The Illinois Public Pension Funding Crisis:

Is Moving from the Current
Defined Benefit System to a Defined Contribution System an Option That Makes Sense?

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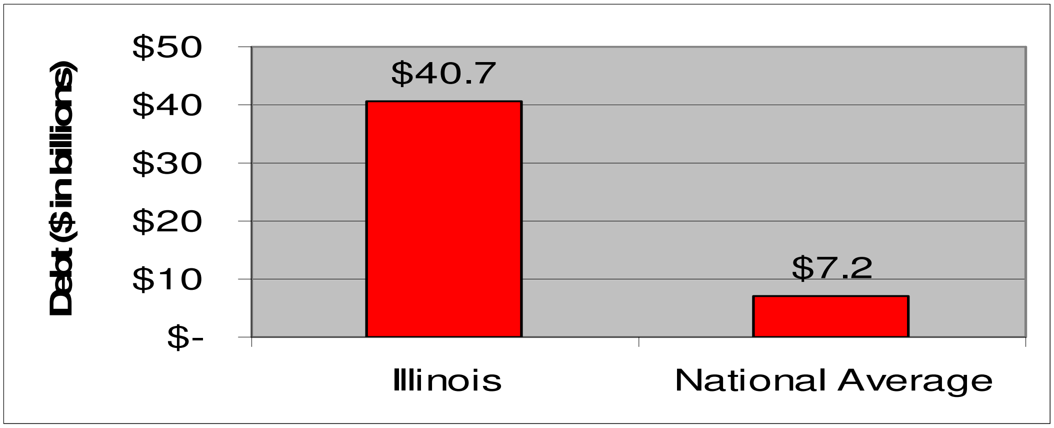
I. Introduction

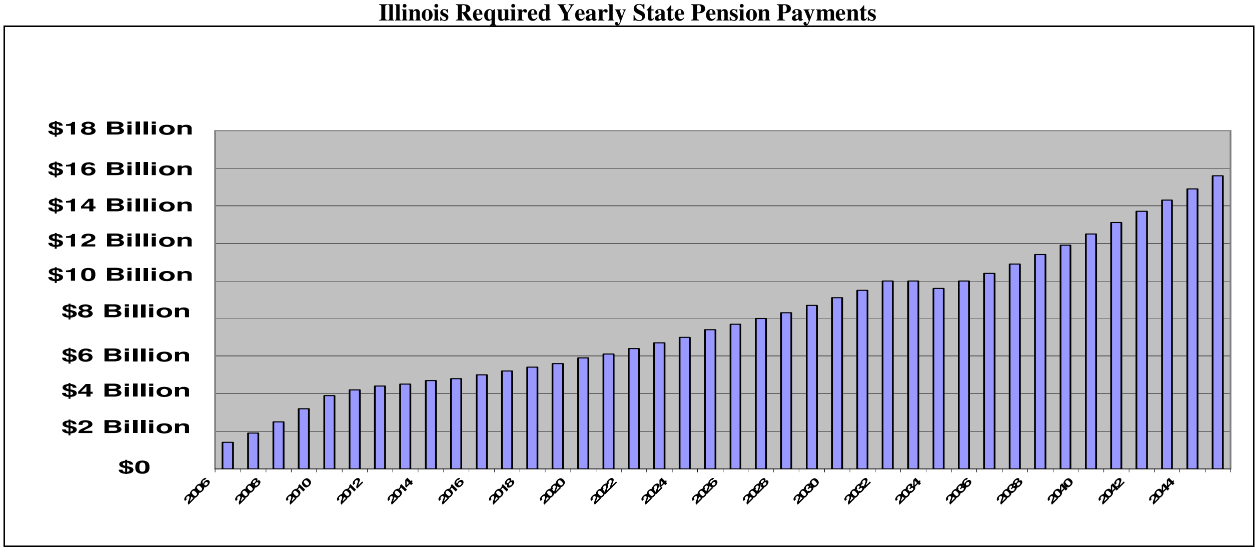
There's a debate raging in Illinois today over the state's public employee pension system. In large part, this debate has its genesis in the fiscal constraints imposed on the state's budget by Illinois' $40.7 billion unfunded pension liability. At more than five times the national average, Illinois has the largest unfunded pension liability in the nation.[1]

Figure 1[2]
Illinois Retirement Debt



Paradoxically, while the debate has its origins in concern over Illinois' outsized unfunded liability, most of the discussion is focused on the type of retirement benefit system the state offers its employees – a defined benefit system —rather than on developing a rational plan for paying the unfunded liability. This distraction is both costly and counterproductive. Since, as Figure 2 shows, the current schedule for repaying the unfunded liability is not feasible, given the states current fiscal system, every year the state fails to implement a realistic solution to its unfunded liability further imperils the state's fiscal health and ability to deliver essential services millions rely upon.

Figure 2[3]
Illinois Required Yearly State Pension Payments



[1] Illinois Commission on Government Forecasting and Accountability, Monthly Briefing, November 2006.
[2] 2004 Wilshire Report, *State Retirement Systems: Funding Levels and Asset Allocation*
[3] Illinois Commission on Government Forecasting and Accountability, Monthly Briefing, November 2006

This unfortunate state of affairs exists primarily due to misconceptions about both the actual cause of the unfunded liability and the perceived advantage of changing the type of pension system the state offers from primarily a defined benefit program to a defined contribution system. This would be a significant change, since defined benefit and defined contribution systems are materially different approaches to retirement security, with very different benefits and risks for workers and costs for taxpayers.

Whether based on misinformation or not, there has been so much attention focused on changing the type of pension system Illinois offers public employees that the concept deserves a thorough analysis. After all, the state owes taxpayers a public employee retirement system that helps attract and retain a quality workforce at reasonable costs and ultimately must pay its unfunded liability in a rational fashion, that does not mortgage the future. In an effort to move the public debate on these contentious issues forward in a positive manner, this paper will address the most common misconceptions that are clouding this issue and review the relative strengths and weaknesses of defined benefit versus defined contribution systems from the perspective of both the public sector and taxpayers.

II. Main Findings

- Illinois' current average state and local government employment retirement benefit is $17,112 per year. This annual payment is not overly generous, considering it is just 3.7 percent more than the national average of $16,488.[4]

- Illinois' current normal costs across its five public employee retirement systems are within national averages.[5]

- Investment returns earned on the assets in the state's five retirement systems fall within national averages.[6]

- Defined contribution systems have significantly higher annual administrative costs than fully funded defined benefit systems.[7] For instance, although not constitutionally permissible,[8] if Illinois moved to a defined contribution system for all current participants in the five Illinois state pension systems, that change would cost taxpayers from $275 million to $610 million per year in additional administrative costs.[9]

- If contribution rates remained the same, defined contribution systems can be expected to generate significantly lower retirement benefits. For example, when Nebraska switched to a defined contribution system, the average benefit was only $11,230 per year compared to $16,797 per year under the defined benefit system.[10]

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[4]United States Census Bureau, Employee Retirement Systems of State and Local Governments. 2001-2002. (This is the latest available national data.)
[5]See each retirement systems Annual Financial Report. National average normal cost based on Norman Jones and Paul Zorn. Harvard Law School Pension and Capital Stewardship Project Conference, October 2005.
[6]2003 Wilshire Report, *State Retirement Systems: Funding Levels and Asset Allocation,* the latest comparison of state by state data available.
[7] Collins, Sean. *The Expenses of Defined Benefit Pension Plans and Mutual Funds,* December 2003.
[8] Illinois is constitutionally required to provide retiree's the benefits they've earned, thus any legislation the state passes to reduce pension benefits will only apply to public employees newly hired *after* the change in law goes into effect.
[9] Center for Tax and Budget Accountability calculations based on Sean Collins, *The Expenses of Defined Benefit Pension Plans and Mutual Funds,* December 2003.
[10]House Committee on Pensions and Investments, Texas House of Representatives, Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature, p. 28 citing Buck Consultants study commissioned to review the benefit adequacy of the Nebraska Retirement System.

- Because of Illinois constitutional restraints,[11] switching to a defined contribution system does not and cannot reduce the state's current $40.7 billion unfunded liability. The sole way to cover this liability is to design a rational program that does not back load costs like current law.

- Defined contribution systems have the advantage of creating fiscal discipline that is absent from a defined benefit system. Due to their construction, defined contribution systems would force the state to make the required employer contribution into the employees account on a per pay period basis, rather than offering promises of future benefits, as under the current defined benefit system.[12]

- From an employee's perspective, a defined contribution system would have two advantages over a defined benefit system: (i) the benefits would be portable from job to job; and (ii) an employee could access his or her defined contribution account for emergencies pre-retirement (although subject to tax penalties, in certain situations).[13]

- The three main disadvantages of a defined contribution system from an employee's perspective are: (i) reduced and uncertain retirement benefits; (ii) lesser investment returns; and (iii) market risks.[14]

- On balance, when funded in a fiscally responsible manner, a defined benefit system permits the public sector to provide its workers with better retirement benefits at lower overall cost to taxpayers than a defined contribution system.[15]

III. The Current Illinois System

1. Five Different Pension Systems. The state of Illinois currently operates the following five public employee retirement systems: the State Employees Retirement System ("**SERS**"), the Downstate Teachers' Retirement System ("**TRS**"),[16] the State Universities Retirement System ("**SURS**"), the Judges Retirement System ("**JRS**") and the General Assembly Retirement System ("**GARS**"). For each pension system, Illinois state government makes the employer contribution and participating employees make their required employee contributions.

2. A Constitutional Mandate. The state's duty to maintain pension benefit levels for its public employees is directly mandated in the Illinois Constitution.[17] The absolute nature of this responsibility means the unfunded liability cannot be legislated away; the debt must be repaid.

In fact, because the state is constitutionally required to provide retirees the benefits they earned, any proposed change to Illinois pension benefits can only operate on a *prospective* basis. That means any legislation the state passes to reduce pension benefits will only apply to public employees newly hired *after* the change in law goes into effect. Thus any significant savings from proposed changes to the state's pension system will not be realized for many years, until those new hires become a significant portion of the state workforce.

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[11] Article XIII, Section 5 of the Illinois Constitution.
[12] Don, Thomson D. "Fitzgerald Floats Trial Balloon To Change State Pension System to a 401(K) plan." January 14, 1997.
[13] House Committee on Pensions and Investments, Texas House of Representatives, Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature.
[14] Ibid.
[15] Ghilarducci, Teresa. *Future Retirement Income Security Needs Defined Benefit Pensions.* Center for Economic Progress. March 2006.
[16] The state provides only a portion of the employer contribution to the Chicago Teachers' Retirement System. Most of the employer contribution is paid by the City of Chicago through a locally imposed property tax.
[17] Specifically, Article XIII, Section 5 of the Illinois Constitution provides, "Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, *the benefits of which shall not be diminished or impaired." (emphasis supplied)*

Because of this constitutional mandate, any change in the type or value of benefits offered public employees will in no way reduce the $40.7 billion in accrued, unfunded pension liability. The only way the state can address this obligation is to develop a rational way to pay it over time, one that does not backload costs, and has a dedicated, sustainable revenue stream.

IV. Misconceptions and the Unfunded Pension Liability

The practice of failing to fund the full normal cost the state owes the pension systems for its employees has been followed since at least the Ogilvie Administration in 1970, and has progressively worsened since. Historically as the state has found itself short of the revenue needed to cover both essential services and its required pension contributions, Illinois frequently opted to skirt full funding of the pensions to maintain spending on services. Essentially, the Illinois state government has been borrowing against the employer contribution it owes the pension systems annually, just to cover the cost of providing services.

Unfortunately, when the state fails to pay its required pension contributions, the amount it ultimately must contribute grows substantially over time. That is because under state law, any funding shortfall like the partial pension holidays taken for Fiscal Years 2006 and 2007, must be paid back with interest, compounded at each retirement system's target rate of return, currently pegged at 8.0% to 8.5% per year, depending on the pension fund.[18] Thus, each year a pension obligation remains unpaid, the investment return the state must make up on the unpaid contribution ***compounds***. Over time, this chronic failure to make the full employer contribution is the primary reason Illinois state government arrived at where it is today, facing a $40.7 billion unfunded pension liability.

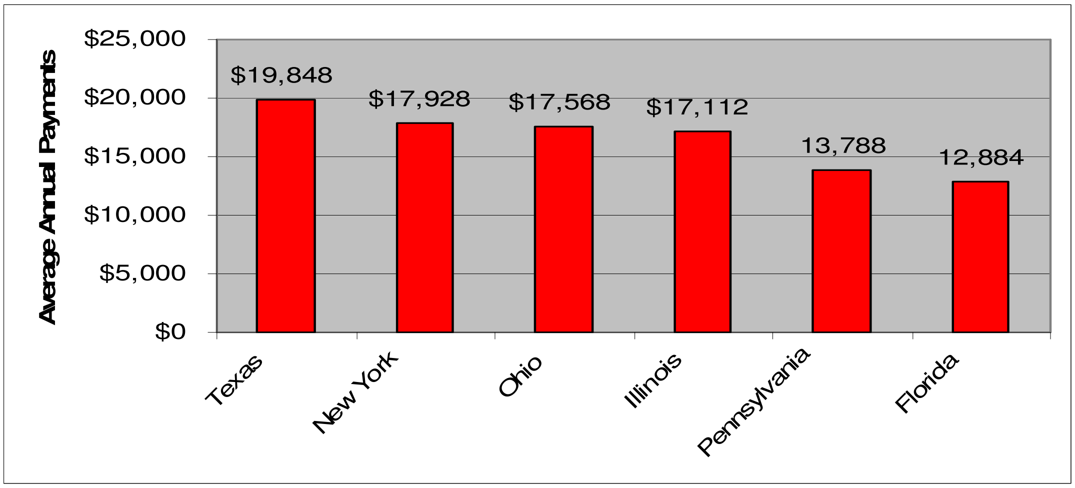
Now, after decades of neglect, Illinois' unfunded pension liability is finally receiving the attention it deserves. This is only appropriate, since every tax dollar used to pay unfunded pension liabilities overdue from the past, reduces the revenue available to fund current and future public services. Given the magnitude of this problem, developing a rational approach to repaying the state's $40 billion plus unfunded liability is one of the most significant public policy challenges facing Illinois.

However, while the growing attention paid to this issue is welcome, to date, much of the public discussion about the state's unfunded pension liability has been wildly off point as to both the actual cause of the problem, as well as how to solve it. In fact, instead of focusing on the state's historic failure to make its employer contribution, and then designing a rational payment plan, the debate has become seriously muddled by four oft repeated, significant misconceptions.

First, is the mistaken belief that pension benefits offered to public employees in Illinois are overly generous. They are not. As Figure 3 illustrates, Illinois' average annual retirement benefit for all public employees, including teachers and public safety employees, is actually less than that paid by the vast majority of comparable states.

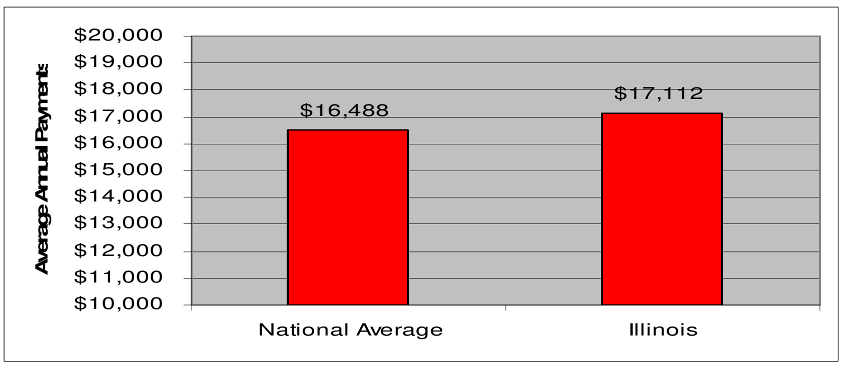
[18] Each system's Comprehensive Annual Fiscal Report lists their actuarial interest rate in the Actuarial Section.

Figure 3[19]
Comparable State & Local Government Annual Retirement Benefits



Moreover, compared to the rest of the country as a whole, Illinois' retirement benefits hover near national average.

Figure 4[20]
Average State & Local Government Employment Annual Retirement Benefits



An annual retirement income of $17,112 is barely enough to live on in Illinois. In fact, an annual income of $17,112 is only $3,422 away from the poverty level for a family of two under federal government standards.[21] Given the data and the proximity of average retirement benefit to the poverty level, it is somewhat difficult to argue that current employee benefits are overly generous.

There is one more, significant factor that makes it even more difficult to argue that the public sector should cut retirement benefits for its employees, even if that may be the current trend with some members of the private sector. The private sector is, as it should be, primarily motivated by increasing profits. This is distinguished from the public sector, which provides public services, and particularly Illinois, which in the preamble to its state constitution undertakes the obligation to, among other things, eliminate poverty.[22] These two different paradigms result in a somewhat different approach to employee retirement benefits.

[19] United States Census Bureau, Employee Retirement Systems of State and Local Governments. 2001-2002 (This is the latest available national data.)
[20] Ibid.
[21] 2007 HHS Poverty Index for family of 2 is $13,690. Taken from: United States Department of Health and Human Services, Federal Poverty Guidelines, 2007.
[22] Eitelberge, Cathie G. *An Elected Officials Guide to Public Retirement Plans* Governors Finance Officers Association, 1997.

A private business has neither the fundamental responsibility nor liability to ensure its former employees have adequate income on which to live in retirement. It will only assume that responsibility if market forces dictate it must to be competitive. However, when seniors retire from both the public and private sector, it is the state government who will be forced to provide them aid if they are left without adequate income. While limited in its ability to control the private sector, it would be quite contrary to public policy, and not cost effective, for the state to reduce retirement benefits for its own workers, only to find itself funding their living costs anyway, through various state programs.

A second common misconception is the belief that Illinois has too many public employees. Nothing could be further from the truth. Figure 5 shows how many individuals are currently earning benefits in each system, how many are currently collecting benefits from each system, and the total number of plan participants.

Figure 5[23]
Participants in the Illinois Pension Plans

	TRS	SURS	SERS	JRS	GARS	Total
Active Members	**250,540**	**153,475**	**89,735**	**947**	**265**	**494,962**
Beneficiaries	**85,153**	**41,638**	**54,678**	**912**	**395**	**182,776**
Totals	**335,693**	**195,113**	**144,413**	**1,859**	**6,600**	**677,738**
Percent of Total IL Population						**5.3%**

Note that the total number of participants in the state's various pension plans represents a very small percentage of Illinois' total population. That's because historically, Illinois has not been a high public employee head count state.[24] Instead, Illinois is mostly a grant-making state—that is, rather than hire state employees to provide services, Illinois disburses grants to independent providers such as Lutheran Social Services or Catholic Charities, which in turn deliver the service to the public. Illinois actually ranks 50th among the states, dead last in the nation, in number of state employees per capita.[25]

The third misconception frequently raised is that the state's defined benefit system is too expensive in terms of the annual contribution required to fund benefits for current workers. Yet, the data indicate this critique is unfounded. Consider "normal cost". Normal cost is the current total contribution required to fund the promised benefit on retirement, based on actuarial tables. It is typically expressed as the percentage of current payroll needed to fund future benefits. The “normal cost” across all five Illinois' pension systems, as a percentage of active members’ payroll, averages 9.13 percent.[26] The national average for state and local government is 12.5 percent,[27] placing the normal cost of Illinois’ current defined benefit program far below the national average. Figure 6 provides details of normal cost for each state pension system.

[23] State of Illinois FY 2008 Budget Book.
[24] United States Census Bureau, Stastical Abstract of the United States, 1993-2006.
[25] Based on 2006 U.S. Census Data.
[26] Weighted average based on date provided by each of the five retirement systems.
[27] Norman Jones and Paul Zorn, Harvard Law School, Pension and Capital Stewardship Project Conference, October 2005.

Figure 6
FY07 Normal Costs of the Five Illinois Retirement Systems

	Normal Cost	Percent of Payroll
JRS	$32,200,000	23.47%
GARS	$2,400,000	19.42%
SERS	$329,000,000	9.17%
SURS	$319,584,000	10.82%
TRS	$650,835,074	8.20%
Total	**$1,334,019,074**	
Total Weighted Average		**9.13%**

The fourth oft repeated misconception is that the state does not generate acceptable returns on the investment of its pension fund assets. Again, the data indicate there is nothing wrong with these investment returns, which consistently exceed national averages.[28] In fiscal year 2006 alone, the system spent $5.3 billion on benefits, expenses and related administrative costs.[29] Member and state contributions only totaled $2.3 billion; however, an additional $6.7 billion was earned in investment income from a healthy world equities market leading to a $3.7 billion increase in pension assets for the year.[30]

The data make it clear that the state's unfunded pension liability accrued to date was not caused by overly generous benefits, high head counts, excessive costs or even poor investment returns. Instead, the real culprit has been, and continues to be, the repeated failure of the state to make its full, annual employer contribution to the systems.

V. Comparison of Defined Benefit and Defined Contribution Plans

1. Defined Benefit Plan Basics. Each of Illinois' five state retirement systems are primarily structured as defined benefit plans. Under a defined benefit plan, the employer guarantees an annual retirement payment for their worker that is based on a formula. The formula usually involves factors like an employee's years of service, age at retirement and either ending salary or average salary over the last few years of service. This annual retirement payment benefit is guaranteed for the life of the member and his or her spouse. These formula determined retirement benefits are funded from three sources: (i) employee contributions; (ii) employer contributions; and (iii) investment earnings on pension fund assets. Unlike the defined contribution setting, individual accounts are not created. Instead, all employer and employee contributions and investment returns are pooled, and the assets are collectively managed. The employer maintains responsibility for managing the plan and for ensuring adequate funding is available for payment of benefits when due.

2. Defined Contribution Plan Basics. In contrast to a defined benefit plan, a defined contribution plan offers no guaranteed benefit on retirement. Instead it creates a retirement savings account for each member such as under a 401(k), 403 (b) or 457 plan. The ultimate retirement benefit is the accumulated value of an individual's account available at retirement, resulting from contributions made to an individual account by the participant and his or her employer, increased by investment earnings and decreased by losses. The employee is responsible for investing his or her own retirement account, but must pay a third party to administer it. Employees make all decisions about where to invest retirement savings and how much to contribute. All market and timing risks concerning the assets in an

[28] 2003 Wilshire Report, *State Retirement Systems: Funding Levels and Asset Allocation*.
[29] Illinois Comptroller, Fiscal Focus, January/February 2007.
[30] Ibid.

individual's defined contribution account are assumed by the employee. It is therefore possible for him/her both to outlive the accumulated assets in the account, and/or to lose all of it in a turbulent market. Figure 7 provides a brief comparison of the major features of both retirement systems.

Figure 7
Features of Defined Benefit and Defined Contribution Plans

	Defined Benefit Plans (DB)	**Defined Contribution Plans (DC)**
Benefit Design	Retirement payments are determined by a formula and annual payments are guaranteed for the life of the retiree and his or her spouse. *Illinois DB average yearly benefit is $17,112.*[31]	Retirement benefit is uncertain, and will be whatever combination of the contributions and investment earnings and/or losses have accumulated in a worker's account. *The DC national average benefit is $11,230 per year.*[32]
Contributions	Employee contributions are set; employers are responsible for contributing that percentage of payroll, which when combined with the employee contribution, is actuarially determined as necessary to provide the promised benefits. *Illinois DB average employee contribution is 4% (9.4% for teachers w/out Social Security).*[33]	Maximum employer contributions are often set and employers are responsible for contribution amounts necessary to sustain them during retirement. *The DC national average employee contribution is 6% of earnings*[34] *with 80% choosing to contribute $0,*[35] *the average employer match is 3% of earnings.*[36]
Benefit Adequacy	Depends on plan provisions. *Illinois DB average annual payment is less than $4,000 more than the federal poverty level.*	Depends on contributions, investment returns, and account balance at retirement. *The DC national average annual payment, that can be anticipated to be generated using the same cost as the state's current DB program, would be 84% below the federal poverty level.*[37]
Benefit Risk	Regardless of investment performance, employers pay a guaranteed retirement benefit that employees can count on for life.	The employer's sole responsibility is to make its scheduled contributions. There is no guaranteed benefit, and employees assume the risk of losing their retirement through market fluctuations and/or outliving their retirement benefit.
Investment Results	Investment performance affects funding, but does not affect benefits. Strong investment performance can lead to reduced taxpayer costs. *The DB average investment return is 11%, almost double the DC average.*[38]	Investment performance, whether good or bad, will directly impact the employee's retirement benefits. *The DC average return is 6%.*[39]
Longevity	Benefit levels are guaranteed for a retiree's lifetime. Retirees are often given the option of providing survivor benefits.	Benefits consist of the account balance existing on retirement, but are not guaranteed unless an annuity is purchased with the benefit on retirement.
Administrative Costs	Significantly lower than a DC plan, on average 0.28% of plan assets.[40]	Significantly higher than a DB plan, on average 0.56% of plan assets.[41] *In Illinois, DC would cost taxpayers annually $275 to $610 million more in administrative costs than the average DB plans.*[42]
Fiscal Discipline	Not much—the benefit, not the contribution, is guaranteed. This allows the state to defer making its full annual employer contribution, and has created the current $40.7 billion unfunded liability.	Very strong, the state would have to make its full, current employer contribution annually.
Portability	Limited to public sector in Illinois.	Full.
Individual Control	Employees have no individual control of benefit levels although benefit levels almost double the DC average.	Employees have individual choices among investment and contribution amounts.

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[31]United States Census Bureau, Employee Retirement Systems of State and Local Governments. 2001-2002 (This is the latest available national data.)
[32]House Committee on Pensions and Investments, Texas House of Representatives, Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature, p. 26.
[33] Preckwinkle, Steve. *Public pension plans a good deal for state taxpayers.* Springfield State Journal-Register, January 10, 2006
[34] Munnel, Alica H. and Sunden, Anika. *Suspending The Employer 401 (K) Match* Center for Retirement Research at Boston College. June 2003.
[35] Lee, James and Munnell, Alicia. Changing 401(k) Defaults on Cashing Out: Another Step in the Right Direction. Center for Retirement Research at Boston College, 2004.
[36] Munnel, Alica H. and Sunden, Anika. *Suspending The Employer 401 (K) Match* Center for Retirement Research at Boston College. June 2003
[37] Ibid. 2007 HHS Poverty Index for family of 2 is $13,690. Taken from: United States Department of Health and Human Services, Federal Poverty Guidelines, 2007.
[38]Olleman, Mark. *Defined contribution Experience in the Public Sector.* Benefits and Compensation Digest, February 2007.
[39]Ibid.
[40] Council of Institutional Investors. *Protecting the Nest Egg: A Primer on Defined Benefit and Defined Contribution Retirement Plans.* http://www.afscme.org/docs/please_add_this_to_pension_facts_you_should_know_section_-__.pdf
[41] Ibid.
[42] Center for Tax and Budget Accountability calculations based on; Sean Collins, *The Expenses of Defined Benefit Pension Plans and Mutual Funds,* December 2003.

3. General Advantages/Disadvantages. Defined benefit plans differ significantly from the defined contribution model. Both plans have advantages as well as disadvantages for employees and taxpayers. A defined contribution program does not guarantee any specific payments that an employee can expect upon retirement. Instead of a defined annual benefit, upon retirement an employee in a defined contribution plan receives the sum total contributions made to his or her account over time plus investment earnings or losses on those contributions. The final benefit is based on contributions made and investment earnings or losses.

Unlike defined benefit systems, where the employee is shielded from market risks, defined contribution systems shift all market risks to the employee. Compare that to a defined benefit system, which delivers a specified retirement income to a worker that can be counted on. Given that, unlike the private sector, the public sector has the responsibility to support impoverished seniors, it is better public policy to ensure former public sector employees receive retirement payments adequate to support themselves, rather than ending up on the public dole.

Defined contribution plans have the advantage of being portable, meaning an employee can take the money and investment returns paid into one defined contribution account and roll them over to another plan when transferring jobs. Because contributions paid by the employer and employee are placed into that employee's individual account, it is easy for an employee to track his or her specific retirement investment over time. However, neither portability nor simplicity is an adequate substitute for value. As detailed in Section VI of this report, the retirement income is both greater and more secure under a defined benefit than a defined contribution system.

From the state's perspective, the main advantage of switching to a defined contribution plan is the fiscal discipline it imposes on state government. Defined contribution funding requirements cannot be legislated to the future. Due to their construction, the state would be required to make their contributions into employees accounts on a pay period basis, rather than offer promises of future benefits, as is the case under Illinois current defined benefit plan. Hence, elected officials would have to pay full, annual employer contribution owed to the system on a current basis, rather than deferring pension contributions to fund other services.

VI. Adequacy of Benefits

The ideal mix of retirement income sources has long been described as a "three-legged stool," with one leg each representing Social Security, an employer pension, and individual savings.[43] The United States Department of Labor recommends replacing approximately 70 percent of one's working income in retirement.[44] Under a defined benefit plan, an employee is much more likely to reach this goal.

The Center for Retirement Research at Boston College ("CRR") found that in 2001, the average 401(k)/IRA account balance of individuals nearing retirement (ages 55-64) was $42,000, whereas CRR's modeling indicates that a regular middle-income contributor should have accumulated almost $300,000 by that age.[45] If a worker retires at 65 years of age, and lives until 85 with only $42,000 in retirement savings, that would leave just $175 per month or $2,100 per year, to cover costs for the remainder of his or her life, not nearly enough on which to survive.[46] At the same time, the average state and local

[43] Please note, Illinois teachers, college and university employees and some state employees are balancing on a two legged stool as they are currently not covered by Social Security. Their pension is the only financial assistance they will receive when they retire.
[44] United States Department of Labor. *Top Ten Ways to Prepare for Retirement.* http://www.dol.gov/ebsa/Publications/10_ways_to_prepare.html
[45] Munnel, Aicia and Annika Sundén. *Suspending the Employer 401(k) Match.* Boston College Center for Retirement Research, 2003.
[46] Lee, James and Munnell, Alicia. Changing 401(k) Defaults on Cashing Out: Another Step in the Right Direction. Center for Retirement Research at Boston College, 2004. *Avg. savings under DC are $42,000 at retirement; computation assumes retirement at age 65 and living until age 85.*

government employee benefit is $1,427 per month or $17,112 per year. Not abundant by any means, but enough to at least live on.

There are multiple reasons balances available at retirement under a defined contribution plan are so low. Unlike defined benefit plans, participation is not mandatory under a defined contribution. Studies show almost 80 percent of employees choose not to participate at all in 401K defined contribution programs when offered, leaving them with no private savings.[47] In addition, CRR found that less than 10% of workers with defined contribution plans actually contribute the maximum allowed.[48]

Inexperience and lack of investment training also greatly contribute to low account balances. The state of Nebraska found that when employees manage their own investments under a defined contribution plan, investment returns are in fact lower then under a defined benefit system. During the period from 1983 to 1999, Nebraska state and county workers averaged a 6 percent return when investing their individual retirement accounts in that state's defined contribution plan, versus an 11 percent return for teachers and judges with the defined benefit plan.[49] The actual investment differential in favor of the defined benefit system becomes even greater, once the lower administrative costs of the defined benefit system are factored in.[50] Nebraska found that ten years after retirement, a retiree with 30 years of service who had an average annual salary of $30,000 had about $11,230 annually in retirement benefits under the state's defined contribution plan[51], less than the poverty level for a family of two. A defined benefit plan participant with similar pay and service credit, however, received $16,797 each year,[52] which is more than $3,000 greater than the federal poverty level for a family of two.[53]

One explanation for why public defined contribution plan returns lag defined benefit portfolios is because asset allocations made by employees in a defined contribution setting are often quite conservative.[54] Again, the Nebraska experience is illustrative. Despite state education programs on the importance of proper asset allocation and eleven different investment options, 90% of Nebraska's employees invested all their individual plan deposits in just three funds.[55] This suggests employees lack the proper skills to diversify their assets and make sound investments. Under a defined benefit system, experienced portfolio managers invest plan assets under carefully considered asset allocation models geared toward long term returns.

Nebraska Public Employees Retirement System's director Anna Sullivan observed that members were making decisions based on emotions and trying to time the market by chasing returns. In the end the majority of them were left with barely anything to live on following retirement.

Recognizing this Nebraska legislators determined the shortcomings of a defined contribution system were too significant to overcome, and changed the systems back to a defined benefit model, ending defined contribution plans for new hires and giving all other workers the option to switch into a hybrid plan. "We had to take a look in the mirror and think, is this really providing a true pension?" said Sullivan. "It's

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[47] Lee, James and Munnel Alica. *Changing 401(k) Defaults on Cashing Out: Another Step in the Right Direction.* Center for Retirement Research at Boston College, 2004.
[48] Ibid.
[49] Anderson, Gary W, and Brainard, Keith. Profitable Prudence: The Case for Public Employer Defined Benefit Plans Pension Research Council, The Wharton School, University of Pennsylvania. 2004.
[50] Hawkins, Ronald L. *The Nebraska Defined Contribution Plans: A Review of the State's Three Decade Plus Experience with Public Employee DC Plans.* Defined Benefits.Org.
[51] House Committee on Pensions and Investments, Texas House of Representatives, Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature, p. 26.
[52] Ibid.
[53] 2007 HHS Poverty Index for family of 2 is $13,690. Taken from: United States Department of Health and Human Services, Federal Poverty Guidelines, 2007.
[54] Ibid.
[55] National Association of State Retirement Administrators, 2002.

really sad what they retire with. It's nothing compared to what people in our defined-benefit plan receive."[56] Sullivan sums up Nebraska's experience by stating, "Our experience with the defined contribution plan has been mixed. We have had over 35 years to 'test' this experiment and find generally that our defined contribution plan members retire with lower benefits than their defined benefit plan counterparts."[57]

Another reason defined contribution plans generate less than acceptable retirement savings is due to the often touted advantageous portability factor. When participants leave a job under a defined contribution system, rather than roll the plan over, a significant portion choose to cash out, leaving them with no retirement savings. A Hewitt study of 200,000 people found that when leaving a job, 45% of people cash out their retirement plan.[58] As fewer people stay at the same job over a career, this tendency for workers to cash out accrued defined contribution savings not only deprives them of retirement savings, but costs them a significant amount of lost income to early withdrawal tax penalties. Under existing federal law, cashing out a defined contribution prior to retirement requires a taxpayer to pay income tax on the withdrawal along with a 10 percent penalty if that withdrawal occurs before the age of 59.5.

A retirees' financial security depends on all three legs of the retirement stool being adequate. A major portion of retirement income has to come from private retirement savings, something defined contribution systems have failed to generate.

VII. System Costs

Moving to a defined contribution system would not necessarily reduce the state's overall annual costs to the system. Depending on the plan, system costs include items such as required employer contributions, employer match, Social Security contributions and administrative fees. When the likely total costs of both defined benefit and defined contribution plans are compared, the data indicate that, far from generating savings, switching to a defined contribution plan would because of its higher costs and lower returns would only save money by drastically cutting retirement benefits.

1 Employer Match. Under a defined contribution plan, employers are not obligated to make contributions, however, the vast majority, 91 percent, offer a match.[59] The employer match consists of two components: the percentage of the employee contribution that the employer will match (the match rate); and the percentage of the employee's earnings on which the match will be provided (the match level). The most common employer match is 50 cents for each dollar contributed by the employee (the match rate) with the match ending when the employee contributions equal 6 percent of earnings (the match level).[60] Beyond 6 percent, plans often permit employees to make unmatched pre tax contributions up to the legislated limit. The median employee contribution is 6 percent of earnings and the median employer match is 3 percent of earnings.[61]

2. Social Security. Currently, only SERS, JRS, and GARS members are covered by Social Security. Those systems collectively constitute only 22% of active and retired members of all five systems. Though not mandatory, the state would most likely either contribute to Social Security for the other 78 percent of employees if it switched to a defined contribution plan, or make up the difference by increasing the state's defined contribution. The Social Security Administration requires both the employer and the employee to contribute 6.2 percent of salary.

[56] National Association of State Retirement Administrators, 2002.
[57] House Committee on Pensions and Investments, Texas House of Representatives, Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature, p. 26.
[58] Hewitt Associates, LLC. 2005.
[59] Munnel, Aicia and Annika Sundén. *Suspending the Employer 401(k) Match.* Boston College Center for Retirement Research, June 2003
[60] Ibid. "*This combination of match rate and match level is equal to an effective match of 3 percent of earnings.*"
[61] Munnel, Aicia and Annika Sundén. *Suspending the Employer 401(k) Match.* Boston College Center for Retirement Research, 2003.

3. Administrative Costs and Fees. While ultimately the state's portion of the defined contribution made to an employee's account is unclear and will be based on numerous factors, one cost point is very clear: switching to a defined contribution plan would impose greater administrative costs on the state and its taxpayers than maintaining the current defined benefit plan. According to the Investment Management Institute, the operating expense ratio for defined benefit plans averages 31 basis points (31 cents per $100 of assets); the average for defined contribution plans is three to six times higher at 96 to 175 basis points.[62] To put that in context of the Illinois pension systems, the administrative costs of a defined contribution system would in all likelihood be anywhere from $275 million to $610 million more expensive annually than the state's current defined benefit systems. In addition, a defined contribution plan must not only be designed and implemented, but separate administrative and bookkeeping systems must be established for the two different plans, further increasing costs to taxpayers.

Defined contribution plans also levy investment fees against each employee's account, reducing the corresponding investment return. Depending on the type of investment fund, fees can be as high as 0.56 percent of plan assets.[63] The United States Government Accountability Office warned "…participants should consider when investing in a 401(k) plan because fees can significantly decrease retirement savings over the course of a career."[64]

In the mid 1960's, when Nebraska switched from a defined benefit to a defined contribution plan for state and county government employees, one major disadvantage the state noticed was the higher administrative costs of the defined contribution system. Nebraska found that, when compared to their defined benefit plan, the state spent significantly more in investment management fees, record-keeping fees, educational programs and material on the defined contribution plan. As a matter of fact, in 1999, Nebraska's expenses for its defined contribution plans were double the costs of its defined benefit plans,[65] as were administrative costs.

The Illinois Municipal Retirement Fund (IMRF), has reviewed the differences in administrative costs if it moved to a defined contribution from a defined benefit system. It found that the switch would cost the IMRF $250 million extra *annually*.[66] Currently, IMRF pays $65 million per year for all administrative and investment expenses. If it switched to a defined contribution system, those expenses would increase to $315 million. The IMRF decided, "…conversions to DC plans will not magically solve the budget constraints of local government and can not guarantee a financially secure retirement for employees."[67]

VIII. Attracting A Quality Workforce

Providing decent pension benefits is a proven technique for attracting quality employees.[68] Since the public sector generally does not pay salaries competitive with the private sector for similar levels of credentials,[69] a defined benefit plan is an effective tool for recruiting and retaining high quality civil servants, many of whom are in typically lower payer but vital and high risk jobs. These workers fight fires, protect our streets, educate our children, and provide medical care. Certainly, it is in the public interest to attract workers with a high level of skill to fill these and other positions. This is an especially

[62] Sean Collins, *The Expenses of Defined Benefit Pension Plans and Mutual Funds*, December 2003.
[63] Council of Institutional Investors. *Protecting the Nest Egg: A Primer on Defined Benefit and Defined Contribution Retirement Plans.*
[64] United States Government Accountability Office, Private Pensions: *Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better information on Fees.* November, 2006.
[65] House Committee on Pensions and Investments, Texas House of Representatives, Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature, p. 27.
[66] Louis W. Kosiba, IMRF General Counsel, Illinois Municipal Retirement Fund, The Defined Benefit vs. Defined Contribution Debate.1999.
[67] Ibid.
[68] Anderson, G.W. & Brainard, K. Profitable Prudence, *The Case for Public Employee Defined Benefit Plans.* Pension Research Council at the University of Pennsylvania Wharton School of Business.
[69] Morsch, Laura *Government Salaries vs. Private Sector Salaries.* Career Builder.Com October 11, 2006.

important recruitment advantage now, as the private sector has been scaling back retirement benefits over the last 15 years, especially in Illinois.[70]

Demographic changes, particularly the aging of the workforce, are making pension benefits an even more crucial tool for the public sector to attract quality workers than in the past. Deloitte Consulting ("Deloitte") identified significant workforce shortages that will materialize in the labor market due to the aging population. Deloitte found that, because more than 10,000 baby boomers are now turning 55 years old every day, for the first time in history, the number of workers entering the labor market will not replace those that are leaving.[71] Deloitte also projects that the number of workers aged 25 to 34 will shrink by almost 9 percent from 2006 to 2016, leading to a total labor shortage of 10 million by 2010, and 35 million by 2030.[72] Changing to a defined contribution pension system of private accounts – with lower, unstable retirement income – will diminish the public sector's ability to attract and retain a solid workforce that serves our taxpayers, especially for high risk, stressful and essential positions.

IX. Conclusion

The data are clear: switching to a defined contribution system will not reduce Illinois' $40.7 million pension debt, and in all likelihood would result in a pension system that has higher administrative costs for taxpayers to pay, with significantly lower and less secure retirement benefits for public employees. Fully funding the state's current defined benefit program, however, would not only provide a greater retirement benefit to workers, but would also reduce long-term costs for taxpayers, as increased investment returns drive down the amount of normal cost that has to be paid from taxpayer dollars.

Moreover, no true long-term savings to the state's budget can be anticipated from a decision to reduce significantly the benefits paid to public employees. That is because the state ultimately has the responsibility to ensure seniors can sustain themselves in retirement. It would be questionable public policy indeed to reduce public employee retirement benefits, while incurring taxpayer funded expenses to supplement income, housing, energy and other needs of retired workers, who receive insufficient pension income on which to live.

When fully funded, defined benefit plans offer the most advantages for both taxpayers and employees of the state of Illinois alike.

[70] http://www.forbes.com/business/2005/06/10/pension-oxford-retirement-cz_0610oxford_pension.html
[71] Deloitte Consulting, LLP, *The Impending Pension and Health Plan Crisis and the Impact of the Aging Workforce and Talent Management*.
[72] Ibid.