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CENTER FOR GOVERNMENTAL STUDIES   Northern Illinois University

- *Illinois' outstate police and firefighters' pensions are generous when compared to the pension systems offered by other states.*
- *Illinois' police and firefighter pension funds are in unsound financial condition – in even worse financial condition than the funds serving Illinois teachers and state employees.*
- *Recent benefit enhancements approved by the General Assembly have imperiled the pension funds' financial condition despite substantial increases in municipal contributions to them.*
- *It is the job of the General Assembly to protect the integrity of the pension funds.*
- *The General Assembly must avoid further benefit enhancements until the funds are returned to sound financial condition.*

issue: *Illinois Police Officers And Fire Fighters: How Good Are Their Pensions?*

by James M. Banovetz and Dawn S. Peters
NIU Center for Governmental Studies

No group of state or local government employees is more deserving of a sound pension system than Illinois' finest: its police officers and firefighters. They willingly face danger – sometimes extreme danger and death – so that Illinois residents and visitors can live in a safer, more secure world. If the need arose, there is every reason to believe that Illinois police and fire personnel would react with the same bravery, determination, and self-sacrifice as did New York City fire and police on September 11, 2001.

Unfortunately, however, the pension systems for all Illinois municipal police and firefighters, even including Chicago, are not financially sound. Even more worrisome, their pensions are becoming less secure with each passing year. Illinois police officers and firefighters, especially the younger ones, ought to be worried about the fiscal health of their pension funds. As the nation learned when New York City went bankrupt in the 1970's, employee pension funds are not exempt from the negative changes that accompany municipal bankruptcy.

Why is there concern about police and fire pensions?

Most Illinois' pension funds for public employees are in financial trouble. The plight of the state's retirement programs for public school teachers and state workers has been widely discussed in the media, *but the pension funds serving police officers and firefighters are in even worse financial condition.*

This conclusion is based upon data compiled in a recent, professionally sound analysis of police and fire pension funds for all Illinois municipalities other than Chicago (herein called "outstate")[1] prepared by the Illinois Municipal League with the cooperation of the Illinois City/County Management Association.[2] Because sound and economically attractive police and fire pensions are critically important to the safety of the citizens of Illinois, this issue of *Policy Profiles* is devoted to an examination of the question:

> *What needs to be done to improve the financial strength of the pension systems for Illinois police officers and firefighters, with special emphasis on those public safety personnel in all Illinois municipalities other than Chicago?*[3]

Do Illinois police and fire fighters have good pension systems?

Illinois' outstate police and fire pension systems are generous when compared to the systems offered in other states. According to the IML report, outstate Illinois police and fire pension systems provide benefits that rank: (1) seventh when compared to 50 other state defined benefit pension programs; (2) third when compared to the pension programs in the 16 Midwestern states; and (3) second only to Iowa when compared with the pension programs of the states sharing a common border with Illinois. Illinois also has the only public pension system in the nation which calculates individual police and fire pensions based either on an annualization of the amount of the last paycheck the individual receives or the individual's highest annual pay, whichever is greater.

On average, Illinois outstate police and firefighter pensioners receive approximately $533 more per month than the average of public safety personnel in the other 50 state defined benefit pension programs; $352 more per month than the average of their peers in the 16 Midwestern states; and $276 more per month than the average of their peers in the states bordering on Illinois.

Then why should police and firefighters in Illinois be concerned?

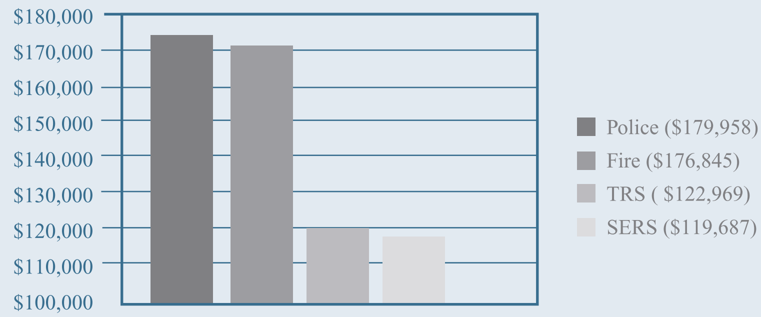
It is a well-known and acknowledged matter of public record that Illinois' public employee retirement systems are in a state of crisis, with over $35 billion in unfunded obligations in pension funds for state employees and an additional $15 billion in unfunded obligations in pension funds serving local government employees.

Most public attention so far has been focused on the Illinois Teachers' Retirement System and the State Employees' Retirement System. Together, these two funds have over $28 billion in unfunded obligations.

However, when unfunded pension obligations are analyzed on a per covered employee basis, Illinois' police and fire pension funds, including both Chicago and outstate funds, are in even worse financial condition. Unfunded obligations for Chicago police and fire personnel amount to approximately $300,000 per employee and outstate police and fire amount to approximately $190,000 per employee. *These unfunded shortfalls are over 270 percent more per employee in Chicago and 170 percent more per employee outstate than the per employee shortfalls in the funds serving the state's teachers and other state employees.*

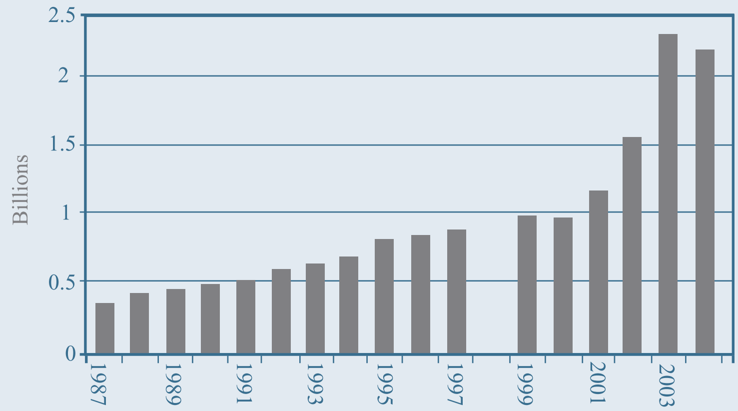
Chart 1 compares the aggregate debt, calculated on a per employee basis, for outstate police and firefighters with the same debt for Illinois teachers and state employees. Clearly, *the pension fund crisis poses much more critical long term risks for police and fire fighters.*

chart*one* **Comparison of Unfunded Debt in Pension Funds**



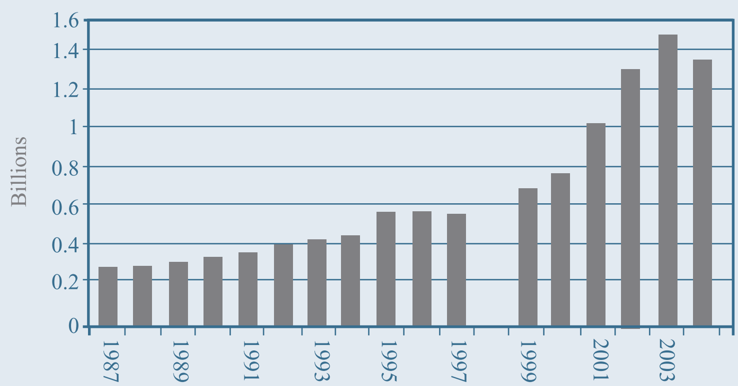
The non-Chicago municipal police and fire pension funds are carrying more debt (in the form of unfunded liability) per active employee than the widely reported debt within the Teachers Retirement System (TRS) and State Employees Retirement System (SERS).
Source: Illinois Municipal League

chart*two* **Downstate Police Unfunded Liability, 1987-2004**



Source: Illinois Municipal League

chart*three* **Downstate Fire Unfunded Liability (1987-2004)**



Source: Illinois Municipal League

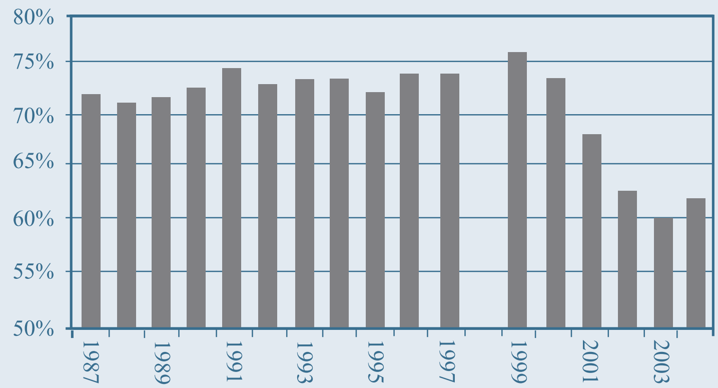
While the state's pension crisis poses no immediate threat to the pension of retired employees, it could pose a threat to the pensions of current workers if benefit changes are forced upon them due to the funds' worsening financial health.

Will the funds' financial condition improve in the years ahead?

The state's public employee pension funds' financial condition has been getting worse, even despite the strong economy of recent years. Indeed, *the condition of the outstate police and fire funds has gotten much worse;* there has been a virtual explosion in the funds' unfunded liabilities in the last five years. Such growth means that the crisis is getting much worse very quickly. This growth is portrayed in Charts 2 and 3.

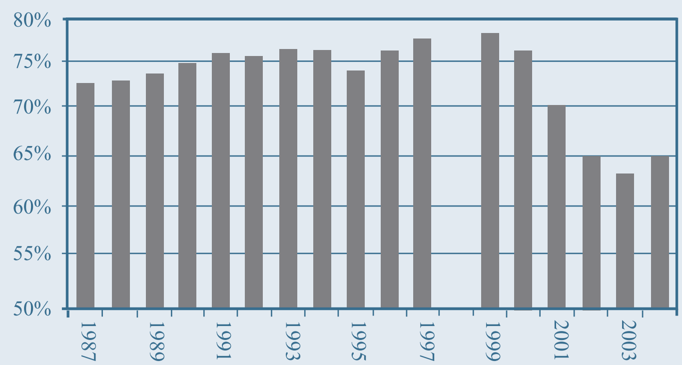
Worst of all, the amount of pension liability that can be covered by monies currently deposited in the pension fund – called the "funded ratio" in accounting terms – has been dropping rapidly in the outstate police and fire funds. In the seventeen years between 1987 and 2004, the funded ratio in the outstate police pension funds has dropped from 72.7% in 1987 to 62.4% in 2004. The funded ratio for outstate fire pensions has similarly declined, from 73.33% in 1987 to 65.9% in 2004. These changes are depicted in Charts 4 and 5 (on the next page). Parenthetically, it should be noted that a standard actuarial rule of thumb holds that a funded ratio of 90% is a strong indicator of a well-funded pension plan.

chart*four* **Downstate Police Funded Ratio (1987-2004)**



Source: Illinois Municipal League

chart*five* **Downstate Fire Funded Ratio (1987-2004)**



Source: Illinois Municipal League

Unless reversed, these trends in the outstate police and fire pension funds mean severe long term problems in meeting the needs of the families of those police and fire personnel who have retired or who have been injured in the line of duty.

Can the problem be solved by increasing the contribution cities and villages make each year to police and fire pension funds?

Most cities and villages are already contributing more – a lot more – to fund police and fire pensions, and still the financial condition of the funds continues to worsen.

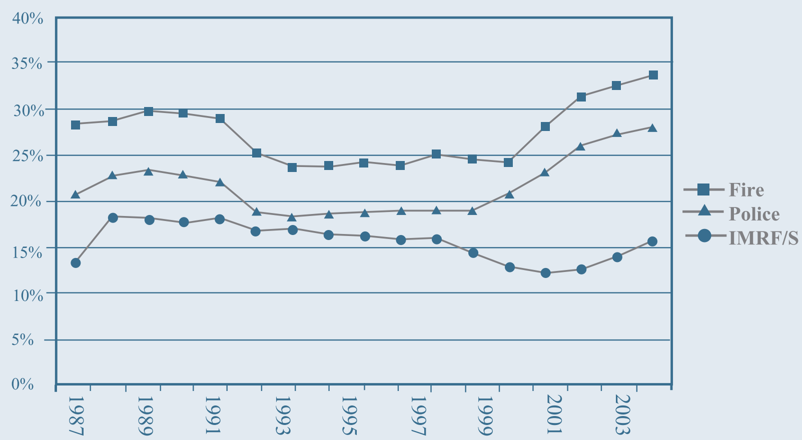
In a targeted analysis of 59 police and fire pension funds in 33 outstate urban area Illinois municipalities,[4] the IML study found that the rate of suggested increase in municipal tax levies,[5] calculated as a percentage of police and fire payrolls, has gone up by approximately 47% between 2000 and 2004 for the police pension funds and by approximately 38% for the fire pension funds. These data are shown in Chart 6 (on the next page). For comparison purposes, Chart 6 also shows that municipal tax levies for the pensions of other municipal employees, also calculated as a percentage of payrolls, are still less than they were in 1988.

On a per person basis, during this same 2000-2004 time period, the rate of contribution, calculated as a percentage of payroll, made by outstate cities and villages to police pension funds increased by approximately 8.5% and to fire funds by approximately 9% while employee contributions to their pension funds in both cases increased by approximately 1%. This data is shown in Charts 7 (on the next page) and 8 (on page 6).

This, in turn, means that police and fire pension fund obligations are already consuming a large and growing percentage of municipal tax revenues: the City of Chicago's property taxes are now devoted almost entirely to pension fund payments. In its August 21, 2007, edition, the *Chicago Sun Times* quoted a Chicago city official as saying,

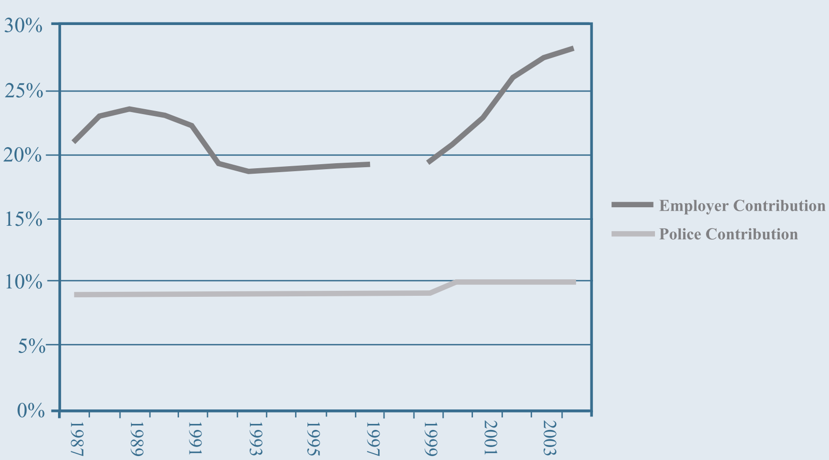
> None of the city's $713.4 million property tax levy is available for day-to-day operations. It's largely eaten up by pension obligations.

chartsix Tax Levy as a Percentage of Payroll



Source: Illinois Municipal League

chartseven Downstate Police Funded Ratio (1987-2004)



Source: Illinois Municipal League

Two other considerations make the situation even more tenuous. First, despite the increases in tax dollar contributions to pension funds, the unfunded liabilities continue to grow every time the Illinois General Assembly increases the level of pension benefits to be paid out. In the last seven years, there have been three new pension enhancements imposed on these funds: enhancements were added in 2000 (fire), 2001 (police), and 2005 (fire). The 2005 fire pension enhancement increased the City of Champaign's fire pension fund unfunded liability by $6 million and dropped its funding percentage by 12 percent, forcing still larger tax contributions.[6]

Second, for outstate municipalities subject to tax caps, the rate of municipal pension fund contributions, as described in Charts 7 and 8, is increasing faster than the tax cap limitations allow their tax levies to increase. As a result, many municipalities, and especially non-home rule cities and villages which rely on property taxes for the bulk of their tax revenues, have had to face a Hobbesian choice. They either have to:

1. Use actuarial assumptions that would enable them to meet their statutory obligations to finance pensions and still keep their rates of property tax increases within statutory tax cap limitations, but not enough more to keep their funds properly financed, or

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2. Begin to utilize revenue sources traditionally committed to other municipal services to make up for the shortfall between the yearly contribution to the pension funds and the amount of funds that can be levied within the restrictions of the property tax cap, or

3. Cut back on police and fire services as well as on other services in order to fund police and fire pensions.

Much too frequently, from a public safety perspective, they cut back on police and fire services by limiting or reducing the number of police and fire personnel serving the community.

What all of this means is simply this: even municipalities that are making Herculean efforts to fund adequately their police and fire pensions are falling further behind. Primary blame for the deteriorating condition of the outstate police and fire pension funds can not legitimately be placed on local elected officials (who must also deal with the anger of local citizens when property taxes are raised).

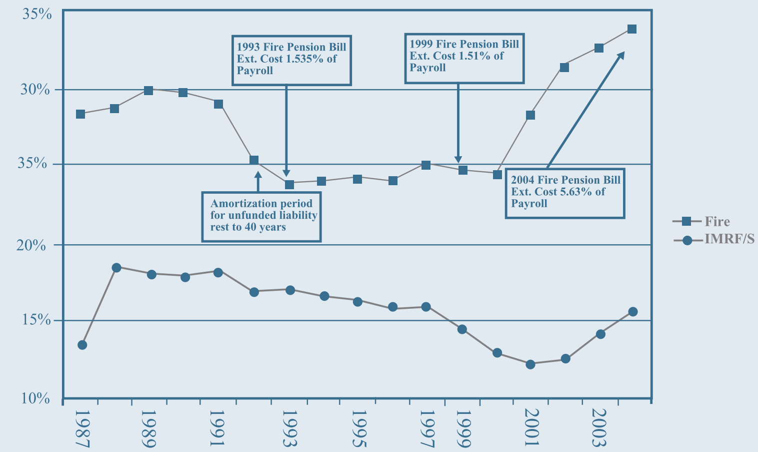
Are individual municipalities really being hurt by the pension fund problem?

Yes, most if not all outstate Illinois municipalities are already being hurt by the problems confronting their police and fire pension programs, but, as might be expected, not all are being affected in the same way. Some are experiencing greater tax levy stress than others; some are being forced to make large increases in their rate of tax levy as a percent of payroll; and others are limiting or reducing the number of police and fire officers on the payroll. Still, all or nearly all municipalities are experiencing an increase in the level of unfunded liability in their police and fire pension funds, and all will ultimately be hurt if the present rate of increases continues.

Even now, the high cost of police and fire pensions is causing adjustments in municipal service levels and may be curtailing the expansion of police and fire personnel on the streets. Some communities have stopped adding new police officers because required pension payments make new positions too expensive.

A case in point is the City of Rock Island. The City recently reported to its residents that it "has doubled its contribution (to its police and fire pension funds) over the past ten years, that its employees have made their required contributions to these funds, and that the investment returns on its pension funds have been good."[7] Yet, despite these funding efforts, the City's unfunded

chart*eight* **Downstate Fire Employer and Employee Contributions as Percentage of Payroll**



Source: Illinois Municipal League

table*one* **The Rock Island Experience**

City contributions to its police and fire pension funds have increased **103%** in the past ten years.

City contributions to police and fire pension funds now total more than **$20,000 per firefighter per year** and more than **$15,000 per police officer per year.** This compares to an annual contribution of approximately $3,500 per employee per year for all other city employees.

City contributions to its police and fire pension funds have *increased* as a per cent of payroll by **31%,** from 26% of payroll to 34% of payroll *in just the last ten years.*

The portion of the *total city property tax levy* used just to fund police and fire pensions has *increased* **75%** *in the last ten years,* going from 16% of total property tax revenues in 1997 to 28% of property tax revenues in 2007.

The percentage of Rock Island property taxes going to pay police and fire pensions **will continue to increase** in the years ahead since the aggregate unfunded liability in the two funds has increased by **more than 150%** in the past ten years.

pension liability has increased 150 per cent over those same years. See Table 1.

The report also notes that the unfunded liability in its police and fire pension funds "now equals $283,590 per active (police and fire) employee and more than $1,000 per capita for our citizens."[8] The City's report led its local newspaper, *The Rock Island Argus,* to label the city's police and fire pension funds system "badly broken."[9]

Small communities, too, face these problems. Bellwood's police pension fund, for example, experienced an increase of 1100% in its unfunded liability in just seventeen years, between 1987 and 2004. During this same period, its police pension fund tax levy, calculated as a percent of payroll, nearly doubled, growing from 19.68% in 1987 to 36.90% in 2004.[10]

What is causing the increase in unfunded pension liabilities?

While there is general agreement that the level of unfunded pension liabilities is increasing, there is less agreement about the causes and seriousness of the problem.

Many causes can be, and have been, cited. One, of course, is the increasing life expectancy of the population which, when combined with the cultural tendency in the United States for people to retire at an earlier age, means that pension funds are being required to support retirees for a longer period of time.

The funds can be negatively affected by factors which can not be known for sure. Pension funds are invested in bonds and other assets to increase fund values, but due to concerns over potential losses of asset value, pension funds are limited by law in their ability to invest in stock funds and other equities. Investment returns vary year by year with economic conditions, and periods of economic downturn, such as the downturn in the late 1970's and early 1980's and in the period of 2000 to 2003, result in lower investment returns and higher levels of unfunded liabilities. In the period covered by the IML report (e.g. 1987-2004), however, investment returns were, on average, much higher than historical norms so that should have reduced their level of fund liabilities. *The fact that the police and fire pension fund liabilities increased during this period simply indicates that the funding problems in those funds are even worse than the data would indicate.*[11]

Different groups affected by local government pension systems have different ideas about the causes of the problem. The views of three such groups are set forth below.

Local government officials place the primary blame on continued benefit enhancements mandated by the state legislature which, in turn, has not made provision for new funds to pay the costs of the new benefits.

Indeed, this is a problem which has plagued many government pension programs: Examples include Congress' failue to provide adequate new revenues when it expanded the benefits paid out by the nation's social security system (e.g. Medicare); and it has been state mandated benefits which, because the General Assembly increased benefits without new funding, now imperil the pension systems for Illinois teachers and state employees.

Local officials argue that improved benefits, while desirable in and of themselves, are not needed to entice more recruits to their police and fire forces. Throughout the state, the supply of recruits has been more than adequate to meet local government needs.

Thus it is not surprising that many local government officials want the Illinois General Assembly to refrain from legislating further benefit enhancements until the pension funds reach the 90% funded level.

Police and fire unions acknowledge their funds' fiscal plight, but place the blame squarely on the failure of municipalities to make adequate contributions to sustain the funds. They argue that municipalities select actuaries who will use assumptions that minimize required municipal contributions. They "are not unsympathetic to the burden passed on to taxpayers for properly funding the municipal pension programs," but assert that "managing a municipality is a difficult task requiring tradeoffs within the budget."[12]

The unions continue to petition the Illinois General Assembly for additional benefit enhancements, most recently a proposal entitled "Deferred Retirement Option Program" or DROP. The proposal would permit Illinois police officers and fire fighters to retire on full pension after thirty years of service and then continue to work an additional five years while simultaneously collecting their pension benefits. After five years of such post-retirement service, the retirees would then collect a lump sum benefit comprised of the funds contributed to the pension fund on their behalf during their five year extension. The unions further argue that this benefit enhancement will not lead to any increase in pension costs.[13] An independent study of the DROP proposal by the Illinois Government Finance Officers Association found that it would increase unfunded liabilities in the police and fire pension funds of 23 municipalities by an aggregate amount greater than $40 million.[14]

The Civic Federation, a widely respected, independent commentator on state and local tax and fiscal policies in Illinois, has expressed grave concern about the structure of pension board governance in Illinois, arguing that most pension boards, including local police and fire pension boards, are poorly organized, with a majority or more of their members made up of active employees or retirees serviced by the funds they control. There are many groups besides union members that have a fiduciary stake in the performance of the pension boards, not the least of which are local taxpayers. The Civic Federation argues,

> The mission of a public pension fund board of trustees should be to safeguard the fund's assets through prudent investments and effective management. Unfortunately, some local pension boards also act as advocates on behalf of fund members, lobbying for benefit enhancements that ultimately increase the fund's liabilities.[15]

The problem described by the Civic Federation was directed at the Chicago police and fire pension fund governance, but it is equally applicable elsewhere in the state.

What is the primary cause of the fiscal plight of police and fire pension funds?

Most of the problems listed above contribute to the financial plight of outstate municipal police and fire pension funds, but the problem is caused by poorly designed pension systems.

Like other public employee pension funds, outstate municipal police and fire pension funds are of a defined benefit nature. That means that the benefits to be paid from the funds are set forth in state statutes. Furthermore, those same statutes also require municipal officials to levy whatever property taxes are needed to meet that community's statutory pension fund contributions for that year.

What this means is that, while it is the Illinois General Assembly that determines the pension fund benefits that must be paid, it is the local governments – local elected officials – who must levy the taxes to pay them. *From a public policy perspective, it is the members of the state legislature who get all the political rewards from raising pension and survivor benefit levels and it is the members of city and village councils and boards who pay the political price for raising the taxes to pay for the benefits.*

The results of this flawed system can be seen in the negative impact of the most recent benefit enhancements mandated in 2000 (fire), 2001 (police), and 2005 (fire) by the Illinois General Assembly to the unfunded liabilities of outstate police and fire pension funds. The mandated benefit enhancements, without provision for new funds to underwrite the added liabilities, created new strains on the affected pension funds. The sharp increases in the outstate police and fire pension funds' unfunded liabilities reported in charts 2 and 3 plus the sharp drop in the funds' funded ratios reported in charts 4 and 5 attest to the impact of these benefit increases.

The ultimate indignity is faced by municipal officials in those communities limited by tax caps. *The Illinois General Assembly* passes outstate police-fire pension benefit enhancements and, in so doing, *requires local property tax increases* to pay for the cost of the benefits. But it is the same General Assembly which, by establishing the tax caps, *limited the taxes that can be imposed* to meet the unfunded liability.

What should be done to improve the funds' financial health?

Ultimately, Illinois Governor Rod Blagojevich put the matter most succinctly in his 2005 annual budget address to the General Assembly when he argued,

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

The formulation of a comprehensive plan to reduce the outstate pension funds' unfunded liabilities is beyond the scope of this paper, but any solution must be predicated on changes made by state lawmakers, local government officials, and police and fire unions.

State lawmakers First, and foremost, the Illinois General Assembly must do no additional harm. No further benefit enhancements should be considered for municipal police and fire pension funds until the legislature has taken meaningful action to make the funds more fiscally sound. By any measurement, current benefit levels are competitive with other states, and therefore *further benefit increases should be postponed until existing benefits are made more secure by better funding.*

The representatives of police and fire unions have stated that the recently proposed benefit enhancements will not add to pension fund costs. State lawmakers should be smart enough to realize that *any benefit increase,* by simple definition, *costs money and increased costs require increased funding which, for now, means increased taxes.* Any benefit change that permits earlier retirement, for instance, absolutely must lead to an increase in fund liabilities and in tax levies to support the enhancement.

Illinois state legislators must understand and be held accountable for any vote for increased police and fire pension benefits because any such vote is a vote to increase the property taxes of their constituents.

In the long run, the Civic Federation got it right: "governments (must) stop granting any new retirement benefit enhancements unless they also increase employer and/or employee contributions sufficiently to *fully fund* the enhancements."[16] (Emphasis in the original)

Local Government Officials These officials are right to resist and seek to minimize local tax increases. They are faced with the most difficult task in government: deciding how to use their governments' limited fiscal resources to maximum advantage while limiting the tax burden on their constituents. At the same time, however, they must make sincere efforts to find the money to reduce the unfunded liabilities in employee pension funds. They must also work with their employees and with state legislators to make them understand that all increases in constituent services and employee benefits have cost implications.

The Unions Union leaders must understand that the management of local pension boards will be enhanced by the achievement of a better balance between self-interested employees and highly qualified professionals from the fields of investment and actuarial science. Such boards will have greater credibility with city councils, village boards, and state legislators.

Unions would also be well advised to avoid the kinds of "double-speak" which has characterized their support of the DROP proposal. Quite apart from the hard evidence cited earlier (see endnote 12), the unions' argument that DROP would not increase costs – based on the lack of hard evidence that it would lead to earlier retirements – is specious at best; the unions would not advance and fight for the proposal unless it was attractive to their membership (meaning that they expected many of their members would take advantage of the added benefits). Benefits that go unused are not benefits at all. Argumentation at this level does nothing to enhance the integrity of their organizations.

Whose job is it, ultimately, to protect the integrity of the pension funds?

Ultimately, it is the job of state legislators. Because they determine the benefit levels, the funding formulae, and the local authority to impose taxes, it is ultimately their responsibility to see that the pension systems are both financially sound and meeting the needs of the state's well deserving police officers and fire fighters. When either objective is not being met, it is the legislature's duty – from both legal and humanitarian considerations – to correct the situation.

In short, it is the Illinois General Assembly that is failing in its responsibility to provide sufficient security for the pension needs of outstate police officers and fire fighters.

Like medical doctors who have taken an oath to "first do no harm," the General Assembly must tackle the police/fire pension problem by first ***doing no harm.***

Illinois legislators must stop making the outstate police/fire pension plans worse by adding new benefits before funds are available to cover the unfunded liabilities exacerbated by past benefit enhancements.

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Endnotes

1. As used in this report, the word "outstate" will refer to all cities and villages in Illinois except Chicago. Thus, what is said in this report refers to all suburban as well as all downstate police officers and firefighters as well as police and fire pension funds.

2. Illinois Municipal League, *Fiscal Analysis of the Downstate Police, Fire, and IMRF Pension Systems* (Springfield, IL: The League, February 2007). The acronym IMRF refers to the Illinois Municipal Employees Retirement Fund.

3. The body of this report focuses on all Illinois municipal police and fire pension funds except Chicago, but most of what is said herein applies with equal validity to the Chicago police and fire pension funds. Indeed, of the 17 major public pension funds or aggregates of similar types of pension funds, the Chicago police and fire pension funds rank number three and four, respectively, in terms of their per capita unfunded liability among active employees (see Chart 1 in the publication cited in footnote #2).

4. Analyzed in the IML study were the police and fire pension funds in the following municipalities: Barrington, Bellwood, Bolingbrook, Carbondale, Chicago Ridge, Edwardsville, Elk Grove Village, Forest Park, Hoffman Estates, Homewood, Lombard, Midlothian, Mt. Prospect, Naperville, Oak Brook, Oak Forest, Peoria, Rock Island, Rockford, Roselle, Schaumburg, Skokie, Springfield, Wilmette, and Winnetka. Also analyzed were the fire pension funds in the following municipalities: Lake in the Hills, Lisle, McHenry, New Lenox, North Lake, Riverside, Westmont, Wood Dale, and Woodstock.

5. The levy information in the table is based on the Illinois Department of Financial and Professional Regulation's suggested tax levies.

6. E-mail from Champaign City Manager Steve Carter to the authors dated September 7, 2007.

7. City Manager's Budget Message, City of Rock Island, February 2006, p. 40.

8. Ibid., p. 40.

9. "Editorials: Another disaster lurking," *The Rock Island Argus,* April 8, 2007, p. A6.

10. Fiscal Analysis of the Downstate Police, Fire, and IMRF Pension System, p. 39.

11. Determining the level of funding needed to assure that future pension obligations can be met requires assumptions about future conditions. These assumptions are made by professionals called "actuaries." In managing their pension funds, municipalities can hire their own actuaries, but all must be fully certified in their profession. To control for this factor, all figures contained in the IML report were based on the actuarial assumptions set forth by the Illinois Department of Professional and Financial Regulation.

12. Undated paper prepared by the Illinois Public Pension Fund Association commenting on the IML report and titled, simply, "Introduction," p. 9.

13. *Pension Trustee Newsletter,* Illinois Public Pension Fund Association, July 2006, pp. 1 and 9.

14. "Why IGFOA Frowns on DROP as Proposed," *Illinois Public Pensions,* Illinois Government Finance Officers Association: Spring, 2006, p. 2. The article can be found on the internet at http://www.igfoa.org/newletters/Pen_spring06.pdf.

15. The Civic Federation, *Status of Local Pension Funding, Fiscal Year 2004: An Evaluation of Ten Local Government Employee Pension Funds in Cook County,* February 27, 2006, p. 30.

16. The Civic Federation (see report described in note # 12) p. 29.

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