

(excerpted from “Analysis Of The Governor’s Fiscal Year 2010 Illinois General Fund Budget Proposal” Center for Tax and Budget Accountability, March 2009)

(a) The Current System.

The state of Illinois maintains five separate retirement systems for public employees: the State Employees Retirement System; the Teachers Retirement System; the State Universities Retirement System; the General Assembly Retirement System; and the Judges' Retirement System. After decades of underfunding its employer contribution to each of these five systems, Illinois now has the greatest total unfunded pension liability in the nation, an astounding \$73.4 billion.²⁰ 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.

Funding the five state retirement systems for public employees has challenged Illinois state government for decades. In fact, the main reason Illinois has such a **large retirement system unfunded liability does not stem from generous benefits, the benefits are about average²¹, or high basic costs (the weighted average normal cost across all five systems is 9.3 %, which is 26% less than the national average)**.²² Instead, **the main reason Illinois has run up a large unfunded liability is simple—the state's revenue system has historically underperformed over time**, creating the structural deficit described previously in this report. As state decision makers continually found themselves short of the revenue needed to cover both maintaining essential services from one year to the next, and making the full, actuarially determined employer contribution required to fund the pension systems, they consistently opted to skip full funding of the retirement systems to maintain spending on services.

Effectively, this meant **Illinois was diverting payments it owed to the retirement systems to cover the cost of providing current public services. Essentially, the pension systems were used as a credit card**. 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 retirement fund.²³

The deadly combination of years of systemic state underfunding of its employer contribution to the pension systems, followed by the cataclysmic decline in asset values caused by the national meltdown in financial markets over the last year, have led to an all-time high in the state's unfunded pension liability. This unfunded liability, or the difference between the systems' accrued liabilities and net assets, reached \$73.4 billion in December, 2008. That was an increase of almost \$20 billion in only a few months.²⁴

The ongoing struggles in financial and capital markets continue to have a negative impact on investment returns for the state's five retirement systems. So much so that in the current fiscal year 2009, investment returns of the Teachers Retirement System are down 25.5 percent, and those of the State Universities Retirement System have declined 26.7 percent. The remaining three systems' investment returns have dropped by 20.9 percent.

Though negative investment returns caused the unfunded pension liability to increase dramatically over the past few months, historically it is not the main reason for the state's unfunded liability. The main reason is the state has often chosen to skip its required employer contribution, and Governor Quinn's FY2010 budget proposal repeats this unsound practice, as detailed in Section 10(d) below.

(b) The Pension Ramp.

The state attempted to address its unfunded pension liability in 1994, under P.A. 88-0593, which became commonly known as the "**Pension Ramp**". Intended to force increased payments to the retirement systems over time, the Pension Ramp established a timeframe during which Illinois was required to fund both: (i) the actuarially determined employer contribution the state owed for retirement benefits accruing to existing employees (the "**Normal Cost**"); plus (ii) make up a portion of previously unpaid employer contributions and the associated return thereon. The Pension Ramp amortized this payment schedule over 50 years, with a target of funding 90% of total actuarial liabilities by 2045. The Pension Ramp 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 annual increments. Since these makeup payments increased annually, they became known as the "**Pension Ramp**", that is, they "ramp-up" over time.

(c) The Pension Obligation Bonds.

In FY2003, then Governor Blagojevich decided the state's revenue system could not fund the required contributions under the Pension Ramp. He therefore had the General Assembly approve issuing \$10 billion in pension obligation bonds (the "**Pension Obligation Bonds**"). The concept supporting the Pension Obligation Bonds was simple, interest rates on the bonds would be lower than the 8 - 8.5 percent compounding interest the state owed on its unfunded pension liability. Selling the Pension Obligation Bonds at the lower interest rate would save Illinois money long-term, over what it would have had to pay the systems in interest. This arbitrage play was quite risky to begin with, but would have worked out better if the state had contributed the full \$10 billion it received from the bond sale directly into the pension funds. Then the only risks would be market based. Sadly, the state only contributed about \$7.3 billion of the bond proceeds to the five retirement systems. It used 2.7 billion to cover basic budget operating costs in FY2003 and FY2004. Governor Blagojevich justified this action by taking the present value of the projected savings over time—a highly unsound fiscal practice, that looks disastrous in retrospect.

(d) Underfunding the Retirement Systems.

In FY2006 and FY2007, on a strictly partisan vote, the General Assembly elected not to make its full, scheduled pension contributions under the Pension Ramp. Collectively over those two fiscal years, the state underfunded its required employer contributions under the Pension Ramp by \$2.3 billion. This was accomplished through legislation that created a two year, partial "**Pension Holiday**" under P.A. 094-0004 (Senate Bill 27). So, Illinois again repeated the unsound practice of borrowing against the retirement systems to cover the cost of providing public services. For FY2010, Governor Quinn has proposed funding the current normal cost across the five systems of \$1.517 billion, and the \$544 million in debt service on the Pension Obligation Bonds the state floated in 2003-2004. But Governor Quinn also proposes skipping \$550 million of the required Pension Ramp payment in FY 2009, and not making \$2.296 billion in required employer contributions in 2010. This essentially skips the Pension Ramp payments over two years, pushing that liability onto future generations. Recall that each year that pension obligations are unpaid, the investment return the state must make up on the unpaid contribution **compounds** at 8.0 percent to 8.5 percent annually. Governor Quinn also proposed several benefit cuts to the five Illinois state retirement systems, which he estimates will save \$162 billion through 2045. These benefit cuts include:

Employee Contributions

- State employees would be required to increase the contribution they make to the pension systems by an additional two per cent of their state wages. Currently employee contributions to the systems for those **not covered** by Social Security range from 8.0 percent of pay to 11.5 percent and for those **covered** by Social Security from 4.0 percent of pay to 8.0 percent.²⁷

Establishing a new lower tier of benefits for new hires, including:

- A reduction in the benefit formula from 2.2 percent to 2 percent for those not covered by Social Security, and from 1.67 percent to 1.5 percent for those who are covered.
- Raising the normal retirement age to 67 across the board. Currently the systems have varying retirement ages depending on years of service.
 - For example currently teachers have the option to retire at age 62 with five years of service, at age 55 with 35 years of service or age 55 with 20 years of service at a discounted annuity.
 - State employees retire at 60 with 8 years of service and 55 for early retirement with a minimum of 25 years of service.
- Capping annual cost of living adjustments (COLAs) to 50 percent of the CPI or 3 percent, whichever is less.
- Ending compounded COLAs.
- Determining final average salary by a participant's highest eight years of service instead of the current highest four years of service.