).

314. *See, e.g.*, N.J. STAT. ANN. § 43:15A-24(b) (West 2015) (providing that for years from 2002 until 2019, any increase in unfunded liability would increase the amortization period for that liability).

315. *See, e.g.*, KY. REV. STAT. ANN. § 61.565(1)(a) (LexisNexis 2015) (setting closed thirty-year period running from 2007).

amended the statute to reset the period in order to reduce required contributions.[316]

By contrast, statutes in states with healthy plans have generally eschewed percent of payroll amortization over open amortization periods. Although South Dakota's statutes make reference to amortization over a closed period using a percent of payroll approach,[317] the system's implicit assumption is that the plan will always be fully funded, making amortization unnecessary.[318] New York and North Carolina both have statutes providing for level dollar amortization over closed periods.[319] Florida and Wisconsin provide for percent of payroll amortization,[320] but Florida explicitly restricts the assumptions the legislature may make about payroll growth, demonstrating an awareness of the potential for underfunding that might otherwise result.[321] Moreover, both Florida and Wisconsin provide for amortization over a closed period.[322]

Nevertheless, the evidence is insufficient to establish that a state's amortization statutes have a significant impact on the likelihood that the state's retirement plan will be adequately funded. Correlation is not causation. Because their retirement plans have consistently been well funded, those states with conservative amortization statutes have never faced the same temptation to use shortcuts to finance pension obligations.

316. *Id.* § 61.565(1)(b) (resetting amortization period for thirty years from 2013).

317. S.D. CODIFIED LAWS § 3-12-120.4 (2018).

318. *See id.* § 3-12-122 (requiring the retirement board to report to the Governor and the Retirement Law Committee if the funding ratio is less than 100% or if the statutory contribution rate does not meet the actuarially determined contribution rate and requiring the Board to make recommendations to improve the situation if those conditions exist).

319. The New York statute generally requires contribution of the full amount of any obligations to the state retirement system. N.Y. RETIRE. & SOC. SEC. LAW § 16(a) (McKinney 2014). On various occasions, however, statutes have authorized amortization of some amounts due, and on those occasions, the statutes have required the State or other participating employers to use level dollar amortization over a closed period. N.Y. RETIRE. & SOC. SEC. LAW §§ 16–a, 16–c, 16–d, 17–a, 17–b, 17–c, 17–d (McKinney 2018). The relevant North Carolina statute is N.C. GEN. STAT. ANN. § 135-69(c) (West 2017).

320. *See* FLA. STAT. § 112.64(3) (2018); WIS. STAT. § 40.05(2)(b) (2018).

321. *See* FLA. STAT. § 112.64(5)(a) (requiring that assumptions about payroll growth shall not exceed the average payroll growth for preceding ten years).

322. *See id.* § 112.64(3) (providing that unfunded liability must be amortized within forty years of first plan year); WIS. STAT. § 40.05(2)(b).

### 2. *Asset Valuation and Smoothing Techniques*

#### a. Volatility in Fund Value

To obtain optimal returns on retirement funds, retirement boards generally invest in equities and other investments that carry risk.[323] As a result, the market value of fund assets can vary significantly from year to year. When market value increases, unfunded liability decreases; when market value diminishes, unfunded liability increases.[324]

If state contributions to the retirement plan must only cover all or part of the plan's unfunded liability, the required contributions may diminish, or disappear altogether, in years when investment returns exceed expectations.[325] Indeed, a state might be tempted to use unexpected investment returns to avoid making normal contributions—the contributions needed to pay for the benefits accrued during the year.

Conversely, when market returns do not meet expectations, or when the fund suffers market declines, a state that has previously used unexpected returns to reduce or eliminate state contributions now faces a triple whammy. First, larger state contributions will be necessary to make up for the absence of investment returns.[326] Second, if the state has previously used unexpected returns to fund other state programs, the state will face pressure to maintain those programs even though it is now obligated to use the money to fund the retirement plan.[327] Third, years in which investment returns are poor are also likely to be years in which state tax revenue is smaller,[328] creating further budgetary pressures.

#### b. Statutory Mechanisms for Reducing the Impact of Market Volatility

Despite the risk of future investment losses, state officials face political pressures to use unexpected market gains as excuses to reduce retirement plan funding in favor of spending that is more visible to the voting public.[329] South Dakota, North Carolina, New York, and Wisconsin have statutory provisions designed to restrain those impulses.

323. *See supra* text accompanying notes 47–50.
324. *See* Loughead, *supra* note 294.
325. *See Basics of Corporation Pension Plan Funding*, MANNING & NAPIER (Sept. 17, 2014), https://www.manning-napier.com/insights/blogs/research-library/basics-of-corporate-pension-plan-funding.
326. *See* Beermann, *supra* note 11, at 35.
327. *See id.* at 30, 34–36.
328. *See id.* at 35.
329. *Cf. id.* at 26–27 (analogizing underfunded pensions to deficit spending and showing how surpluses in the Clinton Administration led to popular deficit spending in the Bush Administration).

South Dakota's statute requires a fixed contribution that does not vary with investment returns.[330] North Carolina's current statute mandates that each year's state contribution will be no lower than the previous year's contribution.[331] A version of that statute has been in place since 1955.[332] Wisconsin and New York have enacted statutes smoothing state contributions more recently. Wisconsin's 2000 statute credits its retirement account with only 20% of the difference between actual returns and expected returns, plus 20% of the difference over the preceding four years,[333] essentially smoothing out investment returns over a longer period of years and reducing the legislature's ability to use unexpected market returns as an excuse to reduce retirement funding. New York's statute, enacted in 2003, requires a minimum contribution, measured as a percentage of payroll, even if no contribution would be needed to avoid unfunded liability.[334] Although these statutes vary among themselves, they all operate to smooth out state contribution levels and to avoid the budgetary fluctuations that would otherwise exist.

The experience in states with less healthy retirement plans demonstrates that statutory smoothing provisions are no panacea, because legislatures can undo them when they prove inconvenient. New Jersey's statutes include a smoothing provision that includes as "valuation assets" only 20% of the difference between expected value and full market value of assets.[335] One of the major contributors to New Jersey's pension difficulties, however, has been the legislature's override of that provision with an enactment providing that "[n]otwithstanding the first sentence of this paragraph, the valuation assets for the valuation period ending March 31, 1996 shall be the full market value of the assets as of that date . . . ."[336] Although Rhode Island did not enact a smoothing statute until 2005,[337] its experience

330. S.D. CODIFIED LAWS § 3-12-71 (2018) (requiring employer contributions equal to specified employee contributions).

331. N.C. GEN. STAT. ANN. § 135-8(d)(3a) (West 2018).

332. Act of May 20, 1955, ch. 1155, sec. 5, § 135-8(d)(3), 1955 N.C. Sess. Laws 1138, 1140 (adding the requirement of an increase of 3% above the preceding year's contribution).

333. WIS. STAT. ANN. § 40.04(3)(am) (West 2017).

334. N.Y. RETIRE. & SOC. SEC. LAW § 23-a (McKinney 2018) (empowering the controller to require contribution of the greater of 4.5% of payroll or an actuarially required contribution).

335. N.J. STAT. ANN. § 43:15A-24(b) (West 2015).

336. Act of June 5, 1997, ch. 115, sec. 1, § 18A:66-18(b), para. 2, 1997 N.J. Laws 417, 418–19.

337. Act of June 30, 2005, ch. 117, art. 7, sec. 2, § 36-10-2(g), 2005 R.I. Pub. Laws 545, 638 (requiring the State to pay to the retirement system 20% of the rate reduction that would otherwise be permitted).

was similar: within five years the legislature enacted exceptions for fiscal years 2009, 2010, and 2011.[338]

Statutory smoothing provisions, if routinely honored, have the potential to reduce the volatility of state pension contributions.[339] And, for the most part, states with healthy retirement plans enacted smoothing statutes before states with troubled plans.[340] But the experience in New Jersey and Rhode Island establishes that the existence of smoothing provisions hardly serves as a bulwark against political pressures.

## IV. IMPLICATIONS AND THE ROAD FORWARD

Unfortunately, our research has uncovered no magic legal structure that ensures full funding of a state's pension plan. The clearest finding is that judicial enforcement of funding requirements has a positive impact on plan health. In this instance, there is evidence of causation rather than just mere correlation: the states in which courts have intervened were states in which the legislature, if unconstrained, would have taken steps to reduce funding levels.[341]

Assessing the effectiveness of other legal mechanisms to ensure funding is a more complex endeavor. States that provide special channels for pension legislation appear to be somewhat more successful in maintaining adequate funding, but the channeling process may simply reflect a preexisting commitment to retirement funding that would have generated adequate funding regardless of the process.

Closed amortization periods, level payment amortization, and techniques for smoothing investment fluctuations should also operate to reduce underfunding. Past practice has demonstrated, however, that even if legislatures adopt these techniques, they will find ways to avoid implementing them when fiscal stress makes them inconvenient.[342]

In the absence of a surefire legal mechanism to avoid underfunding, what road should states take going forward? In principle, defined benefit plans remain an attractive alternative for states seeking to provide for employee retirement—so long as those states can maintain fiscal discipline. With defined benefit plans, the

338. Act of June 10, 2010, ch. 23, art. 16, sec. 1, § 36-10-2(e), 2010 R.I. Pub. Laws 116, 271–72.

339. SOC. OF ACTUARIES, OBSERVATIONS ON INPUT AND OUTPUT SMOOTHING METHODS: HOW DO THEY AFFECT THE FUNDING OF DEFINED BENEFIT PLANS? 2 (2013), https://www.soa.org/Files/Research/Projects/research-2013-in-out-smo-repo.pdf.

340. In addition to Rhode Island, which enacted smoothing provisions in 2005, Illinois enacted smoothing provisions in 2009. b2009 Ill. Legis Serv. PA96-43 (West) (codified as amended at 40 ILL. COMP. STAT. ANN. 5/14-131(g)).

341. *See supra* Subpart III.C.1.

342. *See supra* Subpart III.C.1.

government employer generally bears the risks of actuarial variation and market fluctuation, rather than the individual employee who is less able to bear that risk.[343] Moreover, because of economies of scale, the investment costs associated with defined benefit plans are generally lower than those prevalent in defined contribution plans.[344]

Defined benefit plans have been rapidly disappearing from the private sector for two principal reasons.[345] First, the regulatory structure imposed by ERISA made them unattractive to private companies,[346] and second, defined contribution plans are particularly attractive to employees who expect to change jobs with frequency.[347] Neither of these reasons applies with the same force to government employees; ERISA does not apply to government plans.[348] Because teachers, firefighters, police officers, and sanitation workers have few alternatives to government employment, they are more likely than private employees to spend their entire careers within the same retirement system.[349]

Defined benefit plans, however, do present a host of actuarial and investment uncertainties for government employers.[350] The fluctuating contributions necessary to account for changes in actuarial and investment assumptions can wreak havoc with state budgetary practices.[351] Some states have successfully coped with these difficulties.[352] For states that seem unable to develop the discipline to deal with these fluctuations, defined contribution or cash

343. *See* MONIQUE MORRISSEY, ECON. POL'Y INST., WILL SWITCHING GOVERNMENT WORKERS TO ACCOUNT-TYPE PLANS SAVE TAXPAYERS MONEY? 11 (Mar. 5, 2015), https://www.epi.org/files/pdf/80935.pdf.

344. *See, e.g.*, ALICIA H. MUNNELL ET AL., CTR. FOR RET. RES. AT BOS. COLL., A ROLE FOR DEFINED CONTRIBUTION PLANS IN THE PUBLIC SECTOR 1, 2 (Apr. 2011), http://crr.bc.edu/briefs/a-role-for-defined-contribution-plans-in-the-public-sector/ (noting that pooling of investments reduces investment costs); *see also* MORRISSEY, *supra* note 343, at 7.

345. For an excellent account of the decline of defined benefit plans, see ZELINSKY, *supra* note 58, at 31–38.

346. *See* WOOTEN, *supra* note 58, at 278 (noting that funding standards for defined benefit plans decreased their attractiveness compared to defined contribution plans).

347. Defined benefit plans typically have vesting requirements that impact employees who leave an employer before vesting with no retirement benefits. *See* Patrick W. Seburn, *Evolution of Employer-Provided Defined Benefit Pensions*, 114 MONTHLY LAB. REV. 16, 21 (Dec. 1991).

348. 29 U.S.C.A. § 1002(32) (West 2018); McGraw v. Prudential Ins. Co. of Am., 137 F.3d 1253, 1257 (10th Cir. 1998).

349. *See generally* BUREAU OF LABOR STATISTICS, EMPLOYEE TENURE IN 2018 (Sept. 20, 2018), https://www.bls.gov/news.release/pdf/tenure.pdf (finding that "[i]n January 2018, wage and salary workers in the public sector had a median tenure of 6.8 years, considerably higher than the median of 3.8 years for private-sector employees.").

350. *See, e.g.*, Anenson et al., *supra* note 7, at 52.

351. Munnell et al., *supra* note 23, at 6.

352. *Id.* at 4–5.

balance plans might provide a more stable retirement foundation for employees and taxpayers.[353] They also eliminate complaints about transparency and unfairness that often plague defined benefit plans—particularly concerns about "pension spiking" by employees who manage to increase their hours, and their compensation, in the last years of employment to pad their retirement benefits.[354]

Cash balance plans, in particular, offer employees many of the advantages of defined benefit plans without the need to make investment decisions and without the costs associated with individual account management.[355] They operate by guaranteeing the employee a specified rate of return, removing some of the downside risk associated with defined contribution plans.[356] They may also permit covered employees to share in some of the upside reward associated with higher than expected returns.[357] From the government's perspective, these plans provide for a stable, predictable annual contribution and therefore provide much less prospect for underfunding.[358]

Our objective is not to endorse one approach over another. Indeed, the disparity in experience among the states suggests that different approaches might be better suited to different circumstances. We would be remiss, however, in ignoring the transition issues states face when making significant changes to their retirement plan. As we have seen, many state constitutions include

353. *See generally* Hylton, *supra* note 1, at 464–67.

354. A 2011 California commission defined pension spiking as "[t]he practice of increasing [an employee's] retirement allowance by increasing final compensation or including various non-salary items (such as unused vacation pay) in the final compensation figure used in the [employee's] retirement benefit calculations, and which has not been considered in prefunding of the benefits." Marin Ass'n of Pub. Emps. v. Marin Cty. Emps.' Ret. Ass'n, 206 Cal.Rptr.3d 365, 371 (Cal. Ct. App. 2016) (citation omitted). California's efforts to control pension spiking have spawned considerable litigation and appears destined to reach the California Supreme Court. *See generally* Thompson v. Cal. State Teachers Ret. Sys., No. C075740, 2018 WL 257033 (Cal. Ct. App. Jan. 2, 2018), *review denied* (Mar. 28, 2018). A bill to prevent pension spiking in Kentucky was introduced in the 2017 legislative session. S.B. 104, 2017 Reg. Sess. (Ky. 2017) (limiting the growth in creditable compensation for the last three years before retirement to 10%). Given that pension spiking can have a considerable impact on pension plan liability, imposing such limitations on creditable earnings may help prevent pension spiking for future plan beneficiaries.

355. *See* Anenson et al., *supra* note 7, at 54–55.

356. *See* PEW CHARITABLE TRS, PUBLIC PENSION CASH BALANCE PLANS 3 (2014), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2014/cashbalancebriefv7pdf.pdf [hereinafter PEW CHARITABLE TRS, PUBLIC PENSION CASH BALANCE PLANS].

357. *Id.* at 8; *see* KY. REV. STAT. ANN. § 61.597(2) (West 2018) (Kentucky's cash balance plan guarantees employees a return of 4% plus ¾ of the excess return above 4%, measured over a five-year period).

358. PEW CHARITABLE TRS, PUBLIC PENSION CASH BALANCE PLANS, *supra* note 356.

pension protection clauses,[359] while courts in other states treat pension provisions as contracts protected by the Contracts Clauses of the State and Federal Constitutions.[360] For this reason, much pension reform has focused on new employees or those who have acquired no "vested rights" under existing pension statutes.

Another approach, suggested by Adam Riff, involves using the eminent domain power to condemn existing pensions, paying "just compensation" to participants in the current system by giving them rights of equivalent value in a replacement system.[361] Justices of the United States Supreme Court have indicated that just compensation need not be cash compensation,[362] so from the perspective of the Federal Takings Clause, eminent domain would enable a state to avoid the disruption caused by unanticipated actuarial changes or investment results.[363] Whether state courts would hold that use of the eminent domain power violates state constitutional provisions protecting pensions (or other state constitutional provisions) remains an unresolved question.[364] And, of course, a State considering the eminent domain alternative would have to work out the tax consequences of a replacement system.

## V. CONCLUSION

Many interrelated, economic, and political factors have contributed to the underfunding of state and local defined benefit plans, some of which are beyond legal constraint. Market fluctuations, poor investments, overly rosy projections of returns, competing demands for limited tax revenues, and incentives to provide current benefits while deferring payment for as long as possible have all contributed to underfunding. One approach to combat persistent underfunding is to substitute deferred contribution plans, or cash balance plans, for defined benefit plans. These plans take the uncertainty out of funding for future benefits and in essence

359. *See supra* Subpart III.C.1.

360. *See, e.g.* People *ex rel.* Sklodowski v. State, 695 N.E.2d 374, 379 (Ill. 1998).

361. Adam Riff, Note, *The Eminent Domain Path Out of a Public Pension Crisis*, 37 CARDOZO L. REV. 307, 337–51 (2015).

362. *See* Penn Cent. Transp. Co. v. City of N.Y., 438 U.S. 104, 152 (1978) (Rehnquist, J., dissenting) (concluding that transferable development rights could be counted as part of just compensation; the majority never reached the issue because the justices concluded there was no taking); *see also* Suitum v. Tahoe Reg'l Planning Agency, 520 U.S. 725, 747 (1997) (Scalia, J., concurring in part and concurring in the judgment) (also appearing to conclude that TDRs can be considered a form of compensation).

363. *See Penn Cent. Transp. Co.*, 438 U.S. at 152 (Rehnquist, J., dissenting).

364. For a discussion of the state constitutional issues, see Riff, *supra* note 361, at 341–48.

bring government employees in line with most private employees, who plan for and manage their own retirement savings.

Defined benefit plans, however, retain significant advantages, particularly for career government employees. Administrative costs are likely to be lower.[365] Government employers are generally in a better position to bear the actuarial risks and market risks than are individual government employees. These advantages of defined benefit plans are sufficient to outweigh the risk of underfunding only if the state can put in place effective mechanisms to avoid underfunding—a proposition that has proved elusive for many states.

Elected officials in many states operate under legal constraints on pension funding imposed by constitutions, statutes, and courts. Our examination evidences that when significant constraints are in place—particularly, when courts impose funding requirements and when statutes impose sanctions for failure to make adequate contributions—pension plans are generally better funded than in the absence of those constraints. Although the correlation is not conclusive, the evidence points towards the conclusion that a state can reduce the risk of underfunding by imposing the right set of constraints on legislative behavior. Whether the relevant state actors—judges as well as legislators—have the will to impose those constraints remains an unresolved question.

365. Munnell et al., *supra* note 23, at 2.