THE STATE OF ILLINOIS RETIREMENT SYSTEMS:
Funding History and Reform Proposals

A Civic Federation Issue Brief

Prepared by:
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This article reviews the five retirement systems of the State of Illinois and discusses their current condition, the history of funding shortfalls and benefit enhancements, and attempts to improve the financial health of the systems.

It focuses exclusively on pension benefits and does not address other post-employment benefits such as retiree health care. The State recently projected that its liabilities for retiree health care total approximately $24.0 billion.[1] More details on this liability will be known when the State publishes its fiscal year 2008 audited financial statements next year.[2]

CURRENT CONDITION OF THE STATE PENSION FUNDS

The State of Illinois funds five retirement systems for public employees and retirees: the State Employees Retirement System (SERS), the Judges' Retirement System (JRS), the General Assembly Retirement System (GRS), the State Universities Retirement System (SURS), and the Teachers' Retirement System (TRS). The Teachers' Retirement System includes all public school teachers in the state except those employed by the Chicago Board of Education, which has a separate pension fund.[3] All of these systems are defined benefit plans, which guarantee retirees a specific annuity based on years of service and final salary.[4]

Members

There are a total of 506,338 active members and 189,274 annuitants receiving benefits from the five pension funds. The ratio of active employees to annuitants ranges from a high of 3.6 actives per annuitant in the University fund to a low of 0.7 actives per annuitant in the General Assembly fund. A low active to annuitant ratio can create fiscal stress because it means there are less employee contributions and more annuity payments.

Members of Illinois Retirement Systems: Current Enrollment

Pension Fund	Active Employees	Annuitants	Total	Ratio of Actives to Annuitants
Teachers	258,531	89,269	347,800	2.9
University	156,952	43,395	200,347	3.6
State Employees	89,598	55,265	144,863	1.6
Judges	990	946	1,936	1.0
General Assembly	267	399	666	0.7
Total	**506,338**	**189,274**	**695,612**	**2.7**

Source: Illinois State Budget FY2009, p. 4-1.

[1] Yvette Shields. "Illinois OPEB Smaller but still Daunting," *The Bond Buyer*. April 22, 2008.

[2] Starting with its financial statements for the year ended June 30, 2008, the State will adopt the Governmental Accounting Standards Board Statement No. 45: *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

[3] The State makes limited contributions to the Chicago Teachers' Retirement Fund. For more information see Civic Federation "Status of Local Pension Funding Fiscal Year 2006," pp. 15, 18 at http://www.civicfed.org/articles/civicfed_266.pdf.

[4] A small percentage of state university employees are voluntarily enrolled in a defined contribution option called the Self-Managed Plan, which more like a 401(k). The vast majority of employees are in the defined benefit plan.

Constitutional Protection

Public employee pension benefits cannot be diminished for current employees. Article XIII, Section 5 of the Illinois State Constitution states that:

> "Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."

No such guarantee is provided for other post employment benefits, such as health insurance.

The constitutional protection of pension benefits means that once granted, benefit enhancements cannot be taken away. Benefit levels can only be reduced for new employees.

Basic Measures of Pension Fund Status

The systems have a combined accrued liability of $112.9 billion and $70.7 billion in assets, for a net unfunded liability of $42.2 billion in fiscal year 2007. Accrued liabilities are actuarially calculated estimates of the total pension benefits, both current and prospective, earned by employees on the date of the estimate. Current liabilities are benefits owed to retirees in the current year, while prospective liabilities are all of the future retirement benefits promised to past and current employees and their dependents. The estimate of accrued liabilities expresses in the present value of dollars the amount of money that will be needed to pay for these earned benefits when current employees retire, so it includes assumptions about the investment rate of return, expected salary increases, mortality, turnover, and other factors.

Unfunded liabilities are those liabilities, both current and prospective, not covered by assets. Unfunded liability is calculated by subtracting the actuarial value of assets from the accrued actuarial liability of a fund.

The funded ratios of the five retirement plans range from a low of 37.6% for the General Assembly to a high of 68.4% for the University fund, with a combined funded ratio of 62.6% in FY2007. The funded ratio is the ratio of assets to liabilities and is a common indicator of the financial health of a pension system.[5] The following table shows the five pension systems' unfunded liabilities and funded ratios for FY2007.

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[5] For more on funded ratios and unfunded liabilities, see the Civic Federation, " Status of Local Pension Funds Fiscal Year 2006", pp. 9-10 at http://www.civicfed.org/articles/civicfed_266.pdf .

FY2007 Illinois Retirement Systems Funded Ratios and Unfunded Liabilities ($ millions)				
Pension Fund	**Accrued Liability**	**Net Assets**	**Unfunded Liability**	**Funded Ratio**
Teachers	$ 65,648	$ 41,909	$ 23,739	63.8%
University	$ 23,362	$ 15,986	$ 7,376	68.4%
State Employees	$ 22,281	$ 12,079	$ 10,202	54.2%
Judges	$ 1,385	$ 670	$ 715	48.4%
General Assembly	$ 232	$ 87	$ 145	37.6%
Total	**$ 112,909**	**$ 70,731**	**$ 42,177**	**62.6%**

Source: Commission on Government Forecasting and Accountability, "Pensions: Report on the Financial Condition of the State Retirement Systems," February 2008, p. 14.

Some people believe that there is no real need to achieve 100% funding. They argue that governments, unlike private corporations, are not at risk of dissolving and, therefore, can meet their obligations in perpetuity. However, public pensions should be funded sufficiently to prevent the *growth* of the unfunded liability. If the unfunded liability is growing and the plan has no practical strategy for reducing it, this is cause for serious concern. As stated by Keith Brainard, the Research Director for the National Association of State Retirement Administrators: "More pertinent considerations with regard to funding a public pension plan may be whether: a) the amount needed to fund the benefit and amortize the unfunded liability is causing fiscal stress, and b) the plan's unfunded liability is diminishing, or there is a plan in place to reduce the unfunded liability."[6] An employer's inability to or decision not to meet its actuarially required contribution due to fiscal stress indicates a potentially serious problem. In its recommendations to the Governor and General Assembly of Vermont, the Commission on Funding the Vermont State Teachers' Retirement System put it more bluntly: "While [insolvency] may seem somewhat far in the future, actuaries point out that the critical tipping point is not when assets run out or even decline, but when Governors and Legislatures no longer believe the required contributions are realistic and give up trying to fund the actuarially required contributions."[7] Insolvency is closer for some funds than for others. Prior to the passage of Public Act 94-0839, the Chicago Transit Authoirty pension fund was projected to run out of money to pay retiree healthcare benefits in 2008[8] and become totally insolvent in 2013 if nothing was done to reduce benefits or increase contributions.[9] Public Act 94-0839 required increased contributions beginning in 2009 that would bring the funded ratio to 90% by the year 2058. The passage of Public Act 95-0708 established the funding sources and benefit changes required to allow the CTA pension fund to reach 90% funded by the year 2060.

[6] Keith Brainard, *Public Fund Survey Summary of Finding for FY2004,* (National Association of State Retirement Administrators, September 2005), p. 1.

[7] *Report of the Commission on Funding the Vermont State Teachers' Retirement System: Recommendations to the Governor and the General Assembly*, November 2005, p.12.

[8] Retirement Plan for Chicago Transit Authority Employees, *Actuarial Valuation as of January 1, 2007*, p. 3.

[9] Retirement Plan for Chicago Transit Authority Employees, *Actuarial Valuation as of January 1, 2006*, Presentation by Gabriel Roeder Smith on September 28, 2006, p. 6.

Nationwide Comparison

According to a Standard & Poor's analysis of state pension funds, Illinois has consistently ranked or tied for 47th lowest funded ratio in the nation over the last three years. The ranking examined the two principal state-sponsored pension systems for most states, which included only the State Employees' and Teachers' systems for Illinois. These two systems represent 71% of the total enrollment of the five state retirement systems and 80% of the total unfunded liability.

States Ranked by Pension Systems' Funded Ratio						
Rank	FY2004		FY2005		FY2006	
1	Florida	112.1%	Florida	107.3%	Oregon	110.5%
25	Arkansas	85.4%	Missouri	83.2%	Arkansas	81.3%
45	Louisiana	61.9%	Louisiana	63.5%	Alaska	61.0%
46	Connecticut	59.9%	Rhode Island	59.4%	Oklahoma	59.5%
47	**Illinois (SERS+TRS)**	**59.9%**	**Illinois (SERS+TRS)**	**58.4%**	**Illinois (SERS+TRS)**	**59.5%**
48	Rhode Island	59.4%	Connecticut	58.3%	Connecticut	56.4%
49	Oklahoma	57.0%	Oklahoma	56.9%	Rhode Island	53.4%
50	West Virginia	43.9%	West Virginia	47.1%	West Virginia	52.7%
	Mean (of 50 states)	**83.5%**	**Mean (of 50 states)**	**81.8%**	**Mean (of 50 states)**	**83.5%**
	Median (of 50 states)	**85.4%**	**Median (of 50 states)**	**82.3%**	**Median (of 50 states)**	**85.4%**

Note: The pension fund data for most states include the two principal state-sponsored retirement systems (e.g., state employees and teachers) or, in a few cases, a third large system. For 19 states, the data represent a single, all-inclusive system.

Source: Standard & Poors: *Rising U.S. State Unfunded Pension Liabilities Are Causing Budgetary Stress*, February 22, 2006; *Improved U.S. State Pension Funding Levels Could be on the Horizon*, February 27, 2007; *Market Volatility Could Shake Up State Pension Funding Stability*, February 20, 2008

The Standard & Poor's analysis also computed the unfunded liability per capita for each state based on its principal statewide pension systems. By comparing total unfunded liability to the state population, unfunded liability per capita provides a measure of the pension obligation per resident as well as a basis for comparison across states. Illinois had the 40th or 42nd highest unfunded pension liability per capita in the last three years, with a FY2006 per capita debt of roughly $2,524 for just the Teachers' and State Employees' retirement systems.

States Ranked by Unfunded Pension Liability Per Capita						
Rank	FY2004		FY2005		FY2006	
1	Florida	$ (662)	Oregon	$ (574)	Oregon	$ (1,449)
25	Michigan	$ 928	Missouri	$ 1,100	Maryland	$ 1,259
38	Nevada	$ 1,951	Maine	$ 2,120	Ohio	$ 2,380
39	Mississippi	$ 1,979	Mississippi	$ 2,241	Louisiana	$ 2,430
40	**Illinois (SERS+TRS)**	**$ 2,191**	Nevada	$ 2,370	**Illinois (SERS+TRS)**	**$ 2,524**
41	Maine	$ 2,268	Louisiana	$ 2,385	Kentucky	$ 2,537
42	Louisiana	$ 2,391	**Illinois (SERS+TRS)**	**$ 2,455**	Nevada	$ 2,627
43	Ohio	$ 2,463	Ohio	$ 2,599	Colorado	$ 2,686
	Mean (of 50 states)	**$ 1,183**	**Mean (of 50 states)**	**$ 1,378**	**Mean (of 50 states)**	**$ 1,664**
	Median (of 50 states)	**$ 964**	**Median (of 50 states)**	**$ 1,124**	**Median (of 50 states)**	**$ 1,289**

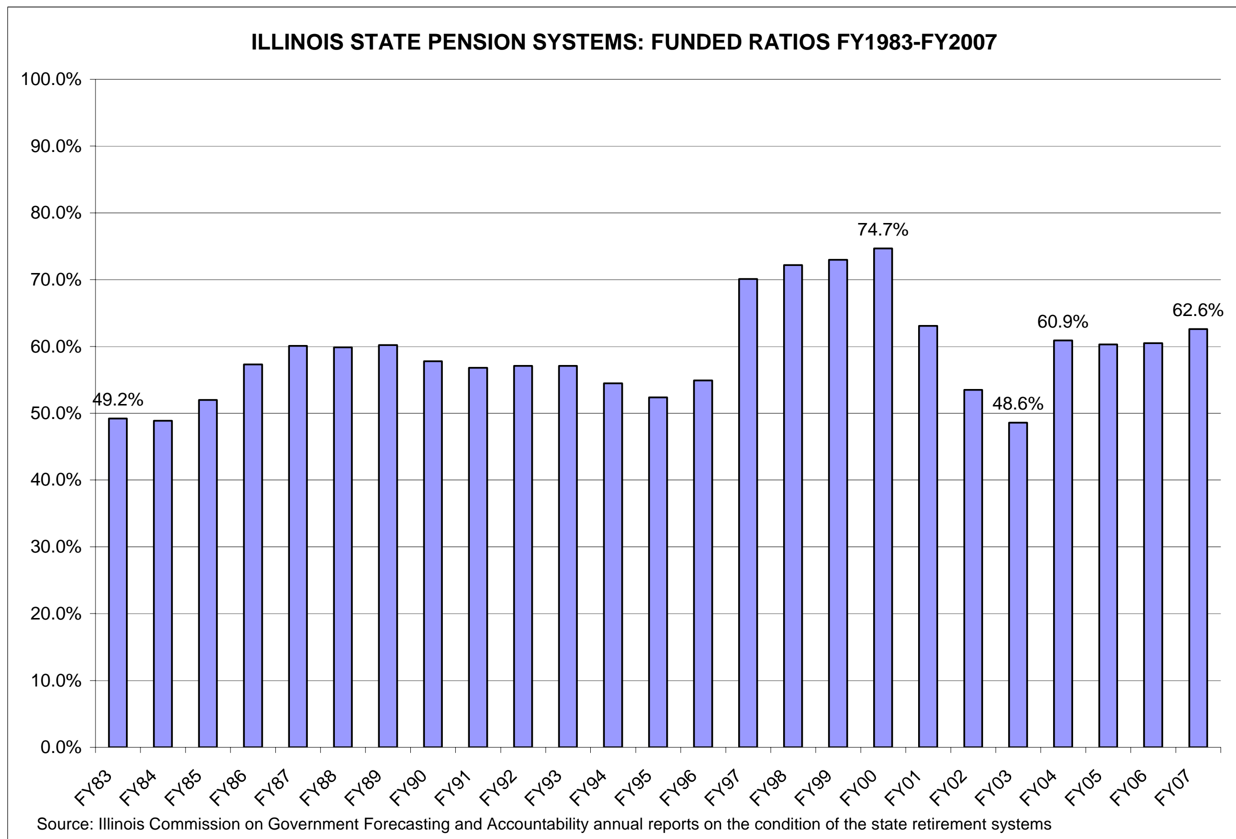
Note: The pension fund data for most states include the two principal state-sponsored retirement systems (e.g., state employees and teachers) or, in a few cases, a third large system. For 19 states, the data represent a single, all-inclusive system.

Source: Standard & Poors: *Rising U.S. State Unfunded Pension Liabilities Are Causing Budgetary Stress*, February 22, 2006; *Improved U.S. State Pension Funding Levels Could be on the Horizon*, February 27, 2007; *Market Volatility Could Shake Up State Pension Funding Stability*, February 20, 2008

Multi-Year Trends

Because pension systems are long-term in nature, pension fund status is best evaluated using multi-year trends, rather than a single year in isolation. Negative multi-year trends are cause for

concern because they show a lack of mechanisms to stabilize and improve the health of the pension fund. The following graph shows the composite funded ratio of the five state pension systems in the twenty-five years between FY1983 and FY2007. The ratio reached a high of 74.7% in FY2000 and a low of 48.6% in FY2003. It is important to note that changes to assumptions based on demographic trends, plan experiences or even a change in actuary can produce substantially different pictures of a fund's status, however. For example, the funded ratio jumped from 54.9% in FY1996 to 70.1% in FY1997 due primarily to a change in asset valuation methodology (changed from book value to market value of assets). Thus even multi-year trends do not necessarily provide strict "apples-to-apples" comparisons but are useful for rough illustrations of trends.



The following table provides more detail on the factors affecting changes in the total unfunded liability of the five state retirement systems. Over the last twenty years, the total unfunded liability has grown by $34.8 billion, a five-fold increase from $8.0 billion in FY1987 to $42.2 billion in FY2007. By far the largest factor in this increase has been a persistent shortfall in employer (State) contributions, accounting for $23.4 billion in additional unfunded liabilities. The shortfall is the difference between the pension contributions made by the State and the "normal cost", which is that portion of the present value of pension plan benefits and administrative expenses which is allocated to a given valuation year, plus interest on the existing unfunded liability. In other words, normal cost plus interest is the minimum amount the employer should contribute in order to simply prevent growth of the unfunded liability, not even to pay it down. In every year except FY2004, the State failed to contribute normal cost plus

interest, so it was not even able to keep the unfunded liability from growing (FY2004 was exceptional due to the infusion of $7.3 billion in pension obligation bond proceeds). As will be discussed later in this article, a State law that took effect in 1995 set a schedule of employer contribution amounts that is actually designed to allow the unfunded liabilities to continue to grow until the year 2034 because it the contributions will be less than normal cost plus interest until then. The fact that the normal cost plus interest contribution is so large that the State determined it would take decades before it could make that level of contribution is an indication of how unaffordable the State's pension promises have become.

In the following table, all negative amounts lower the unfunded liability while positive amounts raise the unfunded liability.

State of Illinois Retirement Systems Causes of Changes in Unfunded Liability FY1988-FY2007
(How the Unfunded Liabilty Grew From $8.0 Billion in FY1987 to $42.2 Billion in FY2007)

	Salary Increases Higher/(Lower) Than Assumed	Investment Returns (Higher)/Lower Than Assumed	Employer Contribution Shortfall	Benefit Increases	Changes in Actuarial Assumptions	Other Misc. Factors	Total Change in Unfunded Liability from Previous Year
FY1988	$ (34,052,059)	$ 6,306,090	$ 519,786,624	$ 49,222,714	$ 118,000,000	$ 1,949,221	$ 661,212,590
FY1989	$ 111,550,715	$ (52,042,288)	$ 565,568,554	$ -	$ (20,887,988)	$ 10,630,631	$ 614,819,624
FY1990	$ 94,547,676	$ (243,972,980)	$ 660,944,428	$ 1,306,464,892	$ 185,673,427	$ (111,177,746)	$ 1,892,479,697
FY1991	$ (54,468,211)	$ 104,663,823	$ 812,237,689	$ 26,065,805	$ 214,173,000	$ 130,791,725	$ 1,233,463,831
FY1992	$ 79,890,460	$ (602,130,431)	$ 1,030,677,439	$ 269,361,507	$ (78,780,129)	$ 474,713,955	$ 1,173,732,801
FY1993	$ 188,489,643	$ (362,058,701)	$ 1,083,975,777	$ 94,564,386	$ 12,544,000	$ 192,352,026	$ 1,209,867,131
FY1994	$ 180,359,391	$ (230,115,526)	$ 1,210,860,533	$ 193,098,000	$ 772,125,000	$ 763,322,396	$ 2,889,649,794
FY1995	$ 66,868,468	$ 237,630,645	$ 1,506,297,408	$ 152,891,000	$ -	$ 519,277,917	$ 2,482,965,438
FY1996	$ 277,985,995	$ (950,269,913)	$ 1,648,415,257	$ 17,772,000	$ (781,711,306)	$ 316,831,110	$ 529,023,143
FY1997	$ (174,569,177)	$ (1,718,043,900)	$ 1,571,561,355	$ 179,117,000	$ (6,629,275,167)	$ 456,217,865	$ (6,314,992,024)
FY1998	$ (113,186,439)	$ (2,788,182,020)	$ 984,293,345	$ 2,250,183,128	$ -	$ 275,635,915	$ 608,743,929
FY1999	$ 77,096,356	$ (988,726,350)	$ 1,007,531,385	$ 33,870,000	$ 125,223,000	$ 769,534,480	$ 1,024,528,871
FY2000	$ 154,524,395	$ (1,307,066,975)	$ 1,047,267,505	$ 2,848,501	$ -	$ 326,927,419	$ 224,500,845
FY2001	$ 43,970,419	$ 6,599,006,799	$ 1,047,049,618	$ 652,110,224	$ -	$ 1,068,141,533	$ 9,410,278,593
FY2002	$ 134,391,291	$ 5,575,370,512	$ 1,740,995,055	$ 234,100,000	$ 1,377,773,875	$ 903,437,467	$ 9,966,068,200
FY2003	$ 125,633,545	$ 2,071,493,135	$ 2,435,147,683	$ 2,425,023,094	$ -	$ 1,101,032,114	$ 8,158,329,571
FY2004	$ 135,696,594	$ (3,841,756,713)	$ (4,689,820,728)	$ -	$ -	$ 385,281,832	$ (8,010,599,015)
FY2005	$ 35,073,822	$ (1,033,615,146)	$ 2,431,545,009	$ -	$ 26,425,000	$ 2,048,339,759	$ 3,507,768,444
FY2006	$ 108,341,567	$ (1,843,091,310)	$ 3,484,514,960	$ -	$ 704,573,166	$ (323,161,524)	$ 2,131,176,859
FY2007	$ 314,931,325	$ (6,064,132,235)	$ 3,321,010,982	$ -	$ 2,735,156,000	$ 1,138,267,050	$ 1,445,533,122
20 YEAR TOTAL	**$ 1,753,075,776**	**$ (7,430,733,484)**	**$ 23,419,859,878**	**$ 7,886,692,251**	**$ (1,238,988,122)**	**$ 10,448,345,145**	**$ 34,838,551,444**

Source: Illinois Commission on Government Forecasting and Accountability annual reports on the condition of the state retirement systems
Note: "Employer Contribution Shortfall" means the difference between the employer contribution and normal cost + interest on the unfunded liability

As shown in the table above, benefit increases also added over $7.8 billion to the unfunded liability since FY1987. In FY1998 the benefit formulas for the Teachers' and State Employees' systems were increased, adding over $2.2 billion to the unfunded liability in that year. An Early Retirement Initiative for state employees added $2.4 billion to the unfunded liability in FY2003.[10]

The effect of investment returns varies significantly from year to year depending on whether returns are higher or lower than the assumed annual rate of return. Actuaries assume a certain annual rate of return on investments based on historical averages, and when actual returns are higher than the assumed rate, they reduce the unfunded liability. The assumed rates of return are currently 8.0% for Judges, General Assembly, and State Employees, and 8.5% for Teachers and University funds. Overall, investment returns helped to reduce the unfunded liability by $7.4

[10] Commission on Government Forecasting and Accountability, "Report on the Financial Condition of the Illinois Public Employee Retirement Systems." August 2006, p.15.

billion over twenty years, but could not overcome the effects of the employer contribution shortfalls, benefit increases, and other factors.

Other “miscellaneous factors” that influence unfunded liabilities include the extent to which actual retirement rates, disability, death, and withdrawals differ from expectations.

THE PROBLEMS: INADEQUATE CONTRIBUTIONS AND UNAFFORDABLE BENEFITS

As noted above, the State of Illinois retirement systems have suffered from low funding levels for decades. The single biggest long-term contributor to State’s growing unfunded liability is the persistent shortfall in State contributions. Investment losses such as those experienced in recent years have also had a significant negative effect, but investment gains in bull markets have done much over the years to offset the State’s failure to make adequate pension contributions.

Because of Illinois’ history of underfunding its pension systems, recent Illinois governors have championed pension funding reform. Governor Edgar successfully won legislative approval of a funding reform law in 1994 that required the State to fund its pensions according to a schedule that would bring them up to a 90% funded ratio by 2045. Governor Blagojevich won legislative approval for and issued $10 billion in pension obligation bonds. He also secured approval for the implementation of several structural reforms initially proposed by a Blue Ribbon Pension Commission. However, benefit enhancements granted between 1995 and 2003 undid much of the progress that was made in reducing the systems’ unfunded liabilities.

Contribution Shortfalls and Attempted Remedies

As noted above, shortfalls in employer contributions[11] are the single biggest contributor to the State’s growing unfunded liabilities. The chronic underfunding of Illinois state pension funds created the impetus for enacting a funding reform law in 1994. Public Act 88-593 went into effect in 1995 and established a fifty-year schedule of funding requirements to compensate for the State’s previous years of underfunding its pension plans. Following a 15-year phase-in period, the law requires State contributions at a level percent of payroll beginning in FY2010 sufficient to achieve a 90% funded ratio by 2045. The retirement systems calculate and certify the amount needed each year to meet the requirements of this funding schedule.

After implementation of the 1995 law annual pension contributions adhered to a fixed payment schedule. Unfortunately, they did not adjust upwards during the late 1990s economic expansion to contribute in excess of the fixed payment amounts provided for in the 1995 funding law. This was a lost opportunity to improve the funding situation during a time of strong state revenues.[12]

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[11] Employees also contribute to the pension systems, at rates ranging from 4.0% to 11.5% of salary depending on the system and whether or not the employee is also in Social Security. See Illinois Department of Financial and Professional Regulation Division of Insurance, “2007 Public Pension Report”.

[12] See The Governor’s Pension Commission: Pension Reform Report and Recommendations for Governor Rod Blagojevich, February 11, 2005, pp. 8-9.

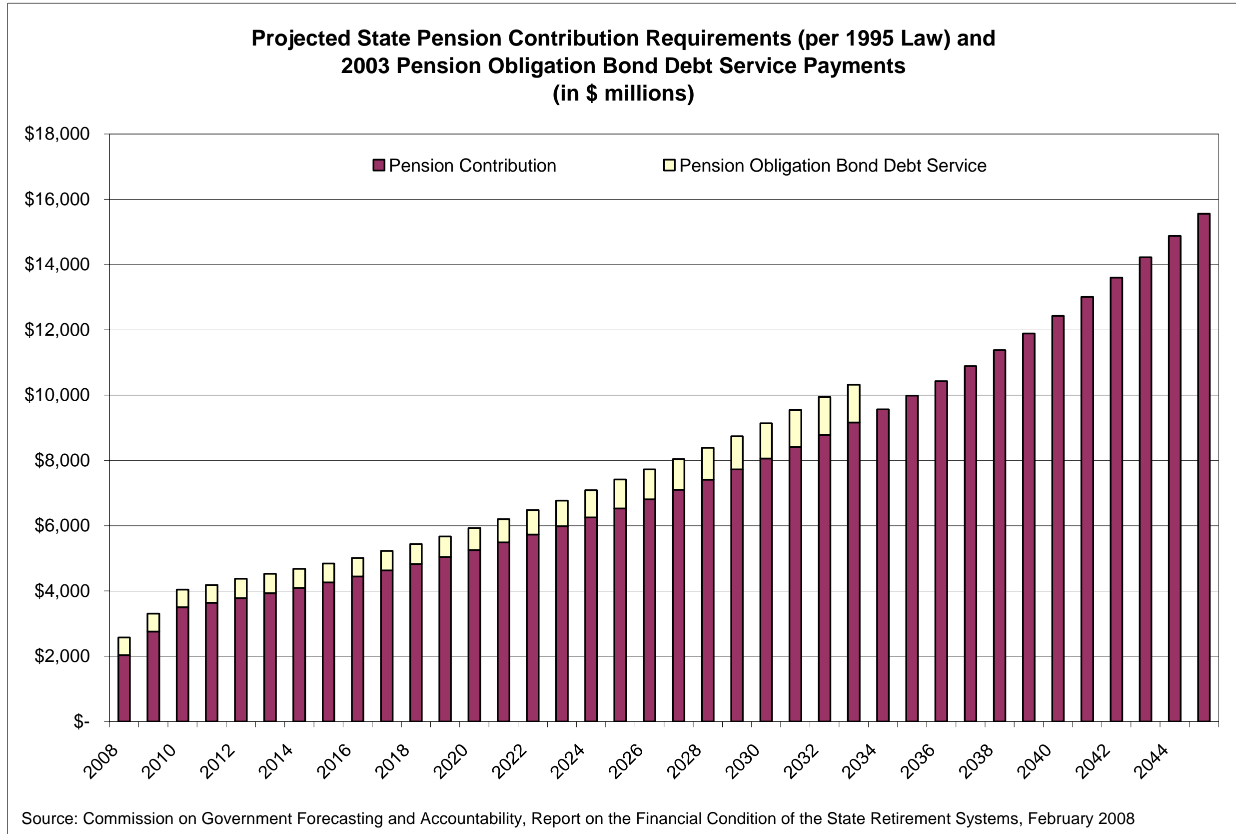
The 1995 funding schedule was subsequently modified in 2005 by Public Act 94-0004, which introduced some structural pension reforms but reduced the FY2006 and FY2007 required State contributions, thus reverting back to old habits of underfunding (see below).

Issuance of $10 Billion in Pension Obligation Bonds in 2003

In his first year in office, Governor Blagojevich championed Public Act 93-0002, which authorized the issuance of $10 billion in pension obligation bonds. The proceeds of these bonds were to be used to boost the pension funds' assets to compensate for past underfunding and reduce future unfunded liabilities. Unfortunately, the State ultimately used a portion of the bond proceeds to pay part of the FY2003 pension contributions and all of the FY2004 contributions, thus creating a hole in future operating budgets and putting a net amount of only $7.3 billion toward the massive unfunded liability.

Initially, the funds' managers and the Governor's financial team estimated that the pension funds would earn investment income at the traditional long-term actuarial rate of 8.0% and that the pension bond proceeds would earn at least that rate over the 30-year life of the bonds. The financial team forecasted that savings would result from issuing the bonds at the then-current market rate of approximately 5.8%, as long as the funds earned a long-term actuarial rate of 8.0%. In fact, the bonds were actually issued at an interest rate of 5.05% while the pension funds' actuaries ultimately projected an 8.5% expected rate of return for the entire asset portfolio. The State estimated that it would realize $860.0 million in additional "savings" from this favorable rate spread. In its FY2005 budget, the State proposed to capture $215.0 million, or 25.0% of the additional "savings", reserving the remainder for capture in future years. The $215.0 million "savings" was used as the justification for reducing the State's pension contribution by a similar amount in FY2005.

The State still owes over $19.4 billion in principal and interest on the 2003 pension obligation bonds. A full accounting of the annual pension payments made by the State should include the pension bond debt service. The following chart illustrates the projected State contributions to the pension funds per the 1995 law as well as the pension bond debt service.



The FY2006-FY2007 Partial Pension Holiday

The General Assembly approved legislation (P.A. 94-0004) in 2005 authorizing reductions in State contributions to its five retirement systems from the amounts originally certified by the systems in both FY2006 and FY2007 (for a total reduction of $2.3 billion). The exhibit below shows the difference between the certified amount for each State pension fund per the 1995 funding law and the amount that was appropriated in FY2006 and FY2007. These figures do not include debt service payments on the 2003 pension obligation bonds.

FY2006 & FY2007 Certified Contributions vs. Final General Assembly Appropriations (In $ millions)

	FY2006			FY2007				
System	Certified Contributions	P.A. 94-0004	Difference	Certified Contributions	P.A. 94-0004	Difference	Total 2-Year Contributions	Total Reduction
TRS	$ 1,058.5	$ 531.8	$ 526.7	$ 1,233.1	$ 735.5	$ 497.6	$ 2,291.6	$ 1,024.3
SERS	$ 690.3	$ 203.8	$ 486.5	$ 832.0	$ 344.2	$ 487.8	$ 1,522.3	$ 974.3
SURS	$ 324.9	$ 166.6	$ 158.3	$ 391.9	$ 252.1	$ 139.8	$ 716.8	$ 298.1
JRS	$ 38.0	$ 29.2	$ 8.8	$ 44.5	$ 35.2	$ 9.3	$ 82.5	$ 18.1
GARS	$ 5.5	$ 4.2	$ 1.3	$ 6.3	$ 5.2	$ 1.1	$ 11.8	$ 2.4
Total	**$ 2,117.2**	**$ 935.6**	**$ 1,181.6**	**$ 2,507.8**	**$ 1,372.2**	**$ 1,135.6**	**$ 4,625.0**	**$ 2,317.2**

Source: Commission on Government Forecasting and Accountability. Report on the 90% Funding Target of Public Act 88-0593, January 2006.

The Commission on Governmental Forecasting and Accountability, a legislative commission that provides the General Assembly with economic and financial research, estimated that the final pension contribution and reform package approved in P.A. 94-0004 would reduce the systems' total liabilities by $38.6 billion over 40 years due to benefit reforms (see page 15). But

because P.A. 94-0004 also allowed a partial contribution holiday in FY2006 and FY2007, the State would ultimately have to contribute $4.7 billion more to the systems over 40 years.

Estimated Impact of P.A. 94-0004 Total Projected State Contributions for FY2006-FY2045 Prepared by CGFA (in $millions)						
State Contributions	TRS	SERS	SURS	JRS	GARS	TOTAL
Pre P.A. 94-0004	$ 160,302	$ 68,065	$ 61,184	$ 6,538	$ 862	$ 296,951
P.A. 94-0004	$ 155,507	$ 78,068	$ 60,531	$ 6,654	$ 877	$ 301,637
Difference	**$ (4,795)**	**$ 10,003**	**$ (653)**	**$ 116**	**$ 15**	**$ 4,686**
FY2045 Liability Reduction	**$ 26,265**	**$ 667**	**$ 11,690**	**$ -**	**$ -**	**$ 38,622**

Source: Commission on Government Forecasting and Accountability, August 2005 Monthly Briefing.

Governor Blagojevich's FY2008 Pension Funding Proposal

In FY2008, the State faced projected pension contribution requirements of $2.0 billion for FY2008, climbing to $2.7 billion in FY2009 and $3.5 billion in FY2010. When debt service on the 2003 pension obligation bonds was included, the total payment projections rose to $2.6 billion in FY2008, $3.3 billion in FY2009, and $4.0 billion in FY2010.[13] The total $2.6 billion payment for FY2008 represented 5.3% of the proposed $49.0 billion FY2008 operating budget.

The Governor's FY2008 budget proposed providing the State's five pension plans with $25.9 billion in new assets. This infusion would have created an 83.0% funded ratio in FY2008, 34 years ahead of the current 50-year funding schedule.[14] It also would have reduced the total required pension contributions and debt service to $1.9 billion in FY2008, $2.1 billion in FY2009, and $2.4 billion in FY2010.

The Governor's proposal utilized two financing mechanisms:

1. *The long-term lease of the Illinois Lottery:* The State proposed entering into a long-term concession of the Illinois Lottery. The State expected that the lease of the Illinois Lottery would generate $10.0 billion in cash; and

2. *The issuance of $15.9 billion in pension obligation bonds:* All proceeds from the bond issue would be paid into the State retirement systems. The structure of the pension obligation bond issue would have resembled the previous transaction in 2003. Debt service payments would have been supported by deductions from the unfunded liability payments that would have been necessary if the bonds were not issued.

The General Assembly rejected the Governor's FY2008 pension funding proposal.

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[13] Commission on Government Forecasting and Accountability, Report on the Financial Condition of the State Retirement Systems, July 2007.

[14] Presentation by John Filan, Chief Operating Officer, State of Illinois, to the Civic Federation, March 14, 2007, p. 25.

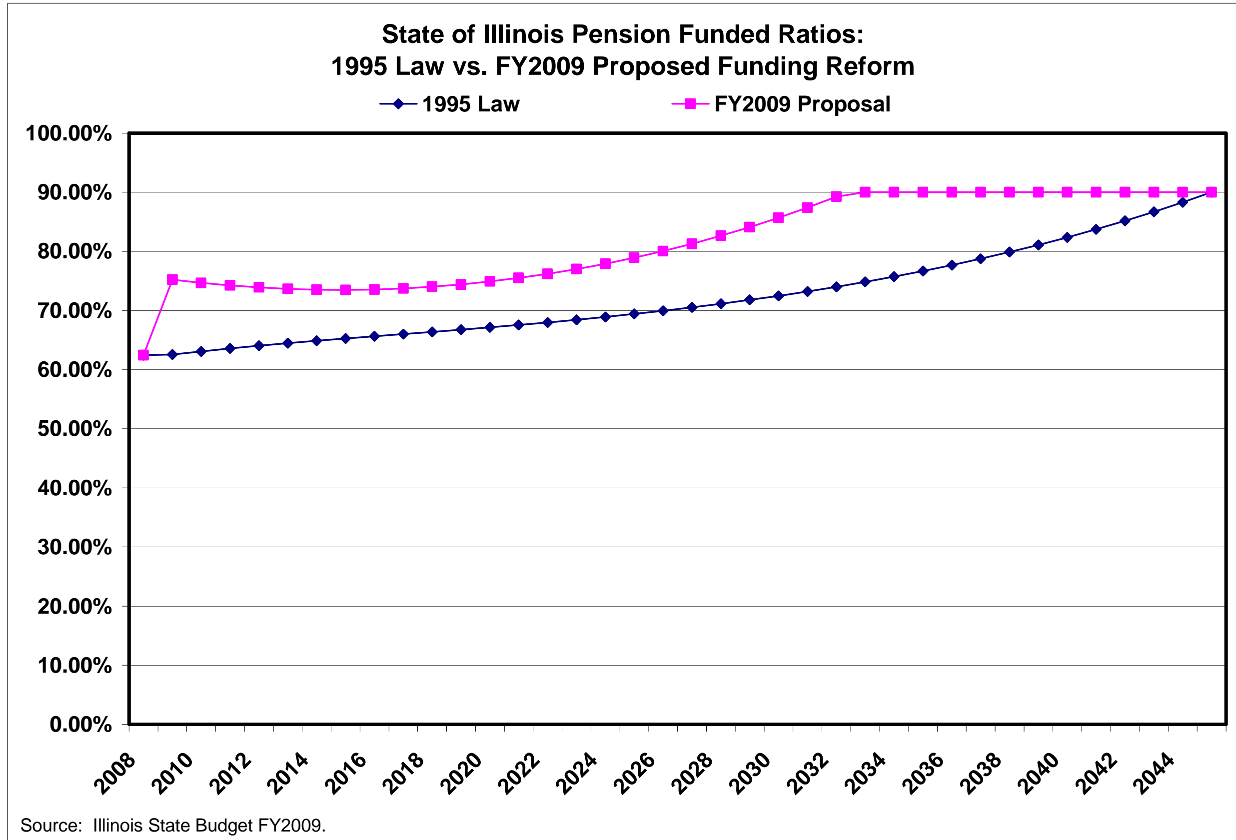
Governor Blagojevich's FY2009 Pension Funding Proposal
In his FY2009 budget proposal, Governor Blagojevich recommended issuing between $12 and $20 billion in pension obligation bonds to increase the assets of the State's pension funds. The bonds would be paid for through General Fund revenues.

If the State issued $16 billion in pension obligation bonds (the midpoint of the Governor's proposal range), it could immediately place $15.9 billion of that amount into the pension funds, thereby increasing the combined funded ratio from 62.6% to approximately 75.2%. One hundred million dollars would be used for administrative costs associated with bond issuance, pension payments would be rescheduled, and FY2009 payments would be set at $280.0 million greater than the payment made in the previous year. In succeeding years, payments would be equal to $280.0 million plus a 3% annual increase until the funds achieved a 90.0% funded ratio in 2033, twelve years ahead of the current schedule.

The Governor's office estimated that the plan would save the State $55.0 billion in future contributions.[15] The "savings" would accrue because the interest rate on the pension obligation bonds would be approximately 5.5% while the borrowed funds would earn 8.5% through investment returns. As with the 2003 pension obligation bonds, the "savings" represent the spread between interest paid on the bonds and interest earned on the invested funds. Also as in 2003, the State proposed to use the savings to reduce its required pension contributions from the 1995 pension funding law schedule.

The differences between the funded ratios of the five State of Illinois pension systems under the 1995 pension funding reform law versus under the Governor's FY2009 proposals is illustrated below. Putting $15.9 billion into the pension funds would immediately increase the funded ratio from 62.5% to 75.2% in FY2009. In FY2033, the funded ratio would reach 90%, as compared to 74.8% under the current system.

[15] Illinois State Budget FY2009, pp. 4-1 and 4-2.



A bill permitting the issuance of $16 billion in pension obligation bonds was passed by the Illinois Senate in May but failed to pass the House of Representatives.

Benefit Enhancements and Proposed Reforms

Between 1987 and 2003, benefit enhancements added $7.8 billion in unfunded liabilities to the pension systems. Between 1995 and 2003, Governors Edgar and Ryan, with support from succeeding General Assemblies, weakened the impact of the 1995 pension funding law by approving benefit enhancements that added $5.8 billion in unfunded liabilities.

Illinois State Pension System Benefit Enhancements: 1995-2003		
Year	**Benefit Enhancement**	**Cost**
1995	TRS Early Retirement Incentive	$ 150,000,000
1997	SURS Conversion from Step Rate to Flat Formula	$ 180,000,000
1998	TRS Conversion from Step Rate to Flat Formula	$ 1,000,000,000
1998	SERS Conversion from Step Rate to Flat Formula; Alternative formula final rate of pay conversion from average of final 4 years to pay on final day	$ 1,250,000,000
2001	SERS Rule of 85 added; alternative formula conversion from Step Rate to Flat Formula	$ 650,000,000
2002	SURS added 30 years of service and out provision	$ 60,000,000
2002	SERS added highway maintainers and DHS security to alternative formula	$ 170,000,000
2003	SERS Early Retirement Incentive	$ 2,370,000,000
	TOTAL	**$ 5,830,000,000**

Source: FY2006 Illinois State Budget, p. 2-2.

One of the biggest contributors to increased retirement costs was the Early Retirement Incentive (ERI) offered to state workers in 2002. The full cost of the ERI was originally estimated to be $622 million in additional unfunded pension liabilities, or approximately $80,000 per employee. The liability was to be amortized over 10 years at an annual cost of $70 million. However, there were a number of errors in the original estimate and assumptions that soon proved false. First, instead of accruing a retirement benefit equal to 1.67% of their final paycheck for the first ten years of service, as is usually the case, retirees in “high stress” jobs such as public safety positions were credited with a 2.5% accrual rate. Approximately one third of state employees were classified as working in “high stress” positions. For all other employees, the ERI package waived the penalty that normally would have reduced annual pension payments by 6% for each year an employee was less than 60 years of age at the time of retirement. Therefore, a 50-year-old employee would reap the same benefits as a 60-year-old employee. These two changes added costs of approximately $62,000 per employee, boosting the average ERI cost of $80,000 to $142,000. [16]

The two changes described above also encouraged younger workers to retire. Roughly half of retirees were 55 or younger. Consequently, the State will pay this group’s retirement costs for a longer period of time than is usually the case because they live longer in retirement, thereby further boosting costs. The ERI also had provisions allowing retirees to purchase additional years of service. These two additional factors added an average of $58,000 in costs per retiree for a total average cost of $200,000, far in excess of the original estimate of $80,000 per person.[17]

When the estimates were revised in 2003, the total additional unfunded liabilities were calculated at $2.4 billion, or four times the original estimate of $622 million. This was a $1.8 billion error. The recalculated annual cost to amortize the ERI jumped from $70 million to $382 million.

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[16] Information on the cost of the early retirement initiative is from Greg Burns, “Pension Debacle Grows,” in *Chicago Tribune*, March 28, 2004.

[17] Greg Burns, “Pension Debacle Grows,” in *Chicago Tribune*, March 28, 2004.

Adhering to the 10-year amortization plan would have required such a sharp increase in pension contributions that Governor Blagojevich and General Assembly subsequently chose to eliminate the 10-year amortization period and fold the ERI liability into the general liability of the pension systems, amortized through the year 2045 (P.A. 94-0004).

FY2006 Pension Benefit Reform Proposals

Governor Blagojevich made a number of pension reform proposals in the FY2006 State of Illinois Budget. These proposals were all originally recommended by the Governor's Blue Ribbon Pension Commission, which was composed of representatives from the General Assembly, business, labor, and civic groups. The Governor accepted all but the following two Commission recommendations:

- Require employees to increase the percentage of salary they pay into the retirement systems by 1%; and
- Consider shifting from a defined benefit to a defined contribution plan at some point in the future.

The General Assembly approved a few of the Governor's proposed reforms with some modifications. The most significant proposals enacted into law as Public Act 94-0004 were capping end-of-career salary increases, eliminating the State Universities Retirement System money purchase option for new hires, limiting eligibility for alternative formulas, and requiring funding for enhanced benefits. The legislators rejected the Governor's proposals to:

- Change the eligibility for full benefits to age 65 with between 8 and 30 years of service; age 62 with 30 to 35 years of service; or age 60 with 35 years or more of service; and
- Limit automatic benefit increases for new hires to the lesser of the change in the rate of inflation or 3% and apply increases only to the first $12,000 in annual pension for retirees covered by Social Security and $24,000 for retirees not covered by Social Security.

New proposals approved by the legislature and signed into law by the Governor enacted a two-year deferral of $2.3 billion in pension contributions, created a second Blue Ribbon Task Force to further study pension reform, created a cost neutral early retirement program, and eliminated lump sum awards for earned and untaken sick pay.

The exhibit below presents a comparison of the Governor's FY2006 original reform proposals, as well as new proposals that were advanced during the legislative session and the final action taken by the General Assembly.

FY2006 Pension Reform Proposals: Governor's Original Proposals vs. Final Approved Proposals	
Governor's Original Proposals	**FINAL BUDGET APPROVED**
Cap End of Career Salary Increases to 3%	6% annual Cap Adopted
Eliminate SURS Money Purchase Option (New Hires)	Approved
Recalculate Money Purchase Interest Rate to Reflect Long-Term Rate of Return, not 9%	Authorized Comptroller to set rate
No New Benefits w/o Funding	Approved
Limit Alternative Formula Benefits (New Hires)	Approved
Limit Automatic Annuity Increases to Rate of Inflation	Not Approved
Change Retirement Age (New Hires)	Not Approved
New Proposals	
Defer Pension Contributions by $2.3 Billion over 2 Years	Approved
Create a second Task Force to Study Pension Reform	Approved
Create Cost Neutral Early Retirement Program Paid for by Local Employers/Beneficiaries	Approved
Eliminate Lump Sum Awards for Unearned Sick Pay to Boost Pensions	Approved

CIVIC FEDERATION STATE PENSION REFORM RECOMMENDATIONS

Over the course of different Governors and different General Assemblies, the State of Illinois has underfunded its retirement systems while approving expensive benefit enhancements. The modest benefit reforms enacted in Public Act 94-0004 represent a small step toward recognition that the retirement benefits granted to public employees have become unaffordable for the State. The contributions required to bring the systems to 90% funded by 2045 are rapidly crowding out spending on other State programs. The projected $4.0 billion required payment for pension bond debt service and system contributions in 2010 will likely represent 7% of the State's total operating budget. The more the unfunded liability is allowed to grow, the more the costs of current government services are shifted onto future generations.

The State of Illinois must implement comprehensive pension benefit reforms if it is ever going to seriously address the long-term costs and liabilities of its five retirement systems. A model for sound pension benefit restructuring was provided last year upon the approval of landmark pension and healthcare reforms for the Chicago Transit Authority through HB 656. The General Assembly, as part of omnibus mass transit funding and structural reform legislation, implemented the following CTA pension reforms:[18]

- Increasing employee contributions to the pension fund from 3% of payroll to 6%;
- Reducing the amount of pension benefits available at age 55 with 10 years of service (pension benefits were formerly available at age 55 with 3 years of service) for new hires; and
- Making full pension benefits available at age 64 with 25 years of service (full benefits were formerly available at age 55) for new hires.

The General Assembly should consider the same types of reforms for the State's five retirement systems. Because the Illinois Constitution protects employees' pension benefits once granted, benefit levels can only be scaled back for new hires. In addition to scaling back unaffordable benefits, the State must also end the practice of taking pension contribution holidays.

[18] See Illinois P.A. 95-708.

Fund State Pension Systems at Certified Contribution Amount

The State of Illinois has a responsibility to follow the mandate of the 1995 pension funding reform law. Fixing the pension funding problem requires discipline and sacrifice. We urge the State to fund its pension obligations at the full amount required by the 1995 law each year. The State should not add new programs and recurring operating expenditures until it pays down its existing, constitutionally-guaranteed pension obligations. Each time the State reduces contributions to the retirement systems, it is deferring expense to future years.

Impose a Moratorium on New Pension Benefits

The General Assembly approved the Pay-As-You-Go Act as part of P.A. 94-0004, which requires that any State pension enhancements also provide for their own funding. While this plan is a more fiscally responsible approach to pensions than the State has had in the past, the General Assembly can still add to the State's already unaffordable pension plans if it identifies new revenues, thus potentially leaving taxpayers on the hook for continuously expanding benefits and costs. The State should impose a moratorium on **any** new employee benefits until the pension system has achieved a 90% funded ratio. We call on the legislature to reject, and the Governor to veto, any new pension enhancements regardless of whether they are tied to additional funding sources.

Raise the Retirement Age for New Hires

Members of the State's retirement systems are currently eligible for full retirement benefits when they reach age 60, unlike most private sector retirement systems, which make 65 the minimum age of retirement with full benefits. The Civic Federation believes that the age at which employees become eligible for full benefits should be increased to age 65 for employees with between 8 and 30 years of service, age 62 for employees with between 30 and 35 years of service, and age 60 for employees with 35 or more years of service.

Fix Automatic Increases for New Hires at the Lesser of 2% or the Rate of Inflation

The current rate of automatic increase for retirement annuities is 3% per year. Other retirement systems index the rate of increase to the rate of inflation, limit the dollar amount of increase, or approve new increases on an ad hoc basis. For new hires only, automatic increases should be limited to the lesser of the rate of inflation or 2% and should apply only to the first $12,000 in annual pension payments for retirees covered by Social Security and $24,000 for retirees not covered by Social Security.

Require Balance on Pension Boards between Employees, Management, and Taxpayers

The State should require a balance of employee, management, and taxpayer interests in the governance of its retirement system Boards. Board seats should be set aside for members with professional expertise or certification in financial asset investment, and all members who do not already possess such expertise should be required to receive some relevant financial training on an annual basis.

Require a 1% Increase in Employee Contributions

Employees covered by the State retirement systems contribute a percentage of their compensation for their own pensions and to fund survivors' benefits. For example, for members of the State Employees Retirement System (SERS), employees covered by the regular retirement formula are required to make the following contributions:

- Members with Social Security: 3.5% of compensation (pension) + 0.5% (survivors) = 4% total
- Members without Social Security: 7% of compensation (pension) + 1% (survivors) = 8% total

The Civic Federation believes that all public employees covered by the State's five retirement systems should contribute an additional 1% of their salaries to the cost of their pensions.

Study the Costs and Benefits of Conversion to a Defined Contribution Plan

The State should undertake a study to determine both the costs and benefits of moving to a defined contribution pension plan such as is now the private sector standard. Such a move would require a very large infusion of assets into the system, such as from a multi-billion dollar asset sale or pension obligation bond issue. This would be necessary because the State would still be required to provide benefits to employees in the existing defined benefit plans for decades. This obligation would persist even as the funding stream for those plans diminishes with the shift of new employees into the new defined contribution plan. There would also be a need for start up funds for the new defined contribution plan.