# STATE OF ILLINOIS PENSION SYSTEMS: ANALYSIS AND RECOMMENDATIONS

**(*Excerpted from the Civic Federation's***
**State of Illinois FY2007 Recommended Operating Budget: Analysis and Recommendations)**

**Prepared by**
**The Civic Federation**
**March 17, 2006**

## CIVIC FEDERATION POSITION STATEMENT ON THE PENSION FUNDING PROPOSALS IN THE FY2007 ILLINOIS STATE BUDGET

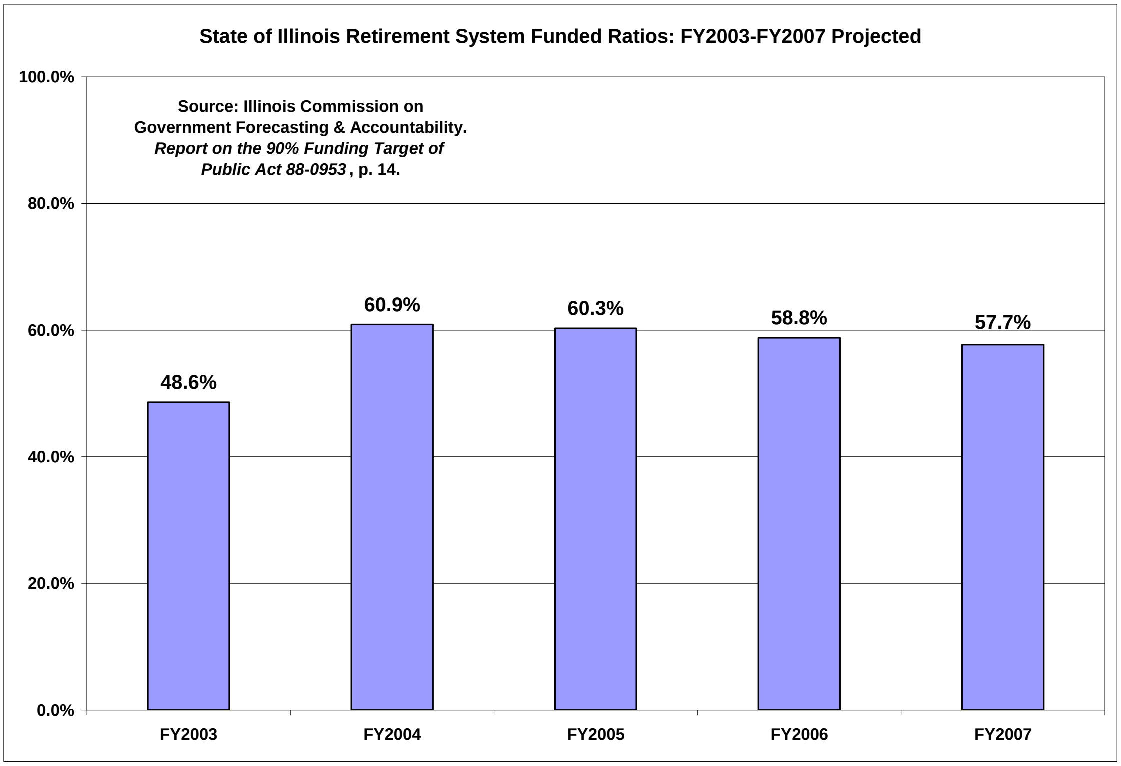
The Civic Federation **opposes** Governor Blagojevich's FY2007 $45.4 billion operating budget because it is built on a foundation that shortchanges the State's pension funds by $1.1 billion. To compound the problem, this is the second year the State has chosen to use this easy short-term fix. Last year, the Governor and General Assembly approved a two-year, $2.3 billion partial pension holiday.

At the same time this budget proposes to underfund the retirement systems, it is proposing hundreds of millions of dollars in expensive new recurring programs. It proposes as much as $261 million in new initiatives, many of which represent recurring costs that could expand dramatically in future years. Deferring huge, ongoing pension obligations to pay for expensive new obligations that will entail recurring costs is short-sighted and jeopardizes the State's long-term fiscal stability.

Governor Blagojevich, in concert with the General Assembly, appears to have abandoned his pledge to fix one of the State's longstanding problems, the chronic underfunding of its pension systems. It comes as no surprise, then, that the funded ratio of the five retirement systems will fall to 57.7% in FY2007 and unfunded liabilities will rise to nearly $45.8 billion, according to recent projections from the Commission on Government Forecasting and Accountability.

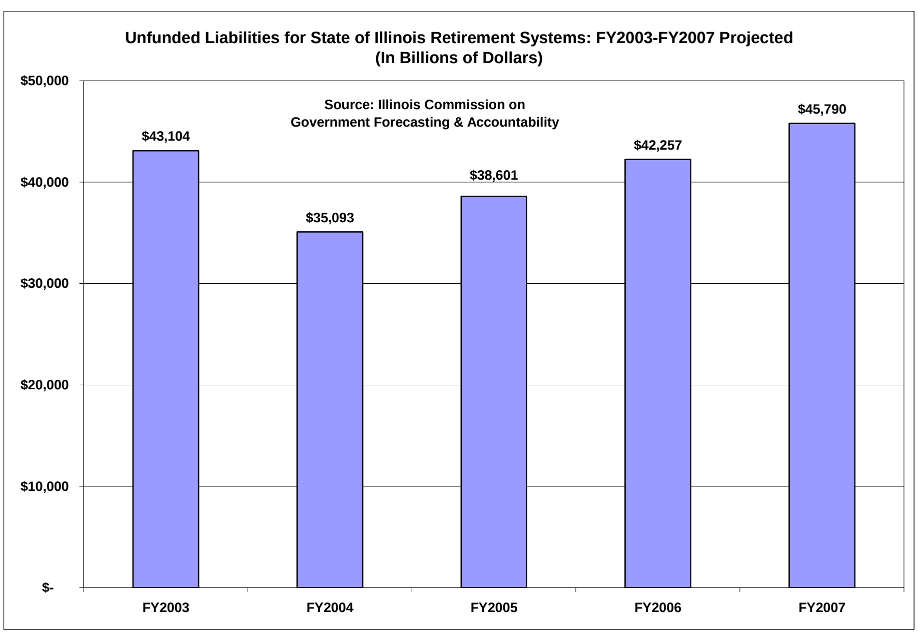
The funded ratio decline is particularly worrisome because it comes after the State issued $10 billion in pension obligation bonds in 2003, and after the State implemented positive pension funding reforms last year that will reduce long-term liabilities from what they otherwise would have been. It is true that between FY2003 and FY2007, the funded ratio for all funds will increase from 48.6% to 57.7%, reflecting that infusion of new dollars. However, since FY2004 the funded ratio has fallen each year. Some of the funded ratio's drop is due to the impact of the Early Retirement Initiative funding fiasco in FY2002, which increased liabilities.[1] But the two-year partial pension holiday has undoubtedly exacerbated the situation.

[1] The original estimated annual cost of amortization of the FY2002 Early Retirement Initiative was $70 million. However, a recalculation has show that there were serious errors in that estimate, and that the actual annual cost will be $382 million. The State has opted to spread out the cost of paying for the ERI over 40 years. These costs are included in the calculation of estimated contributions to the retirement systems over time.



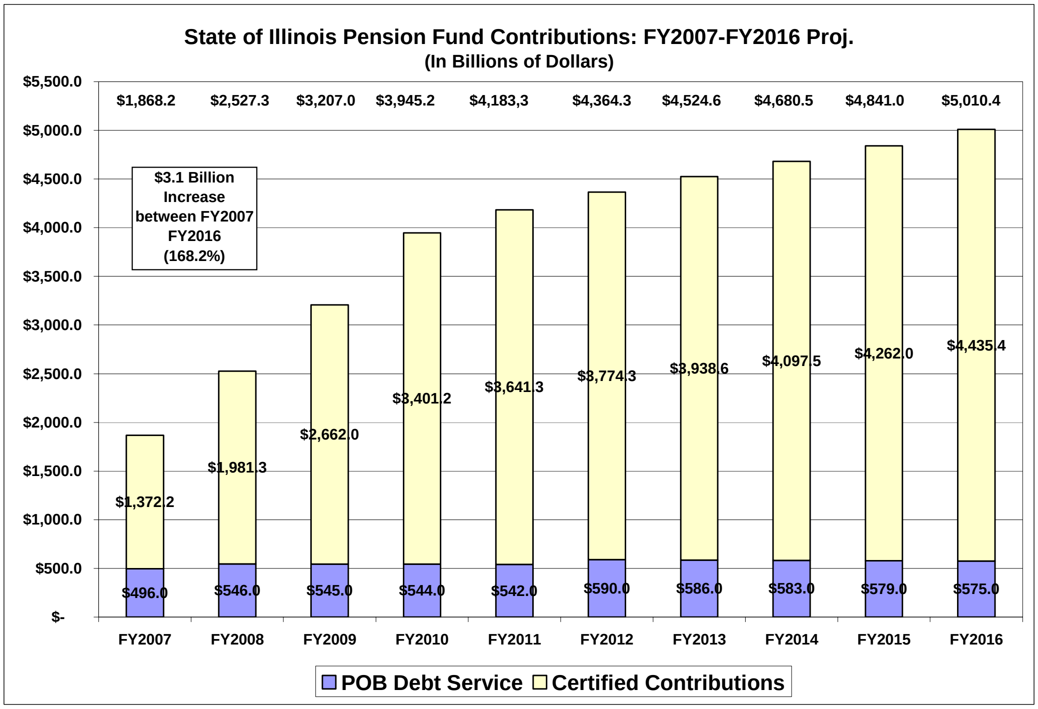

The unfunded liabilities of the State's five pension funds are projected to grow to nearly $45.8 billion in FY2007, according to the Commission on Government Forecasting and Accountability.

This is approximately a 6.2%, $2.6 billion increase since FY2003, when unfunded liabilities were $43.1 billion. In short, unfunded liabilities are even greater than they were before the pension obligation bond issue. This can hardly be considered progress.



*The Pension Funding Crisis is Going to Get Worse*

The pension funding crisis isn't going away.  In fact, from a budgetary standpoint, it's going to get much worse in the future. Assuming that the State makes the full certified contributions for the next 10 years, the annual required payment in FY2016will have increased by 223.2%.  That is a $3.0 billion increase, from $1.4 billion to $4.4 billion. When the debt service payments on the pension obligation bonds are factored in, the amount of increase is $3.1 billion, from $1.9 billion to $5.0 billion.




If State budget appropriations grow at a rate of 5% per year over the next 10 years and the State makes the full certified contributions, the percentage of total appropriations reserved for pensions (including debt service on pension obligation bonds) will rise from 4.1% in FY2007 to 7.1% in FY2016.

| State Pension Expenses as a Percentage of Future Operating Budgets | | | | | |
|---|---|---|---|---|---|
| | All Funds | POB Debt Service* | Certified Contributions | Total Pension Expenses | % of Total Budget |
| **FY2007** | $ 45,427.7 | $ 496.0 | $ 1,372.2 | $ 1,868.2 | 4.1% |
| **FY2008** | $ 47,699.1 | $ 546.0 | $ 1,981.3 | $ 2,527.3 | 5.3% |
| **FY2009** | $ 50,084.0 | $ 545.0 | $ 2,662.0 | $ 3,207.0 | 6.4% |
| **FY2010** | $ 52,588.2 | $ 544.0 | $ 3,401.2 | $ 3,945.2 | 7.5% |
| **FY2011** | $ 55,217.7 | $ 542.0 | $ 3,641.3 | $ 4,183.3 | 7.6% |
| **FY2012** | $ 57,978.5 | $ 590.0 | $ 3,774.3 | $ 4,364.3 | 7.5% |
| **FY2013** | $ 60,877.5 | $ 586.0 | $ 3,938.6 | $ 4,524.6 | 7.4% |
| **FY2014** | $ 63,921.3 | $ 583.0 | $ 4,097.5 | $ 4,680.5 | 7.3% |
| **FY2015** | $ 67,117.4 | $ 579.0 | $ 4,262.0 | $ 4,841.0 | 7.2% |
| **FY2016** | $ 70,473.3 | $ 575.0 | $ 4,435.4 | 5,010.4 | 7.1% |

* Principal + Interest
Assumes 5% appropriation growth per year
Certified Pension Contribution data from Commission on Government Forecasting & Accountability
POB Debt Service figures from FY2007 Illinois State Budget, p. 12-13.

The Civic Federation has consistently supported Governor Blagojevich's efforts to reform the way Illinois funds pensions in order to reduce the staggering unfunded liabilities produced by decades of underfunding. With caveats, we supported the issuance of $10 billion in pension obligation bonds in 2003. We endorsed the Governor's proposed reforms last year. But the administration's abrupt change in direction is exacerbating an already bad situation rather than providing a long-term solution. We must oppose the pension contribution reduction and therefore we must oppose the budget on which it is based.

We recognize that any solution to the pension funding crisis will inflict pain and will require difficult choices. The longer that pain is deferred, the worse the situation will become until the State is forced to take drastic action.

In conclusion, the Civic Federation opposes the FY2007 State operating budget because it fails to adhere to two key fiscal principles:

1. The State of Illinois should fund its retirement systems at the certified contribution amount each year as established by the 1995 pension funding reform law.

2. The State should meet existing obligations before undertaking expensive new programs, particularly those with recurring costs.

FY2007 Pension Proposals the Civic Federation Supports

The Governor's second Blue Ribbon Commission on Pensions made a number of pension reform recommendations. The Civic Federation agrees with four of the Commission's findings that focus on identifying or securing dedicated revenues to fund the retirement systems and regularly reviewing pension benefits:

1. The State should dedicate revenues in excess of a targeted percentage of growth toward the additional funding of the pension systems when those targets are met and establish a minimum when they are not met.
2. If the state sells certain assets, 100% of the proceeds should be dedicated toward reducing pension liabilities.
3. The General Assembly should explore new dedicated revenue sources for the retirement systems.
4. The legislature should regularly review the pension systems' provisions regarding benefits and make determinations as needed.

The fifth recommendation, however, proposes that the State consider issuing additional Pension Obligation bonds to further reduce pension costs as long as market conditions are favorable, and as long as POB issuance is part of a broader plan to reduce the retirement systems' unfunded liabilities. Absent any ironclad commitment by the Governor or Legislature to actually fund the retirement systems at their certified level, we are not convinced that issuing additional debt would in fact improve the funding situation. An influx of bond money might unfortunately become an excuse to reduce budgetary contributions to the retirement systems.

## OVERVIEW OF THE STATE OF ILLINOIS RETIREMENT SYSTEMS

The State of Illinois funds five retirement systems for employees and retirees: the State Employees Retirement System (SERS), the Teachers' Retirement Employment Retirement System (TRS), the State Universities Retirement System (SURS), the Judges' Retirement System (JRS) and the General Assembly Retirement System (GRS). A total of 666,952 individuals are currently enrolled in these five systems.

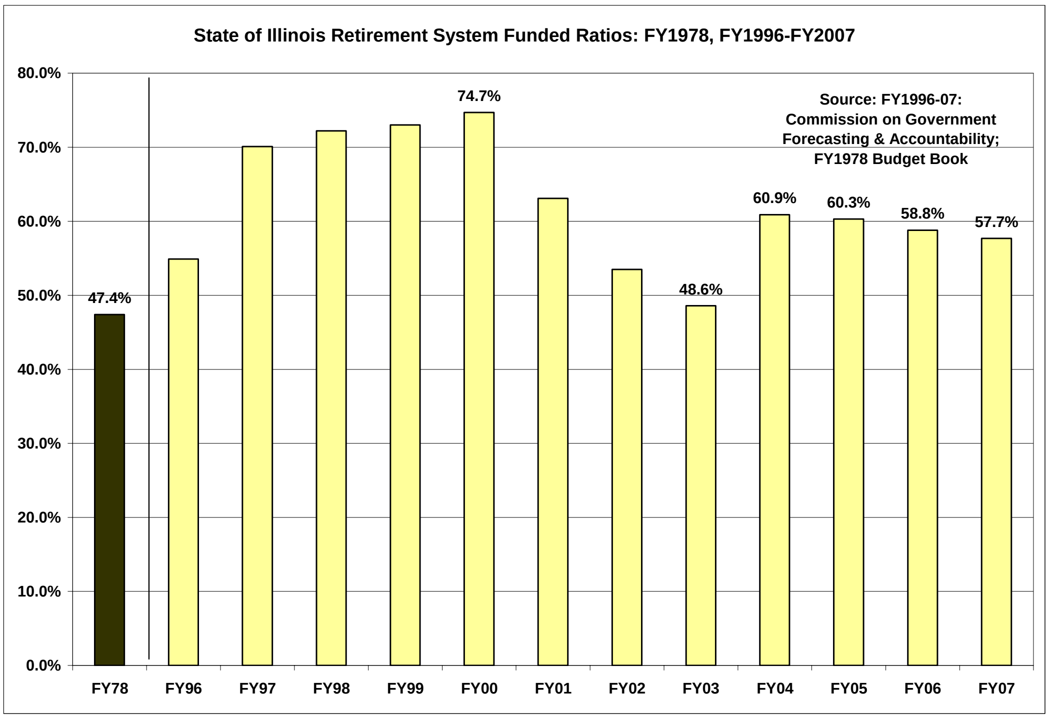
**MEMBERS OF ILLINOIS RETIREMENT SYSTEMS**

| Pension Fund | Members | Annuitants | Total |
|---|---|---|---|
| Teachers | 245,925 | 82,491 | 328,416 |
| University | 149,951 | 39,800 | 189,751 |
| State Employees | 91,423 | 54,828 | 146,251 |
| Judges | 962 | 900 | 1,862 |
| General Assembly | 275 | 397 | 672 |
| **Total** | **488,536** | **178,416** | **666,952** |

Source: FY2007 Illinois State Budget, p. 4-1.

The exhibit that follows shows historic funding ratios for the State of Illinois' five retirement systems. It compares the funded ratio for FY1978, which was 47.4%, to a 12-

year trend from FY1996-FY2007. After passage of the 1995 funding reform law, funded ratios rose to a high of 74.7% in FY2000 before falling once again. The funded ratio rose from 48.6% in FY2003 to 60.9% the following year after the issuance of $10.0 billion in Pension Obligation bonds. However, since then, the funded ratio has dropped each year, according to calculations from the Commission on Government Forecasting and Accountability that consider the impact of pension funding reforms, benefit increases and the two-year partial pension holiday in FY2006-FY2007. In FY2007, to, the funded ratio will fall to 57.7%.



## Pension Obligation Bonds

In 2003, Governor Blagojevich signed Public Act 093-0002 authorizing the issuance of $10 billion of Pension Obligation Bonds. The proceeds of these bonds were to be used to fund current and future unfunded liabilities of the State's five pension funds.

The Civic Federation has traditionally cautioned governments against using long-term debt to address budget shortfalls. However, the Federation recognized the extraordinarily difficult financial position of Illinois and most other state governments. As a result of the dire budget conditions of the State, past funding inadequacies, and historically low interest rates, The Civic Federation supported this proposal.

While supportive of the Governor's proposal, The Civic Federation strongly warned against the practice of debt financing to correct ordinary budget shortfalls or to fund normal operations, which would traditionally include current pension obligations. The Federation also offered the following concerns and suggestions:

- The General Assembly and the public at large should be aware that this financial strategy would not eliminate all the problems associated with the funding of State pensions.
- We strongly encouraged the General Assembly to be mindful of the benefit levels granted to employees.
- In the future, the State should also consider authorizing cost effective, contemporary borrowing techniques such as variable rate obligations.

## The Governor's FY2006 Pension Funding Reform Proposals

Governor Blagojevich proposed a number of pension funding reform proposals in the FY2006 State of Illinois Budget. These proposals were all originally recommended by the Governor's Blue Ribbon Pension Commission, which is composed of representatives from the General Assembly, business, labor and civic groups. The Governor accepted all but two of the Commission's recommendations:

- Requiring employees to increase the percentage of salary they pay into the retirement systems by 1%, and
- Considering shifting to a defined contribution (DC) Plan at some point in the future.

The General Assembly approved a few of the Governor's proposed reforms with some modifications. The most significant proposals enacted into law were capping end of year salary increases, eliminating the State Universities Retirement Systems money purchase option for new hires, limiting eligibility for alternative formulas and requiring funding for enhanced benefits. The legislators rejected proposals to:

- Change the eligibility for full benefits to age 65, with 8 years or more of service; age 62 with 30 years or more of service; or age 60 with 35 years or more of service.
- Limit automatic benefit increases for new hires to the lesser of the change in CPI or 3% and apply increases only to the first $12,000 in annual pension for retirees covered by Social Security and $24,000 for retirees not covered by Social Security.

New proposals approved by the legislature and signed into law by the Governor enacted a two-year deferral of $2.3 billion in pension contributions, created a second Blue Ribbon Task Force to further study pension reform, created a cost neutral early retirement program and eliminated lump sum awards for unearned sick pay.

The exhibit below presents a comparison of the Governor's FY2006 original pension funding proposals as well as new proposals that were advanced during the legislative session and the final action taken by the General Assembly.

| PENSION FUNDING REFORMS | |
|---|---|
| **GOVERNOR'S ORIGINAL PROPOSALS** | **FINAL BUDGET APPROVED** |
| Cap End of Year Salary Increases to 3% | 6% annual Cap Adopted |
| Eliminate SURS Money Purchase Option (New Hires) | Approved |
| Recalculate Money Purchase Interest Rate to Reflect Long-Term Rate of Return, not 9% | Authorized Comptroller to set rate |
| No New Benefits w/o Funding | Approved |
| Limit Alternative Formula Benefits (New Hires) | Approved |
| Limit Automatic Increases to CPI | Not Approved |
| Change Retirement Age (New Hires) | Not Approved |
| | |
| ***New Proposals*** | |
| Defer Pension Contributions by $2.3 Billion over 2 Years | Approved |
| Create Task Force to Study Pension Reform | Approved |
| Create Cost Neutral Early Retirement Program Paid for by Local Employers/Beneficiaries | Approved |
| Eliminate Lump Sum Awards for Unearned Sick Pay to Boost Pensions | Approved |

**Pension Fund Indicators**

The Civic Federation used three measures to present a multi-year evaluation of the fiscal health of the State of Illinois pension funds: funded ratios, the value of unfunded liabilities and pension fund contributions as a percentage of General Fund resources.

*Funded Ratios*

Five years of information on actual and projected funded ratios for the State's pension funds are illustrated in the following exhibit. The ratios were calculated by the

Commission on Government Forecasting and Accountability. The FY2003 figures do not include proceeds of the $10 billion Pension Obligation bond issue.[2]

Between FY2003 and FY2007, the funded ratio for all funds will increase from 48.6% to 57.7%. However, the funded ratio has fallen each year since FY2004; in that year the funded ratio increased dramatically because of the infusion of the proceeds of the $10 billion Pension Obligation bonds. Between FY2006 and FY2007:

- The projected funded ratio for the State Employees' Retirement System will decline from 52.6% to 51.4%;
- The projected funded ratio for the Teachers' Retirement System will fall from 59.5% to 58.6%;
- The State Universities Retirement System projected ratio will decline from 63.9% to 62.5%;
- The Judges' Retirement System projected ratio will decrease from 44.7% to 43.4%; and
- The General Assembly Retirement System will remain constant at 37.2%.

| ILLINOIS STATE RETIREMENT SYSTEMS FUNDED RATIOS | | | | | |
|---|---|---|---|---|---|
| | **FY2003*** | **FY2004** | **FY2005** | **FY2006 Estimate** | **FY2007 Estimate** |
| State Employees' Retirement System | 42.6% | 54.2% | 54.4% | 52.6% | 51.4% |
| Teachers' Retirement System-Downstate | 49.3% | 61.9% | 60.8% | 59.5% | 58.6% |
| State Universities Retirement System | 53.9% | 66.0% | 65.6% | 63.9% | 62.5% |
| Judges' Retirement System | 30.7% | 46.2% | 45.7% | 44.7% | 43.4% |
| General Assembly Retirement System | 25.3% | 40.1% | 39.1% | 37.2% | 37.2% |
| **ALL STATE RETIREMENT SYSTEMS** | **48.6%** | **60.9%** | **60.3%** | **58.8%** | **57.7%** |

*Does not includes proceeds of Pension Obligation Bonds on a pro forma basis.
Source: Commission on Government Forecasting and Accountability. *Report on the 90% Funding Target of Public Act 88-0593* , January 2006, pp. 7-21.

*Unfunded Liabilities*

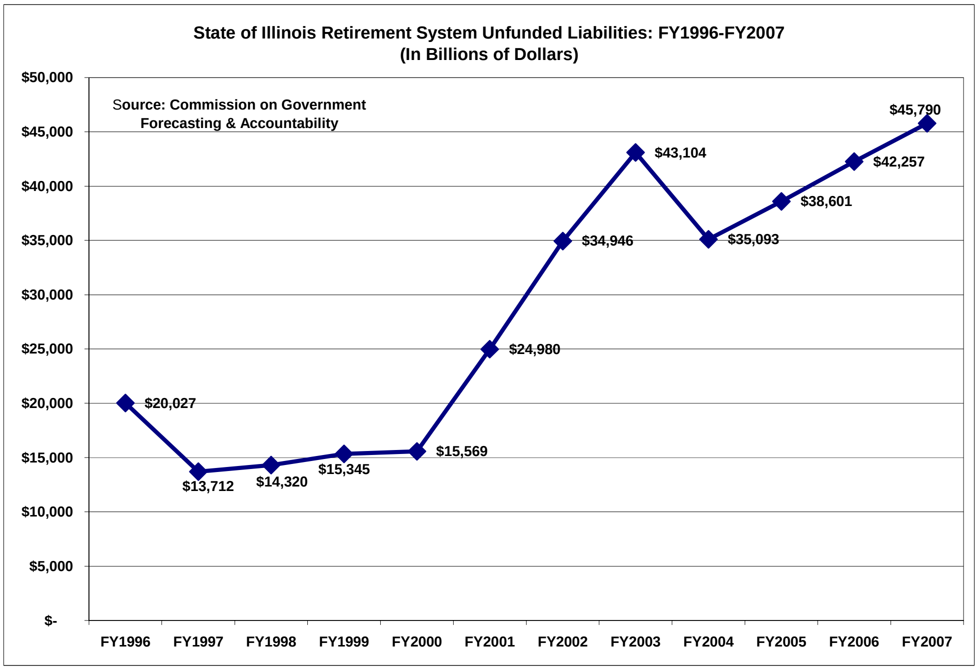
In previous years, the Budget Book included pension fund information through the current fiscal year. However, in FY2007, the Book only provides pension fund information through FY2005. The Commission on Government Forecasting and Accountability has provided funded ratio calculations in its *Report on the 90% Funding Target of Public Act 88-0593*. According to the Commission, the unfunded liabilities of the State's five pension funds are projected to be nearly $45.8 billion in FY2007. This is approximately a 6.2%, $2.6 billion increase over FY2003, when unfunded liabilities were $43.1 billion.

[2] According to a recent report by Standard & Poor's, Illinois's funded ratio was the 47th lowest in the nation, above West Virginia, Rhode Island, Oklahoma and possibly Connecticut. See Standard & Poor's, "Rising U.S. Unfunded Pension Liabilities are Causing Budgetary Stress," February 22, 2006.

| STATE PUBLIC EMPLOYEE RETIREMENT SYSTEMS UNFUNDED LIABILITIES (FY03-FY07) - $ Millions | | | | | | | |
|---|---|---|---|---|---|---|---|
| RETIREMENT SYSTEM | FY2003 | FY2004 Estimate | FY2005 Estimate | FY2006 Estimate | FY2007 Estimate | $ CHG FY03-FY07 | % CHG FY03-FY07 |
| **State Employees'** | $ 10,091.9 | $ 8,452.5 | $ 8,810.5 | $ 9,586.0 | $ 10,328.0 | $ 236.1 | 2.3% |
| **Teachers' Retirement** | $ 23,808.6 | $ 19,402.8 | $ 21,989.8 | $ 24,117.6 | $ 26,207.3 | $ 2,398.7 | 10.1% |
| **State Universities** | $ 8,310.4 | $ 6,495.3 | $ 6,999.6 | $ 7,698.7 | $ 8,337.1 | $ 26.7 | 0.3% |
| **Judges'** | $ 746.1 | $ 621.5 | $ 671.5 | $ 718.9 | $ 774.2 | $ 28.1 | 3.8% |
| **General Assembly** | $ 146.5 | $ 124.4 | $ 129.6 | $ 135.6 | $ 143.8 | $ (2.7) | -1.8% |
| **TOTAL** | **$ 43,103.8** | **$ 35,096.5** | **$ 38,601.1** | **$ 42,256.8** | **$ 45,790.4** | **$ 2,686.6** | **6.2%** |

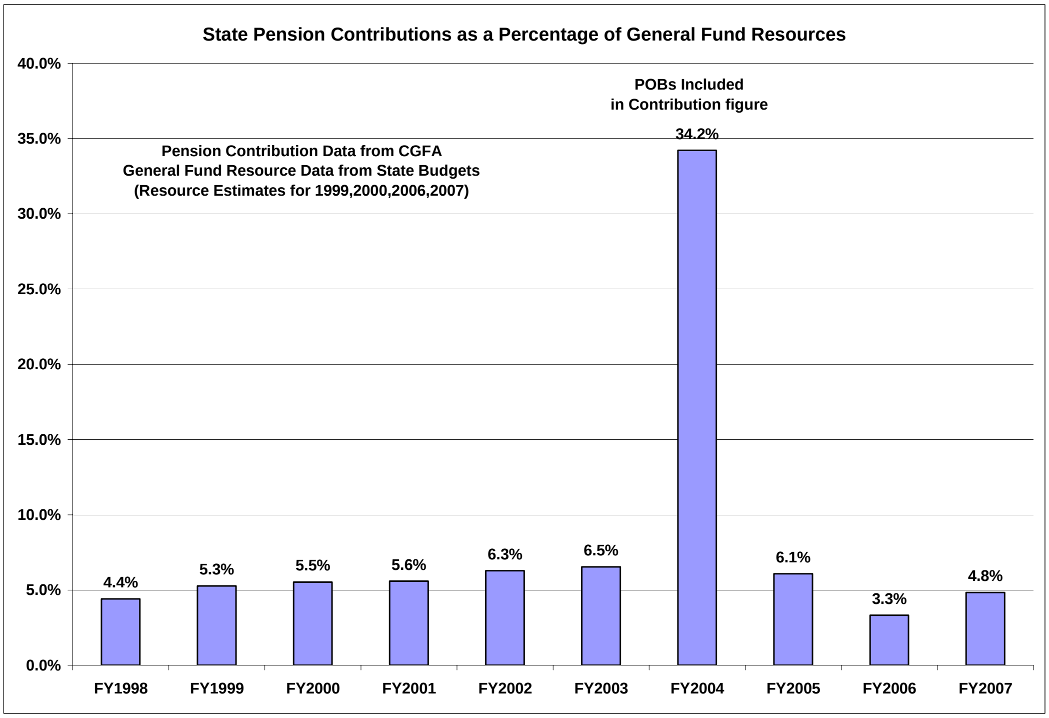
Source: Commission on Government Forecasting and Accountability.
FY2003 calculations do not include proceeds of the Pension Obligation bonds.

The next exhibit presents a 12-year trend of unfunded liabilities in the State's five retirement systems. It shows that since FY1996, unfunded liabilities have grown by 128.6% or $25.7 billion. This represents an increase from $20.0 billion to nearly $45.8 billion.




*Pension Contributions as a Percentage of General Fund Resources*

Pension fund contributions as a percentage of General Fund resources (revenues and other financing sources) rose from 4.4% in FY1998 to 6.5% in FY2003 before falling to a projected 4.8% in F2007. The 34.2% ratio in FY2004 is an anomaly – it can be attributed to the $9.1 billion total contribution to the State's retirement systems that year that included the proceeds of the Pension Obligation bonds.




## The FY2007 Budget Proposal for the Retirement Systems

The General Assembly approved legislation (P.A. 94-0004) last year authorizing reductions in the State contributions from the originally certified amounts to the five State retirement systems in FY2006 and FY2007 totaling $2.3 billion. In accordance with that statute, the Governor proposes to contribute nearly $1.4 billion to the state's retirement funds in FY2007, which is $1.1 billion less than the certified contribution amount. The administration also proposes that any revenues derived from the sale of state assets or the 10th casino license be used to reduce pension fund liabilities. The exhibit below shows the difference between the certified amount for each State pension fund and the amount to be appropriated in FY2006 and FY2007.

**FY2006 & FY2007 CERTIFED CONTRIBUTIONS VS. FINAL GENERAL ASSEMBLY APPROPRIATIONS (In Millions of Dollars)**

| | FY2006 | | | FY2007 | | | | |
|---|---|---|---|---|---|---|---|---|
| System | Certified Contributions | P.A. 94-0004 | Difference | Certified Contributions | P.A. 94-0004 | Difference | Total 2-Year Contributions | Total Reduction |
| TRS | $ 1,058.5 | $ 531.8 | $ 526.7 | $ 1,233.1 | $ 735.5 | $ 497.6 | $ 2,291.6 | $ 1,024.3 |
| SERS | $ 690.3 | $ 203.8 | $ 486.5 | $ 832.0 | $ 344.2 | $ 487.8 | $ 1,522.3 | $ 974.3 |
| SURS | $ 324.9 | $ 166.6 | $ 158.3 | $ 391.9 | $ 252.1 | $ 139.8 | $ 716.8 | $ 298.1 |
| JRS | $ 38.0 | $ 29.2 | $ 8.8 | $ 44.5 | $ 35.2 | $ 9.3 | $ 82.5 | $ 18.1 |
| GARS | $ 5.5 | $ 4.2 | $ 1.3 | $ 6.3 | $ 5.2 | $ 1.1 | $ 11.8 | $ 2.4 |
| **Total** | **$ 2,117.2** | **$ 935.6** | **$ 1,181.6** | **$ 2,507.8** | **$ 1,372.2** | **$ 1,135.6** | **$ 4,625.0** | **$ 2,317.2** |

Source: Commission on Government Forecasting and Accountability. Report on the 90% Funding Target of Public Act 88-0593.

*Financial Impact of Pension Funding Changes to FY2045*

The actuaries of the General Assembly's Commission on Government Forecasting and Accountability (CGFA) and the five retirement systems have each prepared estimates of the long-term economic impact of the FY2006 pension funding reforms. The results of those analyses are shown below.

The CGFA estimates that the final pension program approved for FY2006 will cost the State an additional $4.7 billion and reduce actuarial liabilities by $38.6 billion over 40 years. The retirement systems' actuaries estimate that $6.8 billion more in costs will be incurred and the liabilities will be reduced by $44.6 billion. The State originally projected that pension liabilities would be reduced by approximately $55.0 billion if all of the Governor's proposed reforms were adopted.

**Estimated Impact of P.A. 94-0004**
**Total Projected State Contributions for FY2006-FY2045**
**Prepared by CGFA ($Millions)**

| State Contributions | TRS | SERS | SURS | JRS | GARS | TOTAL |
|---|---|---|---|---|---|---|
| **Pre P.A. 94-0004** | $ 160,302 | $ 68,065 | $ 61,184 | $ 6,538 | $ 862 | $ 296,951 |
| **P.A. 94-0004** | $ 155,507 | $ 78,068 | $ 60,531 | $ 6,654 | $ 877 | $ 301,637 |
| **Difference** | $ (4,795) | $ 10,003 | $ (653) | $ 116 | $ 15 | $ 4,686 |
| **FY2045 Liability Reduction** | **$ 26,265** | **$ 667** | **$ 11,690** | **$ -** | **$ -** | **$ 38,622** |

Source: Commission on Government Forecasting and Accountability. August 2005.

**Estimated Impact of P.A. 94-0004**
**Total Projected State Contributions for FY2006-FY2045**
**Prepared by Retirement Systems ($Millions)**

| State Contributions | TRS | SERS | SURS | JRS | GARS | TOTAL |
|---|---|---|---|---|---|---|
| **Pre P.A. 94-0004** | $ 156,715 | $ 65,340 | $ 60,688 | $ 6,538 | $ 862 | $ 290,143 |
| **P.A. 94-0004** | $ 152,550 | $ 75,928 | $ 60,914 | $ 6,654 | $ 877 | $ 296,923 |
| **Difference** | $ (4,165) | $ 10,588 | $ 226 | $ 116 | $ 15 | $ 6,780 |
| **FY2045 Liability Reduction** | **$ 34,322** | **$ 675** | **$ 9,655** | **$ -** | **$ -** | **$ 44,652** |

Source: Commission on Government Forecasting and Accountability. August 2005.

## Second Blue Ribbon Task Force Recommendations

The second Blue Ribbon Task Force on Pensions created by P.A. 94-0004 included representatives from the General Assembly, the state retirement systems, organized labor and government. The Commission made five principal recommendations:

1. The State should dedicate revenues in excess of a targeted percentage of growth toward the additional funding of the pension systems when those targets are met and establish a minimum when they are not met.
2. If the state sells certain assets, 100% of the proceeds should be dedicated toward reducing pension liabilities.

3. The General Assembly should consider the issuance of Pension Obligation bonds as quickly as practicable to help further reduce pension costs as long as there are favorable market conditions and the issuance of POBs is part of a broader plan to reduce the retirement systems' unfunded liabilities.
4. The General Assembly should explore new dedicated revenue sources for the retirement systems.
5. The legislature should regularly review the pension systems' provisions regarding benefits and make determinations as needed.

## PENSION FUNDING & MANAGEMENT RECOMMENDATIONS

The Civic Federation offers the following recommendations regarding funding and management of the State's retirement systems.

### Fund State Pension Systems at Certified Contribution Amount

The State of Illinois has a responsibility to follow the mandate of the 1995 pension funding reform law. Deviating from the path laid out by that law renders it meaningless. Fixing the pension funding problem requires discipline and sacrifice, even pain. We urge the State to reject the ill-considered $1.1 billion partial pension funding holiday approved last year. The State should fund its pension obligations at the full $2.5 billion amount required by the 1995 law.

### Impose a Moratorium on New State Employee Pension Enhancements

The Civic Federation believes that the time has come to stop expanding employee pension benefits. Therefore, we call on the legislature to reject and the Governor to veto any new pension enhancements whether they are funded or not. In addition, the State must adopt a moratorium on any new benefit enhancements until such time as substantial progress has been made on reducing the State's billions of dollars in pension liabilities and will likely require waiting at least 10 years until the FY2002 Early Retirement Initiative fiasco is full paid for.

### Require Employees to Increase Pension Contributions by 1%

All public employees covered by the State's five retirement systems should contribute an additional 1% of their salaries to the cost of their pensions. This increase should be required immediately for new hires and non-union employees. Although current contracts prevent this increase from being implemented immediately for employees covered by collective bargaining agreements, the State should, as a matter of policy, require increased contributions in future contracts. Stratospheric pension costs pose a serious threat to the financial future of the State of Illinois and its residents, and containing those costs must be a shared, ongoing, focused effort. We do not believe a single percentage point increase is onerous or unreasonable, especially when balanced against the generous retirement benefits state employees receive.

**Study the Costs and Benefits of a Defined Contribution Pension Plan**

The first Blue Ribbon Pension Commission recommended that once the State stabilizes the funding of its pension system, it should consider replacing all or part of its Defined Benefit pension plans for new hires with defined contribution (DC) Plans. DC plans, which are the predominant form of retirement benefit provided to the average American worker, can significantly reduce unfunded liabilities over time and offer employees greater flexibility as they change jobs.

In reviewing the record of the past thirty years, we have seen no evidence that the General Assembly has the requisite fiscal discipline to transparently execute a well funded defined benefit retirement system. For that reason, we think that a shift to a defined contribution system must be seriously considered for new hires when it is financially feasible. We understand that the transition costs for the shift could be expensive because of the current dramatic underfunding of the retirement systems. However, the Civic Federation urges the Governor and the legislature to undertake a study of this option to determine both costs and benefits. This study should include consideration of transition funding mechanisms because the cost savings and benefits of a shift to a DC plan in the long term may outweigh short-term expenses. While the Civic Federation opposes the issuance of any new Pension Obligation bonds to fund current or future State of Illinois pension obligations, there may be the potential for issuing such bonds for the sole purpose of funding the transition costs to a defined contribution plan. This would, of course, be contingent upon financial feasibility and the identification of real, substantial cost savings over time.

**The State Should Not Mandate Local Pension Enhancements without Providing Funding**

The General Assembly frequently approves legislation increasing the level and scope of local government employee pension benefits. However, no funding is provided for what amounts to yet another costly unfunded mandate for cash-strapped local governments. We believe that the concept of "pay as you go" funding should be extended to include State of Illinois actions that financially impact the pension costs of local governments. If the General Assembly sees fit to enhance benefits, it should identify and provide the requisite funding for those enhancements.

**Provide Transparent and Frequent Reporting of Pension Fund Information.**

The FY2007 Budget Book only provides information about the assets and liabilities of the State's retirement systems through FY2005. Traditionally, projections have been provided through the current budget year. This omission is disappointing and in contrast to the transparency of much of the rest of the document.

The public needs full and accurate financial information in order to understand and evaluate the Governor's budget proposals, particularly on an important issue such as pension funding. The Civic Federation recommends that the State fully disclose all relevant financial information about contribution levels for all retirement systems in the Pension section of future Budget Books.

In addition, the Civic Federation believes that the State of Illinois should increase requirements for the public disclosure of pension fund information. Currently, state statute requires that all of the over 600 public pension systems in Illinois prepare and file a biennial report with the Division of Insurance in the Department of Financial and Professional Regulation on their activities and financial condition.[3] In the interest of providing full and transparent information about the assets and liabilities of these constitutionally guaranteed benefits, we believe that reporting should be required on an annual basis and the law extended to require disclosure of information by the Chicago Transit Authority Pension system.

**Reform Pension Board Composition to Provide Balance of Interests**

The membership of four of the five State Pension Boards of Trustees contains a majority of employee and retirees. Employees and annuitants are currently in the minority on the State Universities Retirement System Board; however, while state statute requires four of the nine

members to be annuitants or actives, the governor is empowered to shift that balance by appointing other board members who "may, but need not, be participants or annuitants of the System."[4] These five discretionary appointees currently include the president of the Service Employees International Union Local 73, so it can be argued that the majority of the SURS Board represents the interests of the employees. All seven of the General Assembly's pension board members are beneficiaries.

| Illinois State Public Pension Boards of Trustees Composition | |
|---|---|
| **Fund** | **Employees and Retirees less than 50% of Board?** |
| General Assembly Retirement System | No, 7 out of 7 |
| State Employees Retirement System | No, 4 out of 7 |
| State Universities Retirement System | Yes, 4 out of 9, but variable** |
| Teachers Retirement System | No, 6 out of 11 |
| Judges Retirement System | No, 4 out of 5 |

**State statute allows the Governor discretion to shift the balance of representation by appointing additional active
Source: Illinois Pension Code, 40 ILCS 5

The Civic Federation believes that the proper role of a pension board is to safeguard the assets of the fund and to balance the interests of employees and retirees who receive benefits and taxpayers who pay for pension benefits. All of these parties have an interest in the management of the fund. However, the tilt toward employees on four of the five State pension boards raises questions about how objective the Board can be in its work. In our view, a pension board should:

[3] 40 ILCS 5/2A of the Illinois Pension Code.
[4] 40 ILCS 5-15-159

- Balance employee and management representation on pension boards; and
- Develop a tripartite structure that includes citizen representation on pension boards.

We urge the State of Illinois to seek reform of its Pension Fund governing structures to ensure greater balance of interests.

**Require Financial Expertise on Pension Boards**

Public pension boards are charged with making complex financial and investment decisions affecting millions of dollars contributed by employees and taxpayers. This is a weighty fiduciary responsibility that requires a thorough understanding of asset management. It would be prudent to set aside some board seats for members with professional expertise or certification in financial asset investment, and to require all members to receive some basic education on their fiduciary responsibilities.

Although some Illinois funds require their comptroller or financial officer to sit on the pension board ex officio, only one Illinois state public pension fund, the Teachers Retirement System, explicitly requires inclusion of at least two independent citizen board members with financial experience.[5] The Civic Federation urges The Illinois General Assembly should pass legislation to require the membership of public pension boards to include financial experts with experience in investing or managing large asset portfolios. Furthermore, all pension trustees should receive some relevant financial training on an annual basis.

**Use Proceeds from Student Loan Program Privatization to Reduce Pension Liabilities**

The State of Illinois proposes the competitive sale of IDAPP student loan assets and loan transactions, in effect privatizing the management of the student loan portfolio in much the same manner as other states and the federal government have done. Revenue from the sale would be used to fund the proposed $1,000 per student tuition tax credit.

The Civic Federation supports the State exploring the possibility of selling the assets and transactions of the Illinois Designated Account Purchase Program. We support the outsourcing of management functions for non-core functions of government with certain conditions. There must be an identifiable market of qualified vendors in the marketplace. The government must maintain adequate administrative oversight of the program after privatization to ensure that it fulfills its goals and operates as required under terms of the contract.

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[5] 40 ILCS 5/16-164: "The Governor shall appoint 2 members as trustees in each even-numbered year who shall hold office for a term of 4 years. Each such appointee shall reside in and be a taxpayer in the territory covered by this system, shall be interested in public school welfare, and experienced and competent in financial and business management."

Because the proposed sale of the student loan portfolio will bring a one-time windfall of funds, those funds should not be used to pay for a recurring expense like the tuition scholarship program. A much more appropriate use of the funds would be to help reduce the massive unfunded liabilities of the State's chronically underfunded pension systems.