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Paying for Tomorrow:
Practical Strategies for Tackling the Public Pension Crisis

A Deloitte Research Study

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Executive Summary

Mounting public-sector retirement costs pose a serious threat to state and local governments. Public officials must confront runaway public pension and retiree health benefit expenses or risk voter backlash as these costs hit taxpayers in the pocketbook and force states to spend tax dollars on legacy obligations that could have been used for education, services and infrastructure.

Recent studies paint a grim picture. One survey of 123 state retirement systems (many states have multiple systems serving employees) found that more than 90 percent of them are underfunded, that is, the states have not set aside enough money to cover their pension obligations. Another report warned that unfunded pension obligations could exceed $600 billion across the public and private sectors. Meanwhile, the bill for paying future medical benefits for state and local employees who retire could top $1 trillion.[1]

The problem will only get worse with the impending huge wave of baby boomer retirements. More than half of the state workforce in both New York and California is over age 45; in Michigan more than half the public workforce will be eligible for retirement within 10 years.

Solving the public pension crisis requires action. Continuing to defer retirement costs to future generations is both irresponsible and unfair. Government policymakers must address this challenge by developing sound funding policies for public pension systems and then having the discipline to follow them.

Causes. The current crisis stems from years of bad planning and poor policy decisions. Flush with earnings from a bull market that lasted through much of the 1990s – and masked significant underfunding of many plans that occurred prior to that time – government retirement plans greatly expanded benefits for retirees. States and localities routinely added perks to public-sector retirement plans. Lenient salary, sick-time and vacation-time rules resulted in artificially spiked earnings for many employees in their final few years, which in turn led to bigger pensions. Lucrative benefit packages—intended to boost retention of qualified government workers—had the opposite effect, prompting many to retire in their early 50s. And, thanks to constant improvements in healthcare and resultant increases in life expectancy, retirees now draw benefits longer than ever before.

These factors are magnified by the fact that government retirement plans tend to be much more expensive to support than those offered by private employers. Unlike the private sector, the vast majority of government pension systems offer defined benefit plans, which guarantee retirees a pre-set benefit amount based on the number of years they work and their final or highest compensation amount.

The cost problems of government pensions were masked by a booming stock market in the 1990s. But, as investment markets cooled, the bill came due for generous benefit packages approved during the boom years. But instead of shoring up the pension funds with more revenues, many states and localities used revenues that should have gone into pension funds to finance other priorities such as Medicaid or education, making the situation far worse. This diversion was made possible by the lack of prefunding requirements that would have forced public retirement plan sponsors to adequately fund their pension liabilities.

Unfortunately, there is no “silver bullet” for solving the public pension crisis. Most jurisdictions will require a mix of cost cutting and revenue-enhancing changes to bring their pension systems back into balance.

Short-term solutions. In the short term, jurisdictions facing large unfunded pension obligations must stop the financial bleeding. Strategies for relatively quick improvement include:

- **Curtail abuses** by eliminating pay-raise and sick-leave policies that allow pension benefits to be inflated. Narrow eligibility for costly "public safety" benefits to true public safety employees.
- **Adjust pension benefit formulas.** Reduce or eliminate special benefit formulas that increase overall plan costs. Where possible, raise employee pension contributions to better match rising costs.
- **Explore other revenue sources to improve funding**. Illinois, for example, is looking at selling or leasing the state tollway system. Proceeds from the license sale would be funneled into the state pension system.
- **Reduce administrative costs** by combining multiple pension plans or implementing more efficient systems and procedures.

Medium and long-term reforms. Long-term viability of public retirement programs likely will demand fundamental changes in pensions. Because these reforms sometimes are difficult to apply to existing employees, their impact often won't be felt until a new generation of public workers is hired and some of today's younger workers near retirement. Pension reforms for the medium-to-long-term include:

- **Develop a pension funding policy and stick to it.** Current laws governing state public sector plans allow policymakers to shift huge retirement costs to future generations. States should consider crafting laws that require minimum funding levels for public retirement systems. There's no magic number for what these levels should be — funding targets may range from 80 percent to 100 percent. Policymakers need to decide on a level of pension funding that balances short-term needs with long-term goals.
- **Establish two-tier pension programs** that shift newly hired workers into lower-cost retirement plans. This approach — which is common in the private sector — reduces retirement and health benefits for employees hired after a specific date, while maintaining agreed-upon benefit packages for existing workers.
- **Tie cost-of-living increases to actual inflation rates.** This could produce significant savings, while still protecting retirees from rising living expenses
- **Scale back generous early retirement programs.** As a huge number of aging baby boomers near retirement age, these provisions are proving to be extremely expensive and poorly designed. Restructuring these programs would save money and encourage valuable workers to stay on the job.

When enacting reforms it's important that these issues not be viewed solely through a financial prism. The underlying plans are after all "employee benefit" plans that were designed, even if flawed, to attract, retain and motivate talented individuals to seek and remain in employment.

Introduction

In April 2005, San Diego Mayor Dick Murphy stepped before a hastily assembled crowd of news reporters and announced his resignation. Murphy, elected to office just five months earlier, had become the focal point of public backlash over a city pension deficit of nearly $2 billion.

Not only were San Diego's pension troubles a key factor in Murphy's resignation, they also hindered the city's effort to complete capital projects. San Diego's credit rating fell in 2004, hobbling the city's ability to sell bonds to finance initiatives such as water and sewer improvements, the *Los Angeles Times* reported. [2]

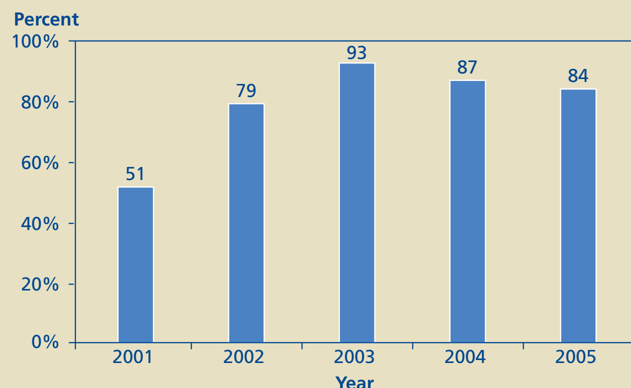
Murphy's resignation may be the most visible fallout yet from unfunded public pension liabilities. But he's certainly not the only public official feeling heat from this festering issue.

- In Texas, the state Pension Review Board placed an unprecedented 18 public retirement plans on its watch list, a warning that the plans have insufficient funds to meet future obligations. Among them are the state's largest pension systems — the Teacher Retirement System of Texas and the Employees Retirement System of Texas — with combined assets in the hundreds of billions of dollars. [3] The list also includes retirement plans for the cities of Austin, Dallas, El Paso, Fort Worth, and Houston.
- In New Jersey, newly elected Gov. Jon Corzine made public pension reform a campaign issue in his state, where taxpayers may need to come up with nearly $400 million in 2006 to cover skyrocketing pension costs for municipal workers, police and firefighters. New Jersey's state and local public retirement systems are underfunded by as much as $35 billion — a shortfall that must be filled either by investment gains or taxpayer contributions over the next three decades. Those growing pension costs are set to broadside local government budgets this year, potentially forcing city and county leaders to contemplate an unsavory mix of tax increases and service cuts. Newark, for example, will see its bill for public pensions jump from $9.6 million in 2005 to $20.2 million in 2006, according to the New Jersey *Star-Ledger.*[4]
- Cities and counties in New York State saw their pension contributions grow by as much as 248 percent in 2004. [5] For example, the pension bill for Binghamton, N.Y., jumped from $1.6 million to $4.2 million in a year, prompting Mayor Richard Bucci to brand the increase a "fiscal atom bomb." The city hiked property taxes 7 percent in 2004 — half of which went to cover pension costs — and another 7 percent in 2005 for the same reason.[6]

The news is similar across the nation, as states and localities confront the widening gap between the amount of money collected by pension plans through employee contributions and investments and the amount of money these plans are committed to paying out in the form of benefits to government retirees.

A 2006 survey of 125 state retirement systems by Wilshire Research shows the breadth and magnitude of the problem. Of the 58 plans that provided actuarial data for 2005, 84 percent of them were underfunded. For those providing data for 2004, the number was even higher at 87%. This is up from 79 percent in 2002 and 51 percent in 2001.[7] (See Figure 1) On average, the underfunded plans had enough assets to cover only 80 percent of their future pension commitments.

Figure 1. Percent of Retirement Systems Underfunded



Another report from the Reason Foundation warned that the current price tag for unfunded pension obligations dwarfs the federal government's bailout of the savings and loan industry in the late 1980s, which cost taxpayers $124 billion.[8] Today, taxpayers may be exposed to more than five times that amount in unfunded pension obligations across the public and private sectors.

Public-sector retirement costs pose a serious threat to state and local governments — making pension reform a key factor in both future economic success for communities and quality of life for constituents. Pension costs consume resources that could be directed elsewhere. For example, spending more budget dollars to fund pension commitments potentially means fewer resources for public safety, education, transportation, health care and other vital needs.

In a recent special report, *BusinessWeek* magazine highlighted the impact of exploding pension costs on several communities.[9] One of these is Jenison, Mich., where contributions to pensions and retiree health care are the fastest-growing expense for the public school system. The bill came to $1 million in 2005 and will jump to $1.5 million in 2006. With state school funds frozen for the past three years, the district coped with growing pension expenses by eliminating teaching positions and instituting fees for after-school sports and field trips.

As these impacts become more pronounced, public officials will face growing public concern over the spiraling expense of government retirement programs. The problem will only get worse when the huge wave of baby boomers begins to retire, starting in 2008.

The bottom line is the world in which retirement programs operate has changed dramatically in recent years, and the programs must be proactively managed in order to maintain a cost-benefit balance.

This paper examines the causes of the current dilemma and presents a roadmap for addressing this increasingly pressing challenge. We also set straight some of the common misperceptions about the pension problems.

Four Myths of Public Pension Reform

Myth #1: Defined contribution plans will fix the problem anytime soon. Though it might be the right thing to do, transitioning to defined contribution plans likely will do little to resolve near- or medium-term pension fiscal problems. Governments must phase in defined contribution pension plans gradually as new workers enter the system, meaning they may not see significant relief for 20 to 30 years. (See page 16)

Myth #2: Plans just need to invest more in equities to get their returns up. Investment policies must balance profit potential with risk. Plans opting for higher-yield investment strategies must understand the risks involved and ensure they can afford the potential losses. (See page 13)

Myth #3: All employees cost the same. Defined benefit pension costs for younger workers are typically significantly less from an actuarial standpoint than pension costs for older workers who have spent long careers in the public sector. (See page 16).

Myth #4: Deferring costs can lessen the fiscal pressures. Deferring pension costs may offer a quick fix for spiraling pension expenses, but the practice usually results in serious, long-term consequences. (See page 12)

Even Bigger Time Bomb: Retiree Health Care Costs

As if the pension issues were not challenging enough, state and local governments also face the daunting task of figuring out how to pay for huge unfunded retiree health care liabilities that soon could approach $1 trillion.[10]

States and localities generally fund retiree health care benefits on a "pay-as-you-go" basis, instead of through the pre-funding model that at least in theory is used to fund pension benefits. Thus, while states and local governments set aside $2.5 trillion to help pay for pension benefits, they generally set aside nothing to pay for retiree health benefits. The result: governments have piled up huge unfunded health care liabilities, the dimensions of which are just now being realized thanks to a pending accounting standard (GASB Statement 45) that requires estimating these unfunded liabilities. "Pay-as-you-go" expensing will no longer be permitted; instead accrual based accounting for expenses is required as well as measurement and disclosure of the plan's funded status.

Consider school districts. In many districts, very generous retiree health benefits were negotiated over the past decade or two. Rising costs and boomer retirees mean the bill for these is now coming due.[12] "It is the single most important issue facing districts nationwide" says Tom Henry of California's Fiscal Crisis and Management Assistance Team.[13]

Table 1. Sample State and Local Retiree Health Care Liabilities

Jurisdiction	Unfunded Liability
State of California	$70B[14]
State of Maryland	$30B[15]
Los Angeles School District	$6.9B[16]
City of New York	$50B[17]

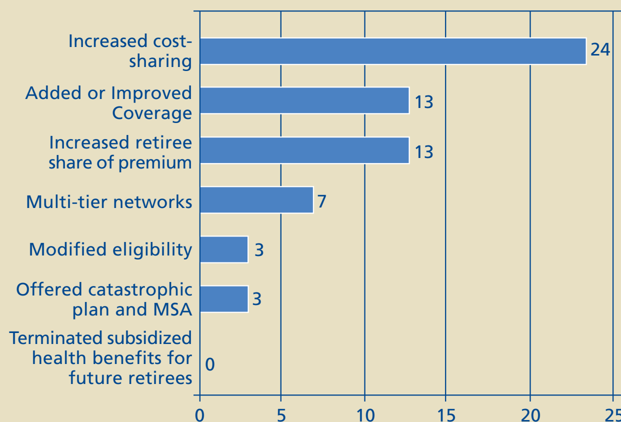
Source: Various and Deloitte Research

States and localities also routinely added perks to public-sector retirement plans to attract qualified workers. For instance, the state of Hawaii pays for life the full cost of medical, prescription drug, dental and vision insurance for retirees with 25 years of service. Ironically, such measures sometimes had the unintended effect of prompting many to retire in their early 50s.[18]

Little by little, states and local governments have begun to address this issue (See Figure 2).[19] New York City Mayor Michael Bloomberg has pledged to set aside $1 billion for retiree health care benefits.[20] Hawaii plans to redefine the eligibility criteria for full benefits, switch to defined-contribution plans and require future employees to make contributions toward their retirement costs. Moreover, workers hired after June 30, 2001, will not get health coverage for their dependents when they retire.[21] Michigan meanwhile is contemplating legislation requiring teachers retiring after 20 years to pay 40 percent of their health insurance premiums as well as co-payments and deductibles.[22]

As with the pension issue, there's no simple solution to this looming crisis. Governments either have to rearrange budgets, raise funds through taxes or bonds, or cut down on retirement health benefits.

Figure 2. States Making Specific Changes to Retiree Health Coverage in Past Two Years



Source: Kaiser Family Foundation Survey of State Retiree Plans, 2003

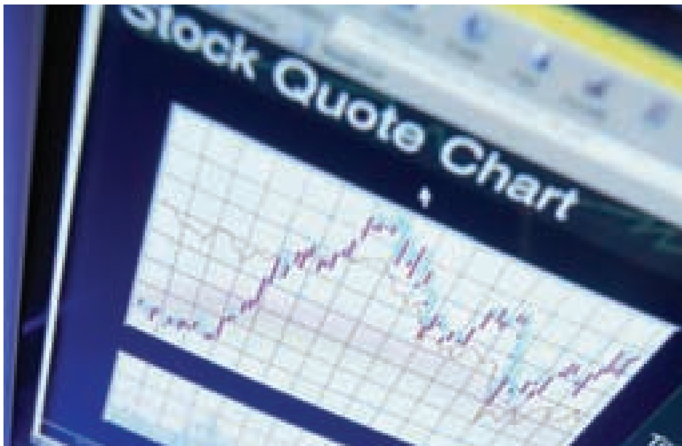
Ten Causes of the Public Pension Crisis

The current pension crisis stems from a mix of poor policy decisions and bad planning — all of which were exposed by the stock market slide that began in 2000.

1. Lack of Prefunding Requirements

There are generally no requirements forcing public retirement plans to fund their pension liabilities. As a result these plans are funded to varying degrees, including some that are completely unfunded and operate on a "pay-as-you-go" basis. Paying less than the actuarially determined contribution each year increases the unfunded liability, which may impact debt ratings for state and local governments and cause future required contributions to be even higher.

By contrast, private-sector organizations must comply with the Employee Retirement Income Security Act of 1974 (ERISA), which sets minimum funding standards for company-sponsored retirement plans. Therefore, these plans tend to be better funded, on average, than their public-sector counterparts — despite the well-publicized private pension problems of recent years.



Pension Funding 101

While the pension crisis presents very complex political and even emotional issues, from an actuarial perspective the "solutions" are quite simple — costs must either be reduced to solve the problem or deferred to postpone the problem.

  Benefits Paid
\+ Administrative Expenses
\- Investment Return on Plan Assets
\= Ultimate Pension Plan Cost

- Benefits paid are determined by negotiated and legislated plan provisions.
- Administrative expenses are determined by investment, funding and system policies.
- Investment return is determined by investment and funding policies.
- Ultimate plan cost is generally shared by employees and employer.
- Annual employee and employer contributions represent a systematic means of prefunding the ultimate system costs.
- Annual contributions for employees and employers are generally set by statute.

Source: Deloitte Research

2. Benefit Expansions

Flush with earnings from a bull market that lasted through much of the 1990s, government retirement plans opted not only to expand benefits for retirees, but also to make those benefits easier to get. States and localities routinely added perks to public-sector retirement plans, often justifying the increases as necessary to retain qualified workers. In some cases, the benefit expansions were given in lieu of politically more difficult pay raises. For example, Texas state lawmakers approved $14 billion in benefit enhancements for public school employees over the past 10 years.[23] Benefit enhancements added in Illinois between 1995 and 2003 boosted liabilities by approximately $6 billion.

3. Growth of Supplemental Benefits

Retirement plans also greatly expanded supplemental benefits over the past 10 years, which in turn significantly increased pension costs. For instance, an ever-growing number of public employees were classified as public-safety workers, thus qualifying them for higher retirement benefits due to the hazardous nature of their jobs. In Illinois, special benefits once reserved for police officers now go to approximately one-third of all state workers.[24] Likewise, one in three California government workers now receives public-safety pensions, up from one in twenty during the 1960s.[25]

In addition, generous rules on selling back unused sick- and vacation-time caused artificial raises in final year earnings. Since retirement benefits usually are based on how much workers earn during their last several years of employment, these income spikes resulted in bigger lifetime pension amounts for retirees and permanently higher costs for taxpayers. Unused sick- and vacation-time sell-back benefits will cost New Jersey taxpayers nearly $1.5 billion in the coming years.[26]

4. Smaller Employee Contribution Share

Most public retirement plans require participants and their employers to contribute to the plan. But as plan costs have risen, employee contributions generally have not kept pace. This has a multiplying effect on pension expenses for public entities.

For example, a retirement plan may have an estimated long-term cost of 10 percent of a worker's pay. The employee contributes 5 percent and the employer matches that amount. But that equation falls apart when questionable policy decisions to increase benefits in "good times" or poor investment returns increase the retirement plan's total cost to 15 percent of pay. The employee's share typically remains at 5 percent, but the employer's share inflates to 10 percent. So, even though the plan costs grew by a third, the burden on taxpayers doubled and the employee's cost remained the same.

In Illinois, for example, state employees contribute 8 percent of pay to their pension plan while teachers contribute 9.4 percent. The state's contribution rate is projected to increase to more than double those rates — reaching 21.3 percent by 2010 and remaining at approximately that rate for the next 35 years.

5. Lucrative Early Retirement Packages

Not only were benefit amounts rising in the 1990s but public retirement systems were paying out fatter pension amounts for longer periods of time. Lucrative "unreduced" early retirement benefit provisions had the effect of actually encouraging many employees to retire in their early 50s. Such early retirement adds significantly to the costs of these plans because earlier benefit commencement coupled with constant improvements in health care (resulting in retirees living longer) mean that retirees now draw benefits longer than ever before.

Second, special early retirement windows programs, implemented to reduce the size of the workforce, are often designed without sufficient consideration given to how to provide the underlying services with a much smaller workforce or to the costs of the window. The result is that early retirement window programs often cost more money in the long run than they save. For example, the state of Illinois implemented an early retirement incentive program in 2003. The program was expected to cost $622 million, based on initial estimates of the number of participants expected to take advantage of the program. However the state significantly expanded eligibility for the early retirement program, as well as the incentives offered under the program. Those changes pushed the actual cost of the program to more than $2.5 billion.

The drive to cut costs by encouraging early retirements also is often done without regard to the skills that may be lost and the impact of those retirements on critical government services.

6. Higher Risks of Defined Benefit Programs

All of the issues already discussed are magnified by the fact that government retirement plans tend to be much more expensive to support than those offered by private employers. Unlike the private sector today, the vast majority of government retirement systems still offer defined benefit plans, which guarantee retirees a pre-set benefit amount based on the number of years they work and their final or highest average compensation amount.

Public employees typically contribute a fixed portion of their paychecks into a pension fund, which is invested to produce revenue to pay for a portion of their retirement benefits. Because retirees are guaranteed a certain benefit amount, the government must make up any shortfall resulting from actual investment returns that are less than anticipated.

By contrast, most private companies have shifted to less risky (from the sponsor's perspective) defined contribution plans. Under these plans, retirement benefits fluctuate with the investment performance of an employee's pension assets. Because employees shoulder the investment risk in a defined contribution plan, rather than taxpayers, there is never a shortfall for taxpayers to make up.

7. Structural Weaknesses Masked by 1990s Stock Market Boom

The increasing cost of government pensions (and the failure of many public pension sponsors to adequately fund their plans) was masked by a booming stock market in the 1990s. Thanks to historic market gains during the "dot-com" era, pension fund investment revenue easily kept pace with expanding retirement perks.

Investment returns were so good, in fact, that many governments made no contribution at all to their retirement funds. Before 2005, local governments in New Jersey had gone six years without paying anything toward public employee retirement plans, the *Star-Ledger* reported.[27] Some retirement systems even gave away extra earnings to plan participants in the form of bonus "13th" pension checks — meaning an extra month's worth of payments — instead of saving the money to offset periods when the market inevitably cooled off.

Although many states underfunded their public retirement systems for years, thanks to the hot investment market, their pension plans remained reasonably well funded. When the dot-com bubble burst, retirement systems accustomed to earning a handsome return on their investments abruptly found themselves in a financial bind.

As investment markets cooled, lucrative benefit packages approved during the boom years began pushing retirement expenses much higher than expected.

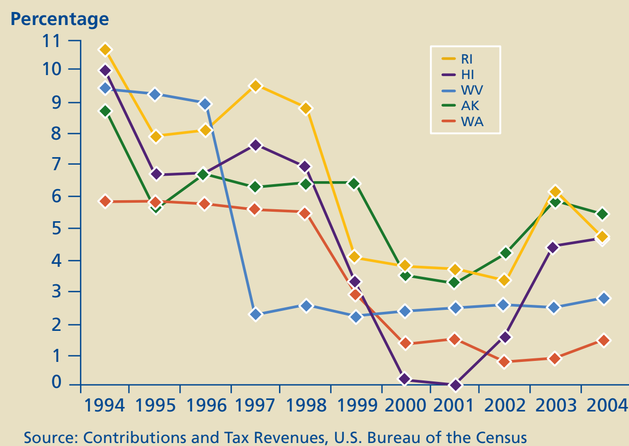
Salary growth, of course, directly impacts on pension costs. Missing revenue or cost estimates even by a few percentage points can have a devastating impact on public retirement systems, potentially leaving them seriously underfunded and requiring a significant infusion of taxpayer dollars. Wilshire Associates forecasts a long-term return on state pension assets equal to 7.2 percent a year, which is 0.8 percent below the average actuarial interest rate assumption of 8.0 percent. If correct, this asset performance shortfall will increase total unfunded liabilities for state pension plans by an additional $40 billion a year.

8. Deferring Pension Contributions to Balance Budgets

Dwindling investment returns and growing pension costs would seem to demand bigger government contributions to prop up the ailing retirement funds. But, in fact, the opposite actually occurred over the past few years (See Figure 3). The faltering economy crimped general government revenues, leading jurisdictions to divert retirement fund contributions toward other priorities. States such as New Jersey and North Carolina reduced retirement fund payments to help balance their books. Now they are struggling to reduce unfunded pension liabilities- — and the rating agencies are taking notice.

Figure 3. State Government Pension Contributions as % of State Taxes

Selected States with Large Contribution Declines



Source: Contributions and Tax Revenues, U.S. Bureau of the Census

9. Little Incentive or Urgency to Fix Problem

Public pension policy often suffers from an "It won't be my problem after I am out of the office" mentality. Although public pension costs are huge and poised to grow even larger, there's often little incentive for fiscal restraint. Policy leaders reap political rewards for creating new benefits for public employees or underfunding retirement systems and using the money for other short-term goals.[28] The bill for increasing unfunded pension liabilities is left for future generations.

10. Difficulty of Modifying Retirement Plans

Pension costs are outpacing contributions, but it is extremely difficult to increase the amount employees pay into their plans or reduce the benefit amounts they receive. Retirement benefits are often the product of collective bargaining agreements, and they're fiercely guarded by employee groups. Politics also plays a very large part of the decision-making process.

Public pensions also aren't like pension plans at private companies. To be sure, it's seldom easy to change private pension plans – particularly for employers subject to collective bargaining agreements and union opposition. Nevertheless, private sector employers can scale back future benefit accruals, freeze benefits, or if they are at or near bankruptcy, they can shed their insolvent pension plans entirely, turning them over to the Pension Benefit Guaranty Corp., a quasi-governmental insurance agency.

Public pension rights, however, typically are considered part of a contract between the employer and employee. That makes it much harder to modify a public pension plan's terms. Furthermore, public employee pension benefits, once approved, have constitutional protection in some states.

Experts generally agree that governments can change or reduce benefits for employees who haven't yet been hired, but they cannot change them for retired employees. The gray area is whether benefits can be reduced for the employees in between — workers who are hired, but not yet retired. The answer may come soon, as some states have signaled a desire to reduce pension benefits for employees already hired but not yet retired.

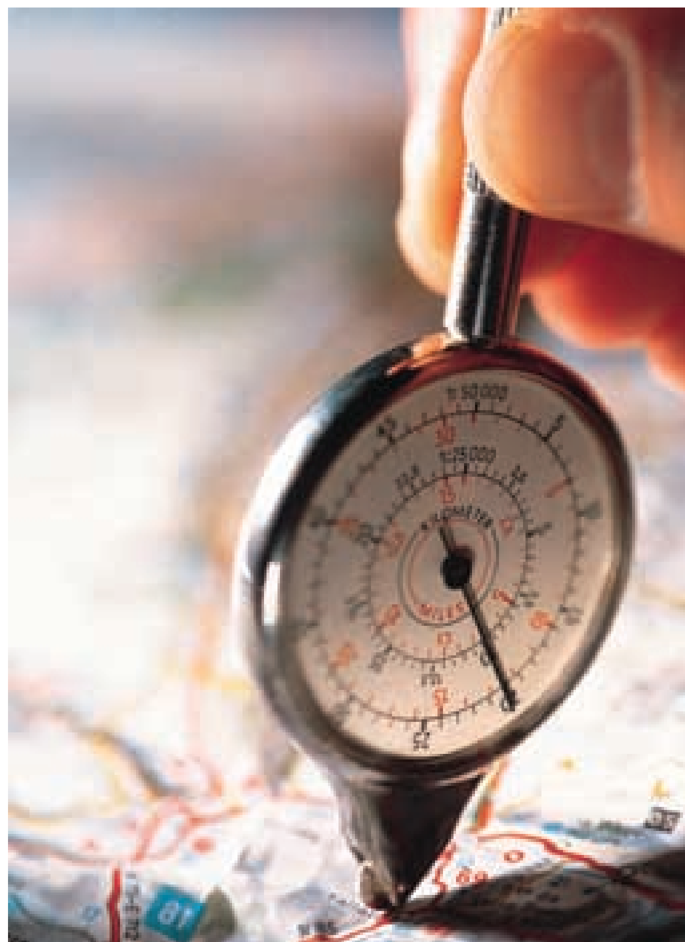
Roadmap to Recovery

How can governments escape the fiscal black hole many already have entered and others are on the verge of falling into? Unfortunately, there is no silver bullet — no single strategy to fit all situations. A number of options exist, and states and localities must choose approaches that best fit their fiscal situation, political climate and future goals.

Setting and meeting funding goals is crucial, but real pension reform ultimately also means reducing the costs of public employee pension programs for governments. There are really only four ways to do so:

- Restructure employee benefits
- Increase investment returns
- Reduce administrative costs
- Find alternate funding sources

This section first explores techniques for producing immediate savings. We then address the needed medium- and long-term reforms to put public-sector retirement plans on firmer financial footing. Individual circumstances will vary greatly; what we offer is a general guide to recovery.



Six Immediate Fixes

For states and localities facing large unfunded pension obligations, it is vital to stop — or at least slow — the financial bleeding. This means first making sure that current contributions at least cover current liabilities.

Ultimately, public retirement plans must reduce the cost of public pension benefits or dedicate more funds toward paying for pension obligations. More than likely, states and localities will need to implement a combination of cost-cutting and revenue-enhancing changes to bring their public pension systems back into balance.

As mentioned earlier in this paper, pension benefits are difficult to modify for existing public employees and nearly impossible for retirees. Therefore, more fundamental reforms often can be applied only to new employees entering the public workforce, so the impact of these changes may not be felt for many years.

The six cost-cutting and revenue-boosting options below, however, could be applied to current public workers, depending upon specific contract and legal provisions. These strategies are designed to deliver relatively quick improvements for underfunded public pension systems.

1. Close Loopholes

A plan sponsor may not be able to change basic benefit formulas for existing workers, but it may be possible to modify ancillary plan provisions, some of which are extremely costly. Options for reform include:

- **Tighten the practice of granting large pay raises in the years immediately before retirement,** which can allow employees to spike final earnings amounts.[29]
- **Tighten overly generous sick-leave policies,** which also can allow employees to spike final earnings amounts.
- **Narrow eligibility for high-cost public-safety pension benefits.**

Generous pay-raise and sick-leave practices may allow earnings to be spiked during the final years of employment. While the employee's agency pays these increased costs only for a year or two, they represent a lifetime increase for the pension plan. Higher final earnings in the last years of employment result in bigger pension payments for retirees and significantly larger plan costs for taxpayers.

The state of Illinois targeted these loopholes through Public Act 94-4, which contains a provision designed to limit the impact of end-of-career raises on state pension plans. The act targets the common practice by local school districts of granting large pay raises to school employees a year or two before they retire. The school district pays the higher salary briefly until the employee retires, but the state absorbs the long-term expense of fatter pension benefits triggered by the salary increase.

The Illinois law shifts the long-term cost of these decisions back to the local school districts, which now pay the pension liability for raises exceeding 6 percent during a worker's final four years of government employment. State officials believe the reform will save Illinois billions of dollars over the next 40 years.

The law also requires agencies to pay the pension costs generated by granting public employees extra sick leave.

These reforms don't necessarily shrink overall pension plan costs — although they may prompt more fiscal responsibility among local agencies, since those employers will feel long-term pain from practices that trigger higher pension payments. The reforms do, however, cut the states' share of the public retirement burden.

Numerous states also have begun to target growth of special public-safety pension benefits by limiting the categories of eligible workers.

2. Adjust Benefit Formulas

Some pension plans offer special benefit formulas that increase plan costs. For example, the State University Retirement System in Illinois had a basic benefit formula and a special money purchase formula. University employees automatically got the most lucrative of the two benefit calculations.

Public Act 94-4 also eliminated the money purchase formula for Illinois state university employees hired after June 30, 2005. The act changed how interest rates are set for current employees who remain eligible for the money purchase formula calculation. Previously, those rates were set by the retirement system. Now they are determined by the state controller. Although the changes don't reduce benefit accruals already earned by university employees, they do limit interest rates (and costs) going forward.

3. Change Employee Contributions

States and localities can consider raising the amount that employees contribute to public retirement plans. As noted earlier in this paper, employee pension contributions generally have held steady as plan costs have increased. Instead, contribution amounts could be tied to actual plan costs. So, for example, if total pension plan costs increase by 10 percent, employee contributions would increase by the same percentage or at least by some amount.

These adjustments are common for employee health plans. But instituting similar practices for pension contributions would depend on potentially difficult negotiations with public employee unions and consideration of constitutional provisions.

Another cautionary note: in the private sector it's rare for employees to contribute to a defined benefit plan. Employees do, however, contribute to Social Security, which they do not do in many public plans.

The Dangers of Deferring Costs

Governments often seek relief from growing pension expenses by deferring the costs to future years. Unfortunately, that merely shifts the pension burden to a new generation of taxpayers. Common cost deferral strategies include:

- Changing funding policy
- Changing actuarial assumptions
- Altering actuarial funding methods
- Adopting new asset valuation methods

Deferring pension costs may offer a quick, short-term fix for spiraling pension expenses, but the practice usually results in serious, long-term impacts. Bond rating agencies are increasingly concerned about underfunded pension liabilities. These liabilities can lead to higher borrowing costs, which can hamstring government's ability to undertake capital improvement projects and other important initiatives. And deferring pension costs simply means that future contributions will be higher.

Furthermore, if pension debt continues to mount, states and localities will eventually be forced to increase taxes to cover the tab. Needless to say, this could have dire consequences for elected officials in office when the bill comes due.

4. Find New Revenue Sources

State and local governments may have untapped revenue sources that could be used to fund pension obligations. Finding these dollars will require innovative thinking, however. Illinois, for example, is exploring selling or leasing it's state tollway system. Proceeds from the sale would be funneled into the state pension system. Public Infrastructure also represents an increasingly popular investment alternative for pension funds. Other revenue sources might include sales of unused public properties.

Another tactic used to pump more revenue into retirement plans is pension obligation bonds. This approach requires governments to issue bonds at low interest rates, then reinvest the bond proceeds into higher-yielding taxable financial investments. The difference between the cost of debt service on the bonds and revenue created by investing the bond proceeds generates income that is used to prop up pension funds.

This strategy depends on careful market timing and therefore is highly risky. The state of New Jersey discovered this when it sold $2.7 billion in pension obligation bonds in 1997 and then heavily invested the proceeds in equities. The investment paid off handsomely for several years, but the stock market crash in 2000 wreaked havoc with the strategy. Invested proceeds from New Jersey's pension obligation bonds have averaged an annual return well below the 7.6 percent the state owes in interest.[31]

Another problem with pension obligation bonds is that the state is converting a soft liability (the pension funding) into a hard liability (the required bond payments). Moreover, voters may balk at the prospect of approving new long-term debt. West Virginia Gov. Joseph Manchin III convinced state lawmakers to sell as much as $5.5 billion in bonds to help cover unfunded pension liabilities. But voters rejected the bond measure in June 2005, leaving state officials — who are under a state Supreme Court order to close West Virginia's pension gap by 2034 — searching for other solutions.

To be sure, sometimes this risky strategy can pay off. Illinois used the technique successfully in 2004, selling $10 billion in pension obligation bonds when interest rates in the bond market had nearly hit bottom. The move allowed the state to, in effect, refinance $10 billion of pension debt at approximately a 5 percent interest rate instead of an 8.5 percent interest rate. The bulk of the bond proceeds went directly into the state retirement fund, increasing the funding status by more than 10 percent overnight.

Despite this successful example, as a general rule pension obligation bonds are a highly risky strategy.

5. Review Investment Policies

If risky, high-yield investment policies are imprudent, overly cautious investment strategies needlessly reduce income potential. They also often don't give the flexibility that is needed to manage the portfolio and manage risk. For example, such policies often place a ceiling on equities and don't allow for hedging or alternative investments. By limiting the types of investments and investment mix they can actually create greater risks under certain market conditions.

Therefore, investment policies must balance profit potential with risk. Plans opting for higher-yield investment strategies must understand the risks involved and ensure they can afford the potential losses. Achieving the right balance of risk and reward maximizes investment income and limits the chance of devastating losses. Plans should undertake a review and analysis of their investments policies to determine if they are appropriate for the particular plans. One way for states and localities to analyze the risk/reward relationship is to conduct an asset and liability projection study. Finally, investment advisors need to be given enough latitude to manage the investments prudently but should fully understand all potential investments.

6. Cut Administrative Costs

Reducing administrative expenses won't solve the pension crisis — not by a long shot. Nevertheless, cutting plan overhead should at least be a component of any comprehensive solution.

The biggest opportunity lies with consolidating multiple pension plans. There are more than 2,600 public employee retirement systems nationwide, according to the U.S. Census Bureau. In Texas, for example, dozens of state and local public retirement plans cover government workers, teachers, police and firefighters. Similarly, the state of Illinois has five separate retirement boards — each with its own workforce and infrastructure.

Combining these plans where sensible would eliminate redundant administrative staffs and functions, producing lower operating costs and leaving more dollars available for pension payments. Consolidating pension plans could be politically difficult, but it's a commonsense reform that deserves consideration.

Outsourcing certain administrative tasks or automating processes represents another opportunity to trim overhead expenses. Jurisdictions can also benefit from a thorough review of vendors and service providers involved in their public pension systems. Analyzing pricing and services provided by third parties — and renegotiating contracts when appropriate — can deliver savings. California, New York and New Mexico are among a growing number of states deploying information technology designed to boost efficiency in their public employee retirement systems.

Savings from administrative changes probably will be small in relation to the size of the pension funding problem, but they are nonetheless worth considering.

Reforms for the Medium and Long Term

Beyond the short-term measures outlined above, fundamental pension changes are needed to protect the long-term viability of public retirement programs — and to prevent shifting a mountain of pension debt to future taxpayers. The impact of these reforms often won't be felt until a new generation of public workers is hired and younger current workers begin to retire.

1. Impose Discipline — Develop a Pension Funding Policy and Stick to It

Jurisdictions must develop sound funding policies for their public pension systems and then have the discipline to follow them. Since there is generally no governmental prefunding requirement for public pension plans, funding decisions must be guided by sound fiscal policy.

For more than 30 years, ERISA has spelled out requirements and responsibilities for private-sector pension and health plans. Yet the absence of similar laws for public-sector plans allows policymakers to shift huge retirement costs to future generations. States should consider crafting laws that require minimum funding levels for public retirement systems.

There's no magic number for pension plan prefunding requirements — funding targets may range from 80 percent to 100 percent. Policymakers need to decide on a level of pension funding that balances short-term needs with long-term goals.

Jurisdictions with seriously underfunded plans also will need to map out practical repayment strategies. Once these policies are set, they should be reviewed periodically to ensure they're still appropriate.

Careful design is vital to the success of repayment strategies. Some repayment plans have proven to be unaffordable once they were put into practice. Illinois set a goal of repaying the bulk of its unfunded pension liabilities over a period of 50 years. The plan was designed to increase the funding ratio for the state's five pension systems to 90 percent by the year 2045. But the payments required for reaching that goal are rapidly becoming unmanageable for the state (See Appendix A: Easing Illinois Pension Challenges").

Furthermore, pension funding policies have little impact if no one follows them. Officials must make the minimum required pension contributions when times are tough. Just as important, they must resist politically expedient pension giveaways when times are good.

Public-sector pension plans differ from private-sector plans in many ways. One particular example is that upside potential — that is, funded ratios in excess of the targeted goal, oftentimes 100 percent — can be nearly as bad as downside risk in the public sector. This sounds counterintuitive. However, when public pension plans are more than 100 percent funded (even if only in the relative short term), politicians may be very tempted to pay out that reserve by increasing benefits or diverting it to other needs. Then when the investment market turns south and assets drop below liabilities, there are fewer assets remaining and the effect on costs is exacerbated.

2. Restructure Pension Benefits

Governments have several options to restructure employee benefits. The most obvious method is to reduce them. There are two basic methods to accomplish this:

- Reduce future benefit accruals for current employees as well as for future employees.[32] This approach will have the greatest impact on costs. But it likely will be politically difficult and may also result in a legal challenge.
- Reduce benefit accruals for future employees only. It will take many years for this two-tiered approach to significantly impact costs.

Two-Tier Retirement Programs. Because of the difficulty of reducing benefits for current employees, scaling back retirement packages for newly hired workers represents the most practical option for paring pension costs. Such two-tier retirement programs, extremely common nowadays in the private sector, reduce retirement and health benefits for employees hired after a specific date, while maintaining agreed-upon benefit packages for existing workers.

Implementing two-tier benefit programs for public workers could also prove politically difficult. Though such programs don't affect existing employees, employee groups have opposed these ideas in the past.

Another risk to guard against is that simply by proposing changes – particularly cutbacks of benefits for younger workers—the question of 'Am I next' starts to creep in. This slippery slope may lead many employees who can retire to go ahead and do so in order to "lock in" their pensions.

Governments have two principal options for initiating two tier programs:

- Defined contribution plans. Probably the most common two-tier pension program strategy is to shift newly hired public employees from traditional defined benefit plans to less risky (from an employer cost perspective) defined contribution plans. Defined contribution plans don't necessarily reduce employee retirement benefits, but they limit employer and taxpayer exposure to investment risk because ultimate retirement benefits under a defined contribution plan are determined by the performance of an employee's retirement investments. By contrast, defined benefit plans pay a set pension amount regardless of a fund's investment performance, with taxpayers picking up the tab for any deficiency. As explained in the nearby box, however, transitioning to defined contribution plans likely will do little to resolve near term pension fiscal problems.
- Floor offset plans. Another two-tier idea is to provide a defined contribution benefit to new workers, but with a guaranteed minimum retirement income (or floor) provided through a defined benefit plan to reduce the investment risk. This approach is typically more expensive than simply providing a defined contribution benefit alone to newly hired workers, but it may be more politically palatable.

The Promise and Limits of Switching to Defined Contribution Systems

Governors of five states proposed strategies in 2005 that would move state workers into defined contribution, 401(k)-style retirement programs.[32]

Of the five, Alaska Gov. Frank Murkowski was the only one to win passage for his reforms. All Alaska state workers hired after July 1, 2006, will be covered under a mandatory 401(k)-style retirement program, where the state contributes a set amount each month into an employee's investment fund. Employees receive the money in these funds when they retire.

Gov. Arnold Schwarzenegger floated a similar proposal in California, but dropped it after running into a buzz saw of opposition from teachers, firefighters and other members of public employee unions. Governors Mitt Romney of Massachusetts, Donald Carcieri of Rhode Island and Mark Sanford of South Carolina also proposed switching to 401(k)-style retirement plans in 2005.

These reform efforts struggled in 2005 and 2006, but it seems likely that over time defined contribution plans will become more common for government workers. Defined benefit plans — once the norm for both private and public employees — continue to disappear from the private sector as employers seek less costly and less volatile pension alternatives. Just 24 percent of private-sector employees now enjoy defined benefit plans with guaranteed payouts, as opposed to 90 percent of public-sector workers.[32]

The impact of defined benefit plans on public-sector compensation costs is substantial. In September 2004, benefit costs for private-sector employees were $6.80 per hour worked, or 28.6 percent of their total compensation, according to the Employee Benefits Research Institute (EBRI).[34] That represents an increase of slightly less than 2 percentage points over 17 years. Conversely, benefit costs for public-sector employees were $10.89 per hour (31.4 percent of their total compensation) in September 2004 — up from $6.79 per hour worked in March 1991, EBRI said.These figures indicate states and localities could save significantly over the long term by shifting workers from traditional pensions to 401(k)-style plans — but those savings may take decades to appear.

Another reason why defined contribution plans are no silver bullet for managing near-term runaway retirement costs is that laws and court rulings make it difficult, if not impossible, to modify existing pension agreements for public employees. So governments must phase in lower-cost retirement plans gradually as new workers enter the system, meaning they may not see significant relief for decades. When younger workers go into defined contribution plans, their contributions go only to the defined contribution plan. The actuarial cost of pension benefits for younger workers is very low compared to pension costs for older, long-service employees, so it is not only the loss of actual dollars into the defined benefit plan, but the problem is compounded for many years.

Indeed, switching new employees to defined contribution plans can actually increase costs in the near term. When Illinois officials studied shifting new hires to a defined contribution plan for one of its pension systems, they found that total costs would be higher over the next 30 years. The reason: transition costs. Putting new hires into a different plan means their contributions would stop flowing into the existing underfunded defined benefit plan, so other revenue would be needed to make up the difference.

Jurisdictions with large underfunded pension liabilities may find the cost of paying off defined benefit plans while creating new defined contribution plans for new, younger workers too painful to bear. Therefore, switching to defined contribution plans is more practical for jurisdictions with reasonably funded retirement plans; these jurisdictions may be able to tolerate higher short-term costs in exchange for minimizing future costs.

So, while the long-term savings of defined contribution plans could be significant, they provide little comfort to jurisdictions facing big pension bills right now.

3. Adjust Cost-of-Living Increases

Automatic cost-of-living increases tied to increases in average salaries are common in public-sector retirement programs. By contrast, these provisions have become rare in the private sector because they are extremely costly.

Contractual issues will make it hard to eliminate cost-of-living provisions for public-sector retirees. Indeed, public retirement systems replace Social Security benefits in many states. So it is politically difficult and perhaps unfair to abolish cost-of-living increases for public-sector plans when private-sector workers receive them through Social Security benefits.

But some public retirement plans offer extremely generous automatic increases — as high as 5 percent, regardless of inflation. Tying cost-of-living increases to actual inflation rates could produce significant savings, while still protecting retirees from rising living expenses.

4. Scale Back Early Retirement Programs

Generous early retirement provisions often allow public-sector workers to retire with full benefits as early as age 55 or 60 — instead of 65 which is typical in the private sector. In some cases, state and local officials also viewed early retirement programs as cost-cutting measures to reduce the size of government workforces with delayed cash implications.

As a huge number of aging baby boomers near retirement age, these provisions are proving to be extremely expensive and poorly designed. In some states, nearly half of the public workforce will be eligible for early retirement within 10 years. Some jurisdictions already have been forced to offer older workers additional incentives not to take early retirement benefits. Restructuring these provisions would save money and encourage valuable workers to stay on the job. Several options are available to reinvent early retirement programs:

Deferred Retirement Option Plans (DROP). Developed to keep experienced workers in the public workforce, these plans typically allow senior employees to collect their full pension benefits and their standard paycheck for a certain number of years beyond retirement age. Pension payments are deposited into an interest-bearing account, and employees collect the money once they actually retire.

Though well-intentioned, DROPs have often proven to be terrifically expensive for state retirement systems and often ineffective at retaining workers. In many instances, DROP benefits are so lucrative that they actually entice senior employees to leave the workforce earlier than they would have otherwise.

Phased Retirement Programs. Phased retirement programs may be a better option than deferred retirement option plans. These plans are designed to keep older employees in the workforce longer and therefore delay the onset of full pension benefits. North Carolina kicked off a program this year where state employees can start receiving partial pension benefits at age 59 — and continue working flexible hours. The goal is to keep many of these workers from fully retiring, thereby reducing both the amount of pension they draw and the period of time over which they will draw full benefits.

Similar ideas are under consideration in the federal government; however, it remains to be seen whether this strategy reduces the number of public employees who take a complete early retirement or instead entices workers who would have remained full-time employees into partial retirement at an earlier age.

Getting from Here to There

As governments embark on the road to pension reform, heeding these five implementation guidelines will help to make the experience a successful one.

1. Assess the Problem

The first step to recovery is gaining an understanding of your current pension situation. What are your real pension costs? How big is the problem?

If your fund is only 65 percent funded, say, you'll first have to stop the bleeding. Once that is accomplished, you can focus attention on longer-term reforms.

What are the root causes? Poorly performing investments? Overly generous benefits? Underfunding? Abuses? Answering these questions requires an in-depth analysis of current pension funds and public retirement benefits. Information revealed by this process will guide the design of pension reforms and avoid repeating similar problems in the future.

2. Involve the Stakeholders

Pension reform often involves difficult and politically sensitive changes. Involving political officials, business leaders, labor unions and other stakeholders helps build support and buy-in for these initiatives. Some states, for example, have appointed independent advisory commissions to develop pension reform recommendations. Giving key players a voice in this process can deliver crucial support for implementing changes.

3. Educate the Stakeholders and Public

Once reform proposals are developed, you'll need a broad education campaign to explain their value to constituents. In Illinois, for example, state officials launched an extensive communications campaign to promote the governor's pension reform plan. They met with most members of the state legislature and with union representatives. They also met with almost every major newspaper in the state and sent letters to teachers and other retirement plan participants. These efforts were designed to explain the magnitude and urgency of the problem and to show how the suggested reforms could fix it.

4. Manage Expectations

Pension problems are complex. They took years to develop and stem from multiple causes. It's unrealistic to believe pension challenges can be solved overnight. Therefore, it is crucial to manage expectations for quick results from pension changes.

Certainly, some of the strategies proposed earlier will deliver relatively quick savings — and it's important to publicize those results in order to show progress. But curing large-scale pension ills will be a long-term, multi-step process. And political officials, plan participants and taxpayers need to be aware of that reality.

5. Don't Separate Pension and Retiree Health Reform from Broader Human Capital Issues

The pension funding crisis — not to mention the looming and equally daunting retiree health care cost crisis — tends to be viewed as a financially driven problem that needs to be addressed with options that will resolve the financial problems facing plan performance, costs and funding. While it is true that it's a financially driven crisis, it should not be viewed purely through a financial prism. The underlying plans are after all "employee benefit" plans that were designed, even if flawed, to attract, retain and motivate talented individuals to seek and remain in employment.

To overlook or underemphasize the impact on the workforce of plan changes may have unintended consequences on the organization's ability to achieve its mission and serve its constituents. While this has always been an important issue, in today's environment the public and private sectors collectively are facing the largest demographic shift from active workers to retirees in the nation's history. The retirement of the baby boomer generation is a certainty—but the timing is not. Therefore all financial decisions are also human resource decisions that may have significant workforce consequences.

When the state of Pennsylvania reviewed its health care plan for retirees, it made several changes for employees retiring after December 31, 2003. By most measures these changes were relatively minor, but they did shift some costs to retirees. Between the announcement and the end of the year, hundreds of unexpected additional employees chose to retire before the plan change deadline. Did the small cost changes drive employee decisions? Most likely.

Many employees are very concerned about the amount and security of their retirement benefits (especially in the last few years of employment when an employee is already "retirement eligible" under plan provisions). Any proposed changes may create employee nervousness. The value to an employee of one or two years of additional salary to stay employed versus perhaps 30 years of retirement benefits is hard for some employees to really grasp and measure. Employees who ask why they should risk lower future benefits may opt to retire while the benefits are still rich.

On the other side of the coin, pension benefits geared almost exclusively to employees who want to work for the public sector for decades can be a disincentive to recruiting younger workers who might not want to make a long career in government.

Either way, the point is that pension issues cannot be divorced from their impact on talent acquisition and management. Clear, understandable and repeated employee communication is critical throughout the period of change.

Time for Action

Clearly, public leaders risk voter backlash as runaway pension costs hit taxpayers in the pocketbook and cripple economic competitiveness. As tax increases or service cuts grow more commonplace, citizens will demand that public policymakers implement reforms to control the price of public employee pension programs. What's more, without corrective action, the pension crisis is likely to worsen as baby boomers start reaching retirement age in the near future.

Interviewed in *BusinessWeek*, Professor Stephen D'Arcy, warned that states could pay a significant price for failing to lower retirement expenses. D'Arcy, a professor at the University of Illinois at Urbana-Champaign's College of Business, said tax hikes implemented to fund pension liabilities could drive employers and residents to other states that are in better financial shape.[35]

Few of the pension reform options mentioned in this paper are painless. Indeed all of them demand strong political leadership and the willingness to confront entrenched interests. Yet the stakes are too high to ignore — and the time for action is now.

Appendix A: Easing Illinois Pension Challenges

Illinois doesn't just have a pension problem that should be addressed; it has a pension crisis that must be solved and soon—warned Illinois Governor Blagojevich in his 2005 annual budget address.

The unfunded liability of the Illinois State Retirement System — which consists of five state sponsored plans — more than doubled from $19.5 billion as of June 30, 1995 (immediately before implementation of a statutory funding plan) to $43.1 billion as of June 30, 2003 (with a funded ratio of 48.6%). Due primarily to infusion of proceeds from the sale of Pension Obligation Bonds in 2003, and associated earnings, the unfunded liability was reduced to $38.6 billion as of June 30, 2005 (with a funded ratio of 60.3%); still ranking the plans among the worst-funded state retirement systems in the nation.

Ballooning public pension costs were squeezing other budget priorities and threatening the future quality of life for Illinois residents. Explained Gov Rod Blagojevich, in his 2005 annual budget address:

> "Unless we reform the way we fund our pensions…we will never eliminate the structural deficit that takes money away from education, from health care, from law enforcement, from parks, and from everything else we care about."

Working with Deloitte Consulting LLP, Illinois officials took a series of steps designed to reduce public pension costs and return the state's underfunded retirement system to firmer financial footing. The project involved:

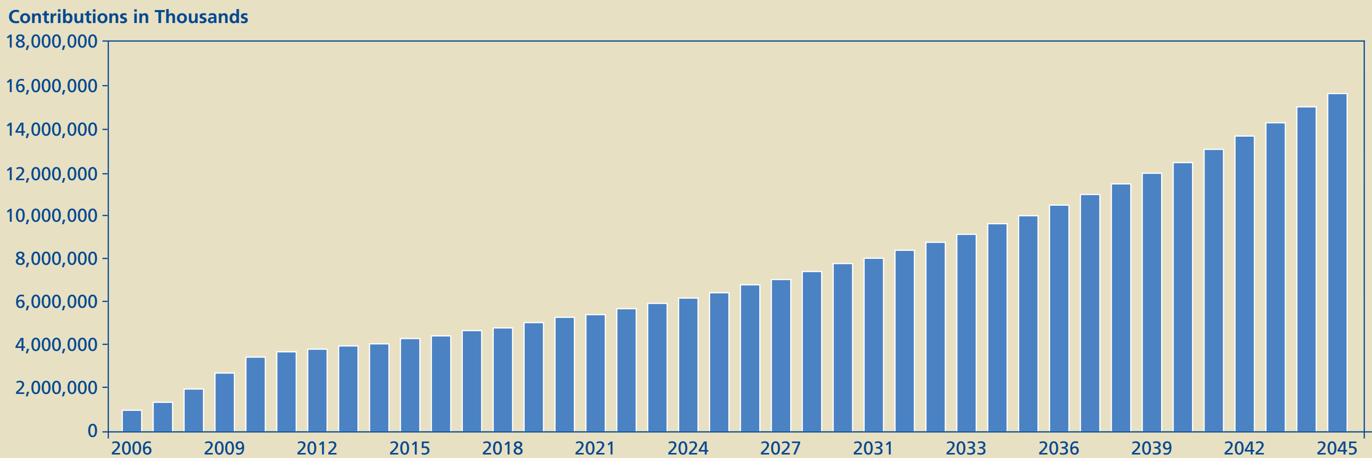
- Reviewing and analyzing the state's retirement system.
- Developing ideas for long- and short-term cost savings.
- Projecting future fund-contribution requirements.
- Developing proposed changes in pension plan provisions and funding policies.
- Creating a communication campaign to educate lawmakers, taxpayers, employee unions, pension system members and others on the proposal.

Anatomy of a Crisis

Illinois' pension funding shortfalls were more than 30 years in the making. State payrolls — a key component of pension costs — grew rapidly throughout the 1980s and 1990s. However, state contributions to public pension plans stayed relatively flat. Strong investment returns temporarily helped bridge the gap, but the deficit had begun to widen by the end of the decade.

In 1995, Illinois lawmakers approved reforms aimed at returning state-sponsored pension plans to fiscal health. The reforms included adoption of a 50-year payment plan that would bring the Illinois retirement system back to a 90 percent funding level by 2045. Under the payment plan, these payments would increase over a 15-year phase-in period set to expire in 2010, and remain level as a percentage of payroll thereafter to 2045. Adopting a statutory payment plan for the state pension systems was needed. Unfortunately, the 50-year payment plan was structurally unaffordable when it was enacted. First of all, it incorporated a 15-year ramp up period, which increased contributions from a starting level that was arbitrary and significantly less than the amount needed to keep the unfunded liability from increasing. In fact, contributions for years after 2010, although determined as a level percent of pay, are also not sufficient to pay normal cost and interest on the unfunded liability until around 2034, which results in the unfunded liability increasing for the next 40 years.

The fact that the 50-year payment plan called for continued underfunding for 40 years until 2035, with the underfunding being paid back at an 8.5% interest rate, caused the annual contribution schedule to quickly become unaffordable. In fact with the end of the phase-in period fast approaching, Illinois faced exploding pension costs. State payments into the pension system are projected to jump from $1 billion in 2006 to $4 billion in 2013, and to approximately $16 billion in 2045.



An analysis of Illinois public pension plans revealed that the unfunded pension liability had increased by $23 billion since 1995.[36] More than $10 billion of that amount resulted from planned for state underfunding of the retirement system in accordance with the 1995 payment plan; about $6 billion from investment losses incurred during the three fiscal years ended June 30, 2003. Surprisingly, $5.8 billion of the deficit stemmed from unfunded new benefit improvements adopted between 1995 and 2002 without any corresponding increases in funding — despite the state's grave pension-funding situation.

The Deloitte Consulting analysis found several causes for expanded pension benefits. The retirement plans are funded by state taxpayers, making it easy for the pension systems, employers and local school boards to support benefit increases since they weren't directly paying for them. Further, the bull market of the 1990s masked the real funded status of the plans. The plans themselves also contained provisions that allowed employers and plan participants to inflate ultimate pension benefit levels. For example, employers commonly granted large pay increases near the end of an employee's career, artificially spiking the worker's pension payment.

Once granted, pension increases also could be hard to reverse. The Illinois Constitution defines public pension benefits as a contractual right that cannot be diminished or impaired. Therefore, courts could interpret the provision as restricting Illinois from reducing pension benefits for current employees.

Devising a Solution

The first step taken by Governor Blagojevich to address the state's pension crisis was to provide the state pension systems with a cash infusion and reduce the state's pension debt. During June of 2003, the state issued $10 billion of Pension Obligation Bonds. Of this total, $7.3 billion was disbursed to the pension systems as an additional state contribution over and above any annual contribution requirements. This additional cash infusion on July 3, 2003 immediately reduced the pension system's unfunded liability from $43 billion to approximately $36 billion, and increased the system's funded ration from 49% as of June 30, 2003 to over 57% literally overnight. (With investment earnings, the funded ratio actually improved to over 60% by June 30, 2005.)

Next, armed with a clear understanding of the state's public retirement system challenges, Illinois officials worked with Deloitte Consulting to craft a realistic long term solution for controlling pension costs.

In light of collective bargaining agreements and employee relations concerns, the state opted against changing the basic benefit formula; instead it focused on modifying ancillary plan provisions. These benefit reductions would apply only to future employees, given the potential legal roadblock to pension changes for existing workers.

Key provisions of the Illinois solution included:

- **Eliminating a benefit calculation method known as the money purchase formula,** which often resulted in higher annuity payments for state university retirees. The calculation is no longer available for university employees hired after June 2005.
- **Reducing the interest rates earned on employee contributions to the State University Retirement System.** Previously the interest rate was set annually by the system's board. The reforms now provide that the interest rate will be set by the state controller. This reform is projected to save the state billions over the next 40 years.
- **Shifting the pension cost of large, end-of-career teacher pay raises from the state to local school districts.** Districts routinely approved generous salary increases for teachers in their final years of employment, producing inflated pension amounts that became the responsibility of state taxpayers when teachers retired. Now, the state will pay for pension increases attributable to pay raises up to 6 percent, but school districts must pick up the tab for pension increases triggered by pay raises in excess of 6 percent.
- **Narrowing the categories of state department of corrections employees who qualify for special-risk benefits.** These enhanced retirement benefits were originally designed for police officers due to the hazardous nature of their jobs. Over the years, however, they had been awarded to an expanding number of state employees beyond traditional law enforcement personnel.
- **Requiring employers to pay pension costs generated by granting public employees extra sick leave.**
- **Boosting contribution rates for employees of the Illinois Teacher's Retirement System to cover the cost of the plan's lucrative early retirement option.**
- **Mandating that all benefit enhancements enacted in the future will expire after five years** unless they are renewed by the governor and the state legislature.
- **Requiring that every future benefit increase must have a dedicated revenue source.**
- **Creating a state advisory commission** to develop additional retirement plan improvements, further safeguarding the public retirement system and preserving quality of life for Illinois residents.

These changes not only produced immediate cost savings, but will also move Illinois toward long-term improvement in its public pension funding.

Illinois policymakers recognized, however, that this is just one step toward putting the state's retirement system on a sound financial basis; therefore they continue to analyze the recommendations of the advisory commission as they look at additional pension system reforms.

Ultimately, state officials fully expect the pension reforms they enact to help strengthen the state retirement system's balance sheet, protect taxpayers and preserve retirement security for public-sector workers.

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