# Fixing the Problem

## Illinois is among the states considering new pension-reform plans

By Tim Anderson

Concerns over unfunded pension liabilities and the budgetary impact of state retirement plans are pushing lawmakers to seek changes that ensure the systems' solvency and prevent runaway costs.

In recent years, a number of ideas have been considered in states around the country, such as the sale of pension-obligation bonds, switching to defined contribution plans, increasing contribution levels and reducing benefits.

The focus on reforming state retirement systems is continuing this year. In Minnesota, for instance, legislation has been introduced to increase pension contribution levels by public workers as well as by cities and counties. Another proposal would cap annual pension-benefit increases in the state's post-retirement investment fund to 5 percent—an attempt to avoid a recurrence of the asset deficit that the fund now faces. In the absence of the cap, double-digit benefit increases had been provided during the unprecedented market growth of the 1990s. But when the market slumped, the fund was left with a permanent liability that cut deeply into its reserves.

Minnesota's situation—recent investment losses, a rise in unfunded pension liabilities and tight fiscal conditions—is emblematic of what has occurred across the country. In addition, longer-term trends, such as the fact that states will have more retirees living longer in the future, mean reform likely will be a priority in the years, and decades, ahead.

### Illinois: 'Facing a Crisis'

More so than in any other Midwestern state, pension reform has become a highly publicized issue in Illinois this legislative session, for several reasons. First, an overhaul of the system is part of Gov. Rod Blagojevich's plan to balance the state budget. Second, earlier this year, a commission appointed by the governor released an extensive list of reform ideas for legislators to consider. Third, the state's five retirement systems are in particularly poor financial health. Illinois has the largest unfunded pension liability among the 50 states ($43 billion in 2003).

"There is a consensus that we are facing a crisis, and that it is a complicated and complex issue that must be dealt with," said Illinois Rep. Rich Bradley of Chicago.

Rep. Mark Beaubien Jr. of Barrington agrees, adding that "virtually all members of the Legislature believe some changes ought to occur."

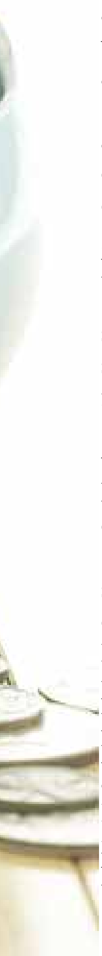
But while most agree on the need for reform, finding consensus on the details of any proposed changes may be difficult.

"The numbers, the unfunded liabilities, speak for themselves," Bradley said. "The dire economic situation of the state also is obvious. Those elements have brought us to a point where people have to go behind closed doors and negotiate an agreement."

Many factors have contributed to the crisis in Illinois. First and foremost, according to Bradley, is the fact that the state has consistently funded pensions below necessary contribution levels over the past 30 years. Beaubien said that the state missed a golden opportunity to begin fixing the system during the latter half of the 1990s.

"We were averaging a billion dollars in new revenue, and some of that should have gone into the pension system," he said. "Instead, when times were good, we passed a lot of benefit enhancements without any funding source."

Then, after these benefits were put in place, the pension systems' earnings declined as a result of the economic downturn, leaving an already underfunded system with a worse financial outlook.



Bradley says one of this year's goals is to make sure future state legislatures do not repeat past mistakes. One idea suggested by the gubernatorial commission—of which Bradley and Beaubien were members—and included in Blagojevich's proposal is a requirement that any new pension benefit be accompanied by a specific revenue stream to pay for it. That and other pieces of the governor's plan will be the starting point for what are expected to be months-long negotiations in the Capitol. The Illinois Constitution prevents any reduction in benefits to existing employees. As a result, most changes would affect only new hires. Blagojevich's proposal includes:

- *An adjustment in the age at which employees are paid full benefits*—Currently, someone who has worked at least eight years for the state can retire with full benefits at age 60. The governor wants to raise the age to 65. Similarly, his plan would change the age at which 35-year employees of the state can retire with full benefits (from 60 to 65).
- *A change in determining pension increases*—The governor says annual increases in retirees' pensions should be tied to cost-of-living increases (based on the Consumer Price Index). Currently, retired workers receive an automatic 3 percent increase, regardless of cost-of-living increases or market performance.
- *A cap on end-of-career salary increases*—This reform targets the large boost in pay that school districts often provide teachers and administrators before their retirement. Because these employees' benefits are based on salaries during their final four years on the job, the large pay increases mean the state has to pay more in benefits. Blagojevich's proposal would cap end-of-career raises at an annual rate of 3 percent; school districts would assume the costs for salary increases above that amount.

These and other pension reforms could save the state $55 billion over the next 40 years. Because of those long-term savings, Blagojevich says, the state can reduce its contributions to the retirement systems by more than $700 million this year, helping balance the budget in the process.

Many lawmakers, while praising Blagojevich for tackling the pension issue, are wary about tying a budget fix to these long-term savings.

"Most of these are prospective reforms, and taking the money up front won't work," Beaubien said.

Some of the specific proposals may be a tough sell as well. The cap on end-of-career salary increases would impact two important constituencies: teachers and local school districts. Either districts will have to come up with the extra money, or teachers' pay raises will be curtailed. Beaubien predicts some kind of cap will be enacted, but that it will not apply to existing school contracts.

Other parts of the pension reform proposal may be challenged on legal grounds. For instance, members of the State University Retirement System (SURS) have the option to take part in a plan in which they are guaranteed an average interest rate of 9 percent. Participants in the other four state systems receive 6 percent. Any law that puts SURS' interest rate in line with the other systems will be challenged as unconstitutional for diminishing current employees' benefits, Beaubien said.

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But despite obstacles like these, both he and Bradley expect the General Assembly to move forward with some version of pension reform.

"There are many stakeholders to consider in this process," Bradley said. "We're doing a thorough job in analyzing all of the possible scenarios, and eventually I think we'll have a plan that addresses the unfunded liabilities we have."

*—Tim Anderson is publications manager for the Midwestern Office of The Council of State Governments. This article originally appeared in Stateline Midwest, a publication of CSG-Midwest.*