





¹ SURS offers members a choice between a traditional DB plan, the Self-Managed Plan (which is a defined contribution plan), and the Portable Plan (which is a hybrid DB-DC plan).

Photo on page 57: IGPA hosted informative panels on public pension policy on all three University of Illinois campuses in April 2011.

Illinois' Pension Puzzle

By Darren Lubotsky

The funding of public-sector pensions has been among the most hotly debated issues in Illinois recently. State-funded pensions currently do not have enough assets on hand to pay all currently-promised benefits. The public perception is that these pension programs, as currently structured, are not sustainable and are a drain on state revenue. This chapter explains how these public programs work, reviews the relevant financial issues, and gives an overview of options for reform.

There are five public-sector pension programs in Illinois: the State Employees' Retirement System (SERS) for employees of the state government; the Teachers' Retirement System (TRS), which provides benefits to most public school teachers (teachers in the Chicago Public Schools participate in a separate plan); the State Universities Retirement System (SURS), which provides benefits to employees of public universities and community colleges; the Judges' Retirement System (JRS), which provides benefits to judges; and the General Assembly Retirement System (GARS) for members of the General Assembly. Most SERS participants also pay into the Social Security system. Participants in the other pension programs do not concurrently participate in Social Security and thus their pension represents their primary source of retirement savings. Participants in all programs are part of the Medicare system.

All five of these programs offer defined benefit (DB) pensions.¹ DB pensions are retirement annuities in which the employee's monthly pension payment is determined by a function of their salary and years of service. For example, the current benefits formula for TRS is 2.2 times a measure of final salary times years of creditable service. The



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pension programs are funded by a combination of contributions from employees and contributions from each respective employer. For example, teachers contribute 9.4 percent of their salary toward the pension program.

The unfunded liability of each program refers to the difference between the assets that each fund has on hand and the estimated present discounted value of promised benefits. Figure 1 shows the estimated accrued liabilities, assets, and the unfunded liability for TRS, SERS, and SURS as of November 2011. These three programs account for 98.5 percent of total liabilities. For ease of exposition, balances for JRS and GERS are omitted. The figure shows that the accrued liability is \$81.3 billion in TRS, \$31.4 billion in SERS, and \$31.5 billion in SURS. Assets on hand are considerably less in each program – 46.1 percent of the TRS liability is funded; 34.9 percent of the SERS liability is funded; and 45.3 percent of the SURS liability is funded.

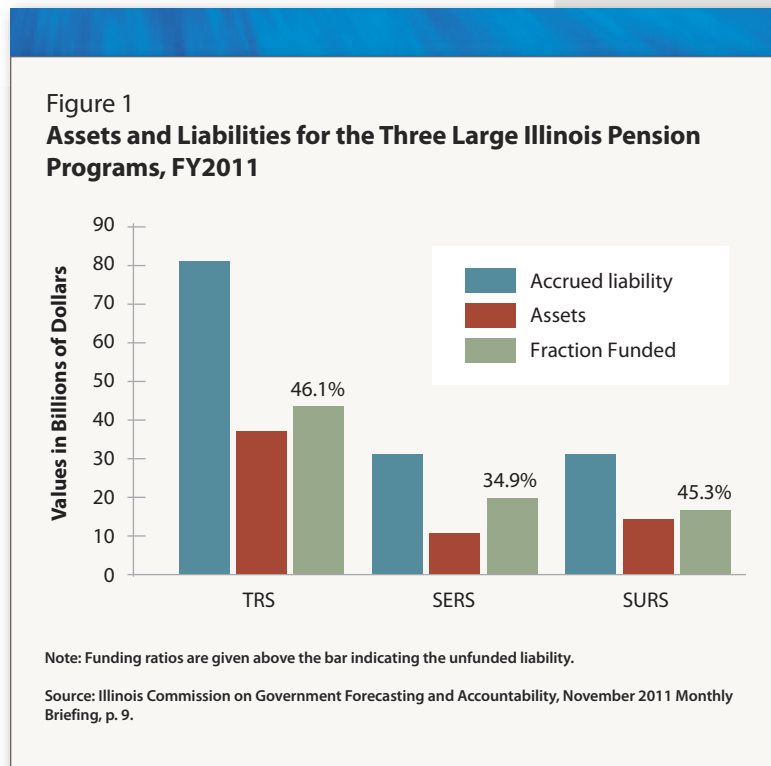
It is important to understand what this unfunded liability represents. An unfunded liability means that the assets currently in

the respective pension funds are not sufficient to pay the projected future benefits that state employers have promised. This unfunded liability results from revenue flowing into the pension fund at a slower rate than future benefits are being accrued. The existence of an unfunded liability does not, on its own, imply that benefits are too high or funding is too low; rather, there is a mismatch between revenue and costs. Either or both could be adjusted to bring the system into balance (although, in this case, Illinois' unfunded liability is largely the result of the state not making its required pension contributions). An unfunded liability does not mean that funds are not available to pay pension payments this year; it also does not mean that the state is prevented from moving other funds into the pension account to pay promised benefits. For example, the state could raise additional tax revenue or reduce spending on other programs to increase the balance in the pension fund.

The following sections of this chapter review the 2010 pension reform law and Senate Bill 512, a major piece of pending legislation that may come up for a vote in 2012; ask what we should expect from a compensation system in general and pension program in particular; discuss some potential policy options that have received less attention recently; and discuss options to dispose of the accumulated unfunded liability.

Recent Reforms and Proposals in Illinois

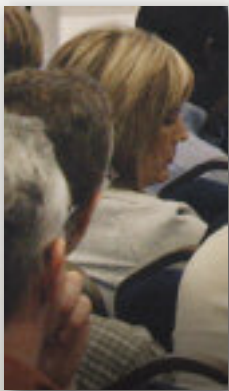
A state law enacted in April 2010 reduced pension benefits in various ways for state employees hired in 2011 or later. For newly hired workers, the normal retirement age is 67; employees hired before 2011 may retire as early as age 55 if they have appropriate service credits. The final salary used to calculate benefits for newly hired employees will be the highest eight consecutive years out of the previous 10 years; the final salary used to compute benefits for



employees hired before 2011 is the highest four consecutive years out of the previous 10. In addition, the salary used to compute the benefits for newly hired employees will be capped at \$106,800 (this cap is tied to the Consumer Price Index and will increase annually). These changes will generally have the effect of reducing the final salary used to compute benefits and therefore reduce pension payments. Employees hired before 2011 will have their pension benefits increased by 3 percent per year. For new employees, benefits will be increased each year by the lesser of 3 percent or one-half of the inflation rate. This will slow down the growth in benefits after an individual retires.

The 2010 law only affects benefits for employees hired after December 31, 2010. There are also proposals to reduce benefits for employees hired before 2011. Perhaps the most well-known is Senate Bill 512, which was proposed in the 2011 General Assembly session but had not been voted on at year's end. This legislation proposes that employees hired before 2011 who

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² Note that the details of SB 512 are under discussion and periodically change. The text above reflects the amended version of the bill as of December 2011. This amended bill is available at <http://www.ilga.gov/legislation/97/SB/PDF/097005B0512ham002.pdf>.

³ A nice summary of DB pension freezes in the private sector is Alicia Munnell, Francesca Golub-Sass, Maurico Soto, and Francis Vitagliano (2006), "Why are Health Employers Freezing their Pensions?" Boston College, Center for Retirement Research, Issue in Brief, Number 44, March. Available at http://crr.bc.edu/images/stories/Briefs/ib_44.pdf.

⁴ This report is available at <http://igpa.uillinois.edu/system/files/IGPA%20Report%20on%20Pensions%202011.pdf>.

participate in a defined benefit plan would have the option to retain their current plan and contribute a substantially higher portion of their pay, or switch to the same defined benefit plan offered to new employees. For example, SURS participants currently contribute 8 percent of their salary to the plan; under the proposed legislation this would rise to 15.31 percent for employees who elect to stay in their current plan. TRS participants currently pay a 9.4 percent contribution; this would rise to 13.77 percent. The state would contribute 6 percent of employees' salaries toward the plan. Beginning in 2017, employees' contributions would be adjusted annually to reflect the so-called normal cost; i.e. the cost of benefits earned in that year, less the state's 6 percent contribution. Employees who elect to switch to the less-generous and less-costly plan offered to new employees would contribute 6 percent of their salary (Chicago and Cook County employees would contribute 7 percent of salary). They would also keep the benefits they had earned before the switch, with the level of pay used to determine this portion of their benefits frozen.²

Existing employees would also have the option to switch to a defined contribution pension (DC) plan, referred to as the self-managed plan. Employees currently in a defined benefit plan who opt to switch to the defined contribution plan would still receive the defined benefit pension that they had already earned, based on their current levels of pay. They simply would not accrue new benefits. It is important to understand, however, that since DB pensions base payments on a measure of salary, freezing future accruals necessarily reduces the value of previously earned benefits for most groups of workers. Put simply, a mid-career worker who switches from a DB to DC plan will have her DB benefits based on her relatively lower mid-career salary at the time of the switch, rather than the higher salary she would

have when she actually retires. It is very difficult, if not impossible, to freeze future accruals and leave all employees unharmed.³ Most employees who opt for the DC plan would contribute 6 percent of their pay toward their defined contribution account and the state would contribute an equal amount (SERS employees who contribute to Social Security would contribute a little over 4 percent of their pay toward the DC plan).

There is no doubt that this proposal represents a decline in the net value of the pension program. Employees hired before 2011 would either pay more money to keep their current plan or switch to a less-generous plan. The Illinois Constitution contains what is known as the non-impairment clause, which reads "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." It is unclear whether this clause allows the kind of changes proposed in SB512. I refer readers interested in understanding alternative legal interpretations of the non-impairment clause to Laurie Reynolds' chapter in "Public Pension Policy in Illinois: An Introduction to a Crucial Issue."⁴

Because SB512 raises the cost for employees to stay in their existing plan, it is likely that many employees will switch to either the less-generous defined benefit plan or to the self-managed plan. The proposal's less-generous DB plan contains an earnings cap so it is certainly the case that most employees who expect to have earnings above this limit will choose the self-managed plan. These incentives put front and center the question of what the appropriate pension program should look like.

What Do We Want From a Public Pension System?

A compensation system should strive to attract and retain appropriate public

employees at the lowest cost to taxpayers. Within the context of a total compensation package, a well-designed pension plan, and a benefits program more generally, can make both employees and employers better off. Employers can generally purchase group insurance and annuity products (such as DB pensions) at a lower cost than what an employee would pay to get the same product on their own. Both of these products involve a shift in risk from the individual to the insurance company or program sponsor. Health insurance, of course, protects people from the risks associated with uncertain medical expenses. Retirement annuities protect against the risk that a person will outlive their assets. While health expenses and longevity are highly uncertain for any particular person, the distribution of these events within a large group of people is quite predictable. Pooling risks within an employee pool lessens the riskiness of the group. Thus, health insurance and retirement annuities can be provided at a lower per-person cost to a group than to each individual on their own. This provides a powerful incentive for businesses and public-sector employers to offer a compensation package that includes health insurance and a pension, and a correspondingly lower salary. Employees benefit because the salary reduction represents a lower implicit price for these products than what they would pay if they bought the products on their own. (The federal tax code provides further financial incentives to offer health insurance and pensions in a compensation package.)

One of the biggest misconceptions about employee benefits is that employers 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 compensation 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.

There are two important consequences of this for public pension design. The first is that reducing the generosity of the pension is equivalent to cutting salary: both represent a decline in total compensation. Cutting the generosity of the pension may not save as much money as it first appears if the employer is then forced to offer correspondingly higher salaries to attract and retain the same quality workforce.

The second consequence is that the pension program should be designed to maximize the retirement security of employees for a given cost level. That is, for a given cost to the employer, the pension should maximize the perceived value of the pension program to employees. While the cost of pensions to the employer is surely important, as is the total cost of compensation, discussion of how to reform the system seems quite disconnected from understanding the effect that various program features will have on employees’ retirement security.

It is important to understand that thinking about the right pension system for Illinois public-sector workers should not be connected to the existence of an unfunded liability. Whether we have a debt or not, we want a compensation system in general and a pension in particular that allows the state to recruit and retain appropriate talent. A debt is a sunken cost. It needs to be addressed, but the logic that says we should have a less-generous pension so



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⁵ Alicia Munnell and Pamela Perun (2006), "An Update on Private Pensions," Boston College, Center for Retirement Research, Issue in Brief, Number 50, March. Available at http://crr.bc.edu/images/stories/Briefs/ib_50.pdf.

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that the state can more easily pay off its debts is mistaken. A better policy would say that if we need to spend less money, cut the program or employees that provide the least amount of value per dollar to taxpayers.

Finally, one frequently hears the complaint that public employees receive pensions that are too generous. This is not the correct way to think about the pension program. What should matter to the state government and to taxpayers is whether the total compensation costs are appropriate. There is some academic work that attempts to measure whether public-sector pay is at the appropriate level. But there is not a consensus among researchers about the appropriate way to credibly answer this question or what the correct answer happens to be. One issue is that it is inherently difficult to find a good comparison group for many classes of public-sector workers. A second issue is that there are many attributes of workers that are difficult to measure, but that affect earnings. Understanding whether differences in compensation are due to these unmeasured factors or because one group is "overpaid" is quite difficult.

Options for Reform of the Public Pension System in Illinois

The preceding discussion makes clear that the state faces two separate and distinct questions: the first is what should be the optimal pension program for state employees moving forward. The second question is how the state should dispose of the accumulated pension liabilities. This section addresses the first question. The next section addresses the second question.

An important issue raised by Senate Bill 512 is what role should defined contribution pensions play in the state of Illinois' pension programs. Employee 401(k) plans and other types of defined contribution pensions have almost completely displaced

defined benefit plans in the private sector over the last 30 years.⁵ There are many reasons for this: defined contribution pensions are portable, while DB pensions tend to penalize workers who change jobs. Defined contribution pensions give workers a foray into the stock market that they may not otherwise have. Finally, it is easier for firms to administer these plans because all contributions are made up-front, as opposed to DB plans in which funds need to be set aside to cover estimated future payments.

Nearly all private-sector workers participate in Social Security and through this program have a baseline, annuitized source of retirement income. In an important sense, private-sector DC plans are a supplement to workers' Social Security wealth. That is not the case for Illinois public-sector workers, except those in SERS who do participate in Social Security. For those employees not in Social Security, giving powerful incentives to switch to a DC-style pension will make it more difficult for them to have a stable, annuitized source of income during retirement.

The primary benefit of shifting employees into a DC-style pension is that it would force the state to pay its pension obligations up-front. The state would pay its share of contributions to a DC pension each pay period, just as employees make their own contributions. This would prevent the state from falling behind in its pension obligations, as it currently has done. Put differently, because DC pensions are funded upfront, they are always fully funded. There is a significant value to having a pension program that is largely fully funded: it gives employees a degree of certainty about their future pension. Under the current system, employees don't know whether the governor and legislature will alter the pension in a way that reduces their future benefits. This uncertainty is costly to the state because it reduces the perceived value of the compensation package. Some individuals who would accept

employment with the current pension do not because they perceive that the pension promise will not be fulfilled.

An option that marries some of the benefits of both DC and DB pensions is to introduce a hybrid pension system in which employees participate in smaller versions of both types of programs. One example of this is the “stacked” program proposed by Alicia Munnell, the Peter F. Drucker Professor of Management Sciences at Boston College’s Carroll School of Management, at the 2011 IGPA State Summit on pension reform.⁶ In a system like this, an employee would accrue benefits in a DB program based on some base level of income, say their first \$50,000. Income above this threshold would not lead to any additional DB benefits, but a portion would be contributed into a DC plan, perhaps matched in part by contributions from the state. A virtue of a hybrid system is that it preserves a basic minimum annuitized source of wealth for all state employees. A second virtue is that it allows employees to reap some of the benefits of both styles of pensions. In particular, it gives employees a degree of flexibility in their investment instruments and, depending on how it is designed, flexibility in their level of savings.

Because uncertainty is costly, as long as the state sponsors a DB plan it is important to consider policies that give employees more certainty that their promised benefits will be paid. A large unfunded liability will always raise questions about whether the state will pay promised benefits. The Illinois Municipal Retirement Fund, which administers pensions for local government employees, is relatively well-funded because local governments are required by law to make their annual payments. One could imagine a law that prohibited the state from skipping payments to its own DB plans, which would force the state to do some combination of cutting spending on other programs, raising the necessary tax revenue, or borrowing the money.

A separate policy issue is whether the state should devolve responsibility for pension funding to other areas of government. For example, most human resource decisions, including salary levels, in local schools and state universities are made by the respective organizations (perhaps through a collective bargaining arrangement). But the pensions are designed and funded, in part, by the state. Michael Hogan, president of the University of Illinois, recently wrote in the *Chicago Sun-Times* that the reduced pensions proposed in Senate Bill 512 would make it more difficult for the university to attract highly skilled and highly mobile faculty who have choices about where to work.⁷ An alternative system is to let each university and local school district (or combinations of them) operate and fund their own pension. This would give each organization the flexibility to design a pension that is most appropriate for their particular employees. If the University of Illinois wanted to offer more generous pensions than, for example, the Illinois Department of Revenue, it would have the flexibility to do so and would pay the full cost.

What Are the Options for Disposing of the Accumulated Pension Liabilities?

The unfunded pension liability is a claim by current employees and retirees on future government resources. As such, it is conceptually the same thing as a loan made by employees and retirees to the government. There are four options for disposing of the accumulated liabilities. The state could simply renege on past promises (that is, default on the implicit loan), borrow additional money, raise additional revenue, or reduce spending on other programs. All of these options raise both equity and efficiency issues.

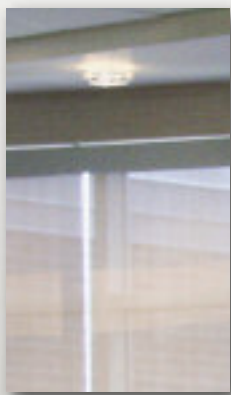
Reneging on past promises means reducing benefits that already have been earned. This raises legal issues that are beyond the scope of this chapter. It also raises important equity issues because a large part of



⁶ A full report on the State Summit is available from http://igpa.uillinois.edu/system/files/IGPA_State_Summit_on_Pensions_REPORT.pdf.

⁷ Michael J. Hogan, “Cutting Pensions Would Lead to U. of I. Brain Drain,” *Chicago Sun-Times*, October 31, 2011. Available at <http://www.uillinois.edu/president/massmail/2011/Nov1.PensionFunding.cfm>

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⁸ Alicia H. Munnell, Thad Calabrese, Ashby Monk, and Jean-Pierre Aubry (2010), "Pension Obligation Bonds: Financial Crisis Exposes Risks," Boston College, Center for Retirement Research, State and Local Pension Plans Issue in Brief, Number 9, January. Available at http://crr.bc.edu/images/stories/slp_9.pdf.

the unfunded liability is a direct result of the past decisions by the state's elected leaders to spend money on other programs, or keep taxes lower than they otherwise would have been, instead of making their required pension payments. The important efficiency consequence of reducing previously earned benefits is that individuals in the future who are contemplating public-sector employment will discount the value of deferred compensation because they will likely perceive a potential for promised benefits to be reduced after the fact.

Borrowing to fund the pensions simply replaces an implicit debt with an explicit one. The government's total debt level is unchanged. Nevertheless, this has some advantages. In particular, it gives employees the certainty that funds are already set aside and makes it less likely that their benefits will be reduced at some future point. Borrowing also makes the total cost of government operations more transparent and shows that future pension liabilities are not inherently different from any other type of government borrowing. Since debt payments must be made on a regular schedule, whether the economy is doing well or poorly, borrowing may make it more difficult for the state to smooth its spending over the business cycle. This inflexibility may be a good thing, however, if it prevents the government from skipping pension payments when times are tough but not making correspondingly larger payments during economic booms. A key conclusion, though, is that when the state borrows to fund its pension obligation, it simply kicks the can down the road and still needs to make real funding decisions later. By borrowing, the state simply defers

making this decision and, in effect, pushes the cost onto the next generation of taxpayers and users of government services.

Some state governments have turned to Pension Obligation Bonds as a way to fund their pension programs. These are controversial because government accounting rules allow pension funds to essentially count the spread between their assumed rate of return on pension assets and the cost of borrowing funds as an immediate net gain in pension assets. Research by Munnell *et al* indicates that these bonds tend to be used by governments that are cash-strapped and have taken on too much investment risk.⁸

The alternative to borrowing or renegeing on the debt is to fund it through spending cuts, increased revenue, or a combination of these. Both have equity and efficiency implications. 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. Raising 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.