REFORMING PUBLIC PENSIONS SUBJECT TO POLITICAL AND LEGAL CONSTRAINTS: THE ILLINOIS EXPERIENCE

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On December 5, 2013, the Governor of Illinois signed into a law a bill that substantially reduced pensions for public sector workers in Illinois. Designed to partially address the severe under-funding problem created from many decades of inadequate contributions to the state’s large pension funds, the new law was negotiated in a highly constrained environment. Strong constitutional benefit protections and political constraints both imposed severe limits on the set of options available to the legislature. This paper discusses these constraints and how they influenced the shape of the final bill. It also analyzes the financial and legal implications of the reform for the state, public universities, and participants.

Key Words: public pension reform, Illinois, retirement plans
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I. INTRODUCTION

Although defined benefit (DB) pension plans have been on a steady decline in the private sector for several decades, DB plans are still the norm among state and local public sector workers in the United States. Falling asset values during the Great Recession clearly exposed the precarious funding status of many public pensions. Official measures of underfunding of public plans in the United States (based on standards issued by the Government Accounting Standards Board (GASB)) pegged the total amount of under-funding at approximately $1.38 trillion in fiscal year 2010 (Pew Center on the States, 2012). Economists such as Novy-Marx and Rauh (2011) estimate the true liability to be much larger, with the difference in the two measures attributable to GASB standards allowing public plans to discount future liabilities using the expected return on their plan assets rather than a risk-adjusted discount rate.¹

¹ Brown and Wilcox (2009) provide further discussion of the appropriate discount rate for public pension liabilities.
Although the Great Recession contributed to the poor funding status of public pension plans, many states had severe funding issues prior to the recession. The state of Illinois had some of the worst-funded pension systems in the United States. GASB estimates placed the total amount of underfunding of the Illinois plans at just under $100 billion in 2013. With funding ratios of about 40 percent, Illinois was last among the 50 states in overall funding status. Indeed, the three largest state plans — the State Universities Retirement System (SURS), the State Teachers’ Retirement System (TRS), and the State Employees’ Retirement System (SERS) — were each individually among the 10 worst-funded individual public plans in the United States (Munnell, 2011).

The broader Illinois state budget is also under stress. As of October 2013 — immediately before pension reform was passed — the Illinois Fiscal Futures project estimated that “the state’s fiscal situation is projected — under current law and estimated rates of growth in revenue and spending — to deteriorate steadily and reach a structural deficit of $14 billion in fiscal year 2025” (Dye, Hudspeth, and Merriman, 2013). As a result of these fiscal challenges, Illinois had the lowest credit rating of any state in the nation in 2013. In response, Senate Bill 1 (S.B.1) passed the General Assembly on December 3, 2013 and was signed by the Governor two days later. The law was far-reaching, with changes to post-retirement benefit increases, retirement age, contribution rates, the pensionable earnings cap, the interest rate applied to the money purchase option, and plan funding. These changes were intended to take effect July 1, 2014, although their implementation is on hold awaiting resolution of legal challenges.

This paper provides a brief overview of the fiscal situation facing Illinois in Section II. In Section III, it explains the structure of one of the major plans — SURS — prior to reform. Section IV provides an overview of the legal and political constraints facing policy makers, and Section V discusses some of the reform ideas that were promoted earlier in the debate. An overview of the final pension reform law is outlined in Section VI, and the implications for state finances, individuals and their employers are discussed in Section VII. Section VIII provides a brief overview of the legal challenges now facing the law, and Section IX provides summary thoughts.

II. THE ILLINOIS FISCAL CONTEXT

In fiscal year 2013, total state of Illinois general expenditures were $35.6 billion,2 relative to 2012 state GDP of $695 billion.3 Total state resources in 2013 (including state taxes, federal sources, and other transfers) totaled $36.4 billion, of which $30.2 derives from state sources, including the individual income tax ($16.5 billion), the state corporate income tax ($3.2 billion), the sales tax ($7.4 billion), and other state resources ($3.2 billion).

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Although this left the state with a general fund surplus of $924 million in 2013, this snapshot substantially overstates the fiscal health of the state. Three facts, in particular, are worth noting. First, as already noted, the pension funding shortfall was nearly $100 billion. Second, as of the end of 2013, the state had a $6.3 billion backlog of unpaid bills to various contractors and providers to the state. Third, these figures include the revenue generated by the “temporary” income tax increase that was implemented in 2011 that increased personal income tax rates from 3 to 5 percent and increased corporate rates from 4.8 to 7 percent for years 2011–2014. Under current law, these rates will automatically decline to 3.75 percent and 5.25 percent in 2015, and then fall to 3.25 percent and 4.8 percent in 2024 (Crosby and Merriman, 2014). Unless the General Assembly and Governor extend these rate increases, large budget deficits will again occur in 2015. Thus, the longer-term fiscal outlook for the state is rather bleak, which is why Standard & Poor’s rating of Illinois was the lowest in the nation (in January 2013, Illinois’ general obligation bond rating was downgraded to A- from A).

III. A SUMMARY OF PRE-REFORM PENSION STRUCTURE: THE CASE OF SURS

Although four of the five of the state systems in Illinois were affected by S.B.1 (the plan covering judges was excluded, presumably in order to avoid conflicts of interest when the state courts must hear cases on the law), this paper focuses on SURS to illustrate the effects of reform. SURS is one of the 100 largest pension plans in the United States, serving approximately 65 state universities, community colleges, and related state agencies (SURS website). As of November 2013, there were nearly 223,000 members (nearly 88,000 active members, almost 79,000 inactive members, and nearly 57,000 beneficiaries). Faculty, staff, and administrators all participate in the system. Importantly, SURS participants do not participate in Social Security based on their SURS-covered employment. Thus, Social Security taxes are not withheld from SURS earnings and Social Security benefits do not accrue from SURS-related earnings. Effectively, this means that SURS substitutes for both Social Security and an employer-provided retirement plan, an aspect that is important to consider when evaluating the effect of reform on participants. Of course, employees who also have Social Security covered earnings from other jobs may still be eligible for Social Security, although most will be subject to the benefit limits specified in the Windfall Elimination Provision and the Government Pension Offset.

Prior to reform, the required employee contribution rate to SURS was 8 percent of pay, whereas the state’s “contribution” (assuming it was actually paid in full by the state) ranged from approximately 8 percent to approximately 13 percent of pay depending on the plan and year. The state of Illinois has a long history of underfunding the plan, however, and thus the state contributions are rarely made in full. As a result, the plan was only 43.7 percent funded on June 30, 2013, with assets of $15 billion falling substantially short of GASB liabilities of $34.4 billion.

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5 Brown, et al. (2013) provide more information on the Windfall Elimination Provision.
From its establishment in 1941 until the late 1990s, all SURS participants were covered by a traditional defined benefit (DB) plan. Starting in the late 1990s, SURS participants are offered a choice among three plans. A brief description of each of these three plans follows.

A. The Traditional Benefits Package

The new Traditional Benefits package is a continuation of the basic DB plan that existed for many decades. It serves as the default option for individuals who do not make an active plan designation within six months of employment. In return for their 8 percent contribution, participants in this plan — prior to reform — were entitled to a retirement benefit, automatic annual 3 percent increases (compounded annually) after retirement, and survivor benefits.

Benefits from the Traditional plan are paid as life annuities. The Traditional benefit formula specifies that those retiring at age 60 receive a benefit that is equal to 2.2 percent times years of service times final average earnings (defined as the average of the four highest years), up to a maximum of 80 percent of final average earnings. The benefit derived from this formula is automatically paid as a joint and 50 percent contingent survivor annuity. If an unmarried individual retires under the Traditional plan, then in lieu of the survivor benefit, he receives a refund of one-eighth of his contributions plus a specified interest rate. Once an individual is receiving benefits, they receive a 3 percent automatic annual increase of benefits every January 1.

Individuals hired before July 1, 2005, have their benefit calculated as the higher of this standard DB formula and a second “money purchase” formula. The money purchase formula was determined by attributing the retirement-only portion of the employee’s contribution (i.e., excluding disability, survivor benefits, and automatic increases) to a virtual account. This contribution ranges from 6.5 to 7 percentage points of the 8 percent-age point contribution, depending on the year. The state adds a 140 percent matching contribution to this virtual account. Each year, interest calculated using the Effective Rate of Interest (ERI) is credited to this virtual account balance, and this ERI has been set well above market interest rates. This virtual account balance is then divided by a unisex annuity factor, and the result is the monthly benefit amount under the money purchase option. The benefit calculation under the money purchase option is compared to that from the Traditional plan formula, and the participant automatically receives the higher of the two. This money purchase option was eliminated for individuals hired on or after July 1, 2005. Given the above-market ERI and annuity factors, it is not surprising that the money purchase calculation provided the larger benefit for the majority of retirees prior to its elimination for new employees in 2005.

6 For non-disabled individuals with less than 30 years of service, there is an early retirement actuarial reduction of 0.5 percent for each month under age 60. For those who retire after August 2, 2002, retirement at any age — without benefit reduction — is permitted if a member has 30 or more years of service. Individuals who reach the 80 percent maximum benefit are entitled, upon retirement, to a refund of excess contributions, with interest.
Although the Traditional DB plan provides a high replacement rate for long-career employees, it is not generous for those who leave SURS employment and take a lump sum benefit. Regardless of length of service, participants in the Traditional Benefit package who take a refund from the system upon terminating employment will receive their own contributions plus a 4.5 percent interest rate on those contributions, but no employer contributions. Individuals who leave their SURS employer are permitted to remain in the SURS system and receive the retirement annuity that they have earned based on their earlier employment.

B. The Portable Benefits Package

The Portable Benefits Package offers a more generous separation package in return for a less generous retirement benefit. Under the Portable plan, if the person leaves the system early (but after vesting) and takes a refund of their contributions, they receive a dollar-for-dollar match from the state and are credited with the ERI on both employee and matching contributions. As noted above, the ERI is set substantially above market interest rates. Individuals who retire under the Portable plan, however, must take an actuarial reduction in benefits to obtain survivor benefits (whereas these are provided with no actuarial reduction in the Traditional plan). Unmarried participants are not eligible for the partial refund of contributions that they can obtain from the Traditional plan. In many other important respects, the two DB plans are identical.

C. The Self-Managed Plan

The Self-Managed Plan (SMP) is a participant-directed DC plan that invests a total of 14.6 percent of salary (8 percent from the employee and at least 6.6 percent from the employer\(^7\)) into an individual account managed by a third party provider (Fidelity and/or TIAA-CREF). After a five-year vesting period, an individual who leaves the system is entitled to a 100 percent refund of employer and employee contributions plus any investment gains or losses. Upon retirement, the individual is able to withdrawal the money as a lump sum or may choose from a wide range of annuities.

D. Tier I versus Tier II

An earlier pension reform affected anyone hired after January 1, 2011, thus creating a two-tier benefit structure in SURS. This new “Tier II” system applies to both the Traditional and Portable Plans. Although the benefit formula is the same as under Tier I, there are important differences in the vesting period, retirement age, the post-retirement benefit adjustments, and the definition of pensionable earnings that make

\(^7\) In total, the state makes a 7.6 percent employer contribution to the SMP. The plan rules specify that “up to 1 percent” of matching funds goes to pay for the disability benefit, leaving a minimum rate of 6.6 percent as a retirement plan match.
the Tier II system substantially less generous. The key differences between the Tiers are summarized in Table 1.

The 2013 pension applies only to Tier I Traditional and Portable participants that had not been affected by the prior reform. Interestingly, both recent reforms made no changes to participants in the Self-Managed Plan, in part because the SMP was already significantly less expensive to provide. Note that after the two-tier system was created for employees beginning employment after January 1, 2011, the SMP became much more attractive relative to the Traditional and Portable plans than before, especially for those with earnings over the Tier II earnings cap.

IV. LEGAL AND POLITICAL CONSTRAINTS ON REFORM

A. The Constitutional Non-Impairment Clause

Article XIII, section 5 of the Illinois Constitution states that, “Membership in any pension or retirement system of the State...shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.” This constitutional guarantee serves as a major constraint on pension reform because it eliminates a number of policy changes from the feasible set. However, the precise meaning of this clause is highly uncertain. There are many possible legal interpretations, but two of the more strict interpretations help to illustrate the range of possibilities.

Those who advocate reform often argue for an interpretation that the non-impairment clause protects all benefits that have been earned or accrued by the date of reform, but that benefits can be changed prospectively. Even this interpretation makes it difficult
to reduce the size of the existing unfunded liability, but it does provide substantial flexibility to legislators to make virtually any change to future benefits. The case for this interpretation was made most thoroughly in a memo by the Sidley Austin law firm in Chicago. This memo states:\(^8\)

An increasingly important question is whether 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 impaired. The answer is No … the only pension benefits protected from diminishment are those which had been earned at the time the pension scheme is altered.

In contrast, others argue in favor of a much stricter interpretation, namely that any provision of the pension code that is in effect at the time an employee is hired is protected from diminishment. Eric Madiar, the Chief Legal Counsel to Illinois Senate President John Cullerton and Parliamentarian of the Illinois Senate, wrote a thorough and forceful legal brief supporting this view.\(^9\) He concludes:

… the rule of law is clear. The Pension Clause not only makes a public employee’s participation in a pension system an enforceable contractual relationship, but also constitutionally protects the pension benefit rights contained in the Pension Code when an employee joins a pension system, including employee contribution rates. The Clause also safeguards pension benefit enhancements that are later added during employment. Further, the Clause bars the General Assembly from adversely changing the benefit rights of current employees via unilateral action. And, the Clause ensures that pensions will be paid even if a pension system defaults or is on the verge of default.

If this view is upheld by the courts, the degree of protection provided Illinois public pension benefits would exceed that of virtually any other retirement program. In comparison, the U.S. Social Security system is subject to change by Congressional action, as affirmed by the U.S. Supreme Court in 1960.\(^10\) In the private sector, it is also very common for employer pensions to be frozen or terminated.


The problem with providing strong benefit protection is that it could cripple the state’s ability to use pension reform to manage its fiscal situation. It would require that the state place pension promises at the “head of the line” for state resources: retired public employees would have seniority over all other state program recipients, and would be at least on par with bondholders. The Madiar discussion, however, does provide one possible path to reform:

The court also clarified that pension benefit rights were “contractual” under the Clause, and as such could be modified if an employee received consideration to accept a reduction in benefits.

This idea of “consideration” played an important role in explaining why legislators chose to reduce employee contributions as part of the reform. At the time of this writing (six months after the reform), there exists tremendous uncertainty about how the courts will rule on the constitutionality of the pension reform law. This will be discussed in Section VIII below.

B. Political Limits to Cost-Shifting

A structural feature of the Illinois public pension system is that public sector hiring incentives are misaligned. When a school district or university is making a marginal decision about whether to hire another worker, the entity making the decision does not bear the full costs of doing so. For example, if a local school district hires another teacher, the district must pay the teacher’s salary and some of the benefits, but the cost of providing this teacher with a pension is a responsibility of the state as a whole. This wedge between the social cost of hiring a marginal worker and the private cost to the hiring entity creates incentives for universities and school districts to hire more workers than may be socially optimal.\footnote{The misalignment of incentives may also contribute to the striking finding of Fitzpatrick (2013) that public school employees in Illinois only value retirement benefits at 20 cents per dollar it costs to provide them.}

An independent reform proposal (Brown et al., 2013) suggested that the state begin shifting pension funding responsibility to the hiring entities in order to better align incentives. In addition to helping align social and private hiring incentives, this would have substantially lowered the annual costs that would need to be financed by direct appropriation from the state legislature. Because the hiring entities would be legally required to make their annual payments, this would have helped solve the problem of perpetual underfunding by the state. This proposal received the endorsement of all of the Presidents and Chancellors of public universities in Illinois. The Democratic Governor of Illinois also indicated support for cost-shifting, as did the conservative Illinois Policy Institute. The powerful Illinois House Speaker, Michael Madigan (D-Chicago), publicly referred to the state’s contribution to Illinois teacher pensions as a “free lunch.”
Despite this coalition in favor of cost shifting, many “downstate” (i.e., non-Chicago)\textsuperscript{12} elected officials opposed shifting costs to local districts, expressing concern about the budgetary impact on local school districts. The average burden was estimated by one source to be about 3.7 percent of the average school district’s budget (Brino, 2012), although the burden was unevenly distributed. Some education advocates warned that the financial burden would be “crushing” (Yount, 2013). Ultimately, this feature was not included in the final bill, although it is frequently speculated that the cost-shifting idea will be revisited in the future.

### C. Political Resistance to Taxes

The Illinois tax base excludes all retirement income, leaving no state income tax on payments received from Social Security, 401(k) plans, Individual Retirement Accounts, defined benefit pension plans, and virtually any other payment from a qualified retirement plan (Hamer, 2005). According to the July 2013 “Tax Expenditure Report” issued by the Illinois State Comptroller for fiscal year 2012, (Baar Topinka, 2013) the value of the tax expenditure for retirement income, including Social Security, was $1.963 billion. Given the absence of evidence that state tax rates affect interstate mobility of the elderly, Brown (2014) concludes that including all retirement income (public and private pensions, as well as Social Security) in the Illinois income tax base would raise nearly $2 billion in annual revenue.

Including public pensions in the Illinois tax base would be equivalent to cutting those benefits 5 percent (the current state marginal tax rate). Unlike an overt benefit cut, however, the taxation of benefits would likely survive constitutional challenge if viewed as a change in tax policy rather than impairment of benefits. Although this idea was included in at least one independent reform proposal (Brown et al., 2012) and has been endorsed by other outside groups, it never gained traction in the General Assembly. Anecdotal evidence suggests that resistance to this idea may have been rooted in a combination of a general anti-tax position among some elected officials and/or a fear of angering retirees — a demographic group that has disproportionately high voter turnout.

### V. A BRIEF SUMMARY OF THE LEGISLATIVE PROCESS

In the years leading up to the December 2013 reform, numerous proposals were put forward. In April 2012, Governor Quinn announced a proposal to increase employee contributions by 3 percentage points, reduce the post-retirement benefit increases (commonly, although inaccurately, referred to as a cost of living adjustment (COLA)) from 3 percent to the lesser of 3 percent or one-half of the consumer price index (CPI) with no compounding, delaying the start of any COLA until the earlier of age 67 or five

\textsuperscript{12} Chicago Public Schools are not part of the Teachers’ Retirement System, whereas “down-state” districts are, leading to political divisions over the equitable way to fund state teachers’ pensions.
years after retirement, increasing the retirement age, and committing to a new funding schedule.13

A month later, the legislature tried a very different route: they attempted to circumvent the constitutional non-impairment clause by giving individuals a choice between keeping their pension and keeping their retiree health insurance. Unlike retirement benefits, retiree health care is not constitutionally guaranteed in Illinois. Thus, the idea was to offer employees and retirees a choice between keeping retiree health care or keeping their 3 percent automatic annual benefit increase after retirement. If they agreed to give up retiree health care, they would keep the compounded 3 percent increase. If they wanted health care, they would have to agree to a COLA of one-half of the CPI or 3 percent, whichever is less. The bill also would have shifted the normal cost of pensions to school districts and universities.

In March 2013, Brown et al. (2013) released a “Six Step Plan,” which was subsequently endorsed by all public university presidents and chancellors. The proposal had three objectives: (1) save the state at least as much money as prior plans under consideration; (2) provide retirement benefits that would allow universities to continue to be competitive with peer institutions; and (3) be constitutional, at least under the interpretation that accrued benefits were untouchable, but that future benefits could be altered.

The six provisions included: (1) replacing the 3 percent automatic increase with an uncapped COLA adjustment equal to one-half of CPI, compounded annually; (2) reducing the ERI that is used by SURS for a variety of benefit-relevant calculations, and which historically had been set far above an appropriate risk-adjusted rate, to be equal to 75 basis points above the rate on a 30-year government bond; (3) shifting an equivalent of 6.2 percent of payroll of the normal cost of pensions directly to the universities; (4) increasing employee contributions by 2 percent of pay; (5) committing the state to a pay-down schedule for the unfunded liability and granting legal standing to the pension system or its members to compel it; and (6) for new employees, provide a hybrid system with a smaller DB plus a defined contribution (DC) plan.

During the summer of 2013, a bicameral and bipartisan pension conference committee was formed. During early July, the committee heard testimony on the Six Step plan, and appeared ready to adopt many of its key provisions with some modifications (such as imposing a cap on the annual COLA adjustment). However, political wrangling among the House and Senate leadership over cost-shifting and the hybrid plan is rumored to have killed the proposal. After continued behind-the-scenes negotiations through the fall, a pension reform bill was publicly released on December 2, just one day before a special session of the Illinois General Assembly called specifically to address pension reform legislation. The bill passed on December 3 and was signed into law by the Governor two days later, December 5.

Reforming Public Pensions Subject to Political and Legal Constraints

There was so little time between the release of the language and its passage that the public (and possibly some members of the General Assembly) did not have the opportunity to carefully vet the bill. A complete actuarial evaluation of the bill was not publicly available, nor was any analysis of its effects on participants. It is unknown whether legislators fully understood the incidence of this reform. As this paper discusses in more detail below, some mid-career, higher income employees experienced expected benefit cuts of 50 to 70 percent (assuming they continue state employment). The hurried approach led to ambiguous legislative language: a leading example is the confusion created about a provision that was intended to avoid a benefit cliff for retirement-eligible individuals around the date of implementation. Indeed, the language was sufficiently confusing that SURS changed its official interpretation in May 2014, fully five months after the bill passed.

VI. KEY PROVISIONS OF ILLINOIS REFORM: THE CASE OF SURS

Public Act 98-599 affected four of the five state-wide public pensions in Illinois (the plan covering judges was excluded on tactical grounds in anticipation of the inevitable court challenges). Although the provisions were very similar for each of the plans, this analysis focuses on the changes to the SURS plan, which covers employees at public universities, community colleges, and a few other related organizations. As noted above, the reform primarily affected Tier I participants in the Traditional and Portable DB plans: participants in the Self-Managed Plan were largely unaffected, and only a small subset of the provisions affected Tier II participants.

A. Changes to the Automatic Annual Increase

The automatic annual increase (AAI) — often referred to as a COLA — is reduced from 3 percent of the total pension amount, compounded annually, to 3 percent of a much smaller amount. Specifically, the new law provides that the 3 percent increase applies to the lesser of the total annuity or $1,000 times the number of years of service, with the $1,000 multiplier increased each year by inflation. For example, if an individual works under SURS for 30 years, then she would receive a 3 percent adjustment on a maximum of $30,000 of annuity benefits. This was designed to be progressive, as those with smaller annuities get a larger increase as a proportion of their benefit. For higher income employees, this represents a very substantial cut in the net present value (NPV) of future benefits.

In addition, the legislation requires individuals to “skip” the automatic annual increase for a number of years based on their age. Those individuals age 50 and over will not receive their 2nd automatic annual increase. Those age 47–50 will not receive their 2nd, 4th, or 6th adjustment. Those age 44–47 miss these plus their 8th adjustment, and those under 43 miss even-numbered adjustments through year 10.

B. Pensionable Earnings Cap

Previously, all earnings up to the IRS maximum ($255,000 in 2013) were included in the SURS benefit calculation. The new law caps pensionable earnings at $110,631 in fiscal year 2015. Individuals already in the system who are earning over this cap are grandfathered so that their annualized June 2014 salary operates as their cap. However, such individuals will never see their pensionable salary increase unless and until the $110,631 cap grows with inflation to the point where it reaches the individual’s grandfathered cap. As will be shown below, this cap represents a very substantial cut in future benefits for individuals who are still a few decades from retirement. Indeed, for individuals subject to the cap, every additional year of work will increase the nominal value of their future pension by only 2.2 percent of their cap. If inflation is exactly 2.2 percent, this effectively means that future real pension accruals are zero. Were inflation to be above 2.2 percent, additional years of work under SURS would be associated with negative real pension accruals.

C. Increased Retirement Age

The new legislation phases in an increase in retirement ages, roughly at a pace of an additional four months per year, so that those age 45 in 2014 experience a four-month delay and those age 31 or younger experience a five-year delay.

D. Changes to the Effective Rate of Interest

As was suggested in Brown et al. (2013) proposal, the new law changes the ERI to 75 basis points over the 30-year Treasury bond rate (which, in May 2014, would be approximately 4.15 percent, relative to the current assumed ERI of 7.75 percent).15 Because a sudden and large reduction in the interest rate would create a large one-time reduction in retirement benefits under the money purchase formula, the legislature included a provision to prevent a benefit cliff that might lead to an exodus of retirement-eligible individuals. This provision was meant to ensure that someone retiring on or after July 1, 2014 (the date of implementation) would receive at least the same benefit that they would have received if they had retired before that date.16

E. Reduction in Contribution Rates for Tier I Employees

The law reduced employee contributions for Tier I participants from 8 percent of pay to 7 percent of pay. Although this seems incongruous with a goal of improving the

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16 In May 2014, two developments affected the implementation of this provision. First, the SURS Board of Trustees voted to change its interpretation of the law so that a benefit cliff would be avoided. Second, a judge issued a stay to prevent the implementation of reform until the constitutionality of the law is determined.
pension’s funding status, this was an overt attempt to increase the odds that the courts would find the overall law constitutional. Recall from the Madiar analysis (discussed above) that although benefit rights were contractual, they could be modified if an employee received “consideration” to accept a reduction in benefits. Thus, the legal logic of this reduction in contributions is that lowering contributions by 1 percentage point is consideration for the benefit reductions. Obviously, however, the value of the benefit reductions far exceeds 1 percent of pay — indeed, cost saving was the entire point of this reform. As will be discussed below, this provision can also be viewed as directly impairing benefits due to its effect on matching contributions.

F. Creation of an Optional DC Plan

Another feature of the reform bill was the creation of an optional DC plan for Tier I employees. This is not a supplemental plan, but rather is meant to be a replacement for individuals who are willing to stop accruing benefits under the DB system. Enrollment in the DC plan is limited to 5 percent of participants, but given its unattractive structure, it is not yet clear if this constraint will be binding.

The lack of generosity of this plan is striking: employer/state contributions are bound between 3 percent at the low end, and equal to the normal cost of the Tier I DB system on the upper end. Given that the law substantially reduced the normal cost of the DB system, the employer contribution to this plan is not expected to be very generous. When compared to the back-loaded benefit accrual pattern in a standard DB, it is especially likely to be unattractive. An exception might arise for those Tier I participants above the new pensionable earnings cap, but this is unclear because the details of this DC plan have not been released.

G. State Funding

Decades of underfunding by the state led to the need for reform. Lacking a credible commitment device, it is quite possible that the state will continue its practice of deviating from required funding schedules. The new pension law specifies that the state is “required” to adhere to a funding schedule that annually contributes the normal cost plus an amortized value of the unfunded liability, with the goal of reaching 100 percent funding by 2044. In addition, the state is directed — starting in 2019 — to receive additional payments using funds that are currently being used to make debt service payments on previously issued pension obligation bonds. A third provision credits the funds with 10 percent of the cost savings from reform, i.e., 10 percent of the difference between what contributions would have been without reform and what they are with reform.

None of these provisions, however, are credible without some sort of an enforcement mechanism because future legislatures can easily undo the commitment made by the current legislature; indeed, this is what has happened repeatedly in the past. To address this, the legislation specifies that if the state fails to make required payments, the state will waive its right to sovereign immunity and the board of trustees of any of
the pension systems are directed to ask the Illinois Supreme Court to compel the state to make payment. Only time will tell how this provision plays out in practice; many have expressed doubts that the courts would require that the state prioritize payments to SURS over other pressing state needs.

VII. IMPLICATIONS

A. Fiscal Effects on the State of Illinois

The primary motivation for reforming public pensions in Illinois was to place the state on a more sustainable fiscal path. There are two ways in which the 2013 reform was intended to do this. First, as discussed above, the reform imposed large benefit reductions on public employees, thus reducing the present value of future benefit accruals. Second, the reform altered the timing of the state’s planned payment schedule for reducing the unfunded liability. Under an older funding plan created by legislation, Illinois had intentionally been paying less than the actuarially required contribution for many years, with the plan being that state contributions would quickly “ramp up” from the current time through the next decade. Indeed, the fact that the state is now on the front end of a steep funding ramp is one of the main reasons that pension reform became such an urgent issue. As part of the 2013 reforms, the time period for paying down the unfunded liability was extended. From publicly available information, it is difficult to precisely disentangle the fiscal effects between real reductions and timing changes.

Figure 1 shows the total annual contributions required by the state for both the pre-reform law and post-reform law as calculated by the consulting actuary (Segal) hired by the Commission on Government Forecasting and Accountability to assess the impact of reforms. Contributions are first expected to decline in 2016, by $1.15 billion. Annual savings are positive in all future years, although there is substantial variation based on the funding path set forth in the legislation. Roughly speaking, the nominal value of the cost reductions averages about $1 billion per year for the first decade, and about $1.7 billion per year for the second decade. In the third decade, the savings average well in excess of $10 billion per year, based on the assumption that the plans will reach full funding by that date.

The present value of the state’s contributions to the plans over the next three decades (through 2045) are reduced by approximately $24 billion using the actuaries’ assumed 8 percent discount rate, although only 45 percent of this savings comes in the first 20 years of the 30 year valuation period.\(^\text{17}\) According to the actuaries, approximately 75 percent of the total reduction in state contributions comes from benefit changes. The rest comes from “financing related changes,” which will depend on how well the state meets its funding plans going forward.\(^\text{18}\)

\(^{17}\) Using a 4 percent discount rate, the value of the savings over the next three decades is $54 billion, although the size of the unfunded liabilities is also substantially greater.

Even with this $1 billion in annual savings over the next decade, the projected Illinois fiscal imbalance is large. As reproduced in Figure 2, Dye, Hudspeth and Merriman (2014) calculate that, even after reform, the state’s budget gap will still rise to $12 billion by fiscal year 2025 (versus a pre-reform estimate for that year of approximately $14 billion). In short, pension reform will generate significant real cost savings to the state in the coming decades, but these savings are not nearly sufficient to balance the state’s budget.

B. The Effect on Benefits

The pension reform law cut pensions substantially, especially for higher income employees. To illustrate this, consider the example of a 40-year old engineering professor earning $200,000 per year who expects to work at the University for 25 more years before retiring. Because this individual is above the new pensionable earnings cap, his salary for pension purposes is frozen at $200,000 per year. As a result, his future pension benefit will grow at a rate of 2.2 percent times $200,000 per year, or $4,400 per year of additional service, with no additional growth due to salary increases. If inflation exceeds 2.2 percent per year, this means that the real value of his pension will decline...
with each additional year of service, i.e., inflation-adjusted pension accruals will be negative for this individual. Because employees will continue to contribute 7 percent of pay toward the pension in each year, the 7 percent contribution effectively becomes a pure tax on working for a SURS employer: in other words, they will be paying 7 percent of pay for essentially no increase in their real pension benefit.

Another way of viewing this is that if this individual expects to receive a 3 percent nominal salary increase every year for the remaining 25 years of employment, then his salary will more than double to nearly $419,000 by the end of his career. Under the old rules, his pension would be calculated based on this higher compensation. Under the new rules, his pension will be calculated based on the cap, which could be as little as half as much. In other words, this single provision reduces the value of this individual’s pension by 50 percent. When one adds in the effect of the new way of calculating the automatic annual increase, the effects are even larger.

Table 2 provides an illustration of how the benefit cuts vary with starting salary, assuming 3 percent annual wage growth and a 2.5 percent annual rate of inflation. The
Table 2

Benefit Reductions from Pension Reform for Hypothetical SURS Employees

<table>
<thead>
<tr>
<th>Salary at start of service (10 years earlier) ($)</th>
<th>40,000</th>
<th>60,000</th>
<th>80,000</th>
<th>100,000</th>
<th>120,000</th>
<th>200,000</th>
<th>120,000</th>
<th>120,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average annual salary growth (%)</td>
<td>0.03</td>
<td>0.03</td>
<td>0.03</td>
<td>0.03</td>
<td>0.03</td>
<td>0.03</td>
<td>0.02</td>
<td>0.04</td>
</tr>
<tr>
<td>Benefit cut (%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At initial retirement age</td>
<td>0</td>
<td>7</td>
<td>30</td>
<td>44</td>
<td>50</td>
<td>50</td>
<td>36</td>
<td>60</td>
</tr>
<tr>
<td>In 20th year of retirement</td>
<td>8</td>
<td>24</td>
<td>43</td>
<td>54</td>
<td>60</td>
<td>65</td>
<td>48</td>
<td>69</td>
</tr>
<tr>
<td>Present value of all lifetime benefits (assuming individual lives 25 years after retirement)</td>
<td>5</td>
<td>17</td>
<td>38</td>
<td>50</td>
<td>56</td>
<td>59</td>
<td>43</td>
<td>66</td>
</tr>
</tbody>
</table>

Notes: Calculations assume nominal salary growth of 3% (except where noted otherwise); inflation of 2.5%; 10 years of service as of reform date; and 25 years of service remaining until retirement.
chart shows how someone with 10 years of service at the time of reform who expects to work another 25 years fares under the reform. Calculations are shown for (1) the effect on the initial benefit at the age of retirement, (2) the effect on benefits in the 20th year of retirement, and (3) a simplified net present value (NPV) calculation that shows cumulative effect over 25 years.

As can be seen, the reduction in benefits is strongly increasing with salary. Someone earning $40,000 per year would see no immediate impact on her pension, although the reduction in the automatic annual increase would lead to an 8 percent reduction in benefits over the subsequent 20 years. The NPV of benefit reductions for this individual is 5 percent of pay. In contrast, an individual earning $120,000 will experience a cut of 50 percent at retirement, with the effect of the change to the automatic annual increase leading to another 15 percentage point reduction over the next 20 years. Overall, this individual experiences a 56 percent reduction in lifetime benefits. Going still further up the distribution, a professor earning $200,000 will experience a nearly 60 percent reduction in the NPV of her pension. The magnitude of the cut is also increasing with wage growth. With 4 percent past and expected future wage growth, the individual earning $120,000 will experience a lifetime benefit reduction of 66 percent. It is not difficult to construct examples of high-income individuals for whom the NPV of benefits would be reduced by over 70 percent.

Importantly, these estimates understate the size of the loss for at least three reasons. First, this stylized calculation does not account for increases in retirement age. Second, it does not account for some additional provisions, such as no longer being able to include unused sick-leave or vacation time in the earnings base upon retirement. Finally, the calculation does not account for the even larger changes that some individuals would experience if their money purchase formula would have provided a larger benefit than the Traditional plan formula under the prior law. Indeed, some of the individuals who would have previously received a higher benefit under the money purchase plan could receive zero nominal increases (and negative real accruals) in their pensions with additional years of work.

C. Effects on Public Universities

Public universities are extremely concerned about “brain drain” among employees, especially those affected by the pensionable earnings cap. This is especially problematical in the higher paid fields (e.g., engineering, law, business, and university administration). This effect is at least partly mitigated among those hired since 1999, at least insofar as some of those individuals chose the Self-Managed Plan which was unaffected by these reforms.

A comparison of the University of Illinois to peer institutions is provided in Table 3. Total employer plus employee contributions to Social Security plus an employer plan at Illinois are roughly 10 percentage points of pay lower than that of the average Big Ten university. Because a large part of the difference is due to Illinois being outside of Social Security, the cleanest comparison is with Ohio State University, which is the
<table>
<thead>
<tr>
<th>Institution</th>
<th>Social Security</th>
<th>University Retirement Plan</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Employee</td>
<td>Employer</td>
<td>Employee</td>
</tr>
<tr>
<td>Minnesota</td>
<td>6.20</td>
<td>6.20</td>
<td>5.50</td>
</tr>
<tr>
<td>Iowa</td>
<td>6.20</td>
<td>6.20</td>
<td>5.00</td>
</tr>
<tr>
<td>Michigan</td>
<td>6.20</td>
<td>6.20</td>
<td>5.00</td>
</tr>
<tr>
<td>Michigan State</td>
<td>6.20</td>
<td>6.20</td>
<td>5.00</td>
</tr>
<tr>
<td>Northwestern</td>
<td>6.20</td>
<td>6.20</td>
<td>5.00</td>
</tr>
<tr>
<td>Penn State</td>
<td>6.20</td>
<td>6.20</td>
<td>5.00</td>
</tr>
<tr>
<td>Purdue</td>
<td>6.20</td>
<td>6.20</td>
<td>4.00</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>6.20</td>
<td>6.20</td>
<td>7.00</td>
</tr>
<tr>
<td>Nebraska</td>
<td>6.20</td>
<td>6.20</td>
<td>5.50</td>
</tr>
<tr>
<td>Ohio State</td>
<td>0.00</td>
<td>0.00</td>
<td>11.00</td>
</tr>
<tr>
<td>Indiana</td>
<td>6.20</td>
<td>6.20</td>
<td>0.00</td>
</tr>
<tr>
<td>Big Ten Average</td>
<td></td>
<td></td>
<td>10.91</td>
</tr>
<tr>
<td>Illinois Tier I</td>
<td>0.00</td>
<td>0.00</td>
<td>8.00</td>
</tr>
<tr>
<td>Illinois Tier II</td>
<td>0.00</td>
<td>0.00</td>
<td>7.00</td>
</tr>
<tr>
<td>Illinois SMP</td>
<td>0.00</td>
<td>0.00</td>
<td>8.00</td>
</tr>
</tbody>
</table>

Notes: For universities with a choice between a DB and DC (e.g., Iowa, Penn State), the contribution levels shown are for the DC system. With exception of Illinois Tier I, all rates are for new employees. Employer contributions for Illinois Tier I and II are estimates.
only other school on this list whose workers also fall outside of Social Security. Ohio State offers a 14 percent employer contribution, which is substantially higher than the 7 to 8 percent contribution offered by SURS.

In response, the University of Illinois is working on a supplemental retirement system in an effort to partially mitigate the damage done to their ability to retain highly compensated talent. Although the Board of Trustees has not yet (as of the time of this writing) authorized this plan, they are expected to do so. The rough parameters of this plan are to make automatic employer contributions to the 403(b) plan of every SURS-eligible employer of about 2 percent of pay, and to also offer a 50 percent match on employee contributions up to 4 percent of pay. For individuals that contribute enough to maximize the match, this would result in 4 percent employer plus 4 percent employee contributions. This would bring the University of Illinois closer to its peer institutions as measured by contributions, although they would still be near the bottom. In recognition of the substantial cuts imposed by the pensionable earnings cap, the University is considering supplemental 5 percent contributions only on those earnings above the cap.

Ironically, although the Illinois legislature chose not to establish a hybrid system, existing employees in the SERS DB plan may still end up with a hybrid system: a smaller SERS DB plan with a supplemental University DC plan.

VIII. LEGAL CHALLENGES

Between December 27, 2013 and January 28, 2014, four separate court cases were filed challenging the constitutionality of the reform law. In general, these cases allege that the pension reform bill violates the non-impairment clause discussed earlier. Some of the cases also make the case that the reform violates protections against the abrogation of contracts, and at least two of them claim the law violates the Equal Protection Clause as well. On March 3, 2014, the Illinois Supreme Court ordered the consolidation of the four cases. Subsequent to that consolidation, the Statue University Annuitants Association, which represents SERS annuitants, filed another legal challenge on behalf of SERS active and retired members. This case argues that each of the following provisions violates the pension protection clause, the contracts clause and the takings clause of the state constitution: (1) the changes to the automatic annual increase (the change in the level, the removal of compounding, and the skipping of years); (2) the salary cap; (3) the change in the ERI, and (4) the increased retirement age.

Although it is possible that the Supreme Court of Illinois could allow or overturn the law in its entirety, it is also very possible that this will not be an “all or nothing” ruling. For example, there is a reasonable case to be made that the change in the ERI is constitutional because the rate itself was not determined by law but rather was left to the SERS board to set based on certain criteria. Indeed, the ERI has changed many times.
Reforming Public Pensions Subject to Political and Legal Constraints

961
times over the years and has never been successfully challenged in court. If one takes
the view that the constitution protects accrued benefits but not future yet-to-be-earned
benefits, then it is also possible that the salary cap — which only affects future accru-
als — would be permissible.

The case for striking down the other provisions appears stronger. The 3 percent
automatic annual increase was quite specifically set forth in the Illinois pension code.
Thus, even benefits accrued as of the date of reform would seem to include future auto-
matic annual increases to those accrued benefits. It seems that the reform would have
been on stronger legal ground had the legislature preserved the 3 percent increase on
benefits already accrued, and lowered it on future benefits. However, this would have
substantially lessened the cost savings from reform and thus it is not surprising that the
legislature chose to attempt to achieve greater cost savings.

From an economic or actuarial perspective, the retirement age increase would
appear to be a reduction in the NPV of benefits already earned as of the date of reform.
Whether or not the courts view this through an NPV lens or through an annual benefit
lens, however, is uncertain.

The legal uncertainty has generated enormous uncertainty for universities and their
employees. In May 2014, a judge issued a stay to prevent the implementation of the
reforms until the constitutionality of the law has been assessed. The timetable for reso-
lution of this case is uncertain.

IX. SUMMARY AND CONCLUSIONS

Economists often model policy decisions (such as pension reform) as a constrained
optimization problem in which the objective function is some measure of social wel-
fare. Properly specified, this optimization problem will account for distributional con-
sequences as well as cost-effectiveness. For example, one might imagine maximizing
the retirement security of participants subject to budget constraints that reflect the cost
of public funds.

From personally observing the Illinois pension reform process, a more empirically
accurate model of how the policymakers acted was as if the objective function was to
generate $X in cost savings, subject to constraints on political and constitutional feasi-
bility. This narrow framing placed little weight on retirement security of participants,
except insofar as this affected the political constraints. Even more striking was the
sense in which the objective — a cost savings of $X — was arbitrarily chosen during
the process, and was set in an economically non-meaningful way. Many public and
legislative discussions of alternative proposals focused on the nominal, undiscounted
sum of future cost savings three decades away. Little attention was paid to whether a
dollar saved in 2016 was worth more than a dollar saved in 2045. Given this, it is per-
haps not altogether surprising that such a large fraction of the total cost savings were
back-loaded so as to increase the ratio of perceived-to-real cost savings.

Illinois, admittedly, may be an extreme case. Its pensions were among the worst
funded in the nation, its state fiscal situation is dire, and its political system is often
viewed as one of the most corrupt. Even so, this case study illustrates how difficult it is to enact efficient pension reform in an environment that is highly constrained by legal and political considerations. Many potential reform options — such as just an across-the-board reduction in benefits, or ending the retirement income exemption in the state tax code — were simply not viable.

The future of the law’s implementation remains uncertain. Sometime in the next one to two years, the state Supreme Court will issue an opinion that could fully or partially overturn the bill, thus throwing the issue back to the legislature. Whether this occurs, the state of Illinois will still be forced to grapple with large budget shortfalls.

ACKNOWLEDGEMENTS

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DISCLOSURES

The author is a Trustee for TIAA, a financial services provider that is one of the Self-Managed Plan vendors for the State Universities Retirement System of Illinois.

REFERENCES


