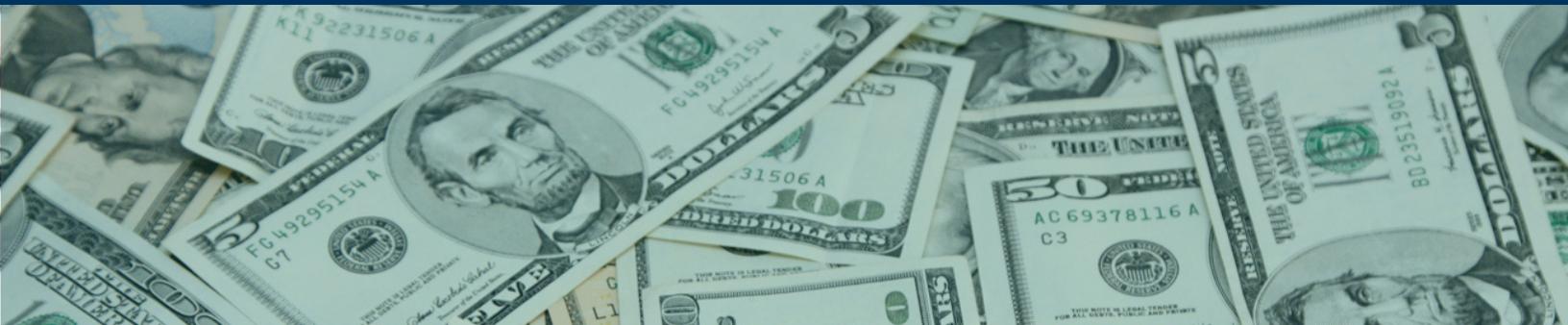


Public Pension Policy in Illinois

An Introduction to a Crucial Issue



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Introduction: Pension Policy Reform

Prof. Robert F. Rich, Director, IGPA

Pensions represent a significant component in the total compensation packages of employees in the public and private sectors. The financial viability and health of pension systems is being called into question as the baby boom generation ages, life expectancy increases, and the state and nation face public-sector budget crises. A recent report released by the Commission on California State Government Organization and Economy concluded, "pension costs will crush government."¹

Nationwide, underfunding of state pension funds totals more than \$3 trillion. Illinois has the worst underfunded pension liability in the entire nation. In Illinois and several other states, pension shortfalls often exceed explicit state debt.² The budgetary and economic problems being faced by most states are exacerbated by problems with public employee pension systems. The pension-related issues or problems include: the size of pension contributions by government and by employees, cost of employee benefits, eligibility requirements, and accounting methods used by states.³ In addition to these economic-related issues, the legal status of pension obligations for current employees is also controversial.

There are many explanations for why states have such severe pension-related problems. It is of little practical value to note that these problems reflect policy choices and lack of fiscal discipline by many state policymakers, which is reflected in failures to make agreed-upon annual payments to finance public employee pensions. These choices provide context for the current debate over the future of pensions. There

is now little doubt that the status quo is unsustainable and that public-sector pension policies need to be restructured and refinanced. This is true even though state economies are recovering from the recession and revenues will be increasing. A recent report by the Pennsylvania Institute of Certified Public Accountants underscores this conclusion: "the simple fact is the pension systems for school teachers, public employees and state lawmakers are not sustainable in their current forms considering the fiscal challenges the state now faces."⁴

Some of the following reforms are being considered:

- Switching from a "defined benefit" (usually financed primarily by the employer) to a "defined contribution" (usually financed by the employee) program
- Increasing the contributions required of employees
- Limiting the total amount of pension for which an employee is eligible
- Changing eligibility criteria
- Limiting retiree benefits or increasing the costs of these benefits (e.g., medical benefits) to employees
- Limiting increases in direct pension benefits by tying these increases directly to rates of inflation.

All of these potential reforms are intended to save money and/or encourage fiscal discipline.

As already noted, there seems to be a consensus nationwide that significant restructuring and reform is required. The dilemma for legislators and governors is: to whom do these reforms apply? To what extent are current employees affected? To what extent will standard private-sector solutions to similar economic problems apply? Should the state freeze benefits owed to employees for services they have already performed and start new, lower benefit levels

¹Miller, Girard, "Pension Reformers Shift Focus to Current Employees", Governing, Web-Newsletter, March 17, 2011, p. 1.

²Biggs, Andrew G, "The Market Value of Public Sector Pension Deficits," American Enterprise Institute for Public Policy Research, April, 2010, p.1.

³Biggs, Ibid., p. 2.

⁴Miller, Ibid., p. 2.

prospectively for future services.⁵ The standard interpretation of the federal Employee Retirement Income Security Act (ERISA) seems to indicate that vested accruals for private-sector employees are untouchable, but future benefits can be modified.⁶ For public-sector employees in Illinois, debate over the legal status of limiting benefits for current employees is a particular problem because pension benefits are directly protected in the Illinois constitution.

In the following report, the Institute of Government and Public Affairs (IGPA) provides a non-partisan, evidence-based analysis of some of the key pension reform issues in Illinois. Prof. Darren Lubotsky and Prof. David Merriman provide a primer on pensions; how they work, including some of the major economic and budgetary problems, and controversies the state currently faces. Lubotsky and Merriman are economists who study labor and budgetary questions

and provide an important critical perspective to these issues. In Section Two, law Prof. Laurie Reynolds analyzes the legal issues and controversies associated with pension reform. A faculty member in the University of Illinois College of Law, Reynolds has expertise in state and local government issues such as pension reform. In the final section, Prof. J. Fred Giertz and I provide an overview of pension issues and reform trends in other states. Giertz, a U of I economist and faculty member at IGPA, has many years of experience analyzing public pension systems and performance as a member of the State Universities Retirement System (SURS).

We hope that this report will provide a useful overview of key dimensions and controversies in the current pension reform debate.

⁵Miller, Ibid., p.2.

⁶Ibid.

Pensions in Illinois: Quick Facts

The Illinois state government funds five public employee retirement systems, including:

- State Employee Retirement System (SERS)
- Downstate Teachers' Retirement Systems (TRS)
- State Universities Retirement System (SURS)
- Judges Retirement System (JRS)
- General Assembly Retirement System (GARS)

Recent changes to the state's pension program include:

- Retirement age is now 67, increased from 60
- Benefits are now based on the eight highest years of pay in the past 10 years rather than the highest pay in four consecutive years
- Cost of living adjustments are calculated using simple interest (no longer compound interest)
- The earnings base used to calculate benefits is now capped at \$106,800
- Cost of living adjustments are limited to 3% per year or ½ of the actual inflation rate (whichever is less).

In May of 2010 Illinois's unfunded pension liabilities were officially estimated at more than \$79 billion.

- Illinois' total new pension obligations were greater than \$11.9 billion in FY2011
- Illinois contributed only about \$3.7 billion to state pension trust funds in FY2011 and took on additional state debt to make this contribution.

Section 1

A Primer on Pensions and Options for Reform

Prof. Darren Lubotsky and Prof. David Merriman
Institute of Government and Public Affairs



Executive Summary



The deficits in the Illinois state government's operating budget and the state's pension fund for public employees are enormous. It is widely understood that developing a plan to fund and possibly restructure the pension system is necessary to improve the state government's overall fiscal situation. This section provides background and a summary of the economic issues surrounding pension benefits and discusses some relationships between state pension policy and the state's fiscal condition. Although this section does not provide analysis of the many specific legislative proposals currently being discussed it provides conceptual background that we believe is essential to understanding the choices Illinois must make.

Illinois faces two important questions:

1. How should Illinois dispose of its accumulated pension liability?
2. What sort of pension system should the state have moving forward?

Of these, the second question is probably more important than the first and so we begin our discussion explaining the important role that pensions play in a compensation package. We reach nine major conclusions.

1. There are gains from structuring compensation to include both salary and benefits.

Employers and employees can be made better off by structuring compensation to include both cash salary and benefits, such as health insurance and pensions. The advantages of including benefits in a compensation package stem from the fact that employees may not be able to obtain these benefits on their own or may only be able to obtain them at a far greater cost than what an employment group would be. Employers gain because employees are willing to forgo some salary to obtain these benefits and

therefore total compensation costs to the employer tend to be lower when benefits are included in a pay package.

2. Defined benefit and defined contribution plans both come with advantages and risks.

In the past, most pension benefits offered by U.S. employers were defined benefit (DB) programs that offered retirees a guaranteed formula-based annuity. In recent years, many private-sector employers have converted to defined contribution (DC) plans that contribute to a retirement fund owned and controlled by the employee. DC and DB plans each have associated advantages and risks. The conventional view that DC plans expose employees to more risk than DB plans refers to investment risk only. Other risks associated with DB plans include the risk of reduced benefits due to voluntary or involuntary job changes and the risk that the employer's promised benefit may not be paid due to financial malfeasance or financial incapacity.

3. Employee benefits are not freebies. Employees who receive higher benefits receive lower salary. Cutting benefits is essentially cutting pay.

One of the biggest misconceptions about employee benefits is that firms give them as "free add-ons" in a compensation package and that employees do not give up anything to get them. In large part, employees pay for benefits in the form of a lower cash wage or salary than they otherwise would have received. Jobs that pay particularly generous benefits do not necessarily pay higher overall compensation levels. Cutting benefits for workers with generous benefits, while leaving take-home salary unchanged, is conceptually the same as a cut in pay and economic analysis suggests that this will cause some workers to opt for alternative employment where they can get the same total compensation that they previously enjoyed.

4. Pension underfunding leads to fiscal imbalance.

Pension costs may contribute to state fiscal imbalances, particularly when pension systems are poorly monitored and incentives are poorly aligned with responsibilities. Because pensions are deferred compensation—they are earned long before they are claimed—there may be a temptation to under-invest in trust accounts that are meant to guarantee benefits. These problems may be particularly severe in public sector DB systems where elected representatives with a short time horizon have an incentive to underestimate the cost of current public services. After a period of time, chronic underfunding leads to a current fiscal imbalance.

5. Fiscal imbalance can occur when those who hire workers and those who administer workers' benefits have differing incentives.

Fiscal imbalance also may result if the agencies responsible for hiring and salary levels are not charged for the costs of accrued pension benefits. This creates a misalignment of incentives and can result in over-reliance on pension benefits, compared to other forms of compensation. Fiscal imbalance also may result if employees are able to “game” the pension formula to obtain larger pension benefits than intended. “Gaming” behavior requires either the explicit or implicit cooperation of the employer and may result from the misalignment of employer’s incentives.

6. In the long-run, a defined compensation plan may limit chronic underfunding. However, switching to a defined compensation program does not reduce previously accrued liabilities.

Recently, public employers (including the state of Illinois) have offered DC programs in addition to, or in lieu of, DB pensions. The switch from a DC to a DB program may limit the potential for chronic underfunding because employer contributions to DC programs are generally made at the time the benefit is earned rather than when it is claimed. However, the switch from a DB to a DC pension system does not reduce previously accrued pension liabilities. In fact, such a switch intensifies any short-term fiscal imbalance resulting from accrued pension liabilities because it limits state flexibility over the use of current pension contributions. Nor will a switch to a DC pension system, in and of itself, reduce the long-run cost of compensation. Compensation costs depend on benefit levels rather than the choice of pension

system—it is always possible to design a DC system that yields smaller, the same, or greater pension benefits than a given DB system. The level of pension benefits is a policy independent of the decision to use DB or DC.

7. Illinois has options to deal with accumulated pension liabilities.

The state has three fundamental options, individually or in combination, for dealing with accumulated pension liabilities. It can: (i) renege on past promises (ii) raise additional revenue to meet these obligations or (iii) cut spending on other government goods and services to meet these obligations. The state also can borrow, but that simply delays the decision to tax, cut spending, or renege on past promises.

8. The state's leaders can think in economic terms about paying off pension liabilities.

We leave the numerous constitutional and ethical questions raised by the first option (reneging on past promises) to others and focus on its economic impact. This option can be viewed as a tax on owners of these pension assets. Depending upon the design of the plan, the tax could be extremely inequitable because it considers a single asset in isolation from households’ ability to pay. The policy may be inefficient because confiscating accumulated wealth may have important reputational effects in the long term.

9. Increasing taxes and cutting spending should both be examined as options to pay off pension liabilities.

The state’s other options for dealing with accumulated pension liabilities (essentially higher taxes or lower spending elsewhere) should be analyzed on a case-by-case basis. Increases in taxes and reductions in spending can each have important effects on economic equity and efficiency. Policymakers should weigh possible alternatives and seek the least costly method of meeting their obligations. Basic economic analysis suggests that total (monetary and non-monetary) cost is minimized by assuring that the last dollar of pension liability reduction has equal cost for each mechanism. This suggests that the state might minimize total costs by a policy of shared sacrifice across taxpayers, pension claimants and service recipients.

Why do employers pay benefits?

Most public and private-sector employers compensate employees with some combination of cash plus benefits, such as health insurance and pensions. At first glance, it might seem that employees and employers would both prefer a cash-only compensation package rather than a mixture of cash and benefits. After all, employees can use cash to buy health insurance, save for retirement, or buy any other goods or services they want. This freedom would allow employees to save for retirement in the method they feel is most appropriate for them (including not saving at all). It would allow employees to seek out the particular health insurance plan that suits their needs (or opt to forgo insurance completely and spend their money on other goods and services).

Additionally, benefits are expensive and time-consuming for employers to administer. Year-to-year changes in the cost of health insurance make benefit planning particularly difficult. It would seem, therefore, that employers also might prefer to pay all employees in cash only. So what advantages do firms and employees gain from having benefits?

Before answering this question, it is important to clarify that the question is not whether a firm should pay, for example, a salary of \$50,000 per year plus a health plan and a retirement plan, or whether it should pay \$50,000 per year without the health and retirement plans. Clearly, if a firm could recruit and retain the same work force with both pay packages, it would prefer not to offer the costly benefits. Instead, the question is whether a firm would want to reduce the amount of cash compensation and substitute the health and retirement plans. The relevant choice for the firm might be between paying \$50,000 a year plus benefits versus paying \$75,000 a year and providing no benefits. Or, the choice might be between paying \$50,000 a year plus a generous and expensive health

plan, or paying \$60,000 a year plus a less-generous and cheaper health plan.

There are three primary reasons why an employer might choose to include benefits in a compensation package: (1) A firm can purchase benefits more cheaply than an employee can; (2) Offering benefits helps firms recruit certain types of workers; and (3) There are tax incentives to offering benefits.

The first reason that a firm may want to provide a benefit is that the firm may be able to buy the product or service at a lower cost than employees would pay if they tried to buy it on their own. Group insurance (such as health and life insurance) and annuity products (such as defined benefit (DB) pensions) are good examples because both involve the pooling of risks across a group of employees. It is less risky to insure a larger group; consequently, the per-person cost of insurance is lower in a larger group.¹ So, for example, a particular insurance plan might cost \$1,000 per employee when purchased by a firm that employs 500 workers, but cost \$2,500 if purchased by a single individual. Employees are therefore better off getting the health plan through their employer and having their cash wages reduced by any amount less than \$2,500. The firm is better off by providing the health insurance to its employees and reducing their wage by anything more than \$1,000. Together, this means that both the firm and the employees will be

¹ To understand why it is less risky to insure a larger group, suppose you were trying to predict the number of times a flipped coin turned out to be heads. If you flipped the coin four times, you would expect to get two heads and two tails, but you would not be terribly surprised if you got three heads and one tail. By contrast, if you had the energy to flip the coin one-thousand times, you should be very suspicious about the authenticity of the coin if you ended up with 750 heads and 250 tails. The more times you flip a standard coin, the more likely it is that you'll receive roughly the same number of heads as tails. In the case of health insurance, the more people in the group, the more likely that total medical expenses will be close to that predicted by the characteristics of people in the group.

better off if the compensation package includes the health plan and salaries are decreased by an amount between \$1,000 and \$2,500. When the firm can buy a benefit for a lower cost than the employee could buy it on their own, the firm is essentially acting as a buying agent for the worker.

A second reason that firms might want to include both cash and benefits in their compensation package is to aid in recruiting and retaining certain types of employees. In management's perfect world, job applications would contain all relevant information about a potential worker, such as his or her future productivity, work habits, career plans, commitment to the firm, and commitment to undergoing future training. Unfortunately, many important characteristics are not observed and managers may have a difficult time eliciting such information. By offering a compensation plan that includes both cash and benefits that are more highly valued by some applicants than by others, a firm may be able to get applicants to reveal some of these characteristics themselves.

For example, some people place a higher value on spending more of their earnings now, while others are willing to forgo current consumption in favor of increased income and security in retirement. Firms that offer a particularly generous pension and an

rate. If the employer increases her pay by \$1,000 in cash, she must pay \$250 of that to the government, leaving her with \$750 in after-tax income. By contrast, if the firm gives her a benefit that costs \$1,000, she receives the full benefit and does not incur any tax burden. A different way to see the effect of taxes on benefit provision is to suppose an employee wants to buy a health insurance policy that costs \$1,000. If she were to buy the policy on her own, she would have to earn \$1,333.33. Of this, she would pay 25 percent, or \$333.33, in taxes to the government, which would leave her with the \$1,000 in after-tax income needed to purchase the insurance. She would be better off receiving the plan as part of her compensation package and having her salary reduced by any amount less than \$1,333.33. Assuming her employer could buy the same policy for \$1,000, the employer also would be better off by including the insurance in the compensation package and reducing the wage by any amount over \$1,000. Putting these bounds together, the employer and employee both are better off if the insurance plan is part of the compensation package and salary is reduced by any amount between \$1,000 and \$1,333.33.

Retirement plans are also partly driven by generous tax treatment. Contributions to qualified pension plans are not taxed; taxes are assessed on withdrawal during retirement. This tax treatment means that

There are three primary reasons why an employer might choose to include benefits in a compensation package: (1) A firm can purchase benefits more cheaply than an employee can; (2) Offering benefits helps firms recruit certain types of workers; and (3) There are tax incentives to offering benefits.

offsetting lower salary will tend to attract the latter type of employee. In addition, as described below, DB pensions are designed to reward employees who stay at a job for a long time. By offering a DB pension, a firm is likely to attract workers who prefer to remain with an employer for their entire career. By contrast, defined contribution (DC) pensions, such as 401(k) plans, are generally preferred by employees who expect to change employers frequently during their career.

A third reason that firms may want to offer benefits is that the tax code provides financial incentives to do so. The most important tax provision is that many benefits are not taxed as income to the employee. Suppose an employee has a 25 percent marginal tax

contributions to qualified retirement plans allow people to invest more money upfront, thereby earning more overall interest. For example, suppose an employee has a 25 percent marginal tax rate and wants to save for retirement. If she receives a paycheck for \$1,000, she'll pay \$250 in taxes and have \$750 to invest. If she earns a 5 percent rate of return for 20 years, she'll earn \$1,240 in interest. If she still pays a 25 percent marginal tax rate during retirement, she'll pay \$310 in taxes on the interest. So her final balance is \$1,680. Now suppose that she has access to a tax-deferred DC pension plan. Her \$1,000 is not taxed when she earns it, so she can invest the entire amount. After 20 years, she'll have earned \$1,653 in interest. At retirement she pays a 25 percent tax on the entire \$2,653 of principle plus interest, or \$663. So

her after-tax balance is \$1,990, or \$310 more than if the favorable tax treatment for retirement contributions did not exist. Although DB and DC pensions are quite different, the favorable tax treatment works much the same way.

Who pays for these benefits?

One of the biggest misconceptions about employee benefits is that firms give them as “free add-ons” in a compensation package and that employees do not give up anything to get them. The truth is that, in large part, employees pay for all of their benefits in the form of a lower cash wage or salary than they otherwise would have received. When people choose which job to apply for and ultimately accept, they consider a range of factors: the salary, the benefits, the commute time, whether the boss is friendly, the intrinsic enjoyment they derive from the work, among many other things. They choose the job that gives them the greatest overall benefit or satisfaction. When comparing jobs that offer different packages, such as one with a higher salary and less-generous benefits versus one with a lower salary and generous benefits, people implicitly (or explicitly) trade off salary and benefits. If a person values a particular health insurance plan at \$10,000 per year, they would be willing to give up \$10,000 in salary to switch from a job without insurance to a job that has that plan as part of the benefits package.

Two important consequences follow from this. First, when the cost of providing a benefit increases, such as when health insurance costs increase, employees pay for the increase in the form of slower wage growth; and firms’ profits are generally not affected. IGPA faculty member Dr. Darren Lubotsky (an author of this paper) and colleague Dr. Craig Olson study Illinois public school teachers’ pay and health insurance benefits. They find that teachers’ unions and local school districts essentially raised teachers’ co-payments dollar for dollar for each additional dollar increase in health insurance costs during the last two decades. Raising these insurance co-payments has the same net effect on take-home pay as reducing base wages.

A second important consequence is that jobs that pay particularly generous benefits do not necessarily pay higher overall compensation levels. Workers are willing to give up some salary to get jobs with particularly generous benefits. An appropriate comparison would be to the total level of compensation (that is, salary plus the value of benefits) across jobs. Cutting benefits for public-sector workers, while leaving take-home salary unchanged, is conceptually the same as a cut in pay and we would expect some workers to opt for private-sector employment where they can get the same total compensation that they previously enjoyed.

Important Terms

Defined Benefit Pension Plan

A defined benefit plan bases pension benefits on a formula. The formula usually takes into account years of service and earning history. Benefits are generally paid as a lifetime annuity. It is the employer’s responsibility to maintain assets in a pension fund to pay benefits promised to employees.

An Underfunded Pension

A defined benefit pension plan is said to be underfunded when assets in an employer’s pension fund are less than the present discounted value of future promised benefits.

Defined Contribution Pension Plan

Defined contribution plans include 401(k) and 403(b) plans. This retirement plan option operates as a tax-deferred savings account. Employees contribute money from their paycheck to their retirement account. Depending on the plan, employees may have discretion about the amount to contribute and employers may also make contributions to their employees’ accounts. Employees control how the money in their account is invested. Upon retirement, employees take the balance in their account as a lump sum or, if the plan allows, convert the balance to an annuity.

The Basics of Employer-Provided Pensions



The two main types of pension plans: defined benefit and defined contribution

Pensions come in two basic types: defined benefit (DB) and defined contribution (DC). Recently, plans that are a hybrid of these two have become common. DB plans were historically the most common form of pension, but DC plans began gaining popularity in the 1980s and are now more common than DB plans in the private sector.

DB pensions are retirement annuities in which the employee's pension payment is specified by a formula. Formulas generally base payments on some measure of the worker's average or end-of-career salary and years of service at the firm (or years worked in the public sector). For example, a pension payment might be defined as 2 percent multiplied by years of service, multiplied by final salary. If the person worked for the firm for 30 years and retired with a salary of \$60,000, the pension payment would be $0.02 \times 30 \times \$60,000$, or \$36,000 per year. A way to think about this formula is that 2 percent multiplied by years of service, or 60 percent in this example, defines a "replacement rate." The worker will receive 60 percent of his or her final salary replaced as a pension benefit during retirement.²

DB pensions are generally paid as monthly lifetime annuities, which means that the stream of pension payments continues as long as the retiree is alive and ends when the retiree dies. Many DB pensions also include a lesser annuity paid to a surviving spouse after the retiree dies. Most private-sector DB payments are not adjusted annually for inflation, though many public-sector pensions are adjusted.

Annuities are an important component of retirement planning because they mitigate the risk that a person will outlive their assets. This is called longevity risk. Planning how much to save during working years requires projecting how long one will live during retirement and how much to spend and save each year during retirement. Those lucky enough to live longer than they expected face the prospect of running out of money. Since annuities, by definition, are a stream of payments that continue as long as the annuitant is alive, the risk of outliving your assets is significantly reduced.

Annuities can be obtained through a DB pension (as described above) or purchased by individuals from a financial or insurance institution. Annuities are generally very expensive to buy on the individual market, so DB pensions and Social Security (which operates in many similar ways to a DB pension) are the primary ways in which individuals obtain retirement annuities. It is increasingly common for DC pension balances to be converted to an annuity upon retirement.

DC pensions (which include 401(k) and 403(b) plans) operate essentially like a tax-deferred savings or investment account. Workers make pre-specified contributions from their paycheck to their retirement account. Employees may be given discretion by their employer as to how much to contribute. Firms also may make a contribution to workers' accounts; these contributions could be a fixed portion of the employee's salary and/or a match of the employee's contribution.

For example, the plan could specify that an employee contribute 5 percent of their salary and the firm will contribute 4 percent of the employee's salary. Or, the plan could specify that the employee has a choice to contribute between zero and 15 percent of their salary and the firm will match contributions dollar-

² Many employers require payroll deductions towards defined benefit pensions. It is important to understand that the benefit is defined by the formula, not as a function of any payroll deductions.

for-dollar. The Internal Revenue Service sets limits on contributions, but firms have discretion in setting up the plan within IRS guidelines.

A retirement account is generally managed by a third-party financial institution. Workers are given a limited number of investment options (such as a broad-based stock fund, a bond fund, etc.) and can allocate the money in their account however they wish. Those who prefer a more aggressive investment strategy may choose to put a larger share of their money into stock funds; those nearing retirement who want more certainty may choose to put their money into bond funds. Upon retirement, workers with DC plans can withdraw the money as a lump sum, take it through periodic distributions, or (if their firm gives them the option) convert the balance to a retirement annuity. When the individual dies, any remaining balance is part of the estate that is passed on to heirs.

DC and DB plans each have advantages and risks associated with them. The conventional view is that DC plans expose employees to more risk than DB plans. This refers to investment risk only: workers with DC plans bear the risk if their chosen investments do poorly. A related problem with DC plans is that most people are not experienced in finance and thus are susceptible to making poor investment decisions.

DB pensions are subject to a different set of risks. DB pensions generally base retirement payments on length of service and salary when an employee leaves the job. Payments are largest for people who remain at one job for their entire career and, as a result, receive a pension based on their end-of-career salary. Consider this simple example: imagine a person who stays at a job for her entire 40-year career. Her salary is \$60,000 when she is ready to retire. The formula for her annual DB pension is 2 percent multiplied by her years of service, multiplied by her final salary. Her annual pension would therefore be $0.02 \times 40 \times \$60,000 = \$48,000$. Now imagine if this employee had decided to switch jobs halfway through her career. Her salary at the time of the job change was \$30,000. Her salary when she retires is \$60,000. Assuming both firms have the same pension formula, her two pension payments would be $0.02 \times 20 \times \$30,000 = \$12,000$ at her first job at $0.02 \times 20 \times \$60,000 = \$24,000$ at her second job. The sum of these two pension is \$12,000 plus \$24,000 = \$36,000, which is \$12,000 less than her pension in the first example. That is, even though both firms used the same pension formula, by changing jobs she cost herself \$12,000 per year. This feature of DB pensions means that a key risk that workers bear when they

have a DB pension is that they will, voluntarily or not, change jobs and reduce the value of their future pension payments.

A second risk with DB plans is the certainty of payment. In the private sector, DB pensions are insured by the Pension Benefit Guarantee Corporation. This insurance is incomplete, however, so if a worker's firm goes bankrupt, she may not be able to collect the full pension she otherwise would have received. An analogous public-sector risk is that the government will decide to reduce pension payments for current employees.

To summarize, key benefits of DB plans are that they shield employees from investment risks and help protect against longevity risk. DC plans, by contrast, give workers more flexibility in their level of savings and investment options, but also require a certain level of financial sophistication or training so that workers can make informed decisions.

Recently, hybrid plans that attempt to merge features of DC and DB plans have become more popular. These plans are, technically, DB plans. Like traditional DB plans, firms invest accumulated assets and pay benefits. But like DC plans employees are credited with a certain amount of money each year, based on their salary and other factors. Employees earn a pre-specified interest rate on their assets. The accrual of pension benefits in a hybrid plan is generally faster than in a traditional DB plan, and payment is less closely tied to an employee's final salary, which reduces the penalty for changing jobs inherent in traditional DB plans.

Pension funding and deferred compensation

DC and DB pensions are funded in fundamentally different ways. DC plans are quite simple: employers or employees, or more typically both parties, make tax-deferred contributions to a DC pension account each pay period while an individual is employed. The employee manages the account within the framework and rules of the plan. The employee is legally entitled the balance in the plan (subject to vesting requirements).

DB pension funding is considerably more complicated and problematic. In a DB plan, workers accumulate future claims. The firm (or state government) is responsible for setting aside the money, and investing

the money to pay future promised benefits. Thus, firms or state governments bear the financial risk associated with plan investments. Put differently, a DB plan is a form of deferred compensation: employees receive part of their compensation (e.g. wages, health insurance) when they work, while part of their compensation is paid when they are retired.

Employers who offer DB plans project future pension payments so that they can adequately set aside funds to meet these obligations. Future DB pension payments depend on how long workers remain on the job, their future salaries, the length of time they draw benefits (i.e. how long they live), among other things. Thus, promised future pension payments can only be estimated. If the money set aside in a pension trust fund at a given point in time is insufficient to pay the projected promised benefits, the pension is said to be underfunded.

There are several key sources of uncertainty that employers face in predicting future benefits. Because DB pension systems include an annuity until the claimant dies, an unexpected increase in life expectancy will increase the length of time claimants receive benefits. If employees stay on their job longer than expected, future benefits will be higher than expected, but the date of the payout will also be delayed. Depending upon the penalties for early retirement embodied in the DB pension formula, a wave of earlier-than-expected retirements means that pension payments may be smaller than expected, but will need to be paid out sooner than expected.

Firms and government employers also bear risk with the assets they have already accumulated to pay benefits. Firms and state governments contract with fund managers to invest DB plan balances and achieve target average rates of return. Investment portfolios can generally be managed so that the return will track the overall growth rate of the U.S. economy with limited variability. Any investment portfolio that has a significant chance to achieve a growth rate exceeding the U.S. average also will have a significant chance of a return that is below the U.S. average. During times of poor national economic performance (like recessions), a pension portfolio designed to track national economic performance will yield low rates of return; actual returns will be less than forecast returns if the poor economic performance is unanticipated. Depending upon the timing and frequency of such periods, poor national economic performance can lead to fiscal stress in the pension system.

State DB pensions and chronic underfunding

A potentially more serious problem for pension funding than uncertainty in predicting future benefits and asset returns is that state governments, Illinois in particular, have simply not set aside enough funds to pay promised benefits. Because there is usually a long time lag between the earning and the claiming of deferred compensation, governments sometimes or often skip payments to their pension accounts so they can fund other government operations at a higher level, or so they can maintain a lower tax level.

When the economy is doing poorly, state tax revenue falls while transfer payments tend to rise. This fiscal squeeze increases lawmakers' incentive to skip required payments to a pension account. This pressure is even more acute if the state government has a balanced budget requirement and cannot borrow money. In principle, this type of fiscal indiscipline would be balanced by extra payments during good economic times.

However, when the economy is doing very well, lawmakers may (mistakenly) see their very large investment returns as a signal that they don't need to set aside as much money to fund future obligations. Put differently, the incentives that lawmakers face are to balance the current budget and to get re-elected. Sometimes the easiest way to do that is to promise generous pension benefits in the future, and leave the funding of those benefits to those who happen to serve in government in the next generation.

State government operations often separate the agency given the budget and responsibility for hiring and salary decisions (call this the "hiring agency") and the agency with the budget and responsibility for pension (and other non-wage compensation) payments (call this the "pension agency"). This separation can result in overuse of pensions as a form of compensation and may contribute to chronic underfunding. Officials in the hiring agency will support an increase in salary any time they perceive the benefits to the hiring agency (better quality work force, more satisfied employees, less turnover, etc.) exceed the costs of the increased salary. Even in the best case, these officials are likely to pay little attention to the increased state pension that accompany the increased salaries because the pension costs are borne elsewhere. If the hiring agency has a limited budget and needs to reduce staff or to make other personnel adjustments, they have an incentive to adopt policies

that shift costs to the pension agency while reducing their own costs even if the costs shifted on to the pension agency exceed the reduction in their own costs.

DB pension benefit formulas present an additional potential for fiscal difficulties. Employees have an incentive to “game” any formula to maximize future pension benefits. For example, many DB programs base post-retirement benefits on the highest average salary over some period of years.

by U.S. Social Security system might provide a model formula that is difficult to abuse.

There are limited circumstances in which chronic underfunding may be sustainable for a long period of time. If, for example, the government labor force is growing over time, chronic underfunding of pensions may continue as investments intended for future deferred compensation claims of younger workers are siphoned off to pay the current deferred compensation claims of retired workers. Similarly,

When the economy is doing poorly, state tax revenue falls while transfer payments tend to rise. This fiscal squeeze increases lawmakers' incentive to skip required payments to a pension account.

Future annuitants may take steps to inflate their salary (for example, by working overtime or taking temporary administrative appointments) just before retiring. In some cases, these individuals may time their retirement to maximize the pension benefits from such additional salary. When the hiring agency does not bear the full pension cost, supervisors may have an incentive to facilitate pension gaming as part of a deal to get additional work done with a limited budget for salaries. The defined benefit formula used

chronic underfunding may be sustainable if the share of deferred compensation in the total pay package is growing over time, even if the size of the government labor force is constant. However, neither of these conditions is likely to be met in Illinois in the near future.

State Options for Dealing with Accumulated Liabilities



As documented in many reports, Illinois has accumulated massive unfunded pension liabilities as a result of years of chronic under-funding.³ With respect to these liabilities, Illinois faces four choices individually or in combination it can:

- Reneg on past promises;
- Raise additional revenues to meet these obligations; Cut spending on other government goods and services to meet these obligations; and
- Increase government borrowing.

This section describes these options, as well as how transitioning from a DB to DC system would affect the state's liabilities.

Reneging on past promises

By some accounts, Illinois' unfunded pension liabilities are so massive that attempting to service them will require huge tax increases or spending cuts that will severely damage the state's economy. Furthermore, some argue that some state workers accrued pension benefits that over-compensated them for the work they performed. Some have advocated simply reneging on previously earned pension benefits for this group.

Proposals of this sort raise numerous constitutional and ethical questions that are beyond the scope of this analysis. We leave those questions to others. We do, however, wish to briefly address some of the equity and economic issues raised by this sort of proposal. Reneging on past pension liabilities can be thought of as a (confiscatory) tax on owners of these assets (i.e. potential pension claimants). Economists generally evaluate taxes primarily based on their equity and efficiency. Equity is further subdivided into horizontal and vertical components.

A tax is said to be horizontally equitable if similarly

situated individuals pay similar taxes. By this standard, reneging on past pension promises introduces horizontal inequity. While the details of any proposal could differ, any policy that cuts already accumulated liabilities substantially would have to become effective soon after it was approved. Thus, individuals who retire just before the effective date would be unharmed while those who could not retire by that date (for eligibility or other reasons) could suffer a substantial capital loss. Reneging on past public pension promises also penalizes workers who many years ago opted for public-sector employment compared to similar workers who opted for private-sector employment. Many public-sector employees including college professors, managers, and janitors have comparable opportunities in the private sector. A tax on accumulated pension benefits only for those in the public sector is horizontally inequitable.

Vertical equity requires that taxes should increase with ability to pay, i.e. that taxes are progressive. A tax on accumulated pension benefits taxes one particular category of wealth without reference to other sources of wealth or income and without reference to the economic circumstance of the taxpayer. Even if accumulated pension benefits are strongly correlated with lifetime earned income and other sources of wealth, a confiscatory tax on a portion of the pension benefits may be inequitable if the tax rate varies abruptly with the level of the accumulated pension. For example, one recent proposal would have imposed a 100 percent tax rate on all benefits above a certain level but a zero percent tax rate on all benefits below that level. This sharply contrasts with the state's personal income tax system which imposes a constant 5 percent tax rate on income.

An economic policy is efficient if it does not distort the use of resources relative to their use in a fully informed free market without spillovers. By this standard, confiscation of accumulated wealth may

appear efficient because no current or future actions can alter an individual's tax liability.

However, like nationalization of private property, a tax on accumulated pension benefits could alter future behavior by establishing the precedent that legally acquired property rights may be insecure. Individuals who interpret this precedent narrowly may be unwilling to work in government jobs that offer pension benefits, or may simply discount the value of promised pension benefits. This has the same effect as a reduction in total compensation and hinders the government's ability to recruit a skilled work force. Those who interpret the precedent more broadly might refuse to enter into any contractual relationship with the government or perhaps any contractual relationship that could potentially require government enforcement. Such a precedent might greatly reduce the efficiency of future economic activity.

It is important to understand that the precedent of taxing previously accumulated pension wealth is very different from a change in a tax rate going forward. Governments regularly adjust tax rates—such as the income tax rate—that alter the tax due based on future actions. While such actions have the potential to change market behavior, taxpayers can assess the costs and benefits of that behavior with complete information about their tax consequences before making economic choices.

Raising additional revenue to meet pension liabilities

An alternative to renege on past pension promises is to raise additional revenue through taxes to pay for some or all of the state's pension liabilities. Proposals to increase taxes to pay public pension liabilities

should be evaluated on a case-by-case basis relative to other alternatives, based on the equity and efficiency criteria discussed above. Raising a dollar of revenue through taxation distorts economic decision-making and leads some people to avoid economic activity in which they otherwise would engage.

The value of this reduction in economic activity is referred to as deadweight loss and represents the true cost of the tax. In general, to minimize this deadweight loss, it is better to have taxes that are assessed on as large a tax base as possible, with as low a rate as possible. That is, to raise a specific amount of money, deadweight loss is minimized by taxing (for example) all income or all consumption, rather than introducing exemptions that require the overall tax to be increased. The cost of additional taxes should be balanced against the benefits of paying off pension liabilities.

Cut spending on other government goods and services

Spending on other government programs could be cut to make funds available to meet pension obligations. Any such spending cuts will have equity and efficiency implications. Proposals to cut spending to pay public pension liabilities should be evaluated on a case-by-case basis relative to other alternatives. Government services generate benefits that are, one would hope, greater than their costs. Efficiency implies cutting those services that generate the least benefit per dollar of expenditures.

Increase government borrowing

A popular misconception is that borrowing money to fund existing pension obligations raises the government's total debt load. It does not. The

The State's Options

- Reneg on past promises
- Raise additional revenues to meet these obligations
- Cut spending on other government goods and services to meet these obligations

government borrowing money through capital markets in exchange for a promise to repay the loan in the future is conceptually the same thing as the government telling a current employee that they will receive compensation for their work in the future, in the form of a retirement benefit. Pre-funding DB pension benefits is equivalent to setting aside money to pay off a traditional loan. An unfunded pension liability, by contrast, represents an implicit loan from the individual owed the money (i.e. the government employee) to the government. Borrowing money in the capital markets to pre-fund DB pension benefits simply changes the owner of the debt from the government employee to bondholders; it does not represent new debt.

Assuming the state government has access to capital markets, it is likely better policy to borrow to fund a pension liability than to leave the pension underfunded. A funded pension provides government employees with the security of knowing their pension will be paid.

However, it should be clear that borrowing to fund pension benefits does nothing to solve the underlying fiscal imbalance because ultimately the debt has to be paid. At some point, there has to be tax increases or cuts in government spending.

Weighing alternative strategies for disposing of accumulated pension debt

Paying off an accumulated debt will always require that the debtor sacrifice some current resources to compensate for goods and services consumed in the past. What weight should be given to each of these mechanisms discussed above?

Economic analysis provides no definitive answer to this question but does provide a methodological approach to think through the answer. The basic task that society must solve is to minimize the total cost to all parties in order to dispose of the debt. In this case, the costs of each solution are multi-dimensional and may include important non-monetary costs such as diminution of social equity, reputational damage to the government and reductions in the economic efficiency of private businesses. Each mechanism is likely to have increasing marginal non-monetary costs, i.e. the non-monetary costs of each mechanism will rise disproportionately with their monetary cost. So for example, the nonmonetary cost of reneging on \$2 billion in pension debt will be more than twice as great as the non-monetary cost of reneging on

\$1 billion of pension debt. Basic economic analysis suggests that total (monetary and non-monetary) cost is minimized by assuring that the last dollar of pension liability reduction has equal non-monetary cost for each mechanism. This suggests that the state might minimize total costs by a policy of shared sacrifice across taxpayers, pension claimants and service recipients.

Replacing a DB pension with a DC pension

Over the last 30 years, DC plans have become considerably more popular than DB plans in the private sector. This is reflected in new firms offering only DC plans and in existing firms transitioning workers from DB plans into new DC plans. There are a number of reasons why this switch has occurred. On the employer side, DC plans may be simpler to manage because they relieve the firm of the responsibility to plan for and set aside funds for future benefits. On the employee side, many prefer the flexibility that DC plans offer or want the ability to participate in financial markets. Financial market innovations have lowered the cost and simplified the process of individual holding of a diversified portfolio of investments.

While such a transition may have substantial benefits, basic economic analysis shows that transition from a DB to a DC pension system will not reduce either (i) accrued liabilities or (ii) future total costs of compensation.

The easiest way to understand this is to think about a very simple example. Let's simplify the year's inflow and outflow of employees and just think about successive generations who work for the state government for one period and then retire. Also suppose the interest rate is zero. The government promises employees that they will receive a pension benefit of \$1,000 when they retire. Employees contribute nothing toward this pension benefit. In this simple example, the government flow of funds would be that every period the government has one generation working while members of the previous generation each receive their \$1,000 benefit. As long as the size of the government work force does not change, this system is stable.

Now imagine that the government institutes a DC pension for its existing work force. Instead of promising their existing employees that they will pay them \$1,000 when they retire, they give these

workers \$1,000 while they are working. Workers invest this money (though in this simple example, the interest rate is zero). So during the year of the switch from a traditional DB pension to a DC pension, the government must pay out twice as much money. They pay \$1,000 to each existing worker and pay the \$1,000 to each retiree from the previous generation.

It should be clear that borrowing to fund pension benefits does nothing to solve the underlying fiscal imbalance because ultimately the debt has to be paid. That is, at some point, there has to be tax increases or cuts in government spending.

Going forward, though, the government still pays out \$1,000 per year. The difference is that they will be giving it to existing employees, rather than to the previous generation of employees.

Three conclusions emerge from this simple example. Most importantly, switching from a DB to a DC pension does not alter the cost of the pension program. A pension program can be made less costly by making it less generous (i.e. providing \$900 to each employee in the example above), but the choice of a DC or DB plan is independent of the generosity of the plan. A corollary of this is that switching from a DB to a DC pension does not help solve (or exacerbate) the problem of the accumulated liability.

Second, switching from a DB to a DC plan involves a one-time “transition cost.” During the transition from the DB to DC plan, the government has to pay past workers their earned DB benefits at the same time as it pays DC benefits to existing workers. This is not a new cost; in the example above, each worker receives \$1,000, but the timing of the payments changes.

Finally, the choice of a DB or DC pension should be based on how the employees and state government view the relative trade-offs described above, not based on the relative costs of each type of pension. It bears emphasis, however, that a key benefit to the state of switching to a DC plan is that it avoids the planning and funding problems described earlier.

As the above example should make clear, there is nothing intrinsic about DC pension systems that makes them less (or more) costly than DB systems so a switch from one system to another will not, in and of itself, have an impact on pension costs. Even more generally, there is no particular reason to expect that a reduction in pension benefits will lower the total

cost of employee compensation if there is market competition for employees. A reduction in pension benefits with no changes in other compensation or working conditions will make employment less attractive and will make it more difficult to recruit and retain desirable employees. In a period of high unemployment, reductions in pensions or other

compensation may bring temporary cost reduction with little loss in productivity, but in the long run the potential employee pool will respond.

This line of reasoning does not necessarily suggest that current compensation packages are appropriate or should not be reduced. It is possible that the current package trades off too much compensation for too little increase in employee desirability—i.e. it might be more economically efficient to lower compensation (wages or pensions) and accept less desirable employees, but this decision is unrelated to the share of compensation paid through pensions.



Conclusions

In this section we have discussed qualitative impacts of the following potential changes to Illinois' public pensions:

- Altering the share of compensation paid through pensions;
- Switching from a DB to a DC system;
- More closely aligning hiring/wage responsibility with responsibility to make pension payments;
- Altering DB pension formula to make "gaming" more difficult;
- Reneging on past pension liabilities.

Pensions are one component of workers' overall compensation package.

Any redesign of Illinois' pension system should be part of an evaluation of the total compensation package offered to state workers. Components of the compensation package include wages and salary, health insurance, pension and other benefits. All of these components help to attract and retain workers. Compensation packages should be designed with consideration of the total level of compensation and the balance among the components. The appropriate balance may differ for different type of workers (highly skilled versus less skilled, for example).

The conventional view is that DC plans expose members to more risk than DB plans. However both DC and DB plans expose both employers and employees to various types of risks.

Deferred compensation facilitates implicit borrowing and future fiscal imbalance.

Deferred compensation (including, but not exclusively, DB pension systems) separate the time an asset is earned from the time at which it is claimed. Because the claimants do not immediately get rights to the compensation, it is possible for employers to less than fully fund promised benefits for a period of time. A system of trust funds, regulatory oversight

and other rules may mitigate this problem but cannot eliminate it.

DB pension systems are inherently vulnerable to "gaming" that may raise compensation costs with comparatively little increase in worker productivity. Because the payout of a DB pension system is determined by a formula, workers can take actions to maximize their pensions. The cost of such actions can be reduced by careful regulation and monitoring but cannot be eliminated.

Reneging on past pension promises is a tax and should be evaluated using the same tools as any other tax.

Pension system participants view their accrued pension benefits as an asset. Any reduction in these benefits is therefore a highly targeted tax on that asset. Economic evaluation of the tax would include its equity and efficiency effects.

Transition from a DB to a DC pension system will increase the state's short term fiscal stress and will, by itself, have no long-term impact on fiscal stress. In the short run, a transition to a DC program will drain resources that could otherwise be used to pay benefits to DB participants. In the long run, however, the cost of providing a given level of retirement benefits is the same within a DC or DB framework.

Alternative strategies for dealing with past pension promises also have large potential costs. A policy of shared sacrifice among owners of pension liabilities and other groups may minimize total social costs.

Section 2

Legal Issues Surrounding Pension Reform

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The Debate Over Legislative Reforms to the State of Illinois' Retirement System



The debate over the legality of legislative reforms to the State of Illinois' retirement systems centers, first and foremost, on the meaning of the state constitution's Pension Clause. Article XIII, § 5 of the Illinois Constitution states: "Membership in any pension or retirement system of the State ...shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." Understanding the meaning of the clause and evaluating its possible relevance in a legal challenge to legislative pension reform may depend on a multitude of extra-legal factors; nevertheless, some legal doctrinal parsing of its words is possible.

The Pension Clause has two distinct parts, each of which is relevant for any analysis of the status of SURS employee benefits. First, the clause establishes that the employees' membership in a pension system

system.¹ The Illinois Supreme Court has adopted this view of the "Pension Clause," and has stressed that the purpose of the clause was to reassure government workers that their participation in a pension system did not exist at the whim of the government employer. *See McNamee v. State*, 672 N.E.2d 1159, 1162 (Ill. 1996).

The second part of the pension clause establishes that pension benefits "shall not be diminished or impaired." The Illinois Supreme Court's interpretation of that part of the Pension Clause appears to have established a line between unconstitutional diminishment of accrued benefits and constitutional legislative action that reduces benefits prospectively. In *Peters v. City of Springfield*, 311 N.E.2d 107 (Ill. 1974), for instance, the court upheld a city ordinance reducing the mandatory retirement age for police and fire service employees. Though that change meant that some

The debate over the legality of legislative reforms to the State of Illinois' retirement systems centers, first and foremost, on the meaning of the state constitution's Pension Clause.

is "an enforceable contractual relationship." When that language was added to the 1970 constitution, it radically changed the status of government employee pension systems in the State of Illinois. Prior to the clause's adoption, many Illinois government pension systems were treated as gratuitous gestures, with the employee totally dependent on continued government largesse. This language made clear that by establishing an employee pension system, Illinois governments were entering a binding, contractual relationship. This first part of the clause, then, speaks to the binding nature of the pension system itself, and not to any question about modifications to that

employees would ultimately suffer a reduction in pension benefits, the court recognized that changing conditions might require prospective modifications of the terms of employment, including pension benefits. The connection between the ordinance and the pension system in this particular case was indirect; hence, there was no unconstitutional diminishment.

In this opinion, though, the court left undecided important questions about the Pension Clause's

¹A second purpose can be gleaned from the constitutional history of the clause. With the 1970 constitution's introduction of a new home rule system for Illinois municipalities, many municipal employees were fearful that the new home rule powers would enable local governments to walk away from the previously established pension systems for municipal employees. This clause put those fears to rest.

scope. While it recognized that the clause “indicates a general intent to protect the pension benefits of public employees,” the court was unwilling to go beyond the interpretation that adherence to the Pension Clause requires that “vested rights not be defeated by reason of the failure to provide necessary funding.” The court noted that beyond that essential baseline, the Pension Clause was not clear about the extent of legislative discretion to modify employee benefits when those benefits had not yet vested. That distinction may well be crucial in a legal assessment of legislatively adopted pension reform. The *Peters* case does not tell us where the court would draw the line in a future case, but it does suggest that there could be an important constitutional distinction between accrued benefits and future benefits.

In another case involving the application of the Pension Clause, the Illinois Supreme Court invalidated one legislative attempt to modify pension benefits as an unconstitutional diminishment. In *Buddell v. SURS*, 514 N.E.2d 184 (Ill. 1987), the court upheld an employee’s claim that a change in service credit requirements could not deprive the employee of the vested right to credit earned under previous, and more generous, regulations. Thus, the Illinois Supreme Court appears to have again drawn a line between accrued, vested pension benefits and the expectation of prospective benefits. The former appears to be constitutionally protected; the latter may not be.

To date, at least four different theories about the scope of the Pension Clause have been offered publicly, either through a legal memorandum or as the basis of proposed legislation. Taken together, they offer a wide spectrum of possible interpretations, each of which would have important consequences for current employee participants in SURS’ defined benefit plan. The following paragraphs discuss each interpretation separately.

1. Pensions are Contracts With SURS Only

Perhaps the most extreme interpretation of the Pension Clause is the argument that membership in the state’s various pension systems (of which SURS is one) creates a legally binding obligation between the employee and the pension system itself. In this view, the State of Illinois is not a party to the pension contract and thus not liable to pay employee benefits if SURS runs out of money. That argument is based on the fact that the constitutional language specifies

only that membership in the pension system is an enforceable contractual relationship; it does not, however, expressly state the identity of the other contracting party.

Although this interpretation might be consistent with a literal reading of the Pension Clause, it does not seem to be consistent with the interpretation underlying Illinois Supreme Court case law interpreting the clause, or with the recorded proceedings of the Illinois Constitutional Convention of 1970. Certainly, though, this interpretation would be the one most favorable to the State of Illinois, as it would essentially eliminate its responsibility to government employees. It is worth noting that the General Assembly has, at least to date, acted on the assumption that it does have an obligation to the pension funds. Its most recent decision to borrow billions of dollars to fund the system seems to indicate its recognition and acceptance of a duty to members of its pension systems.

2. No Guarantees For Pension Benefits

A second approach to pension reform takes a slightly less dismissive view of the state’s obligation to its employees. Under this second view, although the state may recognize its obligation to its employees under the pension system, an immediate reduction of existing, accrued benefits would be legal. The apparent reasoning is that the Illinois Constitution imposes no limits on legislative discretion to reduce pension benefits for current workers. This approach seems to accept some state responsibility for some financial payout to current employees, but would authorize the imposition of many drastic reductions on the benefits of many current employees, most likely concentrated on those whose current salaries are over \$100,000. If legislation along those lines were enacted, it would face legal challenges based on the Pension Clause and on basic principles of contract law. Moreover, the United States Constitution’s Contracts Clause would be relevant as well: “No State shall ... make any ... Law impairing the Obligation of Contracts.” (Article I, Section 10, Clause 1).

3. Only Accrued Benefits Are Guaranteed

Some have suggested that, although current employees may have acquired vested rights to those benefits actually earned to date, the state may modify, decrease, or perhaps even terminate those benefits

going forward. Under this view, employee benefits could be frozen as of the date of legislative enactment; going forward, the employee would be subject to the terms of any newly modified (and reduced) pension system, much as the state has changed the terms of the pension system for new employees.

Prospectively, this approach would authorize substantial reductions and changes to future retirement benefits, under terms substantially different from those in effect when current employees first joined SURS. In essence, a prospective legislative amendment of benefits would divide current employees' pension benefits from SURS into two distinct phases: those earned in Phase 1 before the effective date of the legislation (and calculated under the terms of the original defined benefit plan); and those earned in Phase 2 after the date of the legislation (and calculated under what would likely be much less generous terms). Upon retirement, the employee would receive a total retirement benefit that combines those earned in Phase 1 with those earned in Phase 2. In many ways, this means that current long-term employees would be in the same situation as those employees who left one job, with their pension benefits left behind and untouched until retirement, and started another job, with a new retirement plan, whose terms may well be inferior to the terms of the previous plan.

In comparison to the two previous, more draconian, theories about the state's obligations to existing employee benefits, this third approach could more easily withstand constitutional attack. For one thing, it seems to respect the Illinois Supreme Court's distinction between accrued, vested rights (which are protected), and future benefits (which may not be). And moreover, it is consistent with basic principles of contract law, treats public-sector employees in the same way federal law would treat private-sector employees, and is sensitive to the harsh economic reality of Illinois' unfunded pension liability.

4. No Changes to Pension Benefits are Allowed

Some have argued that the Pension Clause of the Illinois Constitution prohibits the state from undertaking any modifications to pension benefits for current employees at any time during their employment. Under this theory of the Pension Clause, state employees acquired immutable pension rights on the date they began to work for the State of Illinois. That is, the system and benefit schedule

that was in place on the employee's first date is the system that must apply to the employee's earnings throughout the entire course of state employment. This interpretation would mean that the state has no power to change any benefits, to change any formulas for calculating benefits, or to alter any of the terms and conditions of the pension plan that was in effect on the employee's first date at work. This is probably the interpretation of the Pension Clause that is most consistent with employees' understanding of the pension system they joined; it is not necessarily required by state constitutional law, however. In fact, the argument may seem somewhat inconsistent with the reality that the state has the ultimate power to close the University of Illinois and terminate employment of all current SURS members. Along those lines, some have suggested that the state's greater power to close the university should be interpreted as including the lesser power to modify unearned future pension benefits going forward.

This fourth argument is based on the claim that the Pension Clause is intended to guarantee that employee benefits will always be calculated pursuant to the formula that was in effect on the day the employee became a member of the pension system. Although there is some constitutional convention history to that effect,² the Illinois Supreme Court has not endorsed this view; in fact, it has concluded that the scope of the Pension Clause is uncertain in that regard.

Conclusion

In general, the Illinois Supreme Court's interpretation of the Pension Clause has been careful to preserve legislative discretion and flexibility. During the constitutional convention, some delegates opposed the Pension Clause because they assumed that it would give employees the right to compel state funding of the system. In *People ex rel. Skłodowski*, 695 N.E.2d 374 (Ill. 1998), the court made clear that those worries were unfounded. Building on several earlier opinions, the Skłodowski court accepted the state's argument that "the pension protection clause creates enforceable constitutional rights only to receive benefits, not control funding." [Id. at 378.] This opinion follows established case law by

²Delegate Kinney opined that: "If a police officer accepted employment under a provision where he was entitled to retire at two-thirds of his salary after twenty years of service, that could not subsequently be changed to say he was entitled to only one-third of his salary after thirty years of service, or perhaps entitled to nothing. That is the thrust of the word 'diminished.'" Record of Proceedings, Sixth Illinois Constitutional Convention at 2929.

recognizing the need for legislative discretion and by refusing to interfere with a delicate political matter. That deferential approach is likely to inform any judicial review of any adopted legislation that seeks to implement pension reform.

No legal analysis can predict the future. The application of established legal principles frequently produces unexpected results. Each of the four theories described above is based on a different interpretation of the state constitution's Pension Clause. Although the Illinois Supreme Court has made statements in several of its judicial opinions that can be offered as support for one or more of these theories, it would be unwise to use that language as a basis of prediction.

This is particularly so in the case of pension reform, because if the Illinois courts are called upon to resolve a dispute over legislative modifications to the pension system it will likely mean that the state is in an even more disastrous financial situation than the one in which it currently finds itself. At that point, employee pension rights will likely be but one of a number of unmet state obligations. A court is unlikely to allow any private party to force the state over the financial precipice. Moreover, a judicial declaration of employee rights is not the equivalent of a legislative appropriation of funding to meet those obligations, and the fiscal reality at the time of any judicial decree will dictate its real value.

Section 3

How Does Illinois Compare?

Pension Policy Across States

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Sources of Pension Problems

Tolstoy said, "Happy families are all alike; every unhappy family is unhappy in its own way."

This applies to pension systems as well. Well-funded public pension systems are of little interest or concern whereas the troubled ones are increasingly the focus of attention. While many public pension systems are facing serious problems, the sources of these problems vary widely, as do the options for responding to them. This can make comparisons problematic.

As described earlier in this report, underfunding is a characteristic of many troubled pension plans. Most of the underfunding of Illinois' system is the result of deliberate choices made by the state over several decades to not make required annual contributions. Seemingly modest underfunding can have major long-term effects when the investment returns on the underfunding are lost, thus compounding the problem.

Based on data provided by the Illinois State Universities Retirement System (SURS), an analysis shows that if the state of Illinois had made a contribution each year of the actuarial-determined normal cost (as expected, but not required by the pension rules), the system would now have a funding ratio of 104 percent. The state would have had to contribute around 10 to 11 percent of payrolls, which is a reasonable amount given that there were no Social Security contributions. This includes the past 10 years when investment returns have been very modest by historical standards. Note that the state-managed Illinois Municipal Retirement Fund is relatively well funded because Illinois requires local governments to contribute on an annual basis. However, this is a discipline that Illinois has been unwilling to impose on itself.

Underfunding can also result from the extension of more generous benefits that are not matched by increased contributions. For example, early retirement

incentives often reduce current salary costs, but these savings are often offset by the increased pension costs that are not funded.

As described earlier, underfunding also can result from poor investment performance either because of poor market performance or inappropriate asset choices. Two major market declines in the past decade have presented real challenges, but over the long term, this has had a relatively small impact for Illinois. There are also possible problems resulting from the choice of overly optimistic assumptions about investment returns. Higher assumed rates of return reduce the actuarially-determined required funding levels. Return assumptions are being reduced in most pension funds to reflect lower expected inflation rates as well as less optimistic real return prospects.

This has not necessarily been the case for Illinois. Based on data from Illinois State Universities Retirement System (SURS) since 1972, the actual fund returns (calculated on compounded annual rate of return basis) have exceeded the return credited by the system over this period (the Effective Rate of Interest). The annualized rate of return for the system from 1972 until 2010 was above 8.2 percent, which approximates the actuarial assumed rates of return during this period.

Even states with better-funded pension systems than those in Illinois are not immune to problems. For example, several New York state pension funds are funded at above the 100 percent level of assets to liabilities. Nevertheless, New York has budget problems as severe as Illinois. In the past, Illinois has chosen to underfund its pensions systems rather than increase taxes or cut spending in other areas. New York has funded its pension more fully than Illinois through borrowing and other measures. New York now faces problems in relating to high debt and the reliance on other unsustainable revenue sources.

TABLE 1: Government Contributions to Pensions as Percent of Salary*

	Wisconsin Teachers	Wisconsin Milwaukee Teachers	Illinois SURS**
Social Security (OASDI)	6.20%	6.20%	0.00%
State or local paid pensions costs	13.00%	13.00% 4.20%	11.20%
TOTAL	19.20%	23.40%	11.20%

*Up to social security cap (\$106,800). Pensions only. Does not include health care costs.

**This is the expected state contribution in Illinois. The state often contributes substantially less than expected.

California's pension systems are funded in the 80 percent range, also better than those in Illinois. California, like Illinois and New York, faces difficult budget challenges, partially because of benefit increases that will affect pension funding in the future. Increases in benefits also result in pension pressures such as those being experienced in New Jersey and California. These states, as well as New York, have better funded systems than Illinois but face huge future demands to maintain the funding of their systems to fulfill these promises.

It is difficult to determine how generous pension benefits are in isolation. The real issue of generosity depends upon the total compensation package (wages plus benefits). Comparisons also depend on whether a public pension system supplements Social Security coverage or whether it is the sole retirement vehicle as is the case for some Illinois systems such as SURS and STRS. This is illustrated by the situation in Wisconsin.

Similarly to New York and California, Wisconsin has funded its pension systems relatively well. However, this has come at a high cost. Table 1 compares Wisconsin's contributions to pensions for teachers, including Social Security to Illinois SURS. Note that while Wisconsin's system includes Social Security, that is not the case in Illinois. The table shows that the government cost of pensions in Wisconsin is nearly twice (or more) that of Illinois. If Social Security is ignored, the costs would be roughly comparable. Governments that do not provide Social Security coverage must compensate with higher state pensions. Unlike Illinois, which is constrained by the Pension Clause in the state constitution that was discussed earlier in this report, many states have the ability or duty to adjust benefits and contributions to maintain the financial health of their pension systems. For instance, Ohio must adjust contribution rates and benefit arrangements to insure the long-term stability

of its pensions. Without the restrictions of the Pension Clause, these changes can affect current employees and retirees. The changes can occur incrementally and not require huge changes at any particular point.

A summary of approved changes to state public pension systems developed by the National Association of Retirement Administrators¹ indicates that nine states² have increased the contribution rate for current employees. Four states³ have increased the contribution rates for new employees only. Note that employee contributions for pensions can be addressed with more creative techniques such as adjusting basic wage levels with the savings directed to pension funding. These changes would presumably not be affected by constitutional impediments.

The summary indicates that there have been a number of reductions across the country in COLAs for existing employees. While current benefits have not been cut for retirees, the growth of their pension benefits was reduced in many cases. There were few changes in the benefit formula for existing employees. Illinois and New York have had the most dramatic recent changes for new employees. Illinois likely had the most substantial reductions for new employees with employees those starting in 2011 and after receiving benefits far below those of existing employees.

Finally, in reviewing reform proposals from various states, it is important to remember that many will never become law. It is difficult to judge the relative importance of much of what is happening in other states since the full story of each proposal is not known.

¹<http://www.nasra.org/resources/SustainabilityChanges.pdf>

²Arizona, California, Colorado, Iowa, Minnesota, Mississippi, New Jersey, New Mexico, Vermont

³Missouri, New York, Pennsylvania, Virginia



The Sizes of Pension Programs Across States

The number of state and local pension systems vary widely from state to state. Some states centralize pensions for all state and local employees at the state level. Others allow local entities to have their own pensions systems. Illinois has a combination of arrangements such as the State Employees system (which is just for state workers), SURS (which includes state employees and local community college employees) and State Teachers (which includes local school employees, but is run by the state). Illinois also has a number of strictly local pension systems for police and fire employees.

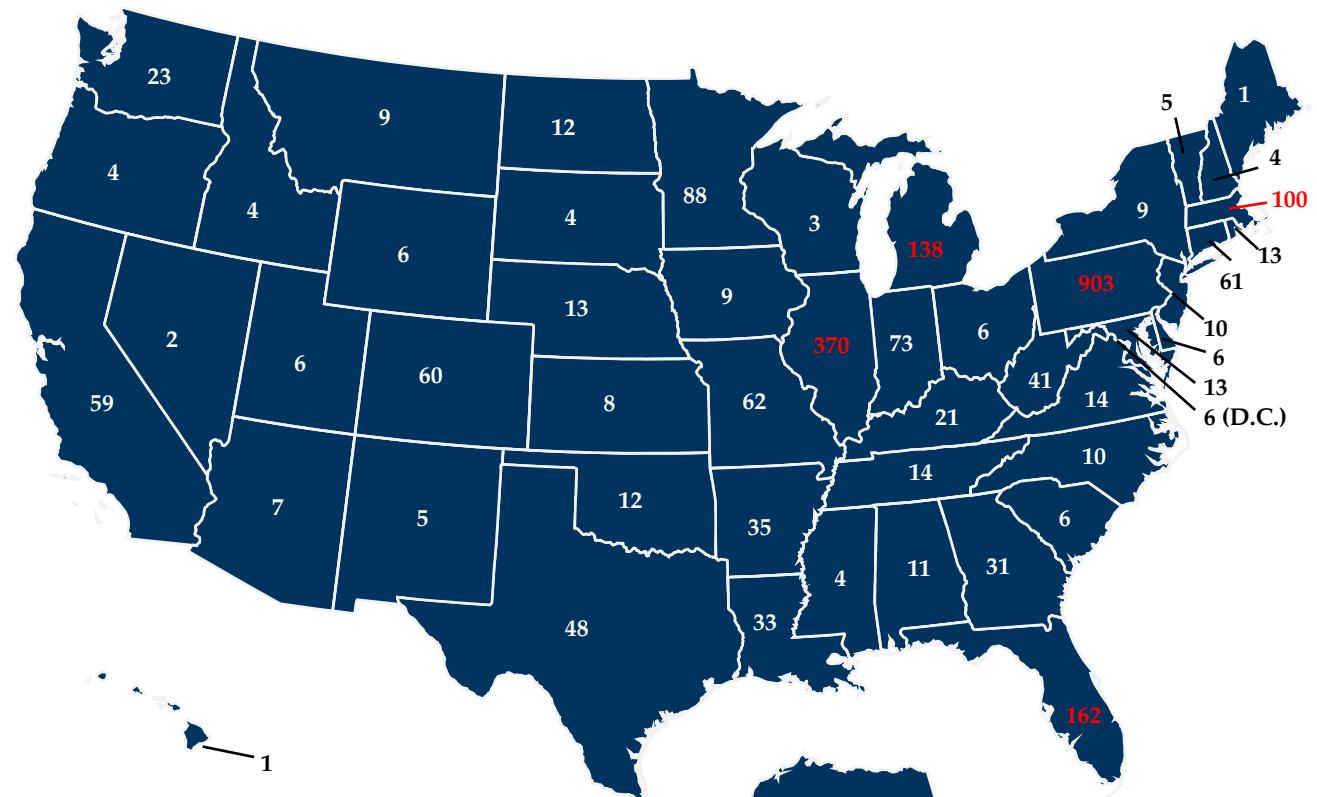
Illinois has 370 state and local pension systems, the second highest number following Pennsylvania. Hawaii and Maine have one system.

Map 1 and Table 2 utilize data from the United States Census Bureau. Map 1 shows how many systems each state has. Table 2 provides information about the number of individuals involved in pension systems for each state. This is presented in total numbers, numbers as a percent of population, and the numbers compared to the national average.

Illinois has about 960,000 people associated with its pension systems. The state's systems include about 628,000 active employees, 332,000 inactive employees and 390,000 receiving benefits. Illinois has 122 percent of the national average of people associated with its pension systems; 101 percent of the national average of active employees; 179 percent of the national average of inactive; and 122 percent of the national average receiving benefits.

MAP 1: Number of State and Local Pension Systems by State*

Source: U.S. Census Bureau



*Top 5 states by number of pension systems in red

TABLE 2: Number and Membership of State and Local Public Employee Systems by State

State	Number of Systems	Total	MEMBERSHIP		Total beneficiaries receiving periodic benefit payments
			Active Members	Inactive Members	
United States	2,550	19,097,226	14,701,442	4,395,784	7,553,373
State	218	17,215,183	13,073,495	4,141,688	6,405,199
Local	2,332	1,882,043	1,627,947	254,096	1,148,174
County	160	576,572	483,239	93,333	274,556
Municipality	1,659	1,148,991	1,005,863	143,128	777,903
Township	395	38,634	35,116	3,518	21,930
Special District	106	45,777	41,620	4,157	28,700
School District	12	72,069	62,109	9,960	45,085
Alabama	11	272,340	244,496	27,844	113,363
Alaska	5	60,731	44,080	16,651	40,615
Arizona	7	504,971	276,638	228,333	119,159
Arkansas	35	158,067	131,058	27,009	58,073
California	59	2,330,929	1,779,811	551,118	1,032,360
Colorado	60	376,160	222,691	153,469	99,473
Connecticut	61	138,223	133,646	4,577	89,574
Delaware	6	46,573	43,918	2,655	24,480
District of Columbia	6	12,436	11,399	1,037	3,587
Florida	162	723,964	640,739	83,225	333,374
Georgia	31	599,029	389,992	209,037	148,998
Hawaii	1	72,436	66,589	5,847	36,260
Idaho	4	76,933	66,842	10,091	31,040
Illinois	370	959,545	627,978	331,567	389,551
Indiana	73	291,466	232,610	58,856	111,924
Iowa	9	237,498	172,823	64,675	91,956
Kansas	8	197,572	155,996	41,576	69,266
Kentucky	21	327,389	225,870	101,519	124,183
Louisiana	33	311,344	221,506	89,838	138,317
Maine	1	68,418	60,225	8,193	34,257
Maryland	13	295,509	240,335	55,174	146,519
Massachusetts	100	379,579	312,942	66,637	183,018
Michigan	138	426,804	393,847	32,957	300,268
Minnesota	88	516,230	292,695	223,535	160,554
Mississippi	4	292,703	166,576	126,127	76,474
Missouri	62	330,815	275,627	55,188	141,014
Montana	9	73,672	52,308	21,364	31,478
Nebraska	13	99,809	74,980	24,829	23,239
Nevada	2	117,794	106,168	11,626	38,197
New Hampshire	4	57,483	52,640	4,843	23,552
New Jersey	10	583,366	512,015	71,351	239,221

State	Number of Systems	Total	Active Members	Inactive Members	Total beneficiaries receiving periodic benefit payments
New Mexico	5	153,627	120,475	33,152	56,551
New York	9	1,378,378	1,257,961	120,417	767,870
North Carolina	10	609,312	510,093	99,219	38,361
North Dakota	12	35,118	30,217	4,901	13,686
Ohio	6	1,199,624	695,200	504,424	383,243
Oklahoma	12	173,706	159,251	14,455	88,225
Oregon	4	215,474	169,059	46,415	108,358
Pennsylvania	903	631,933	497,927	134,006	359,772
Rhode Island	13	47,379	40,229	7,150	28,518
South Carolina	6	378,679	214,096	164,583	112,298
South Dakota	4	53,232	38,770	14,462	19,888
Tennessee	14	281,231	247,986	33,245	123,920
Texas	48	1,566,345	1,354,295	212,050	450,249
Utah	6	134,191	102,009	32,182	40,510
Vermont	5	34,156	26,312	7,844	13,237
Virginia	14	442,793	393,614	49,179	166,667
Washington	23	301,813	258,540	43,273	131,566
West Virginia	41	50,988	37,515	13,473	22,272
Wisconsin	3	424,016	278,950	145,066	155,385
Wyoming	6	45,443	39,903	5,540	19,453

Source: U.S. Census Bureau



The Sizes of Unfunded Liabilities Across States

There are various ways to estimate unfunded liabilities in pension funds. For example, Illinois uses both a three-year moving average measure and a measure based upon the market value at the current time. Estimates of liabilities depend on a number of crucial assumptions, such as expected investment returns, future wage growth, and longevity forecasts.

There has been much discussion over the last few years about the appropriate discount rate to use in liability calculations. Most pension funds use a discount rate based on expected returns, which are subject to considerable uncertainty even though the benefits of defined benefit plans are guaranteed. Critics have suggested that a relatively riskless and much lower rate should be used. Such a change would result in a large increase in the unfunded liabilities of every defined benefit plan and substantially reduce funding ratios. For the most part, these suggestions have not been adopted by actuaries and by most pension plans.

Table 3 gives the conventional funding ratios for 126 large public pension systems including five from Illinois. The data was complied by the National Association of State Retirement Administrators (NASRA). NASRA attempts to use information that allows for rough comparison across systems.

The three Illinois systems funded by the state have some of the lowest funding ratios in the nation. Illinois

SERS ranks 126 out of 126, Illinois SURS ranks 124 out of 126, and Illinois Teachers ranks 119 our of 126. The Illinois funds that are not funded by the state fared considerably better. Illinois Municipal ranked 46 out of 126 and Chicago Teachers ranked 83 out of 126. These two systems are funded by local government contributions mandated by the state. The state of Illinois has been able to impose considerable discipline on local governments to encourage funding.

Table 4 provides information about the absolute size of the unfunded liability (or surplus). The Illinois state-funded systems have some of the largest unfunded liabilities in the nation. Illinois Teachers has the third-largest unfunded liability at \$40 billion, with SURS ranking 10th at \$16 billion and Illinois SERS ranking 12th at \$14 billion.

The information provided here about underfunding gives little insight into Illinois' problems. As discussed elsewhere, underfunding can arise from deliberate decisions not to make the actuarially-required employer contributions, the provision of benefit increases without comparable funding increases, the use of overly optimistic investment return assumptions, poor investment performance, and many other reasons. For the state systems in Illinois, underfunding has been caused by decisions not to make the required contributions over several decades.

TABLE 3: Funding Ratios for 126 Public Pension Systems

Ranking	Plan Name	Actuarial Funding Ratio
1	Washington LEOFF Plan 2	126.4
2	Washington LEOFF Plan 1	124.9
3	Maine Local	112.7
4	NY State & Local Police & Fire	103.8
5	New York State Teachers	103.2
6	Washington Teachers Plan 2/3	101.9
7	Colorado Fire & Police Statewide	101.0
8	NY State & Local ERS	101.0
9	DC Police & Fire	100.7
10	Washington School Employees Plan 2/3	100.4
11	Wisconsin Retirement System	99.8
12	North Carolina Local Government	99.6
13	North Carolina Teachers and State Employees	99.3
14	Washington PERS 2/3	99.3
15	Delaware State Employees	98.8
16	Indiana PERF	97.5
17	San Francisco City & County	96.3
18	South Dakota PERS	96.3
19	Houston Firefighters	95.6
20	LA County ERS	94.5
21	Rhode Island Municipal	92.8
22	DC Teachers	92.2
23	Texas County & District	92.2
24	Denver Employees	91.8
25	San Diego County	91.5
26	TN State and Teachers	90.6
27	Colorado Affiliated Local	89.2
28	Contra Costa County	88.4
29	Denver Schools	88.3
30	St. Louis School Employees	87.6
31	Wyoming Public Employees	87.5
32	Georgia Teachers	87.2
33	Florida RS	87.1
34	Nebraska Schools	86.6
35	TN Political Subdivisions	86.3
36	Texas LECOS	86.3
37	Minnesota State Employees	85.9
38	Oregon PERS	85.8
39	Georgia ERS	85.7
40	Utah Noncontributory	85.6
41	Texas ERS	85.4
42	North Dakota PERS	85.1
43	Pennsylvania State ERS	84.4

Ranking	Plan Name	Actuarial Funding Ratio
44	Montana PERS	83.5
45	California PERF	83.3
46	Illinois Municipal	83.2
47	Texas Teachers	82.9
48	Ohio School Employees	82.0
49	Iowa PERS	81.4
50	Massachusetts SERS	81.0
51	Missouri Local	81.0
52	Missouri State Employees	80.4
53	Virginia Retirement System	80.2
54	New York City ERS	79.7
55	Pennsylvania School Employees	79.2
56	Missouri PEERS	79.1
57	Arizona SRS	79.0
58	Michigan Public Schools	78.9
59	Vermont State Employees	78.9
60	Alaska PERS	78.8
61	Minnesota Teachers	78.5
62	New Mexico PERF	78.5
63	California Teachers	78.2
64	Arkansas PERS	78.0
65	Michigan SERS	78.0
66	Missouri Teachers	77.7
67	North Dakota Teachers	77.7
68	Fairfax County Schools	76.9
69	Duluth Teachers	76.5
70	Minnesota PERF	76.4
71	South Carolina Police	76.3
72	Colorado Municipal	76.2
73	Texas Municipal	75.8
74	Arkansas Teachers	75.7
75	Phoenix ERS	75.3
76	Ohio PERS	75.3
77	Washington Teachers Plan 1	75.3
78	Michigan Municipal	75.0
79	Alabama Teachers	74.7
80	West Virginia PERS	74.6
81	Maine State and Teacher	74.0
82	Idaho PERS	73.7
83	Chicago Teachers	73.3
84	Alabama ERS	72.2
85	St. Paul Teachers	72.2
86	City of Austin ERS	71.8
87	Nevada Regular Employees	71.2

Ranking	Plan Name	Actuarial Funding Ratio
88	Kentucky County	70.6
89	Alaska Teachers	70.2
90	Arizona Public Safety Personnel	70.0
91	Washington PERS 1	69.9
92	Colorado School	69.2
93	New Jersey Police & Fire	68.9
94	Hawaii ERS	68.8
95	Nevada Police Officer and Firefighter	67.8
96	South Carolina RS	67.8
97	New Mexico Teachers	67.5
98	Colorado State	67.0
99	New York City Teachers	66.9
100	Oklahoma PERS	66.8
101	Maryland Teachers	65.4
102	Vermont Teachers	65.4
103	Ohio Police & Fire	65.1
104	Mississippi PERS	64.2
105	Montana Teachers	63.8
106	Kentucky Teachers	63.6
107	Massachusetts Teachers	63.0
108	Maryland PERS	62.8
109	New Jersey PERS	62.0
110	Connecticut Teachers	61.4
111	Rhode Island ERS	60.9
112	Louisiana SERS	60.8
113	Louisiana Teachers	59.1
114	Ohio Teachers	59.1
115	Kansas PERS	58.8
116	New Jersey Teachers	58.6
117	New Hampshire Retirement System	58.3
118	Oklahoma Teachers	49.8
119	Illinois Teachers	48.4
120	Indiana Teachers	48.2
121	Missouri DOT and Highway Patrol	47.3
122	Kentucky ERS	46.7
123	West Virginia Teachers	46.5
124	Illinois Universities	46.4
125	Connecticut SERS	44.4
126	Illinois SERS	43.5

Source: National Association of State Retirement Administrators (NASRA).

TABLE 4: Unfunded Liability for 126 Public Pension Systems

Ranking	Plan Name	Unfunded Liability (Surplus) in Billions
1	California PERF	49.08
2	California Teachers	40.54
3	Illinois Teachers	39.85
4	Ohio Teachers	38.77
5	New Jersey Teachers	23.45
6	Texas Teachers	22.90
7	New Jersey PERS	17.64
8	Florida RS	17.61
9	New York City Teachers	16.77
10	Illinois Universities	16.15
11	Pennsylvania School Employees	15.74
12	Illinois SERS	14.30
13	Virginia Retirement System	13.14
14	Massachusetts Teachers	12.48
15	Michigan Public Schools	11.98
16	South Carolina RS	11.97
17	Connecticut SERS	11.70
18	Mississippi PERS	11.26
19	Maryland Teachers	11.06
20	New Jersey Police & Fire	10.60
21	New York City ERS	10.34
22	Indiana Teachers	9.72
23	Oklahoma Teachers	9.51
24	Colorado School	9.36
25	Louisiana Teachers	9.34
26	Kentucky Teachers	8.51
27	Missouri Teachers	8.30
28	Kansas PERS	8.28
29	Oregon PERS	8.08
30	Georgia Teachers	8.05
31	Nevada Regular Employees	7.95
32	Arizona SRS	7.20
33	Maryland PERS	7.07
34	Alabama Teachers	6.96
35	Colorado State	6.59
36	Connecticut Teachers	6.53
37	Kentucky ERS	6.04
38	Pennsylvania State ERS	5.59
39	Louisiana SERS	5.49
40	Texas Municipal	5.22
41	Hawaii ERS	5.17
42	Ohio Police & Fire	5.00
43	Massachusetts SERS	5.00

Ranking	Plan Name	Unfunded Liability (Surplus) in Billions
44	Iowa PERS	4.93
45	West Virginia Teachers	4.76
46	Minnesota Teachers	4.76
47	Illinois Municipal	4.59
48	New Mexico Teachers	4.52
49	Ohio School Employees	4.50
50	Rhode Island ERS	4.33
51	Washington PERS 1	4.21
52	Chicago Teachers	4.19
53	Minnesota PERF	4.05
54	Texas ERS	4.04
55	Alabama ERS	3.83
56	New Hampshire Retirement System	3.54
57	Arkansas Teachers	3.40
58	Michigan SERS	3.13
59	Kentucky County	3.09
60	Idaho PERS	3.09
61	Oklahoma PERS	3.08
62	Maine State and Teacher	3.04
63	Utah Noncontributory	2.81
64	TN State and Teachers	2.72
65	Washington Teachers Plan 1	2.67
66	Ohio PERS	2.58
67	Nevada Police Officer and Firefighter	2.40
68	New Mexico PERF	2.36
69	Arizona Public Safety Personnel	2.33
70	LA County ERS	2.31
71	Georgia ERS	2.26
72	Michigan Municipal	2.08
73	Alaska PERS	1.94
74	Missouri State Employees	1.93
75	Missouri DOT and Highway Patrol	1.64
76	Montana Teachers	1.57
77	Alaska Teachers	1.56
78	Arkansas PERS	1.53
79	Minnesota State Employees	1.48
80	Texas County & District	1.45
81	West Virginia PERS	1.35
82	Nebraska Schools	1.08
83	South Carolina Police	0.96
84	Colorado Municipal	0.92
85	Missouri Local	0.84
86	TN Political Subdivisions	0.84
87	Wyoming Public Employees	0.82

Ranking	Plan Name	Unfunded Liability (Surplus) in Billions
88	Montana PERS	0.79
89	San Diego County	0.79
90	Missouri PEERS	0.77
91	City of Austin ERS	0.77
92	Vermont Teachers	0.73
93	Contra Costa County	0.69
94	Phoenix ERS	0.62
95	San Francisco City & County	0.58
96	North Dakota Teachers	0.55
97	Fairfax County Schools	0.52
98	North Carolina Teachers and State Employees	0.39
99	Denver Schools	0.39
100	St. Paul Teachers	0.36
101	Vermont State Employees	0.33
102	North Dakota PERS	0.28
103	South Dakota PERS	0.27
104	Colorado Affiliated Local	0.23
105	Wisconsin Retirement System	0.19
106	Denver Employees	0.17
107	Washington PERS 2/3	0.14
108	St. Louis School Employees	0.14
109	Houston Firefighters	0.14
110	Texas LECOS	0.13
111	DC Teachers	0.12
112	Rhode Island Municipal	0.09
113	Duluth Teachers	0.09
114	Delaware State Employees	0.08
115	North Carolina Local Government	0.07
116	Colorado Fire & Police Statewide	-0.01
117	Washington School Employees Plan 2/3	-0.01
118	DC Police & Fire	-0.02
119	Washington Teachers Plan 2/3	-0.11
120	Maine Local	-0.25
121	Indiana PERF	-0.26
122	NY State & Local Police & Fire	-0.83
123	Washington LEOFF Plan 2	-1.05
124	Washington LEOFF Plan 1	-1.12
125	NY State & Local ERS	-1.30
126	New York State Teachers	-2.74

Source: National Association of State Retirement Administrators (NASRA).

Author Biographies





Prof. Robert F. Rich

Robert F. Rich has been Director of the Institute of Government and Public Affairs since 2005. He is in his second tenure as director after also leading the institute from 1986 to 1997. He is the founder and former director of the Office of Public Leadership at IGPA,

which offers educational programs to elected and non-elected local government officials. In addition, he serves as the coordinator for the local and state government strategic initiative of the Partnership Illinois Program. Before joining the faculty of the University of Illinois in 1986, he served on the faculties of the University of Michigan, Princeton University, and Carnegie-Mellon University.

Dr. Rich's research focuses on health law and policy, federalism and the role of the states, environmental policy, and science policy. He has published five books. He has also served as a consultant for a wide variety of federal and state government agencies. He is a faculty member in the College of Medicine, the Political Science Department, and the College of Law.



Prof. David Merriman

David Merriman was appointed as associate director of IGPA on August 16, 2010 after serving one year as head of the Department of Economics at the University of Illinois at Chicago. As associate director, Merriman assists Director Robert Rich

since 1996, also is a Professor of Public Administration in UIC's College of Urban Planning and Public Administration.

Merriman previously spent 20 years on the faculty at Loyola University of Chicago. Professor Merriman received his B.S. in economics and political science (1976) from American University, an M.S. in economics from the University of Wisconsin (1980) and a Ph.D., also in economics (1983), from the University of Wisconsin.

Dr. Merriman's major area of study is state and local public finance. He was named "Researcher of the Year" at Loyola in 2002-2003. He directs the Fiscal Futures Project with Dr. Richard Dye. The project is creating a long term budget-trend projection model for the state of Illinois.



Associate Prof. Darren Lubotsky

Darren Lubotsky joined the IGPA faculty in August 2008. He has been a faculty member at the Urbana-Champaign campus since 2002, holding appointments in the Department of Economics and the School of Labor and

Employment Relations. Lubotsky received his BA from Washington University in St. Louis and his PhD from the University of California-Berkeley in 2000. Lubotsky researches the economic impact of social policy issues, particularly education and immigration.

In 2011 Lubotsky became a co-editor of the journal *Economic Inquiry*. In 2009 he became an external fellow of the Center for Research and Analysis of Migration (CReAM) at University College London.



Prof. Laurie Reynolds

Laurie Reynolds is the Prentice H. Marshall Professor of Law at the University of Illinois. She received a master's degree in Spanish linguistics and a J.D. degree summa cum laude from the University of Illinois where she was editor-in-chief of the Illinois

Law Forum. Before joining the faculty in 1982, she practiced with Jenner & Block in Chicago.

Her current research projects focus on issues of local government law, school funding law, and regionalism, and she has written various law review articles on those topics. With Professor Richard Briffault of the Columbia University School of Law, Professor Reynolds published the seventh edition of *State and Local Government Law* (West, 2010). With Professor David McCarthy, dean emeritus of the Georgetown University Law Center, she co-authored the fifth edition of *Local Government Law in a Nutshell* (West 2003). She collaborates with municipal attorneys, public interest law firms, and local government units to advance home rule powers, public employee rights, intelligent land use planning, and fair commercial practices.



Prof. J. Fred Giertz

J. Fred Giertz has been on the faculty of the Institute of Government and Public Affairs at the University of Illinois and professor in the UIUC Department of Economics since 1980. He received his Ph.D. in economics from Northwestern University in 1970. He

has consulted with a number of state agencies and writes frequently on the Illinois budget and general

economic issues in publications such as *State Tax Notes* and the *Central Illinois Business* magazine and compiles the U of I Flash Index, a monthly indicator of the Illinois economy. Several recent articles have appeared in the *National Tax Journal*.

Giertz served 10 years (1995-2005) as a member of the board of trustees of the State Universities Retirement System (SURS), including terms as chair the board's investment committee, and is currently a member of the SURS board. The board oversees the \$14.0 billion retirement fund for Illinois public university and college employees. Since 2000, he has served as the Executive Director of the National Tax Association, a 1,200 member organization of tax professionals located in Washington, D. C.