

# **CENTER FOR TAX AND BUDGET ACCOUNTABILITY**

70 East Lake Street • Suite 1700 • Chicago, Illinois • 60601 • P: 312/332-1041 • [www.ctbaonline.org](http://www.ctbaonline.org)

## **THE ILLINOIS PENSION FUNDING PROBLEM**

### **Why It Matters**

By:

Chrissy A. Mancini  
and  
Ralph Martire

November 2006

# THE ILLINOIS PENSION FUNDING PROBLEM Why It Matters

## TABLE OF CONTENTS

Executive Summary.....	2
1. Introduction.....	6
2. Illinois State Pension Systems at a Glance.....	7
3. Are State Revenues Adequate to Fund the Pension Ramp.....	8
4. The Second Worst Funded Ratio in the Nation.....	10
5. The Defined Benefit System is Not a Primary Cause of the Unfunded Liability in Illinois.....	12
6. Changing to a Defined Contribution System Does Not Solve the Funding Problem.....	13
7. How Does Funding the Pension Affect the State’s Ability to Fund Public Services.....	15
8. Prior Attempts to Address the Problem.....	17
9. Benefit Increases.....	19
10. The 2002 Early Retirement Incentive (ERI) Worsened the Unfunded Pension Liability.....	20
11. Inadequate Revenues Caused the State to Under Fund the Pensions in Fiscal Years 2006 and 2007.....	23
12. The State Does Not Only Have Pension Debt Problems: Analysis of the State’s Bonded Debt.....	27
13. How Will the New GASB 45 Requirement Affect the State.....	31
14. Policy Options.....	32
15. Conclusion .....	37
Appendix A: Data Tables.....	35
Appendix B: Comparison of Illinois' Retirement Systems Benefits to National Average.....	37

## THE ILLINOIS PENSION FUNDING PROBLEM Why It Matters

### Executive Summary

#### **Illinois: Largest Pension Debt in the Nation at \$42.2 Billion**

After decades of neglect, Illinois now has the greatest total unfunded pension liability in the nation. The debt affects everything from the revenue available to fund public services like education and healthcare, to the state's bond rating and ability to pursue capital improvement projects.

#### **Key Findings of the report:**

- At the end of FY 2006, Illinois had the worst unfunded pension liability in the nation, totaling a projected \$42.2 billion.
- At the end of FY 2006, Illinois had funded only a projected 58.7% of what it owes to its pension systems. The national average is 87 percent.
- Even after the infusion of \$10 billion in pension obligation bonds that decreased the state's unfunded liability and despite no increases in retirement benefits and enacting pension reforms that produce long term cost savings for the state, the partial pension holidays (SB 27) taken in FY 2006 and FY 2007 contributed to increasing the state's total unfunded liability by \$7.1 billion just since 2004.
- For FY 2007, the interest payment on the unfunded liability is an estimated \$3.4 billion. This means the state must make this \$3.4 billion interest payment plus make the "normal cost" payment just to keep the unfunded liability from growing.
- Decades of failing to make the required, employer contribution to the systems is the primary cause of the state's current unfunded pension liability, rather than either the type of pension plan in place or the level of benefits offered, which hover around the national average. According to U.S. Census Bureau data, the average monthly pension payment to state government employees nationally was \$1,374 in 2001-2002. At the same time, the average Illinois payment was \$1,426, a difference of just 3.7 percent. The normal cost for the five retirement systems as a percentage of active members payroll is between 8.0% and 16 percent. The national average is 12.5 percent.
- The longer the state defers its obligation to pay its pensions, the worse the problem becomes, because the aggregate unpaid liability amount compounds annually, at an investment return rate that currently ranges from 8.0% to 8.5%.
- The state's current tax system cannot generate enough revenue to maintain current levels of public services, fund the "normal cost" of the pension contributions the state owes for its current employees and fund the state's unpaid pension liability.
- Illinois' unfunded pension debt is, on a stand-alone basis, over two times greater than all other Illinois state debt, *combined*. This is worrisome, because state debt—excluding the pension liability—is already considered to be at an "unmanageable" level, under the standards of the National Association of State Budget Officers.

- The Illinois Constitution mandates that the state satisfy the pension benefits earned by its employees and retirees—without diminution. That means no change in current pension law can diminish the state's responsibility to provide benefits to either former public employees who have retired or to current employees when they retire.
- The current pension system would be affordable, if the state had the fiscal discipline (and revenue) to have made required yearly payments for benefits earned each year, (the “normal cost”) plus make interest payments on accrued unfunded liability.

### **The Second Worst Funded Ratio in the Nation**

The total unfunded liability amount is only one measure of a pension system's health. The other is its "Funded Ratio". The "**Funded Ratio**" of a pension system identifies the portion of what is owed to a pension that has actually been contributed. It is a percentage, calculated by dividing the pension system's total assets by that pension system's total liabilities.

In 2006, Wilshire Associates analyzed state pension systems across the country. That study found that the average national Funded Ratio for a state pension system was 87%. Illinois'

Funded Ratio of only 58.7% is significantly below the national average. Illinois' Funded Ratio is the second worst in the nation, trailing only West Virginia. Although West Virginia has a worse funded ratio than Illinois, the total unfunded pension liability in West Virginia of \$6.5 billion is significantly less than in Illinois.

### **Why Illinois Has the Largest Pension Debt in the Nation**

Funding the five pension systems for public employees has challenged Illinois state government for decades. The main reason the state has such a large pension unfunded liability does not stem from generous benefits or overspending on workers. The main reason is because Illinois revenue system has historically underperformed inflation, causing the state to continually find itself short of the revenue needed to cover both essential services and its required pension contributions. Illinois frequently opted to skirt full funding of the pensions to maintain spending on services. This means Illinois was borrowing against the pension system just to cover the cost of providing current public services. When the state fails to pay its required pension contributions, the amount it ultimately must contribute grows substantially over time. That is because under state law, any funding shortfall must be paid back with interest, compounded at each retirement system's target rate of return, currently pegged at 8.0% to 8.5% per year, depending on the pension fund. Each year a pension obligation remains unpaid, the investment return the state must make up on the unpaid contribution *compounds*.

### **Defined Benefit System Did Not Cause Pension Unfunded Liability**

The benefits offered to public employees in Illinois under the state's pension systems are around the national average. According to U.S. Census data, the average monthly pension payment to state government employees nationally was \$1,374 in 2001-2002. At the same time, the average Illinois payment was \$1,426, a difference of just 3.7 percent.

Additionally, the normal cost for the five retirement systems as a percentage of active members payroll is between 8.0% and 16 percent. The national average is 12.5 percent. Hence, the normal cost of the state's current defined benefit program is well within national averages. The data indicates Illinois' existing unfunded liability is not due to either the generosity or cost of the benefits provided, but rather the state's repeated decision to not contribute the full, required amount it owed to the pension systems, and the concomitant compounding of that debt over time.

### **Changing to a Defined Contribution System Does Not Solve the Funding Problem**

If Illinois were to switch to a defined contribution plan it would result in little immediate savings to the state or help reduce the unfunded liability. Under the state constitution, present employees are guaranteed a set income under the defined benefit plan, so only new hires would take part in a new defined contribution plan. The state would not realize material savings until those hires become a significant percentage of the workforce. Switching to a defined contribution plan does absolutely nothing to eliminate the \$42.2 billion unfunded liability the state is required to pay.

### **Administration Costs and Risk Associated with a Defined Contribution Plan**

Switching to a defined contribution plan would cost the state more in the short-term than maintaining its current defined benefit plans. A defined contribution plan must be designed, set up, put into place. Separate administrative and bookkeeping systems must be established for the different plans and employees will have to be trained on how to manage their investments. .

Further, defined benefit plans lower overall retirement costs by pooling the risk associated with the market over a large number of participants. This means defined benefit plans, unlike defined contribution plans, can maintain a mix of investments, which likely will provide a higher return and lower contributions over time, when fully funded.

Additionally, unlike a defined benefit plan where investments are selected by experienced professionals, employees, who do not have professional investment experience, would be directing their own investments under a defined contribution plan. Moreover, given the size of the assets available to invest, opportunities will be available to the defined benefit investment trustees that would not be available to employees investing in their personal account. The lack of investment experience coupled with reduced investment opportunities creates the probability that individual employees will not, for the most part, fare as well with their investment returns as will the fiduciaries making investment decisions for the assets of the defined benefit systems.

### **How Does Funding the Pension Affect the State's Ability to Fund Public Services**

Illinois gets the revenue to fund its contributions primarily from general taxes, like income and sales. These are the same revenue sources that constitute the bulk of the General Fund. In addition to covering pensions, the General Fund is the source for funding the vast majority of public services the state provides, including everything from education, healthcare, human services and public safety.

While the cost of providing public services grows normally with the economy over time, the state's poorly designed tax system does not grow with the economy, and hence generates less revenue than needed to maintain current public service levels and make the required pension payments from year to year, adjusting solely for inflation. The Illinois Constitution requires that the state produce a balanced budget each year. Hence, the state's unfunded pension liability competes directly with public services for the revenues the state's tax system generates annually.

Policymakers consistently have been confronted with the politically difficult choice of either significantly reducing the level of public services to pay pension contributions, or modernizing how the state taxes to raise adequate current revenue for the state to pay its bills. Instead of confronting this politically difficult dilemma head-on, policymakers have generally made a fiscally unsound, third choice year after year: defer making the full employer pension contributions then due, just to maintain current services.

However, the state's pension debt is now so large that it simply cannot be put off to future generations. Making these payments is highly unlikely under the current tax system, without drastically cutting public services for future generations. For example, in FY 2006, the state was unable to meet the required contribution of \$2.1 billion, actually paying less than half that

amount. Under this new ramp, next year (FY 2008) the state will owe over \$2.5 billion and just three years later, over \$4 billion. In later years the state will owe between \$11 and 15 billion.

### **Solutions to Paying off the Unfunded Liability**

There are few viable revenue options available that will allow Illinois to pay its unfunded pension contribution liability, and no one option will be sufficient on its own to solve the problem.

1. The first and best option is modernizing the state's tax system to comport with today's economy. This option requires the political will to implement comprehensive reform of the Illinois tax systems, like the framework of SB/HB750, introduced by Senator Meeks in 2004.
  - Under that bill, Illinois would generate renewable revenue that grows with the modern economy, sufficient in amount to fund current service levels, plus the Normal Costs of the five pension systems, some of the accrued but unpaid pension liability, plus enhance education funding and provide property tax relief.
  - That proposal would increase the state's income tax, expand the sales tax base to include consumer (not business) services, and provide tax relief targeted to 60% of Illinois taxpayers.
  
2. Another alternative is a long-term payment program—like issuing pension obligation bonds to refinance the over \$40 billion unpaid liability. However,
  - the rates for the bond issuance must be set at appropriate levels;
  - all bond proceeds must be used to refinance pension debt;
  - the bond payment levels must save the state money over the long term and be attainable; and
  - the state must have the recurring revenue to fund the debt service.
  
3. Finally, the state should also consider implementing a new revenue source targeted to repaying pension liabilities, that is independent of base revenue streams from income, sales, excise and utility taxes, which should be devoted primarily to paying for current services.
  - One such potential new revenue source that has promise as both good public and fiscal policy, is implementing a carbon discharge permit/tax system in Illinois.

Without modernizing current revenue streams, the state simply will not have the financial capacity to pay its unfunded pension liability plus maintain current services.

For more information please contact  
Chrissy Mancini, Director of Budget and Policy Analysis  
at [cmancini@ctbaonline.org](mailto:cmancini@ctbaonline.org)

## 1. Introduction

A state's unfunded pension liability — the difference between what a state owes as its required employer contribution to pension plans for state employees and what it has actually paid — affects everything from the revenue available to fund public services like education and healthcare, to a state's bond rating and ability to pursue capital improvement projects.

Illinois state government's funding of, or more accurately stated, failure to fund, its required pension contributions has generated significant interest lately, even receiving the attention of some candidates for public office and the media. This new found attention is welcome, because after decades of neglect, Illinois now has the greatest total unfunded pension liability in the nation. As Figure 1 below illustrates, Illinois' unfunded pension obligation dwarfs the next worst state, Ohio, by more than \$11 billion, is significantly greater than the state of California, which has three times the population<sup>1</sup>, more than three times the state budget<sup>2</sup> and 310,000<sup>3</sup> more public employees than Illinois. Illinois unfunded pension liability is almost six times greater than the national average.

**Figure 1<sup>4</sup>**  
**Comparison of State Retirement Debt**



No one set out to create this huge liability for state government. In fact, the problem spans over 30 years and includes Republican and Democratic administrations. It may have even grown from good intentions. For decades, Illinois' tax system has failed to produce enough revenue to fund the level of public services being provided.<sup>5</sup> This is despite the fact that Illinois has historically

<sup>1</sup> United States Census Bureau, State Government Employment Data, March 2005.

<sup>2</sup> California Legislative Analyst's Office.

<sup>3</sup> United States Census Bureau, State Government Employment Data, March 2005.

<sup>4</sup> Other state debt and national average debt based on the 2004 Wilshire Report, *State Retirement Systems: Funding Levels and Asset Allocation*, the latest state by state comparison available. The current unfunded liability of \$42.2 billion is based on the Commission on Government Forecasting and Accountability, *Report on the Financial Condition of the Illinois Public Employee Retirement Systems*, August, 2006.

<sup>5</sup> Center for Tax and Budget Accountability (CTBA) analysis of Illinois final budget expenditure reports since 1995. For more information see CTBA's special report, *Illinois has Cut Real Spending on All Services Except Health Care, Pensions and Education Since 1995*, available online at: [www.ctbaonline.org](http://www.ctbaonline.org)

been a low spending state.<sup>6</sup> Working under the constraints of a constitutional balanced budget requirement, elected officials in both parties were consistently presented with the choice of either cutting spending on essential services like education, healthcare, human services, public safety and environmental protection to fund the pensions fully, raising taxes to fully fund the state's than existing employer contribution to the pension, or under funding the pensions to maintain services without increasing taxes. Frequently, the decision was to maintain key public services like education and healthcare without generating the tax revenue needed to support them, through some combination of not making the then current pension contribution and cutting things like human services, affordable housing, public safety and environmental protection.<sup>7</sup> Effectively, ongoing tax revenue shortfalls started the state down the path of borrowing against contributions Illinois was supposed to make to its pension systems, just to maintain existing service levels. This process of continually failing to make required contributions is the primary cause of the state's unfunded pension liability.

Even though no one political party or elected official is to blame for creating the state's unfunded pension liability problem, how policymakers deal with it going forward is everyone's concern, because the ultimate resolution of Illinois' obligation to pay its unfunded pension liability will directly impact the state's solvency and ability to continue providing essential services.

To understand why paying the state's unfunded pension liability has significant implications for every public service Illinois provides, this report will place the unpaid pension liability in context of:

- The state's obligation to fund public employee pensions;
- The state's constitutional obligation to provide benefits earned by retirees;
- The state's constitutional obligation to balance its budget annually;
- The state's ongoing tax revenue shortfalls;
- The role pensions play in compensating public employees; and
- How the pension system in Illinois compares to other states.

## **2. Illinois State Pension Systems at a Glance**

**(a) Constitutional Mandate Means No Easy Way Out.** The state's duty to maintain pension benefit levels for its public employees is directly mandated in the Illinois Constitution. Specifically, Article XIII, Section 5 of the Illinois Constitution provides, "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 (emphasis supplied).*" There is no escaping this obligation. The absolute nature of this responsibility means the problem cannot be legislated away.

In fact, because the state is constitutionally required to provide retirees the benefits they earned, any proposed change to Illinois pension benefits can only operate on a *prospective* basis. That means any legislation the state passes to reduce pension benefits, will only apply to public employees newly hired *after* the change in law goes into effect. This constitutional framework has two significant consequences. First, there is no change in law that can reduce the size of the current unfunded liability. Illinois owes the full amount. Second, any significant savings from proposed changes to the state's pension system will not be realized until those new employees who are hired after the change goes into effect, start to retire. Sure, the amount of the state's

---

<sup>6</sup>United States Census Bureau, Bureau of Economic Analysis Regional Economic Accounts – Annual State Personal Income. National Association of State Budget Officers, *State Expenditure Survey, 2004*. Currently, Illinois ranks 42<sup>nd</sup> in state spending as a percentage of personal income.

<sup>7</sup> CTBA analysis of Illinois final budget expenditure reports since 1995.

contribution for new hires could be less than for existing employees if the state adopted a two-tier system that provided lower benefits to new hires, but new hires will make up only a very small percentage of the workforce for years. Meanwhile, preexisting employees would retain their full preexisting benefits. Hence, any change in law designed to reduce the value of pension benefits afforded public employees will not generate significant savings until years after passing, nor reduce the aggregate amount of the unfunded liability existing before passage.

**(b) The State's Pension Systems.** The five public employee retirement systems in Illinois are the: State Employees Retirement System ("SERS"), Downstate Teachers' Retirement System ("TRS")<sup>8</sup>, State Universities Retirement System ("SURS"), Judges Retirement System ("JRS") and General Assembly Retirement System ("GARS"). For each pension system, Illinois state government makes the employer contribution, and participating employees make their required employee contributions. Figure 2 shows how many individuals are currently earning benefits in each system, how many are currently collecting benefits from each system, and the total number of plan participants.

**Figure 2<sup>9</sup>**  
**Participants in the Illinois Pension Plans**

	TRS	SURS	SERS	JRS	GARS	Total
<b>Active Members</b>	<b>245,925</b>	<b>149,951</b>	<b>91,423</b>	<b>962</b>	<b>275</b>	<b>488,536</b>
<b>Beneficiaries</b>	<b>82,491</b>	<b>39,800</b>	<b>54,828</b>	<b>900</b>	<b>397</b>	<b>178,416</b>
<b>Totals</b>	<b>328,416</b>	<b>189,751</b>	<b>146,251</b>	<b>1,862</b>	<b>672</b>	<b>666,952</b>
<b>Percent of Total IL Population</b>						<b>5.3%</b>

Note that the total of all participants in the state's various pension plans represent a very small percentage of Illinois' total population. That's because historically, Illinois has not been a high public employee head count state.<sup>10</sup> Instead, Illinois is mostly a grant-making state—that is, rather than hire state employees to provide services, Illinois disburses grants to independent providers such as Lutheran Social Services or Catholic Charities, which in turn deliver the public service. Illinois now ranks 50<sup>th</sup> among the states, dead last in the nation, in number of state employees per capita.<sup>11</sup> This dispels the myth that the state's pension funding problems are due to Illinois simply hiring too many public employees. The data makes it clear, poor fiscal policy, rather than over abundant head counts, is the real culprit.

### **3. Are State Revenues Adequate to Fund the Pension Ramp**

Funding the five pension systems for public employees has challenged Illinois state government for decades. The practice of failing to fund the full normal cost the state owed the pension systems for its employees was in use at least since the Ogilvie Administration back in 1970 and has progressively worsened since.<sup>12</sup> As noted previously, as the state continually found itself short of the revenue needed to cover both essential services and its required pension contributions, Illinois frequently opted to skirt full funding of the pensions to maintain spending on services.

<sup>8</sup> The state provides only a portion of the employer contribution to the Chicago Teachers' Retirement System. Most of the employer contribution is paid by the City of Chicago through a locally imposed property tax.

<sup>9</sup> State of Illinois FY 2007 Budget Book.

<sup>10</sup> United States Census Bureau, Stastical Abstract of the United States, 1993-2006.

<sup>11</sup> Based on 2006 U.S. Census Data.

<sup>12</sup> Center for Tax and Budget Accountability historical analysis of actuarial required compared to actual pension payments.

Essentially, Illinois was borrowing against the pension system, just to cover the cost of providing current public services. When the state fails to pay its required pension contributions, the amount it ultimately must contribute grows substantially over time. That is because under state law, any funding shortfall like the Pension Holidays taken for Fiscal Years 2006 and 2007, must be paid back with interest, compounded at each retirement system’s target rate of return, currently pegged at 8.0% to 8.5% per year, depending on the pension fund.<sup>13</sup> Each year a pension obligation remains unpaid, the investment return the state must make up on the unpaid contribution *compounds*.

The situation is quite different if the state makes its pension contribution in a timely fashion. In that instance, the return is not guaranteed, even though the ultimate benefit is. So, as long as the state makes its regular pension contributions when due, short-term fluctuations in market performance do not materially impact the long-term health of the state's pension systems, nor create immediate demands on revenue. Instead, the state can allow its investments to track sound, diversified, long-term strategies. The current pension system would be affordable, if the state had the fiscal discipline (and revenue) to have made the required yearly payment for benefits earned that year, the “normal cost,” plus make interest payments on the accrued unfunded liability.

Illinois continued its practice of under funding each of its five State Public Retirement Systems for over 30 years, ultimately creating the largest unfunded pension obligation in the nation, greater than more populous states like California, New York, Texas or Florida.<sup>14</sup> In essence, the state repeatedly forestalled prior budget problems by shifting pension costs to future generations.

In the past 10 years alone, the state's total unfunded pension liability has grown by over \$20 billion.<sup>15</sup> At the end of Fiscal Year 2006:<sup>16</sup>

- (i) The combined assets held in the five state pension systems totaled a projected \$60.1 billion, versus combined liabilities the state owed to those five systems in contributions and investment returns of a projected \$102.4 billion; which
- (ii) Results in an Unfunded Liability of a projected \$42.2 billion, the largest in the nation.

**Figure 3**  
**Projected Share of Unfunded Liability (Debt) FY 2006**

	TRS	SERS	SURS	GARS	JRS	State Total
<b>\$ in Billions</b>	<b>\$24.00</b>	<b>\$9.50</b>	<b>\$7.80</b>	<b>\$0.136</b>	<b>\$0.719</b>	<b>\$42.2</b>

Pension debt in Illinois has grown to become greater by itself than all other Illinois state debt—combined.<sup>17</sup> Putting the magnitude of this problem in context, **the unfunded pension liability Illinois currently owes is 150% greater than all General Revenue Appropriations for spending on all public services for Fiscal Year 2007.** Illinois' outsized pension debt is impacting the state's credit rating. Illinois now has a bond rating lower than 30 other states, tied with 13 states and higher than only 3 states.<sup>18</sup> In February 2006, Standard & Poor’s made the

<sup>13</sup> Each system’s Comprehensive Annual Fiscal Report lists their actuarial interest rate in the Actuarial Section.

<sup>14</sup> 2004 Wilshire Report, *State Retirement Systems: Funding Levels and Asset Allocation*, the latest comparison of state by state data available.

<sup>15</sup> State of Illinois Comptroller, *Fiscal Focus*, February 2005.

<sup>16</sup> Commission on Government Forecasting and Accountability (COGFA), *Report on the Financial Condition of the Illinois Public Employee Retirement Systems*, August, 2006.

<sup>17</sup> COGFA, *Fiscal Year 2006 Budget Summary*.

<sup>18</sup> Moody’s Investor Service, *Rating Changes for the Fifty States from 1973 to Date*, May 24, 2005.

concise, to the point conclusion that, “higher pension liabilities are pressuring the creditworthiness of these states [with large pension debt].”<sup>19</sup>

#### **4. The Second Worst Funded Ratio in the Nation**

In terms of total dollars, then, Illinois has the worst, that is largest, unfunded pension liability in the nation. The total unfunded liability amount, however, is only one measure of a pension system's health. The other is its "Funded Ratio".

The "**Funded Ratio**" of a pension system identifies the portion of what is owed to a pension that has actually been contributed. It is a percentage, calculated by dividing the pension system's total assets (that is, the total of contributions actually paid in plus the return received on those contributions), by that pension system's total liabilities (that is, the total amount of unpaid contributions then due plus the return owed thereon). If a pension system's assets equal its liabilities, the funded ratio is a perfect 100 percent. A 100% funded ratio means no tax dollars are used to pay interest on any unfunded liabilities. This is the best funded position for a state, as well as the lowest cost to taxpayers. Generally speaking, most public pension systems are not 100% funded. However, a pension system is considered financially able to meet its obligations if its Funded Ratio is 80% or greater.<sup>20</sup> As Figure 4 below demonstrates, Illinois' Funded Ratio is something other than healthy.

**Figure 4**  
**Funded Ratio of the Five Illinois Retirement Systems<sup>21</sup>**

	TRS	SERS	SURS	GARS	JRS	State Total
<b>FY 2006 Projected Funded Ratio</b>	<b>59.5%</b>	<b>52.7%</b>	<b>63.4%</b>	<b>44.7%</b>	<b>37.2%</b>	<b>58.7%</b>

In 2006, Wilshire Associates analyzed state pension systems across the country. That study found that the average national Funded Ratio for a state pension system was 87 percent. Illinois' Funded Ratio of only 58.7% is significantly below the national average. Wilshire Associates ranked Illinois' funded ratio 49<sup>th</sup> and unfunded liability 50<sup>th</sup> in the nation.<sup>22</sup> Illinois' Funded Ratio is the second worst in the nation, trailing only West Virginia.<sup>23</sup> Although West Virginia has a worse funded ratio than Illinois, the total unfunded pension liability in West Virginia of \$6.5 billion is significantly less than in Illinois.

<sup>19</sup> Standard & Poor's, *Rising U.S. State Unfunded Pension Liabilities are Causing Budgetary Stress*, February 2006.

<sup>20</sup> Public Fund Survey Summary of Findings for FY2004, National Association of State Retirement Administrators.

<sup>21</sup> Commission on Government Forecasting and Accountability (COGFA), *Report on the Financial Condition of the Illinois Public Employee Retirement Systems*, August, 2006.

<sup>22</sup> 2004 Wilshire Report, *State Retirement Systems: Funding Levels and Asset Allocation*. 2004 is the latest state by state comparison available.

<sup>23</sup> Ibid.

**Figure 5<sup>24</sup>**  
**Funded Ratio Comparison of Nation's Public Retirement Systems**  
**National Average vs. Illinois**

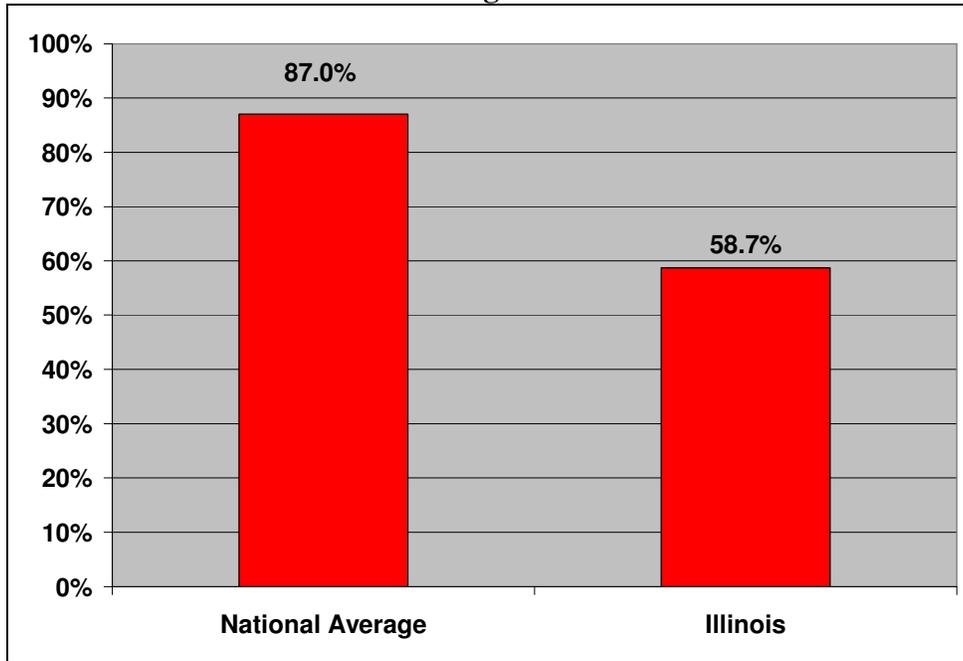
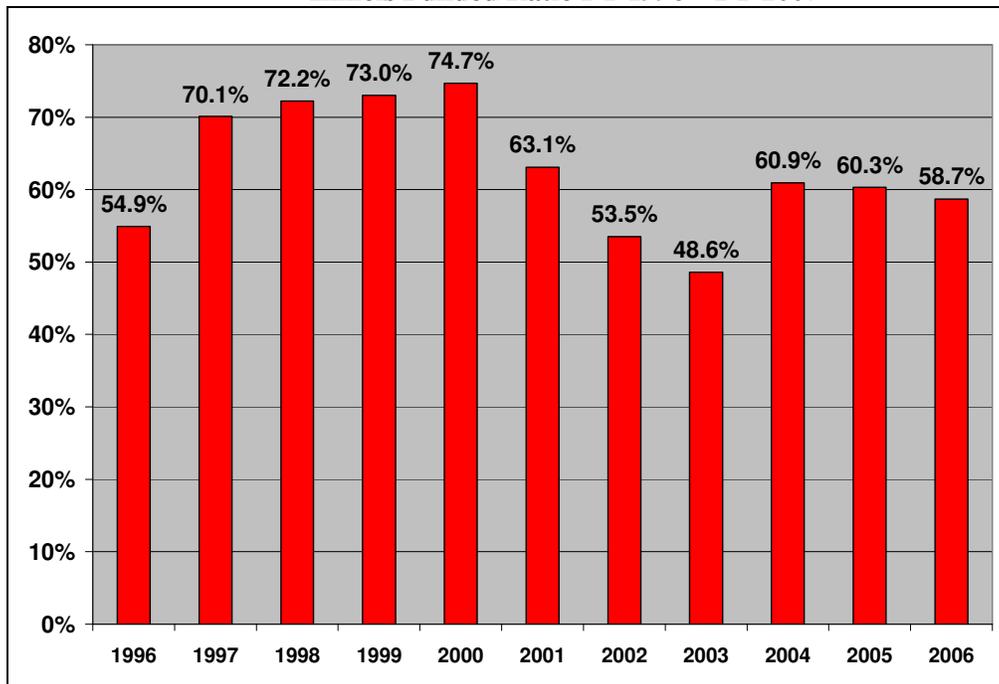


Figure 6 shows that the inability to maintain an adequate funded ratio is an historic, rather than one-time problem in Illinois.

**Figure 6<sup>25</sup>**  
**Illinois Funded Ratio FY 1996 – FY 2007**



<sup>24</sup> National average based on the 2006 Wilshire Report, *State Retirement Systems: Funding Levels and Asset Allocation*, the latest national comparison available. Illinois funding ratio is the FY 2007 data based on COGFA Report on the 90% Funding Target of Public Act 88-0593. The 2006 IL funded ratio was 58.7%.

<sup>25</sup> Commission on Government Forecasting and Accountability, *Report on the 90% Funding Target of Public Act 88-0593*, August 2006.

## **5. The Defined Benefit System is Not a Primary Cause of the Unfunded Liability in Illinois**

One recurring theme in the media has been that the unfunded liability problem in Illinois arises in large part due to the structure of the Illinois public employee pensions as primarily defined benefit rather than defined contribution systems. While this report will not analyze all aspects of that debate, it will address some of the primary differences between defined benefit and defined contribution plans and whether the type of pension system is a primary cause of the state's current unfunded liability.

The state's primary pension systems are defined benefit programs. (The state does offer a defined contribution option to members of SURS). This means a retiree will receive a set, annual retirement benefit based on a formula that factors in years of service and salary. The annual retirement benefit for public employees determined under this formula is guaranteed by the state. After years of paying into the system, employees receive this guaranteed income upon retirement for as long as they live. Defined benefit plans have three sources of funding; returns on investments made by the retirement board who manage the assets of the plans, contributions by employees, and contributions by employers. The Illinois state employer contribution consists of two items, the "normal cost," which is the present value of the benefits earned by members of the retirement systems that year and costs toward paying off its unfunded liability.

This differs significantly from the defined contribution model most prevalent today in the private sector—like a 401(k) plan. A defined contribution program does not guarantee any specific level of payments that an employee can expect upon retirement. Instead, defined contribution programs simply provide a method for employees to contribute a fixed amount (in dollars or a percentage of salary) into tax deferred accounts. Sometimes there is a required match from employers. Legally, private sector 401(k) plans (and their cousins, 403(B) and 457 plans) do not require employers to make contributions to the plan or to manage the plan. In the context of providing an alternative to traditional public defined plans, however, a required employer contribution from the state would be assumed.

In a defined contribution setting, the employee assumes all market risks. So, even if a defined contribution plan has been consistently and fully funded over a career, poor market performance or timing (e.g., an employee retires the day before a major market crash) can dramatically erode the value of the benefit, leaving little for retirement.

Concerns have been expressed that the level of benefits offered under the Illinois defined benefit system are overly generous, contributing to the growing unfunded liability. However, the benefits offered to public employees in Illinois under the state's pension systems are around the national average. According to U.S. Census data, the average monthly pension payment to state government employees nationally was \$1,374 in 2001-2002. At the same time, the average Illinois payment was \$1,426, a difference of just 3.7 percent. (See Appendix B for a comparison of Illinois' retirement systems benefits to the national average.) Since the level of retirement benefits offered in Illinois is approximately the national average, it does not appear benefit levels are a major factor in creating the unfunded liability.

Additionally, the normal cost for the five retirement systems as a percentage of active members payroll is between 8.0% and 16 percent.<sup>26</sup> The national average is 12.5 percent.<sup>27</sup> Hence, the normal cost of the state's current defined benefit program is well within national averages. The data indicates Illinois' existing unfunded liability is not due to either the generosity or cost of the

---

<sup>26</sup> See each retirement systems Annual Financial Report.

<sup>27</sup> Norman Jones and Paul Zorn, Harvard Law School, Pension and Capital Stewardship Project Conference, October 2005.

benefits provided, but rather the state's repeated decision to not contribute the full, required amount it owed to the pension systems, and the concomitant compounding of that debt over time.

The data indicates Illinois' existing unfunded liability is not due to either the generosity or cost of the benefits provided, but rather the state's repeated decision to not contribute the full, required amount it owed to the pension systems, and the concomitant compounding of that debt over time.

## **6. Changing to a Defined Contribution System Does Not Solve the Funding Problem**

If Illinois were to switch to a defined contribution plan it would result in little immediate savings to the state nor help reduce the unfunded liability. Under the state constitution, present employees are guaranteed a set income under the defined benefit plan, so only new hires would take part in a new defined contribution plan. The state would not realize material savings until those hires become a significant percentage of the workforce. Switching to a defined contribution plan does absolutely nothing to eliminate the \$42.2 billion unfunded liability the state is required to pay. In fact, the type of pension system Illinois puts in place or maintains for new hires is unrelated to, and cannot impact, the unfunded liability accrued to date.

Essentially, state decision makers have two, entirely different policy questions before them. The first is how best to pay for the unfunded liability accrued in each of the five public employee systems. The second is, how the state's pension benefit systems should be structured going forward, to accomplish the twin goals of attracting quality employees to the public sector at a reasonable cost to taxpayers. A full analysis of this second inquiry is beyond the scope of this report. However, following is a brief summary of some of the major issues to consider in determining whether it is good public policy to change from a defined benefit program to a defined contribution system.

### **(a) A Quality Workforce**

Provision of good pension benefits is a proven technique for attracting quality employees.<sup>28</sup> Since the public sector generally does not pay salaries competitive with the private sector, a well-designed pension system allows the state to attract and retain employees that might otherwise choose to work in the higher paid private sector, and recruit workers in important and/or high-risk occupations such as teachers, nurses, the state police and prison guards. This is an especially important competitive advantage now, as the private sector has been scaling back retirement benefits over the last 15 years, especially here in Illinois.<sup>29</sup>

Demographic changes, particularly the aging of the workforce, are making pension benefits an even more crucial recruitment tool for the public sector than in the past. Deloitte Consulting ("**Deloitte**") identified significant workforce shortages that will materialize in the labor market due to the aging population. Deloitte found that, because more than 10,000 Baby Boomers are now turning 55 years old every day, for the first time in history, the number of workers entering the labor market will not replace those that are leaving.<sup>30</sup> Deloitte also projects that the number of workers aged 25 to 34 will shrink by almost 9% from 2006 to 2016, leading to a total labor shortage of 10 million by 2010, and 35 million by 2030.<sup>31</sup>

In addition to a general labor shortage, there looms a significant skills shortage, as revealed by the decrease in university graduation rates. From 1998 through 2002, graduation rates at public

---

<sup>28</sup> Anderson, G.W. & Brainard, K. Profitable Prudence, *The Case for Public Employee Defined Benefit Plans*. Pension Research Council at the University of Pennsylvania Wharton School of Business.

<sup>29</sup> [http://www.forbes.com/business/2005/06/10/pension-oxford-retirement-cz\\_0610oxford\\_pension.html](http://www.forbes.com/business/2005/06/10/pension-oxford-retirement-cz_0610oxford_pension.html)

<sup>30</sup> Deloitte Consulting, LLP, *The Impending Pension and Health Plan Crisis and the Impact of the Aging Workforce and Talent Management*.

<sup>31</sup> *Ibid.*

universities fell by 7 percent.<sup>32</sup> By 2012, it is expected that employers will need 6 million more four-year degree candidates to fill jobs than will be available in the labor market.<sup>33</sup> In short, as Baby Boomers retire, much of the future workforce is anticipated to lack the skills and education necessary to fill positions the Baby Boomers vacated. As a result of this national talent shortfall, there will be heightened competition between the public and the private sector to attract qualified candidates. This will require Illinois state government to offer either higher salaries or better benefit packages than in the past to attract talented workers. Scaling back pension benefits for future workers may actually impede the state's ability to attract qualified and skilled workers, leading to a decline in quality of public services delivered.

In that regard, several states which previously switched to a defined contribution plan, reverted back to a defined benefit plan. Even North Dakota, which originally established its pension system as a defined contribution model, changed to a defined benefit system specifically because of the need to attract and retain quality employees.<sup>34</sup> In May 2005, West Virginia passed legislation to allow teachers under that state's defined contribution plan to transfer into a defined benefit plan. State representatives said the change would help prevent teachers from leaving their jobs.<sup>35</sup>

#### **(b) Administration Costs of a Defined Contribution Plan**

Switching to a defined contribution plan would cost the state more in the short-term than maintaining its current defined benefit plans. A defined contribution plan must be designed, set up, put into place. Separate administrative and bookkeeping systems must be established for the different plans. Employees will have to be trained on how to manage their investments. According to the Investment Management Institute, the operating expense ratio for defined benefit plans averages 31 basis points (31 cents per \$100 of assets). The average for defined contribution plans is three to six times higher at 96 to 175 basis points.<sup>36</sup> To put that in context of the Illinois pension systems, the operating expense cost of a defined contribution system would in all likelihood be anywhere from \$275 million to \$610 million more expensive annually than the current defined benefit systems.

#### **(c) Risk Associated with Defined Contribution Plans**

Further, defined benefit plans lower overall retirement costs by pooling the risk associated with the market over a large number of participants. This means defined benefit plans can maintain a mix of investments, which likely will provide a higher return and lower contributions over time, when fully funded. Switching to a defined contribution plan would shift all market risk to each individual employee. Hence, things such as market timing could significantly reduce the benefit available to an employee upon retirement.

Additionally, employees, who do not have professional investment experience, would be directing their own investments. In a defined benefit plan, investments are selected by experienced professionals who can take a diversified portfolio, long-term approach to investment decisions. Moreover, given the size of the assets available to invest, opportunities will be available to the defined benefit investment trustees, such as real estate and infrastructure investments, that would not be available to employees investing in their personal account. The lack of investment experience coupled with reduced investment opportunities creates the probability that individual employees will not, for the most part, fare as well with their

---

<sup>32</sup> Deloitte Consulting, LLP, *The Impending Pension and Health Plan Crisis and the Impact of the Aging Workforce and Talent Management*.

<sup>33</sup> Ibid.

<sup>34</sup> North Dakota Legislative Council, Employee Benefits Program Committee, "Public Employees Retirement Programs – History," October, 1998.

<sup>35</sup> "Pension Bond Will Benefit Taxpayers" *Charleston Daily Mail*.

<sup>36</sup> Sean Collins, *The Expenses of Defined Benefit Pension Plans and Mutual Funds*, December 2003.

investment returns as will the fiduciaries making investment decisions for the assets of the defined benefit systems.

**7. How Does Funding the Pension Affect the State’s Ability to Fund Public Services?**

Pension benefits paid to public employees ultimately come from three sources: employee contributions, state contributions, and the investment income generated when those contributions are invested in the market place. Illinois gets the revenue to fund its contributions primarily from general taxes, like income and sales. These are the same revenue sources that, together with fees, excise and utility taxes and federal government transfers, constitute the bulk of the General Fund. In addition to covering pensions, the General Fund is the source for funding the vast majority of public services the state provides, including everything from education, healthcare and human services on the one hand, to public safety, environmental protection and affordable housing on the other.

The Illinois Constitution requires that the state produce a balanced budget each year.<sup>37</sup> Hence, the state's unfunded pension liability competes directly with public services for the revenues the state's tax system generates annually. If revenue growth from taxes and fees fails to keep pace with both the inflationary cost of funding public services and the growth in pension liabilities, something has to give to balance the budget. Policymakers effectively have three options, cut spending on services, under fund the required pension contribution, or raise taxes and fees.

As Figure 7 demonstrates, Illinois state revenues collected from taxes and fees have failed to grow with inflation over time.<sup>38</sup>

**Figure 7  
Illinois State Tax Revenues Do Not Grow With Inflation**



Figure 7 illustrates how actual state tax revenue growth in Illinois has failed to keep pace with inflation since 2000.<sup>39</sup> It reveals that in the aggregate, state tax revenue has fallen short of inflation by over \$7 billion since 2000. That is 27% of total FY 2007 General Fund

<sup>37</sup> IL Const. art. VIII, § 2. Note: 49 of the 50 states have balanced budget requirements.

<sup>38</sup> CTBA Analysis of tax revenue since 2000.

<sup>39</sup> Includes the personal and corporate income tax, sales tax and public utility tax.

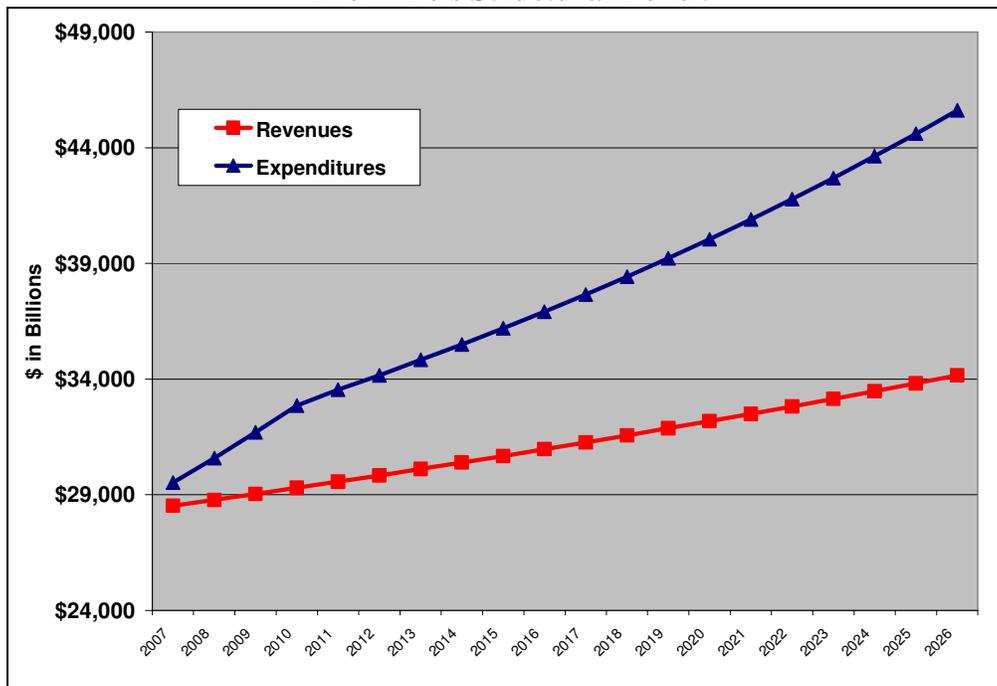
appropriations for all public services, from education to public safety.<sup>40</sup>

Not only does revenue growth fail to keep pace with inflation when comparing revenue from one year to the next, but it also fails to cover the increase in the cost of public services caused by inflation annually.<sup>41</sup> The net result is that every year, the cost of just *continuing* the prior year's level of public services is more than what natural revenue growth can cover. This is what ultimately creates the pressure for public officials to under fund pensions to help maintain current operations.

In essence, most fiscal problems in Illinois really can be traced to, one, very simple phenomenon: while the cost of providing public services grows normally with the economy over time, the state's poorly designed tax system does not grow with the economy, and hence generates less revenue than needed to maintain current public service levels and make the required pension payments from year to year, adjusting solely for inflation.

The inability of a tax system to generate enough revenue to maintain funding the same level of public services from year to year is called a “structural deficit”. Figure 8 illustrates the Illinois structural deficit. The graph in Figure 8 assumes that: the economy is healthy and grows by a robust four percent per year over the next decade and no new programs and no program expansions are passed, only current programs are maintained. The graph then measures the projected costs of maintaining current services over the next decade against projected state revenue increases, adjusting solely for inflation based on the CPI and population growth.

**Figure 8**  
**The Illinois Structural Deficit**



So, even without adding any new programs, the costs to Illinois of providing essential public services like education, transportation, public safety and environmental protection, increase due to economic factors outside the state's control, such as inflation, population growth, healthcare

<sup>40</sup> The Fiscal Year 2007 General Revenue Fund budget is \$25.7 billion.

<sup>41</sup> Center for Tax and Budget Accountability, *Analysis of the FY 2007 General Fund Budget Proposal*, February 2006.

costs and the Pension Ramp. Since Illinois is required by law to balance its budget, and the state's structural deficit has meant there was never enough revenue to cover inflationary costs in the first place, policymakers consistently have been confronted with the politically difficult choice of either significantly reducing the level of public services to pay pension contributions, or modernizing how the state taxes to raise adequate current revenue for the state to pay its bills. Instead of confronting this politically difficult dilemma head-on, policymakers have generally made a fiscally unsound, third choice year after year: defer making the full employer pension contributions then due, just to maintain current services.

For the most part, **the Illinois structural deficit is not caused by the state continually adding programs or engaging in wasteful spending.**<sup>42</sup> Instead, it is caused primarily by an antiquated, regressive state tax system that simultaneously overtaxes low and middle-income working families while failing to respond to the modern economy.<sup>43</sup> In fact, as Figure 9 demonstrates, on an inflation adjusted basis,<sup>44</sup> over the last decade Illinois has cut aggregate spending on all public services other than education, healthcare and the pension system. Put another way, paying for the state's prior deferment of its obligation to fund pensions has cut into Illinois' ability to fund current public services, and has exacerbated Illinois' ongoing fiscal problems.

**Figure 9**  
**Inflation Adjusted Comparison (CPI) of State General Revenue Fund Expenditures Over the Last Decade (\$ in billions)**

Budget Category	FY 1995 Actual	FY 1995 Inflation Adjusted to FY2006 using CPI	FY 2006 Enacted	\$ Difference Between 1995 Adj'd for Inflation (CPI) & 2006 Enacted
<b>General Fund</b>	\$17,302.0	\$22,613.7	\$24,406.4	\$1,792.7
<b>Education</b>	\$3,656.0	\$4,778.4	\$6,093.0	\$1,314.6
<b>Health Care</b>	\$4,319.0	\$5,644.9	\$7,034.0	\$1,389.1
<b>Pensions</b>	\$519.0	\$678.3	\$938.4	\$260.1
<b>All public services except Education, Health Care &amp; Pensions</b>	\$8,808.0	\$11,512.1	\$10,341.0	<b>-\$1,171.1</b>

## 8. Prior Attempts to Address the Problem

(a) **The 50-Year Funding Plan.** The state attempted to address its unfunded pension liability in 1994, pursuant to a change in Illinois law created under P.A. 88-0593, which became commonly known as the "**Pension Ramp**". Intended to force increased allocations to the pension over time, this reform established a timeframe during which Illinois was required to fund the current pension contribution the state owed for existing employees (the "**Normal Cost**"), plus make up unpaid contributions and the return thereon for prior employees, amortized over 50 years with a target of funding 90% of total actuarial liabilities by 2045.

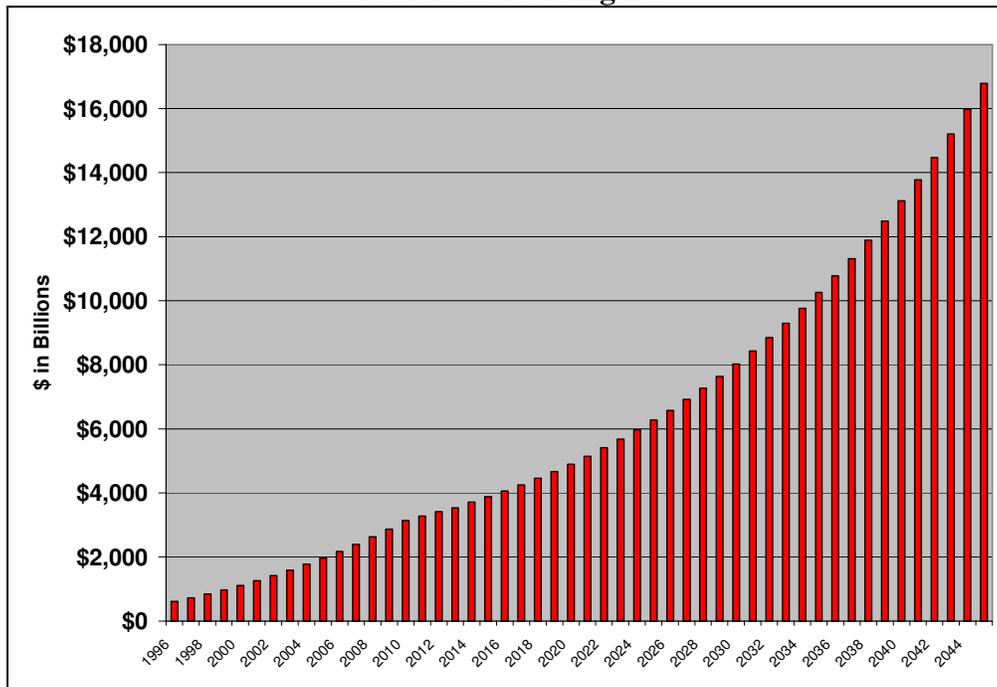
Given that the total unfunded liability had grown so large, the legislation created a framework that established a 15 year ramp period, during which the newly mandated contributions Illinois had to make for current and past employees increased in gradual increments. Since these make-up payments increased annually, they became known as the "**Pension Ramp**", that is, they "ramp-up" over time. Figure 10 below shows how dramatic the original Pension Ramp was.

<sup>42</sup> Center for Tax and Budget Accountability analysis of final budget expenditures since 1995.

<sup>43</sup> Institute on Taxation and Economic Policy, *Balancing Act: Tax Reform Options for Illinois*.

<sup>44</sup> United States Department of Labor, Bureau of Labor Statistics, Consumer Price Index, CPI-U.

**Figure 10**  
**1996-2045 Pension Ramp**  
**Under 1995 Funding Law**



The Pension Ramp became operative in Fiscal Year 1996. Under the plan, if Illinois satisfied its obligations under the Pension Ramp, the state's pension systems would have achieved a Funded Ratio of 90% by the year 2045. The initial 15 year ramp up period was designed to allow Illinois to adapt to its increased financial obligations, because there simply was not enough revenue to move immediately to the appropriate level percentage of payroll to fund the pensions systems or to amortize the liability over a shorter period.

Since it passed, Illinois funded the Pension Ramp as required every year, except FY2006 through 2007.<sup>45</sup> However, the annual increases in the required contribution under the intended Pension Ramp vastly outpace natural growth in the state's tax revenue. This reality, coupled with the constitutional requirement that Illinois balance the budget, meant the state would have to cut spending significantly on services to fund the Pension Ramp, particularly in out years. The net result, Illinois' fiscal system simply could not accommodate the significant contribution increases contemplated under the Pension Ramp. The first major threat to the Pension Ramp was averted with the sale of \$10 billion of pension obligation bonds, discussed below. Then, reverting to past poor fiscal practices, the state significantly underfunded pensions in FY2006 and FY2007, to maintain, and in some cases expand, services.

**(b) Pension Bond Sale.** Continuing historic trends, in 2004 the state confronted another significant shortfall between the costs of both maintaining the prior year's level of public services and paying the Pension Ramp on the one hand, and recurring revenues generated on the other. This time, the deficit was \$2.4 billion.<sup>46</sup> Since no new revenue options were on the table, and cutting services across the board by almost 10%—the amount needed to balance the books—was not politically viable and poor public policy to boot, the state elected to close the deficit, maintain

<sup>45</sup> Commission on Government Forecasting and Accountability, *Report on the Financial Condition of the Illinois Public Employee Retirement Systems*, August, 2006.

<sup>46</sup> Center for Tax and Budget Accountability, *Fiscal Year 2004 Budget Wrap-Up*, June 2004.

public services and make the required pension payments, by issuing \$10 billion in pension obligation bonds. This bond transaction worked out well for the state because equity market rates were low and the cost of issuing the bonds, right around 5.0% in interest, was significantly less than what the state would have had to pay in investment return—8.0% to 8.5%—if it simply underfunded the pensions again. In fact, refinancing a portion of the unfunded pension contribution liability at the lower bond rate was a hedge maneuver that actually saved Illinois money. The savings were so significant that they would have reduced the state's long-term pension liability, if all proceeds received from the sale of the bonds were used to refinance accrued and unfunded pension liabilities.

But that did not happen. Instead, only \$7.3 billion of the \$10 billion in bond proceeds was distributed to the five pension systems to reduce the existing unfunded liability. This effectively refinance \$7.3 billion of unfunded liability at around 5.0% (the bond interest cost) rather than the higher 8.0%-8.5% pension return rate that would otherwise accrue. Because state revenues were again less than what was necessary to make the then due pension contribution and maintain public services, the state used \$2.1 billion of the balance of the bond proceeds as a one-time revenue source to fund its then current pension contributions to the five systems, covering a 15-month period. The final \$500 million of pension bond proceeds was used to cover the first year interest on, and one-time costs of, issuing the bond.

Use of a significant portion (\$2.1 billion) of the pension obligation bond proceeds to cover the state's then current pension contribution rather than to refinance existing unpaid pension contributions had two significant consequences. First, the state's long-term pension related costs were neither reduced nor increased. Instead, the costs of servicing the \$10 billion pension obligation bond offset on a dollar-for-dollar basis, the savings the state realized from using \$7.3 billion in pension obligation bond proceeds to refinance unfunded liabilities owed to the state's five pension funds. If, however, Illinois had used all \$10 billion of the proceeds from the pension obligation bonds to retire unpaid pension liabilities, and used current revenue to make the pension contributions then due for the most recent 15-month period, the state would have saved billions of dollars in pension payments over the long-term. By using \$2.1 billion of the proceeds to cover its current contribution to the pension system, however, Illinois was able to avoid making \$2.1 billion in cuts to services.

**Figure 11**  
**Allocation of the \$10 Billion Pension Bond Sold in 2004**

Total Allocation of Pension Funding Bond Proceeds <sup>47</sup>	\$ Amount
Deposit into the five retirement systems	\$7,317,292,916
Funding the then Current (15 months) of State Pension Contributions	\$2,160,000,000
Capitalized Interest (to cover 1st year's debt service)	\$481,038,333
Discount Cost of Issuance	\$41,668,750

## **9. Benefit Increases**

Excess and unanticipated investment return generated during the dot com boom in the mid to late 1990's actually resulted in an improved funded ratio by 2000. Since that time, as outlined in Figure 12, over \$5.8 billion in new pension benefit enhancements were added, not all of which were fully funded. Some of these enhancements were intended to raise substandard Illinois public employee benefits to a comparable level in relation to other states. State and university employees and teachers covered a portion of the cost of these benefit increases through a combination of greater employee contributions, forgone wage increases and reductions in other benefits such as sick leave and retiree health insurance. As stated previously, pension benefits in

<sup>47</sup> Illinois Office of the Comptroller, *Fiscal Focus Quarterly*, February, 2005.

Illinois are about equal to the national average, even with these enhancements. This of course increased the State's overall unfunded pension liability. In addition, an economic downturn after 2000 caused poor performance on investments so that by 2003, the state's Funded Ratio had fallen back to 48.6 percent.

**Figure 12**  
**New Pension Benefits Added Since 2000**

<b>Year</b>	<b>Description</b>	<b>Cost (\$ m)</b>
1995	TRS Early Retirement Incentive	\$150
1997	SURS converted from step rate to flat formula	\$180
1998	TRS converted from step rate to flat rate	\$1,000
1998	SERS converted from step fate to flat rate (not incld alt formula); Alt formula final rate of pay converted from average of final four years to pay on final day	\$1,250
2001	SERS "Rule of 85" added. Alternative formula converted from step rate to flat rate	\$650
2002	SURS added 30 years of service and out provision	\$60
2002	SERS added highway maintainers and DHS security to alternate formula	\$170
2003	SERS Early Retirement Incentive	\$2,370
<b>Total</b>		<b>\$5,830</b>

**10. The 2002 Early Retirement Incentive (ERI) Worsened the Unfunded Pension Liability**

In 2002, as then Governor Ryan and the General Assembly negotiated the FY2003 budget, it was again clear that Illinois did not have enough revenue to cover the twin costs of maintaining services and making the required pension payments. Governor Ryan proposed offering current state employees (in both SERS and TRS) an early retirement incentive ("ERI"), as a way to free up revenue that otherwise would have gone to employees' salaries and benefits. It was anticipated that 7,300 employees would take the option, which would have saved Illinois \$65 million in payroll related costs FY 2003.<sup>48</sup>

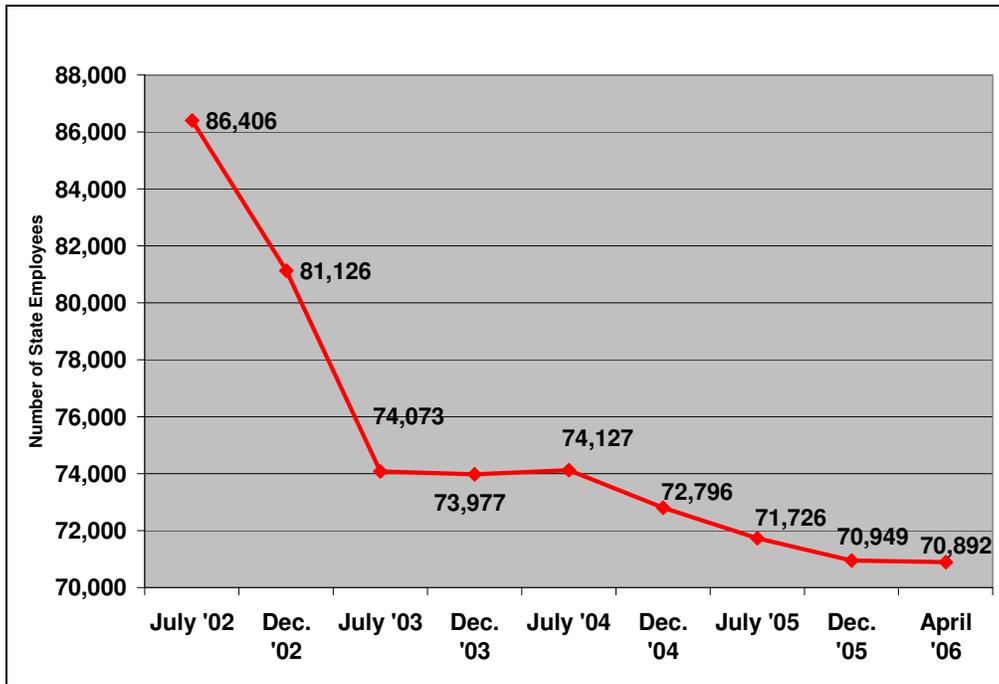
The state, however, underestimated how many people would take advantage of the ERI by almost 4,000. So, for a 2003 salary savings and budget relief of \$115.1 million, the 2002 ERI ended up costing \$2.3 billion in increased unfunded liabilities to the state pension systems.<sup>49</sup> That is a whopping \$1.7 billion more than the original estimate of \$622 million.<sup>50</sup> The sole funding source policymakers identified to cover the ERI was savings from the projected reduction in payroll.

<sup>48</sup> Illinois Office of the Comptroller, *Fiscal Focus Quarterly*, July 2002.

<sup>49</sup> Commission on Government Forecasting and Accountability, *Report on the Cost and Savings of the State Employees' Early Retirement Incentive Program*, June 2006.

<sup>50</sup> State of Illinois FY 2006 Budget Book.

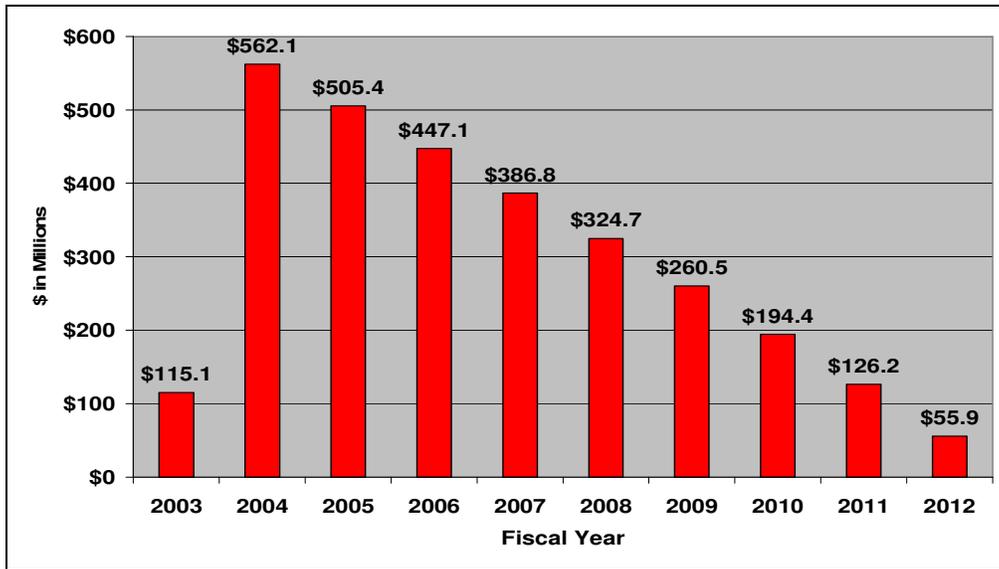
**Figure 13<sup>51</sup>**  
**Impact of the ERI on State Employee Headcount: FY 2003 – FY 2006**



However, the state's ongoing revenue underperformance, which was the reason for the ERI in the first place, was so severe, that the payroll savings were used to cover maintenance of existing services, rather than funding the ERI. So, despite not hiring back the vast majority of the 11,000 workers who took the ERI and left the state's employ, there was no revenue available to cover this new, \$2.3 billion pension contribution. Under the original ERI legislation, the state was supposed to pay the entire added liability off in 10 years, at \$280.5 million per year, beginning in FY 2006. However, in the category of old habits die hard, the state simply added this new liability to the Pension Ramp under Senate Bill 27, rather than pay it off in the promised ten years. The net result, Illinois taxpayers, not payroll savings, will fund the ERI through 2045.

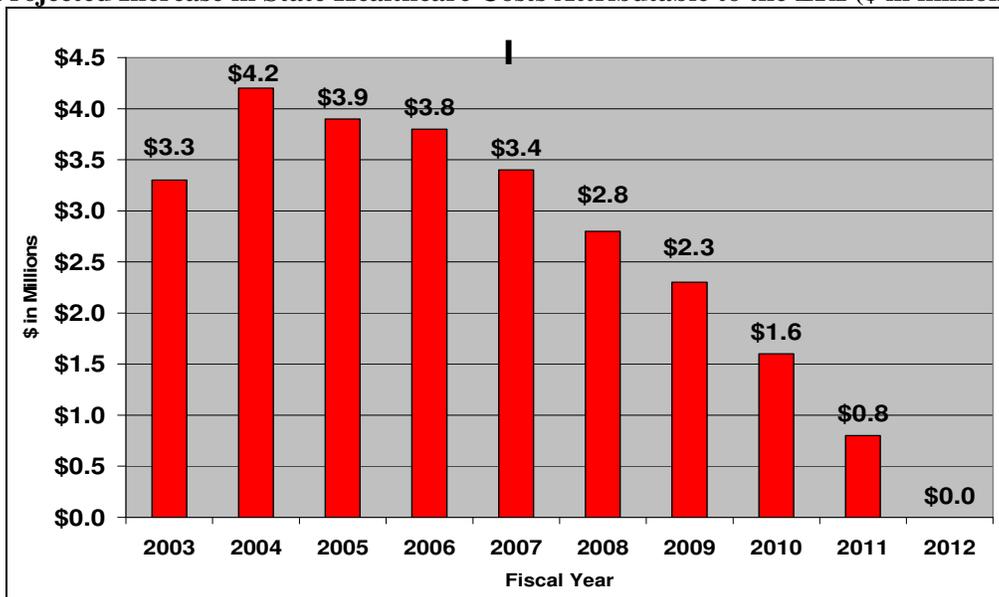
<sup>51</sup> Commission on Government Forecasting and Accountability, *Report on the Cost and Savings of the State Employees' Early Retirement Incentive Program*, June 2006

**Figure 14<sup>52</sup>**  
**Projected Payroll Related Savings Attributable to the ERI (\$ in millions)**



Essentially, through payroll savings, the 2002 ERI created 10 years worth of one-time revenues to fund services. But the state must pay the long-term increased costs of more retirees and increases in retiree healthcare costs. The ERI also resulted in a “bare bones” staff to provide necessary public services, as historically, Illinois has not been a high public employee head count state<sup>53</sup> and now actually ranks 50<sup>th</sup> among the states in number of public employees per capita.<sup>54</sup>

**Figure 15<sup>55</sup>**  
**Projected Increase in State Healthcare Costs Attributable to the ERI (\$ in millions)**



<sup>52</sup> Commission on Government Forecasting and Accountability, *Report on the Cost and Savings of the State Employees' Early Retirement Incentive Program*, June 2006. Savings include reduced payroll and related benefit costs and reduced lump sum payouts for unused sick and vacation leave.

<sup>53</sup> United States Census Bureau, *Statistical Abstract of the United States, 1993-2006*.

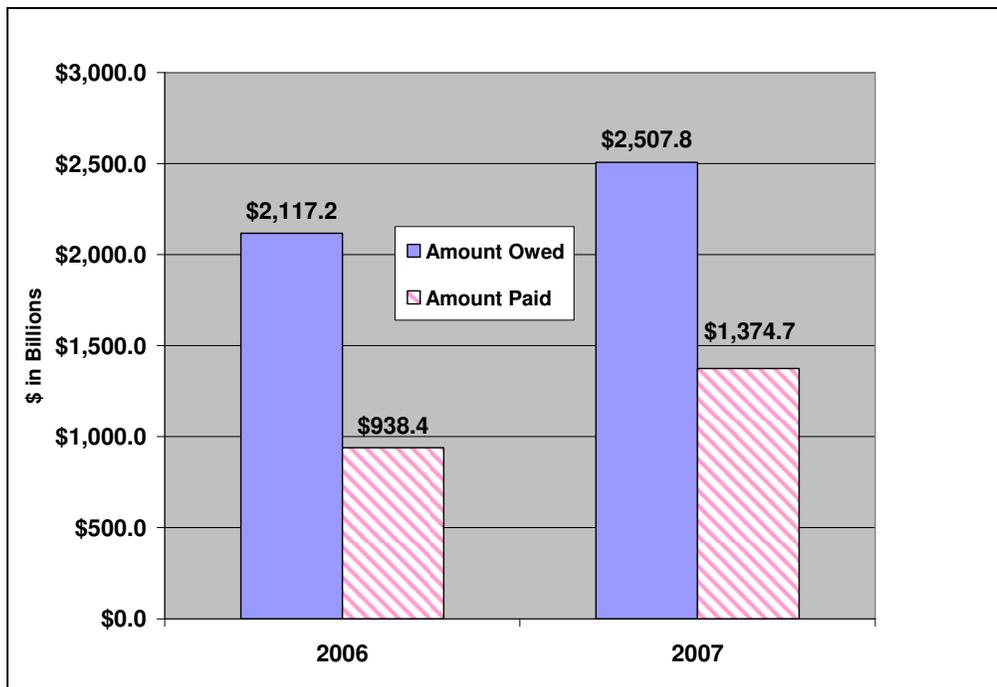
<sup>54</sup> Based on 2006 United States Census Bureau Data.

<sup>55</sup> *Ibid.*

## **11. Inadequate Revenues Caused the State to Under Fund the Pensions in Fiscal Years 2006 and 2007**

(a) **Costs of the Recent Pension Holiday.** When constructing the budget for Fiscal Year 2006 ("FY2006"), the Governor and General Assembly found that, once again, the Illinois fiscal system had failed to generate enough revenue to fund both the pension contribution required by the Pension Ramp, and the same level of public services provided in the preceding Fiscal Year, 2005. Because Illinois is constitutionally mandated to balance its budget, the state's revenue shortfall meant Illinois either had to cut essential services by over 10% across the board, raise taxes and fees, or not make the required pension contribution. On a strictly partisan vote, the General Assembly elected not to make its scheduled pension contributions for Fiscal Years 2006 and 2007 under the Pension Ramp. This was accomplished through legislation that created a two-year, partial "**Pension Holiday**" under P.A. 094-0004 (Senate Bill (SB) 27).

**Figure 16**  
**FY 2006 and FY 2007 Pension Holiday Shortfall**



Effectively, this Pension Holiday repeats the past practice of not making required pension contributions, just to maintain current services. As Figure 17 shows, Illinois freed up \$2.3 billion spread over two fiscal years to fund public services by taking the recent Pension Holiday.

**Figure 17**  
**Contribution Under Funding Attributable to the FY2006-2007 Pension Holiday<sup>56</sup>**

<b>Required Yearly Pension Payments to the Five State Retirement Systems: FY 2006 &amp; FY 2007 Pre vs. Post FY 2006 Pension Holiday (\$ in billions)</b>			
<b>Fiscal Year</b>	<b>Amount Owed</b>	<b>Amount Paid</b>	<b>Amount of Under funding used to Cover Current Services</b>
2006	\$2,117.2	\$938.4	<b>-\$1,178.7</b>
2007	\$2,507.8	\$1,374.7	<b>-\$1,133.2</b>

As with prior practice, the current Pension Holiday created long-term costs. Effectively, the state added \$2.3 billion to the unfunded liability and must pay it, with interest, until 2045. As the Commission on Government Forecasting and Accountability states, “...*deferring State contributions makes the new benefit structure of the retirement systems more expensive than the previous benefit structure.*”<sup>57</sup>

**Figure 18**  
**Breakdown of FY2006-FY2007 Pension Holiday Impact by Pension System  
 \$ in Millions**

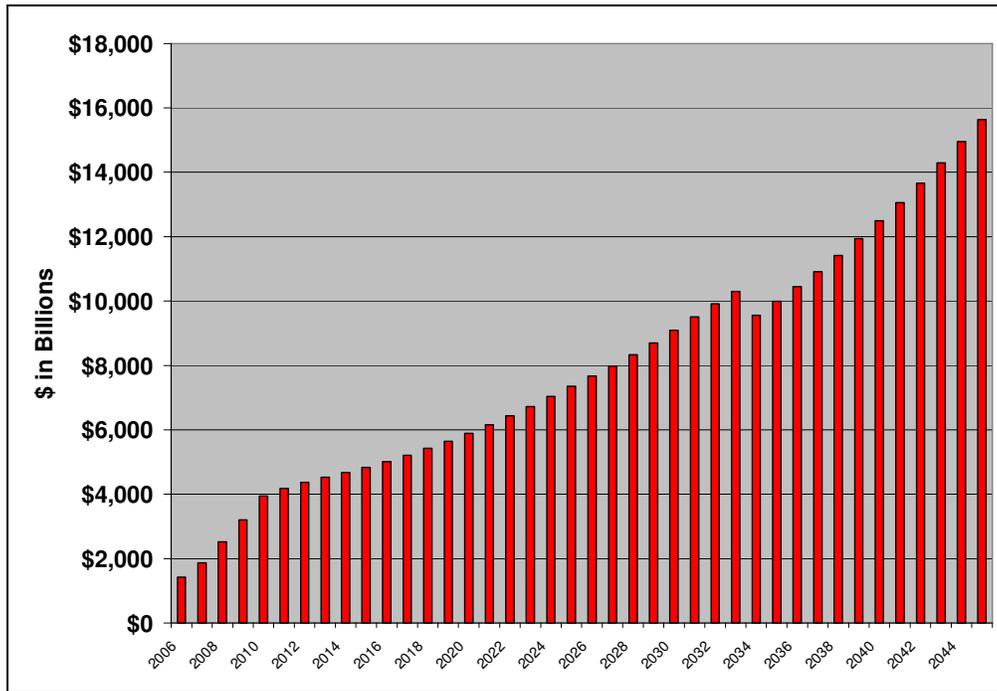
<b>FY 2006</b>				<b>FY 2007</b>			
<b>System</b>	<b>Pre-Pension Holiday Required Contribution</b>	<b>Actual Contribution After the new Pension Holiday</b>	<b>Amount of Shortfall Used to Fund Current Services</b>	<b>System</b>	<b>Pre-Pension Holiday Required Contribution</b>	<b>Actual Contribution After the new Pension Holiday</b>	<b>Amount of Shortfall Used to Fund Current Services</b>
<b>TRS</b>	\$1,058.5	\$534.6	-\$523.9	<b>TRS</b>	\$1,233.1	\$738.0	-\$495.1
<b>SERS</b>	\$690.3	\$203.8	-\$486.5	<b>SERS</b>	\$832.0	\$344.2	-\$487.8
<b>SURS</b>	\$324.9	\$166.6	-\$158.3	<b>SURS</b>	\$391.9	\$252.1	-\$139.8
<b>JRS</b>	\$38.0	\$29.2	-\$8.8	<b>JRS</b>	\$44.5	\$35.2	-\$9.3
<b>GARS</b>	\$5.5	\$4.2	-\$1.3	<b>GARS</b>	\$6.3	\$5.2	-\$1.1
<b>TOTAL</b>	<b>\$2,117.2</b>	<b>\$938.4</b>	<b>-\$1,178.8</b>	<b>TOTAL</b>	<b>\$2,507.8</b>	<b>\$1,374.7</b>	<b>-\$1,133.1</b>

Figure 19 demonstrates the Pension Holiday’s affect on the pension ramp. This displays the dramatic increases in required pension payments through 2045. Making these payments is highly unlikely under the current tax system, without drastically cutting public services. For example, in FY 2006, the state was unable to meet the required contribution of \$2.1 billion, actually paying less than half that amount. Under this new ramp, next year (FY 2008) the state will owe over \$2.5 billion and just three years later, over \$4 billion. In later years the state will owe between \$11 and 15 billion.

<sup>56</sup> Commission on Government Forecasting and Accountability, August 2005 Monthly Briefing.

<sup>57</sup> Ibid.

**Figure 19<sup>58</sup>**  
**Required Yearly Pension Payments**  
**FY 2006 – FY 2045**



**(b) Pension Cost Savings/Benefit Reductions Included in the Recent Pension Holiday Legislation.**

The Pension Holiday did not just create long-term costs. The legislation, P.A. 094-0004 (SB 27), also included a number of benefit reductions and long-term reforms designed to reduce future pension related expenditures. Following is a summary of the long-term cost savings included in the FY2006-2007 Pension Holiday legislation.

- (i) **Alternative Formula Changes (SERS).** The alternative formula pension benefit was introduced as a method to attract people to high-risk jobs such as prison guards, police officers, and fire fighters. The formula calculates final retirement benefits for individuals who perform these high risk jobs at a greater rate than for other state employees who have the same salary and years of service. It also allows employees who work high risk jobs to retire earlier than other state employees. SB 27 reduced the number of types of positions eligible for this alternative formula.
- (ii) **Money Purchase Option (MPO) Changes (SURS & TRS).** The MPO is a formula used by SURS to determine the rate of interest when calculating retirement benefits. Before the Pension Holiday, employees had the option to have their retirement benefits calculated under the General Formula and under the MPO and receive whichever had a higher benefit. The MPO rate was set by the SURS board and based on historic pension performance. SB 27 eliminated the MPO for new employees under SURS and required the Comptroller to determine the interest rate. In September 2005, Comptroller Dan Hynes announced that the interest rate for Fiscal Year 2006 was

<sup>58</sup> Commission on Government Forecasting and Accountability, *Report on the 90% Funding Target of Public Act 88-0593*, January 2006.

8.5% and the interest rate for FY 2007 will be 8.0%, lower than the 9.0% rate set by the SURS trustees for FY 2005. SB 27 also eliminated the MPO for new TRS members.

- (iii) **Salary Increase Payments (SURS & TRS).** SB 27 restricts the end of career salary raises for teachers, school administrators and university personnel to 6% in the years used to determine final average salary for retirement benefit purposes. Because benefits are calculated based on average salary over the final four years of service, this change prevents school districts and universities from granting large salary increases in the final years as incentive compensation, something that had become a highly criticized practice. Now, if an individual's salary increase is greater than 6% over the final four years of service, the school district or university granting said raise must pay the pension costs for the overage.
- (iv) **Sick Leave Credit (TRS).** SB 27 changed the amount of sick leave teachers can be credited with at the end of their careers. It does not allow sick leave to be awarded solely based on retirement.
- (v) **Extension of Current Early Retirement Option (ERO) (TRS).** SB 27 extends the current ERO for teachers to July 1, 2007. Qualifying members must have notified their employer in writing by July 1, 2005.
- (vi) **New ERO for the TRS.** SB 27 requires higher contribution rates for employers and employees retiring under the new ERO (it decreases state contributions). It also limits the amount of those retiring under the ERO to 10% of those eligible.
- (vii) **Required Funding Source for New Benefits (All Pension Systems).** SB 27 requires a new, sustainable funding source be identified to cover the cost of any benefit increases passed by the legislature.
- (viii) **Advisory Task Force on Pension Benefits (All Pension Systems).** SB 27 creates a 15-member task force to make recommendations to the Governor. Eight of its members are appointed by the Governor. Additionally, each legislative leader appoints one member. The executive directors of TRS, SERS, and SURS are also members.

**Figure 20<sup>59</sup>**  
**Comparison Pre and Post Pension Holiday: FY 2006 – FY 2045**

	Scheduled Payments through 2045, before the Pension Holiday Act	Scheduled Payments through 2045, after the Pension Holiday Act	\$ Difference: Pre P.A. 094-0004 - Post P.A. 094-0004
TRS	\$160,302,000,000	\$156,021,600,000	-\$4,280,400,000
SERS	\$68,065,500,000	\$78,068,200,000	\$10,002,700,000
SURS	\$61,183,700,000	\$56,521,400,000	-\$4,662,300,000
GARS	\$861,981,203	\$876,902,225	\$14,921,022
JRS	\$6,538,170,457	\$6,653,848,682	\$115,678,225
<b>Total</b>	<b>\$296,951,351,660</b>	<b>\$298,141,950,907</b>	<b>\$1,190,599,247</b>

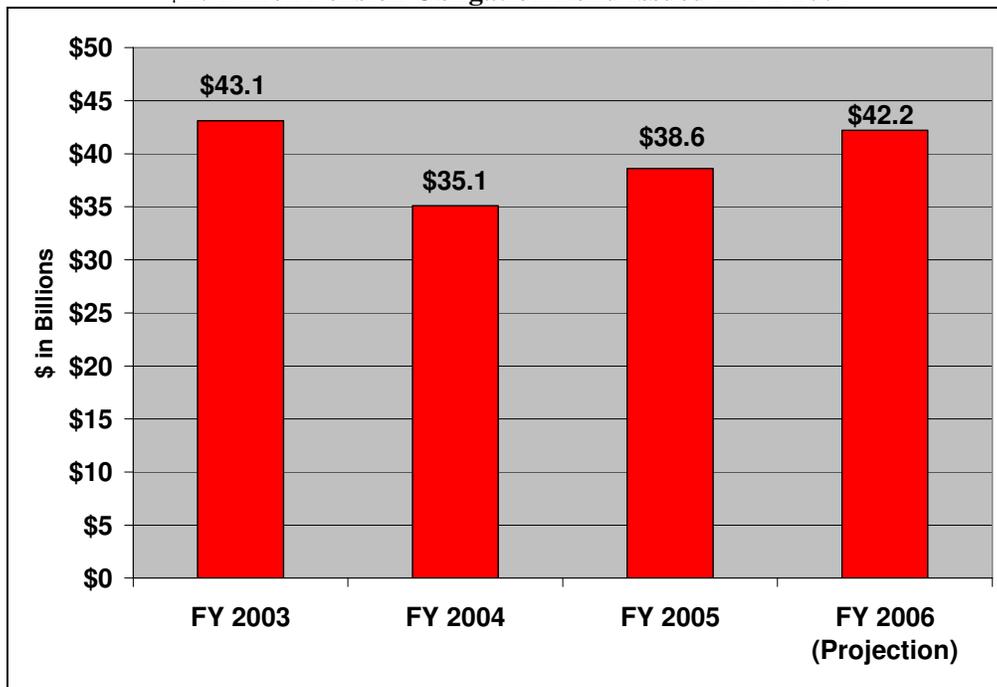
<sup>59</sup> Center for Tax and Budget Accountability analysis of Commission on Government Forecasting and Accountability data. Figures include COGFA TRS salary assumptions and a 7.5% SURS Money Purchase Option rate.

**(c) Partial Pension Holiday Contributes to \$7 Billion increase in Unfunded Liability In Only Three Years**

The partial pension payment holidays (SB 27) taken in FY 2006 and FY 2007 contributed to increasing the state’s unfunded liability by \$7.1 billion in only three years. During that period, no retirement benefits were increased.

Figure 21 displays that even though the state issued a \$10 billion pension obligation bond in FY 2004, because interest on the unfunded liability compounds at between 8.0% and 8.5%, any payment shortfall, such as the pension holiday, quickly increases the unfunded liability.

**Figure 21<sup>60</sup>  
Increase in Unfunded Liability since FY 2003  
\$10 Billion Pension Obligation Bond Issued in FY 2004**



**12. The State Does Not Only Have Pension Debt Problems: Analysis of the State’s Bonded Debt**

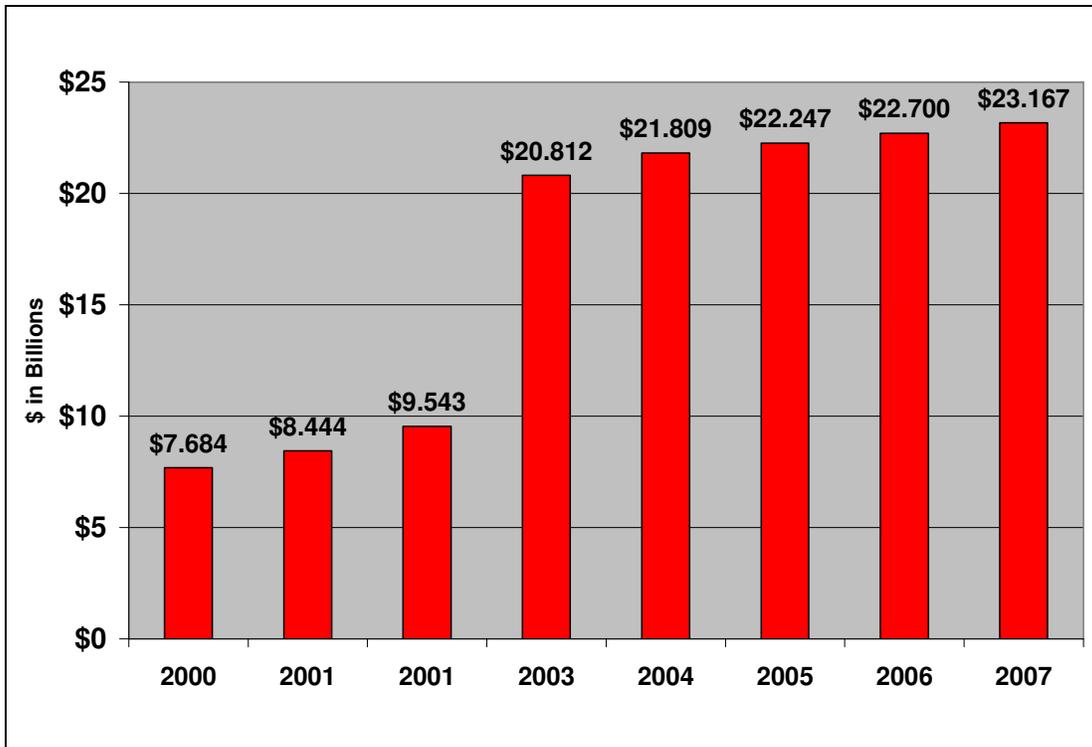
(a) **Overview.** Illinois is not only burdened by pension debt. Debt from state supported general obligation bonds and state issued revenue bonds have also increased dramatically over the past six years. Illinois uses these bonds to finance large public works projects such as roads, bridges, housing developments and universities. Issuing bonds to build a road is similar to a family purchasing a home. Like the state, most families cannot afford to pay cash upfront to buy a home, so they must take out a mortgage and finance the purchase over a number of years. The homeowner will pay more than the stated purchase price of the home in interest because the purchase is being financed over time. Incurring the debt and paying interest is still a wise investment, however, because the house will have a long useful life, justifying the long term debt related costs associated with the purchase. The same goes for public indebtedness, if used wisely to create long-term assets, paying more in debt costs over time is both logical and the only way to create public infrastructure sorely needed for economic development and quality of life.

<sup>60</sup> Illinois Auditor General

Of course, the more debt the state takes on, the more it must pay back in interest over time. Much of the debt the state incurs must be paid from the same revenue streams that fund public services through the General Revenue Fund. Hence, a state must always monitor its debt position to make sure it is manageable, and won't constrain the state's long-term ability to pay for public services.

Figure 22 below shows the state's outstanding debt, not including the unfunded pension liability. It illustrates the growth in state-supported principal outstanding debt from 2000-2006. Since 2000, the state has issued over \$15 billion in debt. Much of this increased bond indebtedness - \$10 billion – came in the form of pension obligation bonds. Recall that \$7.2 billion of the pension obligation bond proceeds essentially refinanced pension debt at a lower, far more cost effective rate for the state. While this arbitrage transaction overall worked in the state's favor, it still increased Illinois' legal bond indebtedness position.

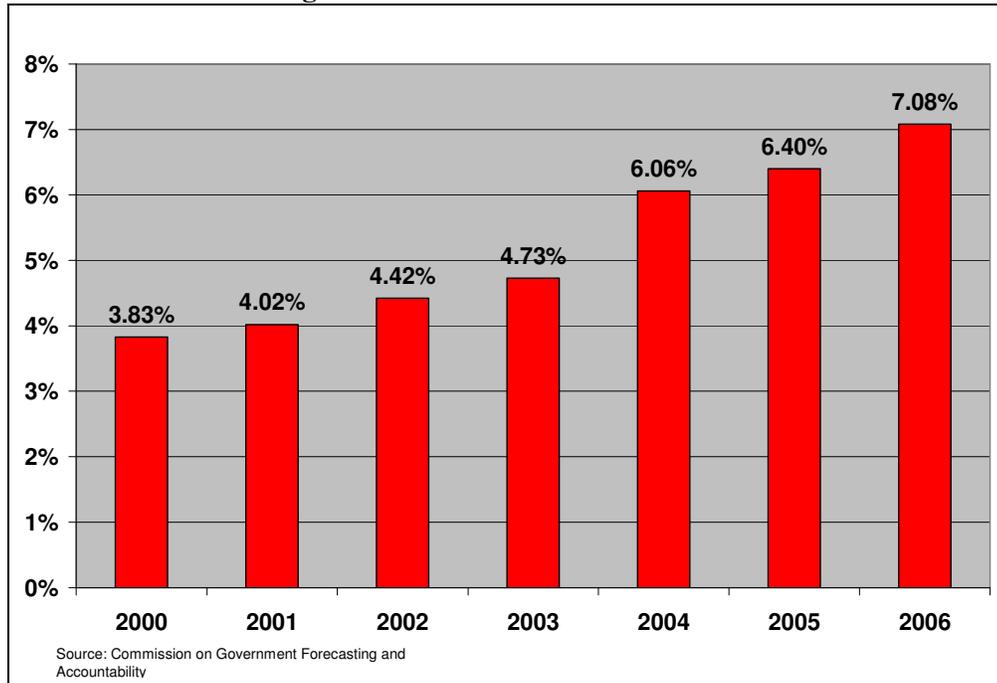
**Figure 22<sup>61</sup>**  
**Growth in State Issued Revenue and**  
**General Obligation Bond Debt - 2000-2006**



<sup>61</sup> Commission on Government Forecasting and Accountability, *Fiscal Year 2007 Budget Summary of the State of Illinois*, August 2006. Note the 2003 increase is due to the Pension Obligation Bond.

Obviously, as the state incurs more debt over time, it has to pay increased debt service costs. As Figure 23 displays, since 2000, the percentage of Illinois' total general fund revenues devoted to paying debt service costs has risen from under 4.0% to over 7.0% of total revenues. In dollars, that means almost \$2 billion of all general funds will be used to pay debt and interest in FY 2006, rather than funding public services.

**Figure 23<sup>62</sup>**  
**General Obligation and State-Issued Revenue Debt**  
**As a Percentage of General Fund Revenues - 2000 - 2006**



**(b) Debt Comparisons: Illinois v. Other States**

By any metric, Illinois has a very high level of state debt. Illinois has more total debt than only two other states, California and New York. In 2004, Moody's reported Illinois owned 7.5% of the total national debt. Moody's also concluded that, one of the reasons the national median debt per capita increased rapidly from 2003 to 2004, was because Illinois issued so much debt in 2004 (i.e. the \$10 billion in pension obligation bonds).<sup>63</sup>

Total debt is not the only metric used to evaluate whether a state's debt position is appropriate. Debt per capita is frequently used to determine whether a state can support its outstanding debt. For both 2003 and 2004, Illinois jumped from 11<sup>th</sup> to 6<sup>th</sup> in the nation in tax supported debt per capita, primarily because of the issuance of the pension obligation bonds.<sup>64</sup> Illinois remained there for 2004, the latest national comparison available.<sup>65</sup> As Figure 24 shows, currently state debt per capita in Illinois is \$2,019, which is more than double the national average of \$999 per capita.<sup>66</sup> The National Association of State Budget Officers has concluded that, when per capita debt is more than \$1,200, as it is in Illinois, the debt is "unmanageable" for the state.<sup>67</sup>

<sup>62</sup>Commission on Government Forecasting and Accountability, *Bonded Indebtedness Report*, 2005.

<sup>63</sup>Moody's Investors Services, *2005 State Debt Medians*, May 2005.

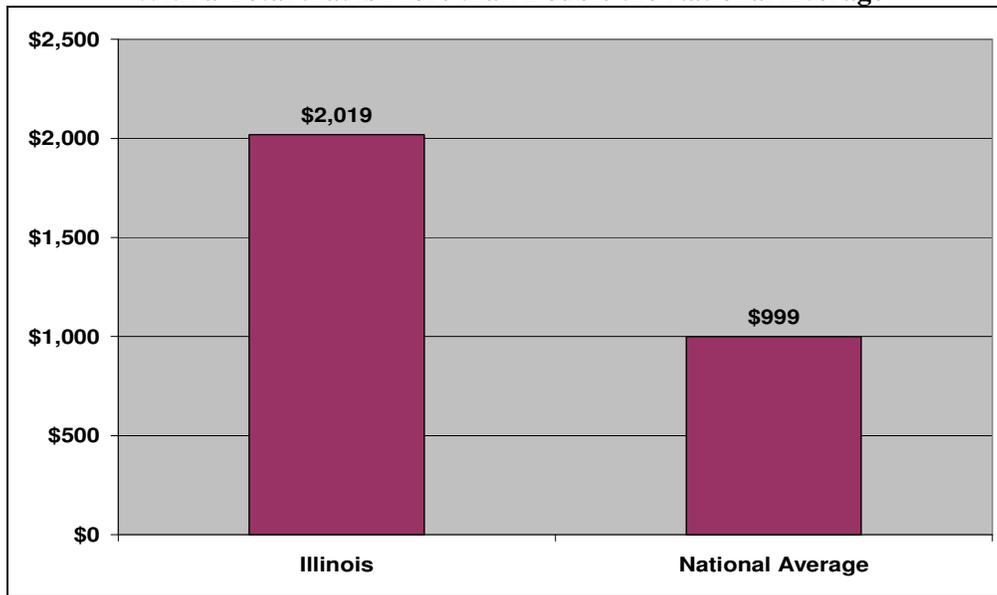
<sup>64</sup>Commission on Government Forecasting and Accountability, *Bonded Indebtedness Report*, 2005.

<sup>65</sup>Moody's Investors Services, *2005 State Debt Medians*, May 2005.

<sup>66</sup>Ibid.

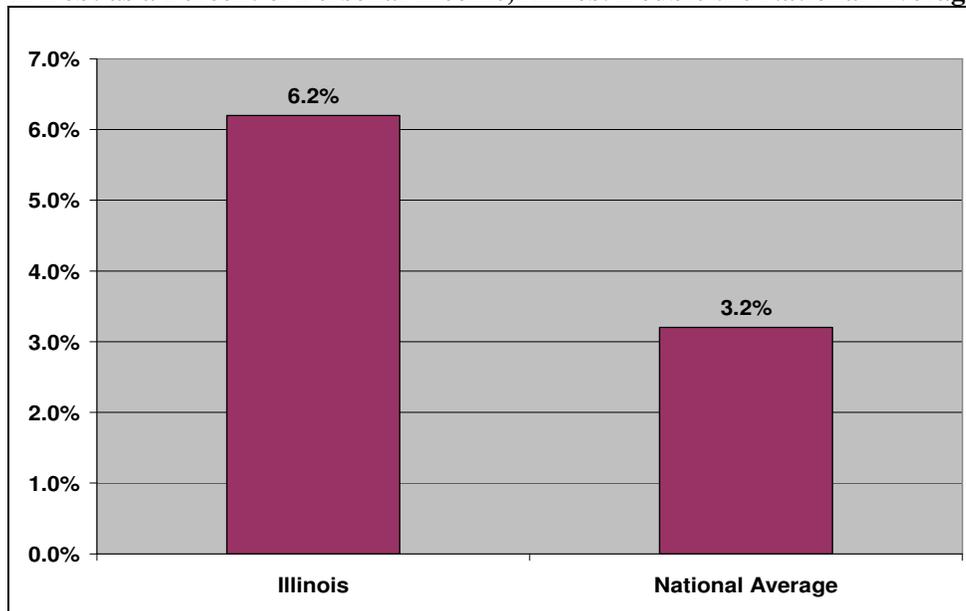
<sup>67</sup>National Association of State Budget Officers, NASBO Budget Analyst Training Program.

**Figure 24<sup>68</sup>**  
**Illinois Tax-Supported Debt Per Capita: Ranks 6<sup>th</sup> Highest Nationally,  
 With a Total that is More than Double the National Average**



The final barometer used to evaluate a state's overall debt position compares total state debt to personal income in that state. Again, Illinois ranks high nationally when comparing tax-supported debt as a percentage of personal income, with a total approaching twice the national average, as show in Figure 25.

**Figure 25<sup>69</sup>**  
**Tax Supported Debt as a Percent of Personal Income: Ranks 6<sup>th</sup> Nationally  
 in Debt as a Percent of Personal Income, Almost Double the National Average**



It is worth bearing in mind that all the debt figures cited in this Section of the Report do not include the projected \$42.2 billion in unfunded pension obligations owed by the state.

<sup>68</sup>Moody's Investors Services, *2005 State Debt Medians*, May 2005.

<sup>69</sup>Ibid.

### (c) **How Does Debt Affect the State's Credit Rating?**

In May 2003, Moody's lowered the state's credit rating from Aa2 to Aa3, after Illinois sold \$1.5 billion in bonds, just to pay overdue bills.<sup>70</sup> Fitch also lowered the state's rating from AA+ to AA.<sup>71</sup> Reductions in bond ratings have real world consequences. When a state's credit rating is lowered, it faces higher interest and insurance costs when it borrows money. Moody's assigns Illinois a lower bond rating than 30 states in its credit rating. Thirteen states rank similar to Illinois and only three have credit ratings lower than Illinois.<sup>72</sup>

Both Moody's and Fitch noted other factors that contributed to Illinois receiving a low bond rating, including poor revenue performance, the pension obligation bond issuance, the state's increasing GAAP deficit, overall budget uncertainty and an increase in state debt ratios.<sup>73</sup> Fitch emphasized Illinois had, "above-average debt levels, a large unfunded pension liability, and constrained finances marked by pension and Medicaid fund pressures."<sup>74</sup> Fitch went on to say, "Persistent sizeable accounts payable liabilities remain and large required pension contributions beginning in fiscal 2008 will pose a challenge [for Illinois]."<sup>75</sup> Noting that Illinois has not raised broad-based taxes for many years, Fitch concluded the state has had to rely on one-time revenue sources, deficit spending, under funding the pension and delaying payments to health care providers, poor fiscal practices all.

### **13. How Will the New GASB 43 and 45 Requirements Affect the State?**

The Governmental Accounting Standards Board ("GASB") promulgates the rules and regulations governmental entities must follow when reporting their financial operations. GASB announced it will change the requirement for how governments report benefits given to former public employees following retirement, that are in addition to pension benefits. Known as "other post-employment benefits" or "OPEB", they include items such as health and life insurance. Beginning in December 2006, GASB is requiring states to report the full amount of accrued other post-employment benefits for all workers, both current and retired.

This new reporting regime is significantly different than the reporting requisite that currently covers OPEB, which are handled on a pay-as-you-go ("PAYGO") system. Under a PAYGO system, the state does not build up assets specifically to cover the cost of future retiree health care and other OPEB. Instead, Illinois simply pays for benefits of current retirees from its current budget as such benefits are claimed. Current regulations do not require states to show future OPEB liabilities.

That reporting will change for fiscal years ending after December, 2006. Pursuant to newly issued accounting and reporting rules 43 and 45, GASB is requiring states to account for and report on the amount of OPEB it will owe all current and former employees over the coming thirty years. These future costs are likely to increase substantially in the next few years as Baby Boomers begin to retire and health care costs escalate.

GASB noted that since OPEB "are part of an exchange of salaries and benefits for employee services rendered,"<sup>76</sup> then "...the cost of OPEB, like the cost of pension benefits, generally should

---

<sup>70</sup> Commission on Government Forecasting and Accountability (COGFA), *Bonded Indebtedness Report*, 2005.

<sup>71</sup> Ibid.

<sup>72</sup> Moody's Investors Services, *2005 State Debt Medians*, May 2005.

<sup>73</sup> COGFA, *Bonded Indebtedness Report*, 2005.

<sup>74</sup> Fitch Ratings, State of Illinois, January 12, 2006.

<sup>75</sup> Ibid.

<sup>76</sup> Governmental Accounting Standards Board Statement No. 45 – Accounting and Financial Reporting by Employers for Post employment Benefits Other Than Pensions, Issued June 2004.

be associated with the periods in which the exchange occurs, rather than with the periods (often many years later) when benefits are paid or provided.”<sup>77</sup>

The new GASB regulations are reporting rules only. They do not change the PAYGO method of funding OPEB. They also do not require governments to set aside money to pay the associated liabilities. Instead, GASB Rules 43 and 45 only require governments to determine the full, anticipated OPEB liability for accounting purposes, ostensibly to help understand the scope of the costs confronting future revenue streams. Illinois can choose either to fund the OPEB or continue to manage them under PAYGO. However, failure to implement a funding mechanism to cover this debt may lead to political, legal and bond rating ramifications (although bond houses in all likelihood already take anticipated liability for future OPEB into account when setting bond ratings), because going forward, any unfunded OPEB obligation must be reported as an unfunded liability on state financial statements.

Given Illinois' budget problems and inability to make the full required pension contributions in FY 2006 and 2007, it is highly unlikely Illinois will have money to set aside to fund future OPEB liabilities.

## **14. Policy Options**

### **(a) Overview**

There are few viable revenue options available that will allow Illinois to pay its unfunded pension contribution liability, and no one option will be sufficient on its own to solve the problem. The first and best option is modernizing the state's tax system to comport with today's economy. This option requires the political will to implement comprehensive reform of the Illinois tax systems, like the framework of SB/HB750, introduced by Senator Meeks in 2004. Under that bill, Illinois would generate renewable revenue that grows with the modern economy, sufficient in amount to fund current service levels, plus Normal Costs of the five pension systems, some of the accrued but unpaid pension liability, plus enhance education funding and provide property tax relief. A thorough review of SB/HB750 is beyond the scope of this report. However, in summary, that proposal would increase the state's income tax, expand the sales tax base to include consumer (not business) services, and provide tax relief targeted to 60% of Illinois taxpayers.<sup>78</sup>

Without modernizing current revenue streams, the state simply will not have the financial capacity to pay its unfunded pension liability plus maintain current services. That said, the Pension Ramp also is not feasible, so an alternative, long-term payment program—like issuing pension obligation bonds to refinance the over \$42.2 billion unpaid liability could make sense, provided the rates for the bond issuance were set at appropriate levels, all bond proceeds were used to refinance pension debt, the bond payment levels both saved the state money over the long term and were attainable, and the state had the recurring revenue to fund the debt service. Finally, the state may also want to consider implementing a new revenue source targeted to repaying pension liabilities, that is independent of base revenue streams from income, sales, excise and utility taxes, which should be devoted primarily to paying for current services. One such potential new revenue source that has promise as both good public and fiscal policy, is implementing a carbon discharge permit/tax system in Illinois.

---

<sup>77</sup> Governmental Accounting Standards Board Statement No. 45 – Accounting and Financial Reporting by Employers for Post employment Benefits Other Than Pensions, Issued June 2004.

<sup>78</sup> For a complete analysis on SB/HB 750 please visit [www.ctbaonline.org/legislation](http://www.ctbaonline.org/legislation).

**(b) The Pension Obligation Bond Option.** Admittedly, the state is already overextended when it comes to debt. But issuing a pension obligation bond will not, in reality, increase the aggregate liability of the state. Illinois owes the \$40 billion it has borrowed from the pensions, and has the constitutional obligation to pay existing pension benefits without diminishment. Rather than increase what the state owes, issuing a bond to cover the unpaid pension liability could actually lessen the long-term costs of paying it, while creating the discipline that will force the liability to be paid, and establishing a long-term payment schedule that is feasible. Of course, to make this option feasible, the state still must modernize its existing tax structure through both income and sales tax enhancements to raise enough ongoing revenue to cover both continuation of public services and the new pension bond debt service. However, in that context, appropriate refinancing of the pension debt could save billions.

Illinois could save money long-term by issuing pension obligation bonds to refinance existing pension debt for one simple reason, lower interest rates. The current interest rate of 8.0% to 8.5% on the unfunded pension liability is higher than interest rates available in the bond market. Similar to a homeowner refinancing a mortgage to take advantage of a lower interest rate, issuing a POB for some or all of the unfunded liability would allow the state to pay it off at a lower interest rate than the current 8.0% to 8.5% rate.

### How a POB Works

The state would issue a \$10, \$20, or \$40 billion pension obligation bond at an interest rate lower than 8.0% and then deposit the proceeds immediately into the pension fund to pay off all or some of the current unfunded liability. If structured appropriately, the state would save money because the interest rate paid on the bond debt will be less than the interest rate on the unfunded liability. For example, the state is currently paying an 8.0% to 8.5% interest rate on the unfunded liability. If the POBs are issued at a 6.0% interest rate, the 2.0% to 2.5% differential is the savings to the state. The bonds will then be paid out of increased revenue generated for the General Revenue Fund from tax enhancements, over a set period, such as 30 years.

Figure 26 displays CTBA's calculation of various POB options. It illustrates various dollar amounts and interest rates the state could issue a POB for over a 30 year period. The actual interest rate and amount of the pension obligation bonds would be determined by the market at the time of issuance.

**Figure 26**  
**Savings Under Various POB Options**

<b>Amount of POB</b>	<b>Interest Rate</b>	<b>Repayment Years</b>	<b>Yearly Payment</b>	<b>Total Payments= Principal plus Interest</b>
\$10,000,000,000	5.5%	30	\$688,054,189	\$20,641,625,670
\$10,000,000,000	6.0%	30	\$726,489,657	\$21,794,689,710
\$10,000,000,000	7.0%	30	\$805,865,588	\$24,175,967,640
\$20,000,000,000	5.5%	30	\$1,376,108,378	\$41,283,251,340
\$20,000,000,000	6.0%	30	\$1,452,979,315	\$43,589,379,450
\$20,000,000,000	7.0%	30	\$1,611,731,176	\$48,351,935,280
\$40,000,000,000	5.5%	30	\$2,752,216,757	\$82,566,502,710
\$40,000,000,000	6.0%	30	\$2,905,958,630	\$87,178,758,900
\$40,000,000,000	7.0%	30	\$3,223,462,352	\$96,703,870,560

Say Illinois issued a \$40 billion pension obligation bond, making one payment annually for 30 years. Figure 27 shows that through 2045, the current ramp will cost the state a total of over \$316 billion in principal and interest on the unfunded liability. However, issuing a \$40 billion bond, even at the 7.0% rate will cost the state \$96.7 billion in principal and interest.

**Figure 27<sup>79</sup>**  
**Total Payments on the Current Unfunded Liability**

Unfunded Liability	Current Interest Rate	Repayment Years	Total Payments= Principal plus Interest	Total Payments= Principal plus Interest Under Bond Scenario	Difference
\$42,200,000,000	8.0% - 8.5%	2006-2045	\$316,288,000,000.1	\$96,703,870,560	\$219,584,129,440.1

Of course, a POB reduces but *does not eliminate* the state’s unfunded liability. There are also bond issuance costs, such as lenders fees, bond counsel fees and other miscellaneous fees. However, unlike current practices, once the state issues a POB it would have the fiscal discipline imposed on it to pay the bonds, because of the legal and contractual obligations owed to the bond holders. Further, unlike the 2003 issued POB when the state used \$2.1 billion of the bond proceeds to help eliminate the budget deficit, the state must use all of the bond proceeds to pay off unfunded pension liability and must adopt an equal annual payment level, rather than a gradually increasing payment schedule, to gain the long-term savings. Back loading the repayment of a POB is simply another way to avoid making the required payment, and effectively defers problem to the future. Finally, while issuing pension obligation bonds could both save money and create fiscal discipline, the option is not truly viable unless Illinois raises enough in new tax revenue to meet both its debt service obligation and maintain essential services.

## **15. Conclusion**

Each time the state fails to make its required pension payment, it simultaneously worsens the worst unfunded pension liability of any state in the nation, while hampering the ability of Illinois state government to satisfy the public service needs of future generations.

Because the state has been unwilling to find a real and sustainable solution to its revenue problems, it has borrowed billions of dollars from the pension system at the cost of funding education, human services, transit and health care.

The only real answer is modernizing the state’s tax system so it grows with the economy and is not overly reliant on the poor and middle class. SB/HB 750 is a real solution to the Illinois budget problems.<sup>80</sup>

When Governor Blagojevich proposed the pension obligation bond sale to cover, in part, the huge budget deficit confronting Illinois in 2004, James Hacking, then Executive Director of SURS wrote, “Given the magnitude of the state’s projected budget deficit, the only other realistic alternative to the governor’s pension bonding initiative would seem to be a broad-based sales and/or income tax increase.” Words that are both prophetic and sensible.

<sup>79</sup> Commission on Government Forecasting and Accountability, Report on the 90% Funding Target of Public Act 88-0593, January 2006.

<sup>80</sup> For more information on HB/SB 750 please visit [www.ctbaonline.org](http://www.ctbaonline.org)

## APPENDIX A DATA TABLES

**Figure 1: Fiscal Years 2006 – 2045:**

- 1. Required State Pension Contributions - \$ in millions**
- 2. Pension Obligation Bond Debt Service - \$ in millions**

Source: Illinois Commission on Government Forecasting and Accountability, August 2006

<b>Fiscal Year</b>	<b>Required State Contribution</b>	<b>Pension Obligation Bond Debt Service</b>	<b>Annual Total Contribution Plus Debt Service</b>
2006	\$935.6	\$496.2	\$1,431.8
2007	\$1,372.2	\$496.2	\$1,868.4
2008	\$1,981.3	\$546.2	\$2,527.5
2009	\$2,662.0	\$545.0	\$3,207.0
2010	\$3,401.2	\$543.6	\$3,944.8
2011	\$3,641.3	\$541.9	\$4,183.2
2012	\$3,774.3	\$590.1	\$4,364.4
2013	\$3,938.6	\$586.4	\$4,525.0
2014	\$4,097.5	\$582.5	\$4,680.0
2015	\$4,262.0	\$578.6	\$4,840.6
2016	\$4,435.4	\$574.5	\$5,009.9
2017	\$4,617.1	\$595.2	\$5,212.3
2018	\$4,808.7	\$614.8	\$5,423.5
2019	\$5,010.6	\$633.2	\$5,643.8
2020	\$5,223.7	\$674.6	\$5,898.3
2021	\$5,448.1	\$713.4	\$6,161.5
2022	\$5,683.9	\$749.8	\$6,433.7
2023	\$5,932.2	\$783.7	\$6,715.9
2024	\$6,193.9	\$840.2	\$7,034.1
2025	\$6,464.7	\$892.2	\$7,356.9
2026	\$6,747.8	\$915.4	\$7,663.2
2027	\$7,040.5	\$936.1	\$7,976.6
2028	\$7,351.4	\$979.2	\$8,330.6
2029	\$7,676.9	\$1,018.5	\$8,695.4
2030	\$8,018.8	\$1,079.0	\$9,097.8
2031	\$8,377.0	\$1,134.4	\$9,511.4
2032	\$8,752.2	\$1,159.7	\$9,911.9
2033	\$9,145.3	\$1,156.1	\$10,301.4
2034	\$9,558.3	\$0	\$9,558.3
2035	\$9,989.9	\$0	\$9,989.9
2036	\$10,442.1	\$0	\$10,442.1
2037	\$10,916.1	\$0	\$10,916.1
2038	\$11,414.9	\$0	\$11,414.9
2039	\$11,937.4	\$0	\$11,937.4
2040	\$12,485.7	\$0	\$12,485.7
2041	\$13,058.9	\$0	\$13,058.9
2042	\$13,659.9	\$0	\$13,659.9
2043	\$14,289.7	\$0	\$14,289.7
2044	\$14,947.9	\$0	\$14,947.9
2045	\$15,636.4	\$0	\$15,636.4
<b>TOTAL</b>	<b>\$295,331.4</b>	<b>\$20,956.7</b>	<b>\$316,288.1</b>

**Figure 2: Pension Contribution Requirements as a Percent of Total General Revenue Funds**

-Total Taxpayer Contributions to Illinois Pension Funds based on the Illinois Commission on Government Forecasting and Accountability, August 2006 and include the Pension Obligation Bond debt service.

- General Revenue Funds growth based on average GRF growth, 1996-2005

<b>Fiscal Year</b>	<b>Required State Pension Contribution \$ in millions</b>	<b>Percent of GRF</b>
2006	\$1,431.8	5.8%
2007	\$1,868.4	7.3%
2008	\$2,527.5	9.5%
2009	\$3,207.0	11.6%
2010	\$3,944.8	13.7%
2011	\$4,183.2	14.0%
2012	\$4,364.4	14.1%
2013	\$4,525.0	14.0%
2014	\$4,680.0	13.9%
2015	\$4,840.6	13.9%
2016	\$5,009.9	13.8%
2017	\$5,212.3	13.8%
2018	\$5,423.5	13.8%
2019	\$5,643.8	13.8%
2020	\$5,898.3	13.9%
2021	\$6,161.5	13.9%
2022	\$6,433.7	14.0%
2023	\$6,715.9	14.1%
2024	\$7,034.1	14.2%
2025	\$7,356.9	14.2%
2026	\$7,663.2	14.3%
2027	\$7,976.6	14.3%
2028	\$8,330.6	14.3%
2029	\$8,695.4	14.4%
2030	\$9,097.8	14.5%
2031	\$9,511.4	14.5%
2032	\$9,911.9	14.6%
2033	\$10,301.4	14.6%
2034	\$9,558.3	13.0%
2035	\$9,989.9	13.1%
2036	\$10,442.1	13.1%
2037	\$10,916.1	13.2%
2038	\$11,414.9	13.3%
2039	\$11,937.4	13.3%
2040	\$12,485.7	13.4%
2041	\$13,058.9	13.5%
2042	\$13,659.9	13.6%
2043	\$14,289.7	13.6%
2044	\$14,947.9	13.7%
2045	\$15,636.4	13.8%

## APPENDIX B

**Figure 1: Comparison of Illinois' Retirement Systems Benefits to National Average**

	Multipliers	Eligibility	COLA	Medical Benefits
<b>National Average</b>	2.48% <sup>81</sup>	62 <sup>82</sup>	3.01% <sup>83</sup>	70% of states offer <sup>84</sup>
<b>TRS</b>	2.20%	62 w/ 5 yrs of service	3.00%	YES
<b>SERS</b>	2.20%	Rule of 85	3.00%	YES
<b>SURS</b>	2.20%	60 w/ 8 yrs of service	3.00%	YES
<b>GARS</b>	First 4 yrs =3% next 2 yrs = 3.5% next 2 yrs = 4% next 4 yrs = 4.5% after 12 yrs = 5%	55 s/ 8 yrs of service	3.00%	YES
<b>JRS</b>	3.5% for 1st 10 yrs & 5% each yr after 10	55 w/26 yrs of service	3.00%	YES

**Definitions:**

**Multiplier:** Formula used to calculate retirement benefits based on average salary and years of service.

**Eligibility:** Earliest retirement age allowed by plan

**Rule of 85:** Allows employees to retire without a reduction in their pension when any combination of age and service credit equals 85

**COLA:** Cost of living adjustment/Increase in benefits per year

**Medical Benefits:** Plan offers medical benefits. All Illinois systems require retiree to pay premiums; 70% of states offer medical benefits

<sup>81</sup> Public Pension Coordinating Council.

<sup>82</sup> Wisconsin Legislative Council – Earliest retirement age for 98% of plans surveyed.

<sup>83</sup> Public Pension Coordinating Council.

<sup>84</sup> 2003 Segal State Health Benefits Survey – All 50 states surveyed.