



Debunking Illinois Pension Myths!

Anyone who has read a newspaper over the last few years knows that Illinois state government has been suffering through repeated budget deficits. Many factors have contributed to the state's ongoing fiscal difficulties. These factors include both a structurally flawed state revenue system, which imposes tax burdens unfairly and fails to track the modern economy, as well as spending pressures for significant budget items, like healthcare, the cost of which increases at rates much greater than regular inflation.

*Among the most discussed – but least accurately portrayed – spending pressures that contribute to the state's fiscal problems, is Illinois' unfunded pension liability owed to the state's five public employee retirement systems: the State Employee Retirement System ('SERS' – **currently 46.1% funded**), the Downstate Teachers' Retirement Systems ('TRS' – **currently 56% funded**), the State Universities Retirement System ('SURS' – **currently 58.5%**), the Judges Retirement System ('JRS' – **currently 42%**) and the General Assembly Retirement System ('GARS' – **currently 32% funded**). Maybe the problem gets misrepresented so frequently due to its enormous scale, an unfunded liability that exceeds \$54.4 billion, the worst of any state in the nation. Or, perhaps the current legislation covering repayment of the liability, frequently called the 'Pension Ramp', which backloads costs and creates escalating fiscal pressure over the long term, causes people to misconstrue the issue. Whatever the reason, almost the entire discussion of what caused the state's unfunded liability to develop in the first place, as well as how best to address the problem in the long run, is woefully off point, dominated by myth and rhetoric, and contrary to the data.*

The following is an effort to dispel some of the more common, and egregious, myths involving Illinois' unfunded pension liability.

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1. Myth: The main cause of Illinois' \$54.4 billion unfunded pension liability is a bloated public sector headcount receiving overgenerous benefits.

Reality: Historically, the Illinois state fiscal system has failed to generate the revenue needed to cover both the inflationary increase in the cost of maintaining public services from year to year and the full employer contribution required to fund pensions. So, rather than cut services, the state usually chose to underfund its employer contribution. Overtime, this chronic failure to make the full employer contribution is the primary reason for Illinois state government's predicament today, facing the worst unfunded pension liability in the country.

2. Myth: Illinois has too many public employees.

Reality: Illinois actually ranks 49th among the states, next to last in the nation, in number of state employees per capita. Historically, Illinois has not been a high public employee head count state. 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 service to the public.

3. Myth: Public employee benefits are too generous.

Reality: For most Illinois public employees, their pension is all they receive upon retirement – fully 78% are not covered by and do not receive Social Security. This is unlike workers in the private sector, who receive both Social Security and private retirement benefits.

4. Myth: Illinois' current defined benefit system is too expensive.

Reality: The 'normal cost' of a pension system is the contribution required from an employer to fund the plan's benefits. The weighted average 'normal cost' across all five Illinois pension systems, as a percentage of active members' payroll, averages 9.13 percent. The national average for state and local government is 12.5 percent, placing the normal cost of Illinois' current defined benefit program far below the national average.

5. Myth: Switching Illinois from a defined benefit to defined contribution system will erase Illinois' \$54.4 billion pension debt.

Reality: Switching to a defined contribution plan from a defined benefit plan cannot reduce or eliminate any of the \$54.4 billion unfunded pension liability that Illinois owes to its five public employee pension systems.

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)." Irrespective of the nature of the plans going forward – the only way to address the unfunded pension liability is to find a rational way to pay it. The problem cannot be legislated away.

6. Myth: Placing new public sector employees into a defined contribution system would save the state money.

Reality: A switch to a defined contribution plan for new employees would not save the state of Illinois money. In fact, a switch to a defined contribution system would likely increase costs; defined contribution systems have significantly higher annual administrative costs than fully funded defined benefit systems.

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. To put that in context of the Illinois pension systems, the administrative costs of a defined contribution system would in all likelihood cost taxpayers anywhere from \$275 to \$610 million more annually than the state's current defined benefit systems.

Reality: If contribution rates remain the same, defined contribution systems can be expected to generate significantly lower retirement benefits for greater costs. This was the specific experience of Nebraska, which switched to a defined contribution system for some of its employees over 30 years ago, and recently shifted back to a defined benefit system.

In the mid 1960's, Nebraska switched from a defined benefit to a defined contribution plan for some of its state and county government employees. Over time, Nebraska found that when compared to its defined benefit plan, the new defined contribution plan cost the state significantly more in investment management fees, record-keeping fees, educational programs and other administrative line items. In 1999, Nebraska's administrative expenses for its defined contribution plans were double the costs of its defined benefit plans. Faced with irrefutable data illustrating that defined contributions systems provide lower benefits for employees at higher costs to taxpayers, Nebraska legislators changed back to a defined benefit model in 2002.

Reality: Going forward, a fully funded defined benefit system can reduce taxpayer costs

In a defined contribution setting, the normal cost is simply what percentage of a worker's pay the government employer has promised to contribute to that worker's retirement account, together with any match. In a defined benefit setting, normal cost is the annual percentage of total payroll a government employer must contribute to fund the promised benefit for its current workforce, based on actuarial tables. This contribution is funded from a combination of employer and employee contributions, tax revenue and investment returns earned on plan asset. If the returns on investments are high enough they can actually reduce the amount of tax revenues needed to fund the contribution - reducing taxpayer cost. In the defined contribution setting, on the other hand, investment returns belong solely to the employee who makes the investment in his or her retirement account, and are not available to reduce the employer contribution.

Frequently, fully-funded defined benefit plans attain high enough investment returns that public sector employers are able to reduce the amount of normal cost paid from tax collections, freeing taxpayer revenue to cover services. This cost savings can be significant, as the experience of the Illinois Municipal Retirement Fund ("IMRF") demonstrates.

The IMRF, the second largest pension fund in Illinois covering public employees such as bus drivers, sewer workers and municipal administrators, has enjoyed a funding advantage for years, in large part because it demands full and on time payments from member government employers and employees. As a result, the IMRF has consistently maintained high levels of funding.

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