



Public Pensions: Frequently Asked Questions

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1. WHAT IS A DEFINED BENEFIT PLAN?

A **defined benefit** plan is one in which an employer guarantees an annual retirement payment for its workers that is based on a formula. The formula typically includes factors like an employee's years of service and either ending salary or average salary over the last few years of employment. Most defined benefit plans also include an annual cost of living—or “COLA”—adjustment to the annual retirement benefit to ensure it does not lose value over time. Under defined benefit plans, this annual retirement payment is guaranteed for the life of the retiree and his or her spouse—and it is the guaranteed annual retirement payment that constitutes the “defined benefit” under the plan.

The retirement benefits are funded from three sources: (i) employee contributions; (ii) employer contributions; and (iii) investment earnings on pension fund assets. Unlike in the defined contribution setting, individual accounts are not created. Instead, all employer and employee contributions and investment returns are pooled together, and the assets are collectively managed. The employer retains responsibility for managing the plan and for ensuring adequate funding is available for payment of benefits when due. Each of Illinois' five state retirement systems are primarily structured as defined benefit plans.

2. WHAT IS A DEFINED CONTRIBUTION PLAN?

In contrast to a defined benefit plan, a **defined contribution** plan does not provide guaranteed annual benefit upon an employee's retirement. Instead, it requires the employer to make a “defined contribution” into the individual retirement savings account (such as a 401(k), 403(b) or 457 plan) created for each member. Hence, the retirement benefit each member of a defined contribution plan ultimately receives is the accumulated savings in his or her individual account upon retirement. This final savings amount is simply the sum of contributions made to an individual account by the member and his or her employer, increased by investment earnings and decreased by investment losses. Each employee is responsible for managing his or her own retirement account, but must pay a third party to administer it. Employees make all decisions about where to invest retirement savings and how much to contribute. All market and timing risks concerning the savings ultimately available at retirement in an individual's defined contribution account are borne by the employee. It is therefore possible for him/her to outlive the accumulated savings in the account, and/or to lose all of or a substantial part of his or her retirement savings in a turbulent market.

3. WHAT IS THE AVERAGE PENSION BENEFIT FOR A PUBLIC EMPLOYEE IN ILLINOIS?

Based on Census Bureau data, in 2014 the national average public pension benefit was approximately \$26,455 per year, and the Illinois average public pension benefit was approximately \$32,896 per year.¹ However, that is not an “apples-to-apples” comparison. This is because the benefits provided under most other public pension plans are supplemented by social security. This is not the case in Illinois, where most of Illinois’ public employees do not get social security—meaning that their public pension is their sole source of retirement income. In Illinois’ five state retirement systems, nearly 90 percent of the members do not get social security.²

Figure 1 shows the average annual pension for retirees in Illinois’ five different state retirement systems for fiscal year 2014.²

Figure 1
Illinois State Retirement Systems’ Average Pension Benefit
as of Fiscal Year 2014

Retirement System	Average Benefit
Illinois Judges' Retirement System (JRS)	\$128,627
Illinois State Employees' Retirement System (SERS)	\$33,115
Illinois Teachers' Retirement System (TRS)	\$50,494
Illinois State University Retirement System (Defined Benefit Members Only) (SURS)	\$48,894
Illinois General Assembly Retirement System (GARS)	\$56,520
Weighted Average	\$45,832

Source: Average annual pension figures for individual systems are derived from the retirement systems’ Fiscal Year 2014 Comprehensive Annual Financial Reports, and the average annual pension is a weighted average calculated by the Center for Tax and Budget Accountability.

The weighted average annual pension presented above (\$45,832) differs from the Census Bureau figure (\$32,896) for several reasons. First, the Census Bureau data is for all state and local pension funds in Illinois, whereas the weighted average in Figure 1 includes just the five state pension systems. Also, the Census Bureau calculation is an arithmetic mean (the most common way to calculate an average). A weighted average is a more appropriate calculation because the five public pension systems in Figure 1 all have different numbers of retirees and different average pensions. A weighted average takes into account the different numbers of retirees and different pension amounts, while a normal average does not. It is not possible to calculate a weighted average using Census Bureau data. Last, the weighted average annual pension in Figure 1 (\$45,832) is based off of only retiree benefits, whereas the national statistic includes survivor and disability beneficiaries, as well as one-time lump-sum payments. Including survivor and disability beneficiaries, as well as one-time lump-sum payments, skews the average down because survivor and disability benefits are typically less than the benefit for a retired employee.

¹ Source: U.S. Census Bureau. *State and Local Government-Employee Retirement Systems*. Washington, DC: U.S. Census Bureau, 2014 data. Please note that the Census Bureau’s data provides only aggregate information, and a weighted average would provide a more accurate figure.

² Figure calculated using active and inactive membership data for FY2014 from each retirement systems’ actuarial report—members of SURS’s self-managed plan were excluded from analysis.

4. WHAT IS AN UNFUNDED LIABILITY?

An unfunded liability exists when the present value of pension benefits earned to date by members of a defined benefit plan is less than the value of the assets the plan has accumulated to finance those benefits

4.1 What is a funded ratio?

A funded ratio places unfunded liabilities in the context of a retirement system's assets. Expressed as a percentage, the funded ratio is calculated by dividing net assets by liabilities. The resulting ratio shows the percentage of a plan's liabilities that are covered by assets. At 100%, a system has sufficient assets to pay all benefits earned to date for all its members—this includes paying benefits to current retirees as well as paying benefits in the future to current members of the plan who will not retire for decades. A funded ratio of at least 80% is generally considered to indicate that a pension system is in sound fiscal condition.³ Figure 2 shows the unfunded liabilities and funded ratios for Illinois' five state retirement systems as of fiscal year 2015.

Figure 2
Illinois State Retirement Systems Funding Status as of Fiscal Year 2015

Retirement System	Funded Ratio	Unfunded Liability (\$ Millions)
JRS	34.8%	\$1,509.9
SERS	36.2%	\$26,001.7
TRS	42.0%	\$62,686.6
SURS	43.3%	\$22,423.4
GARS	16.0%	\$275.6
Total	40.9%	\$112,897.2

Source: COGFA, *Special Pension Briefing* (Springfield, IL: November 2015).

4.2 Borrowing is the primary cause of Illinois' unfunded pension liability

Illinois incurred its substantial pension debt, which now stands in excess of \$112 billion, over decades, by diverting what it should have contributed to fund pension benefits to instead subsidize the cost of providing public services. As Figure 2 demonstrates, Illinois' funded ratio is unacceptably low, with the natural corollary being that its unfunded liability is unacceptably high. Which begs the question: why?

While a number of factors can contribute to the creation and growth of an unfunded liability, like changes in actuarial assumptions and underperformance of investments, the data make it very clear that the primary cause of Illinois' unfunded liability is the decision by elected officials to borrow against what they owed to the systems, rather than make the employer contributions called for.

At the end of fiscal year (FY) 1994, Illinois lawmakers had borrowed so much against the pension systems to fund services that combined the five systems were just 54.5% funded—meaning that just over half of all liabilities were covered by assets—and had an aggregate unfunded liability of \$17 billion. This was almost twice the unfunded liability of \$8.6 billion that existed just five years previously, in FY1989.

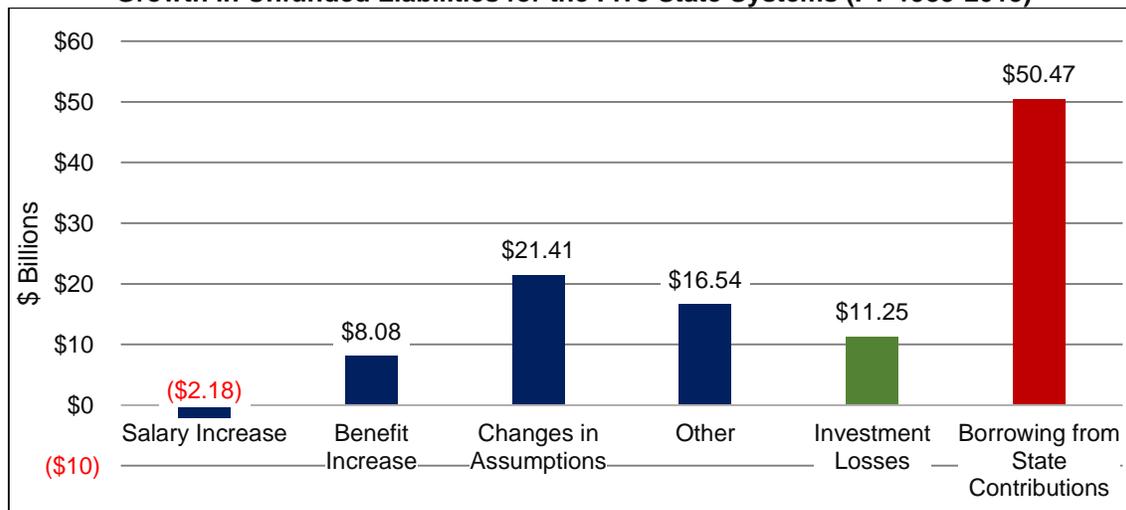
In FY1995, the General Assembly passed and Governor Jim Edgar signed into law Public Act (PA) 88-593, which is commonly referred to as the "Pension Ramp" or "50-year funding law." Even though PA 88-593 was ostensibly created to repay the debt owed to and resolve the underfunding of the pension systems, the legislation—by law—actually continued the practice of borrowing against contributions owed to the pension systems to subsidize the cost of delivering public services for 15 years after its passage. PA 88-593 accomplished this by creating the following two-phase repayment schedule:

³ See: U.S. Government Accountability Office, *State and Local Government Retiree Benefits— Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs* (Washington DC: September 2007),

- Part 1—Fiscal Years 1996-2010—during this “15-year phase-in period”, the state’s annual contributions were calculated as a very low percentage of payroll, which was steadily increased from year-to-year so that by FY2011 the annual contribution would finally reach a point that the state could begin paying debt owed to the retirement systems. This phase underfunded the systems because the state’s contributions required by law were often not enough to cover the cost of funding benefits earned by current workers much less pay principle or interest on the debt. The state’s insufficient contributions during Part 1 effectively increased the unfunded liability of the five pension systems by \$24.7 billion.⁴
- Part 2—Fiscal Years 2011-2045—during this phase the state is annually required to pay a level percent of payroll that is sufficient, when added to employee contributions and investment returns, to bring the systems to a 90% funded ratio by the end of FY2045. A level percent of pay is one way to amortize an unfunded liability. Under this method of amortization, the debt service contribution in dollar amounts increases from year-to-year, creating a backloaded repayment schedule.

Figure 3 shows the sources of growth in the combined unfunded liability across all five state-funded retirement systems from FY1985-FY2015. As Figure 3 demonstrates, the greatest cause of the state’s unfunded liability has been borrowing against the pension systems. This meant that the state’s contributions were not sufficient to pay for both benefits earned by current employees and interest on the pre-existing unfunded liability. Without sufficient contributions, an unfunded liability annually grows by a retirement system’s investment rate assumption (which ranges from 7% to 7.5% among Illinois’ five state systems).

Figure 3
Growth in Unfunded Liabilities for the Five State Systems (FY 1985-2015)



Sources: COGFA, *Analysis of Change in State Pension Unfunded Liability 1985-2012* (Springfield, IL); COGFA, *Financial Condition of the Illinois State Retirement Systems as of June 30, 2014* (Springfield, IL: February 2014); COGFA’s November 2015 Special Pension Brief.

4.3 Aren’t all defined benefit retirement systems severely underfunded?

No. According to the Public Fund Survey, the median funded ratio for more than 100 of the nation’s largest public pension plans was 71.8% in 2013.⁵

⁴ COGFA, *A Report on the Appropriateness of the 90% Funding Target of Public Act 88-593* (Springfield, IL: COGFA, June 2011), 9.

⁵ Public Fund Survey, Summary of Findings for FY 2013, <http://www.publicfundsurvey.org/publicfundsurvey/summaryoffindings.html>

5. WHAT IS ILLINOIS' CONSTITUTIONAL PENSION PROTECTION CLAUSE?

Illinois is one of only seven states that have constitutional protection of pension benefits.⁶ Section 5, Article XIII of the Illinois Constitution, commonly referred to as the pension protection clause, provides that:

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

Section 5, Article XIII of the Illinois Constitution effectively mandates that once an individual joins one of the state's retirement systems⁷ his or her benefits cannot be cut. Recent legislative attempts to ignore this clear mandate and cut pension benefits have been overturned by the Illinois Supreme Court, which has stated that Section 5, Article XIII means exactly what it says, "if something qualifies as a benefit of the enforceable contractual relationship resulting from membership in one of the State's pension or retirement systems, it cannot be diminished or impaired."⁸

⁶ Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, and New York all constitutional provisions that protect pension benefits; however, not all provisions protect both accrued benefits and future accruals. Illinois and New York have provisions in their state constitutions that "expressly prevent the state from reducing benefits that participants expected at the time of employment" (Munnell and Quinby, 2012, p.2). Source: Munnell, A. and L. Quinby, *Legal Constraints on Changes in State and Local Pensions* (Boston: Center for Retirement Research, August 2012).

⁷ This includes the five state retirement systems, as well as all other public pension systems in Illinois.

⁸ *Kanerva v. Weems*, 2014 IL 115811

For more information, contact the Center for Tax and Budget Accountability:
Ralph Martire, Executive Director, (312) 332-1481 or rmartire@ctbaonline.org
Amanda Kass, Research Director, (312) 332-1103 or akass@ctbaonline.org
www.ctbaonline.org
