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EXAMINING THE RETIREMENT SECURITY OF STATE AND LOCAL GOVERNMENT EMPLOYEES

FIELD HEARING

BEFORE THE

SUBCOMMITTEE ON EMPLOYER–EMPLOYEE RELATIONS

OF THE

COMMITTEE ON EDUCATION AND THE WORKFORCE
U.S. HOUSE OF REPRESENTATIVES

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EXAMINING THE RETIREMENT SECURITY OF STATE AND LOCAL GOVERNMENT EMPLOYEES

Wednesday, August 30, 2006
U.S. House of Representatives
Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
Washington, DC

The subcommittee met, pursuant to call, at 11:05 a.m., in room 400, Illinois State Capitol, Springfield, Illinois, Hon. John Kline [Vice-Chairman of the Subcommittee] presiding.

Present: Representatives Kline and Biggert.

Staff Present: James A. Paretti, Jr., Workforce Policy Counsel; Steven Perrotta, Professional Staff Member; Steve Forde, Communications Director and Michele Varnhagen, Minority Senior Benefits Counsel.

Mr. KLINE. Good morning. A quorum being present, the Subcommittee on Employer-Employee Relations of the Committee on Education and the Workforce will come to order.

We are meeting today to hear testimony on Examining the Retirement Security of State and Local Government Employees. I ask unanimous consent for the hearing record to remain open for 14 days to allow members' statements and other extraneous material referenced during the hearing to be submitted to the official hearing record. And I have a note that some organizations have already submitted statements and they will be included in the record.

Without objection, so ordered.

Let me say greetings from the great state of Minnesota. I flew in this morning and it is a pleasure to be here and be in the land of Lincoln and be in this absolutely beautiful Capitol, and a pleasure of course being with my colleague Mrs. Biggert, who served here and who gave me a little tour. It is absolutely terrific, and you should be very proud of it.

Today's hearing will begin an examination of the retirement security of state and local government employees, but before we start, I think some background is in order.

Earlier this month, President Bush signed into law the Pension Protection Act, the most comprehensive reform of the laws governing our nation's private sector pension plans. Just a side note, I had the great pleasure of going to Washington and being there for that signing ceremony and I can tell you there was great joy in the room when that was signed. This bill was overwhelmingly approved on a bipartisan basis by both houses of Congress and rep-

resents a culmination of years of examination and study by this Committee, among others.

Why was the Pension Protection Act necessary? Simply put, it was needed to ensure that workers receive the pension benefits that they have been promised and that they have relied upon. It was needed to ensure that businesses have clarity and certainty as to their pension obligations so that they can budget and plan accordingly. And it was needed to ensure that ultimately taxpayers, through Federal pension guarantees, are not left holding the bag for billions of dollars of pension bailout. The Pension Protection Act takes important steps, some in the near term, others in the longer term, to ensure that the retirement security of private sector workers receiving pensions is guaranteed. The bill does so by adopting tough new funding standards that employers will have to meet to make sure that plans are sufficiently funded with real dollars. It requires plans to use actuarial assumptions that accurately reflect the performance of plans and the marketplace. It targets and adopts tougher standards for those plans whose funding levels indicate that they are at the highest risk. And it does so by following a simple rule. When you are in a hole, stop digging.

The Pension Protection Act prohibits plans from increasing or expanding benefits when the plan is already under-funded and at risk. That's simple common sense and something I expect anyone in this room who has ever had to follow a budget for a company or a school or a household understands all too well.

So what has that got to do with our hearing this morning? As most who have had the good fortune—and I use the term "fortune" advisedly—to dig into the policy of pension regulation knows, pension plans in the private sector are governed by the Employee Retirement Income Security Act, the Federal law known as ERISA.

Now certain plans, notably plans sponsored by states or localities or municipal governments are exempted from ERISA's coverage. Those plans instead are governed by local and state pension laws. One of the questions before us today is does that exemption make sense and are state and local government regulations enough to protect public employees' pensions.

Within the last few months, we have seen more and more reports that states and municipalities are facing the same crises that private employers face with their pension plans—increased benefits, more liabilities and an expanding gap in the funding to pay for them. Across the country, from Texas to California to New Jersey and right here in Illinois, we are seeing on an almost weekly basis reports that the retirement security of some state and local workers may not be as secure as we would hope. The facts speak for themselves. According to the U.S. Census Bureau, major public pension programs paid out $78.5 billion in the 12 months that ended September 2000. By the same period in 2004, pension payouts had grown by 50 percent to $118 billion.

State and local governments currently employ 14 million people with an additional six million retirees. It is estimated that these workers and retirees are owed $2.37 trillion by more than 2000 different state and municipal government entities—$2.37 trillion is a lot to us even in Washington.

Published government estimates suggest that the largest state and local pension funds faced a funding gap of $278 billion in 2003. An analysis by Barclay's Global Investors places the gap at closer to $700 billion. Even those that dispute Barclay's number recognize that the potential under-funding we are talking about is in the hundreds of billions of dollars. Most recently, in March of this year, Wilshire Consulting, based in Santa Monica, California, which has been tracking the funding levels and performance of public pension funds for over a decade, reported that state and local pension systems are only 85 percent funded in the aggregate, down from 103 percent in 2000.

Indeed, we are here today because the State of Illinois has the dubious distinction of having its public pension plans ranked among the most under-funded in the nation. Let me be clear, we are not here today to announce that the Federal Government wants to be or should be in the business of regulating state and local pension plans. Nor are we here to scare public sector employees or suggest that their benefits are at risk today. But whether it's today or years in the future, the looming crisis in public pension underfunding is real. And without action on some level, will not go away.

We all have an interest in ensuring that every worker ultimately receives the pension benefits which they were guaranteed. Congress took bold and decisive action to protect the welfare of private sector workers and retirees. Surely public sector employees deserve no less.

The purpose of today's hearing is to begin to understand the scope of the issue facing us, to ask questions, to listen and to learn. It is not to come to the table with preformed ideas or prejudged solutions.

The panel before us represents some of the leading scholars and advocates involved in this issue, and I look forward to their testimony.

Before I introduce the witnesses, without objection, I will recognize my colleague and good friend Mrs. Biggert for her opening statement.

[The prepared statement of Mr. Kline follows:]

Prepared Statement of Hon. John Kline, Vice Chairman, Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce

Good morning. Today's hearing will begin an examination of the retirement security of state and local government employees. But before we start, I think some background is in order.

Earlier this month, President Bush signed into law the Pension Protection Act, the most comprehensive reform of the laws governing our nation's private-sector pension plans. This bill was overwhelmingly approved on a bipartisan basis by both houses of Congress, and represents the culmination of years of examination and study by this committee among others.

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funded, with real dollars. It requires plans to use actuarial assumptions that accurately reflect the performance of plans, and the marketplace. It targets and adopts tougher standards for those plans whose funding levels indicate that they are the highest risk. And it does so by following a simple rule: when you're in a hole, stop digging. The Pension Protection Act prohibits plans from increasing or expanding benefits when the plan is already under funded and at risk. That's simple common sense, and something I expect anyone in this room who's ever had to follow a budget—for a company, or a school, or for a household—understands all too well.

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As most who have had the good fortune—and I use the term fortune advisedly—to dig into the policy of pension regulation know, pension plans in the private sector are governed by the Employee Retirement Income Security Act—the federal law known as ERISA. Now, certain plans—notably, plans sponsored by states, or localities, or municipal governments—are exempted from ERISA's coverage. Those plans instead are governed by local and state pension laws. One of the questions before us today is, does that exemption make sense, and are state and local government regulations enough to protect public-employees' pensions?

Within the last few months, we've seen more and more reports that states and municipalities are facing the same crises that private employers faced with their pension plans: increased benefits, more liabilities, and an expanding gap in the funding to pay for them. Across the country, from Texas, to California, to New Jersey, and right here in Illinois, we are seeing on an almost weekly basis reports that the retirement security of some state and local workers may not be as secure as we would hope. The facts speak for themselves:

• According to the U.S. Census Bureau, major public pension programs paid out $78.5 billion in the 12 months that ended in September 2000. By the same period in 2004, pension payouts had grown by 50 percent to $118 billion.

• State and local governments currently employ 14 million people, with an additional 6 million retirees. It is estimated that these workers and retirees are owed $2.37 trillion by more than 2000 different state and municipal government entities.

• Published government estimates suggest that the largest state and local pension funds faced a funding gap of $278 billion in 2003. An analysis by Barclays Global Investors places the gap at closer to $700 billion. Even those that dispute Barclays' number recognize that the potential under funding we are talking about is in the hundreds of billions of dollars.

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Let me be clear: we are not here today to announce that the federal governments wants to be, or should be, in the business of regulating state and local pension plans. Nor are we here to scare public-sector employees or suggest that their benefits are at risk today. But whether it's today or years in the future, the looming crisis in public pension under funding is real—and without action, on some level, will not go away.

We all have an interest in ensuring that every worker ultimately receives the pension benefits which they were guaranteed. Congress took bold and decisive action to protect the welfare of private-sector workers and retirees. Surely public-sector employees deserve no less. The purpose of today's hearing is to begin to understand the scope of the issue facing us—to ask questions, to listen, and to learn. It is not to come to the table with pre-formed ideas or pre-judged solution. The panel before us represents some of the leading scholars and advocates involved in this issue, and I look forward to their testimony.

Ms. BIGGERT. Thank you, Mr. Kline, and thank you for chairing this important and timely hearing, and welcome to Illinois.

For several years, you and I have joined colleagues from both parties in a series of Education and Workforce Committee hearings to lay the foundation for the Pension Protection Act that President Bush recently signed into law. During that series of hearings, we spoke with dozens of witnesses and examined a wide array of information that pointed to a private pension system in turmoil. We

heard stories of employers and unions making pension promises they knew they could not keep. We learned that today's outdated Federal pension laws do not reflect the reality of today's economy. And we were told that without real reform to fix outdated Federal pension laws, more companies would default on their worker pension plans, increasing the likelihood of a massive taxpayer bailout of the Pension Benefits Guarantee Corporation, which is the Federal body charged with ensuring private pension plans. And so we acted.

Today, we convene this hearing to focus and to discuss the health of our public pension system. I'm afraid the symptoms we are examining do not look much different than those of our nation's traditional private plans. According to a Wall Street Journal article published last week, the California firm, Wilshire Consulting, reported that our nation's state and local pension systems are only 85 percent funded, down from 103 percent in the year 2000. Moreover, four of every five public pension plans are currently under-funded and as you noted, the total amount of under-funding nationwide is in the hundreds of billions of dollars.

I am troubled to say that my home State of Illinois manages a plan for its workers and retirees that is under-funded by $38 billion, making it the worst funded state pension plan in the nation.

This concerns me for two key reasons. First, I represent workers and retirees who depend on the state pension plan. Do these public servants not deserve the same pension plan assurances as those who work for private employers? Reneging on pension promises to retirees is one of the most shameful and reprehensible practices, whether it is by a public employer or a private employer.

Second, legitimate concerns were raised about a potential taxpayer bailout of the Federal agency that insures the private pension system. And I believe the recently enacted Pension Protection Act will go a long way toward calming those fears.

But similar concerns can and should be raised, arguably with a greater sense of urgency, because taxpayers dollars not only could be used to bailout a collapsed public pension plan, but they also serve as the primary funding source for state and local pensions.

It is no surprise that the Wall Street Journal has been joined by other newspapers across the country in focusing on this escalating crisis and searching for both its causes and its potential solutions. That search brings us today to Springfield, inside the Capitol building, where decisions have been and will continue to be made about the future of our state pension system.

Before we begin, let me be clear, as a former member of our General Assembly, I am sensitive to the fact that the Federal Government does not and should not reach its hands into state government matters. I would not take part in a committee activity that would advocate otherwise. However, I believe that public officials at all levels have responsibilities when it comes to taxes paid and nest eggs expected by those they represent. The public pension crisis is one that is national in scope, so much so that two prominent U.S. Senators, one a Republican and one a Democrat, have requested an official Federal study of this very issue. And it is one that deserves a much closer look, not just by our nation's news-

papers and state and local governments, but by both parties in both houses of Congress as well.

This is precisely why we are here today, to listen and to learn. I thank the witnesses who have joined us and agreed to testify today, and I look forward to discussing this important matter with them.

Thank you again, Mr. Kline, for chairing this hearing and I yield back.

Mr. KLINE. Thank you, Mrs. Biggert. I should say that I am here because the Chairman of this Subcommittee is recovering from surgery and, of course, we wish him well.

We have today a really distinguished panel, and I am excited to hear from them. I would like to sort of briefly introduce all of them to everyone in the room and then we will start down the line.

We have Dr. Fred Giertz, a Professor in the University of Illinois at Urbana-Champaign Department of Economics. He has been on the faculty of the Institute of Government and Public Affairs at the University of Illinois since 1980.

Mr. Keith Brainard serves as Research Director for the National Association of State Retirement Administrators, for which he collects, prepares, distributes studies and reports pertinent to public retirement system administration and policy.

Ms. Irene Jinks is the President of the Illinois Retired Teachers' Association. Ms. Jinks taught mathematics for 34 years in Skokie, Illinois and served on the Board of Education of Parkridge-Niles.

Mr. John Filan is Director of the Governor's Office of Management and Budget. Mr. Filan previously served in state government as a department cabinet officer and is a member of the Governor's staff for Central Management, Employment Security and State Pension Agencies.

Ms. Joanna Webb-Gauvin serves as the Director of Retiree Programs for Council 31 of the American Federation of State, County and Municipal Employees. Prior to her current position, she spent 2 years with the Illinois Attorney General's Office assisting the policy advisor on senior issues.

Mr. Lance Weiss is a Senior Analyst for Deloitte Consulting, LLP in Chicago. He has over 30 years of experience in employee benefits and retirement planning with special emphasis on the design, funding, security, administration and implementation of retirement programs.

Before the panel begins, I would ask that each of our witnesses today please try to limit your oral statements to 5 minutes. Your entire written testimony will be included in the official hearing record. So you can feel free to summarize.

In Washington, we have a light system which would alert you to the dwindling time. We do not have such a system here and I am reluctant to interrupt, but if it looks like it's going to go too long, I may have to do that. Please try to limit your statements to 5 minutes.

And we will start, if everybody is ready, with Dr. Giertz. Sir, you are recognized.

STATEMENT OF J. FRED GIERTZ, PROFESSOR, INSTITUTE OF GOVERNMENT AND PUBLIC AFFAIRS, UNIVERSITY OF ILLINOIS

Dr. GIERTZ. Thank you very much. I am really pleased to be here and hope I can make a contribution to the issue.

First of all, I am from the University of Illinois and my specialty is in state and local government finance, I am an economist dealing with budget issues, but equally importantly I served 10 years on the State University's Retirement System Board of Directors and several years as Chair of the Investment Committee, so I have first hand knowledge of pension systems.

Most of what I will be talking about here today is Illinois-specific and also state specific, not too much about local governments, and a lot about Illinois. But I think a lot of things about Illinois have general applicability.

If there is any good news—I am not sure whether it is good news or bad news—but our problem, and Illinois and the state and local pension systems in the country's have a problem, but that problem pales in comparison to the looming Social Security-Medicare-Medicaid problems. So put in perspective, this is a serious issue, but we have a number of other retirement issues on the horizon that are probably of a magnitude larger than this, so that is something that I think we need to address first of all.

So I am going to suggest today that the pension problem, the pension funding problem, the security problem, is really a twofold problem. It is a problem for state and local workers, retirees, participants, but it is equally severe a problem for taxpayers. This is a dual problem. It is a problem for the participants in the system, it is also a serious problem for taxpayers who in the long run will have to deal with this issue in equal measure.

To talk a little bit about history, the under-funding in Illinois is not an accident. It came about largely because we chose not to fund at the full actuarial cost of the systems as these accrued over the years. This is not an oversight, it was not neglect, it was explicit policy. It was easier to spend money for other things, to not raise taxes, to give raises to a whole host of things rather than set aside money for the pension system. And this is not the last 5 years, 10 years, it goes back decades.

In 1995, the State of Illinois recognized that this was a problem that had become a serious one and was basically out of control, and we set to right ourselves with a multi-decade program to try to get back in balance again. The first 10 years, unfortunately, did not involve a lot of pain, it was more sort of ramping up, getting ready for the serious problem to come in the future. And so the first 10 years, we stayed within the plan guidelines. But 2005 came, the hurdle moved up in size, the contribution the State was supposed to make increased, and we blinked. We changed our plan and did not fulfill the obligation that we chose in 1995 and basically made a new plan starting in 2005 with, again, not very much pain in the early stages and most of the pain pushed back into the later years. So neither the 1995 nor the 2005 changes really righted our—we are going to have to have huge increases in funding obligations in the State of Illinois in just a very few years in the future, obliga-

tions that cannot be met within the framework of our current budget.

We did make some adjustments, we did make some changes in the pension obligations and the payments to future retirees, but we actually, after even 1 year, we went back and changed some of the ways that we were going to save money. For example, we were going to save money by limiting end-of-career salary increases. That only lasted 1 year, that has been modified now. So we still face this very, very large problem, a problem that is not really able to be addressed in the framework of our present budget.

Now the State of Illinois has in its Constitution something called a non-impairment clause. A non-impairment clause basically guarantees the benefits that have been earned to government employees. So that is why I said it is both a taxpayer problem and an employee problem, because most of the pain eventually is going to be felt not necessarily by the people who are retiring, like me, but will be felt by the taxpayers that have to pay the bill for this.

Now I do not have any—one last thing. There is in fact a suggestion abroad that somehow the pensions have gone out of control because of generous extension of benefits, all kinds of changes being made to the benefit of workers. Now there have been a few of those, but most of the changes in the benefits have been a quid pro quo, where there has been some kind of decrease in, for example, 1 year people had to forego a salary increase and the State contributed more to pensions. Another time there was an increase in the cost of healthcare to employees and the State increased pension payments. So the pattern was take back something that you save money today from, but then increase pension benefits sometime in the future. You do not have to pay today, you may have to pay years in the future. So most of the problem is from under-funding, it is not from a lavish extension of benefits to the workers.

Now I am not in a position to talk about solutions. Let me just summarize now.

Douglas Holtz-Eakin was the head of the Congressional Budget Office in Washington, he just stepped down 6 months ago or so. He was asked about what can you do about the Social Security, Medicaid, Medicare problem and he said "This is a really serious problem, but I know that we will address it eventually because we have to address it." There is a famous statement by Herbert Stein, who used to be a Council of Economic Advisors member, he said "Some things cannot go on forever and eventually will end." Well, obviously this cannot go on forever, it eventually has to be solved. The question is how do we solve it. Do we solve it in an effective way or do we solve it in a less-than-effective way? And Holtz-Eakin had two suggestions; one is that any kind of solution has to entail pain, there is no painless way of dealing with this. We cannot insulate taxpayers from pain, we cannot insulate necessarily future workers from pain. So pain has to be part of the equation. The second suggestion he gave was that you have to have all options on the table. You cannot say we are going to solve this problem, but we cannot possibly raise taxes, we cannot possibly do this, we cannot possibly do that. We need to have all options open and then we have to address the issue.

So that is basically my suggestion, no specifics, but this issue has to be addressed, it will be addressed and our challenge is to do it in an effective way.

Thank you.

Mr. KLINE. Thank you, sir. I think right on time. The timekeeper is here. So thank you very much, that was a good job.

Now, Mr. Brainard.

[The prepared statement of Dr. Giertz follows:]

Prepared Statement of J. Fred Giertz, Professor, Institute of Government and Public Affairs, University of Illinois

The State of Illinois' pension systems are among the most seriously underfunded in the nation. This underfunding is the result of decades of neglect where decisions were made to use available funds for purposes other than pensions. The so-called pension problem should be viewed as a more general state budget problem that manifests itself in high pension costs because the state's pension systems have been used in the past to mask more basic budget issues. This problem continues to this day where the state faces huge increases in pension funding costs in the upcoming years to address past underfunding problems. The problem is one of taxpayer "security" as well as retirement "security" for state employees.

On many occasions in the last several decades, maneuvers involving the state's pensions systems have been used to avoid painful political choices of either raising taxes or cutting state programs. The heart of the current pension problem is the long-term underfunding of the state's pension systems where funds that should have gone for pensions have been used for other state programs. Each year, actuaries for the pension systems calculate the normal costs of the systems-the increased liabilities for promised future benefits created in that year. If the contributions of the state and the employees equal this normal cost, the pension systems will remain fully funded, assuming the actuarial assumptions are met.

From their inception, the state has almost always chosen to fund pensions at less than their normal cost, thus creating unfunded liabilities that have to be made up in the future. This was done explicitly during the austere budget days of the 1980s when the state chose to direct the available state resources to other state programs and underfund the pensions. This was not an oversight, but a conscious policy decision. A case can be made to underfund pensions during lean times with the shortfall made up during the good years. In Illinois' case, every year was a lean year and the shortfalls were never made up.

Unfortunately for the state, the underfunding was not invested in the portfolios of the pension systems and therefore missed out on the phenomenal growth in the financial markets from the early 1980s through the end of the century. Simulations for the State Universities Retirement System indicate that had the state made its required contributions along with the contribution mandated for employees (which were made), the system would be fully funded at the end of fiscal 2004 with assets at nearly 110 percent of accrued liabilities even after the decline of the stock market after 2000 and the state would only have to contribute its share of the normal pension costs in the future-a fraction of the costs they now face.

In 1995, the state of Illinois realized the seriousness of the underfunding problem and set out on a course to correct it. It is safe to say the state did not act precipitously in this regard. In fact, the state adopted a 50-year plan to bring the various pension systems up to a modest goal of 90 percent of full funding. Not only did the plan stretch the catch-up over half a century, it delayed any real catching up for a decade. The period from 1995 to 2005 was labeled a ramp phase in which the state still contributed less that the normal pension costs with the serious business of making up the short fall deferred 10 years (to 2005). Note that if the state had dealt with its past budget problems by issuing bonds in the credit market rather than by underfunding pensions, the state would now have a bond repayment problem, not a pension problem. In such a case, would the appropriate policy be to default on the bonds?

Since the pension funding reform in 1995, it is alleged that the pensions systems have provided generous benefit increases and early retirement options. In one sense, there is an element of truth in these statements, but these changes have, for the most part, been instigated by the state in order to save money in other programs. For example, there was an increase in the retirement benefit formula for those retiring under defined benefit plans approved in 1997. However, the increased benefits came at a cost. As a kind of quid pro quo, the state eliminated a costly program

that paid state employees for a portion of their unused sick leave at retirement while also tightening the eligibility requirements for state-subsidized medical insurance for retirees. The state captured the savings in the form of lower general fund spending while the costs were borne by increases in the unfunded liability of the pension system.

In another case, certain state workers gave up a scheduled pay increase in return for the state picking up a larger portion of their retirement contributions. Here again, the state saved the forgone wage costs while the burden was placed on the retirement systems.

Finally, early retirement programs, that have become common in recent years, are portrayed as costly benefits for young retirees. While a strong case can be made for limiting early retirements and possibly raising the retirement age, most early retirement programs were designed to help the state and school districts by moving older workers out of their jobs and into retirement. Again the state and the schools capture the benefits of lower wage costs while the pension systems bear the burden of increased underfunding. It is interesting to note that when officials bemoan the increased underfunding of the pension systems from early retirements, they seldom mention the offsetting savings resulting from the early retirements.

The state is severely limited in its ability to reduce the currently-accrued pension liabilities by Article XII, Section 5 of the State Constitution. The so-called non-impairment clause states:

"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."

The article constrains the ability of the state to directly reduce current pension liabilities and protects current employees and retirees from pension reductions. However, it does not protect state taxpayers or future employees from the consequences of this problem.

As noted above, the state has a budget imbalance problem, not just a pension problem, even though pension costs have come to play an important role in both the problem and its solution. The problem is a serious one and the solutions are not easy. The solutions require a comprehensive review of state expenditures and revenues. Focusing narrowly on pensions will lead to inferior solutions to the state's underlying budget problem. Soon, the state of Illinois must face the prospect either making large and painful cuts in major state programs (not just cuts in pension benefits decades in the future) or finding additional permanent revenue sources to fund its activities.

The 1995 legislation has not solved Illinois pension problem. In 2005 in response to a serious budget shortfall and a reluctance to raise state taxes or make expenditure cuts, the Illinois General Assembly and the governor targeted the state's pension system to free up revenue by reducing funding for the fiscal years 2006 and 2007 by an estimated $2.3 billion. The plan reduced pension benefits for new employees that will reduce funding requirements many years in the future, but booked the expected savings immediately. This increased the underfunding of the state pensions systems at a time when the state pension systems are already the most poorly funded in the nation. In essence, the state is borrowing money from the pension systems which will have to be repaid in future years at an expected implicit interest rate of over 8 percent-the expected return on the pension fund investments in future years. This resulted in large scheduled increases in state pension cost over the next several years.

(NOTE: *This testimony is based on material produced by the presenter over the last several years.)*

STATEMENT OF KEITH BRAINARD, RESEARCH DIRECTOR, NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS

Mr. BRAINARD. Chairman Kline, Representative Biggert, thank you for the opportunity to appear before you today.

Broadly speaking, I believe the retirement security of the nation's state and local government employees and retirees, particularly compared with other groups, is strong. This strength is a result of the system that features pre-funded defined benefit plans; reasonable costs that are shared by public employees, employers

and investment earnings; flexible plan designs that accommodate the objectives of relevant stakeholders; voluntary defined contribution plans that supplement defined benefit plans; exemption from most Federal regulation, allowing cities and states to design, administer and finance retirement benefits in concert with the unique needs of each pension plan sponsor and within the framework of each state's constitution, statutes, case law and political culture; and finally, state protections of pension benefits, many of which predate and exceed Federal regulations of pension benefits among private employers.

Sixteen million Americans, more than 10 percent of the nation's workforce, are employed by a state or local government. These are public school teachers, administrators and support personnel, firefighters, public health officials, correctional officers, judges, police officers, child protective service agents and myriad other professionals responsible for performing a broad array of essential public services. Ninety percent of these workers have a defined benefit plan or traditional pension as their primary retirement benefit, a figure that stands in increasing contrast to the diminishing portion of the nation's private sector workforce with access to a traditional pension. This pension coverage makes a significant and cost-effective contribution to the retirement security of not only these public employees, but also to the Nation as a whole.

Pension plans for the vast majority of state and local government employees are in reasonably good condition. Based on the latest available data, pubic pensions have approximately $2.8 trillion in assets to fund more than 86 percent of the next 30 years of pension liabilities they have incurred. Based on my own projections, this figure will begin rising again in fiscal year 2006 and for the foreseeable future. Absent an extreme downturn in investment markets, 86 percent is likely to be the low point for the aggregate public pension funding level.

There is nothing inherently flawed about defined benefit plans for public employees that makes them risky or expensive to taxpayers, and cities and states that have properly funded their pension plans and managed their liabilities generally are in good condition.

I want to take just a moment to explain the meaning of underfunding in the context of a public pension plan. Most pension benefits for public employees are pre-funded, meaning that all or most of the assets needed to fund pension liabilities are accumulated during an employee's working life, then paid out in the form of retirement benefits. Pre-funding is one way of financing a pension benefit, and it enables a large portion of the benefit to be paid with investment earnings rather than contributions from employees and employers. All else held equal, a fully funded pension plan is better than one that is poorly funded, but a plan's funded status is simply a snapshot of what is happening at a particular point in time in an ongoing pre-funding process. It is a single frame, if you will, of a movie that spans decades. There is nothing magic about a pension plan being fully funded. And even with no changes to funding policies or plan design, most under-funded pension plans will be able to pay promised benefits for decades. Pension liabilities typically extend years into the future, and it is during this time that

a pension fund can accumulate the assets it needs to pay its future liabilities.

The critical factor in assessing the current and future health of a pension plan is not so much the plan's actuarial funding level, as whether or not funding the plan's liabilities creates fiscal stress to the plan sponsor.

Under-funding is a matter of degree, not of kind. Many pension plans remain under-funded for decades with no deleterious consequences. The status of a plan whose funding level declines from 101 percent in year one to 99 percent in year two has changed from over-funded to under-funded. Although the nomenclature describing the plan's funding condition has changed diametrically, the financial reality of its funding condition has changed little. Fully funded and under-funded plans both continue to require contributions and investment earnings.

As mentioned previously, public pensions as a group have accumulated assets equal to approximately 86 percent of their liabilities, a figure I project will begin to rise in the coming months as more of the investment earnings generated since March 2003 are incorporated into public funds' actuarial calculations. In my view, the fact that public pension funds have accumulated as much of their liabilities as they have deserves praise, not condemnation. Whether one refers to the public pension funding glass as 86 percent full or 14 percent empty, the glass undeniably is mostly full.

This is not to suggest that there are not funding problems among some public pension plans—there are and they need to be addressed, but there is no national crisis and suggesting that a plan is in crisis simply because it is under-funded is to misunderstand the meaning of that term.

On a national basis, the cost to taxpayers of public pensions, both as a percentage of public employee payroll and of all state and local government spending, is lower today than during most of the last decade. On a national basis, employer or taxpayer pension costs for state and local government pensions are lower today than they were during the mid-1990's. In most cases, where employer costs have risen sharply, a major factor contributing to that rise is that the employer allowed its contribution rates to decline to very low levels.

For the 22 years from 1983 to 2004, three-fourths of all public pension revenue came from sources other than taxpayers. Unlike most corporate pension plans, most employees in the public sector are required to contribute to their pension plan. Five percent of pay is the median and most popular employee contribution rate.

In addition to promoting retirement security for public employees and the Nation as a whole, traditional pensions for state and local government employees offer other advantages that benefit all Americans relative to defined contribution or 401k plans. For example, traditional pensions strengthen the ability of public employers to attract and retain the personnel needed to perform essential public services. Taxpayers benefit from these plans because they promote worker retention and longevity, encouraging experienced and qualified workers to return the investment in training and experience that has been made in them by their public employers. Those who rely on public services—which includes all of us—enjoy

myriad benefits that emanate, directly or indirectly, from the provision of these services.

Americans also enjoy the economic benefits generated by traditional pension plans for public employees. The $2.8 trillion held by public pension funds is a key source of liquidity and stability for the nation's financial markets. Pension assets are real, invested in stocks, bonds, real estate, venture capital and other asset classes. Public pensions hold in trust approximate 10 percent of the nation's corporate equity and as institutional investors, these funds are an important source of long-term patient capital for the nation's publicly traded companies. Recent studies have found that public pension funds are significant sources of economic support and stimulus that reaches every city and town in the nation. Public pension funds are also a key source of financing for venture capital, which represents the seeds of the nation's future economic growth and productivity gains.

State and local governments take seriously their legal and civic responsibilities for paying promised benefits to their employees and retirees. Comprehensive state and local laws and significant public accountability and scrutiny provide rigorous and transparent regulation of public plans and have resulted in strong funding rules and levels. These safeguards often predate and exceed Federal laws for private sector pensions.

Additionally, public plans are backed by the full faith and credit of their sponsoring state and local governments. And public plan participants' accrued level of benefits and future accruals typically are protected by state constitutions, statutes or case law, which prohibit the elimination or diminution of retirement benefits. These constitutional and statutory protections provide far greater security than are provided to private sector pension plans under ERISA and the PBGC.

Although any group as large as the public pension community could benefit from some common sense reforms, a fair review will lead a reasonable person to conclude that (a) the model for providing retirement benefits for employees of state and local governments is working for all stakeholders; (b) pension benefits of working and retired public employees are safe and assured; and (c) the model used by state and local governments to provide employee retirement benefits contain elements worthy of imitation by other employer groups and segments of the economy.

Thank you.

Mr. KLINE. Thank you, Mr. Brainard.

Ms. Jinks, you are recognized.

[The prepared statement of Mr. Brainard follows:]

Prepared Statement of Keith Brainard, Research Director, National Association of State Retirement Administrators (NASRA)

Mr. Chairman, members of the Subcommittee, I want to thank you for the opportunity to speak to you today. The membership of the National Association of State Retirement Administrators (NASRA) and the National Council on Teacher Retirement (NCTR) administer State, territorial, local, university and statewide public pension systems that collectively hold over $2.1 trillion in trust for over 18 million public employees, retirees and their beneficiaries.

Broadly speaking, I believe the retirement security of the nation's state and local government employees and retirees, particularly when compared with other groups, is strong. This strength is the result of a system that features:

a) pre-funded defined benefit plans;

b) reasonable costs that are shared by public employees, employers, and investment earnings;

c) flexible plan designs that accommodate the objectives of relevant stakeholders, including public employers, taxpayers, those who rely on public services, and public employees;

d) voluntary defined contribution plans that supplement defined benefit plans;

e) exemption from most federal regulation, allowing cities and states to design, administer, and finance retirement benefits in concert with the unique needs of each pension plan sponsor and within each state's constitutions, statutes, case law, and political culture.

f) state protections of pension benefits, many of which pre-date and exceed federal regulations of pension benefits among private employers.

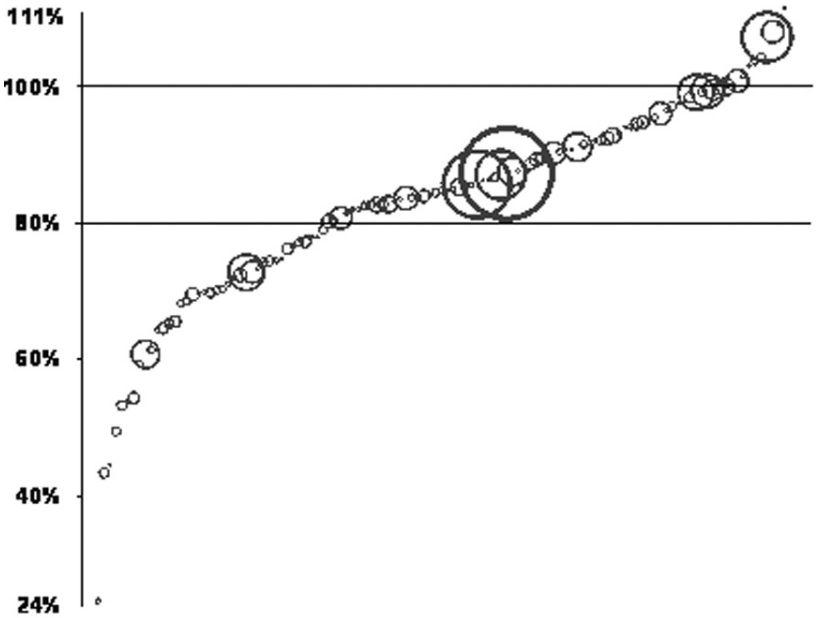
Sixteen million Americans—more than 10 percent of the nation's workforce—are employed by a state or local government. These are public school teachers, administrators, and support personnel; firefighters; public health officials; correctional officers; judges; police officers; transportation workers; child protective service agents; and myriad other professionals responsible for performing a broad array of essential public services.

Ninety percent of these workers have a defined benefit plan, or traditional pension, as their primary retirement benefit, a figure that stands in increasing contrast to the diminishing portion of the nation's private sector workforce with access to a traditional pension. This pension coverage makes a significant and cost-effective contribution to the retirement security of not only these public employees, but also to the nation as a whole.

Pension plans for the vast majority of state and local government employees are in reasonably good condition. Based on the latest available data, public pensions have approximately $2.18 trillion in assets to fund more than 86 percent of the next 30 years on pension liabilities they have incurred to-date. Based on my projections, this figure will begin rising again in FY 2006 and for the foreseeable future. Absent an extreme downturn in investment markets, 86 percent is likely to be the low point for the aggregate public pension funding level.

Figure 1. plots the current funding level of 117 public pension plans around the country. Combined, the plans depicted in this chart provide pension benefits for approximately 85 percent of all state and local government employees in the U.S. The size of the bubbles in the chart is roughly proportionate to the size of each plan. Larger bubbles indicate larger plans, and smaller plans are indicated by smaller bubbles. As the chart shows, most plans are funded above 80 percent, especially most of the larger plans.

FIGURE 1. CURRENT FUNDING LEVEL OF 117 STATE AND LOCAL PENSION PLANS



There is nothing inherently flawed about defined benefit plans for public employees that makes them risky or expensive to taxpayers, and cities and states that have properly funded their pension plans and managed their liabilities are generally in good actuarial condition.

I want to take a moment to explain the meaning of underfunding in the context of a public pension plan. Most pension benefits for public employees are pre-funded, meaning that all or most of the assets needed to fund pension liabilities are accumulated during an employee's working life, then paid out in the form of retirement benefits. Pre-funding is one way of financing a pension benefit, enabling a large portion of the benefit to be paid with investment earnings rather than contributions from employees and employers. All else held equal, a fully funded pension plan is better than one that is poorly funded, but a plan's funded status is simply a snapshot of what is happening at a particular point in time in an ongoing pre-funding process. It is a single frame, if you will, of a movie that spans decades. There is nothing magic about a pension plan being fully funded, and even with no changes to funding policies or plan design, most underfunded public pension plans will be able to pay promised benefits for decades. Pension liabilities typically extend years into the future, and it is during this time that a pension fund can accumulate the assets it needs to fund its future liabilities. The critical factor in assessing the current and future health of a pension plan is not so much the plan's actuarial funding level, as whether or not funding the plan's liabilities creates fiscal stress for the pension plan sponsor.

Underfunding is a matter of degree, not of kind. Many pension plans remain underfunded for decades with no deleterious consequences. The status of a plan whose funding level declines from 101 percent in year one to 99 percent in year two, has changed from overfunded to underfunded. Although the nomenclature describing the plan's funding condition has changed diametrically, the financial reality of its funding condition has changed little. Fully funded and underfunded plans both continue to require contributions and investment earnings.

As mentioned previously, public pensions as a group have accumulated assets equal to approximately 86 percent of their liabilities, a figure I project will begin rising in the coming months as more of the investment earnings generated since March 2003 are incorporated into public funds' actuarial calculations. In my view, the fact that public pension funds have accumulated as much of their liabilities as they have deserves praise, not condemnation. Whether one refers to the public pen-

sion funding glass as 86 percent full or 14 percent empty, the glass undeniably is mostly full.

This is not to suggest that there are not funding problems among some public pension plans. There are, and they need to be addressed. But there is no national crisis, and suggesting that a plan is in crisis simply because it is underfunded is to misunderstand the meaning of that term.

On a national basis, the cost to taxpayers of public pensions, both as a percentage of public employee payroll and of all state and local government spending, is lower today than during most of the last decade. As shown in Figure 2., on a national basis, employer (taxpayer) pension costs for state and local government pensions, are lower today than they were during the mid-1990's. In most cases where employer costs have risen sharply, a major factor contributing to the rise is that the employer allowed its contribution rates to decline to very low levels.

FIGURE 2. EMPLOYER (TAXPAYER) CONTRIBUTIONS TO STATE AND LOCAL GOVERNMENT PENSION PLANS AS A PERCENTAGE OF PAYROLL AND OF TOTAL STATE AND LOCAL GOVERNMENT SPENDING, 1995 TO 2004

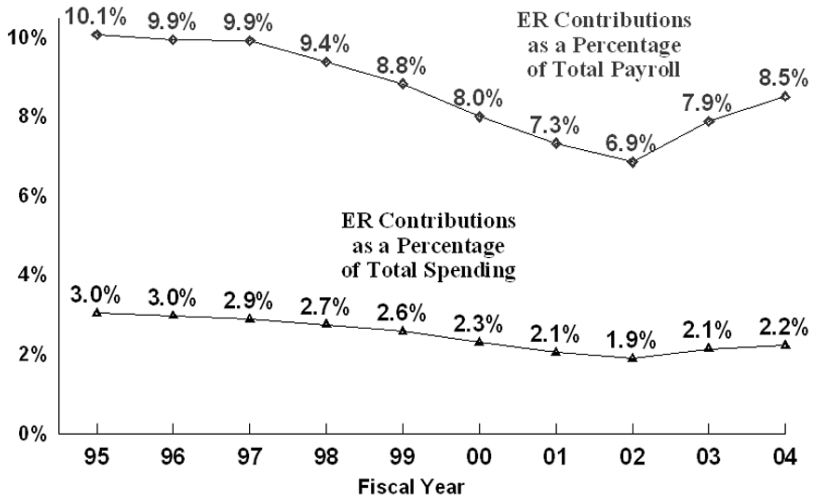
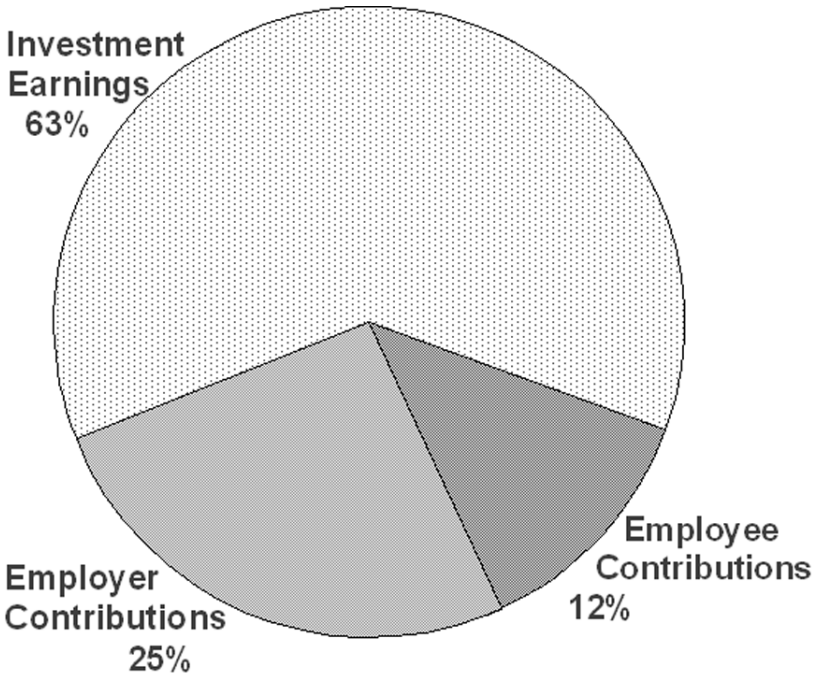


Figure 3 shows the three sources of public pension revenue for the 22-year period from 1983 to 2004 (these are the only years of this data available from the U.S. Census Bureau.) As the figure shows, three-fourths of all public pension revenue came from sources other than taxpayers. Unlike most corporate pension plans, most employees are required to contribute to their pension plan; five percent of pay is the median and most popular employee contribution rate.

FIGURE 3. SOURCES OF STATE AND LOCAL GOVERNMENT PENSION REVENUE, 1983-2004



In addition to promoting retirement security for public employees and the nation as a whole, traditional pensions for state and local government employees offer other advantages that benefit all Americans relative to defined contribution, or 401k, plans. For example, traditional pensions strengthen the ability of public employers to attract and retain the personnel needed to perform essential public services. Taxpayers benefit from these plans because they promote worker retention and longevity, encouraging experienced and qualified workers to return the investment in training and experience that has been made in them by their public employers. Those who rely on public services—which includes all of us—enjoy myriad benefits that emanate, directly or indirectly, from the provision of these services.

Americans also enjoy the economic benefits generated by traditional pension plans for public employees. The $2.8 trillion held by public pension funds is a key source of liquidity and stability for the nation's financial markets. Pension assets are real, invested in stocks, bonds, real estate, venture capital, and other asset classes. Public pensions hold in trust more than 10 percent of the nation's corporate equities, and, as institutional investors, public pension funds are an important source of long-term, patient capital for the nation's publicly-traded companies. Recent studies have found that public pension funds are significant sources of economic support and stimulus that reaches every city and town in the nation. Public pension funds are also a key source of financing for venture capital, which represents the seeds of the nation's future economic growth and productivity gains.

State and local governments take seriously their legal and civic responsibilities for paying promised benefits to their employees and retirees. Comprehensive state and local laws and significant public accountability and scrutiny, provide rigorous and transparent regulation of public plans and have resulted in strong funding rules and levels. These safeguards often pre-date and exceed federal laws for private sector pensions.

Additionally, public plans are backed by the full faith and credit of their sponsoring state and local governments, and public plan participants' accrued level of benefits and future accruals typically are protected by state constitutions, statutes, or case law, which prohibit the elimination or diminution of retirement benefits. These constitutional and statutory protections provide far greater security than are

provided to private sector pension plans under the Employee Retirement Income Security Act (ERISA) and the Pension Benefit Guaranty Corporation.

Although any group as large as the public pension community could benefit from some common sense reforms, on the whole, a fair review will lead a reasonable person to conclude that: a) the model for providing retirement benefits for employees of state and local governments is working for all stakeholders: public employers, taxpayers, recipients of public services, and public employees; b) pension benefits of working and retired public employees are safe and assured; and c) the model used by state and local governments to provide employee retirement benefits contains elements worthy of imitation by other employer groups and segments of the economy.

I am happy to respond to any questions you may have about public pension issues. Thank you.

STATEMENT OF IRENE JINKS, PRESIDENT, ILLINOIS RETIRED TEACHERS' ASSOCIATION

Ms. JINKS. Thank you for this opportunity to speak with you. I appreciate it very much. I am the President of the Illinois Retired Teachers Association, a 31,000 member grassroots organization representing retired educators who taught outside the city of Chicago, because we, of course have the state of Chicago as far as teachers are concerned, with their own pension system.

The Teacher Retirement System, which protects all of those who are downstate teachers, was created in 1939 to provide members with retirement, disability and survivor benefits. As of June 30 of 2005, there were over 155,000 active teacher-members, or educators and 82,575 members receiving benefits. On that date, the average monthly retirement annuity was $3043, but there are more than 1700 annuitants in Illinois who receive less than $1200 a month, many after a lifetime in education.

Funding for our pensions come from member contributions, school district contributions, investment income and the State of Illinois. Over the past 20 years, 21 percent of total TRS income has been from member contribution and 55 percent from investment income. Active educators are now required to contribute 9.4 percent of their creditable earnings each year, considerably more than you mentioned, Mr. Brainard.

Illinois is facing a pension fund crisis. In 1995, following years of the state's failure to adequately fund retirement systems, the General Assembly enacted a pension reform law designed to bring the state's pension to a 90 percent funded level by 2045. Until 2005, the state adhered to the funding schedule. Then, action by the General Assembly reduced funding of the state's pension system by over $2 billion over a 2-year period. The TRS portion of the under-funding is about $1 billion. Of course, IRTA opposed passage of this bill.

The Illinois Constitution guarantees pension benefits, but the Constitution is not inviolable. Illinois educators deserve more than just a promise that the system will be funded. Active teachers and school systems have upheld their responsibilities to pay into the system regularly. The State must do the same.

For most retired Illinois educators, the TRS pension is their only source of income. They do not receive Social Security and even if they have contributed to Social Security through other employment or would be eligible otherwise for a spousal pension, those payments are reduced or even eliminated under the Windfall Elimination Provision and the Government Pension Offset.

IRTA is concerned about present retirees, but also is concerned about the effect on current and future educators. Salaries in education are not high. And we do not have the benefits of profit sharing and bonuses of the private sector. To ensure that we attract the best teachers to our schools, we must protect the retirement system. We need to ensure that the plan to fund the system to 90 percent by 2045 is met. We know that with additional programs or increases, the State cannot meet its pension obligations. We fear that we will be faced with an attempt to change the current payment schedule or the current benefit formula, a change that could create a two-tiered benefit program, which we oppose.

Under-funding has required the Teacher Retirement System to sell assets to meet current obligations. These assets, as well as the interest they would have earned, are lost forever. Without assurance of an adequate pension, people will be less likely to remain in education long term.

I spent 37 years as a teacher and administrator, plus 8 years given as a school board member, so I have spent considerably more than half my lifetime in education. I do not regret 1 day of it, but I certainly hope that we do not find ourselves in a position where people teach for a couple of years and then move on to other things. We will have an inexperienced and much less dedicated cadre of teachers in our schools.

The State of Illinois must not forego its obligations. We retired educators have served our state and the youth of our state. We have fulfilled our obligation by paying into TRS. Illinois must do the same.

Thank you for this opportunity.

Mr. KLINE. Thank you, Ms. Jinks, for your testimony.

Mr. Filan, sir, the floor is yours.

[The prepared statement of Ms. Jinks follows:]

Prepared Statement of Irene Jinks, President, Illinois Retired Teachers Association

Good Morning, members of the Subcommittee on Employer-Employee Relations. My name is Irene Jinks and I am the President of the Illinois Retired Teachers Association (IRTA). I thank you for the opportunity to speak with you today on the important subject of the state's retirement security. The IRTA is a 31,000-member "grassroots" organization, which represents retired educators who taught outside of Chicago.

The General Assembly created the Teachers' Retirement System for the State of Illinois (TRS) in 1939. TRS provides its members with retirement, disability, and survivor benefits. As of June 30, 2005, there were 155,850 active members and 82,575 annuitants and beneficiaries receiving benefits. As of June 30, 2005 the average monthly retirement annuity was $3,043. In addition, there are over 1,700 members who gave most of their lives to education making less than $1,200 per month.

Funding for TRS benefits comes from member contribution, contributions by school districts, investment income and the State of Illinois. Over the past 30 years, 21% of the total income to TRS has been from members, 23% has been from employers, and 55% has been from investment income. Currently, active TRS members are required to contribute 9.4% of their creditable earnings each year towards their retirement.

Illinois is facing a pension fund crisis. In 1995, due to years of Illinois failing to fund its retirement systems adequately, the General Assembly passed a pension funding reform law, Public Act 88-593. The law is designed to bring the State's pension funds to a 90% funded ratio by 2045 by requiring that the state's contribution "equal a percentage of payroll necessary to amortize 90% of unfunded liabilities". Until 2005, the State met its statutory obligation by adhering to the funding schedule. In 2005, the General Assembly passed SB27 (PA 94-0004). This legislation re-

duced the funding to the state pension systems by over $2 billion in a two-year period. The Teachers Retirement System portion of the under funding is approximately $1 billion over the same period of time. The IRTA opposed the passage of SB27 recognizing the additional strain it would put on the system and the threat of jeopardizing future benefits. It should be noted during this time of pension funding abuse; teachers and school districts never missed a payment.

Article 13, Section Five of the Illinois Constitution states "Membership in any pension 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." Some of our members take comfort by this guarantee, but constitutions can be amended. The legislature simply votes to place constitutional questions on the ballot. They would only be voting to allow the general public to decide the outcome.

Our members and other Illinois retired educators' deserve more than a promise that the pension system will be funded. As previously stated, retired teachers and school districts have upheld their responsibility to pay into the pension system, having never missed a payment.

For most Illinois retired teachers their TRS pension is their only source of income. Unless these retirees held other employment, they do not receive any Social Security. Even if they did have outside employment in which they contributed to Social Security, their payments from Social Security have been minimized and in some cases eliminated due to the Windfall Elimination Provision and the Government Pension Offset. Current and future retirees have expected and planned on their teachers' pension being there when they retire. If Illinois continues to miss payments, this may not be the case in the future.

The IRTA is not only concerned about the well-being of current retirees, but we are worried about the impact that this administration will have on our current and future teachers. Educators in Illinois are already burdened by fairly low salaries. In order to ensure that we attract the best and brightest teachers for our future generations, we must protect the retirement system.

The best way to do that is to ensure that the TRS is fully funded to 90% by the previously set date of 2045. We oppose any type of two-tier system or reduction of benefits. In order to bring pension contributions back up to the level required by the 1995 Pension Act, substantial "ramp-up" payments are required in the future years. The first of these comes due July 1, 2007, when the state must increase scheduled pension payments by an estimated $700 million.

Natural revenue growth in Illinois is about $1 billion. The minimum annual education increase is about $300 million. Medicaid absorbs $200 million in revenue growth annually. With any additional programs or increases, the numbers will guarantee that the state will be unable to meet its pension obligation for fiscal year 2007. With this knowledge at hand, we know that we will eventually be faced with an attempt to change the current 2045 date or the payment formula. The IRTA opposes any change to the current formula and believes that pensions should be funded according to the 1995 law.

The under-funding of payments also caused the TRS to have to sell off assets in order to make payments on time. The under-funding now means the pension systems will not be able to invest that money and will lose their projected 8.5% interest earnings each year. This is just one more barrier that TRS must face as they head in a downward spiral while still trying to serve the retired teachers of Illinois.

The State of Illinois must stop forgoing payments into the TRS. Illinois retired teachers have served the State of Illinois by educating our youth, they have fulfilled their obligation by paying into TRS, and it is time for Illinois to do the same.

STATEMENT OF JOHN FILAN, DIRECTOR, GOVERNOR'S OFFICE OF MANAGEMENT AND BUDGET, STATE OF ILLINOIS*

Mr. FILAN. Thank you very much. Vice Chairman Kline, thanks for coming on behalf of the Chairman today; Representative Biggert, nice to see you in Illinois. I appreciate very much the opportunity to appear before you today.

*PowerPoint slides presented during Mr. Filan's statement appear on page 89 of this document.

The State of Illinois sponsors five plans covering state employees, university employees, teachers outside of Chicago as was just mentioned, judges and members of the General Assembly.

As many reports have indicated, Illinois state pensions have been under-funded for more than 30 years, 30 consecutive years I might add. As a point of clarity, recent statements have referred to raiding Illinois state pension funds. Even the word "stealing" has been used. Nothing could be further from the truth. A look at the facts clearly show that these are outright false statements. In fact, the statements have been made so often by some that I can confidently say these statements are in fact totally false.

In 2003, when Governor Blagojevich took office, the combined assets, cash and investments, of the five state retirement systems were approximately $41 billion. At the end of the Governor's first two budget years, June 30, 2005, those same cash and investments totaled $59 billion, $18 billion more than when the Governor first took office. This represents by far the single largest increase in pension assets in any 2 years in Illinois history. Further, according to the Retirement Systems, those same cash and investments as of the recently completed third budget year of the Governor, June 30, 2006, now total $61.9 billion, a full $21 billion more, in fact 50 percent more in assets in the Retirement Systems than when the Governor took office.

So as you can plainly see, there have been no raids, no withdrawals, no transfers, no stealing of pension assets or funds. Instead, there have been record deposits and increases in assets and substantial earnings on those assets since Governor Blagojevich took office. No Governor in Illinois history has deposited more money, $13.3 billion, in one term, into the retirement funds than Governor Blagojevich. In fact, no Governor has budgeted and contributed more money into the Retirement Systems in any one term than Governor Blagojevich.

During the 1970's, 1980's and first half of the 1990's, state contributions were grossly inadequate. It increased the unfunded liability every single year, every adopted budget under-funded the pensions, without exception, during good times and during bad times.

In 1994, the state adopted a payment schedule. That first became effective in fiscal year 1996. However, the payment schedule continued to under-fund each of the pension funds each and every year. And would do so until 2034, 40 years later. At that point in time, June 30, 1995, the plans had a total funded ratio of 52.4 percent, that is assets to liabilities, and an unfunded liability of $19.5 billion in 1995. At that time, according to Wilshire, referred to earlier, they were about the 43rd worse funded system in the nation. You will see, as a result of this plan's funding, Illinois quickly moved to the worst funded pension system in the Nation, and it has been there for many years.

The 1995 payment schedule was structurally and fundamentally flawed when it was enacted. We agree that adopting a payment policy for the state pension contributions was definitely needed, and still is. Unfortunately, the 1995 payment schedule would not decrease the pension debt for 40 years. The $19.5 billion will not go down, but go up, over the next 40 years. Payments were not suf-

ficient to pay normal costs and interest on unfunded liability until around 2034. Thus, the state was guaranteed to experience a growing unfunded liability.

This had the impact of deferring and increasing major debt into the future. As a result, the unfunded liability was originally projected in 1995 to grow from the June 30, 1995 level of $19.5 billion to more than $70 billion in 2034. The plan was structured that way, before it finally reduces to $45 billion in 2045, the last 10 years of the plan, based on projections done by the actuaries in 1995.

As a result, the 1995 payment schedule that was adopted pushed the entire unfunded liability of 1995, every nickel of it, out 40 years, to 2034. The total unfunded liability of the state pension systems more than doubled from $19.5 billion in 1995, the year before the 50-year payment schedule was adopted, to $43.1 billion as of June 30, 2003, the beginning of the current Governor's term. The $43 billion unfunded liability in June of 2003 equated to a funded ratio of 48.6 percent, less than when the 1995 plan started. The primary drivers of the increase in unfunded liability and consequent reduction in funded ratio include state contributions determined in accordance with the 1995 payment plan which were designed not to be sufficient to fund the normal costs and unfunded liability. This amounted to $10.9 billion worth of increase between 1995 and 2003. Significant investment losses incurred during the last three fiscal years amounted to $6.5 billion, those come and go.

Most alarming though, after recognizing the liability of 1995 and how big it was, the State of Illinois adopted benefit improvements, without a single nickel of additional funding, in the amount of $5.8 billion between 1995 and 2002. That practice of adopting pension benefits without a funding source was stopped last spring under this General Assembly and this Governor.

So what have we done about the pension problems since 2003? We have made the pension funds more secure and better funded. We have done it both by increasing the assets, as mentioned earlier, to record levels, and reducing the costs and the rate of growth in liability for the first time in Illinois history. So we have made both immediate improvements in funding assets and short and long term reductions in costs and liabilities. In fact, since 2003, Governor Blagojevich has increased assets by $21 billion, more than 50 percent, primarily due to pension bond proceeds, additional contributions on that and earnings on those additional contributions; increasing the funded ratio, ratio of assets to liabilities from 48 percent to 60 percent, primarily due to pension bonds and earnings on those additional contributions; reducing the long term liabilities of the system by $83 billion, according to the Retirement Systems, based on the reforms that were adopted in the spring of 2005; and maybe most importantly, as I said before, prohibiting by law increasing benefits without dedicated funding.

Another way to look at the impact of the Governor's action is to compare the unfunded liability and funded ratio of the pension systems with and without the proceeds of the pension obligation bonds. With the proceeds of the pension obligation bonds, the unfunded liability and funded ratio, are $38.6 billion and 60.3 percent respectively as of June 30, 2005. Without the proceeds of the pen-

sion bonds, the ratio would have been—I am sorry, the liability and the funded ratio would have been $47.6 billion and 50.4 percent respectively if we had not adopted the pension bond policy. Again, the results are demonstrably better than if the Governor's actions had not been implemented.

Earlier this year, the bipartisan Commission on Governmental Forecasting and Accountability issued a report which compares the actual progress toward the 90 percent funding goal in 2045 on a year-by-year basis. The Commission engaged its own independent actuary, the same actuary developed a year-by-year set of projections back in 1995 when the pension plan was adopted. This year's report compared those 1995 projections to 2005. The bottom line is simple and stark: the 1995 pension payment schedule estimated the funded ratio would be 52.5 percent in 2005, while the actual funded ratio achieved as a result of what I just mentioned was 60.3 percent, clearly ahead of schedule.

So as a result of the policies put in place since Governor Blagojevich took office, the State of Illinois is well ahead of the funding level expected and designed in the 1995 payment schedule. If we had followed the 1995 payment plan, we would have been even lower than the 52.5 percent because of the adoption since the 1995 plan of $6 billion of unfunded benefits.

A direct quote from the report just mentioned: Despite counteractive factors such as formula increases—the $6 billion—investment gains or losses due to market volatility, the infusion of pension bonds and funding reductions as contained in Public Act 94.4, the total cost of the current funding plans has not grown appreciably from what was originally projected in 1994. The significant material increase in the funded ratio was due primarily to the record $7.3 billion of additional contributions not called for in the plan in fiscal year 2004 that came from the pension bond and the $3.3 billion of earnings on that $7.3 billion through June 30, 2006, earnings that could not have been done unless they had that additional money.

Those that accuse the Governor of raiding the pension systems conveniently forget the additional funding that went to the systems in 2004. In fact, the 1995 projections of the Commission actuary estimated that the State would have received—the pension systems, pardon me—would have received $12.3 billion of contributions from 1996 to 2005. In fact, the actual contributions received were $19.8 billion for that same period, exceeding the plan's requirements by $7.5 billion. Once again, one hell of a—once again, pardon me—well ahead of schedule.

In closing, I know that there are a lot of numbers being stated today. Let me repeat those findings of the Commission—$7.5 billion of contributions more than called for in the 1995 payment plan and a funded ratio of 60.3 percent, not 52 percent that was called for there.

I challenge anyone to refute those numbers and that result. Specifically answer this simple question: If the funds were raided, how can they have $7.5 billion more than required by the funding plan and a funded ratio that is 7.8 percent more than the actuary estimated?

Illinois has had the worst funded pension system by far for many years—solely caused by 30 years of under-funding, including many years of planned under-funding of the 1995 plan. Illinois also had a practice of adding billions of dollars of costly benefits without providing any new funding, which only made the longstanding under-funding worse. We have put a stop to that in Illinois, no new benefits can now be adopted without a funding source.

Our submission to the Committee also outlines many of the other steps we have taken and the other recommendations we have made. Illinois has made demonstrable progress on pension funding for the first time in decades. We still have a long way to go and are committed to continue down that path.

By any measure, the Illinois state pension systems are better funded and more secure than they were when the Governor first went into office. Any statement to the contrary, particularly statements or inferences about raiding or stealing, are demonstrably and completely false.

Thank you so much for allowing me to speak here today.

Mr. KLINE. Thank you, Mr. Filan.

Ms. Webb-Gauvin, thank you.

[The prepared statement of Mr. Filan follows:]

Prepared Statement of John Filan, Director, Governor's Office of Management and Budget, State of Illinois

Chairman Johnson, Ranking Member Andrews, Vice Chairman Kline, Representative Biggert, Representative Davis, and Members of the Subcommittee, I am John Filan, Director of the State of Illinois Governor's Office of Management and Budget. I appreciate the opportunity to appear before you today.

Background

The State of Illinois sponsors five retirement plans covering state employees, university employees, teachers outside of Chicago, judges, and members of the state General Assembly. As of the date of the most recent actuarial valuation (June 30, 2005), the plans on an aggregate basis were 60.3% funded, up from 48% in 2003.

During the 1970's, 1980's and the first half of the 1990's, state contributions were grossly inadequate during both good and bad economic times. As a result, in 1994, the state adopted a payment schedule (Public Act 88-593) that first became effective in fiscal 1996. However, the payment schedule continued to grossly underfund each of the pension funds. At that point in time (June 30, 1995), the plans on a total basis were 52.4% funded, with an unfunded liability of $19.5 billion.

Unfunded Growth Since 1995

The total unfunded liability of the state pension system more than doubled from $19.5 billion as of June 30, 1995 (the year before implementation of the 50-year payment plan) to $43.1 billion as of June 30, 2003, the beginning of the current gubernatorial term in office.

The $43.1 billion unfunded liability as of June 30, 2003 equates to a funded ratio of 48.6%. The primary drivers of the increase in unfunded liability and consequent reduction in funded ratio include:

- State contributions determined in accordance with the 1995 Payment Plan were designed not to be sufficient to fund the normal cost and interest on the unfunded liability—this amounted to $10.9 billion. In other words, the 1995 plan was flawed from the beginning.
- Significant investment losses incurred during the three fiscal years ended June 30, 2003—$6.5 billion.
- Benefit improvements passed by the legislature from 1995 through 2003 with out any source of funding—5.8 billion.

A combination of consistently underfunding the pensions and continuing to provide more and more benefits without a way to pay for them resulted in more than doubling the unfunded liability.

The following chart shows the components of the increase in the unfunded liability from 1996 to 2003 (numbers in billions):

Unfunded Liability at 6/30/1995	$19.5
Change due to:	
State Contributions	$10.9
Actuarial Investment Losses (Gains)	6.5
Unfunded Benefit Improvements	5.8
All Other Factors	.4
Total Increase	$23.6
Unfunded Liability at 6/30/2003	$43.1

Failings of 1995 Payment Schedule

The 1995 payment schedule was structurally flawed when it was enacted. We agree that adopting a payment policy for the state pension contributions was definitely needed. Unfortunately, the 1995 payment schedule Governor Edgar's administration proposed would not decrease the pension debt for 40 years. First of all, it incorporated a 15 year ramp-up period, which increased contributions over a period of 15 years from a starting level that was totally arbitrary and grossly less than the amount needed to keep the unfunded liability from increasing. Thus the state was guaranteed to experience a growing unfunded liability from 1996 through at least 2010. This had the impact of deferring and increasing the entire liability into the future. To make matters even worse, 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. As a result, the unfunded liability was originally projected to grow from the June 30, 1995 level of $19.5 billion to more than $70 billion by 2034 before it finally reduces to $45 billion in 2045 (based on projections from the June 30, 2005 actuarial valuation). Ultimately, the 1995 payment schedule did nothing more than push the entire unfunded liability out 40 years to 2034.

2003/2004 Pension Obligation Bonds

In response to the enormous challenges facing the state in funding the state pension systems, Governor Blagojevich developed, and is currently in the process of implementing, a long-term, multi-step plan to reform the state's pension system. The ultimate goal of this reform plan is to develop a retirement program that is affordable for the state, and at the same time, meets the retirement security needs of the state's pension system participants.

The first step taken by the Governor to address these tough issues 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, all of which, except for $500 million which was used to cover issuance costs and initial debt service payments, was paid into the pension systems. Of this $10 billion total, $7.3 billion was disbursed to the pension systems as an additional state contribution over and above any annual contribution requirements. Note this was the first time in the history of Illinois that payments were made above the annual contribution requirements.

This additional cash infusion on July 3, 2003 immediately reduced the pension system's unfunded liability, and increased the system's funded ratio from 49% as of June 30, 2003 to over 57% literally overnight. (With investment earnings, the funded ratio subsequently improved to over 60% by June 30, 2005.) With this single action, the security of the members and retirees' pensions improved significantly. This reduction in liability exceeds the goals set out in the 1995 payment plan.

Governor's Pension Commission

The second step was the Governor's appointment of a Pension Commission to review the pension system's funding issues, and make recommendations focused on improving the system's financial condition and affordability. The Commission met numerous times and issued their report and recommendations on February 11, 2005.

The Governor then examined and considered the recommendations contained in the Commission's report. Based on the recommendations of the Commission, the Governor next proposed changes to the plan provisions and funding mechanisms for the state retirement systems.

Public Act 94-4

The third step taken by the Governor to reform the pension system was to submit the set of proposed changes to the Legislature. After review and negotiation, several reforms to the state pension system, known as Public Act 94-4, were adopted.

The net results of the pension reforms included in PA 94-4 is a projected reduction in the 2045 actuarial accrued liability of approximately $83 billion according to the independent determination of the pension systems' actuaries, as well as a reduction in state contribution requirements of approximately $3 billion over the next 40 years according to the independent determination of CGFA (in their January 2006 report).

The Governor's commitment to streamline and revitalize state government has resulted in the elimination of 13,000 non-essential positions, reducing the state payroll to under 57,000 employees (after decades where the payroll hovered near 70,000 employees, resulting in a bloated and inefficient state government). In addition to the annual payroll savings this effort has generated, the most current actuarial valuation of the State Employees Retirement System (SERS) as of June 30, 2005 projected a savings of approximately $5 billion in state contribution requirements to SERS between fiscal year 2006 and 2045 as a result of this effort. This $5 billion contribution savings represents an additional $2 billion savings over the $3 billion discussed above.

Governor's Pension Reforms

The reforms included in Public Act 94-4 represent the first time future liabilities and costs of the Illinois pension system have ever been reduced.

Recent statements have referred to "raiding" Illinois state pension funds. Those statements are nothing more than political rhetoric from elected officials who, for years, voted for budgets and benefits that drove the unfunded liability to $43 billion. If there's something the Blagojevich administration has been deficient on when it comes to pension funding, it's failing to aggressively halt the attempts of those who created the problem to then re-write history and try to pass the blame onto others.

In 2003 when Governor Blagojevich took office the combined assets of the five state retirement funds were $40.7 billion. By the end of the Gov's first two budget years (June 30, 2005) those assets had grown to $58.8 billion—$18.1 billion more than when the Governor took office. This is, by far, the single largest increase in pension assets in any 2 year period in history.

Further, according to the retirement systems, as of June 30, 2006 those same cash and investments are in excess of $61.9 billion—a full $21 billion more (50% more) than when Governor Blagojevich took office in 2003.

The $21 billion increase in assets came from $12.2 billion of deposits into the retirement funds by the Blagojevich administration through June 30, 2006 as well as investment earnings on those deposits.

There have been record deposits and increases in assets, and substantial earnings on those assets since Governor Blagojevich took office—despite the rhetoric and attacks leveled by politicians seeking to hide their own shameful record when it comes to pension funding and benefits.

Governor Blagojevich's administration has contributed the most funds to the state pension system of the last four administrations. The following table illustrates state contributions to the pension system under the last four administrations:

Fiscal year period	Contributions (millions)	Average annual contribution	Percent of resources
2004–2007 Blagojevich	$13,300.0	$3,325.0	12.9%
2000–2003 Ryan	$5,818.4	$1,454.6	6.08%
1996–1999 Edgar	$3,433.7	$ 858.4	4.30%
1992–1995 Edgar	$2,067.6	$ 516.9	3.28%

Another way to look at the impact of the Governor's actions is to compare the unfunded liability and funded ratio of the pension systems with and without the additional contribution of the pension obligation bonds. With the additional contribution of the pension obligation bonds, the unfunded liability and funded ratio are $38.6 billion and 60.3% respectively as of June 30, 2005. Without the proceeds of the pension obligation bonds, the unfunded liability and funded ratio would have been $47.6 billion and 50.4% respectively as of the same date. Again the results are demonstrably better than if the Governor's actions had not been implemented.

Advisory Commission on Pension Benefits

The fourth step in the Governor's long-term plan to reform the state's pension system consisted of establishing an Advisory Commission on Pension Benefits. The mandate of this Advisory Commission on Pension Benefits (the "Commission") was to consider and make recommendations concerning revenue sources, changing the age and service requirements, automatic annual increase benefits, and employee

contribution rates of the State-funded retirement systems and other pension-related issues.

The Commission met five times between September 23 and October 27, 2005. After extensive and productive discussions of the State Retirement Systems, the Commission crafted several recommendations. The next step in the Governor's plans to reform the state's pension system will be for the legislation to consider the Commission's recommendations. Some of these recommendations were included and adopted in the Fiscal Year 2007 budget.

Commission on Government Forecasting and Accountability ("CGFA")

Earlier this year, the Commission on Government Forecasting and Accountability ("CGFA") (a bi-partisan commission whose statutory role encompasses monitoring of the state's pension systems including their progress toward the funding levels set forth in the 1995 pension legislation) issued a ten year report (on the 1995 payment plan). The report compares the actual progress toward the 90% funded goal (in 2045) on a year by year basis. CGFA engaged its own independent actuary to track the impact of all cash contributions by the state, changes in pension benefits such as the early retirement incentive program (ERI), the impact of the pension obligation bond issued in 2003 and actual investment results. The same actuary developed a year-by-year set of projections back in 1995 when the pension funding plan was adopted. This year's report compared those 1995 projections of where the pension plans were projected to be (relative to the funded ratio level) in 2005 versus what the funding levels actually were at that same date.

In fact, following is a quote directly from CGFA's report in January of 2006 "Despite counteractive factors such as formula increases, investment gains and losses due to market volatility, the infusion of Pension Obligation Bond proceeds and funding reductions as contained in PA94-4, the total cost of the current funding plan has not grown appreciably from what was originally projected in 1994."

The bottom line is simple and stark: the 1995 pension payment schedule estimated the funded ratio would be 52.5% in 2005 while the actual funded ratio achieved was 60.3%. So, as a result of the policies put in place since Governor Blagojevich took office in 2003, the state of Illinois is well ahead of the funding level expected and designed in the 1995 payment schedule.

This significant and material increase in the funded ratio was due primarily to the record additional contribution in Fiscal 2004 associated with the $10 billion pension obligation bond and earnings on that additional contribution.

Those that accuse this governor of "raiding" the pension systems conveniently forget the additional funding that went to the systems. In fact, the 1995 projections of the CGFA actuary estimated that the state would make $12.3 billion of contributions from 1996 through 2005. In fact, the actual contributions for the same period totaled $19.8 billion, thereby exceeding the statutory requirements by $7.5 billion. Once again, we are well ahead of the original 1995 payment schedule.

Conclusion

I know there's a lot of numbers being stated today but let me repeat those findings of the independent actuary of CGFA—$7.5 billion of contributions more than called for in the 1995 plan, and a funded ratio of 60.3% versus only 52.5% (called for in the 1995 payment plan).

I challenge anyone to refute those numbers and that result. Specifically, answer this simple question: if the funds were raided, how can they have $7.5 billion more than statutorily required and the funded ratio is 7.8% more than the independent actuary estimated?

Illinois has had the worst funded pension system by far for many years—solely caused by 30 years of underfunding, including many years of planned underfunding. Illinois also had a practice of adding billions of dollars of costly benefits without providing any new funding, which only made the longstanding underfunding worse. We have put a stop to this in Illinois-the Governor proposed and signed into law in 2005 a key pension reform: no new benefits without a full funding source.

Our submission to the Committee outlines many of the steps we have taken and the recommendations we have made. Illinois has made demonstrable progress on pension funding for the first time in decades. I believe that we have taken the first steps towards the pension reform necessary to strengthen the retirement system's balance sheet, protect taxpayers and preserve retirement security for our employees. We still have a long way to go and are committed to continue down that path.

By any measure Illinois state pension systems for retirees and current employees are better funded and more secure that they were when Governor Blagojevich came into office. Any statement to the contrary—particularly statements or inferences

about "raiding" or "stealing"—is not only patently false, they scream for the records of those making those statements to be examined and the truth revealed.

Thank you for allowing me to speak to you today.

STATEMENT OF JOANNA WEBB–GAUVIN, DIRECTOR OR RETIREE PROGRAMS, COUNCIL 31, AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES

Ms. WEBB-GAUVIN. Good afternoon, Mr. Chairman and members of the Committee. My name is Joanna Webb-Gauvin. I am the Retiree Director for Council 31 of the American Federation of State, County and Municipal Employees in the State of Illinois. I am pleased to be here today representing Council 31 and AFSCME on the subject of examining the retirement security of state and local government employees.

I want to begin by making it very clear that our members do not have gold-plated pensions. The average pension in the State of Illinois is $1500 per month, which is not overly generous. Our members, to earn their pensions, work very hard in public service. They deserve a sound retirement plan that will let them live with dignity and have some level of financial security. That is why our members are deeply concerned that the State of Illinois, for some time now, has not been contributing enough money each year to cover the retirement system's long-term costs. They are concerned that the irresponsibility of our political leaders may compromise the system's ability to protect their retirement security. Unfortunately, our under-funding problem may have even broader implications that we are concerned about. We are afraid it will provide an opening for others to unfairly attack the entire concept of defined benefit pension plans.

Council 31 represents about 75,000 working members and about 23,000 retired members in the State of Illinois and our international union represents 1.4 million working members and almost 230,000 retiree members. One of our principal goals has always been to ensure that workers receive sufficient income in retirement. As a result, AFSCME has been a strong supporter of traditional defined benefit pension plans and the Social Security system. Both guarantee a steady income to retired workers and their spouses, along with disability and survivor benefits. Despite the strength of a defined benefit pension plan, a handful of anti-worker groups and some politicians, claim that public employee retirement systems are unfair and an unaffordable expense. They say these systems must be overhauled and that a financial crisis is looming. We do not agree that major changes are required or that a major crisis is looming. In fact, we feel that most of these attacks are part of a concerted effort to dismantle pension systems around the country and undermine the retirement security of millions of Americans.

We believe that, for the most part, defined benefit plans in public retirement systems across the country are well managed and well funded. Pension systems with problems, such as in San Diego, are the exception. Problems occur when public employers take pension holidays or fail to pay the normal cost of the pension system every year. Public pension plans should not be under-funded. The same

for private sector plans, including those that have been hit by scandal, such as those at Enron and WorldCom.

Moving from secure defined benefit plans to often risky defined contribution plans is not the answer. While much has been made of the growth of 401k style DC savings plans in the United States, most Fortune 500 companies and 90 percent of public sector employers continue to offer traditional defined benefit plans. In fact, the ideal retirement income formula has long been described as a three-legged stool, with one leg each representing Social Security, a guaranteed employer-paid pension—employer-provided—and individual savings. Because a DC plan is a savings plan and not a guaranteed pension, it should be viewed as a supplement to a DB pension plan, not as a substitute. Without a defined benefit plan, the retirement stool gets pretty wobbly. As a result, many workers are being forced to find a third leg—continued employment. Defined benefit plans are especially critical for public employees who, of which a quarter of them including about half of them in Illinois, are not covered by Social Security. And for those employees, an employer-sponsored defined benefit plan is their only dependable source of income in retirement.

Although there a few public sector retirement systems with large unfunded actuarial liabilities, these shortfalls were brought about by situations like the one involving the systems covering state and university employees in Illinois. This is not a recent development in Illinois. For the past 25-30 years, State government has failed to make the necessary contributions to plans covering its employees. In some instances, the State has actually borrowed from what should have been plan contributions to fund education and Medicaid programs. As a result, the systems covering Illinois' state and university employees are funded at an aggregate level of 60 percent. In contrast though, because local employers have made the necessary contributions to the Illinois Municipal Retirement Fund, it is funded at a very healthy 94 percent level. In both instances, however, public employees and retirees have a guaranteed benefit that exceed whatever is provided for in ERISA, in that those current and future accruals are guaranteed by the State Constitution and there is no risk that the plans will be offloaded to the PBGC as a business tactic. This lack of an escape valve adds protections for participants, but also makes it even more important for governments to pre-fund their programs to keep the bulk of the costs paid by investment income.

Workers and retirees in the United States are facing growing economic uncertainty. Our nation is facing an unprecedented Federal deficit and has been introduced to a new era of greedy corporate executives infamous for gross mismanagement of their companies' funds and stocks. Coupled with the White House's scheme to replace guaranteed Social Security benefits with private investment accounts, there is now more than ever a need for certainty and stability in retirement plans. Public sector systems remain healthy and will continue to deliver promised pension benefits.

Government, in its dual role as employer and policymaker, has the responsibility not only to serve as a model employer, but to provide secure retirement benefits for a large part of the nation's workforce. Career employees deserve an adequate pension benefit

that will not disappear in just a few short years into retirement. Without the retirement security provided by a defined benefit pension plan, it would be the burden of the state and local governments to deal with the consequences of an elderly population unable to provide for themselves in retirement.

In closing, Mr. Chairman, I want to thank you for the opportunity to testify on this important issue, and I would be happy to answer any questions that you may have.

Mr. KLINE. Thank you very much.

Mr. Weiss, the floor is yours.

[The prepared statement of Ms. Webb-Gauvin follows:]

Prepared Statement of Joanna Webb-Gauvin, Director of Retiree Programs, Council 31, American Federation of State, County and Municipal Employees (AFSCME)

Good morning, Mr. Chairman and members of the committee, my name is Joanna Webb-Gauvin. I am the Director of Retiree Programs for Council 31 of the American Federation of State, County and Municipal Employees in the state of Illinois. I am pleased to be here today representing Council 31 and AFSCME on the subject of Examining the Retirement Security of State and Local Government Employees.

I want to begin by making it clear that our members do not have gold-plated pensions. In fact, in Illinois the average state pension is only $1500 per month—not overly generous. To earn their pensions, our members work very hard in the public service. They deserve a sound retirement plan that will let them live with dignity and some degree of financial security. That's why our members are deeply concerned that the state of Illinois, for some time now, has not been contributing enough money each year to cover the retirement system's long-term costs. They are concerned that the irresponsibility of our state's political leaders may compromise the system's ability to protect their retirement security. Unfortunately, our under-funding problem may have even broader implications. We're afraid it will provide an opening for others to unfairly attack the entire concept of defined benefit plans.

Council 31 represents about 75,000 employees here in the state of Illinois and our International union AFSCME represents 1.4 million active members and almost 230,000 retiree members. One of our principal goals has always been to ensure that workers receive sufficient income in retirement. As a result, AFSCME has always been a strong supporter of traditional defined benefit (DB) pension plans and the Social Security system. Both guarantee a steady income to retired workers and their spouses, along with disability and survivor protections. Despite the strengths of DB pension plans, a handful of anti-worker groups—and even some politicians—claim that public employee retirement systems are unfair and an unaffordable expense. They say these systems must be overhauled to avoid a financial crisis. We don't agree that major changes are required or that a major crisis is looming. In fact, we feel most of these attacks are part of a concerted effort to dismantle pensions systems around the country and undermine the retirement security of millions of Americans.

We believe that, for the most part, defined benefit plans in public retirement systems across the country are well managed and well funded. Pensions systems with problems, such as in San Diego, are the exception. Problems occur when public employers take pension holidays or fail to pay the normal cost of the pension system every year. Public pension plans should not be under-funded. The same goes for private sector plans, including those that have been hit by scandal, such as those at Enron and Worldcom.

Moving from secure defined benefit plans to often risky defined contribution (DC) plans is not the answer. While much has been made of the growth of 401(k)-type DC savings plans in the United States, most Fortune 500 companies and 90 percent of public sector employers continue to offer traditional DB pension plans. In fact, the ideal retirement income formula has long been described as a "three-legged stool," with one leg each representing Social Security; a guaranteed, employer-provided pension; and individual savings. Because a DC plan is a savings plan and not a guaranteed pension, it should be viewed as a supplement to a DB pension plan—not as a substitute. Without a DB plan, the retirement stool gets pretty wobbly. As a result, many workers approaching retirement may be forced to add another leg—continued employment. DB plans are especially critical for public employees because a quarter of them, including about half of those in Illinois, aren't covered by Social

Security. For those employees, an employer-sponsored DB plan is their only dependable source of income upon retirement.

No matter what happens on Wall Street or how long an individual lives, DB pension plans provide employees and their dependents with a secure retirement income. This is not the case for a DC plan participant, whose private account balance will depend on the level of contributions and, perhaps more importantly, the investment income earned on those contributions. All of the risk is placed on the individual employee under a DC plan.

Look at how investment returns can play havoc with a person's retirement savings. Assume an employee with 30 years of service had accumulated $150,000 in her DC savings plan by the end of 1999. If she happened to retire in 2000, she may have been able to maintain a modest standard of living by combining her savings with Social Security. If she waited to retire until 2002, however, her retirement security would be in jeopardy. That's because market reverses caused average DC account balances to decline by 30 to 40 percent over those two years. Imagine having to get by on two-thirds of the savings you anticipated.

The fact is that retirement prospects for American workers whose employers do not offer a traditional DB plan are poor. According to the Employee Benefit Research Institute (EBRI), the average account balance among DC plan participants was just $57,000 at the end of 2004 and half of those participants had account balances under $20,000. With an average additional life expectancy of about 20 years for an American retiring at age 65, millions of workers will see their savings vanish just a few years after retirement. Even more alarming is that those averages only include employees actually participating in their employer's plan: about one-fourth of workers who are eligible to participate in DC plans do not do so.

It is our strong belief, that dollar for dollar defined benefit plans are a more efficient use of taxpayer money once contributions are made. Unlike the private sector, where employers typically pay all pension plan costs, most public DB plans require worker contributions as well. Public employees generally contribute between 4 and 8 percent of their pay.

Defined benefit plans also have professional management, which allows for a wider set of investment opportunities, leading to higher returns than the average DC plan and much lower fee structures. All of this makes DB plans highly desirable for both public employees and taxpayers. There's another reason that DB plans also make sense from a taxpayer's perspective: they help states and localities maintain a qualified and stable workforce. The billions of dollars in public pension systems go to work for both by earning strong returns that are used to fund on average about 75 percent of the benefits that are paid out. Consequently, taxpayers only pay somewhere between 10 and 20 percent of the cost of the retirement benefit.

It is also important to note that some states have been too precipitous in changing to DC plans only to regret it later. In 2002, the state of Nebraska recognized the numerous problems with DC plans and scrapped its long standing DC plan in favor of a plan that more closely resembles a DB plan. The change followed a study determining that DC plan members had worse returns on their investments than DB plan members and were retiring with only 25 percent of their pre-retirement income, while DB plan participants were retiring with 60 to 70 percent of pre-retirement income. Studies have shown that rates of return for professionally managed DB plans significantly outperform employee-directed DC investments. The actuarial consulting firm of Watson Wyatt found that the rates of return for DB plans exceeded those of DC plans by about 4 percent each year over a recent three-year period.

Defined benefit plan managers are trained in developing ongoing, long-term investment strategies that include an optimum mix of growth potential and risk. Participants benefit from the favorable investment performance of pooled pension fund assets. DC plan participants, on the other hand, are often limited to a handful of investment choices. Furthermore, investments in a DB plan are not affected by the retirement timing of a particular employee so the investment horizon never has to be shortened. As a result, return prospects are enhanced in a DB plan.

Also, of great importance to taxpayers, public pensions are an important source of economic stimulus to every state, city, and town across America. These systems distribute more than $130 billion annually. Their $2.5 trillion in assets are an important source of liquidity and stability for our financial markets. Higher returns generated from pooled and professionally invested funds contribute an estimated $240 billion (or 2 percent) more to GDP than if they had been invested in private accounts.

Defined contribution plan proponents claim those plans provide much-needed portability for a workforce that changes jobs more often than in the past. Numerous studies, however, dispel the notion that workers today change jobs more often than in the past. The Bureau of Labor Statistics reports that tenure for wage and salary

workers was 4 years in January 2004, compared with 3.5 years in January 1983. For public employees, tenure is even longer, with the average public employee having nearly 7 years on the job. Therefore, with most public sector DB plans providing for vesting after 5 years, most public employees will be eligible for a pension benefit commensurate with their service.

Groups that want to eliminate traditional pensions often claim the systems responsible for providing retirement benefits are facing a collective financial crisis. That claim is simply not true. According to the Wisconsin Legislative Council's "Comparative Study of Major Public Employee Retirement Systems," released in December 2005, the average funding ratio of the 88 large plans surveyed was 85 percent, and nearly half of the plans were over 90 percent funded. A plan's funding ratio is simply a comparison of assets to future obligations. Typically, a retirement system's liabilities are amortized over time—similar to paying off a mortgage. As Fred Nesbitt, former Executive Director of the National Conference on Public Employee Retirement Systems, put it, "A family that owes $200,000 on a mortgage wouldn't say 'we're doomed,' because it knows it has 30 years to pay the bill."

Although there are a few public sector retirement systems with large unfunded actuarial liabilities, these shortfalls were brought about by situations like the one involving the systems covering state and university employees in Illinois. This is not a recent development in Illinois. For the past 25 years, state government has failed to make the necessary contributions to plans covering its employees. In some instances, the state has actually borrowed from what should have been plan contributions to fund education and Medicaid programs. As a result, the systems covering Illinois' state and university employees are funded at an aggregate level of 60 percent. In contrast, because local employers have made the necessary contributions to the Illinois Municipal Retirement Fund, it is funded at a very healthy 94 percent level. In both instances, however, public employees and retirees have benefit guarantees that exceed what is provided for in ERISA, in that both current and future accruals are guaranteed by the state constitution and there is no risk that the plans will be offloaded to the PBGC as a business tactic. This lack of an "escape valve" adds protections for participants, but also makes it even more important for governments to pre-fund their programs to keep the bulk of the costs paid for by investment income.

For most DB plans, the vast majority of income comes from returns on investments. The fact that investment losses during bear markets reduce the value of retirement systems' assets should not come as a surprise. What is surprising is that groups attempting to dismantle pension systems fail to account for the fact that DB pension plan funding is structured to be carried out indefinitely. Defined benefit plans are designed for the long haul and do not have an investment horizon like DC savings plans that cover individual employees. Furthermore, governments are ongoing concerns that will not go bankrupt and leave workers unprotected.

Defined benefit plans are also good for employers. Public sector employers must attract, and retain, a uniquely diverse workforce, such as architects, correctional officers, librarians, social workers and zookeepers, to name just a few occupations. Each of these jobs calls for special skills, knowledge and abilities. More than half of all public employees hold positions classified by the Bureau of Labor Statistics in either the "Education" or "Protective Service" fields. These are jobs for which there is little or no private sector equivalent, and their nature makes experience highly valuable. Defined benefit plans have not only done a good job of attracting such a diverse group, but those plans have also promoted retention efforts by rewarding the hard work and dedication of career employees.

Workers and retirees in the United States are facing growing economic uncertainty. Our nation is facing an unprecedented federal deficit and has been introduced to a new era of greedy corporate executives infamous for gross mishandling of their company funds and stock. Coupled with the White House's scheme to replace guaranteed Social Security benefits with private investment accounts, there is now, more than ever, a need for certainty and stability in retirement planning. Public sector retirement systems remain healthy and will continue to deliver promised pension benefits.

Government, in its dual role as employer and policy-maker, has the responsibility to not only serve as a model employer, but to provide secure retirement benefits for a large part of the nation's work force. Career employees deserve an adequate pension benefit that will not disappear just a few short years into retirement. Without the retirement security provided by DB pension plans, it would be the burden of state and local governments to deal with the consequences of an elderly population lacking the resources to provide for themselves.

In closing, Mr. Chairman, I want to thank you for the opportunity to testify on this important issue. I would be pleased to answer any questions you may have.

STATEMENT OF LANCE WEISS, CONSULTING ACTUARY, DELOITTE CONSULTING, LLP

Mr. WEISS. Thank you. Chairman Johnson, Ranking Member Andrews, Vice Chairman Kline, Representative Biggert and members of the Subcommittee, my name is Lance Weiss and I am a pension actuary with Deloitte Consulting, LLC. I very much appreciate the opportunity to appear before you today.

Mounting public sector retirement costs pose a serious threat to many—not all, but definitely many—state and local governments. Public officials must confront runaway public pension and retiree health benefit costs or risk voter backlash as these costs hit taxpayers directly in the pocketbook and force states to spend tax dollars on legacy obligations that otherwise could have been used for education, services and infrastructure.

Solving the public pension crisis requires prompt action. Government policymakers must address this challenge by developing sound funding policies for public pension systems and then having the discipline to follow through on them.

Now, although each state or locality has a unique set of factors which contributed to their own pension crisis, there are a number of causes that are pretty consistent across many plans.

First, there are generally no requirements forcing public entities to fund their pension liabilities. As a result, public pension plans are funded to varying degrees, including some that are funded very well. Unfortunately, it also includes some that are completely unfunded and operate on a pay-as-you-go basis.

By contrast, private sector pension plans are now required by the recently enacted Pension Protection Act of 2006 to reach 100 percent funding of accrued liabilities in 7 years. Most public sector plans, by comparison, are funded over much, much longer periods of time—30, 40 or even 50 years.

Second, flush with earnings from the bull markets that lasted through much of the 1990's, and actually masked significant underfunding of many plans that occurred prior to that time, states and localities routinely added all types of benefit enhancements to public sector retirement plans, often justifying the increases as necessary to retain qualified workers.

Unfortunately, as the investment markets cooled in 2000, the bill came due for generous benefit packages accrued during the boom years. However, instead of shoring up pension funds with more revenues, some states and localities used revenues that should have gone into pension funds to finance other priorities such as Medicaid or education. Thus, making the pension funding situation even worse.

Regrettably, there is no silver bullet for solving the public pension crisis. Most jurisdictions will require a combination of cost-cutting and revenue-enhancing changes to bring their pension systems back into balance. In the short term, jurisdictions facing large unfunded pension obligations must stop the financial bleeding. Several strategies for relatively quick improvement include:

First, curtail abuses by eliminating pay raises and sick leave policies that allow pension benefits to be arbitrarily inflated.

Narrow eligibility for costly public safety benefits to true public safety employees.

Second, where possible, raise employee pension contributions to better match rising total costs.

Third, explore all other revenue sources to improve pension funding.

And last, reduce administrative costs by combining multiple pension plans or implementing more efficient administrative systems and procedures.

Longer-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 will not be felt until a new generation of public workers is hired and some of today's younger workers near retirement.

Pension reform for the medium to long-term include, first, develop an appropriate pension funding policy and stick to it. Current laws governing 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 is no magic number for what the funding levels should be. Funding targets may range from 80 to 100 percent. Policymakers need to decide on a level of pension funding that balances short-term needs with long-term goals.

Second, consider establishing a two-tier pension program that shifts newly hired workers into lower cost retirement plans. This approach, which is now very 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 and current retirees.

Third, tie cost of living increases to actual inflation rates. This could actually produce significant savings while still protecting retirees from rising living expenses.

Fourth, 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 very poorly designed. Restructuring these early retirement programs would save money and encourage valuable workers to stay on the job.

In conclusion, there are no easy answers to the public pension crisis. In the short term, jurisdictions facing large unfunded pension obligations must stop the financial bleeding. In the longer term, jurisdictions must develop sound funding policies for the public pension systems and then have the discipline to follow them. They must make the minimum required pension contributions when times are tough. Just as important, they must resist politically expedient pension give-aways when times are good.

Thank you and I look forward to your questions.

[The prepared statement of Mr. Weiss follows:]

Prepared Statement of Lance Weiss, Consulting Actuary, Deloitte Consulting, LLP

Chairman Johnson, Ranking Member Andrews, Vice Chairman Kline, Representative Biggert, and Members of the Subcommittee, I am Lance Weiss, a consulting Actuary with Deloitte Consulting LLP.

I have over 33 years of experience in employee benefits and retirement planning, with special emphasis on the design, funding, security, administration and implementation of qualified and nonqualified retirement and post-retirement medical programs. I have worked with large public and private corporations, coordinating re-

tirement benefits with other elements of total compensation programs, as well as developing effective benefits and cost containment programs.

I am a Fellow of the Conference of Consulting Actuaries, a Member of the American Academy of Actuaries and an Enrolled Actuary under ERISA.

I've had the unique opportunity to work with leading public and private sector organizations helping them navigate their way through employee benefit challenges and opportunities. Most recently, I have spent a great deal of my time working with public sector organizations assisting them manage their underfunded pension programs. These experiences led directly to my involvement as co-author of a Deloitte Research Paper entitled "Paying for Tomorrow: Practical Strategies for Tackling the Public Pension Crisis."

I think I can be most helpful to the Subcommittee today by focusing on what I have gleaned from my own experiences with public sector pension plans and therefore, I will be testifying on my own behalf and not on behalf of Deloitte or any of its affiliates or clients.

Mr. Chairman, I appreciate the opportunity to appear before you and share my perspective with the Subcommittee.

Introduction to the Public Pension Crisis

"Public Pension Plans Face Billions in Shortages" was the title of a front page article that appeared in the August 8, 2006 New York Times. The first in a series that will examine actions of state and local governments that have left taxpayers with large unpaid bills for public employee pensions, the article states that "By one estimate, state and local governments owe roughly $375 billion more than they have committed to their pension funds."

While some public pension plans are in sound financial shape, too many others are in crisis mode. In fact, funding public pension plans today represents one of the most significant budget issues for many states and local governments.

The news is similar across the nation, as many 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. Several examples follow:

• In April 2005, San Diego Mayor Dick Murphy stepped before a 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.

• In Texas, the state Pension Review Board placed 18 public retirement plans on its watch list, a warning that the plans have insufficient funds to meet future obligations.

• 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 this year 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.

• Cities and counties in New York State saw their pension contributions grow by as much as 248 percent in 2004, according to BusinessWeek. For example, the pension bill for Binghamton, N.Y., jumped from $1.6 million to $4.2 million, 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.

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.

A 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. Today, taxpayers may be exposed to more than five times that amount in unfunded pension obligations across the public and private sectors.

In a recent special report, BusinessWeek magazine highlighted the impact of exploding pension costs on several communities. 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 afterschool 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.

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.

Although not part of this hearing or my testimony, it should be noted that the financial crisis facing many public sector entities is compounded and dwarfed when considered in combination with (1) increasing post-retirement health plan costs and (2) the fact that the workforces of many entities will decline as the competition for a shrinking workforce intensifies. This will result in fewer younger workers contributing to the plans to help fund the higher costs of older and retired workers. Accordingly, any solutions to the pension problems need to be considered in a broader perspective.

Causes of the Public Pension Crisis

The current public pension crisis stems from a multitude of causes, but basically boils down to a mix of ineffective pension policy decisions and a lack of planning, the results of which were exposed by the stock market slide that began in 2000.

Although each state or locality has a unique set of factors contributing to the pension crisis, there are a number of causes that are consistent across many plans. The primary causes of the pension crisis that are consistent across numerous plans include the following:

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), as recently amended by the Pension Protection Act of 2006, which sets minimum funding standards for company sponsored retirement plans. In very simple terms, private plans are now required by the recently enacted Pension Protection Act of 2006 to reach 100% funding of accrued liabilities in seven years. Most public sector plans are funded over much longer periods of time—30, 40 or even 50 years.

Due to the lack of prefunding requirements, there is little incentive for fiscal restraint. In fact, sometimes the opposite is true—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. The bill for increasing unfunded pension liabilities is unfortunately left for future generations.

In recent years, the economic slowdown reduced 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.

Benefit Expansions

Bolstered by the bull market that lasted through much of the 1990s, many States and localities improved benefits in 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. Benefit enhancements added in Illinois between 1995 and 2003 boosted liabilities by approximately $6 billion.

Public pension plans also expanded supplemental plan benefits over the past 10 years. 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. Likewise, one in three California government workers now receives public-safety pensions, up from one in twenty during the 1960s. 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.

Not only were benefit amounts rising in the 1990s but public retirement systems were paying out higher 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.

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 totally masked by the booming stock market of the 1990s. Thanks to historic market gains during the "dot-com" era, pension fund investment revenue easily kept pace with expanding retirement perks under the guise of "only spending the surplus". 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. 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 strong stock 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 pension contribution requirements to unaffordable levels.

Solutions to the Pension Crisis

Since each plan has its own unique set of circumstances, there is no single solution for solving the public pension crisis that will fit all situations. However, there are a number of strategies that public sector entities can adopt to improve the funded position and affordability of their pension plans. In general, most jurisdictions with plans in crisis will require a mix of (1) cost cutting and (2) revenue enhancing changes. Some of the strategies that can be utilized are described below.

1. Cost Cutting Strategies

First with regard to cost cutting, the costs of pension plans are equal to the benefits paid, plus administrative expenses associated with operating the plan, reduced by any investment return generated by invested assets. Therefore, there are really only three ways to reduce plan costs:

- Reduce benefits
- Increase investment return
- Reduce administrative costs

Reduce Pension Benefits

One caution with regard to reducing benefits is that public pension benefits may be very difficult to modify. Public pension benefits are often the product of collective bargaining agreements, and they're strongly supported by employee and union groups.

Furthermore, public employee pension benefits, once approved, are subject to constitutional protection in some states. Experts generally agree that governments can change or reduce benefits for employees who haven't yet been hired, and 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.

Because of the difficulty and uncertainty of reducing benefits for current employees, providing reduced benefits for newly hired employees may be the most practical option for paring costs. Unfortunately this "two-tier" approach will not produce significant cost savings for years.

Some of the options for reducing benefits are to:

- Reduce cost of living increases—automatic cost-of-living increases 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 most likely make it hard to eliminate cost-of-living provisions for public sector retirees. Further, since public retirement systems replace Social Security benefits in

many states, it may be 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.

• Scale back lucrative early retirement benefit provisions—generous early retirement provisions often allow public-sector workers to retire with full benefits as early as age 50 or 55—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.

• Reduce basic pension benefit—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. However, one word of caution—transitioning to defined contribution plans for new hires while still providing pensions to existing employees may actually result in higher total costs for poorly funded pension plans.

• Close Loopholes—although it may not be easy to reduce basic benefit formulas, it may be possible to modify ancillary plan provisions, some of which can significantly reduce plan costs. Options include:

—Tighten the practice of granting large pay raises in the years immediately before retirement, which can allow employees to spike final earnings amounts.

—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 by limiting the categories of eligible workers.

Increase Investment Return

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. Some plans' 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. 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.

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

This strategy depends on careful market timing and therefore is highly risky. Another problem with pension obligation bonds is that it involves converting a soft debt (pension liability) into a hard debt (the required bond payments), which gets the attention of the bond rating agencies. Moreover, voters may balk at the prospect of approving new long-term debt.

Illinois, however, used the technique very 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 basically 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 virtually overnight.

Reduce Administrative Costs

Savings from administrative changes probably will be small in relation to the size of the pension funding problem. 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.

2. Revenue Enhancing Strategies

In terms of enhancing revenue, States and localities should first consider raising the amount that employees contribute to public retirement plans. Employee pension contributions generally have held steady as plan costs have increased. One alternative would be to tie employee contribution amounts 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.

Such 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.

State and local governments should also look and see if they have any untapped revenue sources that could be used to fund pension obligations. Finding these dollars will require innovative thinking. 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. Other revenue sources might include sales of unused public properties.

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.

Finally, 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.

Mr. Chairman and Members of the Committee, there are no easy solutions to the public pension crisis. Hopefully, the information presented in this testimony will assist the federal government (1) better understand the unique challenges facing public sector pension plans and (2) develop solutions designed to improve the affordability and funded positions of public sector pension plans.

Mr. KLINE. Thank you, Mr. Weiss. And thank all of the panel members.

Our plan here is for each of us to ask some questions, I am going to ask a few questions and then I will yield to Mrs. Biggert and then probably another round. I am mindful that people have schedules to keep, both panel members and Mrs. Biggert and I, and I

am sure most people in the audience, so we will try not to have this go too long, but there are some things that I feel need to be cleared up. I am not sure if we can do it here today, but I am going to try just a couple.

Just a couple of comments. It is interesting the different perceptions. We had several panel members talking about the crisis in public employee pensions and other witnesses discount that completely. So we may need to explore that a little bit. I may need to use Ms. Jinks' mathematics skills to help me with Mr. Filan's testimony.

[Laughter.]

Mr. KLINE. That was an impressive array of numbers.

Let me just start with a couple here. I wrote so many notes, I have got to get myself organized a little bit. It seems to me that we have differing ways of looking at the health of these pensions, and I am wondering—I think I will start with you, Mr. Weiss—how much of this debate and confusion is a function of the differing modes of accounting and actuarial assumptions and would a more uniform or standardized set of accounting assumptions give us a better picture? Is that something that you can address?

Mr. WEISS. Sure. I really do not believe it is a function of accounting or actuarial assumptions. I think, you know, if you look at the funded percentages as it compares to accrued liabilities, I think that gives you a pretty good, at least a snapshot, view of the health of these plans, at least in today's terms.

Probably more important though is to look at what is the projected funded percentage ratios of these plans as we go forward, based on their existing funding policies. And for too many plans, the ratios are, in my own opinion, inadequate and trending downward instead of upward, notwithstanding, you know, future investment returns or expectations for investment returns.

So I think it is really a function of looking at the funded percentage, determining if that is appropriate, looking at the affordability of the funding schedule required to improve the funded percentages. So for example, for a plan that is 70 percent funded, I think we probably all agree we would like that plan to get to 100 percent funded within a reasonable period of time. What is the funding required to get there, is it affordable based on the existing level of benefits?

Mr. KLINE. But in determining the percentage funded, you have got to use some basis. Are you assuming a growth of 6 percent, 8 percent, 9 percent? It seems to me that would have a big impact on determining how well funded you are and I do not know—we tried to grapple with that in the Pension Protection Act, but I do not see that there is any uniformity here. Is that of any interest to you at all?

Mr. WEISS. Yeah, it is. I think honestly most public plans make a reasonable attempt to come up with a discount rate to determine their liability, and that is really where it is applicable, determining the liability.

Mr. KLINE. Exactly.

Mr. WEISS. With the assets, the market value is the market value. But it is the liability that there is some flexibility in terms of determining the appropriate discount rate.

You are right, it might require a uniform measure of that liability similarly to what you have done now for the private sector via the Pension Protection Act, might make these plans more comparable but honestly, I think the plans do a very reasonable job in determining, you know, fairly consistent discount rates.

Mr. KLINE. OK, thank you. Anybody else have a comment? Mr. Brainard.

Mr. BRAINARD. If I might.

Mr. KLINE. Yes, please.

Mr. BRAINARD. Mr. Weiss commented that he felt that public pension plan funding levels are trending downward. I believe that they have reached—for the community certainly as a whole and for most plans, they have reached their low point. Most public pension plans phase in investment gains and losses over several years to reduce volatility in funding levels and required contribution rates. For most plans, they have recognized all or most of the investment losses that we experienced through March 2003, but very few of the investment gains we have experienced since then. As more of those investment gains are recognized on the books in the next few years, those funding levels are going to begin to rise. That coincides nicely as well with the last several years of public pension plan liability growth which has been significantly lower than assumed levels, where in the 1990's when there were some benefit enhancements approved, liability growth was 8 percent, 9 percent. The last 3 years average liability growth for the public pension community has been about 5 percent, significantly lower than the assumed rate of 8 percent.

Mr. KLINE. OK, thank you.

Let me—I am going to ask another one or two and then I will be happy to yield to you.

Ms. Jinks, you said that the Teachers Retirement System had to sell off assets to make the payments on time. Could you tell us some more about that, what literally happened?

Ms. JINKS. It is my understanding that the Teacher Retirement System was forced, during this last year, in order to meet the current obligations of payroll, the actual monies to be paid out to annuitants, had to sell some of its invested stocks in one of the funds in which it was invested to use those funds to pay the present annuitants.

Mr. KLINE. And so the effect of that then obviously is you have fewer assets that can earn a return.

Ms. JINKS. It is like spending one's bank account without a reasonable way of replenishing those funds. They are in fact gone.

Mr. KLINE. Yes, sir? You had some more comments here? Go ahead.

Dr. GIERTZ. The fact of a pension system selling assets is really not a clear sign of either good times or bad times. A mature system, a system that has been in operation for many years and accumulated a lot of assets will in fact routinely sell assets to meet its obligation. So it could be a sign of weakness, it might not be. In this case, it probably is a sign, but in general selling assets is not a warning sign of some kind of major problem.

Mr. KLINE. Mr. Weiss.

Mr. WEISS. Actually we did take a look at the Teachers plan and it is more a function of how the assets are invested and the generated cash versus investment—it is really a function of the investment policy that required them to sell assets. The combination of employee contributions, employer contributions and generated investment cash was insufficient to pay the total amount of benefits. In fact, the total assets of the Teachers plan increased, so it is really not the fact that the fund is having to—is being reduced to pay benefits, it is more a function, as Dr. Giertz implied, of the maturity of the plan, the significant dollars that are being paid out in benefits and the investment policies.

Mr. KLINE. I see.

Mr. WEISS. Most importantly, the total funds increased.

Mr. KLINE. I see.

Let me yield now to Mrs. Biggert.

Ms. BIGGERT. Thank you, Mr. Chairman.

Congress, in the Pension Protection Act, acted to toughen up the funding requirement for the private pension plans, requiring a step up to 100 percent by phasing it in, and they required sponsors of severely under-funded plans to step up the funding requirements and probably most importantly by limiting the benefit increases and accruals when the plans are under-funded.

In general, are state plans, in particular Illinois' pension plans, subject to any similar restrictions?

Dr. GIERTZ. I think the answer is no, but we have a kind of odd situation constitutionally. The State of Illinois is mandated to pay the pension benefits, but there has been a court cases that has held that we are not constitutionally mandated to fund the pension system. So the under-funding then becomes a liability to the State of Illinois and the taxpayers of Illinois. So unlike the Federal situation, a poorly funded firm might go out of business and then some of those obligations would fall back on the Pension Guarantee Organization and become an obligation of the taxpayers of the country. But in the case of the state, the funder of last resort is in fact the state and the taxpayers. So there is in fact an argument to be made that the state systems, and probably less so local systems, are kind of hybrid, somewhere between—seems like Social Security was basically a pay-as-you-go and a purely private system should be a fully funded kind of system. So I think it is not unreasonable to think that a system like Illinois could operate at a 90 percent fully funded situation continually because we have an ongoing life expectancy, we do not expect to go out of business, we have the fallback of the taxpayers. So 100 percent would be good, but may not be absolutely necessary.

Ms. BIGGERT. Would you say that there is a certain level that the fund should reach?

Dr. GIERTZ. I think the concern is—we clearly have a source of concern, but there are many ways to fund a pension system. The pay-as-you-go system is the worst way because you end up not paying at the time and having to pay huge amounts in the future. My rough calculation says if you had a fully pay-as-you-go system, we would end up paying about 20 percent of our salary to fund pensions. If you had a fully funded, pre-funded, system, it would take about 10 percent of our salary contributions. So not fully funding

is a very expensive way to do it. It could be done, we have the resources, the taxpayers of Illinois are there, but it not a very good way to go about it.

Ms. BIGGERT. It was mentioned that Social Security is a big problem and Medicare. We tried to take on Social Security because we thought Medicare was harder and now here we are with the pensions. We have a lot to do, and maybe Social Security, because it is a pay-as-you-go, has always been that way.

We heard a lot of testimony about Public Law 88-593 and the 1995 pension law that set up the plan to get Illinois pensions up to 90 percent funding and then SB 27. In your opinion, Mr. Giertz, is SB 27 a step forward toward better pension funding, or a step back away from the improvement plan that the state has been following over the last 10 years.

Dr. GIERTZ. Well, I think it was a temporizing kind of measure that—it was not in a sense catastrophic, but it increased the payback into the future. I used the analogy once that the 1995 law was like saying I am going to go on a diet, I am going to start by reducing my calories 10 years in the future. Well, the 1995 law said we are going to solve our problem, but they did not really attack the pain until a decade later. And when that pain came along, we decided to roll back the clock. So my problem with—Mr. Filan, I think was correct in terms of all the money, we have had a lot of money going into pensions and if you compare the current administration to 10, 20, 30 years ago, they might fare fairly well, the question is what about the future. Just in 2 years, this is the 2007 budget year, 2 years from now, the State is going to have to, according to our rules that are on the books right now, going to have to increase pension funding by 1.3 billion, the year after that another $2 billion. Well, $2 billion is about 7 percent, is a huge percentage of our state budget. So the question is, where is the State, a year and a half from now, going to come up with another $1.2 billion, where is the State going to come up with another $2 billion. Now again, that is not the fault of the administration, these numbers were there, but the question is at some point we have to stop blaming people 20 and 30 years ago and step up to the plate and deal with the problem. That is where we are right now.

Ms. BIGGERT. I have read reports that say that the change in SB 27 would allow the State to contribute $2.3 billion less in pension contributions.

Dr. GIERTZ. Again, I am sure Mr. Weiss and Mr. Filan probably have a different opinion, but it did reduce benefits in the future, especially for new employees. But what they did was to capture those future benefit reductions that are going to occur years into the future and reduced by this year and the preceding fiscal year. So again, it is a matter of reducing benefit growth somewhat but then attributing all those reductions to the current period, and we still have the future demands starting in a couple of years.

The other thing which is a little bit troubling too, one of the reforms of the 2005 law was to reduce end-of-career salary increases that credit toward the pension. It was supposed to save money. We passed it 1 year, the very next year, we rescinded that and as far as I know there was no extra source of revenue coming in to compensate for that.

Ms. BIGGERT. Mr. Filan.

Mr. FILAN. That last statement is incorrect. The Senate Bill 27 that indicated a number of cost reductions going forward, that was referred to, according to the system actuaries, will reduce the long-term liabilities, both a short and long-term challenge, by $83 billion. The changes made this year in what is terms unintended consequences, were minor revisions where the State was not trying to penalize a local school district for increases that were caused not by them but by things such as state statute or other provisions that were not their responsibility. But the vast majority of the end-of-career pay increase controls that were put into place in the law remain in place.

If I may comment just very briefly, I think the question asked of Lance Weiss regarding accounting and economics is an excellent question frankly, I think. I have kidded Lance a couple of times, my background is accounting, his is actuarial science, if we both sent our children to the best schools and one had an accounting degree and one had an economics or actuarial degree and you were looking at any government's financial statements, you would find the accountant's representation of the pension liability and that of the actuary vastly different. In the case of Illinois, it is about half in terms of what they assume and how they report it and how they structure it. So I think it is a very excellent point to pursue.

I would point out on the earlier question, no one goal or no one act should be looked at by itself, I think it is what happens in the entirety. And the question to Lance about the market value of assets is a perfect example. I think for all pension systems, including Illinois, in those four or five boom years in the 1990's, those returns looked so wonderful that it masked the under-funding, it masked the unfunded benefits because the way it worked is you were booking those huge gains as if they would last forever and they do not. And consequently, I think a lot of people were not consciously misled but got an unwarranted amount of comfort from doing that.

So in this case, I think if you look at the entirety and not just any one bill or one action, but what has happened in this case in the last 3 years, as Dr. Giertz said, there is improvement. We have a long-range goal. The only way we fix a $43 billion problem ultimately is with $43 billion. And you do not do it overnight, but it takes a tremendous amount of discipline over many years to dig out of a hole that Illinois has been in for three decades.

Ms. BIGGERT. I guess that is why we do the planning for 40 years. Mr. Weiss.

Mr. WEISS. Thank you. One other comment with regard to the 1995 funding plan. I was not involved with, you know, the State at that point, but they had to know when they implemented that plan that basically it was a payment plan. As Director Filan pointed out, it really was not a funding plan so much as it provided some discipline to the State, it required a certain amount of payment. To me, a funding plan is a plan that sufficiently funds the plan. This did not do it, it pushed most of the liability—again Director Filan pointed this out—it pushed most of the liability out into the future to future generations. And I believe the legislators had to know at some point that payment was going to become

unaffordable. Unfortunately it became unaffordable during Governor Blagojevich's tenure here. And I think SB 27 was one of the actions that the Governor took to attempt to alleviate some of that pain and attempt to bring the plan back into balance. Now as Director Filan pointed out, you know, in and of itself, it is not going to do it, it has got to be part of a series of actions designed to bring the plan back into balance.

Ms. BIGGERT. Thank you. I have not decided whether I want to say I was here then or not.

Mr. WEISS. I was afraid to ask.

[Laughter.]

Dr. GIERTZ. Well, affordability is not a clear term. People talk about, there are words of choice and words of necessity. Affordability is really a question of can you do it. And clearly we can afford to deal with the pension system in Illinois. We chose not to because we ruled out the most important option to be ruled out, spending cuts in other areas. Governor Blagojevich came in saying I will not cut education spending, I will not cut health, I will not cut public safety and so on, and I will not raise taxes.

Well, when you make those kind of promises, almost everything becomes unaffordable unless you do it by borrowing, so affordability is not—it was not unaffordable in the sense if we wanted to, it was unaffordable because we chose not to because we ruled out most of the options that would make it affordable.

Ms. BIGGERT. Thank you. I yield back.

Mr. KLINE. Thank you, Mrs. Biggert. I will ask a few, and we will come back to you in a minute.

Sort of a fairness doctrine here directs that I turn to Ms. Webb-Gauvin, you have been sitting there as this has been going on back and forth. I certainly have no disagreement, and I am sure that Mrs. Biggert does not, nor does this Committee, the Subcommittee, large Committee, that a defined benefit pension plan is a very valuable asset. We worked very, very hard to make sure that those defined benefit plans were fully funded and working, would be there for the retirees in the private sector. So it is not a question of is a defined benefit plan important or is it good, it is a question of is it going to be there when you need it.

And that is sort of what we are grappling with here. We took it on in the private sector and now we are sort of asking the question of ourselves, is there a role for the Federal Government—and neither one of us is at all sure there is, but is there a role for the Federal Government in making sure that the public employee defined benefit plans are going to be there for their employees. And so I guess my question to you is do you or your organization, you have no concerns about the under-funded plans that we have been talking about here?

Ms. WEBB-GAUVIN. By all means, we are concerned about under-funding of pension programs, whether they be in the private or public sector. We believe though that most of the public pension funds are well managed and well funded. Illinois is the exception to that. We are not as well funded as we would like to see, our members are very concerned about that. We think it is not a regulatory problem, it is an under-funding problem. We had the money,

we chose to spend it somewhere else and we believe that that policy here in Illinois needs to change.

I do not know if there is—I do not believe that there is a uniform way for the Federal Government to come in and address this concern. All states are different and their pension systems are unique and they have their own unique problems. I am not sure you could come in with a uniform policy that one size fits all.

Here in the State of Illinois, we have a constitutional guarantee that our members will receive their pension benefits, and we believe that they will be there. The under-funding is a very serious problem and it needs to be addressed. We do not believe that a two-tiered system or reducing pension benefits is a way to address that problem.

Again, as I said in my testimony, our pension benefits here in the State of Illinois are not overly generous. This is purely a funding problem, and we feel that there are other ways that we can address that by raising revenue to address the funding problem.

Mr. KLINE. Thank you. I would say that as we looked at the pension plans in the private sector, it was largely an under-funding problem as well. We had the issue of masking that was discussed earlier with the dot-com in the 1990's that looked like there were a great many assets in these plans, and when the dot-com bubble burst—and I am over-simplifying this a little bit—but it turned out that the assets were not there and private companies had not been putting payments into those plans. So we had some very under-funded plans.

So the problems are not dissimilar in that if you do not put enough money in the plan, there may not be enough money there to make the payments. The difference is, of course, that with governments, state governments, and particularly like Illinois, where you have a constitutional requirement that those benefits be paid, it is going to go directly to the taxpayers and it is a policy decision.

And again, I am not really suggesting that the Federal Government has a role here, that is something we are exploring. We felt the Federal Government did have a role because of the exposure of the American taxpayers in the role of the Pension Benefit Guarantee Corporation in making sure that private sector employers were meeting their funding requirements.

Mr. Weiss, let me turn back to you. You are the last guy in the line here I think, but you have some expertise I want to use to—I want to exploit for just a minute. To what extent does a state, and it does not have to be Illinois, to what extent does a state's deferral of pension plan payments—what role does that play in the broader economic picture in the state or in the country? Bond rating and so forth, what is the impact?

Mr. WEISS. That is a very good question, and the bond rating agencies now are taking a much, much closer look at debt of a state, both hard and soft debt. And in talking to and listening to some of the rating agencies, when they look at a state and rate that state, pension debt plays a major, major issue these days.

More importantly, I think though the rating agencies nowadays are looking at the actions a state is taking to address those issues. So they are not necessarily, you know, nicking a state for past inadequacies in funding, but more importantly, they are looking at

what are you doing to address these liabilities. You have these liabilities, these unfunded liabilities, what are you doing to address these liabilities. And I think it is important for these states to recognize that they have to take some action.

As a pension actuary, I can assure you that—and you all know this from the actions you took by implementing the Pension Protection Act—if you do nothing, pensions that are out of balance do not miraculously come back into balance. You have to take some action, whether it is legislatively or funding-wise or whatever. You have to take some action or change benefits.

So yes, these liabilities have a major impact on a state, the economy, the economic conditions that we are operating in have a role to play. The overall, you know, financial needs, the revenue generation of a state all comes into play, and I think as Dr. Giertz indicated, you know, these states and localities have to find a balance between how much can they cut other sources, how much do they have to fund the plan and where is the revenue coming from, can they increase taxes. It is a fine balance, but they have to take some action. I think the bottom line is they need to take some action and find a fine balance between increasing taxes, reducing benefits or if they do not take action, the rating agencies are going to definitely impact them in lower ratings, which has all kinds of implications for the people living in each state.

Mr. KLINE. I guess that would apply state by state or perhaps even municipality by municipality or whatever the governmental unit is that has the pension plan.

Mr. WEISS. Yes, absolutely.

Mr. KLINE. OK, thank you.

Mrs. Biggert, I will yield to you.

Ms. BIGGERT. Thank you. Mr. Weiss, you talked about some of the things that contribute to perhaps under-funding, such as early retirements. Could you comment on a couple of those?

Mr. WEISS. Sure. Many states, similar to what the private sector did, you know, many years ago, was to increase, improve early retirement provisions. To the extent we are now—and it is not universal, but in many plans, localities, states, et cetera, employees can retire as early as age 50 with unreduced benefits. Now it is not always 50, it might be 55, it might be 60. These provisions vary greatly across the plan. But they are extremely expensive. By allowing an employee to retire early with unreduced benefits, the cost of that is phenomenal. And it also is not only costly, but then you lose all of that talent and every projection we see, every survey we see now is projecting a future shortage of skilled workers coming into the workforce. So if we are losing all this talent and we do not have the skilled workers available to replace them, it is going to be even more of a problem.

So one suggestion we had similarly to what the private sector has done is to tighten some of these early retirement provisions.

Ms. BIGGERT. I think that happened here.

Mr. Brainard.

Mr. BRAINARD. Ma'am, if I might, I infer that your question is referring particularly to early retirement windows where a state or a plan sponsor will say that you will have an incentive to retire until such and such a date. And the actual cost of an early retire-

ment window really depends on the way it is structured and the incentives that are provided. Particularly in down economic times, some states and municipalities have benefited from such windows because, for example, it can allow you to replace an employee who is making say $65,000 with somebody who is making $35,000. So you are generating some immediate savings. And then, of course, you have an actuarial cost to the pension plan. It really depends on how you structure it and how well you manage it.

Illinois offered an early retirement window a couple of years ago that, for whatever reason, ended up costing them a lot more than was initially projected. But by definition, an early retirement window is not expensive and does not necessarily have a cost to it.

Dr. GIERTZ. I am not a defender of early retirement. In fact, I do not think it is a good idea in most cases, but in Illinois it has been used in the same old pattern. What we do is to have—if we have a budget problem, we will have an early retirement program, window, as was mentioned here. People will retire, the State saves money in the short run. The consequence is that pension liabilities increase on the back end and we never fund those. They use the money saved in the early retirement to build a bridge in the short run and then throw the costs onto the pension system. So it is not necessarily bad per se, it is just bad in the way that it is financed. And we have tended not to use the savings in early retirements to bolster up the pension systems.

Ms. BIGGERT. Dr. Giertz, going back to the changes in Senate Bill 27 from the former law, which allowed the State to contribute less, $2.3 billion less in pension contributions for fiscal year 2006 and 2007, will this end up costing more in the long run, you know, over a period of years?

Dr. GIERTZ. Again, there were two parts of the bill, the part of the bill that is to reduce future pension benefits will save money. And the next question was how do you allocate those savings over time, and we chose to allocate a lot of the savings early, early on. So the fact that we are not making those contributions to the pension system means that those funds are not going to be generating revenue in the future, so it is going to be somewhat more costly. But you have to be careful and not compare directly future versus current cost and benefits, because of the value issue. But there is at least a modest cost in moving up the savings in the early years.

Ms. BIGGERT. So did most of this increase take place in fiscal year 2004?

Dr. GIERTZ. Most of the——

Ms. BIGGERT. The increase of the payback?

Dr. GIERTZ. I mean, we were scheduled to have some large increases, according to the 1995 law, that would have taken place in fiscal year 2006 and 2007. Then we passed this new law which sort of recalibrated the payment schedule and what we did was reduced what we would have paid and we had substantial reductions in funding for last year and this year, and the consequence is we will have higher payments in the future.

Ms. BIGGERT. Well, like in fiscal year 2004 then, the ratio went up to 60.9 percent and then it fell to 57.7 in fiscal year 2007?

Dr. GIERTZ. Right. There were several things happening, but it went up hugely when we put in the 7.5 or $10 billion pension bond-

ing proceeds and then the market also took off at that time, so we did very well, but then this last year, the lower contributions did have an impact on funding. For example, with SERS, my understanding is that SERS earned about 11 percent plus for this last fiscal year, which is really great performance, 3 percentage points above our benchmark. But our funding ratio did not improve at all because of the lack of state contributions. So again, that hurt us, but the State is supposed to make that up in the future.

Ms. BIGGERT. Thank you.

Mr. KLINE. OK, thank you very much.

I would like to thank the panel. Really a terrific panel of witnesses, a great level of expertise and coming at it from different angles. Because we have just come through this experience of the Pension Protection Act, I think we are more keenly aware on this Committee of the dangers of an under-funded plan and all the problems that that can lead to.

So I want to thank everybody here today for coming to this beautiful room in this beautiful building to participate with us. I want to thank the witnesses for their very valuable time and testimony. I would like to thank my friend and colleague, Mrs. Biggert.

And if there is no further business, the Subcommittee stands adjourned.

[Whereupon, at 12:42 p.m., the Subcommittee was adjourned.]

[Additional submissions for the record follow:]

[Article submitted by Mr. Filan follows:]

[Article from Governing.com, Management Insights column, July 12, 2006]

Paying for Tomorrow

By WILLIAM D. EGGERS

When Rod Blagojevich began his first term as governor of Illinois in January 2003, he had a host priorities he wanted to address: Improving schools, investing in the state's underfunded infrastructure, increasing access to health care and so on. There was only one problem: A few months into office, he learned that the state's public employee retirement system was starting at an unfunded liability of $43.1 billion (with a funding ratio of under 50 percent).

If things continued on their path, annual state payments into the system would have to jump from $1 billion in 2006 to $4 billion in 2013 and $16 billion in 2045. "Unless we reform the way we fund our pensions," explained the governor, "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."

Illinois has a lot of company. More than 87 percent of state pension systems are underfunded, dwarfing the much-publicized corporate pension problems. In New Jersey alone, state and local public retirement systems are underfunded by as much as $35 billion. Meanwhile, the bill for paying future medical benefits for state and local employees who retire could top $1 trillion. And the problem will only get worse with the impending huge wave of baby boomer retirements.

So what's to be done?

Some experts say the solution is to transition public pension systems from defined benefit to defined contribution 401(k)-style retirement programs. While this may be the right thing to do for the long term, it's unfortunately not a solution to managing today's near-term runaway retirement costs. Reason: 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. In fact, thanks to transition costs, defined contributions would likely increase costs in the near term.

So if that's not the answer, what is? From an actuarial perspective, the "solutions" are quite simple—costs must either be reduced to solve the problem or deferred to postpone the problem. And continuing to defer the problem to future generations is both unfair and irresponsible.

That leaves one option: reduce costs. This brings us back to Illinois. Facing one of the most underfunded public pension plans in the country, resulting from deci-

sions made long before he took office, Blagojevich has methodically gone about taking out costs and liabilities from Illinois' five state retirement systems.

Loopholes and abuses have been curtailed. School districts, for example, had 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. No more. School districts must now pick up the tab for pension increases triggered by pay raises in excess of 6 percent.

Another big cost driver in Illinois was expensive special benefits once reserved for police officers for risking their lives in the line of duty, which over the years had somehow spread to one-third of all state workers. Eligibility for these benefits was cut back to those they were originally intended for: public safety workers.

To avoid making the same kinds of mistakes again that got Illinois into the trouble it's in now, the governor convinced the legislature to mandate that all future benefit enhancements will expire after five years unless they are renewed by the governor and the state legislature. In addition, every future benefit increase is required to have a dedicated revenue source.

Illinois offers important lessons for other states and localities embarking on fixing their pension systems. The first is to gain a firm 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.

Second, involve 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.

Once reform proposals are developed, you'll need a broad education campaign to explain their value to constituents. Illinois 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.

Third, while it's true that public-pension-plan underfunding is a financially driven crisis, it should not be viewed purely through a financial prism. Pension issues cannot be divorced from their impact on talent acquisition and management. 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. All financial decisions are also human-resource decisions that may have significant workforce consequences.

Lastly, Illinois teaches us that few of the pension-reform options 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.

William D. Eggers is the co-author of "Paying for Tomorrow: Practical Strategies for Tackling the Public Pension Crisis," to be published by Deloitte Research in mid-July.

[Commission report submitted by Mr. Filan follows:]

Report on the 90% Funding Target of Public Act 88-0593

Commission on Government Forecasting and Accountability,
703 Stratton Office Building, Springfield, IL 62706

January 2006

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Executive Summary

This report looks at the financial status of the State retirement systems in Illinois. The following is a summary of the findings:

• P.A. 88-593 requires the State to make contributions to the State retirement systems so that total assets of the systems will equal 90% of their total actuarial liabilities by fiscal year 2045. The contributions are required to be a level percent of payroll in fiscal years 2011 through 2045, following a phase-in period that began in FY 1996.

• P.A. 88-593 also requires the Commission on Government Forecasting and Accountability to make a periodic evaluation of whether the 90% target funded ratio continues to represent an appropriate funding goal for State-funded retirement systems in Illinois.

• The funded ratio places the unfunded liabilities in the context of the retirement system's assets. Expressed as a percentage of a system's liabilities, the funded ratio is calculated by dividing net assets by the accrued actuarial liabilities. The result is the percentage of the accrued liabilities that are covered by assets.

• At the end of FY 1995 (the year before the implementation of P.A. 88-593), the systems' total unfunded liabilities were almost $19.5 billion. By the end of FY 2005, the liabilities totaled $38.6 billion, an increase of 97% from the FY 1995 level.

• Investment returns performed above expectations in the early years of the current funding plan, however Fiscal Years 2001 and 2002 saw significant investment losses when compared to actuarial assumptions. Investment losses were also recorded in Fiscal Year 2003. The five State-funded retirement systems have benefited significantly from the upturn in the financial markets over the last two fiscal years.

• P.A. 93-0002 authorized the State to issue $10 billion in general obligation bonds for the purpose of making required contributions to the five state-funded retirement systems.

• P.A. 94-0004 (SB 27) contained several important reforms that are expected to reduce the rate of growth of the accrued liabilities of the five State-funded retirement systems.

Commission staff analyzed projected contributions based on the 1994 actuarial valuations of the five State-funded retirement systems and compared them with the most recent actuarial forecasts. This analysis, shown on pages 16 and 17, shows that the total cost of the current funding plan has not grown appreciably from what the 1994 forecasts had predicted (this despite counteractive factors such as formula increases, investment gains and losses, the infusion of pension obligation bond proceeds, and the funding reductions and reforms contained in P.A. 94-0004). While the current pension funding plan will continue to present significant challenges from a budgetary perspective, the Commission believes that the goal of reaching a 90% funded ratio by 2045 as called for in P.A. 88-593 should be maintained.

I. Public Act 88-593

Public Act 88-593 amended the State-funded retirement systems' Articles of the Pension Code to require annual appropriations to the systems as a level percent of payroll, beginning in FY 2010, following a 15 year phase-in period which began in

FY 1996. The goal of P.A. 88-593 is to attain a 90% funding ratio by FY 2045. After FY 2045, the State must contribute the annual amount needed to maintain a 90% funding ratio.

P.A. 88-593 requires the Board of Trustees of each retirement system to certify the required State contributions for each fiscal year by the preceding November 15th. The Act contains language authorizing a continuing appropriation of the required State contributions, which has removed the contributions from the budgeting process and ensures the certified contributions will be made.

The General Provisions Article of the Pension Code was amended by Public Act 88-593 to state that the General Assembly finds that a funding ratio of 90% is an appropriate goal for the State-funded retirement systems in Illinois. The Act further states "that a funding ratio of 90% is now the generally-recognized norm throughout the nation for public employee retirement systems that are considered to be financially secure and funded in an appropriate and responsible manner."

P.A. 88-593 requires the Commission on Government Forecasting and Accountability (CGFA), in consultation with the retirement systems and the Governor's Office of Management and Budget, to make a determination every five years as to whether the 90% funding ratio continues to represent an appropriate funding goal.

Rationale for 90% Funding Target

According to the June 1994 Survey of State and Local Government Employee Retirement Systems, prepared by the Public Pension Coordinating Council (PPCC), the value of assets as a percentage of the Pension Benefit Obligation averaged 90.2% for the retirement systems surveyed by the PCCC in the summer of 1993. It can be assumed that P.A. 88-593 was referring to this survey when it stated "that a funding ratio of 90% is now the generally recognized norm throughout the nation for public employee retirement systems." A snapshot of national trends in the funding status of public pension funds is shown at the end of Section II. While the volatility in the financial markets in recent years has clearly had a negative impact on the funding status of public pension systems nationwide, the Commission reaffirms the endorsement of a 90% funding target contained in P.A. 88-593.

II. National Overview

The chart below reflects data contained in the 2005 Wilshire Report on State Retirement Systems. The chart provides an overview of the financial condition of 64 State Retirement Systems which provided actuarial values for fiscal years 2000 through 2004. The chart also shows that at the end of FY 2004, 84% of these 64 state pension systems, or 54 systems, have liabilities that exceed assets. Also, the average funded ratio for all 64 state systems was 83 % at the end of FY 04.

FINANCIAL OVERVIEW OF 64 STATE RETIREMENT SYSTEMS

[$ in Billions]

	2000	2001	2002	2003	2004
Total Pension Assets:					
Market Value	$795.0	$730.1	$669.1	$681.7	$778.9
Total Pension Liabilities	$727.4	$792.7	$850.1	$889.4	$942.3
Average Funded Ratio	109%	92%	79%	77%	83%
Underfunded Plans	39%	69%	92%	97%	84%

III. Calculating the Funded Ratio

The Funded Ratio

The funded ratio places the unfunded liabilities in the context of the retirement system's assets. Expressed as a percentage of a system's liabilities, the funded ratio is calculated by dividing net assets by the accrued liabilities. The result is the percentage of the accrued liabilities that are covered by assets. At 100%, a fully funded system has sufficient assets to pay all benefits earned to date by all its members. Of course, in order to calculate the funded ratio, the accrued actuarial liabilities must be calculated and the actuarial value of plan assets must be determined.

Determining the Actuarial Accrued Liability

Various actuarial cost methods have been devised to allocate systematically to employers and employees the expenses incurred under a pension plan as employees earn benefits. In other words, an actuarial cost method determines how much money should be set aside each year so that, when the employee retires, the system will be able to pay the earned benefits. An actuarial funding method is also used

to determine the contributions needed in order to meet the costs of currently accruing benefits and improve or stabilize the system's financial condition. The state-funded retirement systems calculate accrued liability based on the projected unit credit method, as explained below.

Projected Unit Credit Method

The pension benefit obligation (PBO) is the actuarial accrued liability calculated using the projected unit credit actuarial method. The PBO is the sum of the present value of:

- benefits payable to current retirees;
- benefits that will become payable to inactive vested members;
- accrued benefits of active vested members;
- accrued benefits of active employees who are likely to become vested; and
- benefits due to future salary increases.

Calculation of Actuarial Assets

There are four different methods that can be used to determine the actuarial value of plan assets. Assets may be valued at the original purchase price or at the market value on the date of the actuarial valuation. Two methods of valuing assets which smooth short-term market fluctuations are the smoothed market method and the blended method. The smoothed market method uses a moving average to smooth market fluctuations, while the blended method uses the average of the cost and market value of assets. The State-funded retirement systems currently determine the actuarial value of their plans' assets using the market value of the assets on the date of the actuarial valuation.

The Significance of Actuarial Funding Ratios

The ratio of assets to liabilities in a defined benefit pension plan, commonly known as the "funding ratio," is a widely utilized method for gauging the health of a retirement system. If a pension plan's assets are equal to its liabilities, the plan is considered to be fully funded (or funded at 100%). If a plan has a shortfall of assets to liabilities (or a funded ratio of less than 100%) then the plan carries an unfunded liability. Hence, such a plan would be considered underfunded. If a pension plan is underfunded, that does not mean that the plan cannot pay the benefits that its current employees and retirees have earned. Indeed, virtually all underfunded defined benefit public employee pension plans, including the five State-funded plans, continue to meet their current obligations.

All pension plans, whether fully funded or not, depend on employee/employer contributions and investment income in order to remain financially solvent. The primary difference between a fully funded plan and an underfunded plan is that the underfunded plan requires contributions to pay for benefits that are currently being accrued as well as to eliminate the shortfall between assets and accrued liabilities. A fully funded pension plan has no such shortfall and therefore only requires contributions to pay for benefits that are currently being accrued. This does not mean that no future contributions will be required for a fully funded plan, but rather that the actuarial value of the plan's assets equal its accrued liabilities at that moment in time.

It should be stressed that the funded ratio is merely a snapshot based on an assortment of long-term financial and demographic assumptions. It is merely a way of attempting to ascertain what the fund's obligations would be if the plan ended as of the actuarial valuation date and all of the plan's future obligations became payable at once. However, all of the plan's future obligations are not payable at once, but rather they are payable over many years into the future. This period of years allows the plan the necessary time to accrue the assets needed to pay future obligations.

Achieving full funding of a pension plan is not unlike a mortgage, in which a homeowner has a long period of time—usually 30 years—to amortize the mortgage. If the homeowner makes all of his or her scheduled payments, the mortgage would be considered fully funded at the end of the 30-year period. At any point during the 30-year amortization period, the outstanding amount of the mortgage is akin to a pension fund's unfunded liability.

IV. The Financial Health of the State Retirement Systems Under P.A. 88-593

The following table provides a summary of the financial condition of each of the five State retirement systems, showing their respective liabilities and assets as well as their combined unfunded liabilities and funded ratios, as of June 30, 2005.

SUMMARY OF FINANCIAL CONDITION: STATE-FUNDED RETIREMENT SYSTEMS

[June 30, 2005; $ in Millions]

System	Net assets	Accrued liabilities	Unfunded liability	Funded ratio
TRS	$34,085.2	$56,075.0	$21,989.8	60.8%
SERS	10,494.1	19,304.6	8,810.5	54.4%
SURS	13,350.2	20,349.9	6,999.7	65.6%
JRS	565.0	1,236.5	671.5	45.7%
GARS	83.3	212.9	129.6	39.1%
Total	$58,577.80	$97,178.90	$38,601.10	60.3%

Changes in Funded Ratios and Unfunded Liability since Passage of Public Act 88-593

Several factors influence the unfunded liabilities of a retirement system. For the purpose of determining the reasons for the changes in the unfunded liabilities (and the funded ratios) these factors have been grouped in six categories, as follows:

1) Salary Increases. The actuary assumes an average rate of growth of employees' salaries, based on historical figures. Because pension benefits are calculated as a percentage of employees' wages, salary levels are an important factor in determining an employee's future level of benefits. If actual salaries increase more than assumed, the unfunded liabilities also increase. Conversely, if actual salary increases are less than assumed, the unfunded liabilities decrease.

2) Investment Returns. Based on historical averages, the actuary assumes an annual rate of return on assets. If actual returns are greater than the assumed rate, the unfunded liabilities decrease. If actual returns are less than assumed, the unfunded liabilities will increase.

3) Employer Contributions. A widely applied measure of the adequacy of funding compares an employer's actual contributions to the actuarially recognized standard of "normal cost plus interest." Under this funding method, an employer makes contributions sufficient to cover the cost of all benefits earned by employees during the year (the normal cost) plus makes an interest payment on the unfunded liabilities of the retirement system. This funding method attempts to freeze the unfunded liabilities without reducing them in total. If employer contributions are insufficient based on this measure, a system's unfunded liabilities grow. If contributions are equal to or greater than required by this method, the system's unfunded liabilities either remain constant or diminish.

4) Benefit Increases. Under the State Constitution, pension benefits cannot be lowered for current employees, but are often increased for a variety of reasons. Any improvement in benefits causes an immediate rise in the unfunded liabilities of the system.

5) Changes in Actuarial Assumptions. Actuaries periodically revise previous assumptions based on recent experience which they feel more accurately reflects what may occur in the future. These changes could relate to investment returns, salary increases, mortality rates, staff turnover, and many other factors. Some changes, such as a decrease in the assumption on investment returns, cause an immediate increase in the unfunded liabilities. Other changes, such as a reduction in the assumed rate of salary growth, cause a decrease in the unfunded liabilities.

6) Other factors. This factor encompasses all other events that do not fall into one of the previous categories. These factors include a change in the actuarial assumptions, or elements that had previously been overlooked but now must be considered.

This section of the study focuses on how these six factors have affected the unfunded liabilities, and therefore the funded ratios, of the State funded retirement systems since the implementation of P.A. 88-593.

State-Funded Retirement Systems, Combined

At the end of FY 1995 (the year before the implementation of P.A. 88-593), the systems' total unfunded liabilities were almost $19.5 billion. By the end of FY 2005, unfunded liabilities totaled $38.6 billion, an increase of 97% from the FY 1995 level. The following table shows how six factors affected the combined unfunded liabilities of the State-funded retirement systems between FY 1995 and FY 2005.

TABLE 1.—STATE-FUNDED RETIREMENT SYSTEMS: CHANGE IN UNFUNDED LIABILITIES FY 1996–FY 2005

[In millions]

	Salary increases	Investment returns	Employer contributions	Benefit increases	Actuarial assumptions	Other factors	Total
1996	$278.1	($950.4)	$1,648.4	$17.8	($781.7)	$316.7	$528.9
1997	(174.6)	(1,718.0)	1,571.6	179.1	(6,629.2)	456.3	(6,314.9)
1998	(113.2)	(2,788.1)	984.2	2,250.2	0.0	275.7	608.7
1999	77.1	(988.6)	883.4	33.9	125.2	893.5	1,024.5
2000	154.5	(1,307.1)	902.6	3.0	0.0	471.6	224.6
2001	64.2	6,610.6	887.5	652.1	2.5	1,261.0	9,478.0
2002	134.4	5,575.4	1,624.1	234.1	1,377.7	1,020.2	9,966.0
2003	125.6	2,071.5	2,426.0	2,425.0	0.0	1,110.1	8,158.2
2004	135.8	(3,841.7)	(4,713.1)	0.0	0.0	408.5	(8,010.5)
2005	35.0	(1,033.6)	2,393.9	0.0	26.4	2,085.6	3,507.3
Total	$716.9	$1,630.0	$8,608.7	$5,795.2	($5,879.1)	$8,299.1	$19,170.8

As Table 1 shows, the failure to make employer contributions at a normal-cost-plusinterest level over the ten-year reporting period was the most significant catalyst in the increase in unfunded liabilities of all five State-funded systems. A change to a market valuation of assets in FY 1997 served to mitigate the total actuarial loss over this period. Despite strong investment returns during the first half of the reporting period, two years of very poor returns in FY 2001 and FY 2002 contributed to an overall actuarial loss in that category. Pension Obligation Bond (POB) proceeds in FY 2004 had a positive actuarial impact on both investment returns and employer contributions. Because of the POB proceeds, FY 2004 was one of only two years in which the systems' overall actuarial liabilities decreased to a significant degree. Benefit increases and other miscellaneous factors also contributed to the increase in liabilities.

Teachers' Retirement System

The unfunded liabilities of the Teachers' Retirement System have increased by over $10 billion since the end of FY 1995. Table 2 details the factors that caused the increase in unfunded liabilities.

TABLE 2.—TEACHERS' RETIREMENT SYSTEM: CHANGE IN UNFUNDED LIABILITIES FY 1996–FY 2005

[In millions]

	Salary increases	Investment returns	Employer contributions	Benefit increases	Actuarial assumptions	Other factors	Total
1996	$400.4	($577.3)	$966.0	$17.8	$0.0	$166.5	$973.4
1997	(59.1)	(830.9)	992.4	0.0	(2,944.7)	88.8	(2,753.5)
1998	(46.0)	(1,417.7)	776.2	1,000.3	0.0	71.2	384.0
1999	44.0	(389.0)	677.4	33.9	125.2	533.9	1,025.4
2000	(33.4)	(450.4)	723.6	0.0	0.0	197.3	437.1
2001	(10.3)	3,089.8	733.9	0.0	0.0	632.7	4,446.1
2002	4.9	2,696.2	1,074.4	0.0	694.7	360.0	4,830.2
2003	171.8	827.4	1,415.6	53.8	0.0	658.5	3,127.1
2004	217.3	(2,168.9)	(2,811.5)	0.0	0.0	357.2	(4,405.9)
2005	236.7	(682.3)	1,299.8	0.0	26.4	1,706.2	2,587.1
Total	$926.3	$96.9	$5,847.8	$1,105.8	($2,098.4)	$4,772.3	$10,651.0

The leading causes of the increase in unfunded liabilities of TRS were insufficient employer contributions and other miscellaneous factors (such as waiving ERO payments for teachers with 34 years of service). Over the ten-year period, years of strong investment returns in the first half of the reporting period were offset by two particularly poor years in 2001 and 2002. The POB proceeds in FY 2004 served to offset the overall actuarial losses in both investment returns and employer contributions.

State Universities' Retirement System

Table 3 shows the factors that caused the unfunded liabilities of SURS to increase approximately $2.3 billion from the end of FY 1995 to the end of FY 2005.

TABLE 3.—STATE UNIVERSITIES RETIREMENT SYSTEMS: CHANGE IN UNFUNDED LIABILITIES FY 1996–FY 2005

[In millions]

	Salary increases	Investment returns	Employer contributions	Benefit increases	Actuarial assumptions	Other factors	Total
1996	($70.5)	($105.4)	$456.0	$0.0	$0.0	$86.8	$366.9
1997	(44.0)	(312.3)	424.8	179.1	(3,342.4)	198.5	(2,896.3)
1998	5.2	(765.7)	158.8	0.0	0.0	48.1	(553.6)
1999	44.3	(273.3)	147.2	0.0	0.0	314.9	233.1
2000	171.5	(587.5)	162.0	0.0	0.0	13.7	(240.3)
2001	70.3	2,068.5	141.4	0.0	0.0	266.7	2,546.9
2002	90.8	1,568.7	313.9	63.0	485.3	155.6	2,677.3
2003	10.3	583.0	549.4	0.0	0.0	328.4	1,471.1
2004	(62.9)	(950.5)	(846.0)	0.0	0.0	41.2	(1,818.2)
2005	(19.4)	(218.0)	536.8	0.0	0.0	208.0	507.4
Total	$195.6	$1,007.5	$2,044.3	$242.1	($2,857.1)	$1,661.9	$2,294.3

The leading causes of the increase in unfunded liabilities of SURS were investment losses, driven mainly by two years of particularly poor returns in FY 2001 and FY 2002, and also insufficient employer contributions over the ten-year time period (with the exception of the Pension Obligation Bond proceeds in FY 2004). Offsetting the increase in unfunded liabilities somewhat was the changeover to valuation of assets at market value in FY 1997, which caused a decline in the unfunded liabilities of SURS of over $3.3 billion.

State Employees' Retirement System

Table 4 shows the elements that caused the unfunded liabilities of SERS to increase by more than $5.7 billion from the end of FY 95 to the end of FY 05.

TABLE 4.—STATE EMPLOYEES' RETIREMENT SYSTEM: CHANGE IN UNFUNDED LIABILITIES FY 1996–FY 2005

[In millions]

	Salary increases	Investment returns	Employer contributions	Benefit increases	Actuarial assumptions	Other factors	Total
1996	($63.8)	($251.4)	$196.6	$0.0	($781.7)	$47.1	($853.2)
1997	(65.1)	(541.6)	121.7	0.0	(379.9)	152.9	(712.0)
1998	(62.0)	(568.8)	9.4	1,249.9	0.0	148.7	777.2
1999	(12.5)	(307.0)	21.0	0.0	0.0	32.9	(265.6)
2000	14.6	(252.7)	(21.8)	0.0	0.0	250.2	(9.7)
2001	(8.0)	1,368.8	(29.4)	652.1	0.0	310.0	2,293.5
2002	52.0	1,247.3	186.9	171.1	168.1	496.2	2,321.6
2003	(28.3)	629.5	404.5	2,371.2	0.0	97.8	3,474.7
2004	(22.3)	(679.7)	(944.1)	0.0	0.0	6.8	(1,639.3)
2005	(166.5)	(123.1)	503.5	0.0	0.0	144.1	358.0
Total	($361.9)	$521.3	$448.3	$4,444.3	($993.5)	$1,686.7	$5,745.2

The unfunded liabilities of SERS increased by over $5.7 billion from FY 96 through FY 05, driven primarily by benefit increases in FY 98 (retirement formula increase) and FY 2003 (the 2002 Early Retirement Incentive). The actuarial loss in investment returns over the ten-year period was due in large part to two years of poor returns in FY 2001 and FY 2002. Also adding to the overall increase in unfunded liabilities were insufficient employer contributions in each year over the ten-year period (with the exception of the POB proceeds in FY 2004) and other miscellaneous factors.

Judges' Retirement System

The unfunded liabilities of the Judges' Retirement System increased by $362.0 million between FY 1995 and FY 2005. Table 5 details the factors that caused this increase in unfunded liabilities.

TABLE 5.—JUDGES' RETIREMENT SYSTEM: CHANGE IN UNFUNDED LIABILITIES FY 1996–FY 2005

[In millions]

	Salary increases	Investment returns	Employer contributions	Benefit increases	Actuarial assumptions	Other factors	Total
1996	$10.0	($13.7)	$24.5	$0.0	$0.0	$14.9	$35.7
1997	(7.7)	(28.1)	27.2	0.0	37.9	15.3	44.6
1998	(10.2)	(30.5)	34.1	0.0	0.0	7.2	0.6
1999	0.5	(16.5)	32.5	0.0	0.0	8.8	25.3
2000	2.2	(14.1)	33.2	3.0	0.0	8.3	32.6
2001	(7.5)	61.8	35.8	0.0	0.0	17.0	107.1
2002	(11.8)	54.5	42.2	0.0	28.4	8.6	121.9
2003	(26.4)	27.2	49.3	0.0	0.0	18.9	69.0
2004	6.3	(36.7)	(92.3)	0.0	0.0	(2.0)	(124.7)
2005	(15.1)	(8.9)	46.4	0.0	0.0	27.5	49.9
Total	($59.7)	($5.0)	$232.9	$3.0	$66.3	$124.5	$362.0

Insufficient employer contributions, along with changes in actuarial assumptions and miscellaneous other factors caused the unfunded liabilities to increase over the FY 1995 levels. Investment income and slower-than-anticipated salary growth both served to offset a portion of the increase.

General Assembly Retirement System

As shown in Table 6, the unfunded liabilities of the General Assembly Retirement System increased by more than $50 million from the end of FY 95 to the end of FY 05.

TABLE 6.—GENERAL ASSEMBLY RETIREMENT SYSTEM: CHANGE IN UNFUNDED LIABILITIES FY 1996–FY 2005

[In millions]

	Salary increases	Investment returns	Employer contributions	Benefit increases	Actuarial assumptions	Other factors	Total
1996	$2.0	($2.6)	$5.3	$0.0	$0.0	$1.4	$6.1
1997	1.3	(5.1)	5.5	0.0	(0.1)	0.8	2.3
1998	(0.2)	(5.4)	5.7	0.0	0.0	0.5	0.5
1999	0.8	(2.8)	5.3	0.0	0.0	3.0	6.4
2000	(0.4)	(2.4)	5.6	0.0	0.0	2.1	4.9
2001	(0.6)	10.1	5.8	0.0	0.0	1.3	16.7
2002	(1.5)	8.7	6.7	0.0	1.2	(0.2)	15.0
2003	(1.8)	4.4	7.2	0.0	0.0	6.5	16.3
2004	(2.6)	(5.9)	(19.2)	0.0	0.0	5.3	(22.4)
2005	(0.7)	(1.3)	7.4	0.0	0.0	(0.2)	5.2
Total	($3.7)	($2.3)	$35.4	$0.0	$1.1	$20.4	$50.9

The increase in the unfunded liabilities of the General Assembly Retirement System from FY 96 through FY 05 was caused primarily by insufficient employer contributions (with the exception of the FY 04 POB proceeds) and other miscellaneous factors. Some of the factors that mitigated the overall increase were actuarial gains realized from lower-than-expected salary increases and higher-than-assumed investment returns.

V. Original and Current Projections of State Contributions and Funded Ratios

This section of the study compares the original 1994 estimates of annual required contributions (and the resulting funded ratios) with the current projections of annual required contributions, which are based on the June 30, 2005 actuarial valuations for each system.

Original Projections (1994 Projections)

The original projections of required annual contributions for the funding plan created by Public Act 88-593 were based on the June 30, 1994 actuarial valuation. The first year of the funding plan was FY 1996 and the contributions for FY 1996 were certified in November 1994. At that time, the assets of the retirement systems were valued at cost, the actuarial assumptions of the systems were more conservative, and the benefit formulas of the 3 large retirement systems had not yet been increased.

Current Projections (2005 Projections)

The current projections of required annual contributions are based on the June 30, 2005 actuarial valuation. These projections take into account changes in actuarial assumptions, the valuation of assets at market value, Pension Obligation Bond proceeds and changes contained in P.A. 94-0004 such as the elimination of the Money Purchase program in SURS for new hires and the modification of the Early Retirement Option in TRS, as well as the funding reductions in FY 2006 and FY 2007.

State-Funded Retirement Systems, Combined

Table 7 compares the original estimate of the required annual contributions to all of the State retirement systems with the current estimate, as prepared by the retirement systems. Also shown are the original and current projections of the funded ratios. The original contribution column includes the FY 1996 certified appropriations and the estimated contributions for selected fiscal years for the remainder of the funding plan. The current contribution column includes the actual State contributions for FY 1996 through FY 2005, the actual appropriation amounts for FY 2006, the certified contributions for FY 2007 (per P.A. 94-0004), and estimated contributions for selected fiscal years for the remainder of the funding plan.

Except for federal and trust funds paid to SERS, the contributions include only State appropriations from the General Revenue Fund, Common School Fund, and State Pensions Fund. Employer contributions from school districts and all other sources are excluded.

TABLE 7.—STATE-FUNDED RETIREMENT SYSTEMS, COMBINED

[Original and Current Projected Contributions and Funded Ratios; $ in Millions]

FY	1994 Projection P.A. 88-593		2005 Projection P.A. 88-593		Difference (2005-1994)	
	Contribution	Funded ratio	Contribution	Funded ratio	Contribution	Funded ratio
1996	$607.2	52.3%	$609.1	54.9%	$1.9	2.6%
1997	$718.7	52.6%	$712.2	70.1%	−$6.5	17.6%
1998	$839.6	52.0%	$881.5	72.2%	$41.9	20.3%
1999	$970.4	51.6%	$1,122.6	73.0%	$152.2	21.3%
2000	$1,109.4	51.4%	$1,224.7	74.7%	$115.3	23.3%
2001	$1,256.8	51.0%	$1,346.6	63.1%	$89.8	12.1%
2002	$1,419.3	51.5%	$1,469.3	53.5%	$50.0	2.1%
2003	$1,591.7	51.7%	$1,628.3	48.6%	$36.6	−3.1%
2004	$1,776.5	52.1%	$9,178.5	60.9%	$7,402.0	8.9%
2005	$1,967.6	52.5%	$1,638.0	60.3%	−$329.6	7.8%
2006	$2,172.3	52.9%	$935.6	58.8%	−$1,236.7	6.0%
2007	$2,390.3	53.4%	$1,372.2	57.7%	−$1,018.1	4.3%
2008	$2,623.8	54.0%	$1,981.3	57.2%	−$642.5	3.2%
2009	$2,871.4	54.7%	$2,662.0	57.2%	−$209.4	2.5%
2010	$3,140.4	55.4%	$3,401.2	57.7%	$260.8	2.2%
2011	$3,271.7	56.2%	$3,641.3	58.2%	$369.6	2.0%
2012	$3,411.1	56.9%	$3,774.3	58.7%	$363.2	1.8%
2013	$3,536.7	57.6%	$3,938.6	59.1%	$401.9	1.5%
2014	$3,709.1	58.3%	$4,097.5	59.5%	$388.4	1.2%
2015	$3,881.6	59.0%	$4,262.0	59.9%	$380.4	0.9%
2016	$4,062.9	59.7%	$4,435.4	60.3%	$372.5	0.6%
2017	$4,253.1	60.4%	$4,617.1	60.6%	$364.0	0.2%
2018	$4,452.8	61.1%	$4,808.7	61.0%	$355.9	−0.1%
2019	$4,662.7	61.9%	$5,010.6	61.3%	$347.9	−0.6%
2020	$4,898.2	62.5%	$5,223.7	61.7%	$325.6	−0.8%
2021	$5,146.2	63.0%	$5,448.1	62.1%	$301.9	−0.9%
2022	$5,407.2	63.5%	$5,683.9	62.5%	$276.8	−1.0%
2023	$5,681.8	64.0%	$5,932.2	62.9%	$250.4	−1.1%

TABLE 7.—STATE-FUNDED RETIREMENT SYSTEMS, COMBINED—Continued

[Original and Current Projected Contributions and Funded Ratios; $ in Millions]

FY	1994 Projection P.A. 88-593		2005 Projection P.A. 88-593		Difference (2005-1994)	
	Contribution	Funded ratio	Contribution	Funded ratio	Contribution	Funded ratio
2024	$5,969.2	64.6%	$6,193.9	63.4%	$224.8	−1.2%
2025	$6,271.3	65.2%	$6,464.7	63.9%	$193.4	−1.3%
2026	$6,568.1	65.8%	$6,747.8	64.5%	$179.7	−1.3%
2027	$6,920.2	66.5%	$7,040.5	65.1%	$120.4	−1.4%
2028	$7,269.1	67.2%	$7,351.4	65.7%	$82.3	−1.5%
2029	$7,635.7	68.0%	$7,676.9	66.5%	$41.1	−1.5%
2030	$8,020.8	68.8%	$8,018.8	67.3%	−$2.0	−1.5%
2031	$8,425.1	69.7%	$8,377.0	68.1%	−$48.2	−1.5%
2032	$8,849.2	70.7%	$8,752.2	69.1%	−$97.1	−1.6%
2033	$9,294.9	71.5%	$9,145.3	70.1%	−$149.7	−1.4%
2034	$9,763.6	72.6%	$9,558.3	71.2%	−$205.4	−1.3%
2035	$10,255.5	73.7%	$9,989.9	72.4%	−$265.7	−1.2%
2036	$10,772.0	74.8%	$10,442.1	73.7%	−$329.9	−1.1%
2037	$11,314.2	76.0%	$10,916.1	75.1%	−$398.1	−0.9%
2038	$11,884.7	77.3%	$11,414.9	76.6%	−$469.8	−0.7%
2039	$12,485.1	78.6%	$11,937.4	78.2%	−$547.7	−0.4%
2040	$13,115.8	80.0%	$12,485.7	79.9%	−$630.1	−0.1%
2041	$13,778.9	81.5%	$13,058.9	81.7%	−$719.9	0.2%
2042	$14,475.3	83.1%	$13,659.9	83.6%	−$815.4	0.5%
2043	$15,208.2	84.8%	$14,289.7	85.6%	−$918.5	0.8%
2044	$15,978.3	86.6%	$14,947.9	87.7%	−$1,030.4	1.2%
2045	$16,786.6	90.0%	$15,636.4	90.0%	−$1,150.2	0.0%
Total	$312,872.4		$315,142.3		$2,269.9	

The factors that have contributed to the changes in overall projected contributions are detailed system-by-system on the following pages.

Teachers' Retirement System

Table 8 provides a summary of the original projected annual employer contributions and funded ratios, per P.A. 88-593.

TABLE 8.—TEACHERS' RETIREMENT SYSTEM

[Original and Current Projected Contributions and Funded Ratios; $ in Millions]

FY	1994 Projection P.A. 88-593		2005 Projection P.A. 88-593		Difference (2005-1994)	
	Contribution	Funded ratio	Contribution	Funded ratio	Contribution	Funded ratio
1996	$324.3	54.3%	$324.3	57.8%	$0.0	3.5%
1997	390.8	53.4%	378.0	64.5%	(12.8)	11.1%
1998	463.1	52.7%	460.4	66.8%	(2.7)	14.1%
1999	541.6	52.3%	567.1	67.0%	25.5	14.7%
2000	623.8	52.0%	634.0	68.2%	10.2	16.2%
2001	712.1	51.9%	719.4	59.5%	7.3	7.6%
2002	807.0	52.0%	810.6	52.0%	3.6	0.0%
2003	909.1	52.2%	926.0	49.3%	16.9	−2.9%
2004	1,018.5	52.6%	5,358.7	61.9%	4,340.2	9.3%
2005	1,128.9	53.0%	903.9	60.8%	(225.0)	7.8%
2006	1,247.0	53.4%	531.8	59.5%	(715.2)	6.1%
2007	1,372.4	53.9%	735.5	58.6%	(636.9)	4.7%
2008	1,505.9	54.5%	1,049.8	58.2%	(456.1)	3.7%
2009	1,647.1	55.1%	1,418.6	58.4%	(228.5)	3.3%
2010	1,801.9	55.7%	1,814.4	59.1%	12.5	3.4%
2020	2,757.6	58.8%	2,739.5	63.9%	(18.1)	5.1%
2030	4,477.4	62.1%	4,261.8	70.2%	(215.6)	8.1%
2040	7,268.6	75.0%	6,658.6	81.7%	(610.0)	6.7%
2045	9,261.1	90.0%	8,371.6	90.0%	(889.5)	0.0%

Contributions to TRS are generally expected to be lower than originally projected for the remainder of the funding plan. This is due primarily to the infusion of over $4.0 billion in Pension Obligation Bond proceeds in FY 2004 and the reforms contained in SB 27 such as the Modified Early Retirement Option (ERO), the elimination of the Money Purchase Option for new employees, the shifting of costs to school districts for end-of-career salary increases, and requiring school districts to pay the normal cost for granting sick leave in excess of two years.

State Universities' Retirement System

Table 9 compares the original and current projections of estimated annual contributions and the resulting funded ratios for SURS. The current contributions column includes the annual employer contributions to the accounts of participants in the Self-Managed Plan (detailed below Chart 9).

TABLE 9.—STATE UNIVERSITIES' RETIREMENT SYSTEM

[Original and Current Projected Contributions and Funded Ratios; $ in Millions]

FY	1994 Projection P.A. 88-593		2005 Projection P.A. 88-593		Difference (2005-1994)	
	Contribution	Funded ratio	Contribution	Funded ratio	Contribution	Funded ratio
1996	123.9	50.1%	123.9	50.1%	$0.00	0.0%199
7	154.1	49.6%	159.5	79.4%	$5.40	29.8%
1998	186.9	49.3%	201.6	85.8%	$14.70	36.5%
1999	222.5	49.3%	217.6	85.3%	($4.9)	36.0%
2000	261.3	49.4%	224.5	88.2%	($36.8)	38.8%
2001	303.3	49.7%	232.6	72.1%	($70.7)	22.5%
2002	348.6	50.0%	240.4	58.9%	($108.2)	8.9%
2003	397.5	50.5%	269.6	53.9%	($127.9)	3.4%
2004	450	51.1%	1,743.7	66.0%	$1,293.7	14.9%
2005	506.5	51.8%	270.0	65.6%	($236.5)	13.8%
2006	567.3	52.5%	166.6	63.9%	($400.7)	11.4%
2007	632.5	53.3%	252.1	62.5%	($380.4)	9.3%
2008	702.5	54.1%	357.9	61.5%	($344.6)	7.4%
2009	777.3	55.1%	456.5	60.7%	($320.8)	5.6%
2010	857.8	56.2%	572.4	60.3%	($285.4)	4.1%
2020	1,393.40	70.0%	1,021.9	58.1%	($371.5)	−11.9%
2030	2,336.40	77.6%	1,636.7	58.0%	($699.7)	−19.6%
2040	3,909.40	85.2%	2,667.7	72.6%	($1,241.7)	−12.6%
2045	5,054.40	90.0%	3,407.9	90.0%	($1,646.5)	0.0%

Due to the Pension Obligation Bond proceeds, FY 2004 was the only year in which contributions to SURS significantly exceeded projections. Contributions are expected to be significantly lower than projected when P.A. 88-593 was enacted due to the changeover to a valuation of assets at market value in FY 1997 and, to a lesser extent, the elimination of the Money Purchase option for new members after July 1, 2005 as contained in P.A. 94-0004 (SB 0027).

State Employees' Retirement System

Table 10 provides a summary of the current projected State contributions to SERS, as well as the original projected contributions and corresponding funded ratios, per Public Act 88-593, based on the June 30, 1994 actuarial valuation.

TABLE 10.—STATE EMPLOYEES' RETIREMENT SYSTEM

[Original and Current Projected Contributions and Funded Ratios; $ in Millions]

FY	1994 Projection P.A. 88-593		2005 Projection P.A. 88-593		Difference (2005-1994)	
	Contribution	Funded ratio	Contribution	Funded ratio	Contribution	Funded ratio
1996	$144.5	56.1%	$146.4	70.1%	$1.9	14.0%
1997	157.5	55.4%	158.2	80.1%	0.7	24.7%
1998	171.3	54.8%	200.7	75.6%	29.4	20.8%
1999	185.9	54.4%	315.5	79.9%	129.6	25.5%
2000	201.5	54.0%	340.8	81.7%	139.3	27.7%
2001	216.1	53.7%	366.0	65.8%	149.9	12.1%
2002	235.7	53.5%	386.1	53.7%	150.4	0.2%

TABLE 10.—STATE EMPLOYEES' RETIREMENT SYSTEM—Continued

[Original and Current Projected Contributions and Funded Ratios; $ in Millions]

FY	1994 Projection P.A. 88-593		2005 Projection P.A. 88-593		Difference (2005-1994)	
	Contribution	Funded ratio	Contribution	Funded ratio	Contribution	Funded ratio
2003	254.2	53.4%	396.1	42.6%	141.9	−10.8%
2004	273.9	53.3%	1,864.7	54.2%	1,590.8	0.9%
2005	294.7	53.3%	427.4	54.4%	132.7	1.1%
2006	316.9	53.4%	203.8	52.6%	−113.1	−0.8%
2007	340.5	53.5%	344.2	51.4%	3.7	−2.1%
2008	366.4	53.6%	520.0	50.8%	153.6	−2.8%
2009	393.5	53.9%	718.0	51.0%	324.5	−2.9%
2010	422.4	54.2%	929.0	51.9%	506.6	−2.3%
2020	659.8	60.4%	1,328.0	59.1%	668.2	−1.4%
2030	1,065.6	68.2%	1,912.0	65.1%	846.4	−3.1%
2040	1,707.5	80.7%	2,836.0	78.4%	1,128.5	−2.3%
2045	2,177.4	90.0%	3,454.0	90.0%	1,276.6	0.0%

Contributions to the State Employees' Retirement System are projected to be appreciably greater than the original assumptions under P.A. 88-593. The increased funding requirements in future years are due in large part to reductions in contributions of $974.0 million in both FY 06 and FY 07 as contained in P.A. 94-0004. The additional funding obligations created by the 2002 Early Retirement Incentive and the steep market downturn in Fiscal Years 2001 and 2002 have also driven up future contributions pursuant to the current funding plan.

Two significant benefit increases have contributed to the increased cost as well: P.A. 90-065 provided a new flat-rate regular SERS formula of 1.67% of final average salary per year of service for members contributing to Social Security (coordinated), and 2.2% of final average salary per year of service for employees not contributing to Social Security (non-coordinated).

P.A. 92-0014 increased the alternative retirement formula to 3.0% of final average salary per year of service for employees not contributing to Social Security and 2.5% for employees contributing to Social Security.

Judges' Retirement System

Table 11 compares the original and current projections of estimated annual contributions and the resulting funding ratios for the Judges' Retirement System.

TABLE 11.—JUDGES' RETIREMENT SYSTEM

[Original and Current Projected Contributions and Funded Ratios; $ in Millions]

FY	1994 Projection P.A. 88-593		2005 Projection P.A. 88-593		Difference (2005-1994)	
	Contribution	Funded ratio	Contribution	Funded ratio	Contribution	Funded ratio
1996	$12.1	40.7%	$12.1	48.0%	$0.0	7.3%
1997	13.6	39.5%	13.7	44.7%	$0.1	5.2%
1998	15.3	38.4%	15.7	47.7%	$0.4	9.3%
1999	17.1	37.5%	18.7	48.4%	$1.6	10.9%
2000	19.1	36.7%	21.4	48.5%	$2.3	11.8%
2001	21.3	36.2%	24.3	40.7%	$3.0	4.5%
2002	23.5	35.9%	27.5	33.7%	$4.0	−2.2%
2003	26.0	35.9%	31.4	30.7%	$5.4	−5.2%
2004	28.7	36.2%	178.6	46.2%	$149.9	10.0%
2005	31.6	36.6%	32.0	45.7%	$0.4	9.1%
2006	34.6	37.3%	29.2	44.7%	−$5.4	7.4%
2007	37.9	38.1%	35.2	43.4%	−$2.7	5.3%
2008	41.4	39.1%	47.1	42.8%	$5.7	3.7%
2009	45.2	40.3%	60.9	42.9%	$15.7	2.6%
2010	49.3	41.6%	75.6	43.9%	$26.3	2.3%
2020	80.7	53.6%	118.3	54.3%	$37.6	0.7%
2030	130.9	65.0%	183.8	65.7%	$52.9	0.7%
2040	213.6	80.1%	284.4	80.4%	$70.8	0.3%
2045	272.6	90.0%	355.6	90.0%	$83.0	0.0%

The estimated annual contributions based on the current actuarial valuation are larger than those estimated in the original projections for the remainder of the funding period. This is due in large part to insufficient employer contributions, funding reductions contained in P.A. 94-0004, and two years of negative investment returns in FY 2001 and FY 2002.

General Assembly Retirement System

Table 12 compares the original and current projections of estimated annual contributions and the resulting funded ratios for GARS.

TABLE 12.—GENERAL ASSEMBLY RETIREMENT SYSTEM

[Original and Current Projected Contributions and Funded Ratios; $ in Millions]

FY	1994 Projection P.A. 88-593		2005 Projection P.A. 88-593		Difference (2005-1994)	
	Contribution	Funded ratio	Contribution	Funded ratio	Contribution	Funded ratio
1996	$2.4	33.2%	$2.4	40.4%	$0.0	7.2%
1997	2.7	31.3%	2.8	39.4%	$0.1	8.1%
1998	3.0	29.3%	3.1	41.7%	$0.1	12.4%
1999	3.3	27.4%	3.7	41.5%	$0.4	14.1%
2000	3.7	25.6%	4.0	41.6%	$0.3	16.0%
2001	4.0	23.7%	4.3	34.9%	$0.3	11.2%
2002	4.5	22.2%	4.7	29.3%	$0.2	7.1%
2003	4.9	20.8%	5.2	25.3%	$0.3	4.5%
2004	5.4	19.6%	32.9	40.1%	$27.5	20.5%
2005	5.9	18.7%	4.7	39.1%	−$1.2	20.4%
2006	6.5	18.1%	4.2	37.2%	−$2.3	19.1%
2007	7.0	17.6%	5.2	34.4%	−$1.8	16.8%
2008	7.6	17.3%	6.5	31.9%	−$1.1	14.6%
2009	8.3	17.3%	8.0	30.1%	−$0.3	12.8%
2010	9.0	17.6%	9.8	28.8%	$0.8	11.2%
2020	14.5	26.8%	16.0	25.7%	$1.5	−1.1%
2030	23.5	44.9%	24.5	37.0%	$1.0	−7.9%
2040	38.3	72.2%	38.0	67.5%	−$0.3	−4.7%
2045	48.9	90.0%	47.3	90.0%	−$1.6	0.0%

The estimated annual contributions to GARS based on the June 30, 2005 actuarial valuation track closely with the original projections under P.A. 88-593.

VI. Commission Funding Recommendation

Commission Recommendation

P.A. 88-593 requires a periodic evaluation of whether the 90% target funded ratio represents an appropriate goal for the five State-funded retirement systems. As evidenced by the national overview on page 2, the average funded ratio of 64 state retirement systems at the end of FY 2004 was 83 %. While the average funded ratio for all the systems in the survey fell considerably from FY 2001 through FY 2003 due to the downturn in the financial markets, it can be assumed that the average funded ratio for these 64 systems will approach or exceed 90% by the end of FY 2006. Therefore, the Commission believes that a 90% funding target is appropriate in light of national trends. In addition, despite multiple benefit increases and the aforementioned bear market years, the current projections of future contributions are generally on course with the original projections based on the June 30, 1994 actuarial valuations of each of the five State-funded systems. Furthermore, the Commission believes that adhering to an explicit and well-defined funding schedule will produce stable, predictable results for both the state and retirement system members and annuitants.

Office of Management and Budget Letter Concerning 90% Funding Ratio

GOVERNOR'S OFFICE OF MANAGEMENT & BUDGET,
EXECUTIVE OFFICE OF THE GOVERNOR,
Springfield, IL, December 22, 2005.

Senator JEFFREY SCHOENBERG,
State House, Room 218-B, Springfield, Illinois.

Representative TERRY PARKE,
State House, Room 220, Springfield, Illinois.

Re: Review of Public Act 88-593

DEAR SENATOR SCHOENBERG AND REPRESENTATIVE PARKE: Public Act 88-593 established a 50-year payment plan for the live state pension systems. This payment plan was adopted to address the State's inability to pay normal cost and interest on the unfunded liability each year since 1978. The basic principal of this 50-year payment plan is to attain a 90% funded ratio by the end of fiscal 2045 and maintenance of that 90% funded ratio thereafter. The Act also requires the Office of Management and Budget, every five years, to consider and determine whether the 90% funding ratio continues to represent an appropriate goal for state sponsored retirement plans in Illinois.

Following are the findings and recommendations of the Office of Management and Budget with regard to continued appropriateness of the 90% funding ratio.

Illinois Pension System Challenge

Funding of the State's past pension debits, accumulated over three decades, represents the greatest financial challenge for the State of Illinois.

The unfunded liability of the State pension systems more than doubled from $19.5 billion as of June 30, 1995 (the year before implementation of the 50-year payment plan) to $43.1 billion as of June 30, 2003 (with a funded ratio of 48.6%). Due primarily to infusion of proceeds of the 2003 Pension Obligation Bonds (POB), and associated earnings, the unfunded liability is currently at $38.6 billion as of June 30, 2005 (as a funded ratio of 60.3%).

The primary drivers of the increase in unfunded liability between 1995 and 2003 include:

- Slate contributions determined in accordance with the 50-year payment plan that were designed to underfund the normal cost and interest on the unfunded liability, thus increasing the liability.
- Significant investment losses incurred during the free fiscal years ended June 30, 2003.
- Unfunded benefit improvements adopted between 1995 through 2002.

Total required State contributions to the pension system, determined in accordance with the 511-year payment plan, are projected to increase from $609 million for fiscal 1996 to $15.6 billion in 2045. (Reduced from a projected 2045 contribution of $16.8 billion determined when the 50-year payment was first implemented.)

Appropriateness of 90% Funded Ratio

Public Act 88-593 requires the Office of Management and Budget to consider and determine whether the 90% funding ratio continues to represent an appropriate goal for state sponsored retirement plans in Illinois.

For comparison purposes, please note that the private sector has no equivalent percentage funding target, but is subject to additional minimum contribution requirements if the funded level falls below 90%.

Adopting a statutory payment plan for the state pension systems was needed. The 50-year payment plan, however, was structurally unaffordable when it was enacted though. First of all, it incorporated a 15 year ramp-up period, which increased contributions over a period of 15 years from a starting level that was arbitrary and significantly less than the amount needed to keep the unfunded liability from increasing, thereby further increasing the unfunded liability. Thus the state was guaranteed to experience a growing unfunded liability into the future.

Contributions for years after 2010, although determined as a percent of pay, are also not sufficient to pay normal cost and interest on the unfunded liability until around 2034. Therefore, as a result of the 50-year payment plan, the unfunded liability was actually projected to grow from the 6/30/95 level of $19.5 billion to as much as $78 billion by 2034 before it finally begins to reduce to $53 billion in 2045.

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. Both the payment plan structure and high interest cost of the liability required a full examination of how to resolve this decades long structural issue.

The 90% funded target for a state pension plan represents a reasonable and appropriate funding target. The Office of Management and Budget concurs with the majority report of the Advisory Commission on Pension Benefits (established by Public Act. 94-4) which recommends a series of changes needed to attain a 90% funded ratio for state pension systems. (See recommendations of Advisory Commission Report below.)

Governor's Pension Reform Plan

The first step taken by the Governor to address these structural issues was to provide the state pension systems with a cash infusion and reduce the states pension debt. During June of 2003, the state issued $10 billion of Pension Obligation Bonds, all of which, except for $500 million which was used to cover issuance costs and initial debt service payments, was paid into pension systems. Of this $10 billion total, $7.3 billion was disbursed to the pension systems as an additional state contribution over an 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 ratio 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.)

With this single action, the security of the members and retirees' pensions improved significantly. This reduction in liability was never anticipated or included in the 50-year payment plan.

Public Act 94-4

Deloitte Consulting LLP, (the consulting actuary to the Governor's Pension Commission and the Governor's Office of Management & Budget) reports that, of several estimates prepared by different actuaries, the most appropriate, reasonable and complete estimate of the net savings associated with Public Act 94-4 is a projected reduction in the 2045 actuarial accrued liability of approximately $44 billion (or 8%), as well as a reduction in state contribution requirements of approximately $53 billion over the next 40 years.

The Governor's management and budgetary actions have resulted in the reduction of headcount to its lowest level in more than 30 years. In addition to the annual payroll savings this headcount reduction effort has generated, SERS, in their 6/30/05 actuarial valuation, recognized savings of approximately $5 billion in state contribution requirements between fiscal year 2006 and 2045 as a result of this effort. This $5 billion contribution savings is in addition to the $3 billion discussed above.

Governor's Pension Reforms

The reforms included in Pubic Act 94-4 represent the first time future liabilities and benefits of the Illinois pension system have ever been reduced.

In addition to the changes included in Public Act 94-4, payments to the State's pension systems have substantially increased in each of the last four year periods since fiscal 1992.

The following table illustrates payments for the State's pension systems in four year periods between fiscal year 1992 and 2007:

Fiscal year period	Payments (billions)	Average annual payment	Percent of general revenue fund resources
2004—2007	$7,497	$1,874	7.29%
2000—2003	$5,818	$1,455	6.08%
1996—1999	$3,433	$858	4.30%
1992—1995	$2,067	$517	3.28%

Note: Payment numbers DO NOT include the additional infusion of $7.317 billion from the June 2003 Pension Obligation Bonds. If included, the $7.497 billion payment for the period 2004 through 2007 would be increased by an additional $5.829 billion ($7.317 billion net of debt service of $1.488 billion).

Advisory Commission on Pension Benefits

As required under Public Act 94-4, the Governor's established an Advisory Commission on Pension Benefits. The mandate of this Advisory Commission on Pension Benefits (the "Commission") was to consider and make recommendations concerning changing the age and service requirements, automatic annual increase benefits, and employee contribution rate of the State-funded retirement systems and other pension-related issues.

The Commission met five times between September 23 and October 27, 2005 and recommended the following be considered by an agreed bill process:

• The Commission recommends that the State adopt means by which to dedicate revenues in excess of a specific target percentage of growth towards the additional funding of the pension systems when those targets are met, and establish a minimum when those targets are not met.

• The Commission recommends that if the State sells certain assets, then 100% of the resulting revenues should be dedicated towards reducing liabilities, including the Pension Systems' unfunded liabilities, as a component part of a broader plan to reduce those unfunded liabilities.

• The Commission recommends that the General Assembly consider creating incentives for employees to continue working beyond the year when they achieve maximum pension percentage as a means to reduce the State's pension costs.

• The Commission recommends that the General Assembly consider the issuance of Pension Obligation Bonds as quickly as practicable as a financing instrument to reduce the State's pension costs, as long as (1) there are favorable market conditions and (2) the issuance of such POBs is a component part of a broader plan to reduce the Pension Systems' unfunded liabilities.

• The Commission recommends that the General Assembly should explore new revenue sources dedicated to reducing the Pension Systems' debt, as a component part of a broader plan to reduce the Pension Systems' unfunded liabilities.

• The Commission affirms the significance of the benefit reforms achieved in the 2005 Spring legislative session, and also affirms that, at the present time, most SERS, TRS and SURS benefits and employee contributions are comparable to other public pension systems in the United States. The Commission further recommends that the General Assembly should regularly review, as part of the agreed bill process as well as their normal budgetary review process, the affordability of the Pension Systems' plan provisions regarding benefits and make an affirmative determination thereon.

In conclusion, the 90% funded target for a state pension plan represents a reasonable and appropriate funding target. The Office of Management and Budget concurs with the majority report of the Advisory Commission on Pension Benefits (established by Public Act. 94-4) which recommends a series of changes needed to attain a 90% funded ratio for the state pension systems.

Sincerely,

JOHN FILAN,
Director.

EXECUTIVE OFFICE,
STATE RETIREMENT SYSTEMS,
Springfield, IL, December 30, 2005.

Senator JEFFREY SCHOENBERG,
Co-Chairman, CGFA, Evanston, IL.

Representative TERRY PARKE,
Co-Chairman, CGFA, Schaumburg, IL.

DEAR SENATOR SCHOENBERG AND REPRESENTATIVE PARKE: Public Act 88-0503 established a funding goal for the five state pension systems with a 90% funding ratio by the year 2045, and to maintain the funding ratio thereafter. This Act also called for the 90% funding goal to be reviewed every five years by the Systems and the Governor's Office of Management and Budget.

It is not certain why the 90% target was initially included in the legislation, but in view of the length of the funding plan and the consensus of the public funds, we would recommend this goal be raised to 100%. We believe the long term funding target should equal the total obligations, over 40 years, the increased contributions should be relatively small.

Very truly yours,

ROBERT V. KNOX,
Executive Secretary, State Retirement Systems.

JON BAUMAN,
Executive Director, Teachers' Retirement System.

DAN SLACK,
Executive Director, State Universities Retirement System.

Appendix I. Legislative Overview

This section of the report summarizes the major legislative actions that have significantly impacted the State-funded retirement systems since the Commission last reported on the appropriateness of the 90% funding target.

2002 Early Retirement Incentive (ERI)

Public Act 92-0566 (HB 2671) created an Early Retirement Incentive (ERI) Program for certain members of the State Employees' Retirement System (SERS) and State employees covered by the Teachers' Retirement System (TRS). To be eligible for the ERI, members must have been, during June 2002: in active payroll status; on layoff status with a right of recall, or receiving a disability benefit for less than 2 years. Members were required to file the ERI application with the Board of Trustees prior to December 31, 2002 and leave employment between July 1, 2002, and December 31, 2002.

According to SERS, 11,039 members elected to participate in the ERI. Of these, 10,301 were eligible to retire immediately (Option 1), while 738 members elected to terminate employment and receive benefits at a later date (Option 2). The average number of ERI months purchased was 58 and the average age at termination was 57 for Option 1 participants and 48 for Option 2 participants. According to the System, the average cost of purchasing the ERI service credit was $11,624 per participant and the average total monthly benefit of all ERI participants was almost $2,505.

Pension Obligation Bonds

On April 7, 2003, Governor Blagojevich signed House Bill 2660 into law as Public Act 93-0002. The legislation authorized the State to issue $10 billion in general obligation bonds for the purpose of making required contributions to the five state-funded retirement systems. After payment of fees, commissions, and interest, a total of $9,477.3 million was deposited into the newly-created Pension Contribution Fund (PCF). The act specified that the first $300 million was to be used to reimburse the General Revenue Fund for a portion of the FY 2003 State contributions to the retirement systems. In addition, the next $1,860.0 million was reserved to reimburse GRF for all of the FY 2004 employer contributions to the State-funded retirement systems. The remainder of the POB proceeds, $7,317.3 million, was distributed to the retirement systems in proportion to their unfunded liabilities, as outlined in the chart below.

PENSION OBLIGATION BONDS

System	Pre-POB unfunded liability	POB proceeds	Post-POB unfunded liability	Funded ratio before POB proceeds	Funded ratio after POB proceeds
TRS	$23,809.0	$4,330.0	$19,478.0	49.3%	58.5%
SERS	10,092.0	1,386.0	8,706.0	42.6%	50.5%
SURS	8,311.0	1,432.0	6,879.0	53.9%	61.8%
JRS	746.0	142.0	604.0	30.7%	43.9%
GARS	147.0	27.0	120.0	25.3%	39.1%
Combined	$43,105.0	$7,317.0	$35,787.0	48.6%	57.3%

P.A. 94-0004 (SB 0027)

On June 1, 2005, Governor Blagojevich signed SB 0027 into law as Public Act 94-0004. The Act makes several changes to the Illinois Pension Code, including a reduction in the required FY 2006 and FY 2007 State contributions to the State-funded retirement systems, as shown in the chart below:

CERTIFIED AND PROJECTED CONTRIBUTIONS VS. PUBLIC ACT 94-0004 CONTRIBUTIONS

[In millions $]

System	FY 2006			FY 2007		
	Certified contributions	P.A. 94-0004	Reducation	Projected contributions	P.A. 94-0004	Reduction
TRS	$1,058.5	$534.6	$523.9	$1,233.1	$738.0	$495.1
SERS	690.3	203.8	486.6	832.0	344.2	487.8
SURS	324.9	166.6	158.2	391.9	252.1	139.8
JRS	38.0	29.2	8.8	44.5	35.2	9.3
GARS	5.5	4.2	1.3	6.3	5.2	1.1
Total	$2,117.1	$938.4	$1,178.7	$2,507.9	$1,374.7	$1,133.2

P.A. 94-0004 changes the funding plan created in 1994 by Public Act 88-0593 by setting the State contribution levels for FY 2006 and FY 2007, rather than requiring the State to make contributions based on actuarial calculations. In addition, the separate funding of the liability created by the 2002 SERS Early Retirement Incentive was eliminated.

The legislation also contained several reforms that the Commission has discussed in previous meetings. These changes are expected to curtail the rate of growth in liabilities which may result in lower required annual State contributions over the life of the funding plan.

Background

The Commission on Government Forecasting and Accountability (CGFA), a bipartisan, joint legislative commission, provides the General Assembly with information relevant to the Illinois economy, taxes and other sources of revenue and debt obligations of the State. The Commission's specific responsibilities include:

1) Preparation of annual revenue estimates with periodic updates;

2) Analysis of the fiscal impact of revenue bills;

3) Preparation of "State Debt Impact Notes" on legislation which would appropriate bond funds or increase bond authorization;

4) Periodic assessment of capital facility plans;

5) Annual estimates of public pension funding requirements and preparation of pension impact notes;

6) Annual estimates of the liabilities of the State's group health insurance program and approval of contract renewals promulgated by the Department of Central Management Services;

7) Administration of the State Facility Closure Act.

The Commission also has a mandate to report to the General Assembly "* * * on economic trends in relation to long-range planning and budgeting; and to study and make such recommendations as it deems appropriate on local and regional economic and fiscal policies and on federal fiscal policy as it may affect Illinois. * * *" This results in several reports on various economic issues throughout the year.

The Commission publishes several reports each year. In addition to a Monthly Briefing, the Commission publishes the "Revenue Estimate and Economic Outlook" which describes and projects economic conditions and their impact on State revenues. The "Bonded Indebtedness Report" examines the State's debt position as well as other issues directly related to conditions in the financial markets. The "Financial Conditions of the Illinois Public Retirement Systems" provides an overview of the funding condition of the State's retirement systems. Also published are an Annual Fiscal Year Budget Summary; Report on the Liabilities of the State Employees' Group Insurance Program; and Report of the Cost and Savings of the State Employees' Early Retirement Incentive Program. The Commission also publishes each year special topic reports that have or could have an impact on the economic well being of Illinois. All reports are available on the Commission's website.

These reports are available from:

Commission on Government Forecasting and Accountability, 703 Stratton Office Building, Springfield, Illinois 62706. *http://www.ilga.gov/commission/cgfa/cgfa—home.html*

[NASRA letter submitted by Mr. Brainard follows:]

NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS,
NATIONAL COUNCIL ON TEACHER RETIREMENT,
July 14, 2006.

Hon. CHARLES E. GRASSLEY,
Chairman, Committee on Finance, Hart Senate Office Building, Washington, DC.

Hon. MAX BAUCUS,
Ranking Member, Committee on Finance, Hart Senate Office Building, Washington, DC.

DEAR SENATORS GRASSLEY AND BAUCUS: On behalf of the National Association of State Retirement Administrators (NASRA) and the National Council on Teacher Retirement (NCTR), we are writing in reference to your letter dated July 10, 2006, to the Government Accountability Office (GAO) requesting a study of the funding status of public pension plans. The membership of NASRA and NCTR collectively administers State, territorial, local, university and statewide public pension systems that hold over $2.1 trillion in trust for over 18 million public employees, retirees and their beneficiaries.

We appreciate your interest in the general financial health of State and local government defined benefit (DB) plans. We are concerned, however, about some of the statements made in the letter to the GAO, particularly those that could be misleading or are factually inaccurate regarding the governance, protections and financial condition of public employee retirement systems. It is extremely important that an accurate point of departure is used and proper metrics are employed. We welcome the opportunity to work closely with you and the GAO as you examine the areas outlined in your letter, and hope the factual points noted below and future discussions will better ensure a balanced study.

For example, when discussing pensions in the private sector, the letter may be correct in stating that "retirees and workers who 'play by the rules' all their careers now find themselves with far lower actual or future retirement income on which they had counted." However, that statement definitely does not apply to participants (both active employees and retirees) in the public pension plans represented by our two associations. Public DB pension plan promises made are promises kept. Accordingly, we do not understand the basis for the letter's suggestion that public employees need "help" in "avoid[ing] the benefit losses and reduced accruals experienced by their private sector counterparts." We know of no participant in our members' plans who has or may ever lose any part of his or her existing retirement benefit.

Indeed, unlike the private sector in which only the participant's accrued benefit to date is protected, in the State and local DB plan world the benefit formula itself is typically protected from such cutbacks by state constitutions, statutes, or case law that prohibit the elimination or diminution of a retirement benefit once it is granted. Thus, State and local DB plans typically guarantee not only the participant's accrued level of benefit but also protect future benefit accruals from being cut back. The implication that lack of coverage by the Pension Benefit Guaranty Corporation (PBGC) renders government employees at greater risk is a misnomer, and only serves to unduly alarm the participants in our members' systems. Even though public plans may not have the PBGC as a "back-up source for guaranteed benefit payments," the full faith and credit of State and local governments has provided insurance far greater than what is provided by the PBGC. In fact, public employees may actually find increased comfort in knowing that there is no "escape hatch" from pension obligations once they are promised in the public sector. It is a misconception that PBGC coverage will provide any added value to the benefit protections already in place for State and local government employees.

We also wish to take exception to the statement in the letter to GAO that "many" public sector DB plans are "even more poorly funded" than their private sector counterparts, and the implication that an untenable burden will fall on taxpayers and public employees. As a group, public pension plans have funded 86 percent of their liabilities, a figure that is expected to begin rising in the near future as investment gains since March 2003 are more fully incorporated into funding calculations. This figure is also reflective of the funding levels of plans covering the substantial majority of public pension participants. Unlike private sector plans that must rely on uneven employer contributions, State and local DB plans receive a steady stream of both employer and employee contributions that typically is mandated by statute. In addition, State and local government DB plans are long-term investors, whose portfolios are professionally-managed and designed to withstand short-term market fluctuations while still providing optimal growth potential. When placed in context, required contributions to public pension plans continue to be well within State and local governments' budgetary means, and even represent historically low amounts as a percentage of total state and local government spending and payroll.

Finally, we are concerned with the letter's co-mingling of pension benefit funding with the issue of health benefits and the "funded status" of retiree health plans. We agree that adequate health care is essential to overall retirement security, and that health benefit commitments are placing significant and increasing pressure on government resources. However, meeting the fiscal and other challenges in providing healthcare benefits must not be confused with the funding of DB retirement plans. Retiree health benefits are handled separately and independently and often are not administered or funded as part of a government's retirement system.

NASRA and NCTR appreciate the strong record of support that each of you have maintained for State and local government employee retirement programs. We share your interest in keeping commitments to providing a secure retirement for American workers, particularly those who spend a career delivering vital services to the public and whose retirement security the members of our associations guarantee. We welcome the opportunity to work closely with you and the GAO and hope future discussions and consultation will provide an objective and factually accurate study.

To this end, we have attached comments recently sent to the President of the Federal Reserve Board of Chicago. These comments are intended to constructively promote sound public policy regarding issues with far-reaching ramifications affecting millions of working and retired Americans.

We look forward to working with the GAO and are confident that when its study is complete, you will be reassured that the status of public pension plans and their funding condition is sound. Please feel free to call upon either one of us. We would be happy to assist you at any time.

Sincerely,

JEANNINE MARKOE RAYMOND,
Director of Federal Relations, National Association of State Retirement Administrators.

LEIGH SNELL,
Director of Governmental Relations, National Council on Teacher Retirement.

[Letter of support to Messrs. Grassley and Baucus submitted by Mr. Brainard follows:]

NATIONAL CONFERENCE OF STATE LEGISLATURES (NCSL),
AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES (AFSCME),
NATIONAL ASSOCIATION OF STATE TREASURERS (NAST),
AMERICAN FEDERATION OF TEACHERS (AFT),
NATIONAL ASSOCIATION OF COUNTIES (NACO),
COMMUNICATIONS WORKERS OF AMERICA (CWA),
NATIONAL ASSOCIATION OF STATE AUDITORS COMPTROLLERS AND TREASURERS (NASACT),
FRATERNAL ORDER OF POLICE (FOP),
UNITED STATES CONFERENCE OF MAYORS (USCM),
INTERNATIONAL ASSOCIATION OF EMTS AND PARAMEDICS (IAEP),
NATIONAL LEAGUE OF CITIES (NLC),
INTERNATIONAL ASSOCIATION OF FIRE FIGHTERS (IAFF),
INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION (ICMA),
INTERNATIONAL BROTHERHOOD OF CORRECTIONAL OFFICERS (IBCO),
GOVERNMENT FINANCE OFFICERS ASSOCIATION (GFOA),
INTERNATIONAL BROTHERHOOD OF POLICE OFFICERS (IBPO),
INTERNATIONAL PUBLIC MANAGEMENT ASSOCIATION FOR HUMAN RESOURCES (IPMA-HR),
INTERNATIONAL UNION OF POLICE ASSOCIATIONS, AFL-CIO (IUPA),
NATIONAL ASSOCIATION OF GOVERNMENT DEFINED CONTRIBUTION ADMINISTRATORS (NAGDCA),
NATIONAL ASSOCIATION OF GOVERNMENT EMPLOYEES (NAGE),
NATIONAL ASSOCIATION OF NURSES (NAN),
NATIONAL ASSOCIATION OF POLICE ORGANIZATIONS (NAPO),
NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS (NASRA),
NATIONAL CONFERENCE ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS (NCPERS),
NATIONAL COUNCIL ON TEACHER RETIREMENT (NCTR),
NATIONAL EDUCATION ASSOCIATION (NEA),
NATIONAL PUBLIC EMPLOYER LABOR RELATIONS ASSOCIATION (NPELRA),
SERVICE EMPLOYEES INTERNATIONAL UNION (SEIU),

August 2, 2006.

Hon. CHARLES E. GRASSLEY,
Chairman, Committee on Finance, Hart Senate Office Building, Washington, DC.

Hon. DAVID M. WALKER,
Comptroller General of the United States, U.S. Government Accountability Office, Washington, DC.

Hon. MAX BAUCUS,
Ranking Member, Committee on Finance, Hart Senate Office Building, Washington, DC.

DEAR GENTLEMEN: On behalf of the 28 national organizations listed above—representing state and local governments and officials, public employee unions, public retirement systems, and over 20 million State and local government employees, retirees, and their beneficiaries—we are writing in reference to a July 10, 2006 letter between your offices regarding a study into the financial condition of State and local

government defined benefit pension systems. The interests of our numerous organizations may be widely diverse, but we share in the desire to ensure such a study is done accurately and results in a balanced report, and stand ready to work with you to ensure its highest possible quality.

Indeed, such a study may go a long way to correcting the many misperceptions that appear to exist with regard to State and local government retirement systems. We hope you will call upon our collective expertise as this study ensues, as there are fundamental differences between governments and businesses that result in critical distinctions between plans in each sector and the way in which they are accounted for and measured. These distinctions are often unknown or misunderstood. A factual study into the health of public plans must ensure appropriate metrics are used and must not employ a private plan yardstick to measure government retirement systems.

Public plans are in sound financial condition and State and local governments take seriously their responsibility for paying promised benefits to their employees and retirees. Comprehensive State and local laws, and significant public accountability and scrutiny, provide rigorous and transparent regulation of public plans and have resulted in strong funding rules and levels. Public plans are backed by the full faith and credit of State and local governments. Additionally, a public plan participant's accrued level of benefits and future accruals typically are protected by state constitutions, statutes, or case law that prohibits the elimination or diminution of a retirement benefit, providing far greater protections that what is provided by ERISA and the PBGC. A greater understanding of the protections put in place by the governments ultimately responsible for funding these plans may serve to build support for these arrangements and address the erosion of confidence in retirement security in general.

We also hope you will keep in mind that retiree health benefits are handled separately and independently and often are not administered or funded as part of a government's retirement system. While adequate health care is essential to overall retirement security, and health benefit commitments are placing significant and increasing pressure on government resources, fiscal and other challenges in providing healthcare benefits should not be confused with the funding of state and local government retirement plans. It is crucial that retiree health care benefits are clearly distinguished from any study into the financial health of public pension plans.

When you look at State and local government pension plans, you will find there is a good story to tell. It is our hope that a factual and objective analysis might ultimately serve to strengthen retirement programs and build on the success many in the public sector have had in not only enduring market fluctuations and providing security to retirees, but providing stability to our financial markets, and distributing consistent and inflation-protected revenue streams to local communities as well. We are pleased to share the following current facts about state and local plans, which we hope you will keep in mind as your work progresses:

• Public pension plans are in good financial condition. As a group, public pension plans have funded 86 percent of their liabilities, a figure that is projected to begin rising in the near future as the three-year market shock earlier this decade is more fully offset by strong investment gains. This figure also is consistent with funding levels of plans covering the substantial majority of public pension participants. Unlike the contribution volatility that may exist in a private plan setting, State and local plans receive a steady stream of both employer and employee contributions that typically is mandated by statute.

• The bulk of public pension funding is not shouldered by taxpayers. When placed in context, required contributions to public pension plans continue to be well within State and local governments' budgetary means, and even represent historically low amounts as a percentage of total state and local government spending and payroll. This is because the vast majority of public plan funding comes from investment income. Employer (taxpayer) contributions to state and local pension systems over the last two decades have made up only one-fourth of total public pension revenue. Earnings from investments and employee contributions comprise the remainder. This ratio has improved over time. In 2004, investment earnings accounted for 77 percent of all public pension revenue; employer contributions were 15 percent.

• State and local retirement plan assets are professionally-managed and provide valuable long-term capital for the nation's financial markets. The $2.8 trillion held in plan portfolios are an important source of stability for the marketplace and are designed to withstand short-term fluctuations while still providing optimal growth potential.

• State and local pension plans fuel national, state and local economies. Public plans distribute more than $130 billion annually (an amount greater than the total economic output of 22 states) in benefits to over 6 million retirees and beneficiaries,

with an average annual pension benefit of roughly $19,500. These payments are steady, continuous, in great part adjusted for inflation and provide a strong economic stimulus to local economies throughout the nation.

• Public plans are subject to comprehensive oversight. While private sector plans are subject solely to federal regulation, state and local government plans are creatures of state constitutional, statutory and case law and must comply with a vast landscape of state and local requirements, as well as industry accounting standards. These plans are accountable to the legislative and executive branches of the state; independent boards of trustees that include employee representatives and/or ex-officio publicly elected officials; and ultimately, the taxpaying public.

• Public retirement plans attract and retain the workforce that provides essential public services. Active public employees comprise more than 10 percent of the nation's workforce, and two-thirds are employed in education, public safety, corrections, or the judiciary. Retention of experienced and trained personnel in these and other positions is critical to the continuous and reliable delivery of taxpayer services.

We share your continued interest in providing a secure retirement for American workers, particularly those that have spent a career in public service—protecting the homeland, caring for the sick, and educating our children. We believe many public sector systems indeed are innovative models that could be emulated to ensure responsible and prudent pension funding and management of assets. We welcome the opportunity to work closely with the Committee and the GAO as you examine State and local government defined benefit plans, and hope you will consult with us as this study moves forward. Please feel free to call upon our legislative representatives:

GERRI MADRID-DAVIS, NCSL,
ED JAYNE, AFSCME,
DAN DE SIMONE, NAST,
BILL CUNNINGHAM, AFT,
DARIA DANIEL, NACO,
ROSIE TORRES, CWA,
CORNELIA CHEBINOU, NASACT,
TIM RICHARDSON, FOP,
LARRY JONES, USCM,
STEVE LENKART, NAGE/IBPO/IBCO/IAEP/NAN,
ALEX PONDER, NLC,
BARRY KASINITZ, IAFF,
ROBERT CARTY, ICMA,
BARRIE TABIN BERGER, GFOA,
TINA OTT CHIAPPETTA, IPMA-HR,
DENNIS SLOCUMB, IUPA,
SUSAN WHITE, NAGDCA,
BILL JOHNSON, NAPO,
JEANNINE MARKOE RAYMOND, NASRA,
HANK KIM, NCPERS,
LEIGH SNELL, NCTR,
ALFRED CAMPOS, NEA,
HOPE TACKABERRY, NPELRA,
ALLISON REARDON, SEIU.

[GRS letter submitted by Mr. Brainard follows:]

GRS,
March 15, 2006.

MR. MICHAEL H. MOSKOW,
President and CEO, Federal Reserve Board of Chicago, Chicago, IL

DEAR MR. MOSKOW: We are writing because we share your concern about the future of public retirement plans. Together, the authors of this letter have over 35 years of experience conducting surveys and other research related to state and local government retirement plan administration, benefit design, investments, actuarial valuations, and plan funding. Paul Zorn is Director of Governmental Research for Gabriel, Roeder, Smith & Company, a consulting firm that specializes in state and local benefit plans and provides actuarial and other services to over 400 public sector clients. Keith Brainard is Director of Research for the National Association of State Retirement Administrators (NASRA), a non-profit organization for directors and administrators of statewide retirement systems currently covering 16 million working and retired employees.

We read with interest your remarks to the State and Local Government Pension Forum on February 28. We recognize your concerns about public pension funding and the potentially large liabilities related to retiree health care benefits. We also share your concerns about the future of retirement benefits for millions of public employees, including teachers, police officers, firefighters, judges, and other public officials. However, we respectfully disagree with several of your conclusions. Our comments below are intended constructively, in support of sound public policy relating to an important issue with far-reaching ramifications affecting millions of working and retired Americans.

Growth of Public Pension Unfunded Liabilities

The speech characterizes the funding of state and local retirement plans as a problem that will grow rapidly and ultimately reduce the ability of governments to fund other public programs. With regard to public pension plans, we believe this characterization does not accurately reflect the current financial status of plans that cover the vast majority of public employees, nor does it accurately reflect the reasons for the recent decline in the plans' funding condition.

For the most part, state and local retirement plans in the U.S. are in good financial shape. According to the Public Fund Survey, the average funded ratio of large public retirement plans in the U.S. was 88 percent in 2004, with 7 out of 10 plans at least 80 percent funded.[1] While a handful of large plans do have funded ratios below 60 percent, the overall financial health of the retirement plans covering the vast majority of public employees is good. To characterize the current state of public pension plans as "a mess" is to misstate the problem.

The dramatic decline in domestic equity markets that occurred from 2000 through 2002 is the single largest factor influencing the recent growth in unfunded liabilities for public pension plans. Prior to 2000, the vast majority of public plans were well funded and there was no talk of a pension crisis. Then, from 2000 through 2002, domestic stocks lost about 40 percent of their value, the largest market decline since the Great Depression. As a result, public plan funded ratios fell, on average, from a little over 100 percent to about 88 percent now. Even at this level, because of the way the calculations are made, accrued benefits based upon salary and service to date are most likely to be fully funded. Moreover, public plans weren't the only ones affected: the declines in asset values created problems for all retirement plans alike—public and private, defined benefit and defined contribution.

Growth in Employer Contributions

Increased unfunded actuarial liabilities are usually amortized through increases in employer contribution rates. Consequently, the declines in the equity markets caused employer contribution rates to rise. To dampen the immediate impact of large, short-term market fluctuations on employer contributions, most public plans use asset smoothing techniques to gradually recognize investment gains and losses over three to five years. Consequently, even after the investment markets improved in 2003, employer contributions continued to increase.

The good news is that the investment gains from 2003 through 2005 are also being smoothed into the value of assets, and will likely cause employer contributions to stabilize. This is echoed in the recent Standard & Poor's report which observes, if "funds produce adequate investment returns in fiscal 2006, then we may see funded ratios begin to stabilize."[2]

Moreover, when viewed in the context of total state and local government spending, governments (and thus taxpayers) spent less on public pension plans in 2004 than they did during the mid-1990s. From 1995 through 1997, state and local government contributions to pension plans were about 3.0 percent of total state and local government spending annually. By 2002, this had fallen to 1.9 percent, due partly to the smoothing in of investment gains earned during the late 1990s. After 2002, government contributions increased and reached 2.2 percent in 2004, still lower than the 3.0 percent paid in the mid-1990s.[3]

Measuring the Unfunded Liability

The speech uses Barclays Global Investors' $700 billion estimate of public pension plan unfunded liabilities. We believe this figure significantly overstates public pension unfunded liabilities and that the best measure of these liabilities is provided in the actuarial valuations done for the plans. Using this measure, we estimate total current unfunded liabilities for all state and local pension plans to be about $385 billion, roughly half of the Barclays' estimate.

The Barclays' estimate is based on a present value discount rate reflecting fixed-income securities, whereas most pension portfolios are composed of a diversified mix of equity and fixed-income investments, including public and private equities. The problem is that the present value calculation is intended to reflect the amount need-

ed today that, when invested, would be sufficient to pay future benefits. A discount rate based solely on fixed-income investments would systematically overstate the long-term cost of benefits. Moreover, under the Governmental Accounting Standards Board's rules, the discount rate should reflect the expected long-term rate of return on plan investments for determining the cost of pension benefits reported in governmental financial reports. As discussed in GASB Statement No. 25, the GASB considered but rejected using the long-term bond rate as the discount rate for governmental pension plans.[4]

In addition, for an unfunded liability figure to truly have meaning, it must be measured in the context of available assets. For the fourth quarter of 2005, the Federal Reserve reported that public pension plans held assets of $2.72 trillion,[5] a figure that has surely grown in the ensuing period and that far outweighs estimates of unfunded liabilities. Even if policymakers made no changes to public pension plan designs (including to contribution rates), most public pension plans still would have assets sufficient to continue paying their promised benefits, at a minimum, for decades into the future.

Applying ERISA Rules to Public Plans

The speech suggests that a solution to public plan funding would be to make the plans subject to standards similar to those in the Employee Retirement Security Act of 1974 (ERISA), on the grounds that this would make it more difficult for governments to increase pension benefits without identifying adequate funding. While we agree on the importance of funding promised benefits, we disagree that federal legislation like ERISA would be a solution.

First, the current problems with private-sector pension plans demonstrates the weaknesses of ERISA in ensuring plan funding. As the GAO has pointed out, the "current funding rules do not provide adequate mechanisms for maintaining adequate funding of pension plans."[6]

Second, the cost of satisfying ERISA's complicated rules is considered one of the reasons for the decline in private sector pension plans. In 1997, the Employee Benefits

Research Institute published a report on the rise of defined contribution plans in the private sector. In its discussion of the impact of ERISA and other legislative changes, the authors observe: "Many argue that new laws and regulations have raised the DB administrative costs enough to make DC plans more attractive to plan sponsors."[7]

It is true that a handful of large public plans are facing funding difficulties and that in several cases this is a result of employers' unwillingness to fully fund the plans. However, to remedy this, changes to state laws would be more appropriate than the imposition of a one-size-fits-all set of federal regulations. Indeed, a strong argument can be made that state and local government pension plans have, for the most part, flourished in the absence of federal controls, operating instead under governance structures prescribed by state constitutions, statutes, and case law.

A resolution approved by NASRA in 1996 states, in part, "public employee retirement systems already have in place full disclosure, reporting, accounting, and fiduciary standards set by state and local governments and, further, these systems have significantly improved their funding, disclosure, administration and investment management over the past decade; * * * federal regulation that would mandate certain standardized reports, actuarial and accounting analyses, and disclosure * * * would needlessly duplicate what is already required of state and local government retirement systems."[8]

Moving to Defined Contribution Plans

The speech also suggests that moving to defined contribution plans could be a way to reduce government costs while better meeting the needs of workers. While we agree that defined contribution plans can be a useful vehicle to supplement pension benefits by encouraging additional employee retirement savings, we disagree that replacing defined benefit plans with defined contribution plans is a way to reduce government costs or to better meet the needs of workers.

First, as you point out, many state and local governments have strong legal protections on retirement benefits—often based in the state's constitution. Consequently, a defined benefit plan would still need to be maintained (and funded) for currently covered workers. The new defined contribution plan would be established for newly hired workers at an additional cost to the government. Moreover, because the defined benefit plan would be closed to new hires, stricter accounting standards would apply, effectively increasing the annual required contributions to the defined benefit plan. Any savings that would result from this change would take 10 to 15 years to be realized.[9]

Second, defined contribution plans have not been particularly successful in providing adequate retirement benefits, for a number of reasons, including: (1) most DC plan participants don't contribute enough; (2) they tend to invest conservatively which results in lower long-term rates of return than professionally managed assets; (3) they take money out when they change jobs; and (4) they spend it too quickly in retirement. A recent Congressional Research Service study found that only half of older workers in 401(k) plans had saved enough to provide an annual benefit of at least $5,000 from their account.[10] By comparison, public retirement plans paid an average annual benefit of about $19,800 in 2004.[11]

Third, defined benefit plans can be flexibly designed to meet a broad array of objectives for all stakeholders, including public employers, taxpayers, and public employees. As indicated in a 2003 NASRA resolution expressing support for state and local defined benefit plans, such plans can have "progressive changes * * * that accommodate a changing workforce and better provide many of the features advanced by defined contribution advocates."[12] Indeed, many public pension plans have and continue to incorporate flexible features into their benefit structures.

Other Postemployment Benefit (OPEB) Plans

While we believe most public pension plans are well-funded, we recognize this is not the case for most public OPEB plans, including plans for retiree health care. However, we also believe that the issues related to public pension and OPEB benefits should be treated separately. The issues surrounding OPEB funding are substantially different than the issues surrounding pension funding. In most cases, retirees and beneficiaries share in the ongoing costs of retiree health care through deductibles and co-pays. Moreover, in many cases, employers reserve the right to change the retiree health care benefit, and have done so by changing eligibility provisions and by requiring retirees to pay a greater portion of the premiums.

Consequently, retiree health care benefits are not guaranteed in the same way as the pension benefits for many governments. Unfortunately, this will likely mean that more of the health care costs will be shifted to retirees, at a time when they are least able to afford them. However, if health care costs continue increasing at current rates, it won't be long before no one will be able to afford them. Controlling the growth of health care costs is the key to affording these benefits. This is an issue that goes beyond state and local governments.

Broader Economic Implications

The discrepancy in retirement benefits paid through defined benefit and defined contribution plans raises an even broader public policy question: What will happen to the U.S. economy as more people retire? Over the next 25 years, the U.S. population age 65 and older is expected to double, from 37 million in 2005 (12% of total population) to 70 million (20% of total population) by 2030.[13] It is likely that, as a result of the movement to defined contribution plans, the income of many of these retirees will be significantly less than their pre-retirement income. Consequently, demand for goods and services will likely be significantly lower or governmental intervention of some type may be needed. Lower incomes could mean less economic stimulus for the economy, possibly for many years.

By providing sufficient and sustainable retirement income, state and local defined benefit plans help to support the U.S. economy over the long-term. Moreover, they act as financial engines by investing employer and employee contributions to generate investment earnings that provide income to retired public employees over their lifetimes. Since 1982, state and local retirement plans' investment earnings have amounted to over $2.0 trillion, compared with total employer contributions of about $825 billion and total member contributions of $400 billion. During this period, taxpayer dollars paid 25 percent of the cost of public retirement benefits, with the remaining 75 percent coming from investment returns and member contributions.

A 2004 working paper prepared for the Pension Research Council at the Wharton School estimated that the higher investment returns generated by public pension funds, relative to defined contribution returns, creates an economic stimulus of 2.0 percent of GDP, or more than $200 billion, annually. This stimulus is continuous and steady, as the dollars produced by the higher returns are distributed to retired public employees and their beneficiaries in every city and town across the nation.[14]

Steps to Improve Public Plan Sustainability

While we believe most public plans are in good financial condition, we also believe there are steps that plans can take to improve their sustainability, especially in light of a more volatile investment environment. First, to reduce downside investment risk, plans should review their asset allocations in light of likely investment returns and the duration of their liabilities. Second, governments should avoid pro-

viding benefit increases based on plan "overfunding" or "excess assets." Third, governments should consistently contribute the amounts necessary to fund their pension plans and, if feasible, should establish reserves to help ensure contributions are made during cyclical economic declines.[15] Finally, to the extent benefits cannot be sustained, new benefit tiers should be established to provide more sustainable pension benefits to new hires.

Mr. Moskow, as President of the Federal Reserve Board of Chicago, you are in a unique position to support sound public policy with regard to retirement benefits. We hope the information offered in this letter will be useful to you. Please let us know if you have any questions or would like additional information.

Respectfully,

KEITH BRAINARD,
Director of Research, National Association of State Retirement Administrators.

PAUL ZORN,
Director of Governmental Research Gabriel, Roeder, Smith & Company

ENDNOTES

[1] The Public Fund Survey is currently the broadest and most detailed survey of public plans. Sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement, it presents information on the benefits, funding levels, actuarial assumptions, and investments of 127 of the nation's largest public plans, covering approximately 88 percent of all public employees covered by state and local retirement plans.

[2] Standard & Poor's, "Rising U.S. State Unfunded Pension Liabilities Are Causing Budgetary Stress," February 22, 2006, p. 5.

[3] U.S. Census Bureau, "State and Local Government Retirement Systems," and "State and Local Government Employment and Payroll."

[4] Statement No. 25, Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans, Governmental Accounting Standards Board, paragraphs 135—137.

[5] Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States," Fourth Quarter 2005.

[6] U.S. General Accounting Office, "Private Pensions: Changing Funding Rules and Enhancing Incentives Can Improve Plan Funding," October 29, 2003, Summary.

[7] Employee Benefit Research Institute, "Defined Contribution Plan Dominance Grows Across Sectors and Employer Sizes, While Mega Defined Benefit Plans Remain Strong: Where We Are and Where We Are Going," 1997, p 30.

[8] National Association of State Retirement Administrators, Resolution 1996-04, available at: *http://www.nasra.org/resolutions.htm*

[9] Los Angeles County Employees Retirement Association, "Proposals to Close Public Defined Benefit Plans," March 16, 2006. The study estimated that the County's DB plan annual contribution rate would increase by 3.66% ($206 million) if employees hired after July 1, 2007, were required to join a DC plan. While the contribution rate would gradually decline over time, the County would have to wait until 2018 to see any savings in DB plan costs as a result of the change.

[10] Patrick J. Purcell, "Retirement Savings and Household Wealth: A Summary of Recent Data," Congressional Research Service, December 11, 2003.

[11] U.S. Census Bureau, "State and Local Governments Public Employee Retirement System Survey," 2004. Average calculated by authors.

[12] National Association of State Retirement Administrators, Resolution 2003-08, available at: *http://www.nasra.org/resolutions.htm*

[13] Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 2005 Annual Report, p. 77.

[14] Gary Anderson and Keith Brainard, "Profitable Prudence: The Case for Public Employer Defined Benefit Plans," PRC Working Paper 2004-6, Pension Research Council, The Wharton School, 2004.

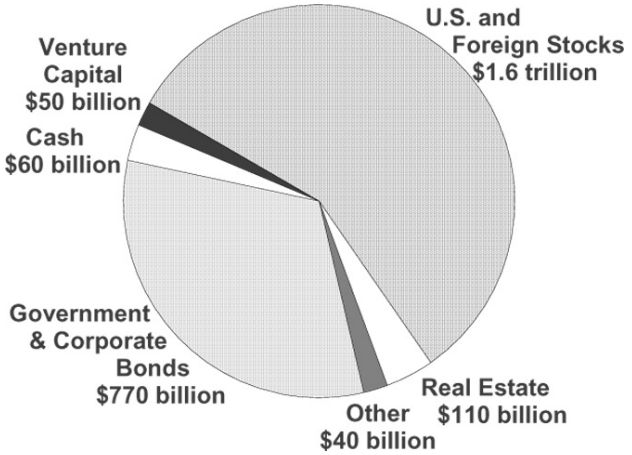
[15] For a concise summary of steps that state and local governments can take to help ensure their plans are properly funded, see the Government Finance Officers Association's recommended practice: "Funding of Public Employee Retirement Systems" at: *http://www.gfoa.org/documents/persfundingrp.pdf*

[Key facts benefits information sheet submitted by Mr. Brainard follows:]

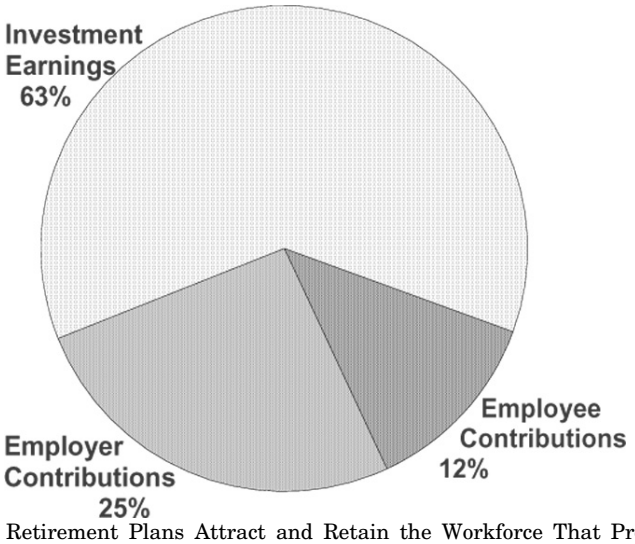
Key Facts Regarding State and Local Government Defined Benefit Retirement Plans

Public Pension Plans are in Good Financial Condition. As a group, state and local pension systems have nearly 90 cents for each dollar they owe in liabilities. These assets are professionally managed and invested on a long-term basis using sound investment policies. As shown on the chart below, the $2.6 trillion (in real assets,

not IOU's) held by these plans are an important source of liquidity and stability for the nation's financial markets.



The Bulk of Public Pension Benefit Funding is NOT Shouldered by Taxpayers. Employer (taxpayer) contributions to state and local pension systems over the last two decades have made up only one-fourth of total public pension revenue. Earnings from investments and employee contributions comprise the remainder. This ratio has improved over time. In 2004, investment earnings accounted for 77 percent of all public pension revenue; employer contributions were 15 percent. Unlike corporate workers, most public employees are required to contribute to their pension plans. The chart below summarizes the sources of public pension revenue from 1983 through 2004.



• Public Retirement Plans Attract and Retain the Workforce That Provides Essential Public Services. There are more than 20 million working and retired state and local government employees in the U.S. Retired public employees live in virtually every city and town in the nation (90 percent stay in the same jurisdiction where they worked). Active public employees comprise more than 10 percent of the nation's workforce, and two-thirds are employed in education, public safety, corrections, or the judiciary. Retention of experienced and trained personnel in these and other positions is critical to the continuous and reliable delivery of public services.

• State and Local Pension Plans are an Integral Component of National, State and Local Economies. Public plans distribute more than $130 billion annually (an

amount greater than the total economic output of 22 states) in benefits to over 6 million retirees, disabilitants and beneficiaries, with an average annual pension benefit of roughly $19,500. These payments are steady and continuous and provide a strong economic stimulus to local economies throughout the nation. A 2004 study for the Wharton School Pension Research Council found state and local government pension distributions contribute 2.0 percent more to GDP (over $200 billion) than if they had been invested in self-directed 401(k)-type retirement accounts.

• State and Local Plans are Subject to Comprehensive Oversight. While private sector plans are subject solely to federal regulation, state and local government plans are creatures of state constitutional, statutory and case law and must comply with a vast landscape of state and local requirements, as well as industry accounting standards. These plans are accountable to the legislative and executive branches of the state; independent boards of trustees that include employee representatives and/or ex-officio publicly elected officials; and ultimately, the taxpaying public.

• State and Local Pension Funds Earn Competitive Investment Returns. For the 3- and 10-year periods ended 6/30/05, public pension funds generated strong investment returns of 9.67% and 9.15%, closely tracking returns generated by corporate pension plans.

[NASRA response to Reason Foundation study submitted by Mr. Brainard follows:]

NASRA Response to Reason Foundation Study, "The Gathering Pension Storm"

Abstract

The Reason Foundation recommends terminating defined benefit plans for public employees because, Reason contends, it is inherent in DB plans that policymakers, operating solely in their own political interest, will approve higher pension benefits for their own selfish, short-term political gain while deferring the cost of those benefits to future generations. NASRA believes the Reason study makes its case by 1) distorting the true financial condition of public pensions in general; 2) mistakenly extrapolating a handful of public pension problems onto the entire public pension community; 3) failing to consider the many negative consequences that would result from terminating DB plans; and 4) advancing arguments that reflect an incomplete understanding of public pension issues. Rather than terminating DB plans (which would have negative consequences for all stakeholders), solutions are available to the public pension problems Reason cites, chiefly by working through normal political processes at the state level.

Introduction

In June 2005, the Reason Foundation published a study titled "The Gathering Pension Storm: How Government Pension Plans Are Breaking the Bank and Strategies for Reform." The study is critical of defined benefit (DB) plans for employees of state and local government and calls for the replacement of DB plans with 401k-style defined contribution (DC) plans.

A resolution approved in 2003 by the National Association of State Retirement Administrators (NASRA) states that NASRA "supports * * * a defined benefit program to provide a guaranteed benefit and a voluntary defined contribution plan to serve as a means for employees to supplement their retirement savings * * * and NASRA supports progressive changes within this prevailing system of retirement benefits in the public sector, either within the defined benefit plan or through supplementary plans, that accommodate a changing workforce and better provide many of the features advanced by defined contribution advocates." [1]

Flexibility of design is a central feature of DB plans. A DB plan can be designed to achieve myriad stakeholder objectives, while retaining core DB plan features—a benefit that cannot be outlived, investment risk that is borne entirely or partly by the employer, and a benefit that reflects the employee's salary and length of service. Working within existing legislative and political processes, this flexibility can be incorporated into the design and governance structure of any public pension plan to achieve desired objectives of all relevant stakeholders: public employers, employees, and recipients of public services and other taxpayers. Indeed, design features already in place in public pensions around the U.S. demonstrate this flexibility, providing ample illustration that DB plans can attain objectives advanced by advocates of DC plans, while continuing to advance the overarching public policy objective of promoting the nation's retirement security.

Summary of Reason's Argument

Reason's overarching complaint regarding DB plans for public employees is that they are a "moral hazard." According to Wikipedia:

In law and economics, moral hazard is the name given to the risk that one party to a contract can change their behavior to the detriment of the other party once the contract has been concluded.[2]

For public pensions, according to Reason, this moral hazard allows lawmakers to grant higher pensions for current workers while deferring the cost of those enhanced benefits to future generations of taxpayers.

Reason insists that state legislators and other policymakers cannot be trusted to make decisions regarding pension benefits, because elected officials will operate in their own selfish political interest while ignoring the long-term effects of their decisions. Reason bases this view chiefly on two criteria: 1) the purported poor financial condition of public pensions, and 2) several examples of alleged abusive pension practices, including pension spiking, deferred retirement option plans, "air time" purchases, and "public safety" employees' benefits expansion.

The Reason study specifies the following examples (accompanied by its title from the study) of alleged public pension abuses to illustrate what Reason contends is the hazard of public DB plans:

- San Diego: A "Perfect Storm" of Financial Mismanagement
- Illinois: Mired in Pension Debt
- California: The Politics of Increasing Benefits and Managing Portfolios
- West Virginia: Banking on Pension Obligation Bonds
- Los Angeles County: Suffering from Pension Obligation Bonds and "Chief's Disease"
- Detroit: Rising Pension Costs and a Declining Revenue Base
- Orange County, California: Ignoring the Lessons of the 1994 Bankruptcy
- Houston: Lavish Benefits and Bad Assumptions
- Contra Costa County, California: The Costs of Unreasonable Assumptions

NASRA Analysis and Response

The issue of retirement benefits for employees of state and local government is no small matter: state and local governments in the U.S. employ 16 million workers—more than 10 percent of the nation's workforce.[3] These employees perform a broad range of essential public services, such as teaching at and supporting public schools and universities, policing streets, fighting fires, guarding prisons and jails, and protecting public health. At the end of September 2005, state and local retirement funds held assets of $2.66 trillion,[4] and they distribute more than $130 billion annually to over six million retired public workers and beneficiaries.[5]

If Reason's chief recommendation—to supplant DB plans with DC plans—were implemented, NASRA believes the ability of public employers to attract and retain qualified workers would be impaired, as would the retirement security of millions of state and local government employees.

NASRA believes the arguments Reason presents in favor of terminating DB plans are flawed in at least four ways:

1. Reason distorts the true financial condition of public pensions in general and the ramifications of pension plan "underfunding."
2. Reason mistakenly extrapolates a handful of public pension problems onto the entire public pension community.
3. Reason fails to consider the many negative consequences that would result from terminating DB plans.
4. Reason advances arguments that reflect an incomplete understanding of public pension issues.

As elected officials operating within the framework of the U.S. and state constitutions, federal regulations, and case law, state policymakers are entrusted with responsibility for drafting and approving laws to establish, govern, and administer pension benefits for employees of state and local government. Reason's belief that elected officials cannot be trusted to make decisions regarding public pension benefits is an indictment of our nation's entire governance structure, one that is based on representative democracy. If, as Reason alleges, our own elected officials are so beholden to narrow special interests that they cannot be trusted to make decisions for the greater good, then our system of government is imperiled.

State legislators and governors are elected to make decisions that have long-term consequences. Such decisions include those regarding development of roads and highways, establishment of educational institutions, taxation and spending, the purchase and sale of real property, protection of natural resources, hiring public employees, and others.

The nation's founders provided processes, within the legal and political framework, to correct problems such as some of those in the public pension community identified by Reason; and for use when citizens believe their elected officials are not making prudent decisions. These processes include:

• amending state constitutions and laws affecting retirement benefits and governance;

• elections, to vote out elected officials perceived to be making decisions not in the public interest, and to vote in others; and, in some states,

• initiative and referendum, whereby citizens and lawmakers can change state constitutions and laws.

One desirable attribute of a pension benefit is that its cost, as much as possible, should be paid by the current generation of taxpayers, a concept known as "intergenerational equity." Acknowledging Reason's concern regarding the potential conflict between the long-term nature of pension liabilities and the shorter time horizon of elected officials, Michael Peskin argues that pension costs can be made transparent and borne by the current generation of taxpayers:

> The solution to this political imbalance is to adopt a rigorous and disciplined framework within which to calculate liabilities and assets, and to establish policies. Such a framework must make the price of options and transfer of costs or risks to future generations transparent. It thus includes a comprehensive stochastic model of the plan going forward many years with explicit modeling of investment, funding and benefit policies. The core economic cost is the present value of contributions to fund the appropriate level of benefits. It is possible to reduce the present value of contributions with appropriate investment and funding policy and tightening of benefit policy to avoid the provision of expensive options.[6]

An arrangement such as one described by Peskin exists in the State of Georgia, whose constitution requires that public retirement plans remain actuarially sound:

> It shall be the duty of the General Assembly to enact legislation to define funding standards which will assure the actuarial soundness of any retirement or pension system supported wholly or partially from public funds and to control legislative procedures so that no bill or resolution creating or amending any such retirement or pension system shall be passed by the General Assembly without concurrent provisions for funding in accordance with the defined funding standards.[7]

Pursuant to this clause, Georgia statute requires that:

• Pension legislation with a fiscal effect may be introduced only in the regular session of the first year of the term of office in the General Assembly, and passed only during the regular legislative session of the second year of the term of office of General Assembly members.[8]

• Retirement legislation with a fiscal effect may not leave its committee or be considered by the House or Senate unless its actuarial cost has been determined.[9]

• First-year funding for retirement bills with a fiscal effect must be appropriated in that year, or the bill becomes null and void.[10]

• The state must maintain minimum funding standards for its pension plans and each year must contribute the pension plan's normal cost plus the amount needed to amortize the unfunded liability.[11]

The Employees' Retirement System and Teachers' Retirement System of Georgia are among the best-funded public pension plans in the nation, with costs and benefits near the national median.[12]

I. Reason Distorts the Financial Health of Public Pension Plans

The Reason study points to public pension funds' combined unfunded liabilities—currently around $340 billion—as evidence of an "ominous storm cloud" of public pension costs. Yet Reason never places this figure into context. As another form of government debt, the absolute dollar value of an unfunded liability, by itself, does not reveal much. To have real meaning, an unfunded liability must be compared with the resources—current and future—available to retire the obligations. These resources usually take the form of assets and future revenue streams of state and local governments that sponsor pension benefits.

Based on these measures, as a group, public pension funds are in reasonably good condition:

• According to the most recent available information, public pension plans in the U.S. have combined actuarial assets of approximately $2.48 trillion and actuarial liabilities of $2.82 trillion, for an aggregate funding level of around 88 percent. Although this funding level is lower than it was several years ago, it is higher than it was for most of the last 25 years of the 20th century.[13]

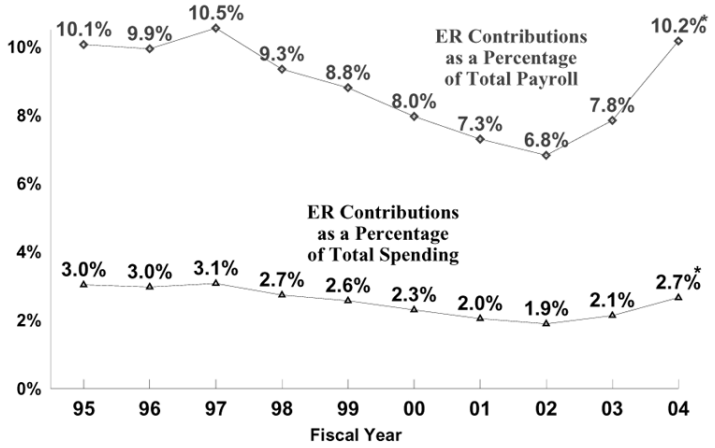
• 70 percent of public pension plans are funded at 80 percent or higher.[14]

Funding a pension benefit takes place over a long period of time, and by itself, an unfunded liability is not necessarily a sign of fiscal distress: Not every public employee will retire tomorrow or next year, and pension liabilities usually extend years into the future. This extended time frame gives pension plans time to amortize their unfunded liabilities, through a combination of investment earnings and employer and employee contributions.

In "The Gathering Pension Storm," Reason refers to sharply rising costs of pension plans. But as shown in Figure A, state and local governments spent approximately the same in FY 04 (the latest year for which data is available) on public pensions than they spent in the mid-1990's, measured both as a percentage of employee payroll and as a percentage of total state and local government spending.

Pension costs for some employers have risen sharply in recent years. In many cases, a root cause of these sharply rising contribution rates is the plan's design, and can be remedied with one or more design changes. But the idea that state and local government pension costs for the entire nation are spiraling out of control is not accurate.

Figure A. State and local government contributions to public pension plans, as a percentage of payroll and total spending.



*FY 04 figures include approximately $8 billion in pension bonds; without which these figures would be 9.0% and 2.4%, respectively.

Source: US Census Bureau

Although the majority of public pensions are in fairly good financial condition, some plans do face serious unfunded liabilities that will require corrective action. Unfortunately, by painting the entire public pension community as awash in crippling unfunded liabilities that are the product of self-serving legislators, Reason ignores the reality of the current public pension funding picture. In so doing, Reason's recommendation to terminate DB plans for public employees is based on a distorted picture of the public pension funding situation.

Of those public pension plans that face serious funding problems, most result from legislative failure over extended periods to remit required contributions. States that chronically failed to remit required contributions enjoyed the savings that were generated by diverting pension contributions to other priorities. Contribution rates in some states declined in recent years to unprecedented levels, including as low as zero. Combined with the decline in equity values, very low or nonexistent contribution rates contributed to the decline. It would be disingenuous to call for the elimination of DB plans because they are expensive, in cases when a major factor contributing to their cost is the diversion of contributions over a period of years, or sharp reductions in contributions due to favorable investment gains.

II. Reason Mistakenly Extrapolates a Handful of Public Pension Problems Onto the Entire Public Pension Community

The Reason study purports to illustrate the flaws inherent in DB plans, in part on the basis of nine examples of alleged abuse or excess. According to the U.S. Census Bureau, there are more than 2,000 public pension plans in the U.S., that provide pension and other benefits for more than 14 million active and 6 million retired public employees. Any community this large is likely to have its share of abuse and excess, and Reason's use of nine examples (of which five are in one state) to demonstrate the fundamentally flawed nature of DB plans, seems to lack proportionality. Every state sponsors at least one statewide retirement system; most states sponsor two or more. Hundreds of cities and towns and counties sponsor public retirement systems.

Reason does not mention the hundreds of public pension plans that are working well on behalf of millions of working and retired public employees, public employers, and recipients of public services and other taxpayers. The highly diffuse and diverse regulatory structure overseeing the public pension community creates an environment in which states and cities can experiment with, design and maintain cost-effective pension plans that meet the multiple objectives of public employers. For every case of public pension abuse and excess cited by Reason, there are many more cases of pension plans assisting, in a cost-effective and responsible way, public employers in providing essential public services. In cases of actual pension abuse and excess, the answer is not to get rid of the plan, but to change the plan's governance structure and benefit design. If necessary, this can be achieved through changes to the constitution, statutes, and elected officials.

Reason makes sweeping conclusions about the entire public pension community on the basis of a rather small subset of that community, a subset that is quite limited geographically and politically.

III. Reason Ignores Many Likely Effects of Its Recommendation to Terminate DB Plans

Like other employers, public employers must compete in the labor market for a limited pool of talent, and a DB plan has long been a central component of the compensation package for most public employees. Removing the DB plan from public workers' compensation would have consequences for all stakeholders: employers, employees, and taxpayers. Yet Reason pays little heed to these consequences, making its recommendations in a vacuum, as if switching from one plan type to another would be seamless and without consequence. In fact, switching plan types would involve costs and have consequences.

A majority of public sector positions are best served when those who occupy them are career-oriented or lat least remain in them for ten years or longer. Two-thirds of public employees are classified by the U.S. Census Bureau as judicial, firefighters, police officers and support, corrections, or educational.[15] The taxpaying public is well-served when individuals remain in these positions for an extended period—long enough to enable the employer and taxpayers to realize the investment made to train the employee and to serve the public through their knowledge and experience. Moreover, taxpayers are well-served when public sector positions are filled with skilled and qualified personnel, rather than inexperienced workers who are learning on the job. Retention of qualified workers is a primary reason that public sector employers continue to offer a DB plan—it creates an incentive for career-oriented workers to remain in their position.

Unfortunately, Reason's study does not acknowledge the role DB plans play in attracting and retaining public employees; nor does the study consider the effects on public employers of implementing Reason's main recommendation: the replacement of DB plans with DC plans.

Reason also does not contemplate the effects on public employers—school districts, police departments, fire departments, etc.—of losing what may be the strongest incentive for public workers to stay on the job. In the absence of a DB plan, public employers will be required to make adjustments in their compensation package. Such adjustments might include improved working conditions, better benefits, or higher pay. It is unrealistic to think that the behavior of current and future public employees will not change in the wake of a change to their compensation package. All else held equal, if the DB plan is taken away, other compensation costs would need to rise.

The Reason study does not acknowledge the improved financial security enjoyed by millions of working and retired public employees from having a DB plan. Studies have documented the crisis the nation faces as millions of workers approach retirement with savings far short of required levels. Many Americans face the real prospect of outliving their retirement assets. Some indigent elderly will turn to the

state, as the provider of last resort, to meet their basic needs. Yet the Reason study is silent on this scenario, which is a real possibility were Reason's recommendation to be implemented.

A 2004 Pension Research Council paper identified the economic effects of public pension funds. These effects include the investment of pension fund assets in venture capital projects; the added liquidity and stability added by public pension assets to financial markets; and the stimulus provided to the nation's economy as a result of the additional assets produced by higher investment returns generated by public pension funds.[16] If public DB plans were terminated, the economic stimulus they provide to every city and town in the nation would diminish, slowly but surely, as the effects of higher investment returns from professionally-invested DB assets fades away. A generation of public employees relying on self-directed retirement accounts would result in fewer assets available for retirement and declining salutary effect on local economies.

In an analysis of public employers exploring switching to DC plans, bond rating agency Standard & Poor's recognized the potential risks of closing off DB plans in favor of DC plans:

> The decision on pension plan design for a governmental entity should include a very long-term view of the welfare of employees: They must be given the tools to build sufficient resources to live during retirement, including the combined resources of pensions, Social Security (if applicable), and personal savings. If this strategy fails to meet expectations, the result could be that government retirees will require some form of public assistance at a point in the future. These unanticipated increased employer costs to make up for below-average retiree wealth could offset, partially or totally, the earlier direct benefits from lower, more predictable contribution rates gained through a DC conversion.[17]

S&P concluded its analysis by warning that converting to a DC plan is no silver bullet for challenges facing state and local governments:

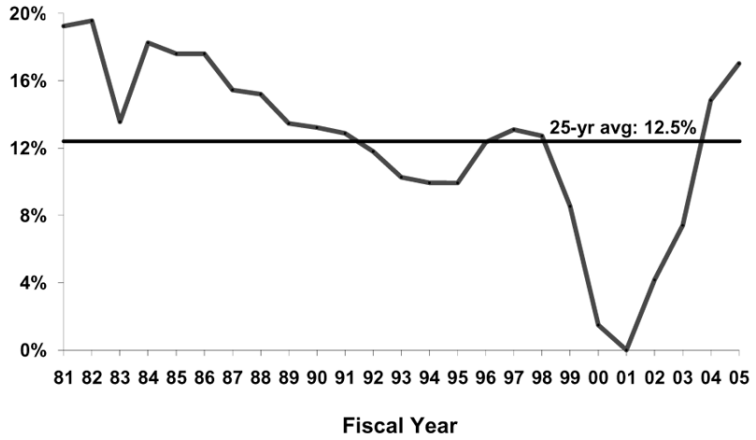
> From a credit perspective, a DC conversion plan cannot be automatically considered a positive factor in that the effects must be weighed over a very long time period. The benefits of a conversion to a government's cost structure in the early years could be undone in the later years if retiree income expectations are not realized and unexpected costs show up elsewhere. While the private sector has had some success with the DC model, the historical experience in the public sector is really too new to prove that it will be effective. When employers are considering the DC option, overall public policies concerning the well being of employee citizens and fiscal policies must be integrated into a monolithic policy for long-term retirement income stability.[18]

IV. Reason Advances Arguments That Reflect an Incomplete Understanding of Public Pension Issues

Many arguments advanced in the Reason study indicate an incomplete understanding of public DB plans. Following are some statements made by Reason in its study, followed by a NASRA clarification or correction.

Reason on employer contributions to public pension plans: "Ballooning pension obligations necessarily draw resources away from other quality-of-life priorities like transportation, education, and public safety. In California, for instance, the state's obligations to its government-employee pension system have skyrocketed from $160 million to $2.6 billion annually just since 2000."

Figure B. Employer contribution rate for California state employees, Tier I



Source: CalPERS

NASRA: Reason's reference to "ballooning" pension obligations is based on a highly selective use of statistics which does more to confuse than clarify the issue of employer contributions. Figure B (above) depicts a longer and more comprehensive data set of the employer contribution rate for the largest group of California state employees. This rate is representative of employer contribution rates for other large groups of CalPERS participants.

As the chart shows, due chiefly to robust investment earnings, the contribution rate fell sharply in fiscal year 1999, remaining well below historic averages through fiscal year 2003, when the effects of the decline in equity markets and the cost of recent benefit improvements were more fully recognized actuarially. Yet to make its argument that pension obligations are "ballooning," Reason pointed only to the low and what is likely to be the high points of California state contributions to CalPERS. Reason excluded other information that would have presented the issue in a more complete and accurate context.

Presenting this issue in a fuller and more fair context would mentioned the savings enjoyed by plan sponsors—the state and many of its political subdivisions—when contribution rates were low. Unfortunately, to make its point that benefit obligations are "ballooning," the Reason study focuses exclusively on two narrowly-captured data points, while ignoring other relevant data.

A defining attribute of DB plans is that their design can be modified to reach any of multiple objectives. To reduce volatility in its contribution rates, the CalPERS Board of Administration in 2005 changed its method for calculating the actuarial value of assets, by:

• increasing the period over which investment gains and losses are recognized (a recommendation made by Reason in its study) and,

• widening the permissible corridor of the actuarial value of assets to market value of assets.

Criticism of CalPERS contribution rates should be tempered by the fact that for several years, California taxpayers contributed relatively little, on a historic basis, to the pension plan for state employees and for many employees of local governments in the states. The reforms implemented by CalPERS are intended to smooth future year-to-year changes in the contribution rate.

Other changes public pensions have effected in recent years to moderate contribution rates include:

• Modifying the plan design to reduce pension "spiking," which occurs when an employee's salary rises sharply in the period immediately preceding retirement, resulting in a higher pension benefit? Several states in recent years have implemented anti-spiking provisions.

• Establishing a minimum contribution rate. This prevents contribution rates from declining to extremely low levels, including zero, which occurred at a number

of plans around the nation in the wake of investment market gains during the late 1990's.

• Placing a limit on the annual increase in contribution rates, such as to one percent, a policy in effect for pension plans in Iowa and Kansas.

• Establishing floating amortization periods. This moderates the funding level by extending the amortization period during times of underfunding and shortening it as the funding situation improves.

• Linking cost-of-living adjustments to investment returns. Establishing a relationship between COLA's and investment earnings allows all participants—employers, actives, and annuitants—to benefit when investment returns exceed assumptions and to bear some of the burden of lower-than-expected market returns, either through higher contribution rates or by a smaller COLA.

Reason on participant access to retirement funds: "Under defined-benefit plans, employees have limited ability to access their money if they terminate employment before the regular retirement age. Also, benefits cannot be "rolled over" if the employee switches jobs, and usually cease upon the retiree's death."

NASRA: Reason is correct in saying that DB plans restrict employees' access to their retirement savings. The purpose for providing a retirement plan is not to serve as a source of ready cash, but to save money for retirement. A retirement plan that allows participants to spend retirement savings before retirement is falling short of its purpose, and Reason's criticism of DB plans in this way seems bizarre.

One of the chief shortcomings of DC plans is the amount of assets that leave the system prior to retirement. Studies consistently show that many DC participants borrow against their retirement savings; or "cash out" when switching jobs, leaving the employee financially unprepared for retirement. Although Reason cites the limited access employees have to their retirement savings as a problem, NASRA believes this restriction is actually one of many advantages DB plans have over DC plans.

Reason on the ability of public workers to "roll over" their retirement funds: "(DB plan) benefits cannot be "rolled over" if the employee switches jobs, and usually cease upon the retiree's death."

NASRA: Reason's statement about the ability to roll over DB plan benefits, is simply incorrect. Most public DB plan participants are required to contribute to their pension benefit, and terminating employees are entitled to their contributions, usually with interest. Some public plans also allow entitle participants to some or all employer contributions made on the worker's behalf.

Moreover, many public DB plans allow workers to purchase service accrued with another public employer and to transfer their assets and service credit from other plans. Those states and cities that do not allow service purchase may do so if they wish; contrary to Reason's assertion, there is nothing systemic in a DB plan that prevents DB plan sponsors from allowing the purchase or transfer of service accrued at another plan.

Reason's contention that benefits usually cease upon the retiree's death is at best misleading and in the case of most plans, simply wrong. Public pension plans allow retirees to designate a beneficiary, such as a spouse, who continues to receive a benefit, should they be preceded in death by the retiree. In fact, it is not uncommon among public pension plans to require married pension participants to secure the written consent of their spouse to request an annuity benefit that does not include a benefit for the surviving spouse.

Reason on the cause of the recent decline in public pension funding levels: "(T)he central causes of the (pension) crisis are poor planning and decisionmaking. At the heart of the pension crisis is a set of incentives which create a "moral hazard."

NASRA: What "poor planning and decisionmaking" represent to Reason is not clear, but it may be safe to infer that Reason is saying is that benefit enhancements approved by self-serving legislators are the primary cause of the decline in pension funding levels after they reached their peak in 2000.

An analysis by consultant Gabriel, Roeder, Smith[19] strongly suggested that the chief cause of the decline in public pension funding levels after 2000 was the decline in equity values. The combined value of state and local government pension funds declined from 12/31/00 to 12/31/02 by more than $360 billion, or nearly 16 percent.[20] Although benefit enhancements for public employees were approved during the past decade, there is no evidence that these enhancements are the primary factor contributing to these declines. (Public pension fund values rose to $2.66 trillion in September 2005, an increase of nearly 38 percent above their low point at the end of 2000.)[21]

In addition, benefit enhancements for many public employees often are approved in lieu of salary increases. Had salary increases been approved instead of pension benefit enhancements, pension funding levels might have been marginally higher, but current salary obligations for public employers would be greater, possibly leaving public employers worse off than they otherwise would have been.

Reason on compensation levels in the public and private sectors: "Supporters of pension benefit increases routinely argue that they are needed to attract a high-quality workforce that is paid less than their private-sector counterparts. Unfortunately, this claim is simply not true. According to the Bureau of Labor Statistics, the average wage for state and local government employees is $23.52 per hour, compared with $16.71 per hour for private-sector employees. When benefits (including pensions) are included in the calculation, state and local government employee compensation jumps to $34.13, compared to total private-sector compensation of $23.41. In other words, even when private employees' benefits are included, they still make less than the raw wage of state and local government employees."

NASRA: Some public sector workers earn salaries that are higher than their private sector counterparts; many earn salaries that are lower. Broad comparisons of private and public sector salaries and benefits often overlook the fact that most public employees work in professional positions that require higher levels of education or physical risk than those in the private sector workforce. For example, more than one-half of all state and local government employees work in education. These are school teachers and administrators, librarians, college professors and higher education staff. Many other public employees work as firefighters, police officers, and correctional officers, whose responsibilities entail significant physical risk and have few comparable positions in the private sector.

When possible, most positions in the public sector—education and public safety in particular—should be filled with career-oriented workers. It makes good public policy to encourage professionals such as these to remain in their positions long enough not only to realize a return on the investment public employers have made in their training, but also to enjoy the benefits of their experience and qualifications. Allowing qualified public employees to leave their position due to compensation shortfalls is disruptive to the orderly and effective delivery of public services and results in added costs to train new workers.

Finally, the BLS study cited by Reason does not acknowledge that most public employees are required to contribute to their pension benefit; the median contribution rate for Social Security-eligible public employees is five percent. State and local government employee contributions account for approximately 12 percent of all public pension revenue.

Reason on the effects of changing corporate pension policy: "The enactment of ERISA and the 1978 Revenue Act would prove to be a pivotal change in pension history. Since their passage, the private sector has seen a steady trend toward "401(k)" and similar "defined contribution" plans * * * and away from defined-benefit plans. Now even government pension systems are re-evaluating defined-benefit plans in favor of defined contribution plans."

NASRA: Despite good intentions to strengthen corporate DB plans, the passage by Congress of ERISA in 1974 and subsequent changes to the tax code, has contributed to the steady decline in the percentage of American workers with a DB plan. Many of these DB plans have been abandoned in lieu of DC plans. Unfortunately, as workers' reliance has shifted from DB to DC plans, the nation's overall retirement security has declined.

Yet advocates of supplanting DB plans with DC (like Reason) justify their view partly on the basis that relatively few DB plans remain in the private sector.

Although many corporate DB plans have been frozen or terminated, a majority of the Fortune 1000 continue to provide a DB plan to their workers.[22]

More importantly, the relevant issue is not whether the public sector should abandon DB plans because many in the private sector have done so, but rather, whether it is prudent for state and local governments to pursue a policy that is known to diminish the retirement security of its employees and the nation as a whole. A DC plan, by itself, is a poor vehicle for delivering retirement assets and promoting retirement security. In fact, the primary DC plan type in the U.S., the 401(k) plan, was created not as a retirement savings tool, but as a tax shelter that was subsequently adopted by private sector employers (and a few in the public sector).[23] The mere fact that many employers in the private sector have embraced a DC plan does not mean that switching public sector workers to a DC plan is a good idea.

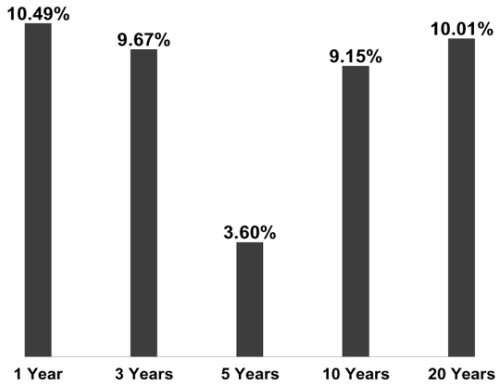
Reason's statement that, "even government pension systems are re-evaluating defined benefit plans in favor of defined contribution plans," paints a distorted picture of reality. Although some states have given some groups of public employees the op-

portunity to choose a DC plan, and two states (Alaska and Michigan) limit retirement coverage to large groups of their public workers to DC plans, far more legislative activity in recent years has surrounded modifications to existing DB plans, rather than incorporating DC plans.

Indeed, states and other sponsors of public pension plans are taking advantage constantly of the remarkable flexibility offered by DB plans to achieve key employer objectives.[24] This flexibility takes the form of hybrid pension plans, service purchase options, increased portability features, return-to-work provisions, and others. Despite extensive consideration given to which type of retirement plan they should use, most public employers have recognized that they are better off continuing to work within the prevailing framework of DB plans than to switch to a retirement benefit structure that is unreliable in terms of delivering retirement benefits and retaining qualified workers.

Reason on investment return assumptions: "Pension systems have become underfunded, in part, because investment returns are not meeting expectations and thus contributions are not covering costs. Moreover, over-optimistic expectations are not confined to just a few state and local governments. According to the Public Fund Survey, a survey of government pension plans conducted by the National Association of State Retired Administrators and the National Council on Teacher Retirement, the median investment return assumption for fiscal year 2003 was 8 percent. Unfortunately, nationwide, the median government pension has only grown an average of 4.1 percent over the past five years."

Figure C. Median Public Pension Investment Returns for Periods Ended 6/30/05



Source: Callan Associates

NASRA: Reason's use of a five-year period, to the exclusion of other data, is selective and exclusive and borders on the disingenuous. According to investment consultant Callan Associates, as shown in Figure C, for the 10-year period ended June 30, 2005, the median public pension fund investment return was 9.15 percent,[25] well above the public pension community's standard investment return assumption of 8.0 percent.

For the 20-year period ended June 30, 2005, the median public fund return was 10.01 percent.[26] Pension plans are long-term operations, and investment returns over longer time periods, like 10 and 20 years, are more representative of public funds' actual results than the single 5-year period cited by Reason (which happens to incorporate the first time stocks have declined 3 consecutive years since the Great Depression).

Reason on pension obligation bonds: "The idea of issuing one debt to pay another, particularly when issuing bonds to pay an annual operating expense, is poor fiscal policy. Pension obligation bonds are a short-term solution to a long-term problem—this is effectively the same as a family using a credit card to pay utilities because they don't have enough money at the end of the month and, in the process, run up credit debt with increasing minimum payments. Not only has the credit bailout not addressed the underlying mismatch in revenues and expenditures, it has also contributed to higher minimum payments (in the case of pension bonds, this is new debt service). At the end of the day, the family that follows this strategy is

actually worse off. Elected officials must abandon the idea of pension obligation bonds and learn to make difficult decisions to meet their pension obligations."

NASRA: Reason's characterization of pension bonds as issuing one debt to pay another, is misleading and misrepresents the benefit of using pension bonds. An unfunded pension liability is a form of public debt. Issuing pension bonds to reduce or eliminate an unfunded pension liability can be a responsible course of fiscal action, as it can enable a pension plan sponsor to take advantage of low borrowing rates to reduce long-term pension liabilities.

Issuing a pension bond is analogous to a homeowner who takes advantage of lower interest rates by refinancing her mortgage. A family that refinances their mortgage with a lower rate of interest is normally better off, not worse. With interest rates in recent years at historic lows, reducing or eliminating an unfunded pension liability through the use of pension bonds may well be a prudent course of action. Reason's characterization of pension bonds as using a credit card to pay utilities falsely represents the way they have been used in most cases. In an analysis of pension bonds, credit rating agency Standard & Poor's said:

> While no panacea, POBs (pension obligation bonds) are basically an arbitrage play based on the premise that, as a result of the bond proceeds being invested at an expected yield above the cost of the bonds, net savings will be achieved by the sponsor over the life of the bonds. In other words, after the issuance of the POB, combined debt service plus pension contribution costs will be lower than they would have been without a POB. The success of this formula depends on the realization of a certain investment return, which is in no way guaranteed. Whether a POB succeeds or fails cannot fully be evaluated until the final maturity of the bond, and it is a given that some years will be winners and others losers. The bad years may add short-term fiscal stress to the POB issuer (pension sponsor), which could be significant based on the amount of leverage the POB exerts. With most POBs having been issued over the past 10 years or so, it would be premature to pronounce them an unqualified success (or failure). The best that can be said to date is that POB results have been mixed, with some having met or exceeded expectations while others have come up short based largely on the vicissitudes of market timing."[27]

Reason on public employee preferences for pension plan types: Referring to Nebraska's shift from a DC plan to a cash balance plan, Reason says: "Tellingly, however, there has not been an exodus from the defined-contribution plan. In fact, approximately 70 percent of the members of the defined-contribution plan chose to remain under that plan when the cash-balance plan went into effect. If the defined-contribution plan was so disastrous, as critics claimed, many more people would have switched out of the plan. Apparently, people value the freedom to make their own retirement investment decisions." Also, referring to choice in the Florida Retirement System, Reason says, "(N)ew employee participation in the defined contribution plan has increased from 8 percent in mid-2003 to 19 percent for the first half of 2004."

NASRA: Just as there was no exodus from Nebraska's DC plan, neither was there an exodus from DB plans in any of the five states Reason does not identify that have extended to some of its workers the opportunity to switch from a DB to a DC plan. Once again, Reason selects its comparative examples carefully, to the exclusion of other relevant examples.

Two common themes have emerged in each state where employees have been given a choice of retirement plans: 1) Most employees do not actually make a choice of retirement plan unless required to do so; and 2) of those who do express a preference, the vast majority elect the DB plan. Contrary to Reason's reasoning, Nebraska's experience of most workers not making a decision does not indicate employee preference to "make their own retirement investment decisions." Rather, this result is consistent with results in other states, which suggest employees—for whatever reason(s)—do not make a decision regarding their retirement benefit.

In Michigan in 1996-97, during a period of rising stock markets, fewer than six percent of state employees elected to switch to the DC plan. Similarly, in Florida in 2001-02, when given a choice, approximately five percent elected to participate in the DC plan. New workers in Ohio, like those in Florida, are permitted to choose their retirement benefit. Since the inception of choice in 2001, around five percent have elected the DC plan. South Carolina and Montana experienced similar results. No empirical evidence exists to support Reason's contention that a meaningful percentage of workers prefer a DC plan over a DB plan; in fact, just the opposite appears to be the case.

What Are the Real Issues?

The issue of retirement benefits for public employees is not whether there are excesses or problems with DB plans. Any community this large, with this much money involved, is bound to have some problems. The real issue is how best to resolve these problems, how to avoid them in the future, and what retirement plan design best meets the multiple and sometimes conflicting objectives of public employees, public employers, and recipients of public services. Reason's solution—to terminate DB plans and replace them DC plans, is not only simplistic but also is likely to create more problems than it solves, problems that the Reason study largely ignores.

NASRA's response to the Reason study has attempted to clarify some of the issues raised by Reason's paper and to identify solutions that will yield better results than if Reason's recommendation—to supplant DB plans with DC plans public employees—were implemented. Our nation's legislative and political structure, complete with mechanisms to change and correct existing policies, enables those who wish to do so to address Reason's concerns, without threatening the retirement security of the nation's public employees or the ability of public employers to attract and retain qualified workers.

Rather than eliminating DB plans for public employees, the focus of the retirement plan debate should center on such issues as:

• What type of pension plan can best meet the objectives of key stakeholders—public employers, recipients of public services, taxpayers, and public employees?

• How can policymakers increase public pension intergenerational equity and increase transparency of public pension plan costs?

• How can the many positive attributes of defined benefit plans be extended to workers outside the public sector?

NASRA believes that a fair and factual analysis of these questions will lead to some form of a DB plan.

ENDNOTES

[1] National Association of State Retirement Administrators, "NASRA Standing Resolutions No. 2003-08."

[2] Wikipedia, *www.wikipedia.com*

[3] U.S. Bureau of Labor Statistics, "The Employment Situation," December 2005

[4] U.S. Federal Reserve Board, "Flow of Funds," Third Quarter 2005

[5] U.S. Census Bureau, "2004 State and Local Government Employee Retirement Systems."

[6] Michael Peskin, "Asset/Liability Management in the Public Sector." In Pensions in the Public Sector, (1999) ed. Mitchell and Hustead, Pension Research Council, Philadelphia, University of Pennsylvania Press

[7] Georgia State Constitution, Article III, §X, Paragraph V

[8] Unannotated Georgia Code, §47-20-34

[9] ibid.

[10] ibid., §47-20-50

[11] ibid., §47-20-10

[12] Public Fund Survey, *www.publicfundsurvey.org,* National Association of State Retirement Administrators and National Council on Teacher Retirement

[13] Public Fund Survey, *www.publicfundsurvey.org,* National Association of State Retirement Administrators and National Council on Teacher Retirement

[14] "Summary of Findings for FY 04," Public Fund Survey, NASRA and NCTR

[15] U.S. Census Bureau, 2004 Public Employment Data, State and Local Governments

[16] Anderson and Brainard, "Profitable Prudence: The Case for Public Employer DB Plans," In Reinventing the Retirement Paradigm, (2005) Pension Research Council, Philadelphia, Oxford University Press

[17] Parry Young, Standard & Poor's, "Public Employers Are Considering a Switch to Defined Contribution Pension Plans," November 2005

[18] Parry Young, Standard & Poor's, "Public Employers Are Considering a Switch to Defined Contribution Pension Plans," November 2005

[19] Paul Zorn and Norm Jones, Gabriel, Roeder, Smith and Co., "Questions About the Future of Public Pension Plans: Short-term Problems or Structural Failures?," in Public Sector Pensions: Current Challenges and Future Directions, Harvard Law School, October 2005, *http://www.law.harvard.edu/programs/lwp/Zorn-Jones%20(POWER%20POINT).pdf*

[20] U.S. Federal Reserve Board, "Flow of Funds," Third Quarter 2005

[21] ibid.

[22] "Recent Funding and Sponsorship Trends Among the Fortune 1000," Insider, by Watson Wyatt, June 2005

[23] Employee Benefits Research Institute, "History of 401(k) Plans: An Update," February 2005

[24] National Conference on State Legislatures, "Pensions and Retirement Plan Enactments in 2005 State Legislatures," and preceding years, *http://www.ncsl.org/programs/fiscal/pensun05.htm*

[25] Callan Associates, "Returns for Periods Ended 6/30/05"

[26] ibid.

[27] Parry Young, Standard & Poor's, "Managing State Pension Liabilities: A Growing Credit Concern," January 2005

[Slides presented during Mr. Filan's statement follow:]

State of Illinois

The Illinois Pensions Systems: A Comparative Perspective

Governor's Office of Management & Budget

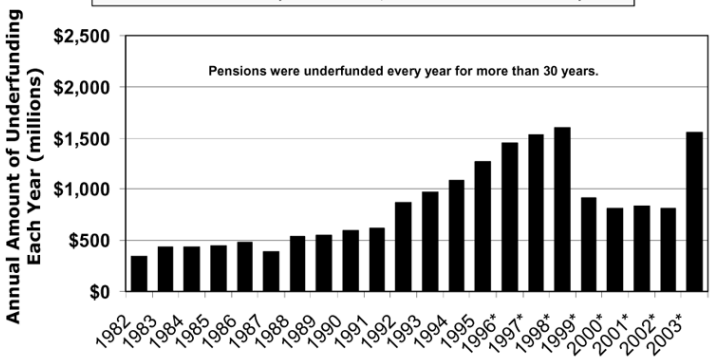
John B. Filan, Director

August 30, 2006

Where We Started in 2003

Where We Started—Escalating Pension Debt

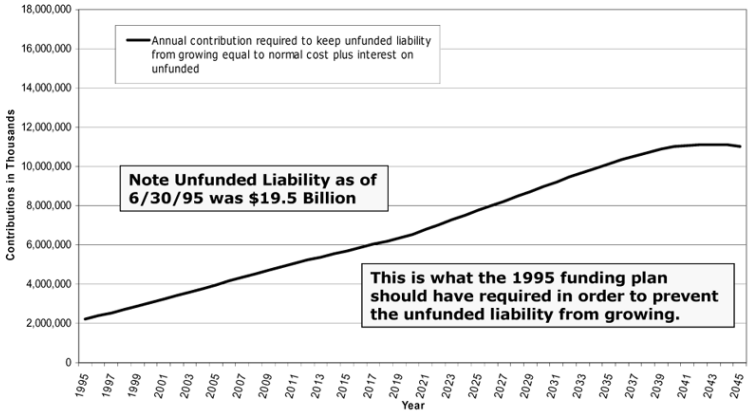
From FY93 to FY03, pension payments were underfunded by at least $870 million annually.



The Total Underfunding increased from 1982 – 2003 by $18.5 Billion.

3

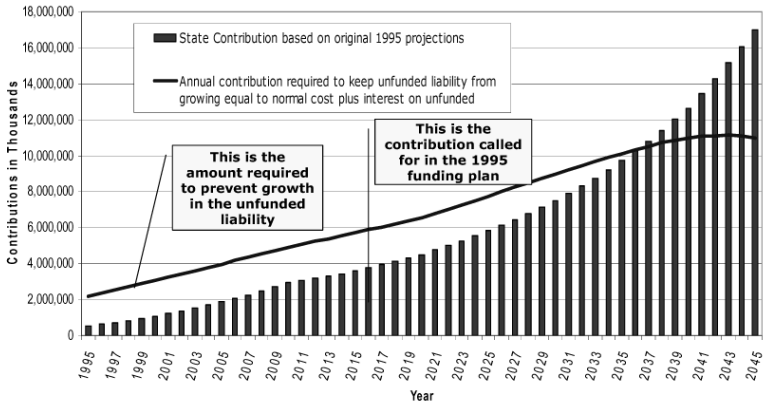
Annual State Contribution Required to Keep Unfunded Liability From Growing Based on Original 1995 Funding Projections



Source—6/30/94 Actuarial Valuation Reports

4

Projected State Contribution Schedule In Accordance with Original 1995 Funding Policy

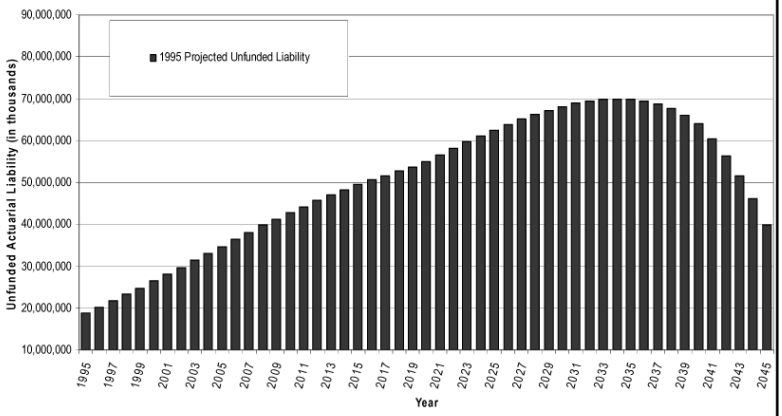


The 1995 funding plan was designed to increase the unfunded liability every year until approximately 2034.

Source -- 6/30/94 Actuarial Valuation Reports

5

1995 Projected Unfunded Liability



The 1995 funding plan, by design, forces the unfunded liability to almost quadruple by 2034 before declining.

Source—System Actuarial Reports

6

Components of Change in Unfunded Liability 1996 to 2003 (In Billions) Increases/(Decreases)

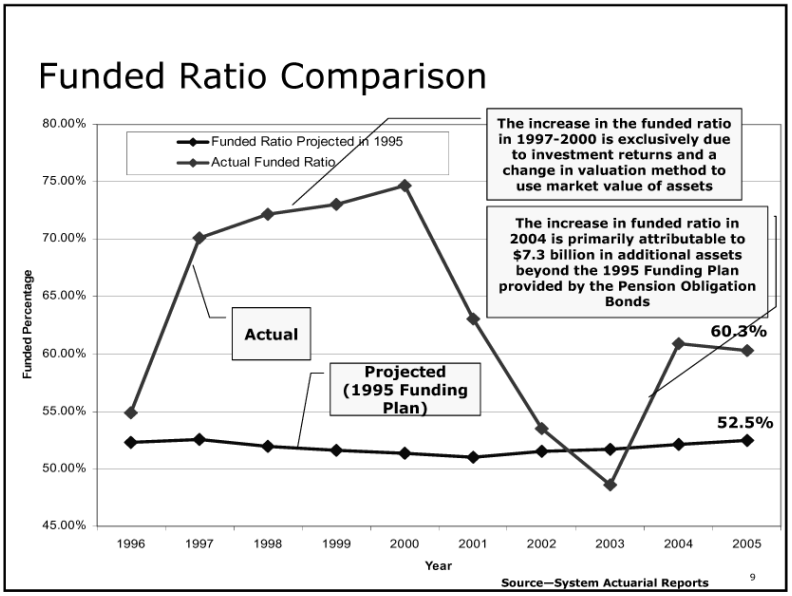
Unfunded Liability at 6/30/1995	$19.5
Change due to:	
State Contributions	$10.9
Actuarial Investment Losses (Gains)	6.5
Unfunded Benefit Improvements	5.8
All Other Factors	0.4
Total Increase	$23.6
Unfunded Liability at 6/30/2003	$43.1

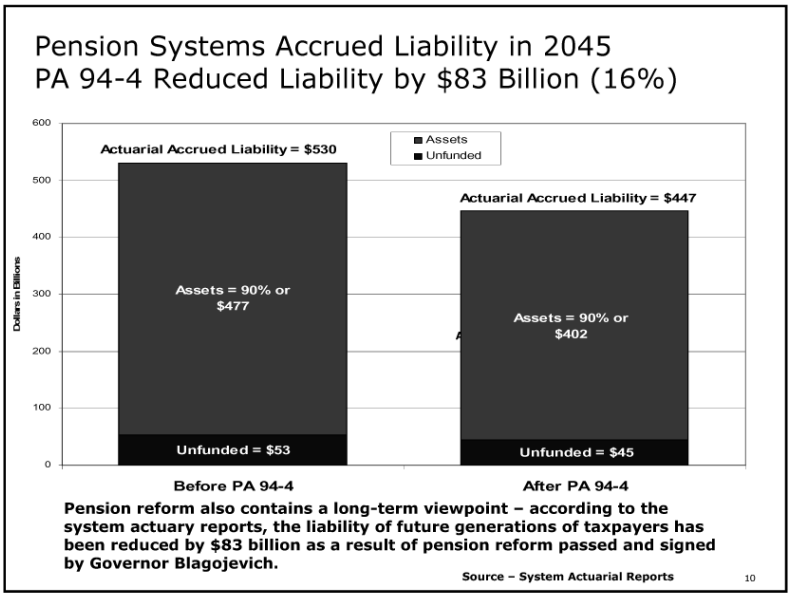
$16.7 billion increase in unfunded liability is due to planned insufficient contributions and new unfunded benefits.

Source 2006 CGFA Report on 90% Funding

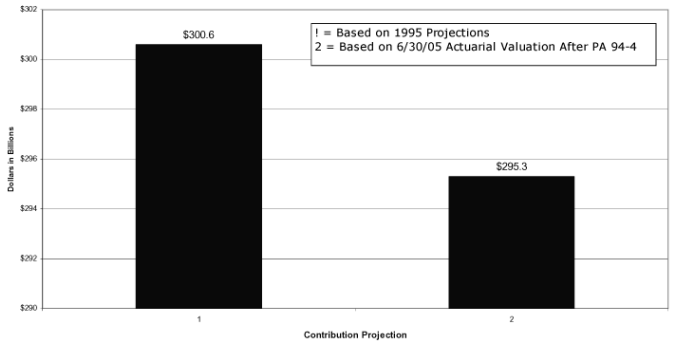
7

Progress Since 2003


Funded Ratio Comparison
Funded Ratio Projected in 1995
Actual Funded Ratio
The increase in the funded ratio in 1997-2000 is exclusively due to investment returns and a change in valuation method to use market value of assets
The increase in funded ratio in 2004 is primarily attributable to $7.3 billion in additional assets beyond the 1995 Funding Plan provided by the Pension Obligation Bonds
Actual
Projected (1995 Funding Plan)
60.3%
52.5%
Funded Percentage
80.00%
75.00%
70.00%
65.00%
60.00%
55.00%
50.00%
45.00%
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
Year
Source—System Actuarial Reports
9


Pension Systems Accrued Liability in 2045
PA 94-4 Reduced Liability by $83 Billion (16%)
Assets
Unfunded
Actuarial Accrued Liability = $530
Assets = 90% or $477
Unfunded = $53
Actuarial Accrued Liability = $447
Assets = 90% or $402
Unfunded = $45
Dollars in Billions
600
500
400
300
200
100
0
Before PA 94-4
After PA 94-4
Pension reform also contains a long-term viewpoint – according to the system actuary reports, the liability of future generations of taxpayers has been reduced by $83 billion as a result of pension reform passed and signed by Governor Blagojevich.
Source – System Actuarial Reports
10

State Contribution Requirements 2006 Thru 2045

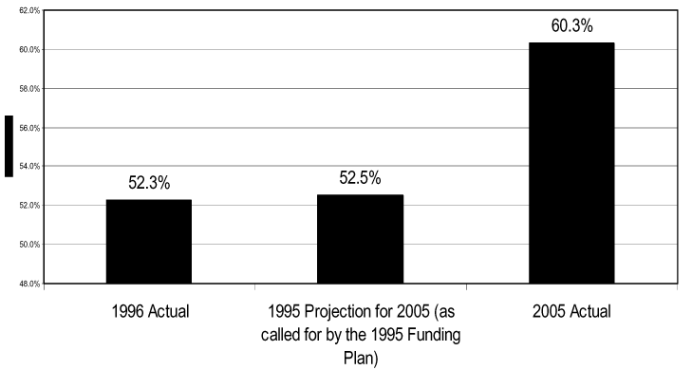


Three Factors That Positively Impacted Contributions include (1) POB, (2) Pension Reforms and (3) Headcount Reduction

Source: **Scenario 1--CGFA Report ; Scenario 2 --System Actuarial Reports**

11

Funded Ratio at 6/30/05 1995 Projection Vs. Actual

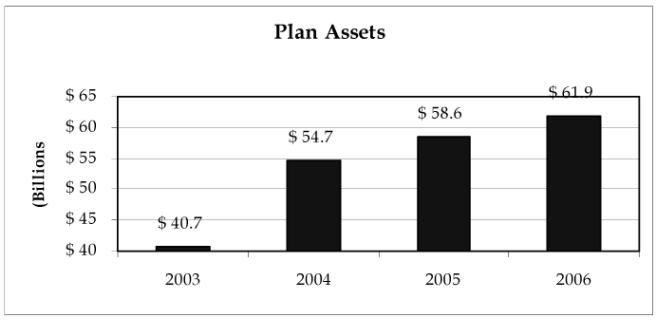


Under the terms of the 1995 Funding Plan, no increase in the funded percentage was anticipated for 10 years.

Source - System Actuarial Reports

12

Asset Values 2003 - 2006



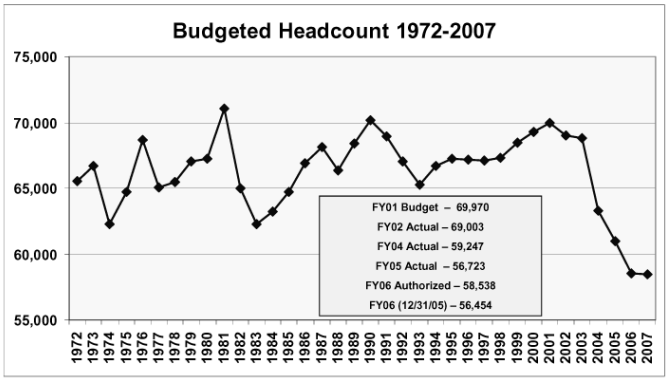
Since 2003 assets have increased by $21 billion, a 50% increase since Governor Blagojevich took office.

Source – 2003-2005: System Actuarial Reports
2006: Retirement Systems

13

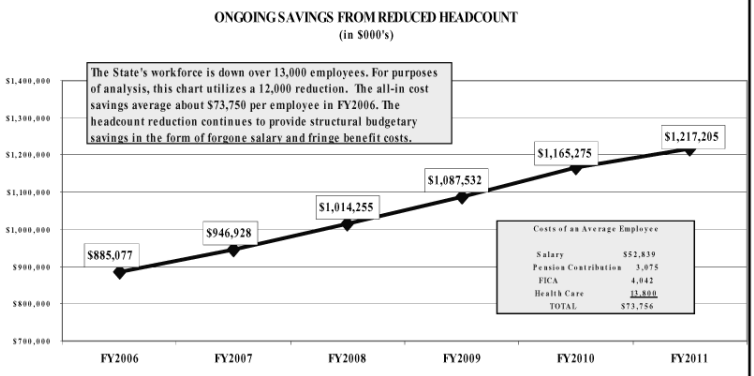
State Headcount is at Lowest Point in 30 Years

The All-Time High was in the 1990's



14

Addressing the Structural Deficit: Ongoing Savings from Reduced Headcount



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