

Fiscal Sustainability *and* Retirement Security: A Reform Proposal for the Illinois State Universities Retirement System (SURS)

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I. The Urgent Need for Reform

Public pension reform is a national issue. As a result of many factors, including inadequate funding discipline, rising life expectancies, an increase in the number of retirees, and most recently, declining or stagnant tax bases, pension liabilities for public sector employees now far exceed the assets set aside to fund them. This problem has only been exacerbated by the challenging economic environment since 2008.

Illinois ranks 50th among the 50 states when it comes to adequately financing public pensions. It is in this economic context that Illinois public pensions are in urgent need of reform, and the State Universities Retirement System (SURS) is no exception. For a variety of reasons, including many decades of insufficient funding by state government, the assets held by the SURS system are only a fraction of what is needed to pay the benefits to which current workers and retirees are constitutionally entitled. These pension funding problems are occurring during a time of tremendous fiscal stress in the state, further increasing the urgent need for reform. After years of

questionable fiscal practices that include borrowing for operating expenses, use of one-time revenue sources, and creative accounting, Illinois entered the recession of 2008 with a substantial imbalance between continuing revenue and planned spending. As in other states, the recession hit Illinois hard. The decline in economic growth and fall in employment dragged down the revenue obtained from the personal and corporate income taxes and the sales tax. At the same time, spending—particularly spending on social services—rose. The federal stimulus program helped cushion the fiscal blow in 2009, 2010 and part of 2011, but now Illinois is on its own. Even with the additional revenue generated by the substantial increase in personal and corporate income tax rates enacted in January 2011, Illinois is unable to pay even its current bills, let alone the accumulated debt. In addition to unfunded pension obligations and outstanding debt, the Comptroller estimates that Illinois has more than \$4 billion in unpaid bills, leaving many vendors waiting for months to get paid.

With current tax and revenue policies, Illinois' fiscal situation is virtually guaranteed to deteriorate over the

next several years. Without corrective action, annual operating deficits are projected to grow from their current level of about \$3 billion per year to more than \$13 billion annually. There are two primary drivers for the expected deterioration in Illinois' fiscal situation: health care and retirement.

First, Medicaid expenditures, already a substantial share of state spending, will grow due to the after-effects of a severe recession, the continued aging of the population (which will increase expenditures on long-term care), and the fact that *per capita* medical costs are likely to continue to grow faster than revenue.

Second, pension costs will grow substantially in the coming years. Under current law, Illinois is required to follow a pension-funding path that will result in the pension systems being 90 percent funded by 2045. This so-called "pension ramp" has already necessitated increases in appropriations for pensions of hundreds of millions of dollars in recent years. Over the next five years or so, mandatory pension payments will grow steadily and require more than \$2 billion additional state dollars each year. In addition, Illinois will have to generate additional revenue to service the pension obligation bonds that were issued over the last decade. Coming up with these additional dollars would be difficult in the best of times. In the face of an on-going fiscal crisis, it will be a momentous challenge.

It would be a mistake, however, to view pension reform as a purely fiscal exercise. Pensions, after all, are an important part of the compensation package for public workers. In the current environment, the tremendous uncertainty about the viability of our public pension system is hurting the ability of public institutions to attract and retain employees. Universities – including our employer, the University of Illinois – compete in a global labor market in an effort to attract and retain many of the world's leading scholars. The U of I's ability to maintain its status as a world-class university hinges critically on its ability to make *credible* promises about employee compensation.

Recent pension reforms have created a "two-tier" system in SURS. New employees receive substantially reduced pension benefits compared to prior employees. Further, the imbalance in the relative adequacy of the new Tier II traditional defined benefit (DB) plan and the Self-Managed Plan (SMP) – an imbalance that was created by recent reforms – is effectively forcing many individuals into the SMP, which is a 100 percent defined contribution (DC) retirement system. While DC systems have many benefits to employees – and ought to be part of any solution – few pension experts would recommend a 100 percent DC retirement system for employees who do not participate in the U.S. Social Security system.

In short, Illinois has a critical need to reform public pensions for both fiscal and human resources reasons. In this brief, we provide the broad outline of a plan to reform the State Universities Retirement System (SURS) that will make substantial progress on both fronts relative to both the existing system and existing legislative proposals. In recognition of the fact that institutions of higher education – the primary institutions covered by the SURS system – face a different set of human resources challenges than school districts or other public employers, we focus this discussion on SURS. However, we do believe that many of the reform ideas outlined here could be applied – perhaps with appropriate modifications – to other public pension systems in Illinois.

II. The Goals of Pension Reform

In the case of the Illinois SURS, we propose three overarching goals that should be central to any reform package:

1. Retirement Security

A reformed SURS must provide public universities and colleges with the ability to compete in a global labor market by providing a credible promise of retirement security to long-service employees. Without the ability to attract talented faculty and staff public universities cannot continue their historic role as economic engines for the state. Two issues are central to achieving this goal. First, the benefits provided to SURS retirees must be adequate to fulfill the dual role of SURS in replacing Social Security and providing employee pensions. Second, for promises to be credible, a reformed SURS system must have secure and reliable funding sources.

2. Financial Sustainability

A reformed SURS system must be financially sustainable for the state, SURS employers, and participants. This requires reducing Illinois' pension liabilities through real reductions in future cash outflows from the retirement system, as well as a sustainable distribution of future costs across the various stakeholders. Achieving this goal requires that the state make a firm, credible commitment to consistently and predictably funding the amortized value of its existing unfunded liabilities.

3. Constitutionality

Any reform must respect the existing constitutional protections against the impairment of already-accrued pension benefits. There are strong ethical and fairness arguments supporting the idea that the retirement benefits of current retirees, as well as the already-accrued benefits of current participants, should be honored in full. But even if policymakers disagree with these arguments, there is an important constraint on any reform: the non-impairment clause of the Illinois Constitution. Put simply, there is little point passing a reform proposal that will

subsequently be struck down by the courts. We realize that the extent of constitutional protection is controversial and open to some degree of interpretation. However, we believe that this very strong constitutional protection is important to take into account. Thus, we focus on reforms that change the system in ways that we believe may be constitutionally permissible.

III. Additional Reform Principles

To achieve the three objectives above, we believe that pension reform should:

1. Respect the employer / employee relationship

In the private sector, it is widely understood that retirement plans and other employee benefits are provided in a broader context of an employer/employee relationship. Put simply, retirement plans are a human resources issue as well as a financial issue. This means they are a critical part of attracting, retaining, and managing the separation or retirement of employees. To treat pension reform as nothing more than an exercise in cost-saving is a mistake.

2. Align incentives

Public institutions should face proper economic incentives when making decisions about the size of their workforce. Currently, the legislature, not employers, has statutory responsibility for funding pensions. This not only creates inadequate funding for pensions in Illinois, but it also means that public institutions do not have sufficient “skin in the game” when managing the workforce. Better aligning pension funding responsibilities with workforce management decisions would also help to ensure that employers and employees do not take advantage of the pension system (such as by back-loading compensation to pass a larger fraction of an individual’s lifetime compensation onto the state).

3. Rely on shared sacrifice

The existing fiscal challenge facing the state of Illinois is enormous. It is simply not reasonable to assume that these problems can be solved unless the burden is shared broadly. Thus, we believe any reasonable pension reform must find a fair and equitable way to share the burden among universities and colleges, SURS participants, and Illinois taxpayers.

4. Learn from others

In recent years, we have had the opportunity to substantially increase our understanding of optimal retirement plan design. As the U.S. pension landscape has undergone dramatic transformations, especially in the private sector, we have learned about the relative advantages and disadvantages of defined benefit (DB) versus defined contribution (DC) systems, and, in particular, about the opportunities for combining the

best features of both. Our knowledge has also been substantially enhanced by a large body of academic research that helps us understand the importance of plan design on influencing participant behavior – such as the role of default options or investment menu design, and the importance of emphasizing lifetime income. Illinois should apply these lessons when designing a reformed public pension system.

5. Promote simplicity and transparency

All major elements of the retirement system should be transparent to participants, employers and taxpayers. For example, reform should seek to eliminate “hidden subsidies,” such as those created by the use of artificially high interest rate assumptions and annuity conversion rates that are too poorly understood to be highly valued by participants, but which are quite costly to taxpayers. Transparency will also help increase confidence in the system, reduce abuses of pension rules, and lead to a more politically, as well as fiscally, sustainable system for the long-run.

IV. A Proposal to Reform SURS

In this section, we provide the broad outline of a proposal that would meet the three primary objectives stated in Section II, and would be consistent with the principles outlined in Section III. We note at the outset that this particular reform proposal is meant to operate “as a whole” – we would strongly caution against focusing on any one element of this reform without considering the important interactions with other pieces. At the same time, we also stress that there are numerous ways to modify this basic proposal to achieve objectives, while still delivering a plan that is consistent with these goals and principles for reform. We also note that this proposal assumes that the accrued DB benefits for current employees would remain unchanged up to the point of implementation of the reform. Any changes for current employees would be limited to prospective benefits that do not abridge the reliance that current employees have on existing constitutional protections.

We also stress the importance of recognizing that any reform must specify not only how future employees will be treated, but also how existing Tier I and Tier II employees will be affected. In particular, the reform that created the existing Tier II system (for those employees with start dates of January 1, 2011 or after) requires special attention, as it currently is widely viewed as inadequate, especially for employees with incomes above the pensionable earnings limit.

There are several major parts of this pension reform proposal that are designed to work together:

1. Create a hybrid Defined Benefit / Defined Contribution system for new employees

The SURS system is meant as a replacement for two different systems – the U.S. Social Security system *and* an employer-based retirement program. The dominant form of retirement plan in the private sector in the U.S. today is a DC system plan (such as the 401(k)), but, importantly, it is a DC system that is layered on top of a public-provided DB system (Social Security). This mix of systems helps to balance the pros and cons of each system individually. For example, a DB-style system like Social Security provides a steady source of guaranteed income, shields individuals from investment risk, and provides a basic level of security even for financially unsophisticated participants. At the same time, a DC-style system, such as that provided by 401(k) plans, ensures full funding, provides participants with more control, and allows individuals to tailor their investment options to match their lifestyle and risk preferences.

Here we outline a plan that would establish a hybrid retirement system that would be the sole option for new employees and that would cost the state no more than it is now spending on the current Tier II system. We propose that the current SURS DB formula be scaled down for new employees, so that instead of providing a 2.2 percent replacement rate for each year of service, it would provide a 1.5 percent replacement rate for each year of service. This approximately one-third reduction in the DB benefit would generate substantial cost savings for the state, part of which would then be used to help fund a DC account. While not exactly equivalent to Social Security, one can think of this scaled-down DB plan as playing a role similar to that of Social Security for private-sector workers: it provides a basic level of guaranteed retirement income that cannot be outlived.

On top of this DB system, we propose that all SURS participants be automatically enrolled into a defined contribution (DC) account. Participants and employers would *both* contribute to this plan. Specifically, part of the combined state and employer contributions would be used to make a small automatic contribution to all DC accounts. Employers (i.e., colleges and universities) would also provide a 50 percent match on all employee contributions up to a limited percentage of salary (e.g., 4 percent). All participants would be automatically enrolled at a savings rate that maximizes the employer match, and also provides a high level of expected retirement income. The DC account would share many similarities, but also a few important differences, from the standard 401(k) account found in the private sector. Like the most efficiently designed private-sector plans, individuals would have access to a carefully chosen menu of low cost, diversified investment options, including life-cycle or similar funds that help put individuals on an automatically diversified and age-appropriate glide path

toward retirement. An important difference from typical 401(k) plans, however, is that the DC option in SURS would emphasize – in structure, product availability and communication – guaranteed lifetime income in retirement.

The overall funding burden of this plan for the state is comparable to the existing Tier II system. It is worth noting, however, that the hybrid system would increase overall participant confidence that the system will be funded. By definition, DC plans are required to be fully funded. While members of the General Assembly can choose to underfund public DB plans year after year, employers are not able to escape their funding responsibilities for a DC plan. Put simply, no third-party DC vendor will accept “IOUs” in lieu of real retirement plan contributions. Thus, a DC component will increase participant confidence in the system, while also helping to impose much-needed fiscal discipline on the state of Illinois.

Given the constitutional constraints facing Illinois, we recommend that this new hybrid system be mandatory for new employees, but voluntary for current employees. It is our expectation that many Tier II employees (those hired after January 1, 2011) would find it advantageous to switch to the new system.

It is worth noting that a hybrid public pension system would not be unique to Illinois. A number of state and local governments (e.g., Rhode Island, Georgia, Oregon and Orange County, California) have recently enacted or are considering hybrid systems. Although the details vary, each of the plans recognizes the value of balancing the advantages and disadvantages of DB and DC systems.

2. Peg the SURS “Effective Rate of Interest” to Market Rates

Under the current SURS system, the Effective Rate of Interest (ERI) is used for several purposes, including as an interest crediting rate under the money purchase option, as well as the rate used to calculate annuity conversion rates. Unlike other aspects of the SURS benefit formula, which are specified by formula, the ERI is set by the SURS Board and/or the state Comptroller. As such, we do not believe that these rates are constitutionally guaranteed.

Over the past three decades, the ERI set by the SURS board has exhibited extremely low volatility relative to any external benchmark (e.g., actual SURS returns, interest rates, or market indices).¹ Yet the level of the return (which has only varied between 7.5 percent and 10 percent over the past 30 years) is exceedingly high relative to this low level of volatility. The use of such a

¹ Over the past 30 years, the ERI Credited Rate has remained unchanged 19 times. When the ERI has been adjusted, the typical change has been only +/-0.50 percent.

high ERI to price annuity conversions under the money purchase option essentially amounts to a huge and hidden taxpayer subsidy to pensioners. Essentially, taxpayers are being forced to provide a very costly guarantee of high future returns to SURS participants and retirees.

We propose that the ERI be pegged to an economically meaningful benchmark. For purposes of this proposal, we suggest that it be set at a small premium over the yield on long-term government bonds. In practice, this proposal would have the effect of eventually shifting most individuals back to the basic SURS DB benefit formula, rather than retiring with a higher benefit under the money purchase formula. As such, it generates substantial real cost savings to the SURS system and the state.

3. Redistribute the SURS funding burden

Although the state will continue to have sole responsibility for funding the already existing liabilities, we propose that employers, employees and the state all contribute toward the funding of the normal cost of the SURS system going forward. In a major shift from the past, we propose that SURS employers – i.e., public universities and colleges in Illinois – be required to contribute toward the funding of both the DB and DC portion of the hybrid pension system for new employees as well as to fund benefits for current Tier I participants. This would help to appropriately align incentives by “internalizing” pension costs at the level of the employer. It would also substantially enhance the security of pension funding, as individual employers would have a legally binding responsibility to make their annual pension contributions. University contributions toward normal costs will also reduce the annual pension costs for the state, thus allowing the state to consistently fund the amortized value of existing unfunded liabilities.

We stress three caveats to this new role for employers. First, the entire funding burden should not be shifted to employers. Not only would this be financially infeasible in a period of declining state appropriations, but it is also important that the state maintain “skin in the game” given that the legislature controls the generosity of pension benefits. Second, so as not to create a substantial one-time budget shock for universities and colleges, these contributions should be phased in over a period of several years. For example, employers could be required to contribute 1 percent of pay in the first year, 2 percent of pay in the second year, and so on, until they reach their target contribution rate. Third, the ability of colleges and universities to undertake this burden is contingent upon the state committing to maintaining at least the current level of state appropriations. Unlike local school districts or municipalities, public universities in Illinois do not have the ability to independently raise tax revenue to fund these commitments.

In the spirit of shared sacrifice and shared responsibility,

SURS participants should also be asked to pay more. However, unlike S.B. 512, which would result in an immediate, near-doubling of the current 8 percent employee contribution rate, we propose a much more modest increase of no more than 3 percent of pay. Given that our plan reduces pension costs (through the ERI reduction) and also provides a role for employer contributions, we believe that contribution increases beyond this range are unnecessary. As with employers, this increase should be gradually phased-in so as to avoid large shocks to the household finances of SURS participants. It would be especially desirable to keep the rate of increase in the contributions below the expected rate of increase in nominal pay, so that employees do not have to absorb a sudden cut in net pay. We recognize that there is some debate about the constitutionality of requiring additional pension contributions: on February 3, 2012, a lower court in Arizona (a state with a pension non-impairment clause like Illinois) published an opinion that public employees cannot be required to contribute more without additional benefits. Were a similar ruling to hold in Illinois, these costs would need to be reallocated among the state and the employers. Alternatively, the additional contributions could be linked to explicit benefits, such as the continued provision of cost-of-living adjustments.

The state government also has obligations in this plan. First, the state must, at a minimum, contribute 6.2 percent of payroll to fund future pension obligations. This is the amount the state would be required under federal law to pay in FICA taxes to support Social Security had the state not opted out of that system.

Second, the state should be the “residual contributor” if future pension liabilities turn out to be higher than projected. We believe it is appropriate that such funding risk should be shared by the broadest possible group (e.g., taxpayers, which include participants), rather than imposing all funding risk on a more narrow group (e.g., participants only).

Third, and perhaps most important, it is the responsibility of the state of Illinois to finance the already-existing underfunding of pension promises that have been made to date. There is little question that these past obligations were underfunded as the direct result of the past failures of political leadership to make the annual required contributions to fund SURS. Illinois taxpayers were the short-term beneficiaries of such decisions, as the decision to skip pension funding was used as a substitute for other spending reductions or tax increases. Now the time has come to repay the debt owed to the pension system. The long term effectiveness of this or any other reform proposal is contingent on the state taking the necessary steps to fulfill its financial obligations on an annual basis.

4. Align pension vesting rules with the private sector

In the current Tier II DB system, individuals must participate in the SURS system for 10 years before vesting.² This makes the SURS system extremely unattractive to potential new employees, such as faculty members who face a tenure decision around year six. We believe this substantially hurts universities' ability to attract new talent because the vesting period is significantly higher than those at most other universities. It also harms the retirement security of individuals who spend a substantial part of their career – but less than 10 years – working for a SURS employer, as they would lose out on Social Security and employer pension contributions.

To rectify this, we propose that the SURS vesting schedule mirror that of most private sector DB plans, which under federal law (ERISA) must meet minimum vesting requirements. We propose that state/employee contributions to SURS be vested according to a “2-to-6” year step vesting schedule that entitles employees to 20 percent of state/employer contributions after two years of service, 40 percent after three years, and so on until they are 100 percent vested after six years of service.

V. A Call to Action

In this paper, we have outlined a pension reform plan that would help public colleges and universities in Illinois more effectively compete for talent in a global labor market, while simultaneously improving the state's fiscal situation. We understand that it is possible to modify this plan along many dimensions. However, it is important to point out that a “partial reform” should not be undertaken. For example, simply shifting the distribution of funding responsibility without simultaneously taking steps to reduce the overall funding burden could spell financial disaster for SURS employers and participants. Similarly, focusing only on cost reduction without recognizing the need to address the substantial competitive *disadvantage* that the existing Tier II system has created would pose a serious long-term threat to the quality and prestige of our public institutions.

It is also important to note the substantial advantages of the hybrid system over a wholesale replacement of the existing SURS system with a poorly-conceived, 401(k)-

style system. Reliance on a 100 percent DC system would unnecessarily harm the retirement security of university employees who do not participate in Social Security. It would limit public universities' ability to attract and retain talent. And, notably, it would massively *increase* the short-term fiscal crisis faced by the state of Illinois, which would find itself in the position of being required to fully fund the new 401(k) system while simultaneously needing to service the implicit debt owed to the legacy DB system.

We believe this proposal has many advantages over S.B. 512 that was considered by the Illinois legislature during the fall 2011 session. First, because of the provisions to reduce the ERI, this proposal results in genuine cost savings to the system. Second, we advocate a better approach to sharing the funding burden. S.B. 512 would result in an immediate near-doubling of the contributions required by current employees, a fact that would have substantial negative effects on our ability to attract and retain talented employees. Third, the hybrid system outlined here would provide a much more balanced approach to retirement security than the plans suggested under S.B. 512. Finally, unlike S.B. 512, this plan provides a more attractive option than the current Tier II system. We believe this plan will demonstrate that it is possible to achieve substantial savings for the state, while still providing a competitive benefits package for employees.

Finally, it is important to underscore that this proposal would reduce the state's funding burden to support the pensions of public university employees by more than half for current employees. In addition, the proposed hybrid plan would cost the state no more than it is currently paying for employees hired after January 1, 2011.

² A vesting schedule refers to the timeline over which the ownership of employer pension contributions transfers to the employee.



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