MERCATUS CENTER
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RESEARCH SUMMARY

Rethinking the California Rule, Reforming Public Sector Pensions: An Opportunity the State Supreme Court Should Not Pass Up

California's pension system faces a significant fiscal crisis—but also a real opportunity for reform. So argues Scott Andrew Shepard in "The California Rule and Its Potential Abolition."

According to the author, the state pension system is in crisis because of the following:

- It has offered pensions that are larger than the state and its municipalities now seem willing (or possibly able) to pay their employees.
- It has made retroactive increases to benefits that provided no obvious benefit to taxpayers.
- It has permitted practices such as pension spiking that increase pension benefits beyond what was contemplated at the time pension promises were made.

A PROBLEM EXACERBATED BY ADHERENCE TO THE CALIFORNIA RULE

Putatively grounded in the federal Contract Clause, the California Rule is said to forbid the state to decrease any pension benefits for any government workers for any work they might perform at any time during their employment. However, three California courts and Governor Brown's administration are now arguing that the government can, in some circumstances, reduce the pension benefits it promises to pay its employees.

This alternate interpretation of the California Rule presents the state supreme court with the opportunity to rule definitively on the question. Ruling in favor of, and rounding out, this alternate interpretation can help protect and do justice to California government workers while protecting taxpayers from being taken advantage of. It can also prevent California from driving out its productive privately employed taxpayers.

THREE TYPES OF PENSION PROMISES, THREE TYPES OF REFORM

- Type 1 Promises—to pay pension benefits that have already been earned for work already performed. Benefits that are so extravagant as to represent a constructive fraud on the taxpayer should be subject to reduction. However, changes should be made only with the most exacting, specific justification and only under careful review.
- Type 2 Promises—to pay pension benefits that have been made by express contractual or statutory provision and have been set to last until some specified date in the future. In other words, these promises involve work that has not yet been performed but for which benefits have already been contractually promised. The Contract Clause protects these benefits. Reductions should only be justified by effective government need.

- Type 3 Promises—expectations (rather than promises per se) that the government won't reduce benefits not yet earned or contracted for, attached to work not yet performed. These should lie wholly within the legislative authority of the government and be subject to reduction or elimination without any Contract Clause or California Rule analysis.