"Maintaining the excellence of public higher education in Illinois requires comprehensive, fair and equitable pension reform as soon as possible."

Building on a set of proposals published earlier this year*, the authors propose additional steps to reduce future costs and liability of the pension system. The proposal includes the following measures:

- **Change some SURNS administrative rules to reduce costs and significantly improve transparency.**
  - *For example:* Peg the effective rate of interest (ERI) to the yield of long-term government bonds with a small premium added.
  - Changing the effective rate going forward to 4 percent will reduce the unfunded liabilities by nearly $1 billion and reduce normal cost by as much as 1.5 percent of pay, which is a 10 percent reduction of the amount that the state currently pays.

- **Give participants a fair incentive to accept lower benefits in the future by providing lump-sum payments in exchange.**
  - The payment would be equal to the present value of the foregone future benefits discounted by the long-run average historical effective rate of interest.
  - The payment would be transferred to a self-managed retirement account, and could be invested in assets that would provide better inflation protection (such as inflation-adjusted bonds).
  - The trade-in is guaranteed to reduce projected liabilities and costs for SURNS.

- **End the tax exemption for retirement income.**
  - Illinois is one of only four states that completely exempt pensions, annuities and Social Security benefits from a broad based income tax.
  - Exemption for retirement income is unfair to wage earners whose incomes are taxed.
  - Exempting federally taxed retirement income and social security benefits from state income tax costs Illinois about $1.1 billion per year.

- **Improve upon or eliminate some components of SB 1673.**
  - Although the DB-DC hybrid plan proposed in the previous IGPA report is preferred, the cash balance plan proposed for reforming Tier II is an improvement and a necessary step in the right direction.
  - Universities should be responsible for at least some portion of annual pension costs. However, shifting all costs to universities will undoubtedly result in tuition increases, decreasing access to public education for many low- and middle-income families.
  - If universities take on some funding obligation, they should also be given some control of decisions made about the pension plan.
  - Forcing participants to choose between a lower COLA or access to healthcare benefits is unfair to employees and also limits the ability to make changes to the health insurance system in the long term.
  - Equally unfair is the proposal to freeze pensionable salaries; this would mean that employees will not accumulate pension benefits for any pay increases they receive in future.

- **No other aspect of pension reform is as important as the amortization of unfunded liabilities and a guarantee by the state to make required pension payments on time forward.**

Read the entire proposal at igpa.uillinois.edu/pensions.

Questions can be directed to: Dr. Avijit Ghosh, ghosha@uillinois.edu or Dr. Jeffrey Brown, brownjr@illinois.edu

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*The experts’ proposal builds on “Fiscal Sustainability and Retirement Security: A Reform Proposal for the State Universities Retirement System (SURNS),” published on February 9, 2012 by Dr. Jeffrey Brown and Dr. Robert F. Rich. (See the paper at igpa.uillinois.edu/pensions). The ideas, proposals, and opinions expressed by the authors reflect their views and are not necessarily those of their institution.
I. An Urgent Need for Reform

It is now a well documented fact that Illinois ranks 50th among the fifty states when it comes to adequately financing public pensions. For a variety of reasons—including decades of insufficient funding by state government, low investment returns and archaic governance rules—liabilities for public sector employee pensions now far exceed the assets set aside to fund them. Many have aptly called the situation a crisis.

It is in this context that Illinois public pensions are in urgent need of reform, and the State Universities Retirement System (SURS), to which employees of Illinois’ public universities belong, is no exception. The tremendous uncertainty about the viability of the pension system has put public universities on the brink and the economic engine they power at the risk of stalling. The fear of losing their retirement benefits is prompting many employees to leave, often for universities in other states. At the same time, retirement applications are at an all time high.

Universities compete aggressively in a global labor market to attract world renowned scholars who are extremely mobile in choosing where to work. The lack of credible commitments to stabilize the pension system is hindering the ability of universities to recruit the next generation of scholars who will educate our citizens to become the workers, the educators, the entrepreneurs and the leaders of tomorrow. The excellence of the public higher education system that has taken the state over a century to build is at risk.

At the same time, Illinois’ fiscal challenges are real and cannot be ignored. The state’s fiscal obligations for public pensions account for a significant share of the taxes and fees it generates each year and is crowding out investments in other priorities (including appropriations to universities). This, of course, is the result of past policy choices and lack of fiscal discipline on the part of the state to make the required annual pension payments over the past four decades.

But it serves little practical purpose to lay blame or point fingers at this time. What is required instead is agreement on a reasonable path to a solution—a plan to stabilize the pension system. Earlier this year, the Institute of Government and Public Affairs at the University of Illinois (IGPA) published such a plan for the State University Retirement System (SURS)\(^1\). The plan, authored by Jeffrey Brown and Robert F. Rich, February 8, 2012. igpa.uillinois.edu/pensions.

Brown and Robert Rich, received considerable support among a broad cross section of stakeholders. The principles and proposals outlined by Brown and Rich continue to provide a foundation for pension reform. Here we offer some additional suggestions especially in the context of SB 1673, the pension legislation discussed last summer.

II. Principles of Reform

At the outset it is important to reinforce some overarching principles of pension reform proposed by Brown and Rich.

- First, any reform must comply with the existing constitutional protections against the impairment of already-accrued pension benefits. While not all legal scholars agree on the boundaries of this protection, little will be gained by passing reforms that will clearly be turned down by the courts.

- Second, a reformed pension system must also be financially sustainable going forward. This will require reductions in future payments through real reductions in costs as well as a sustainable redistribution of those costs to ease the required pension payments by the state.

- Third, the burden of any reform must be shared by all stakeholders including retirees, current employees, universities, the state and the tax payers. Each group must play its part.

- Fourth, any reform proposal must recognize the undeniable fact that university employees have diligently paid their share of the cost year after year without failure. They cannot go back and readjust their careers and retirement decisions retroactively. So the burden of making up the pension shortfall—the unfunded liability—must remain solely with the state.

- Fifth, a successful reform proposal must be perceived as fair, equitable and credible by the participants and citizens at large. In this context it is important to remember that university employees do not receive social security benefits. If the state had not decided to exempt its employees from social security, it would be required to pay 6.2 percent of pay for each employee as its contribution to the social security fund.

III. Three Reform Suggestions

In this section we build on the SURS reform ideas suggested in the IGPA proposal by offering three additional suggestions. Taken together these suggestions can create a credible reform package that provides retirement security for participants, fair and acceptable steps towards reducing the cost and liabilities of the pension system, a plan for equitable sharing of annual costs and the amortization of the unfunded liability by the state. Such a plan would restore confidence in public universities, enable them to compete globally and reverse the exodus of talent from the state.

1. Change SURS Rules for Transparency and Cost Reduction

The annual normal cost of the SURS pension program is affected directly by how SURS creates its own administrative rules. Many of these rules are not mandated by the constitution but established by the SURS board or the Comptroller. Brown and Rich had earlier highlighted how the effective rate of interest (ERI) used to set interest rates for crediting money purchase agreements impacts normal cost. They noted that historically the ERI has been set between seven and ten percent and has not varied much since its inception. Real market returns have had much greater variability during the same period and thus carried a much greater risk.

The combination of low variability and high average ERI in essence represents a hidden subsidy to participants who are eligible for the money purchase option. To stop such subsidies the ERI should be pegged to the yield of long-term government bonds with a small premium added. This would be the commensurate return for an essentially risk-free asset. According to SURS’ own actuarial estimates, changing the effective rate going forward to four percent—a 1.25 percent premium over the current risk free long-term treasury rate—will reduce the unfunded liabilities by nearly $1 billion and reduce normal cost by as much as 1.5 percent of pay, which is a 10.0 percent reduction of the amount that the state pays currently. Even a smaller reduction in the ERI would significantly reduce unfunded liability and future cost. It is important to note that a lower ERI has no effect on the defined benefit of 2.2 percent of income for each year of service that participants are entitled to.

Other SURS rules should also be examined. For example, SURS currently disregards the cost of providing survivor benefits and cost of living adjustments (COLA) when it annuitizes money purchase benefits. To compensate for this omission it calculates the total balance in the member’s account by crediting the account with a 6.5 percent contribution rate instead of 8 percent. We would suggest that SURS credit the member with the full 8 percent contribution but then fully account for the cost of providing 50 percent survivor benefit and COLA. This will increase transparency of the pension system. Equally important is the fact that actuarial estimates show that the change would reduce unfunded liability by approximately

2 The current ERI is 7.5 percent.
adjustment.

percent, 5 percent or -1 percent. It is simply an automatic annual annuity
a guaranteed 3 percent increase in annuity whether inflation is 1 percent, 2
justment (COLA), since it is not linked to actual inflation rate. It is simply
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pension system and the universities that employ them.
lose, tails you win! Presented with such punitive options
such a choice. As one participant described it—its heads I
feature that calls into question the constitutionality of
participants will be forced to give up some of their current
future retirees. Irrespective of the option they choose,
argue with the goal of reducing liabilities and costs; but
1673, introduced last summer, offers members a choice
to accept a smaller increase. For example, Senate Bill (SB)
proposals have focused on inducing or forcing participants
benefit—either retirement benefit or health care benefit—a
participants can be achieved.

2. Convert Some Future Benefits to Lump Sums

The provision of the current pension plan that has received
the greatest attention is the automatic annual adjustment
to the retirement annuity; typically referred to as the cost
of living adjustment, or COLA. This provision guarantees
that the retirement annuity grows at a compounded
rate of 3 percent annually. It seems clear that when this
provision was introduced in 1990 the state did not consider
the full cost of this benefit. Participants were paying half
a percent of pay for a “cost of living adjustment.” The
real cost of providing a 3 percent increase, on the other
hand, is about six times that amount. The benefit was
changed but the payment remained the same despite the
additional financial burden on the pension system. And
the impairment clause makes it impossible to correct that
mistake.

Given the high cost, it is not surprising that reform
proposals have focused on inducing or forcing participants
to accept a smaller increase. For example, Senate Bill (SB)
1673, introduced last summer, offers members a choice
of accepting a lower increase or foregoing access to state-
provided retiree health care benefits and lose pension
eligibility of future salary increases. One can hardly
argue with the goal of reducing liabilities and costs; but
the choice offered in the bill is confusing and unfair to
current employees and will lead to inequities among
future retirees. Irrespective of the option they choose,
participants will be forced to give up some of their current
current—either retirement benefit or health care benefit—a
feature that calls into question the constitutionality of
such a choice. As one participant described it—its heads I
lose, tails you win! Presented with such punitive options
participants are likely to lose even more confidence in the
pension system and the universities that employ them.

So what is the appropriate way to offer choices? Participants will surrender a constitutionally guaranteed benefit only if they feel they can get something they value in return. It will not be a great surprise to most people that due to the gross underfunding of the pension system many participants have lost some degree of confidence in the system. Participants want funding to be restored. But given that funding restoration can only happen over decades, not days, they want to diversify some of their pension assets to reduce risk in the meantime. The state’s priority is also clear. It wants to reduce the burden of pension payments and reduce the liability. Pension reform in the private sector offers examples of how the objectives of both parties can be achieved.

One way to induce participants to forego a portion of their annual increase (or any other benefit) is to offer them a lump-sum payment for accepting the lower benefit. We propose that the amount of the payment be equal to the present value of the foregone future benefits discounted by the long-run average historical effective rate of interest. This way each participant would be compensated for the future benefit payments he or she is giving up (using a discount rate commensurate with how those benefits were calculated) and also diversify the risk to his or her pension assets. As the old adage goes, in times of uncertainty it is better not to keep all your eggs in one basket.

To maintain a prudent pension plan the lump sum amount should be transferred to a qualified self-managed retirement account. The funds in the account would, of course, be subject to normal market risks but it would be free from the perceived risk caused by past and any future underfunding of SURS. The individual could also use the funds to invest in assets that would provide a better inflation hedge than a fixed annual increase, such as inflation-adjusted bonds.

The state also gains from the transfer. Recall that the lump sum amount is calculated by discounting the stream of forgone future benefits by the historical effective interest rate. Because the historical effective rate of interest is higher than the currently assumed rate of interest as well as currently prevailing market rates, the value of the lump sum will be lower than the actuarial cost of providing the additional benefit. Thus the exchange will lower future projected costs and liabilities even after accounting for the value of the lump sum. So the state will get what it seeks: lower liabilities. Lump-sum transfers can also significantly reduce risks and future costs for SURS. One of the greatest risks to SURS, and all of the state’s pension systems, is that the actual investment returns could be less, perhaps significantly less, than the actuarial prediction. If the investment returns are indeed lower, as most experts fear, then the cost savings from the lump-sum exchange will be even larger.

It is actually a misnomer to refer to this benefit as the cost of living adjustment (COLA), since it is not linked to actual inflation rate. It is simply a guaranteed 3 percent increase in annuity whether inflation is 1 percent, 2 percent, 5 percent or -1 percent. It is simply an automatic annual annuity adjustment.
The lump-sum exchange is the only constitutionally feasible way for participants to voluntarily “trade-in” a portion of their guaranteed benefits. Because the trade-in is guaranteed to reduce projected liabilities and cost for SURS, it is beneficial for the system long-term even though it requires immediate cash outlay. Since the cost savings are higher than the payout it is feasible to implement necessary funding strategies, particularly in the current low-interest environment.

This concept can be applied to other situations too. For example, some participants may be willing to diversify their risk further by converting a portion (say 10 to 20 percent) of their earned benefits into a lump sum and deposit that sum in a self managed plan. Indeed, one can offer a portfolio of such exchanges as long as prudent pension planning principles are followed. We would of course strongly reinforce the importance of ensuring adequate lifetime income that cannot be outlived.

3. Reform the Tax Code

As true with many pension programs, a large portion of SURS’ projected liabilities is due to payments earmarked for current retirees. Some have suggested that current employees have been forced to take on a disproportionate burden of the cost of the retirement system. For example, over the past decade, retirees received 3 percent increases each year while active employees received little or no salary increases and were subjected to furloughs. Retirees also receive another very special privilege. Illinois is one of a handful of states that exempts retirement income from state income tax. Thus while current income is taxed by the state at the rate of five percent, retirement annuities are tax-free.

According to a report published by the Institute on Taxation and Economic Policy, Illinois is one of only four states that completely exempt pensions, annuities and Social Security benefits from a broad based income tax. There is little theoretical or practical justification for treating retirement income differently from ordinary income. For example, it is hard to justify why pension benefits should be exempt while the earnings of seniors who are forced to work full-time to make ends meet are fully taxed. Indeed, public finance theory highlights the inefficiency of providing such special treatment for retirement income and posits that income from both sources should be treated the same way; especially given that retirement contributions are made with before-tax dollars.

Some have suggested that exempting retirement income from taxation motivates more retirees to stay in the state. However, there seems to be little evidence to suggest that states that exempt retirement income from taxation have a differential advantage in out-migration rates. Moreover, the state should be equally concerned about out-migration by active workers since in general they tend to have higher migration rates than retirees.

Thus we suggest that it is time to amend the state’s tax policy and end special treatment of retirement income. A report released by the State Treasurer’s Office estimates that exempting federally taxed retirement income and social security benefits from state income tax costs Illinois about $1.1 billion per year. At a time when all citizens are feeling the pain from the state’s budget shortfall, Illinois can ill afford to continue this policy that benefits retirees only. These revenues would augment state cash flow and go a long way in addressing the state’s many unpaid bills, including pensions.

IV. Senate Bill 1673

Last summer the legislature debated Senate Bill (SB) 1673 with the goal of enacting a comprehensive reform plan for the state’s five pension systems. The bill makes some desired headway, but falls short of the mark. In this section we briefly discuss the major features of the bill and offer suggestions for improvement.

The bill is structured around four major components:

- A new “cash balance” plan to replace the current Tier II plan for new employees;
- A plan to shift over time the responsibility of paying the annual normal cost of pensions to SURS from the state to the universities and community colleges;
- A set of choices for traditional Tier I employees and retirees aimed at lowering the annual adjustments (COLA); and
- A promise by the state to fully amortize outstanding unfunded liabilities on an accelerated schedule contingent on at least 50 percent of the participants accepting a reduced COLA.

1. Tier II Reform

The attention that SB 1673 gives to reforming the Tier II program is laudable. The inadequacies of the Tier II program, which covers all employees joining public universities after January 1, 2011, are now well documented. Tier II has handicapped all Illinois public universities in their recruitment efforts. As just one

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example, it made the University of Illinois dead last among its Big Ten peers in terms of retirement benefits. SB 1673 proposes to replace the Tier II program with a new “cash balance” plan.

We would have preferred a hybrid plan like the one described in the IGPA paper by Brown and Rich. But the cash balance plan, with its lower vesting period, higher limits on pensionable income, flexible retirement age and some hybrid-like features, is a step in the right direction. We would be remiss, however, if we did not note that the long-term stability of the cash balance plan requires strict funding discipline and avoiding promises of returns that are not prudent and exceed rates offered in the market place. The failure to maintain these disciplines is at the root of the current underfunding problem and must not be repeated.

2. Redistribution of Funding Obligation

SB 1673 also proposes to shift over time the responsibility of paying the annual normal cost from the state to the universities. There is considerable economic theory to support the concept that direct employers—the universities—should be responsible for paying at least some portion of the annual pension cost. Simply stated, universities need to have “skin in the pension game.” Currently, universities have no responsibility for funding the pension program; which means that they can make hiring decisions without any thought to the cost of the pension—thereby underestimating the true cost of hiring. Proper alignment of workforce management decisions and pension funding obligations is a step in the right direction in our opinion.

But SB 1673 goes too far by proposing to shift all normal costs to universities. With state appropriations steadily declining for the past decade the negative consequence of a full cost shift is not hard to visualize: higher tuitions that would close the doors to a university education for many low- and middle-income families. Moreover full cost shift creates another kind of misalignment that is equally faulty. The state would then retain for itself all the powers to design and modify the pension plan while shifting to the universities the cost of paying for it. So now the state can alter the plan without being responsible for any of the cost. For these reasons we suggest that the responsibility for paying the normal costs be shared between the state and the universities. This would be more equitable and fair. For the same reasons we suggest that the requirement in the cash balance plan that universities pay the entire normal cost of the plan from day one be amended to follow the principles of transition and sharing.

3. Benefit Choice by Participants

We find the third component of SB 1673—the benefit choices presented to participants—to be especially troubling. The bill would require all traditional Tier I participants to make a choice between two options. In the first option employees and retirees would retain all current benefit levels but they would lose eligibility to receive state retiree health care benefits and current employees would also lose pension eligibility of future salary increases. The second option retains eligibility to participate in group health care as well as pension eligibility of future income increases. However, in exchange for keeping those benefits, participants would have to accept a lower annual annuity increase (COLA). The COLA would start at age 67 or 5 years after retirement, whichever is first; and it would be the lesser of 3 percent or ½ CPI calculated on the original annuity.

We understand the dilemma that led to these extreme choices. Given the high cost of guaranteed 3 percent increase, the intent is to induce participants to accept a lower increase to reduce cost and liability. But, as noted before, the choices in the bill are punitive. It is also doubtful that a majority of the participants would choose the lower COLA, thereby precluding accelerated amortization of unfunded liabilities. This would defeat the major goal of pension reform.

A major drawback of the choice scenario in SB 1673 is that it links pension benefits with health care coverage. This is undesirable for a variety of reasons. First, it is much better to deal with retiree health care issues separately from pension reform. By linking it with pensions, we lose the flexibility to make rational changes to the health care program for employees and retirees. Second, with the passage of PA97-0695 (SB 1313), the state has already reserved the right to set health premiums at its own discretion. So, participants cannot properly estimate the benefit of retaining health care coverage. Finally, it is not surprising that most participants object to the use of health insurance eligibility as a lever to accept a reduction in already earned pension benefits.

The idea of freezing pensionable salaries of current employees is also of great concern to us as it is to most pension experts. This would essentially mean that an employee who plans to work for the university long-term will accumulate no additional pension benefits for pay increases that might be earned during all those additional years of service. This would seem to violate the spirit, if not the terms, of the agreement that granted the state exemption from the social security rules. We know of no other major employer who would pay no social security tax and freeze the income level for future contributions to a retirement plan it makes on behalf of its employees. Despite our strong misgivings about the choice scenarios
offered in SB 1673, we believe that the idea of offering choices to participants has considerable merit if they are replaced with lump-sum trade-ins of the type described in the earlier section of the paper.

4. Accelerated Amortization of Unfunded Liabilities

No other aspect of pension reform is as important as the amortization of unfunded liabilities and a guarantee by the state to make required pension payments on time going forward. In SB 1673, the state’s promise to amortize unfunded liabilities and make on-time payments, is contingent on at least 50 percent of the participants accepting lower annual annuity adjustments. Given that the unfunded liability is the result of missed payments by the state, it should make the good faith offer to accelerate the payment of past dues without condition. The cost reduction ideas presented in this paper, if enacted, would provide the state with enough financial resources to make such a promise.

V. The Time to Act

In this paper we have suggested ways to improve current proposals for stabilizing public pension systems in Illinois. In brief, we first suggest ways to construct fair choice scenarios to improve the ones presented in SB 1673. Amending SB 1673 along these lines will benefit both the participants and the pension system. We also demonstrate how changing certain SIRS administrative rules would reduce costs significantly while also improving transparency. Just the two examples we have noted in this paper are estimated to reduce SIRS liability by nearly $1.5 billion. These same steps will also reduce normal cost. Future liability should also be reduced by exchanging future benefits with lump-sum payouts. Finally, we suggest amending the tax code to end the special treatment for retirement income.

These changes coupled with direct employers assuming responsibility for paying a portion of the annual normal cost would significantly reduce the cost of the pension system and improve the state’s ability to adequately fund SIRS. In addition, we would suggest, as did the Brown and Rich proposal, that employees enrolled in the Tier I traditional plan also share a greater portion of the normal costs by contributing an additional two percent of their pay. Since all four of us are members of SIRS, these proposals were made with SIRS in mind; but the same principles should be equally applicable to the other pension systems.

Now is the time for action. Delay will not make the problem easier or make it go away. In fact, the problem has becomes more challenging with the passage of time. Maintaining the excellence of public higher education in Illinois requires comprehensive, fair and equitable pension reform as soon as possible.