SIEPR Discussion Paper No. 13-020

Judicial Intervention In Public Pension Crises: An Institutionalist Critique

By

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JUDICIAL INTERVENTION IN PUBLIC PENSION CRISES: AN INSTITUTIONALIST CRITIQUE

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Preliminary Draft – September 20, 2013

Abstract: Legal scholars have long debated the role for courts in with respect to governmental action in response to crisis. Most of those crises, however, are exogenous to the political process. The courts' role in response to politically endogenous crises is more complicated. We evaluate the role of the judiciary in those endogenous crises, looking most closely at the judicial treatment of public pensions. Assessing institutional competence schematically with reference to an institution's democratic accountability and fact-finding ability, we argue that, where institutions function properly, judicial intervention in politically endogenous economic crises should be close to nonexistent. But because parties invoke the courts' jurisdiction to resolve fiscal disputes, and that jurisdiction is not otherwise barred, judicial determinations will continue to occur. We argue that, in those circumstances where the judiciary must intervene, that intervention should respect the judiciary's comparative institutional incompetence by treading lightly, constitutionally speaking: where the legal question leaves the court room, and where a non-constitutional determination is possible, courts addressing the state's fiscal policy-making apparatus should avoid constitutional pronouncements entirely. We then apply this framework to two areas where courts have or might breach it: the out-of-bankruptcy application of the Contracts Clause to public pensions (in favor of public employees), and the in-bankruptcy application of the Supremacy Clause (against those employees). The critique, then, is an institutionalist one: the point is not to promote or demote the interests of a single class or faction active within the fiscal policy-making process—whether bondholders, public unions, taxpayers, or the government—but to locate that policy-making process within the most democratically responsive and empirically competent institutions.

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INTRODUCTION

The recent financial crisis has led to an important debate among legal scholars and policy-makers regarding the authority and efficacy of various institutions—whether the President, courts, Congress, and others—in responding to the exigencies of such crises.[1] There is nothing new, of course, in comparative analysis of institutional competence.[2] What is new, or at least resurgent, is comparison in the context of crises.[3] When the stakes are high and time is short, the question of institutional competence in the first response becomes especially important.

But that crisis-focused effort to describe and prescribe the role of institutions in the face of crises has discussed mostly the governmen-

[1] ERIC A. POSNER & ADRIAN VERMEULE, THE EXECUTIVE UNBOUND: AFTER THE MADISONIAN REPUBLIC 54 (2010) [hereinafter Posner & Vermeule]

[2] NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY (1994).

[3] David A. Skeel Jr., *Institutional Choice in an Economic Crisis*, 2013 WISC. L. REV. 629 (2013).

tal response to *exogenous* crises.[4] These crises include terrorist attacks, financial crisis, natural disasters or any other event that becomes acute, or is recognized as acute, relatively suddenly and requires in turn swift governmental reaction. Political and legal machinery then begin to turn in the face of the crisis, to varying effects. It is the policy processes and products that are deployed in the face of those exogenous crises that have animated almost all of the recent attention.

This debate is important and informative. But not all invocations of judicial authority come in response to exogenous crises. Some crises, and most fiscal crises, are *endogenous*.[5] In exogenous crises, the government's role is to respond. In endogenous crises, the government is both the source of the crisis *and* the first responder. For fiscal crises, the crisis *is* the politics. Political institutions must assess the proper level of taxation and spending, responsive to and constrained by the demands of the electorate. When political actors cannot do so sustainably, a profound mismatch between revenues and expenditures will result. A political failure to resolve that mismatch is at the very heart of a fiscal crisis; it is in this critical respect self-induced. The current crisis over the funding of pubic employee pensions is fundamentally a crisis endogenous to the political process – political institutions set the size of future pension payments, determine the necessary funding and impose the taxes that fund the pensions. A shift in focus from exogenous to endogenous crises thus frames our inquiry: what are the appropriate roles of different institutions, in particular the courts, *when the crisis is internal to the political process itself*?

In this article, we address the current public pension crisis both as an object of interest and as a lens through which to address the role of courts in fiscal crises. To address the question of institutional competence in the context of endogenous crises, we define institutional competence as the intersection of the extent of an institution's democratic legitimacy and its fact-finding capacity. Generally, the institution with the greatest competence is the one for whom the combination of these two criteria is higher than alternative institutions. We will see that the most institutionally competent actors to address fiscal crises will be the political institutions – the engine of the crises' endogeniety. Fiscal policy-making is at the heart of their political

[4] Posner & Vermeule, supra note 1, at 31.

[5] To be sure, exogenous factors such as economic recession or financial crises can contribute to the immediacy of the endogenous crisis. But even in those situations, a political resolution—through decreased services and increased revenues—can be sought. The inability to resolve the problem, in most cases, reflects a political breakdown, not an economic one.

roles.

But there are two reasons why political institutions will punt the resolution of these disputes to courts of various types. First, if the crisis has truly revealed a political impasse, whether as a consequence of choice, strategy or ineptitude, then the institutional competence (as we use the term) of the political institutions is significantly diminished: however effective may be the capacity for neutral fact finding in the abstract, in a political impasse that capacity is at best diminished, at worst destroyed. Second, whether there is a genuine fiscal crisis or not, players within the fiscal process—public employees, other creditors, the government— still will invoke the courts' jurisdiction strategically. Recognizing the difference between genuine fiscal crisis and strategic invocation of courts' jurisdiction is next to impossible for courts, at least ex ante. Consequently, a decision rule is necessary to delineate a court's role in resolving the fiscal crisis despite the judiciary's comparative institutional debilities with respect to democratic legitimacy and fact-finding ability.

We argue here that the decision rule that should guide courts whose jurisdiction in response to fiscal crises should be a variation on the doctrine of constitutional avoidance: if a non-constitutional resolution is available, courts should pursue that resolution. In the institutional framework we propose, courts that must decide fiscal crisis issues should avoid declaring principles of constitutional law unless the principle is wholly uncontroversial. Such a constitutional soft touch forces the issue back to the political branches, with both the opportunity and the continuing obligation to address the fiscal crisis. In this formulation, a judicial decision does no more than allocate the burden of political resolution back to the politically accountable institutions by correcting the fiscal impact of judicial decisions.

To illustrate the framework and the role of courts within it, we address a central legal issue that directly bears on fiscal crisis-driven pension litigation: the so-called "California Rule." The term refers to a California state court doctrine that prospective pension assurances are protected by the Contracts Clause of the California and U.S. Constitutions, which then prevents states from reducing the manner in which unvested pension benefits accrue in the future to current employees. We look closely at the legal and economic context of the California Rule and acknowledge that constructing the terms of the public employees' bargain is difficult particularly in light of longstanding precedent. Given that difficulty and courts' comparative institutional disadvantages, we argue that the courts lack the institutional competence to resolve the matter. Thus, our institutionalist framework directs that the case be resolved in a way that avoids a constitutional determination that has the dual debilities of relieving current political institutions from addressing the fiscal crisis and ties the hands of future political actors in the process.

The essay proceeds as follows. Part I goes into more detail regarding the intersection of endogenous crises and the institutions that respond to them. Unlike recent literature that focuses on the role of the executive and the relative irrelevance of legal restrictions—including judicial efforts to restrict executive action —we argue that endogenous fiscal crises are quite distinct from exogenous financial or national security crises, but that courts nonetheless remain institutional less competent than political institutions to address them. We lay out the institutional competence framework, and explain why even less competent institutions must sometimes intervene because of political gridlock. We then describe the decision rule that should guide that intervention: the court's proper goal is to force the political institutions to address the issue rather than displacing them by constitutionalizing the issue.

Part II then applies the institutional competence framework to the California Rule. We disagree with other commentators who have criticized the rule on jurisprudential grounds—as a matter of constitutional law, the treatment of unvested pension promises is difficult because of California's long adherence to the rule, giving it a stronger value as precedent, and because the standard governing the application of the Contracts Clause in this context remains largely undeveloped. But precisely because of this legal uncertainty, we argue, courts are wrong to render decisive constitutional judgment. Institutionally, the better approach is to force more competent political institutions to resolve the contractual status of unvested benefits through private negotiation, electoral politics, or strategic action, such as default on the government's part or strikes by the unions. This judicial deference to political-fiscal institutions thus allows the costs and benefits of fiscal policy-making to be fully born by politically accountable actors.

Part III then concludes with a brief application of the comparative institutional competency framework to a quite different but related issue, that of the federal constitutional issues within municipal bankruptcy, and in particular the case of Detroit. We note that the federal constitutional issues involved in municipal bankruptcy generally, and in Detroit in particular, are quite different from the out-of-bankruptcy rule in California, in their focus on vested versus unvested pensions, the difference in degree of fiscal crisis, and the intersections of state and federal law. Even so, the institutionalist critique developed in this essay would counsel constitutional humility in the Detroit case just as it does in California: a federal bankruptcy judge may have evaluative competence not seen in all judicial contexts, but democratic legitimacy is even lower. We argue, then, that the federal courts should tread lightly in constitutional interventions that fix the relative positions of bargaining parties in a way that the Detroit and Michigan electorate cannot undo.

I. INSTITUTIONAL COMPETENCE AND FISCAL CRISIS

A. *Context of Institutional Comparison*

For policy purposes, the measure of any institutional evaluation is inherently comparative. The question is posed not in the abstract, but in response to a problem, in our case, the need to respond to an endogenous fiscal crisis: which institution among available alternatives can best resolve the crisis? Neil Komesar poses a useful frame for analyzing an institutions fit with a particular problem.[6] Under the Komesarian analysis, the question of institutional fit is inherently a comparative one:

> Issues at which an institution, in the abstract, may be good may not need that institution because one of the alternative institutions may be even better. In turn, tasks that strain the abilities of an institution may wisely be assigned to it anyway if the alternatives are even worse.[7]

As David Skeel has recently argued, a hole in the Komesarian analysis leaves open how the existence of a crisis may radically change the comparative analysis that would otherwise be applicable in calmer times.[8] Attributes such as speed of reaction and capacity for detailed fact finding may figure differently in the analysis when circumstances are more extreme. However, even as crisis changes the relative importance of specific institutional attributes, it does not change the basic thrust of the comparative analysis: the goal is still to locate the most effective institutional alternative for resolving a specific public policy dispute. That goal remains, even in a crisis, a relative rather than an absolute inquiry.

To be sure, the presence of a crisis can shift the institutional

[6] See generally KOMESAR, supra note 2. For related analyses, see Howard S. Erlanger & Thomas W. Merrill, *Institutional Choice and Political Faith*, 22 LAW & SOC. INQUIRY 959, 963 (1997); Richard J. Price, Jr., *Public Utility Regulatory Takings: Should the Judiciary Attempt to Police the Political Institutions?,* 77 GEO. LJ. 2031, 2040 (1989)

[7] KOMESAR, *supra 2*.

[8] Skeel, *supra* note 3.

comparison in favor of the institution best able to act decisively in the face of crisis, even in the face of legal prohibition or institutional deficiencies that would loom large absent the crisis. Posner and Vermeule take this position: descriptively and prescriptively, the executive—including the administrative state that the executive ostensibly oversees—will be best situated to respond to crises consistent with popular sentiment, even if not always consistent with law.[9] Particularly when the legal system will be available to sort out the consequences of swift if debatably lawful institutional actions, the fact of the crisis may privilege speed over certainty of authority.

Posner and Vermeule's institutional defense of the executive is not without critics.[10] But we need not engage that debate for our purposes. For them, the comparative institutional evaluation takes place in the face of *exogenous* crises: that is, crises that are largely not creations of the political institutions themselves. We are concerned with *endogenous* crises, where the economic debacle is itself a result of a political process.

Before proceeding, it is important to acknowledge that the designation between endogenous and exogenous crises may blur somewhat at the margin. The 2008 financial crisis illustrates the point well. Critics from the left and right have highlighted several actions, ranging from the repeal of Glass-Steagall,[11] to changes in SEC leverage requirements,[12] to the Congressional support for government-sponsored enterprises Fannie Mae and Freddie Mac[13] or the Fed's monetary policies in the early 2000s,[14] which with the benefit of hindsight might have adverted or moderated the 2008-2009 financial crisis. Indeed, almost tautologically, hindsight renders government action or inaction inherently a cause of financial crises – the govern-

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[9] The role of the Treasury and Federal Reserve in influencing wither Bank of America could close its acquisition of Merrill Lynch without the delay that would be associated with recirculating the proxy statement to approve the transaction in light of arguably material new information poses this issue nicely.

[10] See Saikrishna B. Prakash & Michael D. Ramsey, *The Goldilocks Executive*, 90 TEXAS L. REV. 973 (2012).

[11] Cyrus Sinati, *10 Years Later. Looking at the Repeal of Glass-Steagall*, N.Y. TIMES DEALBOOK (Nov. 12, 2009), http://dealbook.nytimes.com/2009/11/12/10-years-later-looking-at-repeal-of-glass-steagall/?_r=0

[12] Alan S. Blinder, *Six Errors on the Path to the Financial Crisis,* N.Y. TIMES (Jan. 24, 2009), http://www.nytimes.com/2009/01/25/business/economy/25view.html

[13] Nick Timiraos, *Five Years Later, Fannie Mae and Freddie Mac Remain Unfinished Business*, WALL ST. J. (Sept. 6, 2013), http://online.wsj.com/article/SB10001424127887323423804579022672911329450.html

[14] John B. Taylor, *How Government Created the Financial Crisis,* WALL ST. J. (Feb. 9, 2009), http://online.wsj.com/article/SB123414310280561945.html

ment could have acted or could have acted differently. In invoking the endogenous/exogenous taxonomy, though, we distinguish between cases where the government *contributes* to an exogenous financial crisis, and those, as with fiscal crises, the government *is* the crisis. The endogeneity of fiscal crises remains the governing framework even when, as will almost always be the case, economic recession or financial crisis magnifies the fiscal panic. Because the fiscal policy-making apparatus remains in control of optimizing revenues and expenditures, the inability to bring them into balance still reflects a breakdown of that political process. A comparative institutional assessment in the face of politically endogenous crises is the focus of our inquiry.

B. *Fiscal crisis*

There is no question that the American states are facing a profound mismatch between commitments to public pensions and the funding devoted to support those commitments.[15] The gap between the amount promised to present and future retirees and the funds on hand to honor those promises is staggering. By one estimate, that mismatch amounts to between $3 and $5 trillion, or between $27,000 and $45,000 per American household.[16] The extent of this fiscal mismatch reflects much more than public pensions: it is a fundamental breakdown in the entire fiscal apparatus in the form of a combination of a preference for low taxes and high services. As one commentator colorfully put it, in the context of California, its citizens expect to be “taxed like libertarians, but subsidized like socialists.”[17] For public pensions alone, one source estimates the current unfunded pension liability as ranging from $10.53 billion, or $885 per California household, using a 9.5% discount rate, to $497.9 billion, or $40,850 per household, using a 4.5% discount rate.[18]

[15] *See generally* Olivia Mitchell, *Public Pension Pressures in the United States*, *in* WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS (Peter Conti-Brown & David Skeel eds., 2012)

[16] Amy B. Monahan, *Statutes as Contracts? The “California Rule” and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1031 (2012) [hereinafter Monahan]

[17] Troy Senik, Who Killed California?, Nat'l Affairs, Fall 2009, at 60, available at http://www.nationalaffairs.com/doclib/20091229_Senik_Fall09.pdf

[18] Joseph Nation, *Pension Math: How California's Pension Spending is Squeezing the State Budget* 27-28 (Stanford Institute for Economic Policy Research, 2011). The discount rates reflect the assumed investment rate on amounts contributed, ranging from the lowest rate, which reflects the return on Treasury instruments, to the highest rate, which is slightly higher than estimates of the largest

As we will see, the size of the shortfall reflects the size of the promised pension benefits. Those benefits in turn reflect an inherently political process by which total wages are allocated between current pay, funded through the current budget and necessarily in competition with other demands on the budget, and future pension benefits, the budgetary impact of which can be put off into the future by, among other techniques, the choice of the return assumptions and simple underfunding.

Democratic preferences for low taxes and high services may be sustainable—or at least deferrable—during times of economic growth. When recession comes, however, a combination of increased demands on the public fisc and lower revenues can render the fiscal situation more difficult, sometimes impossible, to sustain under previous assumptions. In the face of that reality, the hard choices of public policy—who should bear burdens of higher taxes and lower services to stem the fiscal tide, and how should those burdens be structured—follow directly.

The timing of when political actors must confront their ambitious past promises has special bearing on the question of pension funding shortfalls. At precisely the time when voters employed in the private sector see their pensions cut or eliminated as a result of difficult economic times, the promised benefits from public pension plans made in a previous era come due under more constrained budgetary circumstances.

C. *Fiscal Crises and Public Pensions*

The consequence of promises made in good times coming due in hard times is at the core of what the fiscal policy-making apparatus in the political branches must confront. But a familiar feature of political economy has made that fiscal landscape for states and municipalities even more difficult. As does every participant in the labor market, government employees seek the best compensation for their services. That compensation typically comes in the form of a combination of current wages and deferred pension benefits. Generally, employers and employees should be indifferent between net-present value equivalents in their immediate distribution (wages) versus deferred distribution (pensions).[19]

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funds' investment returns over the last 20 years. The arguments in favor or against each level of return are discussed in id., at 10 -17.

[19] For present purposes, we ignore rational reasons for employees to discount future benefits, especially when there is a vesting requirement, for example, when current employees do not expect employment to last longer than the vesting period. We also ignore employee risk aversion. As will become apparent, it does not

Generally, but not always. Resolving labor and employment negotiations through optimistically funded or even unfunded increases in pensions rather than through increases in wages has attractive features for both employers and, as a result, for employees, that are grounded in the familiar political economy of public employment. Increases in compensation through wages must be funded currently, with the result of displacing other competing demands on the government whether by using current tax revenue or the government's borrowing capacity. A responsible public official may then be forced to consider strikes associated with the provision of important government services, like schools and public transportation. And in their evaluation of such a strike, the public official will also realize that the voters may be badly hurt by a strike – working parents may not have alternative day care if the schools are closed, or alternative transportation to work if public transit is shout down, etc. The public may also support, politically, the provision of the compensation public employees seek. In contrast to present compensation, then, future promises of pensions resolve negotiation impasses in the short-term, without tapping the immediate budgetary constraints facing the public officials in same time horizon and without angering the electorate.

The fiscal and political concerns only arise, then, when either the assumptions motivating the higher pensions are no longer supported by the relevant economic climate, or because the promises made whatever the economic climate cannot be delivered by the future political will. Thus, at the time of negotiations, it may be in all parties' interests – the employees, the elected officials and the general public – to defer the hard choices until a later point when at least the elected officials and the electorate may be different. In other words, the easy resolution to a thorny current fiscal problem is to make it the problem of future politicians, future employees, and future citizens.

But while the incentives may push all parties to accept the terms of that deferred bargain, the future, of course, ultimately comes. And when there is a gap between a pension promise made at an earlier time and the amount now in pension funds to keep that promise, the once future, now current public officials face a second problem of political economy. Those officials have two options. First, they can honor the pension commitments by raising taxes, taking on further debt, or eliminating other services. But during times of economic recession and necessarily facing high levels of leverage, these options may be politically and economically unsavory; many of the state's most expensive non-employment services—health care, welfare sup-

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change the outcome of the analysis. For significant and important exceptions, see Part II.B.27, infra.

port, unemployment insurance, etc.—experience their most critical demand during a recession. And politically, there may be little enthusiasm for more debt and fewer services to support previous pension commitments at a time when the differences between public and private pension funds will be most salient to the voters.

Second, the officials can renege on those commitments via bankruptcy (if a municipality rather than a state), renegotiation, litigation, or default. The failure to honor that commitment can trigger a countervailing political concern, including public strikes or political opposition from government employees, their unions, and sympathizers in the general public.

The choice between these two classes of options will have political consequences. Public employee unions are active participants in the political process, and so will have supporters within the executive department and the legislature. And, as noted, honoring what are perceived as overly generous pensions while cutting other services, raising taxes, or expanding debt will trigger outcry from voters unsympathetic to public employees. Perhaps more directly, either option will invariably require participation of the legislature, which may be a source of the fiscal tension in the first place.

From a purely institutional perspective, an abstract prescription the option every executive should pursue in every fiscal crisis is folly. Even assuming that the choices are binary, rather than blended, is inaccurate. The point here is only to recognize that the policy process that will result in either the "increase revenues" or the "pension default" options is, in all ways, irretrievably *political*, in the Weberian sense.[20] It deals with the distribution of state authority and power within that state and is irreducibly distributive.

D. *Institutionalist Critique*

Because the tradeoff between increase revenues and decrease pensions default is inherently political, it also necessarily requires a comparative institutional analysis. In the traditional framework, those contending institutions are three: legislative, executive, and judicial.[21]

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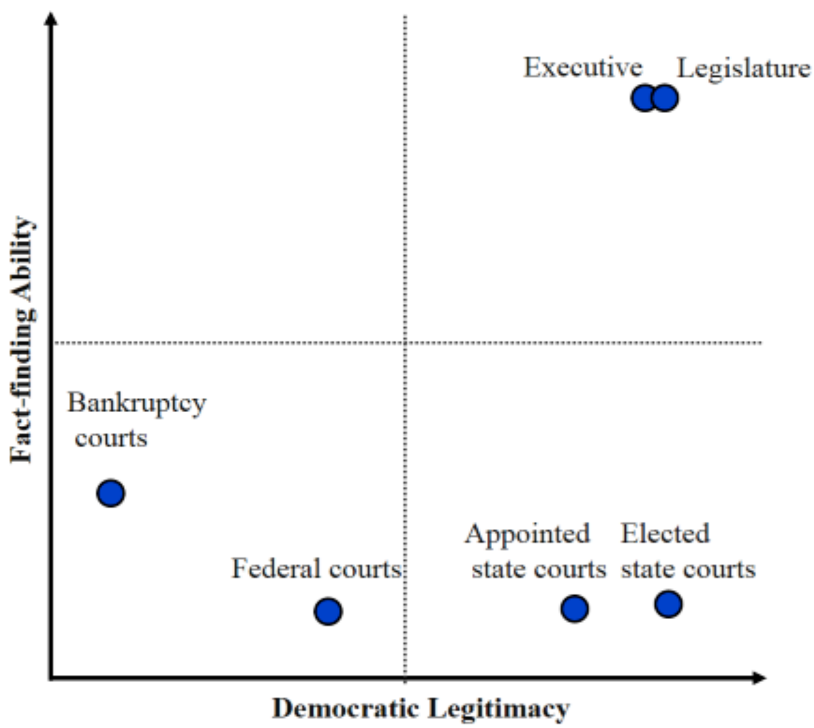
[20] MAX WEBER, POLITICS AS A VOCATION (1919), *reprinted in* FROM MAX WEBER: ESSAYS IN SOCIOLOGY 77, 79 (H.H.Gerth and C. Wright Mills ed., 1991)

[21] We can imagine a role for delegated authority to other institutions. See Peter Conti-Brown, *Direct Democracy and Fiscal Crises: The Problem of Too Much Law*, 7 DUKE JOURNAL OF CONSTITUTIONAL LAW & PUBLIC POLICY 43 (2012) (proposing a federal-state collaboration in creating ad hoc committees given state legal authority to analyze fiscal lawmaking and its contributions to fiscal impasse).

The judiciary has a specific, but extremely limited role, to play in so political a game as fiscal policy-making. To understand why, consider two axes: (1) the democratic legitimacy of the institution, and (2) the institution's ability to gather the facts necessary to evaluate competing proposals to resolve the gap between revenue and expenditures. Figure A describes the interaction between those two axes, and locates several institutions within the resulting quadrants.

Figure A. Comparative Institutional Competence



The figure outlines the intersection of democratic legitimacy on the horizontal axis and institutional fact-finding ability on the vertical axis. The political institutions of the legislature and executive score the highest on both counts. The executive is essentially untrammeled in its fact-finding—its motivations may be entirely political, but it has access to any information through its own experts or outside consultants. Legislative hearings serve the same function. Democratic legitimacy is also high for both. While the entire legislative body may be divided by house at the state level, both state and local legislatures (in the form of city councils) face the electorate frequently.

And then there is the judiciary. In the face of the fiscal mismatch between spending and revenues described above, the most competent institution is that furthest northeast on Figure A.[22] In all cases where all institutions are functioning, the courts will always be southern. Federal courts organized under Article III of the Constitution possess limited democratic accountability; lifetime terms are designed to provide federal judges protection from such accountability. To be sure, the local citizens vote for the President who appoints the judges. But historically the appointment of non-Supreme Court justices have rarely been a serious political issue, and indeed in some jurisdictions the President, in practice though not by law, yields that appointment power in part to Senators and with significant input by the local bar.[23] While more recently appointments of judges to the federal district courts and courts of appeal have become more political, the politicization of their appointment and confirmation do not lessen their independence from the political process. Even when the relationship between the President and judicial appointment is more direct, as

[22] If we cold model the tradeoff between fact-finding and legitimacy, Figure A would reflect a curved frontier whose shape would reflect the marginal rate of substitution between units of fact-finding and units of legitimacy. Understating the terms of the tradeoff and hence the institutions that might be on the frontier requires better theory and more careful analysis – both beyond our need for or ambition here.

[23] *Judicial Nominations and Confirmations*, UNITED STATES SENATE COMMITTEE ON THE JUDICIARY, http://www.judiciary.senate.gov/nominations/judicial.cfm ("The American Bar Association's Standing Committee on the Federal Judiciary also provides an evaluation of the professional qualifications of a judicial nominee"); *Nominations*, UNITED STATES SENATE, http://www.senate.gov/artandhistory/history/common/briefing/Nominations.htm ("Throughout the nation's history, appointments to judicial posts below the Supreme Court have generated little controversy…due in part to the large number of such appointments and to the tradition of "senatorial courtesy," which defers to the preferences of senators belonging to the president's party who represent a particular nominee's home state")

with nominations to the Supreme Court, the President faces a national electorate and a host of other policies for which he is accountable. To assume that lower-court judicial appointments would have significant electoral consequences is heroic at best; Supreme Court nominees may have greater salience, but even here their importance likely requires an issue that is expected to come before the court that is important to a large number of voters.

Elected state courts are closer to the polity and hence have greater legitimacy. But even there, the courts' institutional competence is constrained by courts' inherently limited fact-finding abilities. In common law traditions, the courts review only what is presented to them by the parties, whose discretion in choosing what to present is limited by the rules of evidence. And while adversaries in litigation can be quite thorough in their presentation of the law, they will always do so through the lens of litigation. Legislatures and mayors/governors, whose inquiry is shaped by the policy problem at hand rather than the legal framing of the claim to which the policy problem may give rise, are simply better situated to gather information than courts.

Bankruptcy courts occupy a slightly improved situs for fact-finding purposes, but only slightly. Bankruptcy judges have more familiarity with the debt resolution procedure under the Bankruptcy Code. Theirs is a specialized docket, unlike courts of general jurisdiction. But that specialization is focused overwhelmingly on individual and corporate liquidation and reorganization. It is a contested question whether expertise with those kinds of restructurings increase bankruptcy courts' competence to evaluate fiscal policy.

And, indeed, the bankruptcy courts have even less democratic legitimacy than other courts. They are an additional remove from the political process than the other federal judges. By statute, bankruptcy judges are appointed by appellate courts in consultation with the local bankruptcy bar.[24] These courts enjoy more democratic legitimacy than, say, the bankruptcy bar itself, but not much more.

Courts' deficits of democratic legitimacy is a problem in a variety of contexts,[25] but in crises this deficit is particularly pronounced. As Posner and Vermeule explain,

> the basic problem underlying judicial review of emergency

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[24] 28 U.S.C. § 152 (2005)

[25] Kevin J. Mitchell, *Neither Purse Nor Sword: Lessons Europe Can Learn from American Courts' Struggle for Democratic Legitimacy*, 38 CASE W. RES. J. INT'L L. 653, 656 (2007) (corruption of individual judges as well as apparent judicial bias)

> measures is the divergence between the courts' legal powers and their political legitimacy in times of perceived crisis. . . . [E]mergency measures [taken by the executive] can be "exceptional" in the sense that although illegal, or of dubious legality, they may nonetheless be politically legitimate, if they respond to the public's sense of the necessities of the situation. Domesticating this point and applying it to the practical operation of the administrative state, courts reviewing emergency measures may be on strong legal ground, but will tend to lack the political legitimacy needed to invalidate emergency legislation or the executive's emergency regulations.[26]

Thus, even when the legal answer in the litigation is a clear one—that is, the executive's decision to restructure, in or out of bankruptcy, public pensions is clearly legal or illegal—judicial intervention is suboptimal on the basis of democratic legitimacy alone.

The point is broader than the *political* legitimacy of the government's actions in the face of fiscal restructuring. It is that the courts lack *institutional* legitimacy in this context. Interjections in this profoundly political space necessarily require interference with the very essence of democratic politics – the allocation of government attention and resources among competing claimants. As one court, in the context of Contracts Clause litigation put it,

> Finding a [legislative action is forbidden by the Contracts Clause] has considerable effect. It means that a subsequent legislature is not free to significantly impair that obligation for merely rational reasons. Because of this constraint on subsequent legislatures, and thus on subsequent decisions by those who represent the public, there is, for the purposes of the Contract Clause, a higher burden to establish that a contractual obligation has been created.[27]

This same reality, in light of the courts' inferior democratic legitimacy and fact-finding abilities, render them institutionally less competent to address the inherently political resolution of a fiscal crisis.

[26] POSNER & VERMEULE, *supra* note 1. As we discussed previously, the fact that a court may reexamine executive action after the crisis has abated provides a check on marginally legal (or worse) executive actions taken in the heat of the crisis.

[27] *Parella v. Ret. Bd. of the R.I. Emps.' Ret. Sys.*, 173 F.3d 46, 60 (1st Cir. 1999)

E. *Justiciability and Political Dysfunction*

It would be tempting, then, to dismiss *any* judicial participation in the resolution of fiscal disputes. But two factors make that judicial participation inevitable, one legal and one pragmatic.

The legal factor is the doctrines of justiciability that govern the kinds of cases that the courts can or cannot entertain. For present purposes, we need not detail these extensive doctrines,[28] but the simple point is that, assuming basic personal and subject matter jurisdiction, courts with only few exceptions must resolve the cases that litigants have properly brought before them. A lack of institutional fit that does not exclude the matter from the courts' jurisdiction does not relieve the court from its obligation to address the case. As we will see, however, it does counsel that the court's limited institutional competence should result in the court restricting the extent of its intervention

One doctrine of justiciability, the political question doctrine, is of most direct relevance. The political question doctrine, in its iconic formulation, allows an exception to the general requirement that courts resolve cases before it when "there is a textually demonstrable constitutional commitment of the issue to a coordinate political department; or a lack of a judicially discoverable and manageable standards for resolving it."[29] So, for example, courts will refuse to meddle with the internal operations of the U.S. Senate, but will still adjudicate hot-button public policy disputes.

The resolution of fiscal policy disputes comes close to the second factor announced by the Court: "a lack of judicially discoverable and manageable standards for resolving" the issue. That said, courts adjudicate disputes between the government and its employees, citizens, bondholders, and other creditors all the time. The entire tax court system, reviewed by Article III courts, exists to adjudicate citizen challenges to fiscal policy (in the form of tax policy).

Thus, the question of whether unvested public pension commitments can be altered is not a political question in the constitutional sense of that term. Nor do we advocate raising the justiciability bar to preclude these kinds of disputes. Instead, we suggest a decision rule that might be viewed as a fellow traveler with that doctrine. It is, indeed, a rule that recognizes that, although justiciable, "the political question"—in the natural rather than the legal meaning of those words—points toward a need for the judiciary to tread very lightly.

[28] See ERWIN CHEMERINSKY, FEDERAL JURISDICTION CH. 2(2012).

[29] *Nixon v. United States*, 506 U.S. 224, 228 (1993) (quoting *Baker v. Carr*, 369 U.S. 186, 217 (1962)).

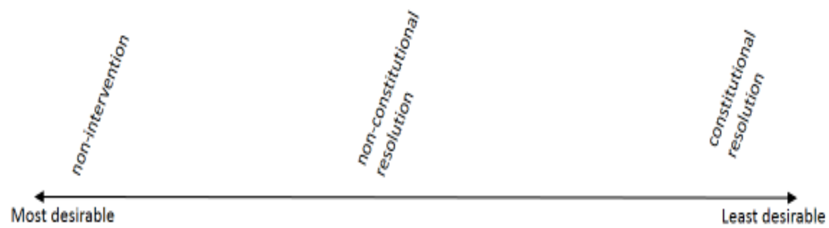
As we said earlier, there is also a pragmatic inevitability of judicial intervention in fiscal policy. Because fiscal crises are endogenous, the institutions with greater institutional competence, as we have defined it, are operating in the dysfunctional range. In other words, when the state's inability to bridge the fiscal gulf previous promises have created, the institutionally superior actors may no longer able to take advantage of their institutional superiority.

In those instances, the Komesarian charge to look for the "least bad" institutional option creates a role for limited judicial intervention. In effect, the crisis results in a change in state for the institutionally more competent politically accountable institutions. The fluidity of these institutions freezes, leaving them conceptually competent but practically frozen and therefore dysfunctional.

We must be careful, however, not to overstate the potential for judicial intervention in fiscal crisis because of the political dysfunction of more competent institutions. That the inability of other institutions to act creates the need for some judicial action does not alter the courts' limited competence. Political actors—be they the institutions themselves, or those actors or factions whose interests are most affected by the resolution of the fiscal mismatch—can be expected to seek judicial intervention not only because the political process has broken down, but because litigation is in the party's strategic interests. Sophisticated political actors then can take advantage of the courts' lack of institutional competence to further their own interest. Thus, courts must keep in mind their own limited competence when, predictably, they are drawn into the resolution of a fiscal crisis.

F. *Jurisprudential Difficulty, Constitutional Avoidance*

This conclusion—that courts, despite their institutional infirmities, will entertain fiscal disputes so long as their jurisdiction is properly invoked—does not end the institutional comparative inquiry. It is, rather, the beginning, because now we must evaluate the harder question: *what* the judiciary will do, not *whether* it will do it. The "what" is the commitment to walking softly we have already introduced: when a court's jurisdiction is properly invoked in a fiscal context, the response should be thoughtfully and thoroughly restricted. That the courts are put in a position where they must act does not improve their institutional competence. Rather, recognition of courts' limited institutional competence helps delineate the self-imposed constraints that should define the court's role in addressing fiscal crises. Figure B illustrates the continuum of the breadth of judicial intervention in response to litigation prompted by both a fiscal crisis and the inability of more competent politically accountable institu-



Of the three rough types of interventions available to courts when confronted by fiscal crisis litigation, the most desirable outcome in the abstract would be non-intervention. More precisely, perhaps, the ideal situation is where fiscal litigants elect no to invoke the courts' jurisdiction. But the strategic character of fiscal crisis-related litigation makes this outcome highly unlikely. At least in the abstract, had the more competent institutions been able to act, the fiscal crisis could have been avoided in the first place. By the time of litigation, the courts may be the only institution left standing.

Having been put in this position, the court's response must now reflect its absolute competence level, not its relative competence compared to politically accountable institutions who are strategically or objectively frozen. Thus, at this point the most desirable outcome is that the court act with humility, which in this context means avoiding reliance on the constitution as a basis for judicial action.

The reason for the superiority of non-constitutional resolutions is simple. Where the courts respond to fiscal crisis-based litigation with constitutional pronouncements, the self-induced freezing of the politically accountable institutions becomes permanent. Subsequent efforts by the more competent institutions cannot undo what courts have done, regardless of whether these institutions would prefer to roll back the courts' constitutional pronouncement and regardless of whether the popular will supports that response. When the courts invoke the constitution to resolve a fiscal crisis, the court's resolution can be reversed only through a constitutional amendment, a much more cumbersome process than straightforward litigation.[30]

[30] Kenneth P. Miller, *Constraining Populism: The Real Challenge of Initiative Reform*, 41 SANTA CLARA L. REV. 1037, 1067 (2001) ("The California rule, however, locks in initiative-made policies and thereby significantly undermines the

Ours is not an argument that plain violations of constitutional law should be ignored simply because that violation occurs in the context of fiscal policy. Where the constitutional violation is plain and jurisdiction proper, judicial determination is appropriate. Instead, ours is a variation on the doctrine of constitutional avoidance, spiked with the political question doctrine. Under constitutional avoidance, even if there is doubt as to the constitutionality of a specific governmental action (including legislative action), "it is a well-established principle governing the prudent exercise of . . . jurisdiction that normally the Court will not decide a constitutional question if there is some other ground upon which to dispose of the case."[31] The prerequisite for judicial non-constitutional intervention, then, is that the legal issue be close enough that a non-constitutional determination is available to the court without doing damage to the constitutional principle invoked. To be sure, such self-limited judicial intervention, while neutral in institutional terms, will never be neutral in political terms. A court's action has distributional and political consequences, as it must since the litigation will always have a central strategic element: one party has chosen to move the issue out of the political arena and into the courts.

Figures A and B establish the three parts of our argument. First, courts are institutionally ill-suited to resolve fiscal crises. Second, because fiscal crises are endogenous to the political system, parties will seek judicial intervention only when there is a strategic or absolute inability to resolve the fiscal impasse through conventional political means. The third part follows from the first two. When courts are forced to intervene despite their limited institutional competence, and where the legal issue allows them the room, they should do so in a way that leaves the future resolution of the fiscal question to the political process. This "walk softly" decision rule reflects both the judiciary's absolute institutional incompetence at making fiscal policy, but also the near impossibility, ex ante, to separate strategic litigation from absolute breakdown of the political process.

II. The California Rule and the Institutionalist Framework

The framework just described is well illustrated by its application to litigation concerning the so-called California Rule, a judicial rule

legislature's authority and flexibility")

[31] Escambia County v. McMillan, 466 U.S. 48, 51, 104 S.Ct. 1577, 80 L.Ed.2d 36 (1984)

that regards the statutes that describe the state's public pension obligations as contracts protected by the Contracts Clause of the state and federal constitutions, even for benefits that have not yet accrued. Most states regard pension obligations that have vested as protected by the Contracts Clause of the Constitution;[32] what makes the California Rule unusual is its equivalent treatment of the expectation of pension rights that have not vested but which accrue at a specified rate.[33]

In a recent article, Amy Monahan carefully frames the debate surrounding the California Rule, and provides a thorough analysis of the legal and economic principles at stake in the principle. In the end, she powerfully criticizes the California Rule on legal, economic, and institutional bases, and urges its abrogation.[34]

If Monahan's critique of the law and economics of the rule were entirely successful, there would be no reason to invoke the institutionalist framework we have described in Part I. Where the legal case is plain and within the obvious competence of the judiciary, a court has no need to defer to other institution's competence to address the consequences of an endogenous fiscal crisis. That is, the implications of a comparative institutional analysis requires that the legal issue leave room for the court to respond in a fashion that leaves the politically accountable and more competent institutions free to alter the judicial resolution.

While we agree with Monahan's ultimate conclusion regarding the Rule's debilities on institutionalist grounds, we think the legal and economic issues are less clear cut. As we will see, the case for the California Rule – for why public employees might prefer a contract that locks in future pensions but allows the public employer to reduce future pension benefits, and thereby reduce current funding obligations, either by lowering employee's wages or simply firing them – simply reifies the political economy pathology that gave rise to the endogenous fiscal crisis in the first place. And it is precisely *because* the law gives the court room that the institutionalist framework must be invoked. In this circumstance, the determination of the contours of the state's fiscal apparatus should be left to resolution by—indeed, foisted back upon—the more legitimate political branches. The judiciary should be in the business not of ending those negotiations through constitutionalizing the result, but in forcing more competent political institutions to resolve them.

[32] NEA COLLECTIVE BARGAINING & MEMBER ADVOCACY, NEA ISSUE BRIEF ON PENSION PROTECTIONS IN STATE CONSTITUTIONS (2004)

[33] Twelve states follow California. Monahan at 1071

[34] Monahan at 1032-1033

This Part summarizes Monahan's case against the California Rule on both legal and economic bases, and then demonstrates why that case is harder than Monahan suggests. Recognizing the hard case in law and economics concerning future pension promises lays bare the institutional framework that ultimately reaches Monahan's same result.

A. *The Legal Case for and against the California Rule*

Monahan critiques the California Rule on two independent legal bases: (1) "it runs contrary to the well-established legal presumption that statutes do not create contractual rights absent clear and unambiguous evidence that the legislature intended to bind itself";[35] and (2) federal Contract Clause jurisprudence "holds that prospective changes to a contract should not be considered unconstitutionally impairments."[36] But neither of these conclusions is inexorable; there are reasons why a court could conclude that the California statute here does express clear evidence of contract; that the prospective changes referenced in federal Contracts Clause case law are different from pension obligations, especially as California has construed them; and that general principles of contract law are not offended by the peculiar terms of the pension contract as California courts have interpreted them.

We consider each argument in turn, but do not undertake to resolve which side has the best of the argument. Rather, we show that precisely because the questions are hard, a court can and should be guided by an anti-constitutional decision rule that would facilitate pushing the resolution of the fiscal issue back to the political process. In this case, that rule would lead to a decision not to constitutionalize the California Rule's interpretation of the pension contract.

1. <u>Statutes as Contracts</u>

Monahan cites several cases for the general proposition that "[a] state law does not normally create contractual rights, but 'merely declares a policy to be pursued until the legislature shall ordain otherwise.'"[37] The question for the California Rule is whether the statute that specifies the accrual and vesting of future pension benefits is

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[35] Monahan at 1032

[36] Monahan at 1033.

[37] Monahan at 1037, citing U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 17 n.14 (1977).

"clearly and unequivocally expressed."[38]

As we will see, the discretion granted courts in the context of Contracts Clause jurisprudence makes the initial determination of whether there's a contract at all the key point of the analysis. However, there is a critical second step in the analysis, which the case law unfortunately does not clearly differentiate. It is one thing to conclude that the state law providing state employee pensions was intended to create a contract. But the second step is one of traditional contract interpretation: *what* rights does the contract create?

Determining the existence of a contract is governed largely by state law. While some federal courts, including the U.S. Court of Appeals for Ninth Circuit (that covers California), have concluded that "federal rather than state law controls as to whether state or local statutes or ordinances create contractual rights protected by the Contracts Clause,"[39] issues of contract formation are generally a question of state law. Thus, even if it were concluded that there was a federal common law of contracts, in the first instance federal courts would have nowhere to look to determine that Federal law other than to state contract law. Constitutional law then operates to protect the contractual terms that state law principles of contract interpretation (or the Federal common law of contracts as derived from state law) identify. This is the likely explanation for the result that Monahan's careful research has suggested: in the federal Contracts Clause jurisprudence, there are apparently "no federal cases where a federal court ruled in direct opposition to a state court's finding that a contract existed under federal law."[40]

And so, the first question remains whether California statutes have created a contract. Monahan argues that the long line of California Rule precedents is flawed at the point of origin by the logic of the first California court to consider the question in 1917. In Monahan's words, "the notion of pension rights as contractual rights became law through a single sentence of dicta in a California Supreme Court opinion describing pensions as a form of deferred compensation that are therefore 'in a sense' part of the contract of employment."[41] The "in a sense" language was something of a throwaway

[38] National R.R. Passenger Corp v. Atchison, Topeka & Santa Fe Ry. Co. 470 U.S. 451, 466 (1985).

[39] San Diego Police Officers' Ass'n v. San Diego City Employees' Retirement System, 568 F.3d 725 (9th Cir. 2009).

[40] Monahan at 1045

[41] Monahan at 1046. For non-lawyer readers, dicta are statements by a court concerning a legal rule that are not necessary to actually resolve the matter before the court, and so are not precedent binding on future courts. The Law Dictionary, available at http://thelawdictionary.org/dictum/ (last visited September 15, 20130.

assertion that assumed the conclusion in the first litigation where a California court encountered the issue.

Monahan's discovery is historically interesting, but legally irrelevant. The question is not whether a court in 1917 commented in passing that a statute of that era may have created constitutionally-protected contracts. Rather, the question is whether California courts have done so today with respect to the current state statute. The entire edifice of common law jurisprudence is built incrementally, where dictum in one case becomes the basis for a holding in another, not because it is binding but because it is persuasive. Indeed, there is an entire literature on the evolutionary dynamic of dicta becoming precedent.[42] Moreover, even precedent may turn out to be unpersuasive to later courts. As Justice Frankfurter wrote when explaining why he was taking a position contrary to that which he had taken in an earlier case: "Wisdom too often never comes, and so one ought not to reject it merely because it comes late."[43]

Thus, an analysis of whether the California Rule is subject to legal reversal today because of a questionable point of departure one hundred years ago does not resolve the matter. For almost a century, California has followed this course. That century worth a law provides solid precedent for the conclusion that the pension statutes are contracts. Whether they *should* be is a different question; and whether current California courts would adhere to that precedent today is also a different question.

But, as we have seen, there is also a second question, which is less precedent dictated than the constitutional determination of whether a contract existed. To say the statute creates a contract is a different determination than an explanation of what the contract contains. In terms of contract law, the first question goes to the existence of a contract, while the second goes to its interpretation. The answer to the first question determines whether the Contract Clause is invoked. The second question goes to whether the state's action actually impairs the contract. The California Rule precedent, which bears on the first question, remains subject to reconsideration. And the second question, whose answer is not dictated by precedent and is not itself a constitutional issue, is open to evaluation as a matter of contract law and contract theory, both of which have changed markedly

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[42] See, e.g., Judith M. Stinson, *Why Dicta Becomes Holding and Why It Matters*, 76 Brook. L. Rev. 219 (2010).

[43] Henslee v. Union Planters Bank, 335 U.S. 595, 600 (1949)(Frankfurter, J. Dissenting).

since the origin of the California Rule.

The consequence of the divide between the existence and the interpretation of the contract is a situation where precedent supporting the California Rule cannot be ignored, but also does not foreclose reconsideration. The question is *not* simply whether the California courts erred by inferring the existence of a contract in the body of the statute defining public pensions. It is whether the constitutionally-protected contract actually protects prospective pension accruals at all. And with that shift in focus, a court can, consistent with precedent, revisit the consequences of earlier precedent in a way that reflects the institutional sensitivities we describe in the institutionalist framework.

2. The Federal Contract Clause and Prospective Changes

Monahan's argument that the California Rule is inconsistent with federal Contracts Clause jurisprudence, while persuasive, is also not unassailable. Again, the first step is to determine whether there is a contract at all. Assuming there is, federal courts will then proceed through two additional steps in addressing whether the Constitution forbids the abridgment of that contract. The next step is to determine whether the state action has "operated as a substantial impairment of a contractual relationship."[44] If there is such a substantial impairment, the court must inquire whether it is "justified by a significant and legitimate public purpose" and is "both reasonable and necessary to fulfill such public purpose."[45]

Monahan's research indicates conflicting authority on the question whether promises of future compensation will reach the level of constitutional protection.[46] The precise question of whether state pension promises reach that constitutional level—that is, whether the California Rule is correct as a matter of contract interpretation and so is protected by federal constitutional law—has not been litigated. How that dispute will be decided is therefore an open question.

The task for a litigator is to persuade a court of the rightness of her client's cause. The task for a scholar is to address separately the positive and the normative elements of an issue: how a court *will* decide and how it *should* decide a contested question. To the first, predictive, question, the answer is uncertain. Each side will make strong arguments in law and policy, and the ultimate outcome will depend importantly on the judge who hears the case; we can assume the ad-

[44] Ching Young v. City of Honolulu, 649 F.3d 907, 914 (9th Cir. 2011)
[45] *Id*. (citations omitted).
[46] Monahan at 1042.

vocates on both sides will present their clients' position well.

But the second, normative, question is the institutionalist one. Precisely because the legal question is uncertain, a court *should* invoke the decision rule that resists a constitutional conclusion that freeze-frames a specific fiscal posture in one point in time that will remove from the political-fiscal process an alternative resolution at another. Even if the courts—state or federal—conclude that the California Rule is on strong footing as a matter of a contract's existence, a court can honor the institutionalist decision rule by construing the terms of that contract in a way that avoids the constitutional determination, or can conclude that the state's own fiscal exigencies justify abrogation of that contract (consistent with the third prong of the Contracts Clause analysis). The path matters less than the destination: given its absolute institutional incompetence at making fiscal policy, a court should walk softly, leaving as little trace of judicial intervention as possible that would restrict a political resolution of the issue.

3. Legal Indeterminacy and the Institutionalist Critique

To this point we have argued that the legal case against the California Rule is uncertain. In turn, that leaves a court room to act on the institutionalist analysis we have described here. Certainly if the watchword is precedent, the California Rule is not without significant support. But Monahan's historical critique is also persuasive, and her invitation to California courts to reexamine the Rule on first principles is a provocative.

But precisely because the outcome is not dictated in either direction, we think the institutionalist critique—that courts should not be in the business of picking winners in fiscal crises when that selection will last for generations— dictates overturning the California Rule. The mechanism is clear. In federal law, the last step, even after determining there is a contract in the first place (hardly a foregone conclusion, as Monahan ably argues), and that there is a substantial impairment of that contract (an inquiry we address in the next part) is for the court to determine whether the action is "justified by a significant and legitimate public purpose" and is "both reasonable and necessary to fulfill such public purpose."[47]

A court could determine that responding to an endogenous fiscal crisis satisfies the public purpose requirement and that reducing the level of pension underfunding is an appropriate means to address that purpose[48] And that might be the mechanism by which the judiciary

[47] *Id*. (citations omitted).
[48] Whitney Cloud, *State Pension Deficits, the Recession, and A Modern View*

declines to engage in fiscal policy-making, while acknowledging the institutionalist concern that such issues are better left to the political process. This position would be buttressed by the frank acknowledgment courts are institutionally unsuited to resolving fiscal crises by removing that resolution from the political arena by constitutionalizing it.[49]

B. *The Economic Case for and against the California Rule: What is the Contract that is Protected by the Contract Clause?*

Monahan's critique of the California Rule is economic as well as legal. She writes that the Rule

> appears to create inefficiency, in that it fixes in place one part of an employee's compensation. Under existing law, states can terminate employees, lower their salaries, and change their fringe benefits absent explicit agreements to the contrary. Yet California courts have held that even though the state can terminate a worker, lower her salary, or reduce her other benefits, the state cannot decrease the worker's rate of pension accrual as long as she is employed. This framework can be welfare reducing. Given the option, an employee may prefer to accept lower future pension accruals in return for avoiding termination or a reduction in current compensation, but such deals are hard to accomplish in a system that protects the right to future accruals. It should also be noted that the protections the California Rule appears to offer are illusory, given that it simply forces a state that needs to reduce costs to do so in some area other than pension accruals—for example, through layoffs or salary reductions. Viewed holistically, the California Rule simply does not protect employees' economic interests, and in some cases the rule may even harm the interests of the very employees it is meant to pro-

of the Contracts Clause, 120 YALE L.J. 2199, 2209 (2011) (Although allowing legislatures to use financial downturns as justification for modifying state contracts is risky, the effects of the Recession on pension deficits justify Contract Clause exception for Colorado's pension modifications)

[49] See Peter Conti-Brown, *Is the Federal Reserve Unconstitutional? And Who Decides?*, LIBRARY OF LAW AND LIBERTY (Sept. 1, 2013) http://www.libertylawsite.org/liberty-forum/is-the-federal-reserve-constitutional/ (summarizing the doctrine of "equitable discretion" that prevents a court from reaching a conclusion on a case that is otherwise justiciable)

tect.[50]

Monahan's discussion of the economics of constitutionalizing protection of future pension accruals brings us to the missing step in the California Rule's constitutional analysis: What are the terms of the contract being protected?

To reach a conclusion on that front, the economic incentives of the contracting parties are central. Indeed, contract interpretation has become increasingly economically oriented over the last twenty years. From this perspective, the interpretation question is straightforward. If there is ambiguity concerning the substance of the contract, it is resolved by determining the hypothetical bargain that reasonable parties would have struck had they thought hard about the issue. From this perspective, the bare tradeoff that the California Rule implies appears vulnerable. Why, indeed, would any reasonable person trade present wages for a guarantee of the rate at which future payments would accrue so long as the person remained employed, when the state is under no obligation to continue his employment in the first place?

On closer analysis, however, there are at least three reasons why, depending critically in each case on assumptions about future circumstances, the California Rule might reflect the best bargain that employees and the state could secure. First, the probabilities that modify each likelihood (i.e., what are the odds that in the absence of any restriction the state either would terminate the employee or adjust the rate of future pension accruals), given the costs to the state of pursuing each option, may encourage employees to push harder for pension protections than termination protections. Second, it may be easier (but it may not) for employees to get a new job if terminated even in a recessionary environment than to replace favorable pension accruals. Given the decline in defined-benefit pensions in the private sector, there may be no substitutes for existing pensions when the substitute is needed.

Finally, and perhaps most importantly, the political economy of public employee negotiations may make it more desirable for the state to substitute sufficient future compensation through increased pension accruals for current wages, so that the tradeoff between current wages and future pension will be favorable to the employee. This last point, which is the most plausible, builds on the political pathology associated with public employment negotiation: increases in current wages displace other government benefits that will disfavor cur-

[50] Monahan at 1033.

rent voters and public worker strikes will seriously inconvenience many voters, in both cases to the disadvantage of current political incumbents. Thus, elected officials will be eager to trade future pension benefits for current wage increases at a rate that favors the employee. Indeed, it is this pathology that endogenizes a fiscal crisis. Put differently, the hypothetical bargain between current elected officials and current employees will reflect the gains to both sides from imposing costs on future elected officials who will have to confront the results of overpromising and underfunding future pensions. The resulting employee-friendly rate of substitution between current wages and future pensions makes up for the risk that an employee will be terminated.

1. The Probabilities of Termination versus Pension Adjustment With No Contractual Guarantees

The task, again, is to determine whether employees would want to structure their employment contracts with greater protection for the terms of prospective pension payments even if their ultimate receipt depends on the employer not terminating further accrual by terminating the employee. The first indication of such a preference is that the probabilities for each outcome are markedly different. If the employer faces no penalty in adjusting future pension promises, the cost for doing so to the employer is lower than the cost of layoffs. Layoffs are costly to a state employer because they mean the employer produces less of the particular government service for voters. But the employer must retrain replacements, and face consequences in the both the labor market for layoffs and in the political market for the drop in services. Those costs are direct, and for the most part immediate.

But adjustments to prospective pensions have only the cost of difficulty in employee retention – some employees may quit, although that prospect is reduced in times of fiscal crisis because the crisis typically is associated poor general economic conditions. Even if the employer reduces future pensions entirely—as many private employers have done[51]—such elimination is unlikely to be the equivalent of direct terminations. Only a percentage of employees will quit over the change in pension benefits. For the public employer, the budgetary benefit can be expected to come with a smaller impact on services valued by voters.

[51] Daniel Gross, *Bye-Bye Pension!*, SLATE (Jan. 27, 2006, 4:17 PM), http://www.slate.com/articles/business/moneybox/2006/01/byebye_pension.html

A rational employee might want to roll those dice. She might reason that the government employer will lay off x percent of its employees y percent of the time, and that her individual risk of layoff is xy. The employee might also reason that, historically, xy has been very low. She might also suspect that, absent stronger guarantees, the employer is likely to adjust pensions a percent of the time for 100% of its employees. And given the costs to the employer of such adjustments and employee's discount of the lost future pension benefits, $a > xy$, potentially by a long margin. A rational employee could therefore want to avoid the greatest loss of compensation, adjusted for probabilities, and that would point toward guaranteeing the rate of future pension accruals even if those accruals remain subject to the employees' termination before vesting.

2. Substitution Costs Associated with Each Form of Compensation

A second reason why rational employees would accept the combination of a guaranteed rate of future pension accruals even if an employee could be terminated before benefits vest is the employees' relative substitution costs – the costs of being forced to find a new job compared to the availability of similar pension benefits in other employment. That comparison may favor guarantees for prospective payment over guarantees of current employment. During years of employment, a terminated employee can seek reemployment in the labor market. The costs of doing so depends on the availability of alternative employment and the substitute wage. The likelihood of replacing a defined-benefit pension, on the other hand, is quite low in today's economy; the number of defined benefit plans has dropped significantly in the private sector. In 1990, defined contribution plans and Individual Retirement Accounts (IRAs) totaled $1.5 trillion, and private defined benefit plans approximately $1.6 trillion. Almost all of the subsequent growth in retirement assets took place in defined contribution plans and IRAs ($9.2 trillion in total by 2010), rather than in private defined benefit plans ($2.2 trillion by 2010). Moreover, the remaining defined benefit plans were increasingly in the public sector.[52]

[52] The data comes from the Investment Company Institute, 2011 Investment Company Fact Book 101 fig.7.2, 102 (2011),,available at http://www.ici.org/pdf/2011_factbook.pdf ; David Crane, *Traditional Pension Plans Can Still Work. Really*, BLOOMBERG (June 24, 2013),

The employee's utility function extends presumably over her natural life: if the rational outcome is to maximize that function, then an economic assessment of the California Rule – the foundation for the hypothetical contract assessment of the constitutionally protected contract's interpretation – must pay attention to likely substitution costs to the employee of *both* termination of employment and adjustment/termination of future pension benefits. It is easy to imagine that function maximized for prospective pensions, particularly if (1) the likelihood of pension adjustment absent guarantee is higher than termination; (2) the likelihood of termination does not go up materially as a result of pension guarantee; (3) the availability of the alternative employment is high; but (4) the alternative for comparable post-retirement compensation is very low.

3. <u>The Reification of the Public Employee Bargainning Pathology</u>

The foregoing analysis is essentially a possibility analysis. Depending on the coefficients assigned to each variable, employees might or might not favor guaranteed pension accrual rates over increased wages. But the difficulty of the analysis for present purposes is that over time the value of the coefficients will change with economic and labor market conditions. For the hypothetical bargain interpretation to support constitutional protection of future pension accrual rates, the employees and the government employer's preference must remain constant, because constitutional protection serves to petrify the labor contract. There is, however, one explanation for why the parties might select the California Rule as a matter of preference that is far less sensitive to changing economic conditions: the political economy pathology of public employee bargaining. We addressed this point in Part I, but revisit it here to emphasize the potential reasonableness of the public employment contract here at issue from the employees' perspective.

Elected officials will have a significant preference for securing labor and potentially electoral peace by pushing costs of to the future when the burden will be borne by future elected officials, in no small measure because doing so shifts the incidence of the costs from cur-

http://www.bloomberg.com/news/2013-06-24/traditional-pension-plans-can-still-work-really-.html ("These traditional retirement benefits have been disappearing in the private sector…yet defined-benefit plans remain the dominant form of pension for state- and local-government employees") rent to future voters. This phenomenon, it will be recalled, is the central factor in endogenizing fiscal crises: they result importantly from political system failures.

And here is the central irony in the California Rule. Employees may prefer pension protection over current wages, but this preference is highly sensitive to the fact that elected officials' political preferences causes them to impose a high discount rate to future compensation for political as opposed to fiscal reasons. Thus, employees may well prefer the California Rule, but only because elected officials, in effect, are willing to pay more from the employees' perspective in future benefits than in present wages. The result is that the necessary interpretation of the constitutionally protected contract using hypothetical bargain analysis results in reifying the political pathology that endogenizes fiscal crises in the first place.

C. *Institutionalist Critique*

Subparts A and B have demonstrated that there are bona fide legal and economic issues concerning the California Rule. The question thus remains: *did* the California legislature intend to bind itself to the state and/or federal Contracts Clause with its statutory pension framework? Would the abrogation of executory contracts in the public employment context be justified by the state's police power? And, finally, if there is a constitutionally protected contract, did the parties intend that its substance was the California Rule?

It is our contention that these questions are necessarily fiscal, and because neither party has a clear-cut victory, with as we will see one exception, the judiciary is ill-suited to resolve the matter.

Judicial resolution of these disputes has a deep problem. The conclusion the Contracts Clause supports the conclusion that future pension guarantees of unvested benefits cannot be abridged not only removes the resolution of the dispute over the terms of public employment from the political process today. It also removes the dispute from the political process in every instance hereafter because it constitutionalizes a particular form of contract. Such is the nature of constitutional adjudication: legislatures cannot override those determinations in the usual course, and must rely on the extraordinary remedy of constitutional amendment to do so.

The institutionalist critique of the fiscal judiciary is not only that the judiciary is ill-equipped to pick fiscal winners and losers, but that it is also illegitimate to make that policy on a permanent basis. And the wisdom of the result is magnified because the most persuasive reason for why the substance of the California Rule is in the employees' interest is the pathology of the bargaining process – the incentive of current elected officials to have a higher discount rate for future costs than employees have for future benefits. The better outcome is to force the fiscal policy-making apparatus to reconvene and force a current resolution to a fiscal crisis at a time when elected officials can no longer pay employees to push costs into the future. In fiscal policy-making, the judiciary should not constitutionalize a political economy pathology – that issue is best addressed by the more competent institutions – the legislature and the executive. Precisely because these institutions have the capacity to resolve the pathology and the fiscal crisis through creative methods means not available to court working in the narrow confines of constitutional law,[53] they are institutionally better situated to address endogenous political crises.

This reality is why we ultimately agree with Monahan's conclusion that "[i]t is up to the state and its citizens to determine how best to approach the problem of underfunded public pensions."[54] In our view, this conclusion flows not from the dubious contention that under no circumstance might employees prefer protection of accrual rates of future unvested pension rights, nor that California courts have plainly misapplied the law. Instead, the resolution of endogenous fiscal crises is necessarily a political process that should be the purview of shifting coalitions, political suasion, and the democratic process. Courts, when their jurisdiction is invoked, should be in the business of facilitating that process, not terminating it through constitutionalizing the issue.

The California Rule demonstrates exactly why courts are bad at resolving the "hard cases" in the Dworkinian sense, where neither statute nor precedent points to a clear result.[55] And while we aren't taking sides in the jurisprudential debates between Dworkin and Hart and their successors, it is sufficient to note that the jurisprudential principle here is not controversial: the democratic debilities of the judiciary render it ill-suited to resolve, forever and ever, fiscal disputes. When those hard cases must be resolved regardless, it is both discretion and principle that points toward the need to walk softly, constitutionally speaking. Given the endogeneity of fiscal crises, the crises will be recurring. Judicial intervention—especially of a constitutional sort—freezes the outcome in time.

III. The Institutionalist Critique Abroad: Tentative

[53] See Peter Conti-Brown, *Direct Democracy and State Fiscal Crises: The Problem of Too Much Law*, Duke J. L. Public Policy (2012).

[54] Monahan at 1034.

[55] *See, e.g.*, Ronald Dworkin, *Hard Cases*, 88 Harv. L. Rev. 1057, 1088 (1975).

THOUGHTS ON DETROIT

This Part pauses briefly to explain why the decision rule we have described above is not a partisan one meant to undermine the negotiating positions of one side or another, but a broad principle that casts judgment on the institutional competence of the judiciary, executive, and legislature. The Detroit bankruptcy provides another example, though not exactly analogous, of the institutionalist framework in action. We conclude by noting, but do not resolve, the institutionalist issues that underlie the resolution of a central issue in the Detroit fiscal crisis.

The Detroit bankruptcy presents what may be the first opportunity for a federal court—first a bankruptcy judge, but subsequently through appeals to Article III courts in the district, circuit, and Supreme Courts—to navigate the collision of state laws protecting public pensions promises and federal bankruptcy law permitting restructuring plans that abrogate those promises.

At first blush, the federal courts will face a constitutional temptation to removes the political institutions from state and city fiscal policy-making, and replace them with federal bankruptcy judges. As Figure A illustrates, federal bankruptcy judges—experienced though they may be with corporate and individual liquidation and restructuring—are not the most institutionally competent entity to resolve a city or state's fiscal problems. This does not mean that they are not the *best* institution, only that they are not a particularly good one, in an absolute sense.

The decision rule for Detroit is simple, although somewhat indeterminate: The federal courts should resist the constitutionalist temptation to invoke the federal Supremacy Clause to invalidate state law as long as there are bona fide, legitimate alternatives.

To make sense of that argument, consider the legal context. Under the U.S. Constitution's Supremacy Clause, "the Laws of the United States" made pursuant to the U.S. Constitution "shall be the supreme law of the land . . . anything in the constitution or laws of any state to the contrary notwithstanding."[56] Where there is a direct conflict between state and federal law, it is black-letter law that the state law must give way to federal law.

Because of the straightforward nature of the Supremacy Clause, a direct conflict between federal bankruptcy law and state constitutional law would not qualify for the institutional framework we advocate here under the second presumption—that the legal question be an open one.

[56] U.S. CONST. art. VI, cl. 2

The Detroit bankruptcy illustrates, however, that the Supremacy Clause proviso that there be a direct conflict between the two laws is arguably missing in this context. The Bankruptcy Code provides for municipal bankruptcy under a separate set of provisions, found in Chapter 9, from the corporate and individual bankruptcies. Chapter 9 includes an important qualification on the bankruptcy judge's ability to approve a "plan of adjustment" offered by the government's representative. Section 943(b)(4) of the Bankruptcy Code provides that a court can confirm the plan only if the municipal debtor "is not prohibited by law from taking any action necessary to carry out the plan." And under the Michigan constitution, "The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby." Mich. Const. Article IX, § 24.

The legal question is whether the rest of the Bankruptcy Code, which would allow the municipal debtor to reject contracts according to the regime outlined in the Code (especially in Chapter 9) when the out-of-bankruptcy rejection would not be permissible under Michigan's constitution, and therefore could not be included in a plan of arrangement.

The bankruptcy court can take one of three approaches to resolve this tension. First, it can find that the provisions do not conflict, and that then construe Michigan law to permit the Bankruptcy Code's restructuring of public pensions. Second, it can find that the provisions do not conflict, and then construe the Michigan law to forbid the restructuring of public pensions in the bankruptcy process. And third, it can find that the two provisions cannot be reconciled, and that the state law must yield to the federal Bankruptcy Code under the Supremacy Clause.

The first two approaches would satisfy the institutionalist framework we propose in this essay; the third would not, at least not initially. The reason is self-evident. If the court reaches either of the first two conclusions, the people of Michigan—here through a constitutional amendment, to be sure[57]—can revisit that opinion and express themselves more clearly to contradict the bankruptcy court's decision. In the third instance, the only mechanism for correction is at the

[57] Of course, one of the same institutionalist concerns that motivates the judicial critique would be suspicious of Michigan's original constitutional intervention. The constitutional provision in Michigan removes from present policy-makers decisions about pension assurances that those policy-makers might need to make in the face of fiscal considerations. But because the amendment began with the democratic process, it retains much greater democratic accountability than a similar decision made by a judge.

federal level, removed from beyond the reach of the Michigan citizenry.

As between the first two options, which point in different directs with respect to public employee's pensions, it is clear neither what the bankruptcy court *will* do, nor, frankly, what the bankruptcy court *should* do. But some have advocated an immediate invalidation of state law that *could* conceivably conflict with the Bankruptcy Code. The courts should temper this recommendation and reach for that sledgehammer only after exhausting all other feasible alternatives.

CONCLUSION

Fiscal crises are, primarily if not exclusively, political crises. When these political crises arise, judicial intervention can either facilitate dysfunction or temporarily resolve it. Given courts' institutional debilities in resolving fiscal disputes, and the difficulty recognizing the line between genuine political institutional failure and strategic use of judicial intervention is so difficult, courts should tread very carefully.

This essay has tried to explain why. Institutionally, courts lack both robust fact-finding abilities and democratic legitimacy, making them institutionally less competent at resolving fiscal disputes. Less competent, but not altogether incompetent. When their jurisdiction is invoked, the result should be deference, even insistence, to the political branches for further resolution. Because fiscal crises are political crises that reflect shifting democratic priorities from one election to the next, judicial intervention that fixes principles of political crises across epochs removes the ability of political groups to resolve these concerns through a political process. The best judicial participation in fiscal disputes, then, is no participation at all. But if that option is made unavailable by invocation of the courts' jurisdiction—through the filing of municipal bankruptcy, or by litigation challenging abrogation of prospective public pension assurances—the next-best solution is judicial intervention that future political players can undo by statute. Constitutional pronouncements in fiscal crises should only occur where there is no reasonable argument to be made on behalf of the non-constitutional determination.

That process will not be perfect, and may well create rent seeking opportunities for one or another politically powerful constituency. But that is the nature of the political process, and has always been. Destroying that process by judicial fiat merely crystallizes the political valence of a given epoch at the expense of shifting sentiment and temporary exigencies.