

## Pension Modernization Task Force

### Minority Report of the Civic Committee of The Commercial Club of Chicago

#### **I. Factual Background**

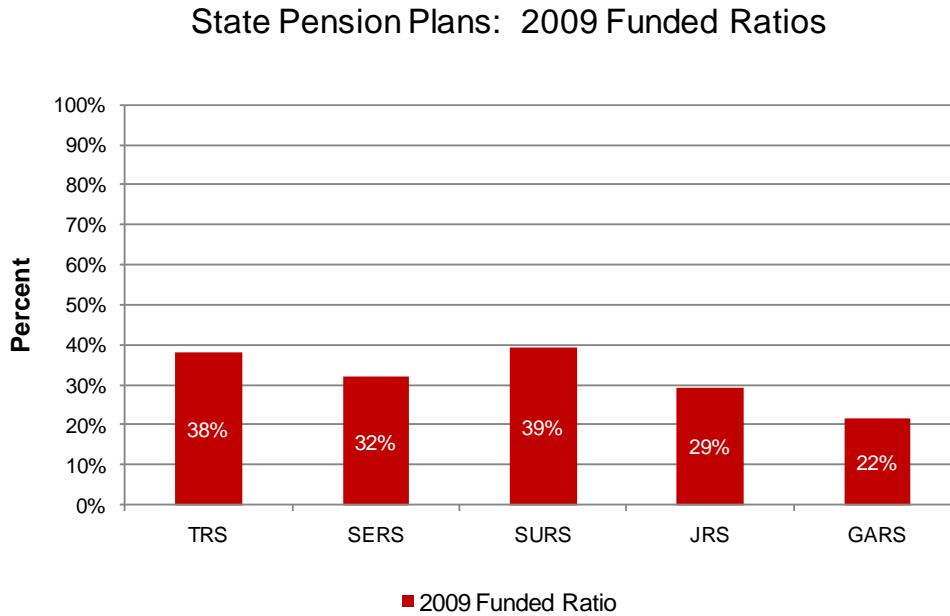
The State of Illinois is nearly bankrupt. The operating budget for the current fiscal year, FY2010, is not balanced. The Commission on Government Forecasting and Accountability material submitted to this Task Force suggests (at p. 42) that the State's current real budget deficit for FY2010 – after eliminating borrowed money from revenues, and eliminating one-time, non-recurring revenue sources, and taking into account the real economic costs of the pensions and retiree health care – may be in the range of \$15 billion. One of the main reasons we are in this fiscal mess is that Illinois does not adequately fund its pension costs. It has not done so for at least a decade. (The State likewise does not adequately fund its retiree health care costs.) The State's "normal" pension costs amount to about \$1.6 Billion per year. But the State's \$79 billion of piled-up unfunded pension obligations is increasing – due to reversal of the 8.5% discount rate – to the extent of about \$6.7 billion per year. Just to keep the unfunded obligation from growing, the State should be funding pensions to the extent of about \$8.3 billion out of operating revenues.

Illinois cannot afford to continue to fund adequately – or pay – these pensions. Nor should it. The level of pension benefits provided by the State's plans generally exceeds those available in the private sector – i.e. available to taxpayers who pay the State's bills.

The State's pension plans must be reformed and made less costly. And adequate funding – consistent with actuarial principles – must be provided. Illinois cannot and should not continue to deal with its pension costs by borrowing – by transferring the current cost of pensions to future budgets and generations of taxpayers. If Illinois does not seriously address these problems now, there may soon come a time when no combination of service cuts or tax increases will be sufficient to cover these mounting costs. Taxpayers will be unwilling to pay both current costs and those left over from the past. They will take their businesses, their investments, and their jobs to another state – one unburdened by a huge costly legacy from the past. The longer we wait to fix our pension problems, the more we jeopardize our future.

The basic facts are not in dispute. Illinois' pension funds are radically underfunded (Figure 1).

**Figure 1**



Source: Commission on Government Forecasting and Accountability Pension Briefing, April 2009

The underfunding of these pension plans is so serious that it threatens the fiscal stability of the State and its subdivisions – municipalities, schools and other local government agencies throughout Illinois that rely on State funding or revenue-sharing<sup>1</sup>. In the coming years, the annual contributions necessary to pay off the mountain of pension debt will rise and consume a larger and larger share of the State's annual revenues. The State then will be faced with two difficult choices: massive cutting of State expenditures and grants, or raising taxes to such a high level that some businesses and residents will flee Illinois. Or both.

The pension debt crisis has been in the making for years. The main reason we have such an enormous unfunded liability today is because in the past, instead of balancing budgets and

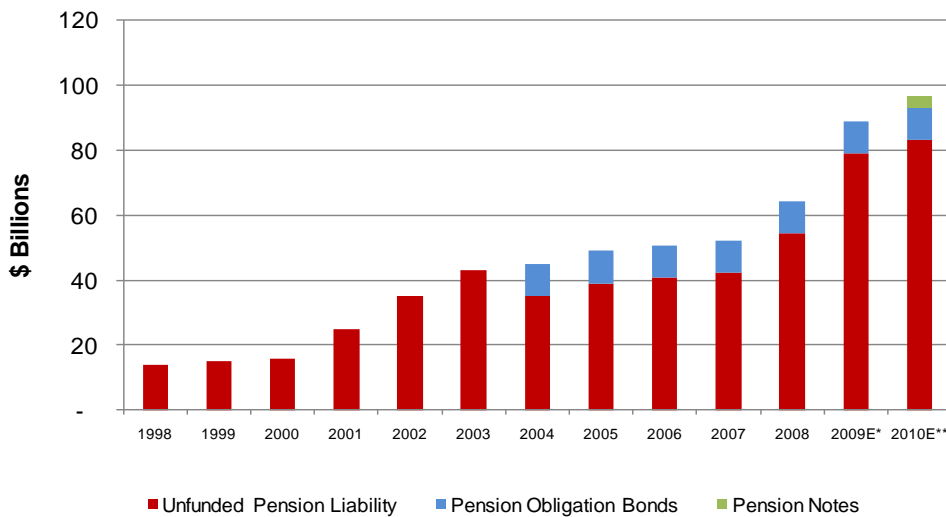
<sup>1</sup> For example, local governments currently receive a 10% share of the State's personal income tax revenue; they also receive 1.25% of the total State and local sales tax rate of 6.25%. In addition, most school districts are dependent on the State for "foundation level" school funding.

making hard choices, the State has borrowed to cover current costs. In particular, the State has failed to cover the costs of public pensions on a current basis, instead shifting them from the present to the future through underfunding and also through borrowing in the form of pension bonds or pension notes.

The State’s total pension obligation – both the unfunded obligation and the remaining pension debt – has jumped in the last 10 years from \$15 billion at the end of FY1999 to \$89 billion at the end of FY2009 (Figure 2). That obligation is expected to rise to more than \$95 billion by the end of FY2010, as the unfunded liability continues to grow and the State takes on even more pension debt with the issuance of \$3.5 billion in pension notes to pay its statutory FY2010 pension contribution (Figure 2).

**Figure 2**

**State Unfunded Pension Liability and Other Pension Debt**



\*Estimate is based on COGFA April 2009 Pension Briefing projection of \$78.9 B unfunded liability at the end of FY2009.  
 \*\*Estimate is based on COGFA April 2009 Pension Briefing projection of \$83 B unfunded liability at the end of FY2010 and \$3.5 B in pension notes issued in FY2010. The Governor’s proposed \$16 B in new pension bonds would not change the total amount of pension debt, but would convert approximately \$16 B (minus transaction costs) of unfunded liability into pension obligation bonds.

Source: “2008 Bonded Indebtedness Report of the State of Illinois,” January 2009, Commission on Government Forecasting and Accountability; Commission on Government Forecasting and Accountability Monthly Briefing, April 2009; “Report on the Financial Condition of the State Retirement Systems,” February 2009, Commission on Government Forecasting and Accountability; Commission on Government Forecasting and Accountability Monthly Briefing, February 2009; “Report on the Financial Condition of the State Retirement Systems,” February 2008, Commission on Government Forecasting and Accountability; “Report on the Financial Condition of the State Retirement Systems,” July 2007, Commission on Government Forecasting and Accountability; Historical unfunded liability data from Senate GOP staff.

Figure 2 shows that as of the end of the most recent fiscal year – FY2009 – which was June 30, 2009, the State’s unfunded liabilities in its pension plans added up to about \$79 billion (Pension Briefing April 2009, Commission on Government Forecasting and Accountability).

The Commission on Government Forecasting and Accountability (COGFA) recently submitted to this Task Force a statement showing that the unfunded liabilities are much less – only \$61 billion. COGFA’s statement is simply false. The amount of the unfunded liabilities does vary over time because both the amount of the liabilities and the values of the assets in the funds vary. However, the most recent information with respect to these liabilities and asset values – as of the end of FY2009 – shows that the unfunded liabilities amount to approximately \$79 billion. The lower number was calculated by COGFA using a methodology that does not accurately reflect the financial condition of the State’s pension plans.

COGFA’s calculation is purportedly based on a law passed by the Legislature permitting “asset smoothing” (Senate Bill 1292). Senate Bill 1292 allows “*for purposes of determining the required State contribution...* for fiscal years after June 30, 2008, any actuarial gains or losses from investment return incurred in a fiscal year shall be recognized in equal annual amounts over the 5-year period following that fiscal year.” But in determining and reporting the *financial reality* – including the unfunded status – of the pension funds, “asset smoothing” cannot possibly justify false reporting. The economic reality is that (1) the present value of the liabilities in the pension funds as of 6/30/09 was about \$125 billion, and (2) the present value of the assets in the pension funds as of 6/30/09 was about \$46 billion. The unfunded liability as of 6/30/09 was *in fact* \$79 billion -- not \$61 billion.

## **II. Why Illinois’ Pensions are So Massively Underfunded.**

The pension funding crisis is the result of a number of factors.

### **A. Benefits more generous and more costly than those generally available in the private sector.**

State retirees currently receive more generous pension benefits than those available to most Illinois taxpayers. Generally speaking, the State’s five pension plans permit employees to receive “normal” (unreduced) retirement at or before the age of 60 with 8-10 years of service (depending on the plan). Pensions are based on average total salary in the highest consecutive 4 years within the last 10 years of employment. Retirees receive annual increases to their pensions intended to offset increases in the cost of living (COLA). These increases are 3% per year, compounded.

Some State retirement system provisions are even more generous than those described above. Members of the General Assembly may retire at the age of 55 if they have 8 years of service or more, and the formula used to determine their retirement benefit is quite generous – once they have achieved 20 years of service, members of the General Assembly will receive 85% of their salary on the last day of their service. In essence, a legislator who wins his/her seat at the age of 35, and retains it for the next 20 years, may retire at the age of 55 and receive 85% of final salary each year thereafter – with a 3% annual cost-of-living adjustment, compounded.

Some participants in the State Employees Retirement System receive more generous benefits under the “alternative formula,” which applies not only to higher-risk jobs such as fire fighters, State police and State highway maintenance workers, but also to revenue investigators and commerce commission police officers. Alternative formula employees may retire at age 55 with at least 20 years of service and age 50 with at least 25 years of service, and they accrue benefits at a higher rate than other State employees. Their pension benefit is calculated based on their rate of pay on the last day of employment, or the average of the last 48 months of compensation, whichever is *greater* (and then receive the 3% compounded COLA after retirement).

In the private sector, employee pensions have in recent years become less generous – and less costly – as a result of competitive and other economic pressures on employers. Many companies have shifted away from defined benefit plans to defined contribution plans, and others have retained defined benefit plans but trimmed benefits.<sup>2</sup> Still others have adopted two-tier plans – one for existing employees whose rights have vested, and new ones for new employees.<sup>3</sup>

For new employees, defined contribution plans are overwhelmingly prevalent in the private sector; only one employer in a recent Hewitt Associates survey offered only a defined benefit plan to new employees (Figure 3). More than half of surveyed employers offered only a defined contribution plan to new employees, and the rest offered a defined benefit plan in conjunction with a defined contribution plan.

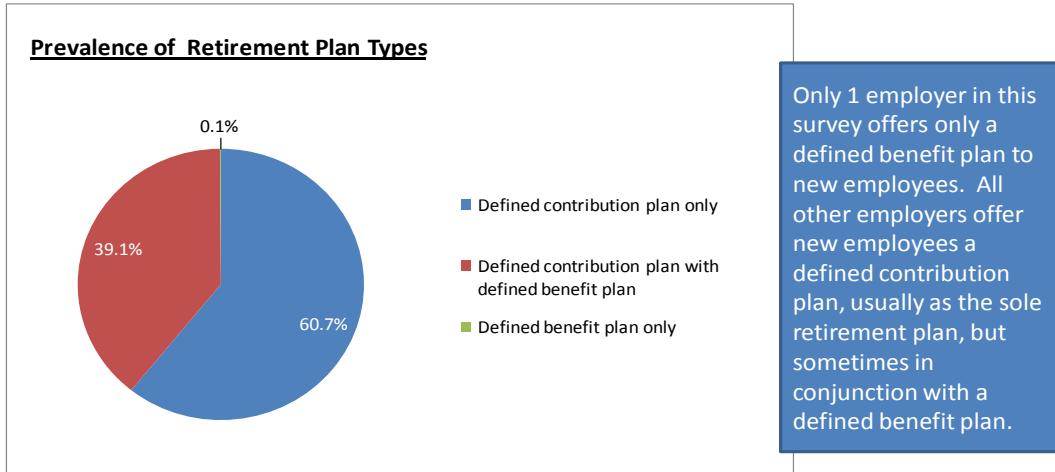
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<sup>2</sup> Private sector employees also participate in Social Security, which requires additional contributions by both the employee and employer each year and provides additional benefits upon retirement. Almost 80% of State employees do not participate in Social Security. State employees as a group have had opportunities to join Social Security in the past, but have declined participation, which has allowed both the employees and the State to avoid making annual Social Security contributions.

<sup>3</sup> Aon Consulting presentation to the Pension System Modernization Task Force, August 12, 2009, p. 10.

**Figure 3**

**Prevalence of Defined Benefit and Defined Contribution Plans:  
New Employees in the Private Sector**



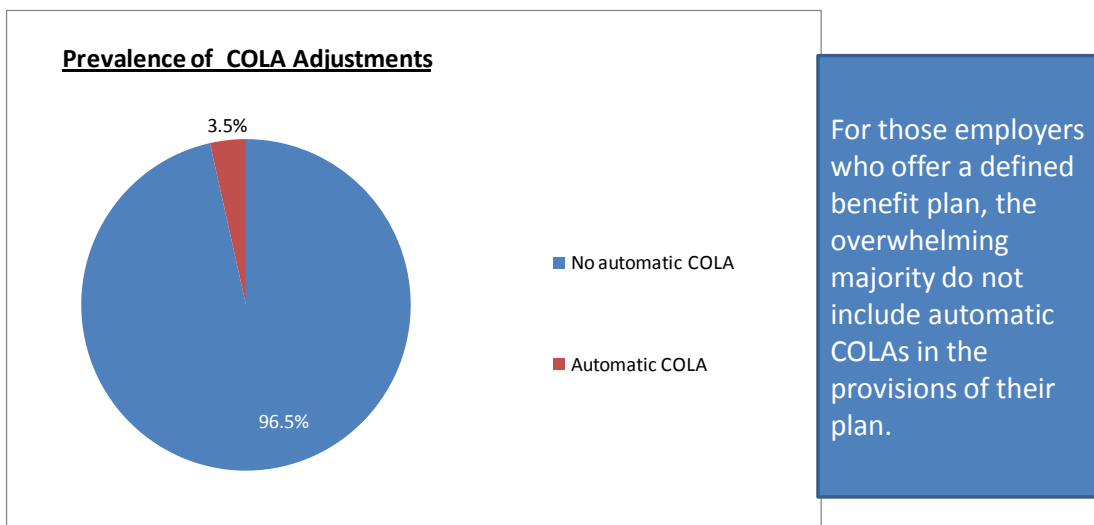
Source: Hewitt Associates survey of 940 private sector employers

For those companies that offer a defined benefit plan (in conjunction with a defined contribution plan), the provisions of those plans are significantly less generous than those of the State’s pension plans, particularly in terms of cost of living adjustments and age requirements for full retirement benefits.

Provisions for automatic cost of living adjustments (COLAs) – such as the 3% COLA provided to State retirees – are extremely rare in private sector defined benefit plans (Figure 4).

**Figure 4**

**Prevalence of Automatic Cost-of-Living Adjustments:  
Private Sector Defined Benefit Plans**

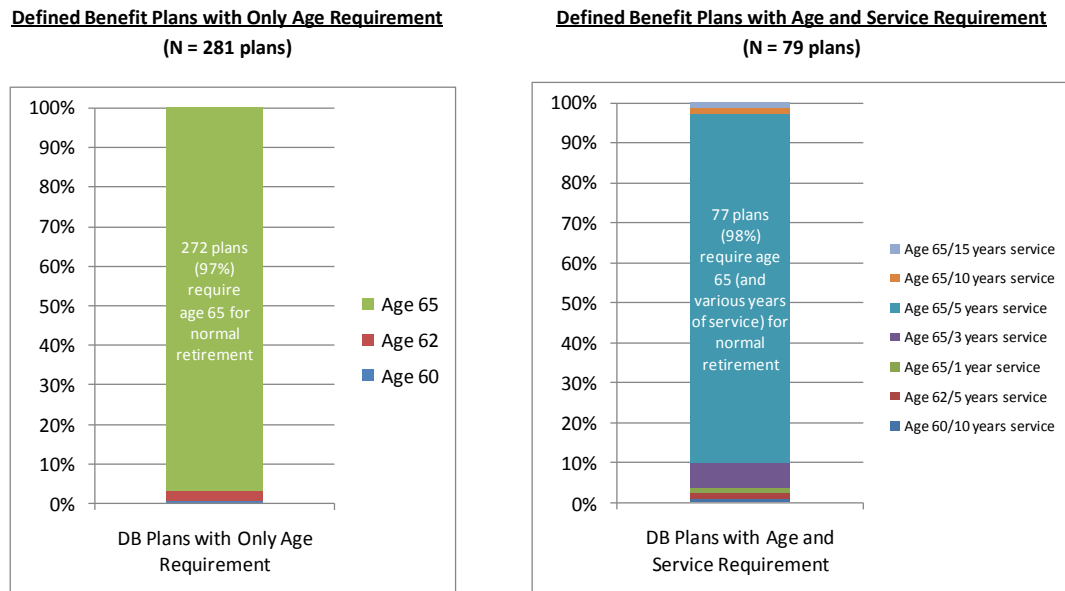


Source: Hewitt Associates survey of 371 private sector defined benefit plans (almost all are offered in conjunction with defined contribution plan).

Age requirements for normal retirement are also significantly different between the private sector and the State. The State's pension plans allow for normal retirement at or before the age of 60. The vast majority of private sector defined benefit plans require age 65 for normal retirement, either alone or in conjunction with a service requirement (Figure 5).

**Figure 5**

**Prevalence of Different Age Requirements:  
Private Sector Defined Benefit Plans with Age Requirement for Normal Retirement**



Source: Hewitt Associates survey of 360 private sector defined benefit plans that have some age requirement for normal retirement.

A substantial disparity thus exists between pension benefits generally available in the private sector and the State’s pension plans. This disparity should not continue, for two reasons. First, the State cannot afford it. Second, maintaining such a disparity is unfair to taxpayers – who largely work in the private sector – who must pay higher taxes to support the more generous and more costly benefits provided to the State’s employees.

**B. Pension abuses.**

Illinois’ public sector pensions have been subjected to abuse. The *Chicago Sun-Times* recently reported that nearly 4,000 retired government workers now have pensions that pay them at least \$100,000 per year; and more than half have collected more than \$1 million each since they retired. A few have topped \$2 million, and five have received more than \$3 million each. (*Sun-Times*, September 11, 2009.)

One way to abuse the system is to “double up” – arrange to get more than one pension from the funds. The *Sun-Times* reported that the former chair of anesthesiology at Cook County Hospital and the University of Illinois has two pensions totaling \$447,233 per year.

Another way is to retire from one job and take another – thus earning both a pension and a salary. This can happen because the State’s pension plans permit retirement long before normal retirement age. The *Sun-Times* reported the case of a Chicago city worker who retired from one job at age 49 and took a new job with the City – and now receives a pension and salary totaling \$246,721 per year. (*Sun-Times*, September 13, 2009.) Another 62-year old worker was reportedly drawing three pensions – totaling over \$280,000 – and drawing a salary of over \$246,000.

Another way is to manipulate the career-end compensation number. The amount which public pension beneficiaries receive is dependent on the amount of their salary at career end. A sharp escalation of salary at career end – either in the final year, or some number of years used as the base for pension calculations – can dramatically increase pension benefits. It has been particularly tempting for local school districts to play this game at career end since the State – rather than the local school district – bears the increased pension costs generated by such manipulation.

Still another form of abuse, as recently described by the *Chicago Sun-Times*, is to permit career-end salary hikes to increase pension rights, even when the employee is no longer working for State government or the schools. The *Sun-Times* found “more than five dozen” retired government workers whose pensions are based not on their public salaries, but rather on the higher salaries that they were paid by labor unions, lobbying groups and other non-governmental organizations after they left the State’s payroll.

These abuses have added to the build-up of the State’s pension liabilities.

**C. Pension underfunding has shifted the burden of current costs onto future budgets and taxpayers.**

The principal cause of the build-up in unfunded liabilities has been the *failure of the State to fund* the pension costs on a current basis. Under pressure from the groups which benefit from the pensions, the State – both the Executive Branch and the Legislature – has allowed the benefits to become very costly; and it has been unwilling to trim them back. For similar reasons, the State has been unable to make substantial cuts in its general State budget. But over time the State’s revenues have become inadequate to cover the State’s increasing expenditures and grants. And raising taxes would be unpopular. So – unable to cut and unwilling to take the risk of raising taxes – the State has ignored rising pension and retiree health care costs. It has in effect shifted them off to the future – to future budgets and future taxpayers. It has accomplished this through formulas which back-end-load costs and through borrowing.

In 1995 the State legislature enacted Public Act 88-593 to deal with pension underfunding. This law created a 50-year payment plan to bring funding ratios to 90% by 2045 (an estimated unfunded liability of \$54 billion on a total accrued pension liability of around \$540 billion). The 1995 law required the State to make contributions at a level percent of payroll, but with an initial “ramp-up” phase-in from 1996-2010.

The 1995 plan was structurally flawed from the beginning because it did not require State contributions to cover “Normal Cost Plus Interest” (reversal of the 8.5% discount each year) until after 2030 – thereby substantially “back-end loading” the State’s pension funding and guaranteeing that the unfunded liability would continue to grow for many years. In addition, the State has failed to make its required statutory contributions in recent years, leading to even further growth in the unfunded liability. The net result of this underfunding has been a quadrupling of the unfunded liability from \$16 billion in FY2000 to \$79 billion at the end of FY2009 (Figure 2).

The stock market decline of 2007-2008 contributed to the substantial increase in the unfunded liability over the last few years, but the pension funds were in trouble long before the current economic downturn. The Civic Committee issued its report warning of the impending implosion of the State’s finances in December 2006 – well before the stock market collapse of 2008. Figure 2 shows that in FY2007 the unfunded liability was about equal to its level in FY2003 – the year that the State issued \$10 billion in pension obligation bonds and dumped part of the proceeds into the pension funds. The growth in the unfunded liability back to this level by the end of FY2007 was largely the result of ongoing underfunding of annual pension contributions.

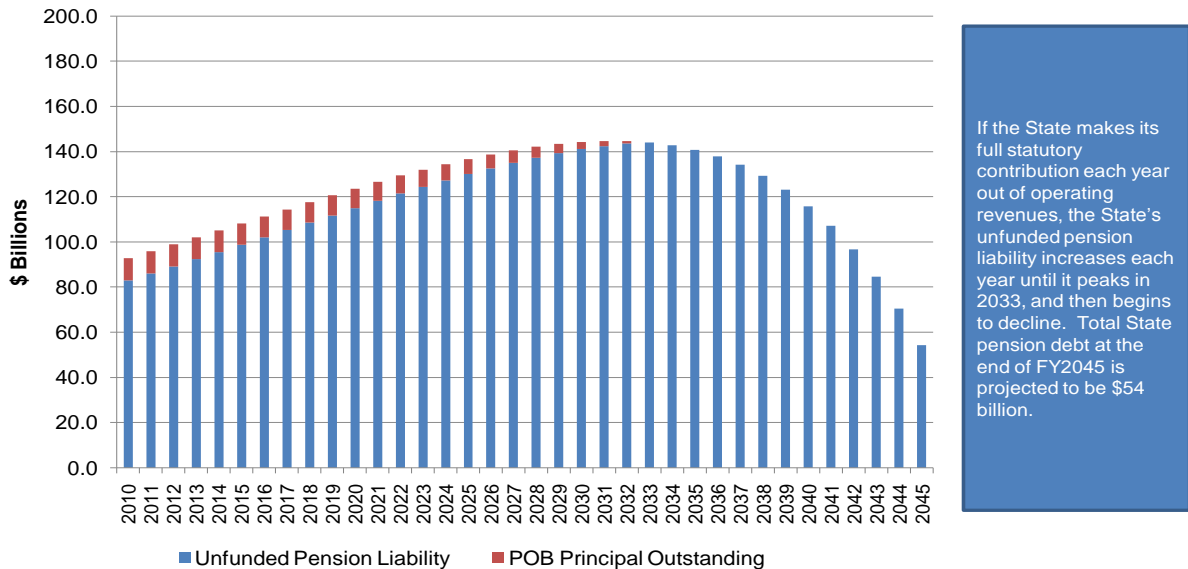
Because of the structural flaws in the 1995 plan, the unfunded liability is projected to grow even more over the next 25 years. As shown in Figure 6, even if the State makes its required statutory contribution going forward, the unfunded liability is projected to grow to more than \$144 billion by 2033 – when it is projected to peak and then begin to decline (as the statutory contribution in those later years surpasses “Normal Cost Plus Interest”).<sup>4</sup>

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<sup>4</sup> The graphs in this document use the most recent projections published by COGFA – a pension briefing published in April 2009 and a report on the pension funds published in February 2009 – and therefore do not include the impact of pension asset smoothing (SB1292). Pension “asset smoothing” reportedly would reduce the FY2011 statutory contribution from \$5.4 billion to \$4.5 billion – further back end loading the State’s pension funding.

**Figure 6**

**Total Pension Debt:  
Statutory Contribution From Operating Revenue**



Source: "2008 Bonded Indebtedness Report of the State of Illinois," January 2009, Commission on Government Forecasting and Accountability; Commission on Government Forecasting and Accountability Monthly Briefing, April 2009.

The problem with this massive and growing unfunded liability, reflecting the significant underfunding in the early years of the statutory schedule, is that huge and unsustainable contributions from the State would be required in later years to reduce the unfunded liability to \$54 billion by 2045. According to the statutory schedule, by FY2026 the State’s required pension contribution is projected to exceed \$10 billion, and by FY2040 it is projected to exceed \$20 billion. From 2034-2045, pension contributions would be *more than 33% of the State’s payroll* each year. Given the State’s inability to make its pension contributions in recent years – when those payments were less than 20% of payroll – the required contributions from 2034-2045 are impossibly high. And with each year that the State fails to make its statutory contribution now, the required payments in those later years would be even higher.

If the State continues its historical practice of balancing its annual budget through borrowing, Illinois may soon reach a “tipping point” beyond which it will be impossible to reverse the fiscal slide into bankruptcy. This is because the radical cost cutting and huge tax increases necessary to pay all the deferred costs from the past would become so large that many businesses and individuals would be driven out of Illinois, thereby magnifying the vicious cycle of contracting State services, increasing taxes, and loss of the State’s tax base.

### **III. The State's Pension Plans Must be Reformed.**

The State's pension programs must be reformed to reduce costs and mirror more closely the standards and yardsticks that have been adopted in the private sector. The State cannot afford the current programs any longer. Moreover, it is unfair to require taxpayers to bear the costs of the current pension programs for the State's employees.

#### **A. Creation of a second, less-costly tier of pension benefits for new employees**

The State should create a second and less-costly tier of retirement benefits for new employees – preferably a defined contribution plan, but at a minimum a defined-benefit plan with less-costly benefits – with adjusted employee contributions.

The detailed recommendations below parallel the recommendations of earlier amendments to Representative McCarthy's bill (SB1292) and draw on many of the recommended approaches described in Aon's recent presentation to the Commission<sup>5</sup> and implemented in other states.<sup>6</sup>

- Increase the normal retirement age to 67 (with 10 years of service) and the early retirement age to 62 (with 10 years of service).
- Reduce the benefit accrual rate to 2.0% of pay for employees not covered by Social Security and 1.5% of pay for employees covered by Social Security.
- Limit COLA to the lesser of 3% or ½ of the Consumer Price Index.
- Change current provisions for the calculation of pension benefits to be calculated solely on base salary up to the Social Security Covered Wage Base. Calculate final average salary on the average of the highest consecutive eight years out of the last ten years, with the provision that the final 12 months average cannot exceed final average pay by more than 25%.
- As proposed in earlier amendments to SB1292, the above prospective changes in pension benefits should be accompanied by adjustments to employee contribution levels.

When second-tier plans are adopted for new workers, if the plans are reasonably well funded, there appears to be no problem with pooling the assets of the old and new (second-tier) plans. Such pooling does not put at risk the contributions made by the new employees who will participate in the new or second-tier plans.

But when the pension plans are as badly-underfunded and at risk as the Illinois pension plans, it could well be unfair to pool the contributions of the new employees in the second-tier

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<sup>5</sup> Aon Consulting presentation to the Pension System Modernization Task Force, August 12, 2009, p. 12.

<sup>6</sup> Aon Consulting presentation to the Pension System Modernization Task Force, August 12, 2009, p. 15.

plans with those in the old plans. In effect, this would permit the plan administrators to use the contributions of the new employees to pay out benefits to the employees in the old plans, rather than to build values that would be available when the time comes for the new employees to start to receive pensions. To allow such pooling in these circumstances would be to create a sort of Ponzi scheme – in which initial investors are paid out of the monies contributed by subsequent investors. Injecting such features into a second pension plan for new employees – when existing pension plans are radically underfunded – would not only be unfair to the new employees, but would create or impose on the plan administrators potential conflicts of duty – arising from the impossibility of paying pensions to the earlier group of employees (under the existing plans) without using revenues contributed by the new employees to make the payments, instead of building up values for the pension needs of the new employees in the second tier.

This problem would be avoided by structuring the second-tier plans as defined contribution plans, since the contributions of each new employee would be cordoned off and used entirely to build retirement programs for the new employees. Accordingly, we recommend the use of defined contribution plans. But if the State decides to continue with the defined benefit plan approach, that choice will underscore the need to separate the asset pools, and not to use contributions of the new group of employees to pay out benefits to the employees participating in the current plans.<sup>7</sup>

## **B. Reforming the current pension programs prospectively for current active employees**

The Pension Protection Clause of the Illinois Constitution provides:

“Membership in any pension 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.” Ill. Const., art XIII, #5.

Representatives of employees have suggested that this clause does more than protect an employee’s contractually vested rights. They have argued – or assumed – that provisions in pension plans could not be altered prospectively if the effect were to reduce benefits which might be accrued in future years. Accordingly, they have argued that the State’s current pension benefits could not be reformed prospectively to make them less costly to the State.

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<sup>7</sup> One might ask: isn't the problem identified here one that already exists *within* the structure of the existing pension plans? Aren't contributions of employees hired later, and younger, being used to pay benefits to the older group of employees as they retire? The answer is that with plans as underfunded as the State's, there is clearly potential unfairness here as well. Where assets are already commingled, there may be no good way to avoid the problem. But it clearly should be disclosed. The administrators of the current plans should make disclosure to all their members – particularly the new employees and those farther from the point of retirement – that contributions from these younger members are being or may be used (or assets acquired with those contributions are being or may be used) to fund pensions for retirees or older employees, rather than to build up asset values that will be available for their own retirement when the time comes.

The 1970 amendments to the State’s Constitution were intended to grant contractual status to participation in public pension plans. Such status means that accrued rights have contractual protection. Such status does not mean that provisions in pension plans might not be changed prospectively to make them less costly – so long as rights accrued prior to the change are fully protected. The “benefits” which “shall not be diminished or impaired” are the contract rights vested under the “enforceable contractual relationships” protected by the Constitution. (See Appendix A.)

Under pressure of economic circumstances, many plans available to employees working in the private sector have been adjusted prospectively, without interfering with vested rights. Such incidents of prospective adjustment have not been deemed to violate employees’ contractual rights.

Similarly, the changes proposed above for a second-tier of pension benefits for *new* employees can and should be considered as amendments to the pension plans for prospective application to *current active* employees. If current active employees moved prospectively into the second-tier plan, it is estimated that the current \$79 billion in unfunded liabilities would be reduced by perhaps \$18-19 billion – to around \$60 billion.<sup>8</sup> The annual “normal” pension cost would also immediately decrease to something below \$1.6 billion, as current and new employees would accrue future benefits under the less-costly, second-tier plan.

Alternatively, if the Illinois courts should ultimately determine that the current pension plans cannot be amended prospectively for current employees, such employees should be required by law to increase their pension contributions to an average of 11% for employees not covered by Social Security and 7% for employees covered by Social Security.

#### **IV. Proposals Submitted to the Task Force for More “Ramping” and More Massive Borrowing Simply Invite the Governor and Legislative Branch Leaders to Avoid the Problem By Continuing to Shift it Off to Future Leaders, Future Budgets, and Future Taxpayers.**

At the heart of our State’s current fiscal crisis is a continued pattern of avoided responsibility – of avoiding hard choices needed to balance our State’s budget, of putting off problems to the future ... to some other Governor, or some other Legislature. The politics of avoiding blame – or placing it on others – has trumped responsible government. When our elected officials refuse to make hard choices, Democracy fails. Proposals for further “ramps” – i.e., supposedly-temporary underfunding – or more massive borrowing are nothing more than invitations to further avoidance of responsibility and further failure.

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<sup>8</sup>Under this approach, accrued contract rights are protected, but no participant accrues any further benefit under the old plan based on either additional years of service or compensation growth. Replacing the “final average salary” assumption in the current benefit formula with each participant’s current salary is estimated to reduce the unfunded liability by \$18-19 billion.

### **A. Creation of a new pension ramp.**

Ramp or stair-step increases that take many years to move the State to full actuarial funding are one way to shift today's costs to the future and postpone making hard decisions. We have seen such ramps before. As one ramp leads upward to an appropriate but uncomfortable level of funding, we adopt another ramp – another postponement of bearing today's costs today.

Annual pension funding should be based on actuarial requirements, not what the State thinks it can comfortably afford. The State's unwillingness in the past to make the difficult budget choices that would allow for full actuarial funding of the pensions is what got us to our current crisis. It cannot be allowed to continue.

### **B. Issuance of more pension obligation bonds.**

Some observers have suggested that pension obligation bonds (POBs) are like a person facing bankruptcy using a VISA card to pay his MasterCard debt. Actually, POBs are far worse than that. Reliance on massive borrowing to get out of a fiscal mess would be like ignoring one's mortgage, one's MasterCard debt, and one's American Express Card debt – and ignoring all the other elements of budget deficit and fiscal difficulty – and then using a VISA card to buy stocks in the hope that increases in stock values would solve the problem.

Pension obligation bonds (POBs) are an avoidance – not a solution. POBs would shift a huge burden to the future. They would allow State leaders to continue to put off making hard decisions. The State's leaders should do their fiduciary duty, which includes – in the circumstances we now face – cutting the costs of State government, making needed reforms in the State's programs and grants, and meeting the State's obligations.

Pension bonds are a terrible idea for a number of reasons:

1. Pension bonds would create an additional “full faith and credit” obligation on the part of the State. The State already has to pay off the \$10 billion in bonds issued under Governor Blagojevich. It will also have to pay off the \$3.5 billion in pension notes which were approved earlier this year. It must pay not only the principal of these obligations, but interest as well.
2. The State has recognized the dangers of too much debt by setting a limit on the amount of general obligation bonds it may issue (based on the amount of debt service on all outstanding bonds as a percentage of general fund appropriations – currently set at 7%). With the additional borrowing necessary to fund the new capital plan, the addition of more pension obligation bonds would likely put the State's debt over this limit.
3. Such borrowing would almost certainly be used (as Governor Blagojevich used it) as an excuse for continuing not to fund pension costs at an actuarially-correct level out of current revenues. And the mountain of debt would just keep getting bigger.

4. Such borrowing would be enormously risky. In the private sector it is called “arbitrage.” One borrows at a lower rate of interest in order to invest the borrowed money in an investment that may draw a higher return. Private-sector arbitrageurs pursue such strategies with their own money only subject to careful controls and limitations. Moreover, such arbitrage investment strategies involve taking on greater risk – as shown by the history of New Jersey’s experiment with pension bonds. (After New Jersey issued \$2.7 billion in pension obligation bonds in 1997, the equity markets into which these monies had been invested plummeted between 2000 and 2002 – leading to “negative arbitrage.”)<sup>9</sup>
5. Such borrowing is also costly. Lawyers and investment bankers charge for their services incurred in issuing the bonds. The risk of “pay to play” is increased.
6. What happens when the borrowed money runs out? Would we issue still more bonds? And pile up even more costs to be paid by future taxpayers?

The advocates of ramping and borrowing – and cost shifting generally – say that times are hard and that the State cannot afford to bear these costs. Times will be better in the future, they say, and these costs will be more affordable then.

Times are indeed hard. Budget cuts would be painful. Taxes would be burdensome. These have always been the arguments – the very same arguments – for avoiding hard choices and shifting costs to the future. These arguments are why – over the past decade – Illinois has accumulated \$79 billion of unfunded pension liabilities, and another \$24 billion-plus of unfunded retiree health obligations – as well as additional billions of pension-related debt. Such shifting of burdens to the future cannot go on indefinitely.

The State officials who allowed this to happen over the past decade will go down in the history of the State as people who created a terrible problem by avoiding hard choices. Our recommendation to Governor Quinn is that he should not be one of those officials.

## **V. The State Should Fund its Pensions Out of Current Operating Revenues Consistent with Actuarial Principles.**

Once needed pension reforms – including a second-tier of benefits prospectively for both current and future employees – have been put in place<sup>10</sup>, the State must increase its annual

<sup>9</sup> For a few years after the issuance of the POBs, New Jersey’s pension funds generated returns in the double-digits. But with the market decline of 2000, returns fell dramatically. Overall, from 1997-2005, the pension funds averaged an annual return well below the 7.6% that New Jersey promised in interest on the bonds, thus leading to “negative arbitrage” (over and apart from the transaction costs associated with issuing the bonds). (*Business Week*, June 13, 2005)

<sup>10</sup> In addition, the State should address the related subject of retiree health care. The current program, which provides a 100% premium subsidy to retirees with 20 years of service or more, is expensive and unsustainable long-term. Just as the State’s pension program, the State’s retiree health care program needs to be brought into line with the programs available to Illinois taxpayers. Unlike pensions however, retiree health care benefits are not even arguably protected under the State’s Constitution – making this a critical area for reform and cost-cutting.

pension contributions to levels required by actuarial principles. The annual pension contribution should be sufficient to cover the “normal cost” each year, plus an appropriate amortization of the unfunded liability. An actuarial formula that reflects projected inflation by tying the State’s contribution to a “percentage of payroll” makes no sense when the assumed future “percentage of payroll” far exceeds any sustainable level. Back-end-loading of costs must cease.

Union representatives have made it clear – understandably, given their responsibility to those they represent – that they oppose a second tier of benefits prospectively, either for new employees or current ones. Their duty is to their members. But the Governor and members of the Legislature have a different set of duties – to the citizens of Illinois for whom State Government exists and who pay its bills. The unions and the business community may join in supporting the adequate pension funding consistent with actuarial principles. But an essential part of the package of reforms must be pension reform and cost reduction – a second-tier plan prospectively. These must be conditions of any enhanced funding. Organized labor cannot have it both ways – no reforms and enhanced funding. Without the needed reforms, and without enhanced funding, the pension funds will run out of money at some point soon. Retirees will have sound legal claims against the funds, but – as the old legal saying goes – “you can’t get blood out of a turnip.” Any attempt at that point to solve the problem through massive tax increases would simply drive businesses and individual taxpayers out of the State.

Assuming that labor and business and other interested groups can come together on a package that includes both pension reform and support for actuarially-correct funding, difficult budget choices will be necessary on both the cost side and the revenue side. Cost savings from the pension reforms will not be nearly enough. The State’s retiree health care program offers the potential for substantial reform and additional cost savings. In addition, significant cost-cutting will be necessary in other State programs and grants. And if taxes are increased, then the increased revenues must be used to pay down the liabilities we already have – not to pay for new programs or new liabilities. Given that the assignment of this Task Force is pension reform and modernization, it would be inappropriate to go beyond our mandate and address the additional cost-cutting and/or particular revenue measures that may become necessary. However, all reform and cost-cutting options should be exhausted before any such measures are considered.

## APPENDIX A

### Pension Reform Analysis

The Pension Protection Clause of the Illinois Constitution provides: “Membership in any pension 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.” Ill. Const., art. XIII, § 5. As the Supreme Court recognized, the “primary purpose” of the clause was “to eliminate any uncertainty as to whether state and local governments were obligated to pay pension benefits to their employees.” *People ex rel. Sklodowski v. State*, 182 Ill. 2d 220, 228 (1998). Prior to the 1970 Constitution, when a pension plan was mandatory, “the rights created in the relationship were considered in the nature of a gratuity that could be revoked at will.” *Id.* The Pension Protection Clause changed that, “mak[ing] participation in a public pension plan an enforceable contractual relationship [that] demands that the ‘benefits’ of that relationship ‘shall not be diminished or impaired.’” *Id.* at 228-29.

An increasingly important question is whether a *prospective* diminishment in pension benefits — meaning a diminishment that applies only to an employee’s future service, not to benefits already accrued from the employee’s prior service — causes a pension benefit to be “diminished or repaired.” The answer is No. Four years after the 1970 Constitution, the Supreme Court held that “the purpose and intent of the constitutional provision was to insure that pension rights or public employees *which had been earned* should not be ‘diminished or impaired’ . . . .” *Peters v. City of Springfield*, 57 Ill. 2d 142, 152 (1974) (emphasis added); see also *People ex rel. Ill. Fed’n of Teachers v. Lindberg*, 60 Ill. 2d 266, 271 (1975) (reiterating standard from *Peters*). Thus, the only pension benefits protected from diminishment are those “which had been earned” at the time the pension scheme is altered. Pension benefits earned in the past cannot be reduced, while benefits that the employee hopes to earn in the future can be reduced.

The Attorney General considered this very issue in Atty. Gen. Op. No. S-1407, 1979 Ill. Atty. Gen. 9 (Jan. 10, 1979) (attached hereto). In Public Act 80-841, the General Assembly amended the manner in which the Pension Code calculated an employee’s pension. Prior to the amendment, the pension was based on “final average compensation,” meaning the actual monthly pay during any four of the employee’s last ten years of service, which usually was the last four years, when the employee’s wages generally were the highest. The amendment provided that, for purposes of calculating “final average compensation,” the employee’s salary for the last 12 months of the four-year period could not exceed the “final average compensation” by more than 25%.

The Attorney General recognized that the amendment, “by changing the way in which State employees’ compensation is considered for pension calculation purposes, may result in lower pensions for some employees than they would have received otherwise.” *Id.* at 10. For example, if “a State employee happened to receive \$9,000 each of the first three years and then was appointed to a \$13,000 position the fourth year,” the employee’s “final average compensation” would have been \$10,000 under the former system, but about \$200 less under the amendment. *Id.* at 11. The question was whether the amendment diminished pension benefits under the Pension Protection Clause.

In answering that question, the Attorney General focused on the above-quoted passage from *Peters*, which makes clear that the Clause was designed to protect only those pension rights “which had been earned.” *Id.* at 13. Applying that principle, the Attorney General concluded that “applying the [amendment] to pay received before January 1, 1978,” the amendment’s effective date, would violate the Clause. *Id.* By contrast, the Attorney General stated that the amendment “may be applied only to earnings received after” the effective date.

The lesson of *Peters*, then, is that the Pension Protection Clause prohibits state and local governments from reducing pension benefits earned in prior years, but permits state and local governments to reduce pension benefits an employee may earn in the future, benefits that have not yet accrued. This conclusion is in accord with the underlying premise of the Clause, which was to “create a contractual right to benefits.” *Sklodowski*, 182 Ill. 2d at 233. “Statutory pension rights cannot be altered, modified, or released except in accordance with usual contract principles,” meaning that “the constitutional protection afforded public pensions extends as far as the pension rights conferred by statute and contract.” *Smithberg v. Illinois Mun. Retirement Fund*, 306 Ill. App. 3d 1139, 1143 (1999). Contract law does not permit one party to deprive its counterparty of fruits of the contract that have already been earned. But contracts, and statutes, are not frozen in place for all eternity, and can be amended to alter the parties’ relationship on a prospective basis. See *Peter*, 57 Ill. 2d at 151-52 (municipality may lower retirement age from 63 to 60 even if effect is to reduce pension benefits of retirees); *Higgins v. Sweitzer*, 291 Ill. 551, 554 (1920) (“the right to prospective salary of an office or position is not a property right”). By adding the Pension Protection Clause to the 1970 Constitution, the Framers intended to adopt those very principles to govern the rights and obligations inherent in public pensions.



## The Civic Federation

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October 28, 2009

Donald McNeil  
Chairman, State of Illinois Pension Modernization Task Force  
c/o Barnes & Thornburg LLP  
One North Wacker Drive  
Suite 4400  
Chicago, IL 60606

Dear Chairman McNeil:

The Civic Federation seconds and supports the proposed report submitted by Eden Martin to the State of Illinois Pension Modernization Task Force. We believe that his report best reflects the financial condition of the State pension systems and more completely fulfills the mandate of House Joint Resolution 65.

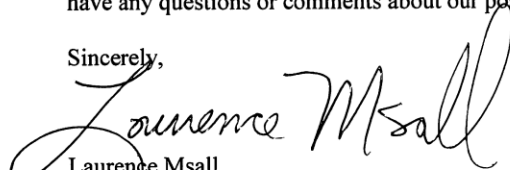
While Mr. Martin's report describes the State of Illinois as "nearly bankrupt," we believe there is mounting evidence that a judge could find the State is already insolvent. For several years, the State of Illinois has routinely acted to push current obligations into future years by borrowing, skipping pension payments, failing to pay vendors on time, and simply passing unbalanced budgets. It is difficult to see how the State could claim that it is currently solvent when it is demonstrably unable to pay its bills.

If the State is found to be insolvent under the classical cash flow definition of insolvency, which is the "inability to pay debts as they come due," it is not only the pension rights of non-vested employees that will be in jeopardy. All the **obligations** of the State, whether vested or not, will be competing for funding with the other essential **responsibilities** of State government. Even vested pension rights are jeopardized when a government is insolvent.

For these reasons, we strongly urge the Task Force to adopt Eden Martin's proposed report including the recommended changes to reduce benefits and increase funding for the State pension systems. Additional revenues will be necessary once pension reforms have been made for the State to meet its pension funding obligations; we recommend an income tax increase to achieve this purpose, but only if the outlined pension benefit reforms are made. We reject any further pension borrowing by the State and urge this Task Force to recognize the damage that borrowing has already done to both the pension systems and the State's finances.

The Civic Federation appreciates the opportunity the Illinois Pension Modernization Task Force has afforded us to analyze and propose reforms to the State's crisis-ridden pension systems. If you have any questions or comments about our position, please call me at 312-201-9044.

Sincerely,



Laurence Msall  
President

cc: Governor Pat Quinn  
David Vaught

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## Taxpayers' Federation of Illinois

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October 30, 2009

Mr. Donald McNeil  
Chairman, State of Illinois Pension Modernization Task Force  
c/o Barnes & Thornburg LLP  
One North Wacker Dr., Suite 4400  
Chicago, IL 60606

Dear Chairman McNeil:

We have reviewed the Proposed Pension Modernization Task Force Report submitted by Eden Martin of the Civic Committee of Chicago and a member of the Task Force. We find the draft report appropriately presents the dire financial position of the state pension funds specifically and the overall financial condition of state government. It is clear that the funding of pensions has been a low priority of our state's policy makers and we cannot continue the ways of the past. Funding priority is important but pension reform must be incorporated in the plan.

The current benefit and cost sharing structure is unaffordable given current and future expected demographics. The benefit structure far exceeds what is available in the private sector. If the taxpayers of our state are expected to support a "solution" to the financial challenges facing our state, they demand reform of our public benefit plans as part of that solution. Historically, the justification given for the generous government employee benefit structure was the lack of comparable wage compensation programs for government employees. That is no longer the case. Current reports of the U.S. Bureau of Labor Statistics show public employees are compensated considerably higher than the employees in the private sector.

We strongly support the proposed reforms set forth in Mr. Martin's draft report and urge the Task Force to adopt them as its recommendations.

Sincerely,  
  
J. Thomas Johnson  
President

cc: Rep. Kevin McCarthy, Vice-Chairman

**From:** Mark Denzler [mailto:mdenzler@ima-net.org]  
**Sent:** Wednesday, October 28, 2009 5:54 PM  
**To:** dmcneil@btlaw.com  
**Cc:** Mark Denzler  
**Subject:** Pension Reform Task Force Response

Chairman McNeil:

On behalf of the Illinois Manufacturers' Association, I would like to express our very strong support of the report submitted by Eden Martin to the Pension Task Force. There is absolutely no doubt that this report best reflects the current status and accuracy of Illinois' pension systems and offers the best course for resolving this issue that threatens Illinois' economic future. Without action, the problem will only worsen dramatically causing the further exodus of jobs and people.

The IMA, and our Board of Directors, strongly encourages the Pension Task Force to adopt Eden's proposed report. Thank you for the opportunity to analyze and respond.

Regards,

Mark

**Mark Denzler**

Chief Operating Officer, VP Government Affairs

Illinois Manufacturers' Association

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**From:** Rob Karr [mailto:rkarr@irma.org]  
**Sent:** Wednesday, October 28, 2009 5:37 PM  
**To:** 'McCurdy, Steve'  
**Cc:** 'Carol Gadbois'; Laurence Msall; 'Mark Denzler'  
**Subject:** Pension Task Force

Steve, thank you for re-sending me the call-in information last Monday morning. Unfortunately, for whatever reason, I was unable to connect through to the Pension Task Force meeting Monday despite repeated attempts. Nevertheless, I have sat through the various meetings, read handouts, reviewed COGFA's draft and, most recently, Eden Martin's proposed amendment to the COGFA draft. As a business representative of the Task Force, I wholeheartedly support Mr. Eden's report as an accurate reflection of what has occurred to date and urge its adoption. – Rob Karr, IRMA

*Rob Karr  
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