Planning Past Pensions

*Julie Roin**

Evidence of state and local government dysfunction surfaces in many areas. One is the operation of employee pension plans. Free from the strictures of the Employee Retirement Income Security Act ("ERISA"), some state governments failed to adequately fund their pension promises. With the imminent retirement of the baby boom generation, these states are facing what appear to be insurmountable pension debts.

Illinois is one of the worst hit states, with grossly underfunded pension plans, a state constitutional prohibition on reducing pension benefits, and a sizable non-pension-related budget deficit. Illinois courts will likely strike down recently passed pension "reforms." There are no easy solutions to its pension woes, but this Article seeks to lay out a few steps that Illinois and other states can take now, under current law. This Article also suggests more long-term policy and legal changes that Illinois should consider for the future.

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* Seymour Logan Professor of Law, University of Chicago Law School. I am grateful to Saul Levmore, Lawrence Zelenak, Peter Barnes, and participants in Duke Law School's tax policy workshop for their comments on earlier drafts, and to the financial support provided by the Samuel J. Kersten Faculty Fund.

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INTRODUCTION

In 1974, Congress made a calculated decision to exclude governmental plans from the strictures[1] of its landmark pension legislation, the Employee Retirement Income Security Act ("ERISA").[2] Governments, unlike private employers, were neither required to fund their pension promises during their employees' working careers, nor to pay into the federal insurance program that protected private sector employees against their employers' bankruptcies.[3] Congress decided that public employees did not need these pension protections because governments could always raise the additional revenue necessary to fund their pension promises.[4]

Not only were governments excused from the funding obligations attached to private plans, but they also were largely excused from divulging information about the financing—or lack thereof—of their pension plans.[5] That is, unless provided otherwise under state law,

1. Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1003(b) (2012) ("The provisions of this subchapter shall not apply to any employee benefit plan if—(1) such plan is a governmental plan (as defined in section 1002(32) of this title) . . . ."). Section 3(32) of the Act defines the term "governmental plan" as "a plan established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing." *Id.* § 3(32). Governmental plans have been specifically exempted from adherence to the minimum participation standards, I.R.C. § 410(c)(1)(A) (2012), the vesting standards, *id.* § 411(e)(1)(A), and the minimum funding standards, *id.* § 412(e)(2)(C).

2. The Employee Retirement Income Security Act of 1974 is the official designation of the Pension Reform Act of 1974, now codified at 29 U.S.C. §§ 1001–1461.

3. Melanie Walker & Cathie Eitelberg, *Regulation of Public-Sector Retirement Plans*, *in* FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS 428–29 n.5 (6th ed. 2009), *available at* www.ebri.org/pdf/publications/books/fundamentals/2009/43_RegCost_PUB-SCT_Funds-2009_EBRI.pdf ("Government plans are exempt from most of ERISA's reporting, disclosure, and funding requirements (Title I) and plan termination insurance (Title IV)."). Of course, not all governmental employers can declare bankruptcy. *See infra* note 67 and accompanying text (discussing the history and potential of governmental bodies and states to declare bankruptcy).

4. *See* Jack VanDerhei, *Funding Public and Private Pensions*, *in* PENSION FUNDING & TAXATION: IMPLICATIONS FOR TOMORROW 59, 75 (Dallas L. Salisbury & Nora Super Jones eds., 1994) ("The legislature considered the ability of the governmental entities to fulfill the obligation to employees through their taxing powers an adequate substitute for minimum funding standards."). The decision to exclude public plans from ERISA's coverage was controversial. *See* Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3, 9 n.13 (2013) (citing sources from the 1970s warning about the underfunding of public pensions).

5. *See* Fiona E. Liston & Adrien R. LaBombarde, *Changing Public Pension Funding Rules*, *in* PENSION FUNDING & TAXATION: IMPLICATIONS FOR TOMORROW, *supra* note 4, at 127 ("Even the accounting rules for reporting the funded status to creditors and others are not as strict."); Walker & Eitelberg, *supra* note 3 (noting that government plans were not required to comply with

subnational governments were not required to disclose either the actuarial value of their accrued pension liabilities or how those accruals matched—or did not match—the amounts that had been set aside to pay for them.[6] Instead, while required to reflect the difference between their "annual required contributions" and their actual contributions to the plan as liabilities on their balance sheets,[7] the applicable accounting rules often allowed governments to manipulate actuarial assumptions in such a way as to reduce those annual required contribution amounts to unreasonably low levels to avoid showing any liability at all.[8]

ERISA's reporting and disclosing provisions). Accounting standards for state and local governments are set by the Governmental Accounting Standards Board ("GASB"), an independent, not-for-profit organization formed in 1984 for that purpose. Although the organization does not have enforcement authority, some states require their governmental entities to follow GASB standards for financial reporting purposes, and auditors rely on those standards when "render[ing] opinions on the fairness of financial statement presentations in conformity with GAAP." GOVERNMENTAL ACCOUNTING STANDARDS BD., FACTS ABOUT GASB 1 (2013). In addition, bond-rating agencies "generally consider whether GASB standards are followed when assessing credit standing." Alicia H. Munnell et al., *How Would GASB Proposals Affect State and Local Pension Reporting?*, 23 CTR. FOR RETIREMENT RESEARCH AT B.C., Nov. 2011, at 1–2.

6. This situation is fast coming to an end. The GASB adopted new standards for the disclosure of pension obligations that apply to financial statements as of December 31, 2014 (GASB Statement No. 67) and December 31, 2015 (GASB Statement No. 68). These new standards require governments to disclose the difference between their "total pension liability" and the fair market value of pension assets. Further, they require the use of much more realistic actuarial assumptions for purposes of calculating the total pension liability figure. News Release, GASB, News Release 06/25/12, GASB Improves Pension Accounting and Financial Reporting Standards (June 25, 2012), *available at* www.gasb.org/cs/ContentServer?pagename=GASB/GASBContent_C/GASBNewsPage&cid=1176160126951.

7. *See generally* GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 25: FINANCIAL REPORTING FOR DEFINED BENEFIT PENSION PLANS AND NOTE DISCLOSURES FOR DEFINED CONTRIBUTION PLANS (1994) [hereinafter STATEMENT NO. 25]; GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 27: ACCOUNTING FOR PENSIONS BY STATE AND LOCAL GOVERNMENTAL EMPLOYERS (1994) [hereinafter STATEMENT NO. 27].

8. *See* Liston & LaBombarde, *supra* note 5, at 128 ("A report recently issued by the General Accounting Office (GAO) on the funding practices of state and local governments raises some concerns that . . . actuarial assumptions are being manipulated in order to reduce required plan contributions . . . ."). Thus, from an accounting perspective, underfunded plans appeared to be fully funded. *See* Apostolou et al., *Bridging the Government Pension Reporting Gap: The Effects of New GASB Standards on Governments Pension Accounting*, CPA J., Aug. 2013, at 28, 29 (discussing how GASB Statement 27 was "roundly criticized for severely understating the pension obligations on the balance sheets of public entities by disclosing the amount of unfunded pension liability in the notes to their financial statements, rather than recognizing a liability on the face of the balance sheet" and for allowing governments to provide a misleading number—"the difference between the required contributions to a pension plan in a given year and what was actually funded"—as the measurement of liability on the balance sheet); Michael A. Moran, *A "Sea Change" in Public Pension Reporting on the Horizon*, GOLDMAN SACHS ASSET MGMT. 2 White Paper (Dec. 2012), *available at* https://assetmanagement.gs.com/content/dam/gsam/pdfs/us/en/advisor-resources/sales-library/retirement/wp-public-pension-sea-change.pdf ("[P]lans that fully paid their [annual required contributions] each year showed no liability on their balance

Moreover, the rules allowed governments to use a thirty-year period for amortizing changes in actuarial assumptions and unfunded liabilities, even when associated benefits were to be disbursed over a shorter time frame.[9] Unfunded pension and pension-related obligations[10] thus operated as secret debt, largely hidden from employees, taxpayers, credit agencies, and bondholders.[11] Public and political concern about underfunding did not become widespread until the Government Accounting Standards Board ("GASB") adopted an accounting standard forcing the disclosure of unfunded, non-pension retirement benefits (chiefly medical benefits) in 2004.[12] The new standard forced states and municipalities with annual revenues of $100 million or more to disclose the present value of accrued, non-pension liabilities and the value of the assets set aside to pay them in 2007; the reporting deadline for smaller governments was 2010.[13]

As the required reports trickled out, revealing underfunding on a vast scale,[14] employees, taxpayers, and investors in state and local bonds

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sheets even if the plan was underfunded.").

9. *See* Suesan R. Patton et al., *GASB Statement No. 68 Brings Needed Pension Transparency*, AM. INST. CPAS (Jan. 2014), http://www.aicpa.org/interestareas/businessindustryandgovernment/newsandpublications/downloadabledocuments/gasb_statement_68_government_brief.pdf (praising change in GASB Statement No. 68 which requires "most changes in the net pension liability from period to period (changes in estimates) will be charged to expense in full in the next period—not amortized, say, over the GASB Statement 27 maximum amortization period of 30 years").

10. Many states promised to provide medical and other benefits to retirees in addition to their pensions. *See* Joshua Franzel & Alex Brown, *Spotlight on Retiree Health Care Benefits for State Employees in 2013*, (Ctr. for St. & Loc. Gov't Excellence, Washington, D.C.), June 18, 2013, at 1, *available at* http://slge.org/wp-content/uploads/2013/06/OPEB-Spotlight-06176.pdf ("[T]he largest portion of OPEB benefits is retiree health insurance, which most states provide to retired employees.").

11. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENT PENSION PLANS: ECONOMIC DOWNTURN SPURS EFFORTS TO ADDRESS COSTS AND SUSTAINABILITY 7 (March 2012) [hereinafter GAO, STATE AND LOCAL GOVERNMENT PENSION PLANS] ("In 2008 and 2010, respectively, the Securities and Exchange Commission took enforcement actions against the city of San Diego and the state of New Jersey for misrepresenting the financial condition of their pension funds in information provided to investors."); Michael Corkery, *SEC Says Illinois Hid Pension Troubles*, WALL ST. J., Mar. 12, 2013, at A1 (announcing settlement of security fraud charges under which Illinois avoided paying a penalty or admitting wrongdoing).

12. GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 45: ACCOUNTING AND FINANCIAL REPORTING BY EMPLOYERS FOR POSTEMPLOYMENT BENEFITS OTHER THAN PENSIONS (2004) [hereinafter STATEMENT NO. 45].

13. *Id.*

14. *See, e.g.*, Div. of Local Gov't & Sch. Accountability, *GASB 45: Reporting the True Cost of Other Post-Employment Benefits*, OFF. N.Y. ST. COMPTROLLER 1 (May 2008), *available at* http://www.osc.state.ny.us/localgov/pubs/research/opeb_policyreport.pdf ("Preliminary estimates indicate that these unfunded OPEB liabilities in the public sector exceed $1.5 trillion nationally."); *Cities Squeezed by Pension and Retiree Health Care Shortfalls*, PEW CHARITABLE TRUSTS 1 (Mar. 2013), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/

became concerned about the underfunding of pension plans as well as these other retirement benefit plans.[15] This concern, as well as more generalized concern about the transparency of the reporting rules, led the GASB to initiate a project to reform the rules for reporting pension benefits.[16] This project resulted in the issuance of new accounting standards, which, as of 2014 required governments to disclose the difference between the present value of accrued pension benefits and the fair market value of the assets set aside to pay them as liabilities on their balance sheets.[17] Meanwhile, at least in some jurisdictions, the shortfalls continue to grow.

The state of Illinois is in a particularly perilous situation, but it provides a reasonably good illustration of the pension problems facing many states. Its unfunded pension debt amounts to $7346 per

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Pewcitypensionsbriefpdf.pdf (noting how just thirty cities had a long term shortfall of $104 billion for retiree health care and other non-pension benefits in 2009).

15. Concern about such underfunding was not new. Beermann, *supra* note 4, at 9 n.13 (listing articles about underfunding of public pension plans dating back to 1976). However, it has become more widespread and strident ("all over the news," *id.* at 10) in recent years as the combination of increased disclosure and the effects of the recession on both pension assets and the availability of government funding for pensions made the situation more dire. *Compare* U.S. GOV'T ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENT RETIREE BENEFITS: CURRENT FUNDED STATUS OF PENSION AND HEALTH BENEFITS 3 (2008) ("58% of 65 large public pension plans were funded to [the 80% or better] level in 2006, a decrease since 2000 when about 90% of plans were so funded."), *with* GAO, STATE AND LOCAL GOVERNMENT PENSION PLANS, *supra* note 11, at 7 ("[M]ost plans have experienced a growing gap between actuarial assets and liabilities over the past decade, meaning that higher contributions from government sponsors are needed to maintain funds on an actuarially based path toward sustainability. . . . State and local governments experienced declining revenues and growing expenses on other fronts, and growing budget pressures will continue to challenge their ability to provide adequate contributions to help sustain their pension funds.").

16. This project began in 2006 with a research project on the effectiveness of the then-operative accounting rules. *See* GOVERNMENTAL ACCOUNTING STANDARDS BD., STATEMENT NO. 68: ACCT. AND FIN. REPORTING FOR PENSIONS 73–74 (2012) [hereinafter STATEMENT NO. 68] (discussing the GASB's approval for research of the effectiveness of Statement Nos. 25 and 27).

17. GASB Statement 67, effective for fiscal years beginning after June 15, 2013, and GASB Statement 68, effective for fiscal years beginning after June 15, 2014, not only require the use of actual, rather than smoothed, asset values for purposes of determining the value of pension trusts, but also mandate the use of more realistic actuarial assumptions for determining pension costs, from discount rates to the use of the "entry age normal/level percentage of payroll" for determining annual liability accrual. Apostolou et al., *supra* note 8, at 29. However, some think that the new rules do not go far enough, and may even be counterproductive because they fail to require governments to highlight differences between amounts necessary to amortize plans' unfunded liability over a thirty-year period and their sponsors' actual contributions for the year. Cory Eucalitto, *GASB's Ineffective Public Pension Reporting Standards Set to Take Effect*, ST. BUDGET SOLUTIONS (June 5, 2013), www.statebudgetsolutions.org/publications/detail/gasbs-ineffective-public-pension-reporting-standards-set-to-take-effect (describing flaws).

resident[18]—and this figure reflects only the pensions due to state employees. Many of its municipalities and other local government units have considerable unfunded pension plan liabilities of their own.[19] The discrepancy between promised benefits and pension trust funds is so substantial that some estimates have the state running through those trust funds in 2018.[20] Future benefits will have to be paid out of general state revenues or simply not paid. If events follow their current course, by 2025, it is estimated that pension payments will eat up twenty-two to twenty-five percent of state tax revenues.[21]

Unfortunately for Illinois residents, current state revenues do not cover the state's current expenses, let alone generate the additional funds that will be needed to defray these pension costs. Despite a fifty percent increase in its income tax rate in 2011,[22] the state still had a $5.4 billion backlog of unpaid "current" bills in 2014.[23] Moreover, that tax increase was temporary and lapsed at the end of the 2014 fiscal year.[24] This cascade of fiscal woes has "caused the major credit rating agencies to downgrade Illinois to the lowest credit rating of any state."[25]

In response to this crisis, the Illinois state legislature passed a pension reform bill at the end of 2013 that the governor's office estimated will save the state about $145 billion over the next three decades, reduce the $100 billion of unfunded pension liabilities by about $40 billion, and lead to a fully funded pension system by 2044.[26] Unfortunately, as explained in Part I below, the bill is likely to be held unconstitutional in

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18. Shawn P. O'Leary & Kristen DeJong, *The True Cost of Illinois' Pension Reform Failures*, NUVEEN ASSET MGMT. 2 ex.1 (Oct. 2013).

19. *Id.* (noting also that total per capita liability, including both state and local pension debt, of Chicago residents amounts to $18,924).

20. *See* Josh Rauh, *The Day of Reckoning for State Pension Plans*, KELLOGG SCH. OF MGMT. (Mar. 22, 2010), http://kelloggfinance.wordpress.com/2010/03/22/the-day-of-reckoning-for-state-pension-plans/ (noting how pension trust will be exhausted in 2018).

21. *Illinois Needs to Pass Public Pension Reform*, PEW CHARITABLE TRUSTS 3 (July 2013), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/Illinois20Needs20Pension20Reformpdf.pdf [hereinafter PEW REPORT].

22. Personal income tax rates were raised from 3.75% to 5%, while the corporate rate increased from 5.25% to 7%. Thomas A. Corfman, *Civic Federation: Keep Most of Illinois' 'Temporary' Income Tax Hike*, CRAIN'S CHI. BUS. (Mar. 3, 2014), http://www.chicagobusiness.com/article/20140303/NEWS02/140309994/civic-federation-keep-most-of-illinois-temporary-income-tax-hike (describing tax increases).

23. *Id.*

24. Bob Sector & Rick Pearson, *Illinois Income Tax Drop Kicks In*, CHI. TRIB., Jan.1, 2015, at 1.1.

25. Kerry Lester, *Illinois Unions Sue Over Pension Reform Cuts*, HUFF. POST (Jan. 29, 2014, 6:59 PM), http://www.huffingtonpost.com/2013/01/29/illinois-unions-pension-reform_n_4686627.html.

26. *See id.* (describing bill).

the lawsuits that have been filed challenging its legality.[27] Rather than waste more time and compound the existing problems, the Illinois state government needs to pursue reforms that are legal and that would protect the valid interests of state employees.

I. THE LIKELY INVALIDITY OF THE 2013 PENSION REFORMS

Although Illinois law once treated governmental pensions as mere "gratuities" that state and local governments could nullify at will,[28] the drafters of the Illinois Constitution of 1970 included a provision intended to protect government employees against forfeitures. One of the Illinois Constitution's provisions, commonly known as the Pension Protection Clause, specifically provides that:

> 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

27. Complaint, Retired State Emps. Assoc. v. Quinn, Topinka, Rutherford & Bd. of Trs. of the State Emps. Retirement Sys., No. 2014MR000001 (Circuit Court of the Seventh Judicial Circuit, Sangamon Cnty., Ill., filed Jan. 2, 2014) (seeking class action status in lawsuit to declare Public Act 98-599 unconstitutional to the extent it "diminishes and impairs the 3% Automatic Increase"); Complaint, Ill. State Emps. Ass'n Retirees vs. Bd. of Trs. of the State Emps.' Ret. Sys. of Ill., No. 2014CH000003 (Circuit Court of the Seventh Judicial Circuit, Sangamon Cnty., filed Jan. 2, 2014) (seeking class certification and declaratory judgment that alterations in three percent automatic increase invalid); Complaint, Heaton, Keller, Lee v. Quinn, Topinka & the Bd. of Trs. of the Teachers' Ret. Sys. of the State Of Ill., No. 2013CH28406 (Circuit Court of Cook Cnty., filed Dec. 27, 2013) (seeking class certification and challenging alterations in automatic increases, increases in retirement age, and cap on salary used in pension calculation). These cases have been consolidated in Sangamon County, the county within which the state capital, Springfield, is located. Doug Finke, *Illinois Pension Reform Lawsuits to be Merged*, PEORIA J. STAR (Mar. 3, 2014, 9:34 PM), http://www.pjstar.com/article/20140303/News/140309759. The Circuit Court imposed a temporary restraining order and preliminary injunction preventing the new law from taking effect on June 1, 2014. Ray Long, *Court Puts Pension Law on Hold,* CHI. TRIB., May 15, 2014, at 1.10. That same Circuit Court judge struck down the Illinois pension reform act on November 21, 2014, agreeing with public employee unions and retirees that the law "'without a question' violates the state constitution's provision that a public worker pension cannot be 'diminished or impaired.'" Ray Long & Hal Dardick, *Judge KO's Pension Law, Illinois to Appeal Ruling that Reductions in Retiree Benefit are Unconstitutional*, CHI. TRIB., Nov. 22, 2014, at 1.1. The judge "brushed aside" the State's argument that "modifications in pension plans could be made in extraordinary circumstances," concluding that "'The pension protection clause contains no exceptions, restrictions or limitations for an exercise of the state's police powers or sovereign powers.'" *See id.* (quoting Sangamon County Circuit Judge John Belz). The Illinois Attorney General immediately announced that she would file an expedited appeal to the state supreme court. *See id.* The request for an expedited hearing was granted, Monique Garcia, *State's Top Court to Hear Pension Case in March*, CHI. TRIB., Dec. 11, 2014, at 1.7, and the Supreme Court heard oral arguments in the case on March 11, 2015. Rick Pearson, Monique Garcia & Bob Secter, *Illinois Supreme Court Grills State's Solicitor General on Constitutionality***,** CHI. TRIB., March 12, 2015, at 1.1.

28. *See, e.g.*, Bergin v. Bd. of Trs. of the Teachers' Ret. Sys., 202 N.E.2d 489 (Ill. 1964).

> relationship, the benefits of which shall not be diminished or impaired.[29]

The language of the Pension Protection Clause could be interpreted in several different ways. One possible interpretation would accord with the non-impairment rules established under ERISA for the termination and/or modification of private pension plans. This interpretation would forbid the state from reducing accrued pension benefits, while allowing it to reduce benefits earned through the future performance of services. Another possible interpretation, which is supported by prior decisions of the Illinois courts, does not allow the state to diminish either past accruals or the rate of future pension accruals by current state employees.[30] The pension reforms that Illinois enacted in 2013 meet neither of these standards.

A. Protecting Past Accruals: The Federal Analogy

Private employers are not, and never have been, required to provide pension plans for their employees.[31] Federal law provides employers with tax advantages for maintaining plans meeting certain requirements,[32] but those requirements do not mandate that plans, once established, have to be continued ad infinitum. Indeed, Congress predicted that some plans would be terminated, and ERISA spells out the consequences of such terminations—and modifications—in substantial detail.[33]

These rules protect employees against clawbacks of benefits earned through services provided prior to the date of a plan's termination[34] or

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29. ILL. CONST. art. XIII, § 5.

30. Employees hired after the date of enactment of pension-reducing statutes, however, would accrue pension benefits in accordance with those new rules.

31. *See* PETER J. WIEDENBECK, ERISA: PRINCIPLES OF EMPLOYEE BENEFIT LAW 18 (2010) ("ERISA does not infringe on employers' freedom to choose whether to sponsor employee benefit programs.").

32. These plans allow employers to provide their employees with tax-advantaged compensation. Employees neither pay tax on amounts contributed on their behalf nor on any earnings generated through the investment of those amounts until those amounts are distributed to them following their retirement. Employees thus defer payment of taxes, generating time-value-of-money gains, and often end up paying the tax dues on these amounts in years in which they face relatively low marginal tax rates. *See* JEFFREY G. SHERMAN, PENSION PLANNING AND DEFERRED COMPENSATION 103 (2d ed. 1990) (quantifying the benefit).

33. Employment Retirement Income Security Act of 1974, §§ 4041–4048, 29 U.S.C. §§ 1341–1348 (2012).

34. *See* I.R.C. § 411(d)(3) (2012) (requiring qualified plans to provide that in the case of termination or partial termination "the rights of all affected employees to benefits accrued to the date of such termination, partial termination, or discontinuance, to the extent funded as of such date, or the amounts credited to the employees' accounts, are nonforfeitable").

modification,[35] but allow employers unfettered freedom to modify the terms under which additional benefits can be earned through the future performance of services.[36] Employers have as much freedom to modify the terms of their pension programs going forward as they do wage rates. As a practical matter, this means that when federal rules apply, employees covered by defined benefit plans similar to those maintained by the state of Illinois and its agencies are entitled to retirement benefits equal in value to the present value of any benefits earned through service performed as of the date of the plan's termination[37] or amendment.[38] This protection applies to unvested and vested benefits, as federal statutes provide that the act of amendment or termination vests any unvested benefits provisionally earned as of that date.[39]

Employers have some flexibility regarding the form in which the protected benefits can be provided to covered employees. Depending on the circumstances, these accumulated benefits may be distributed in the form of lump-sum payments equal to the actuarial value of the accrued benefit.[40] Alternatively, the employer can provide an annuity policy with that actuarial value from a third party provider such as an insurance company.[41] Finally, the actuarial value of such benefits may be the employee's opening balance in a cash-balance pension plan established by the employer as a follow-on plan to the original plan.[42] No matter the form though, each employee is entitled to receive the

35. *Id.* § 411(d)(6) (disqualifying any plan "if the accrued benefit of a participant is decreased by an amendment of the plan"); Treas. Reg. § 1.411(d)-3 (2009).

36. Smith v. Nat'l Credit Union Admin. Bd., 36 F.3d 1077, 1081 (11th Cir. 1994) (holding that plan modifications are effective after "the amendment has been appropriately adopted in a formal, complete and written form"); Prod. & Maint. Emps.' Local 504 v. Roadmaster Corp., 954 F.2d 1397, 1404 (7th Cir. 1992) (finding that plan continues in force until "properly amended"); Treas. Reg. § 1.411(d)-4, Q&A (2)(a) (1988).

37. *See* WIEDENBECK, *supra* note 31, at 278–79 (describing "standard" termination of a plan with assets equal to accrued liabilities). Benefits owed to employees under terminated, under-funded plans are guaranteed by the Pension Benefit Guaranty Corporation ("PBGC"), a government corporation funded by mandatory insurance premiums levied on plan sponsors, up to certain statutory maximums. *See id.* at 270–71 (describing PBGC's guaranty).

38. *E.g.*, *id.* at 220–22 (describing the "accrued benefit anti-cutback" rule).

39. *See id.* at 221 ("Retroactive reductions in accrued benefits would often violate ERISA's vesting rules, but the accrued benefit anti-cutback rule is broader, as it protects even nonvested participants from pension cutbacks.").

40. *See id.* at 279 (option available if present value of benefit is under $5000).

41. *Id.* ("The plan administrator provides for most participants and beneficiaries by purchasing irrevocable commitments from an insurance company to pay all promised benefits.").

42. Technically, this option does not count as a termination of the original plan, and the rules for the conversion from a traditional defined benefit plan to a cash balance plan are provided by another statute. *See id.* at 218 ("[T]he Pension Protection Act of 2006 amended ERISA to . . . grant a safe harbor for conversions of traditional defined benefit plans into cash balance plans.").

actuarial value of the benefits he or she had earned prior to the change in the plan.[43]

Illinois pension plans[44] are not subject to these termination rules any more than they are to the funding rules. Instead, as is described in the next Subpart,[45] they appear to be covered by even more restrictive limitations on termination or modification imposed by the state constitution. However, it is worth noting that the pension reforms that Illinois enacted in 2013 fail to meet even these federal standards because they take back some benefits earned through the performance of services prior to the effective date of the legislative pension plan changes.[46] Thus, for Supreme Court of Illinois to uphold these reforms,

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43. Moreover, that benefit must be determined in accordance with the pre-amendment actuarial assumptions. I.R.C. § 430(h)(5) (2012); Rev. Rul. 81-12, 1981-1 C.B. 228; WIEDENBECK, *supra* note 31, at 222 n.45 ("The alteration of a defined benefit plan's method of determining actuarial equivalence, such as changing the plan's interest rate assumption, can have a dramatic impact on the amounts payable under different timing options, so retroactive changes in actuarial assumptions have long been understood to be impermissible.").

44. The state of Illinois maintains several different defined benefit pension plans, and the pension reform bill separately amends each such plan. As these amendments amend each of these plans in identical, or almost identical, ways, in the interest of readability, this Article is written as if only one such plan exists, and cites to the legislative language applicable to just one plan.

45. *See infra* Part I.B (discussing Illinois pension plans and their various complexities and restrictions).

46. Although ERISA, by its terms, would not apply, some have suggested that the retraction of previously accrued pension benefits could violate either the Takings Clause, *see* U.S. CONST. amend. V, or the Contracts Clause, *see* U.S. CONST., art. 1, § 10, cl. 1. It is clear that the state cannot take back money that it previously paid for the performance of services without running afoul of the Takings Clause. Why should a governmental promise to pay money for services that had been performed be deserving of less protection in a world in which "government contractual promises may be considered property for constitutional purposes"? Beermann, *supra* note 4, at 63. Doctrinally, what seems to matter is the legal strength of the underlying promise: Is it one that is considered sufficiently "property-like" to be recognized as property for constitutional purposes or is it still "contingent"? *Id.* at 64; David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 698 (2012). The apparent strength of the pension guarantee under Illinois state law suggests that a Takings Clause claim may be tenable in Illinois. *See* Beermann, *supra* note 4, at 65–66 ("[T]he Takings Clause is likely to follow the Contract Clause in recognizing only those claims that involve unmistakable contractual promises already protected from reduction under state law."). However, as the strength of this federal constitutional claim hangs on the degree of state-law protection of the underlying pension rights, the federal claim is unlikely to add any legal heft to a claim based on the state's Pension Protection Clause. Moreover, as discussed in greater detail *infra* notes 262–72 and accompanying text, the federal constitutional claims may be precluded by the continued existence of a state breach of contract action. Most importantly, if the Supreme Court of Illinois determines as a matter of state law that governmental pension rights are not protected against diminution, the federal Takings Clause claim would disappear. *E.g.*, Beermann, *supra* note 4, at 64 n.226 (citing cases); *see* Skeel, Jr., *supra*, at 698 ("The weakness of the Takings clause argument lies in the facts that property rights are ordinarily protected only up to the value of the underlying property and that the beneficiary's investment-backed expectations would be limited by the uncertainty as to whether the state could make good on its unfunded promises."). A claim based on the Contracts Clause of the U.S. Constitution—which

it would have to adopt a termination standard that falls below federal minimum standards applicable to privately sponsored plans.

The failure of the 2013 reforms to protect previously accrued benefits is obvious from the financial projections provided by the sponsors of the bill that was eventually enacted. It is also obvious from even a cursory examination of the features of those reforms.

The modifications are expected to reduce the "current unfunded liability" of the state plans by $20 billion.[47] That unfunded liability is the difference between the actuarial value of the retirement benefits already earned by employees and the funds set aside to pay those benefits. By definition, then, the plan must be "diminishing or impairing" previously earned benefits, not merely future benefit accruals. The day after the modifications go into effect, some employees will be worse off than they were the day before. The actuarial value of the benefits they had already accrued will be lower the day after the reform proposal goes into effect than it had been the previous day. They will be lower because the Illinois legislation reduces promised annual increases in pension benefits and because it increases retirement ages.

The modification plan cuts back on some employees' already-accrued post-retirement cost-of-living adjustment ("COLA") increases in two ways.[48] First, under prior law, COLAs were calculated with respect to

provides that: "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts," U.S. CONST. art. I, § 10, cl. 1—would face the same legal hurdles. The Illinois Constitution also contains protection against governmental takings, *see* ILL. CONST. art. I, § 15, and against laws impairing the obligation of contracts, *see id.* art. I, § 16. These constitutional protections might or might not be interpreted consistently with federal courts' interpretations of the similar language found in the U.S. Constitution. Such consistency is not required; interpretation of the language of the Illinois Constitution lies wholly within the province of the Supreme Court of Illinois. However, it would be nothing short of bizarre for the Court to substantially weaken its past interpretations of the Pension Protection Clause in order to legitimate the legislature's pension reforms only to hold that those same pension reforms must be struck down under another state constitutional provisions.

47. *See* Ray Long & Rafael Guerrero, *State House Takes 1st Big Step on Pensions*, CHI. TRIB., Mar. 22, 2013, at 1.1, 12 (stating that the bill would "immediately cut the unfunded liability by as much as $20 billion").

48. Some employee groups have objected to the description of Illinois' post-retirement increases as cost-of-living adjustments, as the amount of the adjustments are not specifically linked to increases in the Consumer Price Index or any other cost-of-living index. They prefer to use the term "automatic annual increase." *See* Yvette Shields, *Illinois Pension Law Challengers Lay Out Their Cases*, BOND BUYER (Jan. 7, 2014), www.bondbuyer.com/issues /123_5/illinois-pension-law-challengers-lay-out-their-cases-1058756-1.html (discussing the dispute over terminology). This Article uses "COLA" throughout because it is close enough in meaning and more readily recognizable. Under the pre-reform rules, most Illinois retirees' benefits increased each year by three percent. Judy Baar Topinka, *Illinois State Pension Systems: A Challenging Position*, FISCAL FOCUS, May 2011, at 6 (May 2011), www.ioc.state.il.us/index.cfm/

an annuitant's entire pension.[49] If an individual qualified for a $60,000 pension in 2014, the annual increase calculated under prior law for 2015 would have been three percent of that amount or $1800, resulting in a total pension for the year of $61,800.[50] Under the new law, the annual increase is limited to the lesser of the annual increase calculated under prior law or three percent of $1000 multiplied by the annuitant's years of service.[51] Assuming this individual had thirty-five years of service, the annual increase would be only three percent of $35,000 or $1050, resulting in a pension for the year of $61,050. This differential would grow over time, and as a result, the change would be expensive for many employees and current retirees.[52]

Further, the new law outright eliminates some of the annual COLAs for younger workers.[53] The legislation provides that up to five of the previously annual increases will simply be eliminated, depending on the age of the employee on the effective date of the legislation.[54] Employees who are fifty years of age lose only one "automatic annual increase"; those who are forty-seven lose three; those who are forty-four lose four; and younger employees lose five.[55]

Those cutbacks affect COLAs paid with respect to annuity payments attributable to services rendered before the pension reform was enacted, as well as to annuity payments earned thereafter. Indeed, even current retirees could see their COLAs reduced. For example, suppose that at the time the pension reform bill had been enacted, an employee had

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resources/fiscal-focus/may-2011-illinois-state-pension-systems-a-challenging-position/ (see table entitled "Tier 1 versus Tier 2 Benefits"). Employees hired after January 1, 2011, so-called "Tier 2 employees," will receive COLAs equal to the lesser of three percent or one-half the rate of inflation. *Id.*

49. *See* Matthew Heimer, *Illinois Legislators Pass Pension Reforms*, MARKET WATCH (Dec. 3, 2013), blogs.marketwatch.com/encore/2013/12/03/Illinois-legislators-pass-pension-reforms/ (last visited Apr. 26, 2015) ("Under legislation passed in the 1980s, most current Illinois retirees get a 3% annual COLA.").

50. $60,000 x .03 = $1800. $60,000 + $1800 = $61,800.

51. 40 ILL. COMP. STAT. 5/2-119.1(a)(a-1) (2014); Heimer, *supra* note 49. The $1000 will be adjusted for inflation beginning in 2016. 40 ILL. COMP. STAT. 5/2-119.1(a)(a-1).

52. Complaint, Harrison v. Quinn, No. 2014CH00048 (Circuit Court of the Seventh Judicial Circuit, Sangamon County, Ill., filed Jan 30, 2014); Complaint, Retired State Emps. Assoc. v. Quinn, Topinka, Rutherford & Bd. of Trs. of the State Emps. Retirement Sys., No. 2014MR000001 (Circuit Court of the Seventh Judicial Circuit, Sangamon County, Ill., filed Jan. 2, 2014) (seeking class action status in lawsuit to declare Public Act 98-599 unconstitutional to the extent it "diminishes and impairs the 3% Automatic Increase").

53. 40 ILL. COMP. STAT 5/2-119.1.(a)(a-2); STATE UNIVS. RET. SYS. OF ILL., SUMMARY OF PUBLIC ACT 98-599 (PENSION REFORM) (2013), *available at* www.surs.com/pdfs/legal/Pension-Reform-Summary-SB1.pdf [hereinafter SUMMARY OF PUBLIC ACT 98-599].

54. 40 ILL. COMP. STAT. 5/2-119.1(a)(a-2).

55. *Id.* at 5/2-119.1(a)(a-2)(2)-(4).

accrued enough credits under the pre-existing plan's terms to become entitled to a pension of $48,000 per year starting at her normal retirement age. This employee then continues to work for the state. After thirty years of service, when she reaches normal retirement age, her additional credits raise her initial benefit to $60,000. To fully protect this employee's pre-amendment benefit, the state would need to pay $60,000 plus an annual, compounded three percent COLA adjustment on $48,000 of that amount, plus any COLA due on the last $12,000 of base retirement earnings under the new pension law (which would be $0 under the terms of current law). But the pension reform act does not do that. Not only does it provide a COLA for only the first $30,000 of the employee's benefit—thereby entirely eliminating the COLA on $18,000 of the $48,000 of already-accrued pension benefit—but it also completely eliminates several years of COLA on this diminished amount. Under federal law, these diminutions in pension benefits would be regarded as illegal clawbacks.

In addition, the new pension law raises the age at which some current workers can start receiving retirement benefits.[56] There is nothing inherently wrong about raising the retirement age, but again, under the federal rules applicable to private employment plans, workers who had already-accrued benefits under the old formula would need to be compensated for receiving these benefits later (and, given that the law does not increase employees' life expectancy, for a shorter period) under the new plan.[57] Again, assume that under the old rules, a forty-three-year-old employee had earned the right to receive a base benefit of $20,000 starting at age fifty-five, and then the plan was modified to raise the retirement age to age sixty-five. Assuming a five percent discount rate and a life expectancy of eighty-three, the present value of a $20,000 per year annuity starting at age fifty-five would be $176,916.53.[58] The present value of a $20,000 per year annuity starting at age sixty-five, however, would be only $86,671.26.

The higher value of the previously accrued annuity could be

56. *Id.* at 5/2-119(a)(a-1); *see* SUMMARY OF PUBLIC ACT 98-599, *supra* note 53 (showing progressive rise in retirement ages); Heimer, *supra* note 49 ("Workers who are currently age 45 or under would see their retirement age rise by up to five years.").

57. Indeed, under federal law they would have to be allowed the option of receiving the already-accrued benefit on the original schedule. *See* WEIDENBECK, *supra* note 31, at 222 ("Consequently, a defined benefit plan early retirement option, whether subsidized or not, must continue to be made available with respect to benefits previously accrued.").

58. This example, and the one that follows it, make the simplifying assumption that each annual payment is paid, in full, on the first day of the year, and was calculated using EXCEL's XNPV function.

protected without compromising the legislature's ability to change benefit accruals going forward. For example, the retirement payments at age sixty-five could be increased to reflect the fact that fewer such payments would be received, and that they begin at a later date. Instead of receiving $20,000 per year on account of the years of pre-enactment service, the retiree could receive a benefit of $41,000 per year (or slightly less) starting on the later date.[59] That would be the base upon which later benefit accruals would be built. Private employers are forced to make these calculations and adjustments when they eliminate incentives for early retirement in their pension plans, but the Illinois legislation that changes state pension plans fails to provide such monetary adjustments.[60] Thus, it would be considered an impermissible cutback under federal law.

Proponents of the legislative change point to two "benefits" that they claim offset the detriments suffered by employees under the plan. First, the new pension law decreases the pension contributions required of employees covered by the state pension plan.[61] Second, the law gives employees the right to sue the state if it fails to adequately fund the pension fund in the future.[62] However, these alleged benefits fail to pass a straight face test as adequate compensation for the losses suffered by current employees. First, the purported benefits granted under the legislation are not correlated with the losses suffered by individual employees as a result of the plan modifications. Thus, even if the

59. The present value of an annuity of $41,000 starting at age sixty-five would be $177,676.10, about $700 in excess of the present value of the original promise.

60. Some state legislators appear to believe that there is no state law impediment to increasing the retirement age, apparently relying on the case *Peters v. City of Springfield,* 311 N.E.2d 107 (Ill. 1974), in which the Supreme Court of Illinois held that an ordinance reducing the mandatory retirement age of firefighters from sixty-three to sixty years of age did not constitute an "impairment" of pension benefits under the Pension Protection Clause even though it would prevent some firefighters from earning enough service credits to qualify for the maximum possible pension under Illinois law. *Id.* at 111–12. The Court in that case distinguished between an unprotected "right to work until a specified age" and "a pension benefit." *Id.* at 109. It held that the Pension Benefit Clause protected only the quantum of benefits earned while an employee worked for the state, but did not protect any employee's right to continue to work and earn additional benefits. *Id.* at 112 ("Municipal employment is not static and a number of factors might require that a public position be abolished, its functions change, or the terms of employment modified."). Raising the retirement age—the age at which an employee can start to receive his or her retirement annuity—as explained above, *supra* notes 56–60 and accompanying text, clearly diminishes the quantum of retirement benefits earned by an employee during his or her working years. Thus, *Peters* provides no support for a state law rule more favorable than the federal one.

61. 40 ILL. COMP. STAT. 5/2-126(c).

62. *Id.* at 5/2-125(c)-(d) (explicitly waiving the "State's sovereign immunity solely to the extent that it permits the Board to commence a mandamus action in the Supreme Court of Illinois" to pay pension contributions).

amount of "new" benefits provided to employees as a group under the new legislation matched the losses imposed by this legislation on employees as a group, some individual employees will be undercompensated while others are overcompensated.

The most significant monetary offset—a one percent decrease in future pension contributions—is explicitly tied to the provision of future, rather than past, services. An employee may be made "whole" from a monetary perspective for the reduction in his or her COLA on past accrued benefits only if he or she continues to work for the state for long enough that those reductions in pension contributions add up to the same amount as the lost COLA benefits.[63] But that is a condition many employees (and certainly current retirees[64]) will not meet. Moreover, even if an employee were to be fully compensated through the reduction in pension contributions, this compensation would be a consequence of, and a return on, the provision of future services; it would not exist on the day the plan changed. The day the reforms were effective, which under federal law would be the relevant date for determining whether accrued benefits are fully protected,[65] the actuarial value of the employee's accrued benefits would be lower than the previous day, when the entire accrued retirement benefit was entitled to an annual (and compounded) three percent COLA.

Furthermore, the second alleged offset—granting employees the right to sue the state in the future for failing to make adequate payments to the pension fund—also fails to make up for a diminution of already-accrued pension benefits. Indeed, it is hard to see how this "benefit" provides employees with any financial benefit at all, given that the adequacy (or not) of the State's advanced funding of pension benefits does not provide Illinois with a legal excuse for failing to fulfill its legal

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63. Suppose, for example, that an employee earning $60,000 retires the following year with a pre-COLA retirement benefit of $40,000. In his last year of employment, the employee's pension contribution would be reduced by one percent of his $60,000 salary, or $600, However, he will lose the COLA attributable to $5000 of his annuity—three percent of $5000, or $150—each year for as long as he lives. If he lives as little as four years, he would be a net loser. Whether any particular employee gains or losses from the exchange would depend on the length of time prior to retirement (how much he would save in retirement contributions) as well as the amount of his or her pre-COLA annuity (how much COLA he would lose). Because the point of the Pension Reform Act is to reduce Illinois' pension costs, *see* Long & Guerrero, *supra* note 47 (estimating cost savings), the state must be expecting that there will be more losers than winners under the new scheme.

64. Current retirees will lose COLA benefits without gleaning any offsetting advantages, as they have ceased making pension contributions.

65. *See* 26 C.F.R. § 1.411(d)-3(a)(4) ex. 1 (2012) ("[T]he plan amendment fails to satisfy the requirements of section 411(d)(6)(A) because the amendment decreases the accrued benefit of Participant N . . . immediately before the applicable amendment date.").

obligation to pay promised retirement benefits.[66] This is particularly true given the absence of any legal regime under which a state might declare bankruptcy and reduce its pension obligations.[67] Finally, it is highly unlikely that the legislative offsets come anything close to making employees as a class whole; if it did, there would be no decrease in unfunded liability.

Interestingly, in some respects the legislation does protect accrued

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66. Indeed, the Supreme Court of Illinois made precisely this point in cases in which it held that employees could not sue the state for failing to adequately fund its employee pension plans. *See, e.g.*, People *ex rel.* Sklodowski v. Illinois, 695 N.E.2d 374 (Ill. 1998); McNamee v. Illinois, 672 N.E.2d 1159 (Ill. 1996); People *ex rel.* Ill. Fed'n of Teachers v. Lindberg, 326 N.E.2d 749 (Ill. 1975). The court pointed out that the records of the Constitutional Convention make clear that no such funding obligation exists. Helen Kinney, the major proponent of the Pension Protection Clause, stated in no uncertain terms in response to questions from others, that the Pension Protection Clause did not obligate the state to provide advance funding for these plans. *Sklodowski*, 695 N.E.2d at 378 ("This court in *McNamee* exhaustively reviewed the debates from the convention . . . [and] found that the 'transcripts from the convention make clear that the purpose of the amendment was to clarify and strengthen the right of state and municipal employees to receive their pension benefits, but not to control funding.'"). At the time of the Constitutional Convention, the pension plans were only about forty percent funded. *See* Shields, *supra* note 48 ("In 1970, the state's unfunded liabilities were $2.5 billion and the [retirement] system was just 41.8% funded."). Moreover, the court has repeatedly suggested that it might uphold a funding requirement in the event it appeared likely that the State would default on its obligations to pay promised benefits. *See, e.g.*, *Sklodowski*, 695 N.E.2d at 379; *McNamee*, 672 N.E.2d at 1166. This dicta suggests that state employees and retirees may have had this right under prior law due to the parlous conditions of the state treasury further undermining the contention that the "new" funding right contained in the 2013 pension reform act conferred an offsetting benefit on retirees.

67. Historically, the absence of a bankruptcy regime for state governments has been tied to constitutional concerns. *See* Skeel Jr., *supra* note 46, at 707 (noting concerns about impermissible interference with state sovereignty and Contracts Clause obligations). However, more recent scholarship suggests those objections could be overcome by enacting a state bankruptcy law "that could be invoked only by the state itself . . . ." *Id.* at 708. In addition, states may not have felt the need for such a regime because the combination of the Eleventh Amendment's prohibition of federal court jurisdiction over suits against states by out-of-state and foreign plaintiffs, *see* JOHN V. ORTH, THE JUDICIAL POWER OF THE UNITED STATES: THE ELEVENTH AMENDMENT IN AMERICAN HISTORY 7 (1987) ("Always a dollars-and-cents proposition, the Amendment was adopted to overturn an early Supreme Court decision that an out-of-state plaintiff could sue a state in federal court to enforce a debt."), and the doctrine of sovereign immunity, which prevented the prosecution of such suits in state courts, historically has allowed states to simply repudiate distasteful debts, *see id.* at 4–6 (describing historical instances of repudiation of state debt). These "obstacles to collection" obviated the most "familiar justification for bankruptcy . . . inefficient liquidation," Skeel Jr., *supra* note 46, at 686–687, although he points out that "[t]he ugly repercussions of default would linger," *id.* at 706. One question is whether these obstacles undercut the supposed ironclad constitutional protection of pension benefits—or whether (in Illinois) the Pension Protection Clause constitutes a limited waiver of sovereign immunity granting state courts the power to order payment of employee pensions. Thus far, Illinois seems to be operating under that assumption; at the very least, it has not defended itself against previous state lawsuits brought by pensioners' on jurisdictional grounds.

benefits. For example, the legislation imposes caps on the amount of salary that can be counted when calculating an employee's pension benefits.[68] However, the legislation specifically provides that in the case of current employees, the cap will be the higher of the newly imposed legislative limits or those employees' compensation as of the effective date of the legislation.[69] It also protects current employees' rights to receive service credits for accumulated vacation and sick days.[70] But it does not protect all accrued benefits of current employees.

In sum, even assuming the Supreme Court of Illinois reverses its prior precedent[71] and declares that the Illinois Constitution's rule against impairing pension benefits—like ERISA—protects only already-accrued pension benefits, many of the modifications made to the state pension plans in 2013 should or would not survive judicial scrutiny. But it is likely that the Supreme Court of Illinois will hold the state to an even higher standard of protection.

B. Protecting Future Accruals: The Apparent Illinois Rule

Although Justice Scalia reviles the practice of using legislative history to interpret statutes,[72] "[w]hen discerning the purpose of constitutional provisions," the courts of Illinois "attach great weight to the Record of Proceedings of the Constitutional Convention."[73] Unfortunately for proponents of pension reform in Illinois, one of the co-sponsors of the Pension Protection Clause, Helen Kinney,[74] repeatedly made clear that she believed that it was meant to "guarantee that people will have the rights that were in force at the time they

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68. 40 ILL. COMP. STAT. 5/14-103.10 (2014).

69. *Id.* at 5/14-103.10(h).

70. *Id.* at 5/14-104.3; *id.* at 5/14-106.

71. This possibility cannot be entirely discounted. After all, judges in Illinois are elected officials, and thus are at least somewhat responsive to public opinion, which is not overwhelmingly favorable to state employees. As elaborated *infra* note 78, however, there is as yet no sign that the courts are reconsidering their prior precedents.

72. *See, e.g.*, Pennsylvania v. Union Gas Co., 491 U.S. 1, 30 (1989) ("It is our task, as I see it, not to enter the minds of the Members of Congress . . . but rather to give fair and reasonable meaning to the text of the United States Code . . . ."); Thompson v. Thompson, 484 U.S. 174, 191–92 (1988) (Scalia, J., concurring) ("Committee reports, floor speeches, and even colloquies between Congressmen . . . are frail substitutes for bicameral votes upon the text of a law . . . .").

73. Vill. of Sherman v. Vill. of Williamsville, 435 N.E.2d 548, 551 (Ill. App. Ct. 1982).

74. Helen Kinney was the first female assistant state's attorney in DuPage County, and later became its first female judicial appointee. She was later elected to the position of circuit judge. Kiley M. Whitty, *From Our President*, DUPAGE ASS'N OF WOMEN LAWYERS, http://www.dawl.org/home (last visited Apr. 26, 2015).

entered into the agreement to become an employee."[75] As a result, Illinois courts have consistently held that changes in pension rules that adversely affect employees can only affect employees hired after the date of the changes, and previous pension reform legislation carefully protected pre-existing employees.[76] The courts have not distinguished between changes in previously accrued benefits and those earned through the performance of future services.

Others have ably made the argument that it is illogical from a public policy standpoint to have a rule holding that pension accrual formulas must be held constant (or be a one-way upward ratchet) once an employment relationship begins when cash salary and other types of benefits can vary over time.[77] I do not disagree with that judgment. It is probably unfortunate that the Illinois Constitutional Convention took place in 1970 rather than after the enactment of ERISA, when the constitution's drafters may have been more sensitive to the distinction between already accrued and merely anticipated pension benefits and made a more nuanced policy decision. However, past decisions of the Illinois courts indicate that they will take the Kinney language to heart when interpreting the meaning of the Pension Protection Clause of the Illinois Constitution and will strike down the recently enacted pension

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75. *Verbatim Transcript of July 21, 1970*, *in* 4 SIXTH ILLINOIS CONSTITUTIONAL CONVENTION, RECORD OF PROCEEDINGS 2893, 2931–32 (1972); *see id.* at 2929 ("[The Pension Protection Clause] is simply to give them a basic protection against abolishing their rights completely or changing the terms of their rights after they have embarked upon the employment—to lessen them."). For an excellent and exhaustive description of the struggle to get the Pension Protection Clause included in the Illinois Constitution, see Eric M. Madiar, *Is Welching on Public Pension Promises An Option for Illinois? An Analysis of Article XIII, Section 5 of the Illinois Constitution* 10–20 (July 5, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=1774163.

76. For example, pension reform legislation enacted in 2011 created two sets of employees, Tier 1 employees, hired before the effective date of the legislation, and Tier 2 employees, hired after the effective date of the legislation; reductions in pension benefits contained in that legislation affected only Tier 2 employees. *See* Topinka, *supra* note 48, at 6 ("Public Act 96-0889, effective January 1, 2011, made substantial changes to the pension plan for new government employees in Illinois by creating what is known as 'Tier 2.'").

77. *See, e.g.*, Amy Monahan, *Statutes as Contracts? The "California Rule" and its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1033 (2012) (protecting employees' rights to future retirement benefit accruals "contrary to general contract theory . . . [and] create[s] economic inefficiency, in that it fixes in place one part of an employee's compensation . . . . Viewed holistically, the California Rule simply does not protect employees' economic interests, and in some cases may even harm the interests of the very employees it is meant to protect"); Alicia H. Munnell & Laura Quinby, *Legal Constraints on Changes in State and Local Pensions*, 25 CTR. FOR RET. RESEARCH AT B.C., Aug. 2012, at 1, 3, *available at* http://crr.bc.edu/wp-content/uploads/2012/08/slp_25.pdf ("But future benefits, much like future payroll, should be allowed to vary based on economic conditions.").

reforms on that basis.[78]

Illinois courts have consistently held that an employee's rights in the pension system "vest" on the later of two dates: the date on which the employee enters the system by making contributions to the plan, or the date on which the 1970 Constitution containing the Pension Protection Clause became effective.[79] Most importantly, "vesting" has been interpreted as applying to the benefit accrual formula itself.[80] On several occasions, Illinois courts have held that a state employee's pension rights are "governed by the actual terms of the Pension Code at the time the employee becomes a member of the Pension system,"[81] so that only employees hired after the effective date of an adverse change in pension terms can be affected by the change.[82]

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78. Indeed, in the first test of the 2013 legislation, a circuit court judge granted a preliminary injunction against the implementation of the new pension rules. This judge followed up his preliminary injunction with a decision holding that the 2013 legislation violated the Pension Protection Clause of the Illinois Constitution. *See supra* note 27 and accompanying text (discussing multiple pension lawsuits that were merged and held the legislation invalid). The Supreme Court of Illinois is expected to rule on the appeal of that decision in the spring or summer of 2015. Some believe that political pressures will militate some relaxation of its precedent, as the justices are elected officials. *See id.* ("But even Mr. Raucci isn't making any predictions about the court, which is not just a legal but a political body . . . ."). There is as yet no indication of such a relaxation. Indeed, on July 3, 2014, the Supreme Court of Illinois, in a case of first impression, extended the reach of the Pension Protection Clause to cover state contributions to health insurance premiums for retirees. In *Kanerva v. Weems*, 13 N.E.3d 1228 (Ill. 2014) the court reversed an appellate court's dismissal of challenges to the constitutionality of Public Act 97-695, which amended the State Employees Group Insurance Act of 1971 by eliminating standards for the state's contributions to health insurance premiums for members of three of the state's retirement systems. *Id.* at 1230. Stating that "where there is any question as to legislative intent and the clarity of the language of a pension statute, it must be liberally construed in favor of the rights of the pensioner," *id.* at 1244, the court held uncompromisingly that "the State's provision of health insurance premium subsidies for retirees is a benefit of membership in a pension or retirement system within the meaning of [the Pension Protection Clause] . . . and the General Assembly was precluded from diminishing or impairing that benefit for those employees, annuitants, and survivors whose rights were governed by the version of section 10 of the Group Insurance act that was in effect prior to the enactment of Public Act 97-695." *Id.*

79. *See, e.g.*, Barber v. Bd. of Trs. of Vill. of S. Barrington Police Pension Fund, 630 N.E.2d 446, 450 (Ill. App. Ct. 1993); Hannigan v. Hoffmeister, 608 N.E.2d 396, 402 (Ill. App. Ct. 1992); Schroeder v. Morton Grove Police Pension Bd., 579 N.E.2d 997, 999 (Ill. App. Ct. 1991); Carr v. Bd. of Tr. of Peoria, 511 N.E.2d 142, 143 (Ill. App. Ct. 1987).

80. People *ex rel.* Sklodowski v. Illinois, 695 N.E.2d 374, 378 (Ill. 1998); McNamee v. Illinois, 672 N.E.2d 1159, 1162 (Ill. 1996); Di Falco v. Bd. of Trs. of Firemen's Pension Fund of Wood Dale Fire Prot. Dist. No. 1, 521 N.E.2d 923, 925 (Ill. 1988).

81. *Sklodowski*, 695 N.E.2d at 378; *see McNamee*, 672 N.E.2d at 1162; *Di Falco*, 521 N.E.2d at 925.

82. Employees "vest" in beneficial changes by continuing to work and contribute to the pension plan after such changes have been adopted. *E.g.*, Gualano v. City of Des Plaines, 487 N.E.2d 1050, 1051–52 (Ill. App. Ct. 1985); Taft v. Bd. of Trs. of Police Pension Fund of Vill. of Winthrop Harbor, 479 N.E.2d 31, 35 (Ill. App. Ct. 1985). Although retirees likely can be stripped of benefit enhancements enacted subsequent to their retirement, it is unclear how many such

For example, in *Buddell v. Board of Trustees, State University Retirement System of Illinois*, the state university hired an employee in 1969.[83] In 1969, employees were allowed to purchase service credit in the state retirement plan for time spent in military service.[84] In 1974, the Illinois Pension Code was amended to provide that credit for military service would only be allowed for those who "have applied for such credit before September 1, 1974."[85] Although Buddell was eligible to apply for this credit before September 1, 1974,[86] he did not apply or pay the necessary fee for the credits prior to this date.[87] Instead, he attempted to apply for the credit in 1983, and was denied.[88] Both the circuit court[89] and the Supreme Court of Illinois held that this denial was improper because his contractual "right to purchase the additional credit" could not be divested by the legislature.[90] The fact that he delayed making the required payment for such credits until well after the date of the pension amendment was deemed irrelevant; what "vested" was not the benefit itself, but the pension formula under which he had a "right to purchase additional credit."[91]

Similarly, Illinois courts have refused to apply revised definitions of "final salary" for purposes of determining the retirement benefits of employees hired before the adoption of those revisions. In *Kraus v. Board of Trustees of the Police Pension Fund of the Village of Niles*,[92] a policeman sued to have his retirement benefits determined under the formula applicable at the time he was hired, rather than the revised

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situations exist or how much money is involved. The Illinois Attorney General's brief in the pension litigation points to retirees and dependents receiving pensions in 1989, at the time the COLA provision was first enacted, as examples of parties who should be considered to have no protection against the loss of that benefit. Eric M. Madiar, *Illinois Pension Reform: What's Past Is Prologue*, ILL. PUB. EMP. RELATIONS REP., Summer 2014, at n.238 and accompanying text, *available at* https://www.kentlaw.edu/ilwreport/index.php/2014/09/volume-31-issue-3-summer-2014/2/.

83. 514 N.E.2d 184, 185 (Ill. 1987).

84. *Id.* ("At the time that Dr. Buddell became employed by the University, the version of section 15–113 in effect allowed employees to purchase service credit for time spent in the military service.").

85. 108 1/2 ILL. COMP. STAT. 15–113(i) (1969) (current version at 40 ILL. COMP. STAT. 5/15-113.1 (West 1985)).

86. *Buddell*, 118 N.E.2d at 185. His military service predated his university service. *Id.*

87. *Id.* at 185 ("In 1983, Dr. Buddell applied to the University Retirement System to purchase military service credit.").

88. *Id.*

89. *Id.* at 185–86 (citing circuit court opinion).

90. *Id.* at 188 ("The rights to exercise this option and to make these additional payments are contractual rights . . . and the legislature cannot divest the plaintiff of these rights.").

91. *Id.* at 187.

92. 390 N.E.2d 1281 (Ill. App. Ct. 1979).

formula that was effective on the date he became eligible to retire.[93] The court could have decided in favor of the patrolman on the narrow ground that the more favorable formula was in place on the last day that he provided services for the Village of Niles,[94] and thus the retirement benefits, in a very real sense, already had been "earned" at the time of the legislative change.[95] However, the court specifically and deliberately sought to establish the more expansive rule, that "[the Pension Protection Clause] prohibits legislative action which directly diminishes the benefits to be received by those who become members of the pension system prior to the enactment of the legislation, though they are not yet eligible to retire."[96] The court was not persuaded by the argument that its decision "will freeze pension legislation for at least 20 years, thus making the repeal of section 3-114 not truly effective until 1993,"[97] pointing out that "the Pension Laws Commission attempted to have language allowing a reasonable power of legislative modification added to the section or read into the debates to establish intent, but no such action was taken during the convention."[98]

The Supreme Court of Illinois adopted this absolutist position in *Felt v. Board of Trustees*.[99] In 1982, the Illinois Code was changed, redefining the basis for computing retirement annuities from the salary on the last day of service to the average salary for the final year of service, a matter of some moment in years in which mid-year salary increases occurred.[100] Again, the court could have limited its holding to protect only the portion of the benefit earned prior the date of the legislative change. The outcome of the case would have been a little

93. *Id.* at 1283 ("The issue is whether the trial court erred in holding that under section 5 of article XIII of the 1970 Illinois Constitution, plaintiff was entitled to receive a pension based on a section of the Pension Code in effect at the time of his entry into the pension system . . . although the section was subsequently repealed and replaced prior to the time plaintiff retired or became eligible to retire.").

94. *See id.* at 1283 (detailing the chronology). The plaintiff was placed on disability leave in October 1967, approximately four years before the statutory change in pension terms was effective, and never returned to active service; he applied for regular retirement status after accruing twenty years of service through a combination of eleven years of active service and nine years of disability leave. *Id.*

95. This reasoning would have been consistent with the decision in *Peifer v. Bd. of Trustees of the Police Pension Fund of the Village of Winnetka*, 342 N.E.2d 131 (Ill. App. Ct. 1976), in which the court held that the pre-amendment retirement benefits formula applied to determine the benefits to be received by a policemen because he was eligible to retire prior to the date the new rules came into effect. *Id.* at 134–35.

96. *Kraus*, 390 N.E.2d at 1292–93.

97. *Id.* at 1294.

98. *Id.*

99. 481 N.E.2d 698 (Ill. 1985).

100. *Id.* at 699.

different, but almost the entire benefit at issue would have been protected under that lesser standard of protection. Instead, the court dismissed the legislature's concerns about underfunding of pension plans and the state's budgetary concerns, while deliberately making the broad holding that the amendment was "unconstitutional as applied to these plaintiffs and to other judges in service on or before the effective date of the amendment."[101]

If the Supreme Court of Illinois continues to apply this standard, additional features of Illinois' new pension law will be struck down. For example, the newly imposed caps on the amount of salary that can be taken into account for pension calculations would be unacceptable.[102]

Although the position taken to date by the Illinois courts may seem extreme, it is far from unusual.[103] Some of the courts that formerly adopted similar positions under their state contracts clauses have repudiated those positions, but several states continue to uphold comparable levels of protection of retirement benefits under either their contracts clauses or more particularized state constitutional pension protection clauses.[104]

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101. *Id.* at 702. Likewise, the court could have based its decision on another constitutional provision, one specifically forbidding the reduction of judicial pay, but it chose not to. ILL. CONST. art. VI, § 14.

102. *See* 40 ILL. COMP. STAT. 5/14-103.10(g) (2014) (imposing limits). As discussed *supra* notes 68–69 and accompanying text, under the old law, a Tier 1 employee's entire salary was taken into account for purposes of calculating his or her base pension; under the new law, the amount of salary taken into account is capped at the greater of the employee's salary on the effective date of the legislation or the cap established by statute (currently about $110,000). 40 ILL. COMP. STAT. 5/14-103.10(h).

103. *See* Monahan, *supra* note 77, at 1032 ("[C]ourts in California and the twelve other states that have adopted California's precedent have held not only that state retirement statutes create contracts, but that they do so as of the first day of employment. . . . [C]ourts interpreting the California Rule have held that the contract protects not only accrued benefits (a relatively uncontroversial position) but also the rate of future accrual."); Munnell & Quinby, *supra* note 77, at 2 tbl.2 (identifying states' legal justifications for protecting pension rights). The "California Rule" is built around more general proscriptions against "impairment of contracts" rather than a provision such as the one found in the Illinois constitution specifically protecting retirement benefits. *See* Monahan, *supra* note 77, at 1032 (describing the "California Rule"). Professor Monahan argues that the impairment-of-contracts doctrine, as ordinarily applied in federal and some state courts, would not protect employees against changes in the rate of future pension plan accruals, and thus that the various states applying the rule differently in the pension contract context are wrong as a matter of law as well as policy. *Id.* at 1032–33 (noting that the interpretation is "contrary to federal Contract Clause jurisprudence, . . . contrary to general contract theory, [and] it also appears to create economic inefficiency"). Whatever the merits of Professor Monahan's Contracts Clause argument, thus far, the Supreme Court of Illinois has held Illinois to a higher standard under the Pension Protection Clause.

104. *Id.* at 1071 (listing states that adopted the California Rule).

Of course, nothing prevents the Supreme Court of Illinois from reconsidering its prior decisions and deciding that, after all, the Illinois Pension Protection Clause protects only already earned pension benefits, leaving the legislature free to reduce future accruals on a prospective basis. Indeed, as discussed above, most if not all of the holdings (as opposed to the expressed rationales) in the previously decided cases are consistent with the federal standard of protecting accrued benefits while allowing the diminution of prospective benefits. Some forecast such a turnaround, inasmuch as the members of the court are elected officials and hence subject to pressure from a tax-averse electorate.[105] But such a turnaround is by no means assured.

More importantly, as also discussed above, the courts would have to go much further than that to uphold the current set of pension reforms. To uphold the current set of reforms, the Supreme Court of Illinois would have to accept the state's argument that the legislature can reduce already-accrued benefits under its "reserved sovereign powers (sometimes referred to as the State's police powers),"[106] and essentially

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105. *See* Phil Ciciora, *Is Illinois' Pension Reform Constitutional?*, THE NEWS-GAZETTE (December 8, 2013, 8:00 AM), www.news-gazette.com/opinion/guest-commentary/2013-12-08/illinois-pension-reform-constitutional.html (contrasting views of two University of Illinois law professors, John Columbo and Laurie Reynolds). Certainly, the court's recent decision in *Kanerva v. Weems* (for a discussion of the case, see *supra* note 78) does not indicate the court's receptiveness to such arguments. *See* Monique Garcia et al., *Court Affirms Pension Rights*, CHI. TRIB., July 4, 2014, at 1.1 ("While the state's highest court did not rule directly on new state laws altering pension benefits of public employees and changes in retiree health care for some Chicago workers, the language of its decision signaled that a majority of justices believe the constitution protects public employees' retirement benefits from legislative attempts to diminish them.").

106. *See* Answer and Defenses at 19, *In re* Pension Reform Litig., Retired State Emps. Assoc. v. Quinn, No. 2014 MR 1 (Cir. Ct. Sangamon Cnty. May 15, 2014) (defending the legislation). The Illinois Attorney General has also taken the position that the three percent COLA benefit is "'not part of the core pension benefit'" protected by the Pension Clause." Madiar, *supra* note 82, at nn.237–43 and accompanying text. Although she may be right as to some of the COLA beneficiaries, *see id.*, the argument is quite weak for those employees who began or continued working after the institution of the COLA in 1989. Although some state (not Illinois) lower court judges have distinguished between base pensions and cost-of-living adjustments, *see* Mary Williams Walsh, *Two Rulings Find Cuts in Pensions Permissible*, N.Y. TIMES, July 1, 2011, at B1, the Supreme Court of Arizona, in a state which has in its constitution a provision almost identical to Illinois' Pension Protection Clause, recently refused to distinguish between base pension benefits and statutory benefit increases, holding both equally protected against impairment. *See* Fields v. Elected Officials Ret. Plan, 320 P.3d 1160, 1165–66 (Ariz. 2014) (concluding that both were "embraced by the term 'benefits' in the Pension Clause"). The Supreme Court of Colorado upheld that state's right to reduce its COLA provision in the case referred to in the Walsh article, but Colorado does not have the equivalent of the Pension Protection Clause in its state constitution. The case was brought under the state's Contracts Clause, and critical to the court's decision was its presumption against creating a contractual right "unless there is a clear indication of the legislature's intent to be bound." Justus v. State, 336 P.3d 202, 209 (Colo. 2014). The court found that no such intent existed because the COLA

read the Pension Protection Clause out of the state constitution. It is past time to start working up real solutions to the pension problems facing Illinois. This Article now turns to some possibilities.

There are two quite disparate parts to the pension problem. One consists of cleaning up the mess created in the past; the second is devising mechanisms to prevent the recurrence of similar problems in the future. The first entails raising more revenue; the second requires coming up with a pension scheme going forward, at least for new employees, that is not as subject to the dysfunctional habits of the Illinois state government and yet protects the interests of state employees. There are no simple or pleasant answers for either of these questions. But the following Parts of this Article attempt to sketch out some sensible possibilities.

II. RAISING REVENUE: ADDING RETIREMENT INCOME TO THE INCOME TAX BASE

Although investment losses have played a small part in the underfunding of Illinois' pension plans, the legislature's systemic underfunding of its plans has played a far larger role. The plans' assets had already fallen far short of their accrued liabilities in the year the constitutional drafters adopted the Pension Protection Clause,[107] and, with few exceptions, their finances have steadily worsened over time. Indeed, until 1981, the state's "budgetary policy" consisted of paying current benefit outlays out of current state revenues[108] while using employee contributions to build the pension reserve.[109] The state abandoned that policy due to "fiscal stress" and sharply reduced state contributions in 1982 and 1983; its contributions then "increased modestly through fiscal year 1995."[110]

These modest increases nowhere near compensated for rising pension expenditures. In 1995 alone, the state contributed a mere $519 million to the funds while retirement fund expenditures amounted to $1.9

provisions "do not use the word 'entitled,' nor do they include any similar words creating an unmistakable vested contractual right." *Id.* Moreover, the Court noted that "the COLA formula paid to retirees changed repeatedly during the employment of each named retiree . . . ." *Id.* at 210. It is worth noting that many of the other states where COLA-reducing reforms were upheld also lacked the equivalent of Illinois' Pension Protection Clause, which provides an independent basis for arguing that the statutory language provided an enduring claim.

107. *See* Shields, *supra* note 48 (describing the shortfall).

108. Topinka, *supra* note 48, at 4. Technically, the state contributed this amount to the pension trust, which disbursed the funds to retirees. *Id.*

109. *Id.* Although bearing "no relation to actuarial calculations of liability," this funding program "guarantee[s] a steady increase in state contributions." *Id.*

110. *Id.*

billion.[111] Alarmed at the growing shortfall, the state legislature passed legislation in that year creating a fifty-year plan to achieve ninety percent funding of the plans.[112] After a fifteen-year period of phasing in higher pension contributions, the plan required the legislature to contribute a set percentage of payroll until the plans were ninety percent funded.[113] Between higher contributions and the booming stock market, the plans reached 74.5% funding in fiscal year 2000—only to fall back to a funding ratio of 48.6% by the close of fiscal year 2003 due to a combination of falling equity values, increases in pension liabilities—"caused in part by benefit increases"[114]—and shortfalls in state contributions.[115] In fact, with the exception of 2004, when the state deposited most (but not all!) of the proceeds of a $10 billion general obligation bond floated specifically to provide funds for state pension plans,[116] the state has never contributed an amount sufficient to cover its actuarially computed pension obligation for the year—the amount necessary to cover that year's increase in pension liabilities, plus interest on accrued contribution shortfalls—let alone money to eat away at that deficit.[117]

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111. *Id.*

112. *Id.* (referring to P.A. 88-593, effective July 1, 1995).

113. *Id.*

114. *Id.* at 4–5. According to a Pew Foundation Report, only 4.19% of the current funding shortfall can be traced back to benefit increases, PEW REPORT, *supra* note 21, at 3, but it does seem odd that the legislature would increase benefits due under an already underfunded plan. The benefit increases consisted of sweetening the benefit accrual formula (from 2.2% of final average salary to 3% of final average salary per year of creditable service plus the provision of mechanisms through which covered employees could purchase additional years of service credit. *See* COMM'N ON GOV'T FORECASTING & ACCOUNTABILITY REPORT ON THE FINANCIAL CONDITION OF THE STATE RETIREMENT SYSTEMS FY 2010, at 7–8 (2011) [hereinafter FORECASTING & ACCOUNTABILITY REPORT 2010] (describing P.A. 91-0927, P.A. 92-0014, and P.A. 92-0566, and outlining changes).

115. *See* PEW REPORT, *supra* note 21, at 3 ("Approximately one-third of the growth is attributable to employer contribution shortfalls . . . ."). The PEW Report attributes 33.55% of the total shortfall to "Employer Underfunding" and almost as much, 31.56%, to "Lower Investment Returns." *Id.* However, the "lower investment returns" could easily be ascribed to "employer underfunding" as one time-honored mechanism for understating the amount of actuarially required employer contributions is to over-estimate expected investment returns on plan assets. *See* WIEDENBECK, *supra* note 31, at 265 ("Experience showed that plan sponsors in financial difficulty often minimized their minimum funding obligation by adopting overly optimistic assumptions regarding investment performance . . . ."). Although some of the Illinois retirement plans reduced their investment expectations in 2011, they remained "toward the upper end in the assumptions of rate of return." Topinka, *supra* note 48, at 5.

116. *See* Topinka, *supra* note 48, at 4 (depicting "State Contributions and Retirement System Expenditures").

117. *See* COMM'N ON GOV'T FORECASTING & ACCOUNTABILITY, ILLINOIS STATE RETIREMENT SYSTEMS, REPORT ON THE FINANCIAL CONDITION OF THE STATE RETIREMENT SYSTEMS FY 2013, at 113 app. M (2014), (showing employer contributions falling short of

The dismal state of its pension funds is just one aspect of Illinois' larger fiscal problems. For many years, Illinois has been spending more money than it has been raising in taxes.[118] Even if the state slashes future spending, it will have to increase taxes to make up for those past expenditures.[119] But which taxes, and from whom?

One very natural move—and perhaps a permissible clawback of sorts—would be to expand the base of the income tax by eliminating the state's income tax exclusion for retirement income. Adding retirement income to the income tax base will not bring in enough revenue to solve Illinois' pension woes,[120] but it would be a start. Most of all though, it would be the right move from a fairness perspective. It would place part of the burden of financing the pension shortfalls on the people responsible for creating them in the first place: residents who underpaid for the costs of the governmental services they received in earlier years.[121] In addition, those who favor the rollback on state employee COLAs should also favor the inclusion of retirement in income, as it has much the same effect; although the state will pay pension benefits

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actuarial increases in benefit liabilities in every year from 1996–2013, save 2004, the year in which the state deposited some of the proceeds of a bond issue in the plans); FORECASTING & ACCOUNTABILITY REPORT 2010, *supra* note 114, at 24 (detailing changes in unfunded liabilities from 2006–2012). The state even reduced its pension contributions when the stock market boomed from 2005–2007. FORECASTING & ACCOUNTABILITY REPORT 2010, *supra* note 114, at 24. *See generally* Karen Eilers Lahey & T. Leigh Anenson, *Public Pension Liability: Why Reform Is Necessary to Save the Retirement of State Employees*, 21 NOTRE DAME J.L. ETHICS & PUB. POL'Y 307, 319–20 (2007) (explaining Illinois' unfunded pension debt as a combination of "annual state contributions of less than the necessary actuarial amount, increased pension benefits, investment losses, and a downturn in the economy"); Madiar, *supra* note 82, § II (tracing the history of underfunding from 1917 to the present).

118. *See* STATE BUDGET CRISIS TASK FORCE, ILLINOIS REPORT 16 (2012), *available at* www.statebudgetcrisis.org/wpcms/wp-content/images/2012-10-12-Illinois-Report-Final-2.pdf ("[T]he origins of the structural gap between spending growth and sustainable revenues can be traced to the 1990s.").

119. After winning the election, Governor Rauner declared that: "[o]ur financial condition is far worse than has ever been discussed publicly before," suggesting that he may be more amenable to revenue raising measures than his campaign indicated. Bob Secter et al., *Rauner's Great Red-Ink Challenge*, CHI. TRIB., Jan. 4, 2015, 1.1, 6. However, his first budget proposal focuses on spending cuts. *See* Ray Long, *Protesters Descend on Capitol Building*, CHI. TRIB., March 12, 2015, at 1.4 ("'Gov. Rauner . . . is committed to solving [the budget crisis] without raising taxes on hardworking families and without irresponsible borrowing.'").

120. Thomas A. Corfman, *Civic Federation: Keep Most of Illinois' 'Temporary' Income Tax Hike*, CRAIN'S CHI. BUS., Mar. 3, 2014, http://www.chicagobusiness.com/article/20140303/NEWS02/140309994/civic-federation-keep-most-of-illinois-temporary-income-tax-hike. "The exemption cost Illinois roughly $2 billion in fiscal 2012." *Id.* "Illinois' pension debt has grown by $79 billion since 2001" or more than $6.5 billion per year. PEW REPORT, *supra* note 21, at 3.

121. Given Illinois' climate, it is unlikely that many people move to the state to retire. Most retirees are individuals who have aged in place, and thus are the same individuals whose taxes failed to cover the cost of past governmental spending from which they benefited.

inflated by the COLA, part of that benefit will have to be returned to the state treasury in the form of income taxes.[122]

At present, Illinois law contains one of the country's most extensive tax exemptions for retirement income. It excludes from its income tax base payments made under public pension plans, private pension plans, Individual Retirement Accounts ("IRAs"), 401(k)s, social security benefits, redemptions of U.S. retirement bonds, qualified annuities, and Keogh plans.[123] Although most states exclude some retirement income from the base of their state income taxes,[124] only four other states have similarly generous exclusions.[125] There is no need for Illinois to be such an outlier.[126]

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122. This Article takes no position on the question of whether Illinois state employees (taking cash salaries and benefits into account) are routinely overpaid, as more than enough ink has already been spilled on this question. For a sampling of the contrasting views on this subject, see ALICIA H. MUNNELL ET AL., CTR. FOR STATE & LOCAL GOV'T. EXCELLENCE, COMPARING COMPENSATION: STATE-LOCAL VERSUS PRIVATE SECTOR WORKERS 8 (2011), *available at* slge.org/wp-content/uploads/2011/12/BC-brief_Comparing-Compensation_12-082.pdf ("The estimated difference nationwide is about 4% in favor of private sector workers."); Beermann, *supra* note 4, at 16–26; Andrew G. Biggs & Jason Richwine, *Overpaid or Underpaid? A State-by-State Ranking of Public-Employee Compensation* 59 tbl.2 (Am. Enter. Inst. Pub. Pol'y Research, Working Paper No. 2014-04), *available at* www.aei.org/files/2014/04/24/-biggs-overpaid-or-underpaid-a-statebystate-ranking-of-public-employee-compensation_112536583046.pdf (rating Illinois as paying its employees a "[v]ery large premium" of more than 20% in excess of comparable private employees). It is beyond dispute that any reduction in pension benefits constitutes a reduction in overall salary, which not only hurts current employees but also reduces the attraction of such jobs going forward. This will likely adversely affect the pool of potential state employees, possibly diminishing the quality of future public services. Lunch is rarely free.

123. Kelly Soderlund, *A Plan to Tax Retirement Income*, AARP BULL., June 2014, at 36; *Illinois*, RETIREMENT LIVING INFO. CTR., https://www.retirementliving.com/taxes-alabama-iowa#ILLINOIS (last visited Apr. 26, 2015).

124. NAT'L CONFERENCE OF STATE LEGISLATURES, STATE PERSONAL INCOME TAXES ON PENSIONS & RETIREMENT INCOME: TAX YEAR 2010, at 2 (2011), *available at* www.ncsl.org/documents/fiscal /taxonpensions2011.pdf. Thirty-six of the forty-one states with personal income taxes "offer exclusions for some or all specifically identified state or federal pension income or both,, [sic] a retirement income exclusion, or a tax credit targeted at the elderly." *Id.*

125. *Id.* at 3 (Alabama, Hawaii, Pennsylvania, and Mississippi).

126. There is no argument in Illinois, as there is in some states, that the income tax exemption constitutes part of the state retirement system protected under the Pension Protection Clause. Following the Supreme Court's decision in *Davis v. Michigan Department of Treasury*, 489 U.S. 803 (1989), that granting immunity from state income taxation to state and local pension benefits and not federal pension benefits violated the statutory and constitutional principles of intergovernmental tax immunity, a number of states that had previously exempted only state and local pension benefits had to choose between taxing all governmental retirement benefits or none. Oregon and North Carolina were among the states that had included specific language guaranteeing state tax exemptions in their pension statutes. When they attempted to repeal those exemptions, state employees sued, claiming that the removal of the exemptions violated either state constitutional provisions against impairment of pension benefits or state contracts clauses.

A. The History of the Exclusion

Tax relief for seniors[127] got off to a slow start in the United States. In 1916, when the federal personal income tax was enacted, none of the seven states that had income tax systems provided preferential treatment for seniors.[128] The first state to enact such a preference was Vermont. It exempted pensions from the tax base when it enacted a revised version of its income tax in 1931. However, the exemption appears to have been an oversight.[129] It took another sixteen years for other states to begin providing tax relief for seniors.

The first significant income tax relief provided for seniors at the federal level came in the form of an administrative ruling excluding social security benefits from income.[130] Most states followed the federal government's lead in treating those benefits as tax exempt.[131] The first legislated tax relief came in the form of uniform exemption for

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Although these claims were successful in Oregon and North Carolina, *see, e.g.*, Bailey v. State, 500 S.E.2d 54, 60 (N.C. 1996) (holding unconstitutional a law revoking the state tax exemption for pension benefits paid by state and local governments); Hughes v. Oregon, 838 P.2d 1018, 1035 (Or. 1992) (holding the same), they were rejected in several other states. *E.g.*, Spradling v. Colo. Dept. of Revenue, 870 P.2d 521, 524 (Colo. App. 1993) (upholding the limitation of tax exemption for beneficiaries of state disability benefits against a Contracts Clause claim because "neither the statutory language nor the surrounding circumstances manifest an intent on the part of the General Assembly to create a contractual entitlement to the tax exemption"); *In re* Request for Advisory Opinion Regarding Constitutionality of 2011 PA 38, 806 N.W.2d 683, 698 (Mich. 2011) (upholding the constitutionality of a law reducing or eliminating statutory tax exemption for public pension income); Pierce v. State, 910 P.2d 288, 305 (N.M. 1995) (upholding the dismissal of a class action challenging a law revoking the tax exemption for public pension benefits). The impairment argument is even less tenable in Illinois, inasmuch as, as the discussion *infra* notes 140–50 makes clear, in Illinois the pension tax exemption was neither codified as part of the pension statute, nor was it ever restricted to governmental pension payments, let alone state and local governmental pensions. As a benefit granted historically to all retirees, it cannot be described as a feature of a program for state employees, and like any other tax exemption or benefit, may be altered or removed by the legislature. Finally, the Illinois Constitution specifically provides that "[t]he power of taxation shall not be surrendered, suspended, or contracted away," ILL CONST., art. IX, §1, which would have made any attempt to protect such an exemption from revocation ultra vires.

127. I use the term "seniors"—and not "retirees"—deliberately. Most of the early instances of tax relief were linked to age (sixty-five plus) and not employment (or former employment) status.

128. Karen Smith Conway & Jonathan C. Rork, *The Genesis of Senior Income Tax Breaks*, 65 NAT'L TAX J. 1043, 1045 (2012).

129. *Id.* (describing Vermont's exclusion in 1931 as "due to an oversight rather than a deliberate action").

130. *Id.* at 1046. It appears that the ruling was, or speedily became, controversial within the Treasury Department. *See id.* (citing U.S. Treasury Dep't, Div. of Tax Research, *Individual Income Tax Exemptions*, *in* TAX STUDIES 8–17 pt. 10, at 26 (1947)) (discussing the problems associated with such exceptions).

131. *Id.* at 1046 n.7.

seniors that was not tied to the source of the senior's income.[132] The Chairman of the Ways and Means Committee, Harold Knutson, began pushing for the federal income tax to include a special $500 exemption for persons over the age of sixty-five in 1945,[133] although it was not added to the Internal Revenue Code until the passage of the Revenue Act of 1948.[134] Vermont preceded the federal government by one year, adding a $500 exemption in 1947, the same year it revised its income tax base to include pension income.[135]

Once the federal government adopted the senior exemption, states began following suit. First was Colorado, the home of the chief sponsor of the Senate bill containing the exemption, enacting a senior exemption of $750.[136] By 1960, fifteen states and the District of Columbia had adopted some form of senior exemption, credit, or deduction.[137] Additional states included such provisions in the design of newly adopted income tax systems.[138] The practice is now virtually universal.[139]

States started adopting pension-specific exclusions in the 1970s. Illinois was among the first.[140] When it adopted its first income tax in 1969, it treated pensions as a form of investment income, taxable to the extent their value had been generated after the August 1, 1969 enactment of the tax.[141] This cut-off date was removed in 1971, permanently exempting pensions from the tax base.[142] There was little or no discussion of this change at the time, suggesting it may have been

132. *Id.* at 1047.

133. *Id.*

134. Revenue Act of 1948, Pub. L. No. 471, 62 Stat. 110 (1948) ($600 exemption); Conway & Rork, *supra* note 128, at 1047.

135. Conway & Rork, *supra* note 128, at 1047 (finding "no evidence" of a relationship between the adoption of the exemption and the inclusion of pension income in the tax base).

136. *Id.* at 1048, 1050 tbl.1 (indicating that Colorado adopted the senior exemption in 1948).

137. *Id.* at 1049; *see id.* fig.2A (identifying the adoption of a senior exemption by state and year).

138. *Id.* at 1049. Illinois was included in this group; the state adopted its first income tax in 1969. *Id.*

139. *See id.* ("By 1980, 90 percent of states with income taxes had an exemption/deduction/tax credit for the elderly.").

140. *See id.* at 1053 (noting that Illinois adopted its pension exemption in 1969 after Delaware, Hawaii, and Maryland). There were two earlier, and short-lived, pension exemptions. Vermont excluded pensions from its income tax base from 1931–1947, when it enacted a senior exemption. *Id.* at 1051. Delaware excluded pensions from its income tax base from 1947–1953. *Id.* Hawaii exempted pensions from its income tax beginning in 1953. *Id.* In 1965, Maryland began excluding pensions in an amount up to the maximum possible social security benefit. *Id.* at 1053.

141. *Id.*

142. *Id.*

viewed as a simplification device.[143]

Shortly after Illinois adopted its exemption, however, other states began adopting their own pension exemptions[144] in a deliberate attempt to attract pensioners.[145] Pensioners were regarded as desirable citizens, because the federal government covered most of the costs of servicing their needs and they neither need schools nor occupy expensive prison space.[146] Yet few states then provided, or today provide, exclusions that are as generous as the exclusions Illinois provides. Only four other states exempt all retirement income from their tax base,[147] although ten exempt all governmental pensions from income.[148] Six states and the District of Columbia tax out-of-state pensions more heavily than distributions from federal or in-state governmental plans.[149] Fourteen states and the District of Columbia fully tax private pension income.[150]

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143. *See id.* (proposing that the limitation may have been removed to simplify and expedite the state's taxation).

144. *See id.* ("[W]idespread diffusion of pension exemptions did indeed begin around 1972.").

145. *E.g.*, NAT'L CONFERENCE OF STATE LEGISLATURES, *supra* note 124, at 1 ("State policies on retirement income exclusions vary greatly, but have one or both of two purposes: to protect the income of taxpayers who are no longer in the workforce, and to serve as an economic development tool by attracting retired people to, or retaining them in, a state."); Conway & Rork, *supra* note 128, at 1066 (noting that while the first few states seemed to adopt pension exemptions "due to oversights, legal expediency or . . . accidental breaks already in place[,]" states began to use the exemptions as "weapon[s] of policy competition.").

146. Conway & Rork, *supra* note 128, at 1052 ("This chronology of federal expenditure programs demonstrates how the needs of the elderly . . . were systematically taken over by the federal government such that by 1972 the vast majority of these needs were met by the federal rather than the state government. Such a shift in responsibilities could have the effect of making the elderly as a whole—not just the very rich—valuable to a state."); *id.* at 1056 ("In sum, our investigation into the history of federal and state income tax breaks for the elderly suggests that the first tax breaks were due to oversights, but that they ended up lending justification for more tax breaks . . . [and the pension exemption] has become a weapon of policy competition.").

147. NAT'L CONFERENCE OF STATE LEGISLATURES, *supra* note 124, at 3 (identifying the four states as Alabama, Hawaii, Pennsylvania, and Mississippi).

148. *Id.* at 2 (noting the ten states as Alabama, Hawaii, Illinois, Kansas, Louisiana, Massachusetts, Michigan, Mississippi, New York, and Pennsylvania).

149. *See id.* at 5–13 (itemizing in table form each state's treatment of retirement income). The six states are: Arizona, Idaho, Kansas, Louisiana, New York, West Virginia, and the District of Columbia. *Id.* Michigan and Massachusetts tax out-of-state governmental pensions less favorably than in-state pensions unless the source state extends reciprocal treatment to their pensioners. *Id.* at 8. States that exempt pensions paid by their own state plans must also exempt pensions paid by the federal government. *See* Davis v. Mich. Dep't of Treasury, 489 U.S. 803 (1989) (holding that the Michigan statute taxing federal retirement benefits and not state government retirement benefits violated the Public Salary Tax Act). They are not, however, required to exempt pensions paid by other states' governmental plans, and, as noted above, some continue to treat out-of-state plans less favorably.

150. NAT'L CONFERENCE OF STATE LEGISLATURES, *supra* note 124, at 5–13 (including Arizona, California, Connecticut, Idaho, Indiana, Kansas, Massachusetts, Minnesota, Nebraska, New Mexico, North Dakota, Rhode Island, Vermont, and West Virginia).

Many of the exclusions are capped.

B. Does the Exclusion Make Sense?

The justification for granting income tax favors to seniors (and pensions) has always been less than clear-cut,[151] and in today's economic conditions, may be perverse. In absolute terms, the elderly are now better off than younger workers. They are, for example, less likely to be living in poverty.[152] They are also wealthier.[153] Although the elderly may not be able to compensate for financial adversity by seeking employment, as can many younger people,[154] all but the very oldest[155] probably have a higher standard of living than younger taxpayers with equivalent incomes.[156] Employment costs, such as

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151. *See* Conway & Rork, *supra* note 128, at 1044 ("[O]ur research suggests that these tax breaks . . . appear to have accidentally made their way into the tax code; once in place, however, their diffusion—especially that of pension exemptions—appears driven by competitive and political factors.").

152. *See* Judith A. Seltzer & Jenjira J. Yahirun, *Diversity in Old Age: The Elderly in Changing Economic and Family Contexts*, *in* DIVERSITY AND DISPARITIES: AMERICA ENTERS A NEW CENTURY 270, 280 (John R. Logan ed., 2014) ("In 1970 the elderly were much more likely to be poor than were children, with about 16 percent of those under eighteen living in poverty compared to 27 percent of those who were at least sixty-five years old. By the end of [2009], almost 19 percent of children were poor compared to slightly less than 10 percent of the elderly . . . ."); Richard Fry et al., *The Old Prosper Relative to the Young: The Rising Age Gap in Economic Well-Being*, PEW RESEARCH CTR. 1, 5 (Nov. 7, 2011), http://www.pewsocialtrends.org/files/2011/11/WealthReportFINAL.pdf (showing a higher percentage of households headed by adults younger than thirty-five in poverty in 2010 than those headed by adults ages sixty-five or older); *Young, Underemployed and Optimistic: Coming of Age, Slowly, in a Tough Economy*, PEW RESEARCH CTR. 1, 2 (Feb. 9, 2012), http://www.pewsocialtrends.org/files/2012/02/young-underemployed-and-optimistic.pdf ("In a 2004 Pew Research survey, similar shares of young adults (50%), middle-aged adults (52%) and older adults (50%) rated their personal financial situation 'excellent' or 'good.' By 2011, a large gap had opened up between older adults and everyone else . . . .").

153. Although older households should have greater wealth than younger ones, because they should have accumulated retirement savings, the wealth disparity has grown over time. In 1984, the median net worth of households headed by adults aged sixty-five and older was ten times that of households headed by adults younger than thirty-five; in 2009, the ratio was forty-seven times. *See* Fry et al., *supra* note 152, at 1 (noting the widening gap of median net wealth between the age groups).

154. This inability is often cited as grounds for providing tax favors to seniors. Conway & Rork, *supra* note 128, at 1047–48 (citing the proponents of federal tax relief for seniors in 1948).

155. The oldest old may suffer from severe disabilities requiring extensive and expensive care. *See* Jonathan Barry Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, 21 ELDER L.J. 375, 380 (2013) ("The poverty rate increases with age. . . . Disability and institutionalization generally increase with age.").

156. *See* Alicia H. Munnell et al., *The National Retirement Risk Index: An Update*, CTR. FOR RET. RESEARCH AT B.C., Oct. 2012, at 2, *available at* http://crr.bc.edu/wp-content/uploads/2012/11/IB_12-20-508.pdf ("People clearly need less than their full pre-retirement income to maintain [their pre-retirement standard of living] once they stop working since they pay less in taxes, no

commuting costs, can be quite high. Moreover, many younger workers support dependents, whose expenses far outstrip the limited tax relief provided for them.

Nor is it clear that the income of retirees is any more "fixed" than that of many workers. A large part of most seniors' income, social security, is automatically adjusted for inflation.[157] Worker salaries are not automatically adjusted for inflation, and in the last ten years, many workers—and especially poor workers[158]—have seen their wages grow by less than the rate of inflation.[159] Nor is it necessarily easy for younger workers to increase their incomes by working more hours or taking another job. In fact, many already work two jobs.[160] Others have few job skills, or have skills that are no longer in demand. In

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longer need to save for retirement, and often have paid off their mortgage.").

157. About fifty-five percent of the income derived by households headed by adults aged sixty-five and older comes from social security. *See generally* Seltzer & Yahirun, *supra* note 152. Social security benefits have been automatically adjusted for inflation since 1975. Alicia H. Munnell & Dan Muldoon, *The Impact of Inflation on Social Security Benefits*, CTR. FOR RET. RESEARCH AT B.C., Oct. 16, 2008, at 1, *available at* http://crr.bc.edu/wp-content/uploads/2008/10/ib_8-15.pdf (noting that "keeping pace with inflation is one of the attributes that makes Social Security benefits such a unique source of income," but pointing out ways in which this inflation protection is undermined by Medicare premium increases and income taxes); *Cost-of-Living Adjustment: History of Automatic Cost-of-Living Adjustments*, SOC. SEC. ADMIN., http://www.ssa.gov/news/cola/automatic-cola.htm (last visited Apr. 26, 2015). As discussed below, state and local government employees may not be covered by social security. However, some state pension plans provide more generous cost of living increases than does social security.

158. David Leonhardt & Kevin Quealy, *U.S. Middle Class No Longer World's Richest*, N.Y. TIMES, April 23, 2014, at A1, A14 ("Among the poor, incomes in the United States have declined or stagnated in real terms after 1980 [and] . . . per capita income has declined between 2000 and 2010 at the 40th percentile, as well as at the 30th, 20th, 10th, and 5th.").

159. Alec Friedhoff & Howard Wial, *Work*, *in* BROOKINGS METRO. POLICY PROGRAM, STATE OF METROPOLITAN AMERICA, 118, 119 (2010), *available at* http://www.brookings.edu/~/media/research/files/reports/2010/5/09%20metro%20america/metro_america_report.pdf ("From 1999 to 2008, the inflation-adjusted earnings of high-wage workers grew by 3.4 percent. This occurred while hourly earnings for middle-wage workers fell by 4.5 percent and the wages of low-wage workers fell by an even greater 8.3 percent."); Jonathan Weisman, *Economic Yields Few Benefits for the Voters Democrats Rely On*, N.Y. TIMES, May 20, 2014, A14 ("Income for households in the exact middle of the income distribution declined 4.26 percent from 2009 to 2012. . . . [P]retax income for the top 1 percent grew by 31 percent over that same time frame. The other 99 percent saw income growth of 0.4 percent."); Tom Kertscher, *Even Adjusting for Inflation, Most Americans' Wages Haven't Increased in Over 10 Years?*, POLITIFACT WIS. (Feb. 23, 2014, 5:00 AM), http://www.politifact.com/wisconsin/statements/2014/feb/23/barack-obama/even-adjusting-inflation-most-americans-havent-see/ ("So, the inflation-adjusted median wage during the final quarter of 2013 was $334—$1 lower than during the final quarter of 1999, more than a decade earlier."); *The Lost Decade of the Middle Class*, PEW RESEARCH CTR. 1 (Aug. 22, 2012), http://www.pewsocialtrends.org/2012/08/22/the-lost-decade-of-the-middle-class/ ("Since 2000, the middle class has shrunk in size, fallen backward in income and wealth . . . .").

160. *See* Weisman, *supra* note 159 ("Nearly 6.7 million people reported holding multiple jobs as Americans prepared to vote in 2010. That number now tops more than seven million.").

today's economy, many workers are unemployed or underemployed.[161] Indeed, seniors now have a lower poverty rate than younger workers.[162]

Having said that, it must be acknowledged that the standard of living enjoyed by many retirees' may be lower than the one they enjoyed during their working years. Pensions (including social security), after all, are rarely intended to replace 100% of a worker's former salary.[163] Additional retirement funds are supposed to come from private savings.[164] Private savings equalize living standards at both ends. Money that is diverted to savings cannot be used to improve one's lifestyle during one's working years, thus lowering the baseline for comparing post-retirement living standards. Dissaving during retirement provides funds to improve one's living standards in those years. People who failed to accumulate private retirement savings—and that includes many Americans[165]—thus face a diminished standard of living in retirement.

However, there is no reason current workers should compensate past workers (by paying higher taxes) for failing to save for retirement. The necessary tax increases would make it harder for current workers both to save for their own retirements, and to enjoy a comparable standard of

161. *See* Econ. Policy Inst., *The Great Recession: Unemployment and Underemployment*, STATE OF WORKING AM., http://www.stateofworkingamerica.org/great-recession/ unemployment -and-underemployment/ (last visited Apr. 26, 2015) ("Around 27 million workers—roughly one out of every six U.S. workers—are either unemployed or underemployed."); News Release, Bureau of Labor Statistics, Household Data: Table A-15. Alternative Measures of Labor Underutilization (Jan. 9, 2015), *available at* http://www.bls.gov/news.release/empsit.t15.htm (showing twelve percent of U.S. workers "unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force" as of August 2014).

162. *See generally* Seltzer & Yahirun, *supra* note 152.

163. And indeed, median income for households headed by the elderly ($43,401) is lower than that of all households ($57,297); households headed by adults aged forty-five to fifty-four ($70,118) and fifty-four to sixty-four ($69,847) are considerably higher. Fry et al., *supra* note 152, at 20.

164. Not surprisingly, households headed by adults aged sixty-five and older have the highest median net worth. *Id.* at 2. Moreover, the wealth gap between younger and older households is expanding. *Id.* at 1 (noting that the median net worth by households headed by adults aged sixty-five and older ten times that of households headed by adults younger than thirty-five in 1984; by 2009, it was forty-seven times).

165. Approximately thirty-five percent of Americans over age sixty-five rely entirely on social security for their income, and thirty-six percent of Americans do not save anything for retirement. *Retirement Statistics*, STATISTICS BRAIN, http://www.statisticbrain.com/retirement-statistics/ (last visited Apr. 26, 2015). However, eighty-two percent of Americans over the age of fifty-five claim to have saved money for retirement. EMP. BENEFIT RESEARCH INST. & GREENWALD & ASSOC., 2014 RCF FACT SHEET: AGE COMPARISONS AMONG WORKERS 1 (2014), *available at* http://www.ebri.org/pdf/surveys/rcs/2014/RCS14.FS-4.Age.Final.pdf.

living in their younger years.[166] Indeed, current workers could end up providing seniors with a higher standard of living in retirement than they themselves are likely to enjoy at any point in their lives. Moreover, current workers will inevitably end up paying (at least in the state of Illinois) for a large portion of the governmental benefits received by the earlier generation anyway since the taxes generated by taxing retirement income will not come close to financing the accumulated pension shortfall. From a redistributive perspective then, it is hard to defend forcing younger workers to compensate older workers for the entirety of their overspending, both personal and governmental.

If there is any argument for exempting retirement income from the base of the state income tax, it must be the competitive one. If one fears that including retirement income in the base of the state income tax will cause retirees to leave or avoid coming to the state, the state treasury (and younger workers) might be a net loser. It depends on whether the benefits (including the benefit of paying other forms of Illinois tax, such as property and sales tax) of having retirees in the state exceed the costs of servicing them. While it is true that seniors rarely have children still in need of expensive school services, seniors are hardly maintenance free. Like other residents, they benefit from fire protection and police services, roads and public transit, and myriad other public services. And it is unclear that including retirement income in the income tax base would impel many retirees to move out of state, as many attractive retirement destinations include some or all pension income in the base of their income taxes; moreover, many retirees prefer to stay within their existing social and kinship networks rather than move away.[167]

166. *See* Seltzer & Yahirun, *supra* note 152, at 270 ("Within families the economic welfare of the oldest generations has improved compared to the welfare of the younger generations."); Jeanna Smialek, *Lean Nest Eggs for Gen X as Wealth Lags*, CHI. TRIB., July 2, 2014, 2.5 ("Gen Xers might have to live on just half their pre-retirement income, compared with 60 percent for the baby boom generation. . . . 'They are not doing well relative to the last generation.'"); Fry et al., *supra* note 152, at 1 ("Households headed by older adults have made dramatic gains relative to those headed by younger adults in their economic well-being over the past quarter of a century."); Munnell et al., *supra* note 156, at 6 ("Today's working households will be retiring in a substantially different environment than their parents did. The length of retirement is increasing as the average retirement age hovers at 63 and life expectancy continues to rise. At the same time, replacement rates are falling. . . . The NRRI shows that, as of 2010, more than half of today's households will not have enough retirement income to maintain their pre-retirement standard of living, even if they work to age 65 . . . and annuitize all of their financial assets . . . .").

167. In general, the level of state taxes has little impact on most Americans' interstate moves. Michael Mazerov, *State Taxes Have a Negligible Impact on Americans' Interstate Moves*, CTR. ON BUDGET & POL'Y PRIORITIES 1 (May 21, 2014), http://www.cbpp.org/files/5-8-14sfp.pdf; *see* Karen Smith Conway & Jonathan C. Rork, *No Country for Old Men (Or Women)—Do State Tax Policies Drive Away the Elderly?*, 65 NAT'L TAX J. 313, 315 (2012) ("Our results are

If the state legislature is truly concerned about competitiveness for senior citizens, though, it might be more productive to think about options for how to tax retirement income rather than whether to tax retirement income. As the discussion below reveals, a tax on retirement income can be structured in a way that minimizes the dangers posed by retirees leaving the state, though doing so would be far from easy.

C. Structuring the Taxation of Retirement Income

Assuming the sole obstacle to imposing a tax on the retirement income of Illinois retirees is the fear that doing so will encourage retirees to leave for more tax favored climes, Illinois could structure this tax to minimize the benefits of leaving the state. Unfortunately, the easiest mechanism for doing so is out of reach, due to federal law. It would be convenient if Illinois could tax residents on their retirement income (with a credit for income taxes, if any, paid to a source state on income attributable to employment outside the state) and nonresidents on any retirement income earned through the performance of services in Illinois.[168] Illinois employees would not be able to escape such a tax on their retirement income by moving to a lower tax state; indeed, the tax could be effectuated through a withholding tax imposed on the retirement payment at source, just like wage withholding is imposed on salary income.

Unfortunately, in 1996, Congress enacted Public Law 104-95,[169] which makes this alternative impossible. This law prohibits state taxation of the retirement income of nonresidents.[170] The fact that this

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overwhelming in their failure to reveal any consistent effect of state tax policies on elderly migration across state lines.").

168. This is, incidentally, how wage income is taxed.

169. Act of Jan. 10, 1996, Pub. L. No. 104-95, § 114, 109 Stat. 979 (1996) (codified as 4 U.S.C. § 114).

170. 4 U.S.C. § 114(a) (2012). This law was enacted in response to earlier efforts by other states to tax such income. *Federal Statute Enacted Prohibiting State Income Taxation of Certain Pension Income of Nonresidents*, STATE & LOCAL TAX BULL. (Pillsbury Winthrop Shaw Pittman LLP., New York, N.Y.), Feb. 1996, *available at* http://www.pmstax.com/state/bull9602.shtml. The "prime mover behind this legislation" was the congressional delegation of a destination state, Nevada. *Id.* The income covered by the legislation includes "most qualified and tax-favored plans under the Internal Revenue Code. Also exempt is 'any plan, program, or arrangement described in section 3121(v)(2)(C)' of the I.R.C. if the income from such plan, program, or arrangement is part of a series of substantially equal periodic payments (not less frequently than annually) made for either the life or life expectancy of the recipient or a period of not less than 10 years." Timothy P. Noonan, *The Ins and Outs of New York Nonresident Allocation Issues*, 55 STATE TAX NOTES 439, 440 (2010); *see* Jean M. Klaiman, *Take the Money and Run: State Source Taxation of Pension Plan Distributions to Nonresidents*, 14 VA. TAX REV. 645, 647–49 (1995) (discussing the inner workings of nonresident pension plans and the advantages for which individuals use them); *cf.* Walter Hellerstein & James C. Smith, *State*

simple alternative is unavailable does not mean, however, that nonresident retirees' retirement income cannot be taxed at all. What it does mean is that a state's regime for taxing such retirement benefits must be more convoluted. The tax must be imposed before the resident leaves the state. The way to do that is to tax pension contributions rather than—or in addition to—taxing pension distributions.[171]

If the state wants to maintain—for state income tax purposes—the level of tax favoritism granted to such plans under federal tax law, it can require all contributions made to retirement plans on behalf of Illinois employees to be included in the income tax base in the year such contributions are made while excluding all distributions from the tax base.[172] This may not be easy, but it is possible.

As a technical matter, it is relatively simple to determine on an annual basis the amount of contributions made to an employee's account under a defined contribution plan.[173] Employees benefiting from such plans have individual accounts and receive periodic reports of the contributions to such accounts. Employer contributions could be added to employees' wages[174] on their information returns, and the

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Taxation of Nonresidents' Pension Income, 56 TAX NOTES 221, 223 (1992) ("States plainly possess the power, under the Due Process Clause, to tax income derived from sources within the State, even if the income is recognized years later when the taxpayer no longer has any connection with the state . . . .").

171. Obviously, as discussed below in *infra* notes 179–92 and accompanying text, should the state decide to tax distributions as well as contributions, to avoid double taxing pension income it would have to allow recipients an offset for taxes paid with respect to those contributions.

172. This would mimic the tax treatment of contributions to Roth IRA accounts. *See* I.R.C. § 408A(c)(1) (2012) (disallowing deductions for contributions to such accounts); *id.* § 408A(d)(1) (excluding distributions from income). If one assumes constant tax rates and normal rates of return, this tax treatment is indistinguishable from that accorded other qualified pension plans for which a deduction for contributions is allowed up-front and distributions are fully taxable; both exclude the investment return on the contributed assets from tax. Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 825 (2005) ("[T]he equivalence of the prepaid and postpaid consumption taxes . . . holds under just two seemingly innocuous conditions, constant tax rates and constant rates of return."). In the real world, though, not only do tax rates change but "'windfall' or 'inframarginal' returns to capital" exists as well, and in many of those situations, a tax payable on distributions rather than on contributions is preferable. *Id.* at 827.

173. Indeed, it may be simpler to determine the amount of contributions attributable to services provided in a given state than distributions attributable to such service. One of the justifications proffered for restricting source state taxation of pension distributions was the difficulty inherent in determining the source of pension income received by retirees who had worked in multiple jurisdictions. Klaiman, *supra* note 170, at 662–63.

174. Alternatively, employers may be denied a deduction for such contributions. *Id.* at 666. The revenue consequences would be the same if the employer's tax rate matched that of its employees. However, even if that were true (and often it would not be—many employers are either tax-exempt or generate losses, eliminating their tax liability), the political optics (an additional tax levied on local businesses) would probably be unacceptable.

deduction eliminated for employee contributions.[175] The only difficult issue is deciding whether the taxes due on such contributions should be payable out of the retirement accounts, in the form of (at least for employer contributions) a lower contribution accompanied by additional tax withholding from funds that otherwise would have been directed into the accounts, or whether employees should be faced with paying the entirety of the tax on the diverted income out of other funds. Requiring employees to pay these taxes out of other income or funds would certainly be easier from a mechanical point of view and would maximize the amount of funds deposited in such accounts.[176] However, employees may lack the liquidity to bear the full cost of the tax out of current salary,[177] and prefer to pay some of it by reducing the amount of income diverted into a retirement account. Different employees may have different preferences on this issue, and employers may be forced to choose between them. Further, if contributions are reduced in order to pay the state income tax levy, employers will have to decide whether those payments count as "contributions" for purposes of triggering an employer "match."

Taxing contributions to defined benefit plans is more difficult because employees do not gain rights to any particular contributions (or funds in a pension trust) prior to the time those funds are distributed in the form of retirement distributions. Although employee contributions to such plans can be included in their taxable income (i.e., no deduction allowed) with ease, the amount of employer contributions is (or at least should be) determined on the basis of actuarial calculations made with

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175. Many states adjust the federal income tax base for state tax purposes by "adding in" items (such as interest from municipal bonds) excluded or deducted from federal taxable income; retirement contributions could be just another addition.

176. The rate of withholding on cash salary, for example, might be increased to ensure that such taxpayers do not arrive at the end of the tax year with a large, outstanding tax liability. By contrast, using money from the retirement account to pay taxes due on a contribution could have unwelcome federal tax consequences. The money so used would probably be treated for federal tax purposes as a "distribution" from the account, which not only would be includable in federal taxable income but, depending on the age of the employee, might also be subject to an additional tax as a "premature distribution." This is the treatment accorded funds withdrawn from traditional IRAs, which are used to pay the income taxes due upon the conversion of the traditional IRA to a Roth IRA. *See* Marvin Rotenberg, *Roth IRA Conversion 10% Penalty Trap*, SLOTT REP. (Jan. 18, 2011), https://www.irahelp.com/slottreport/roth-ira-conversion-10-penalty-trap (noting that funds used to pay taxes due on conversion to Roth IRA "are not actually converted to the Roth, so they will be subject to the 10% penalty, in addition to income tax, when the consumer is under the age of 59 ½").

177. Klaiman, *supra* note 170, at 666–67 ("[I]ncluding pension plan contributions in adjusted gross income at the time of the contribution would place economic hardships on employees, be seen as a tax increase, and contradict federal tax policies aimed at encouraging pension plan contributions.").

reference to its entire workforce and is not, in the first instance, allocable to any particular employee.[178] Thus, it would be difficult, if not impossible, to back out the contribution made on behalf of particular employees for purposes of including such amounts in their income for tax purposes. As a practical matter, this means that any tax on employer contributions to such plans will likely have to be paid by the employer.

However, this raises additional issues. For example, the state would have to decide what rate to apply. The easiest way to effectuate such a tax would be to eliminate the employer's deduction for such contributions, which would have the effect of taxing the contributions at the employer's tax rate. Given that some employers are tax exempt or incur losses, this leaves open the possibility that the tax would not raise any revenue, defeating the point of the tax. The alternative would be to mandate a specific tax rate at which contributions would be taxed, a rate that approximates employees' tax rate. While that would generate additional money for the state, this additional tax payment effectively serves as a salary increase for the employees unless their employers can negotiate offsetting reductions in their cash salaries—especially if the tax on contributions is part of a two part tax, with taxes levied both on contributions as made and on distributions, as discussed *infra* notes 183–92 and accompanying text, and retirees are allowed either a credit or exclusion for amounts previously taxed in the hands of the employer.[179] Indeed, without such an adjustment, state employees would be held harmless from any tax imposed on their retirement contributions,[180] while the tax would become an additional tax on private employment in Illinois![181] Multistate employers operating defined benefit plans will confront an additional problem in that they will have to determine which portion of their contribution is attributable to services performed by Illinois employees and which to employees

178. Though this is certainly true of traditional defined benefit plans, under some variants of these plans—such as "cash balance plans"—individual allocations may be a realistic possibility.

179. It is unclear, however, how such an attribution would be made.

180. The state, as the employer, would be responsible for paying the tax on the contribution (to itself—so this would be a wash); if the tax "paid" then reduced the amount of tax payable on the retirement distribution in the year of said distribution, the state would derive no tax revenues even though a tax was "imposed" on these contributions.

181. Given the diminution in active defined benefit plans maintained by private employers, this may not be a significant problem. *See* William J. Wiatrowski, *The Last Private Industry Pension Plans: A Visual Essay*, BUREAU OF LABOR STATISTICS: MONTHLY LABOR REV., Dec. 2012, at 3 ("In 2011, only 10 percent of all private sector establishments provided defined benefit plans, covering 18 percent of private industry employees. . . . In addition to the decline in coverage, recent trends among these plans reflect employer decisions to convert to cash balance plans or limit future accruals.").

rendering services in other states.

Contributions would be taxed in the year, and in the amount, made. If a pension trust runs short of the funds necessary to pay promised benefits, any funds contributed by an employer to make up the deficit would be treated as additional, taxable contributions to the trust.[182]

In the short run, of course, merely taxing contributions to pension plans would not raise much in the way of tax revenue—and certainly not from the right people—for the simple reason that the bulk of the pension contributions that will be used to finance the retirement benefits paid to the baby boom generation have already been made.[183] Unless the contributions tax is explicitly made retrospective, past contributions will escape the tax. Thus, for a transitional period at least, Illinois will need to impose a tax on pension distributions as well as contributions. To avoid double taxation, of course, this tax on distributions would need to take into account any taxes previously paid on contributions. The question then becomes how this should be done. Several alternative mechanisms exist, with different practical and theoretical implications.

The choices again are both easier to implement and to understand in the context of defined contribution plans rather than defined benefits plans. If Illinois wants to replicate the tax treatment of Roth Individual Retirement Arrangements ("Roth IRAs") at the federal level, employees would need to set up separate retirement accounts to hold contributions on which the Illinois tax had been paid—just as they need to set up separate accounts to distinguish between Roth IRAs and regular IRAs. Distributions from the taxed contribution accounts would be exempt from further Illinois taxation, while distributions from the other account would be fully includable in income, assuming the retiree still lived in Illinois.

Suppose, however, that Illinois concludes that the federal tax benefit for retirement savings is sufficient, and it should tax the investment income derived from the investment of taxed pension contributions just

182. If the employer's contributions relate to benefits payable to employees located in many states, the contribution would have to be allocated between them.

183. Large numbers of the baby boom generation have already retired, and thus have ceased adding to their retirement accounts. Others have only a few working years left in which to make contributions. *See* Matthew Boesler, *Here's What's Really Going On With Baby Boomers and The Labor Force*, BUS. INSIDER (Feb. 24, 2014, 4:28 AM), http://web.archive.org/web/2014 1113224915/http://www.businessinsider.com/baby-boomers-are-retiring-2014-2 ("Millions of 'baby boomers'. . . have retired from the workforce over the past six years."); Tom Sightings, *12 Baby Boomer Retirement Trends*, U.S. NEWS & WORLD REP. MONEY (July 22, 2014 11:05 AM), http://money.usnews.com/money/blogs/on-retirement/2014/07/22/12-baby-boomer-retirement-trends ("[P]eople born between 1946 and 1964, are starting to turn 65 and beginning to retire in droves. . . . About 65 percent of workers retire by the time they turn 65.").

as it taxes other investment income. It would have two options. One would be to tax this investment income on a yearly basis, i.e., to include in employees' taxable income each year that year's increase in the value of their retirement account(s). Distributions would be includable only to the extent they exceeded the amount previously taxed.[184] Minimizing the tax on distribution minimizes the benefits of moving to another state upon retirement, but accelerating the tax burden may create liquidity issues for employees, particularly given federal restrictions on premature withdrawals from pension accounts.[185] These liquidity concerns can be dealt with through advance planning, but may require a degree of financial expertise that is beyond that possessed by most workers.

Taxing retirement distributions, rather than the yearly increases in account balances, solves these liquidity concerns. To avoid duplicative taxation of already-taxed contributions, the state either can exclude from income an amount equal to such already taxed contributions or allow the taxpayer to claim a tax credit for taxes paid with respect to earlier contributions.[186] Providing an exclusion leaves the taxpayers indifferent as to interim changes in tax rates, while the tax credit option leaves taxpayers at risk for payment of an additional tax (or tax benefit) should the tax rate change between the year in which a contribution was taxed and when it was distributed back to the retiree.[187] Both of these

184. The tax on distributions would pick up any as-yet untaxed contributions. A variation on this approach would tax employees on only the income and realized gains in their retirement accounts, comparable to the treatment of investors in mutual funds.

185. Withdrawals before a taxpayer reaches the age of 59.5 trigger a ten percent penalty tax in addition to being included in income and being subjected to income tax at ordinarily applicable rates. *See* I.R.C. § 72(t) (2012).

186. Of course, the taxpayer should be allowed only one opportunity to exclude a contribution, or claim credit for a tax payment. For example, suppose an individual has a section 401(k) account with a balance of $100,000, of which $20,000 was taxed (included in income) in the year it was contributed to the account. If the individual takes $15,000 out of the account in the year immediately after retirement, the entire amount should be excluded from his taxable income. However, if, in the following year, that individual takes another $15,000 out of the account, he should include $10,000 of that second distribution in his income.

187. If taxpayers were granted a dollar-for-dollar credit for previously paid taxes and tax rates increased in the interim between the contribution and the distribution, in the year of the distribution, the taxpayer would have to pay the difference between the tax paid with respect to the contribution in the earlier year and the amount of taxes due on that amount of the distribution in the later year. For example, suppose the taxpayer paid $20 of taxes with respect to a $100 contribution in year one, and in year fifteen, a year in which he was in a twenty-five percent marginal tax bracket, he received that $100 back as part of a retirement distribution. His $20 tax credit would offset only part of the taxes due on that distribution; he would owe an additional $5 in tax. Of course, if his marginal tax rate in year fifteen was fifteen percent, unless his tax credit was limited, he would have $5 of credits to offset taxes due on other portions of his retirement distribution.

options, though, would favor retirees who move to lower-tax states at retirement, as Illinois cannot impose the distribution tax on non-residents.[188] Even the annual taxation option fails to completely eliminate the incentive for moving to a lower tax jurisdiction, though, because post-move increases in value—created by post-move investment earnings—would escape the Illinois tax net.[189]

Designing a transitional (or more than transitional) tax on distributions to employees covered by defined benefit plans such as the various Illinois state pension plans poses more difficultly, for the same reasons taxing contributions to such plans is more difficult. As mentioned above,[190] given the absence of a one-to-one correspondence between particular contributions and particular employees receiving distributions, it is hard to envision how to make such an allocation, and thus, how to avoid duplicative taxation of already-taxed contributions. It may be even harder to allocate interim increases and decreases in the value of the assets held by an investment trust for purposes of imposing a tax on yearly investment income. And again, employers with operations—or even retirees—residing in many states will face additional implementation issues.[191] Assuming such allocations can be made, however, recipients of distributions from these plans can be offered either exclusions or tax credits under rules similar to those devised for recipients of benefits from defined contribution plans. Alternatively, the distributions can be treated as annuities, with the already-taxed contributions and/or investment returns as the

188. *See supra* text accompanying notes 169–70.

189. One interesting question is whether a new state would have to grant credits or exclusions for amounts previously subject to tax in Illinois when levying its own tax on retirement distributions. The answer is not clear. *See* Klaiman, *supra* note 170, at 652–66 (defending the constitutionality of source-based pension taxation); *id.* at 655–56 ("[T]he constitutionality of a state's tax on nonresidents does not turn on the layout of another state's tax code . . . the existence or absence of tax credits in other states does not either forgive or create constitutional impediments for the state imposing the source tax."); *see also* Hellerstein & Smith, *supra* note 170, at 226 ("[S]tates generally lack the constitutional power to tax the portion of a former resident's pension income that reflects accumulations after the taxpayer's change of residence [and] must limit their taxation of nonresident pension income to the deferred employment income and the income accumulated prior to the retiree's change of residence."). The absence of such an exclusion or credit could turn even a low tax state into a high tax state for some formerly-Illinois retirees—which might encourage them to stay in Illinois.

190. *See supra* notes 179–80 and accompanying text (discussing the possibility of an attribution or tax on nonresidents obtaining pension benefits).

191. *See* Hellerstein & Smith, *supra* note 170, at 226–27 ("[I]t may be difficult, if not impossible, for a state (or for an employer with state withholding tax obligations) to determine, on a pension-check-by-pension-check basis, what proportion of the payment reflects deferred payment for serviced rendered in the state and what proportion represents investment income that accrued while the taxpayer was a nonresident of the state.").

constructive premium; these amounts could then be recovered ratably as distributions are paid.[192]

Though these protocols appear both elaborate and inelegant, in the modern world of computerized tax preparation it may turn out that their actual burden is less significant than it first appears. The most difficult part of the process for traditional defined benefit plans—determining the amount contributed to those plans on behalf of Illinois employees—will fall on sophisticated employers who already rely on actuaries in order to set up such a plan. Employers can also be required to keep records of the contributions they make to defined contribution plans, so well as of any employee contributions made to obtain employer matches. Individual taxpayers will need only to compile the amount of their contributions to their IRAs. The state could make this record-keeping easier by adding a line to tax returns requiring taxpayers to report their accrued contributions to such accounts; taxpayers could determine the number by pulling the previous year's total from last year's return and adding current-year contributions.

That said, it undoubtedly would be simpler merely to include retirement income in taxable income in full in the year it is received, as long as every other state does the same. It avoids the possibility of retirement income being subjected to two sets of state income taxes—Illinois' on the basis of source, and some other state on the basis of residence if the retiree has moved states prior to receiving the pension distribution.[193] Inasmuch as it is unclear whether substantial numbers of taxpayers really will move to other states to avoid taxation of retirement income,[194] taxing only distributions may be the preferable alternative. Even if Congress could be persuaded to revoke Public Law 104-95,[195] the statute forbidding states from taxing the retirement income of nonresidents on the basis of source, some of the technical issues described above would arise whenever employees received retirement benefits from pension arrangements derived from

192. The excludable fraction of the benefit would equal a fraction the numerator of which would be the amount of taxed contributions and the denominator of which would be the expected benefits payable under the plan. *See* I.R.C. § 79 (2012) (outlining rules for excluding portion of annuity payments attributable to return of already-taxed premium payments). This treatment is somewhat less favorable than the exclusion described earlier, because it defers some of the exclusion to later taxable periods.

193. *See supra* note 189 and accompanying text (discussing the sourced-based pension taxation). It is unclear, of course, whether Illinois ought to care about such people.

194. *See supra* note 167 and accompanying text (claiming that state taxes have only a small effect, if any at all, on whether individuals move to or from the state).

195. *See supra* note 170 and accompanying text (describing the federal statute that prohibits states from taxing retirement income of non-residents).

employment in other states. Pensions paid directly by employers under the terms of defined benefit plans for services performed wholly within Illinois might be sourced to, and thus taxable by, the state of Illinois,[196] but distributions from defined contribution plans might have to be allocated between Illinois and any new residence state. The issue of pro-ration also would arise if an individual receives taxable social security benefits, particularly if that individual worked in a state other than Illinois for part of his or her career. Recent (and future) changes in pension configurations make Public Law 104-95 seem more defensible than when it was first enacted, as the investment component of withdrawals from defined contribution plans, and thus the need for complicated source allocations, becomes more obvious.

Taxing retirement benefits raises tax revenues, but it is not the only way to deal with retirement costs. Another much simpler—but perhaps altogether too obvious—alternative is to reduce retirement costs by reducing the cash salaries (and especially cash salaries earned in the immediate pre-retirement years) of state employees. This alternative is explained in greater detail in the next Part.

III. EXPLOITING THE RELATIONSHIP BETWEEN CASH SALARIES AND RETIREMENT PAYMENTS

The pension plans maintained by the state of Illinois are what is known as "final pay" plans. Pension distributions are keyed to the amount of cash salary received by an employee in his or her last years of service.[197] The lower the cash salary during those years of service, the lower the retirement benefit. Holding the line on salary increases—or even reducing cash salaries—would both free up cash that can be used to pay down the accrued indebtedness of the pension system and reduce the amount of future accruals.

If, as some contend, state employees were "overpaid,"[198] across-the-

196. *But see* Hellerstein & Smith, *supra* note 170, at 226 ("The fact that pension payments include deferred compensation components and investment income components creates a serious practical complication in state taxation of nonresident pension income.").

197. Prior to 2011, the base for calculating annuities was the average of the employee's salary during his of her four highest paid consecutive years of service during his or her last ten years of employment. In 2011, the rule was changed for newly hired employees to the average of the highest eight years of the last ten, with a $106,800 cap (adjusted for inflation, the cap is now $110,631). Topinka, *supra* note 48, at 6 (Tier 1 versus Tier 2 Benefits). The recently passed reform ostensibly imposes that cap on all non-retired employees whose income currently falls below the cap; the cap for current employees is the greater of the new cap or their income in the year the reform bill becomes effective. The terms of this salary cap accord with federal standards of retroactivity, but not the anti-forfeiture limits previously imposed by Illinois state courts.

198. I express no opinion on this much-disputed issue. *See supra* note 122 and accompanying

board pay restrictions or pay cuts would be warranted. Whether they would be achievable is another matter entirely. Not only do the state employee unions have statewide political power, but they also have effective control over their own members and would undoubtedly engage in some adverse job action, up to and possibly including a strike.[199] Which side would prevail in a labor dispute is unclear, but a serious disruption in the delivery of public services undoubtedly would have deleterious effects on the political and economic climate in Illinois.

A more realistic possibility may be to reduce or eliminate a variety of work rule and compensation practices that allow employees to "spike" their salaries in the year leading up to their retirement. Illinois can change work rules in ways that adversely affect retirement benefits without running afoul of the Pension Protection Clause. In *Peters v. City of Springfield*,[200] the Supreme Court of Illinois held that the city was entitled to adopt an ordinance reducing the mandatory retirement age of firefighters from sixty-three to sixty, even though that reduction had the effect of preventing some firefighters from qualifying for the maximum possible pension under Illinois law. The court reasoned that "a right to work until a specified age is not a pension benefit"[201] and intimated that other changes in the terms of employment would also be acceptable, even though the changes "might affect the pensions which plaintiffs would ultimately" receive.[202] There are several changes that could be made that would have the effect of reducing some of the most scandalous abuses of the Illinois pension system.

One obvious target would be late-career salary spikes that boost pensions.[203] Although Illinois passed a law in 2011 limiting the extent

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text (elaborating on the issue of overpaid state employees while avoiding any specific stance on the topic).

199. The union representing Illinois state workers threatened to go out on strike when contract negotiations stalemated in 2013. *See* Christine Byers, *Illinois State Workers' Union Talking About Strike*, ST. LOUIS POST-DISPATCH (Feb. 24, 2013), http://www.stltoday.com/new/local/govt-and-politics/illinois-state-workers-union-talking-about-strike/article_8fe223a3-ef4e-5e95-ab50-b3a20c6f9041.htm ("[U]nion leaders say they're seriously considering the prospect [of a strike] as contract talks have stalemated . . . ."). The parties agreed on a new contract before a strike was called.

200. Peters v. City of Springfield, 311 N.E.2d 107 (Ill. 1974).

201. *Id.* at 151.

202. *Id.* ("Municipal employment is not static and a number of factors might require that a public position be abolished, its functions changed, or the terms of employment modified.").

203. *See, e.g.*, Joseph Ryan & Joe Mahr, *Retirement Perks Cost Towns Millions*, CHI. TRIB., Sept. 17, 2010, at 1.1 (recounting examples of retirement perks); Steve Schmadeke, *Police and Fire Pensions Get Padded Despite Illinois' Pension Deficit Crisis*, CHI. TRIB., July 16, 2010, http://articles.chicagotribune.com/2010-07-16/opinion/ct-met-pension-deals-20100716_1_police-

to which such spikes can be included in the base for determining an employee's pension, the limitation applies only to employees hired after the legislation's date of enactment, because it constituted a change in the pension formula.[204] For this sort of reform to have an effect in fewer than twenty years, it must take the form of an across-the-board limitation on salary increases, not pension increases. A salary limitation, unlike a change in the rules for computing pension payments, would count as a permissible change in "terms of employment."[205] For example, Illinois could forbid the payment of all bonuses or limit pay increases for individual employees to 1.5 times the average increase of all employees in their employment unit.[206] Such a change could have deleterious consequences in some situations—it could, for example, make it more difficult to retain an employee who receives a more lucrative offer of employment elsewhere—but the benefits in terms of reducing abusive behavior[207] may well outweigh those costs.

Another useful change would be to limit employees' ability to cash out of unused vacation and sick days. Such payments have also been used to "spike" final year salaries and to extend the term of covered service.[208] Current employees[209] will have to be allowed to use their

pension-illinois-pension-final-salaries/2 (recounting pay raises in Chicago Ridge, Willow Springs, Westchester, and other towns).

204. Op-ed, *The Pension Spike Survives*, CHI. TRIB., Jan. 4, 2013, at 1.18; Ray Long, *Bill Limits Late-Career Pension Increases*, CHI. TRIB., Apr. 16, 2011, at 1.4.

205. Although no Illinois court seems to have directly ruled on this issue in the pension context, the Supreme Court of Illinois relied on precedent from New York when deciding *Peters v. City of Springfield*, 311 N.E.2d 107 (Ill. 1974), because "a similar provision is contained in the Constitution of New York and has been construed by the courts of that State." *Id.* at 151; *see* Hoar v. Yonders, 67 N.E.2d 157, 159 (N.Y. 1946) ("We find nothing in the text of article V, section 7, of the Constitution or in any State statute or local law which withholds from the appropriate official body of the City of Yonkers the power to reduce or increase the compensation which the plaintiff shall receive and which serves as the basis for computing his pension rights."). *Peters* itself seems to equate salary with length of service (which it held could be diminished through a lowering of the retirement age) without running afoul of the Pension Protection Clause. *See Peters*, 311 N.E.2d at 151 ("The firemen's pension fund formula is based on salary and length of service and obviously any change in these variables will affect the amount of the pension. . . . [A] number of factors might require that a public position be abolished, its functions changed, or the terms of employment modified.").

206. The restriction would have to apply to all employees in a unit, rather than employees on the cusp of retirement, not only to avoid the possibility of its being deemed a cutback of pension benefits but also to avoid being struck down as a violation of the federal Age Discrimination Act.

207. *See supra* note 203 and accompanying text (describing articles detailing situations in which insiders granted other insiders last-minute salary increases to boost retirement annuities).

208. *See* Schmadeke, *supra* note 203 (recounting examples of retirement perks).

209. The Pension Reform Act already prevents employees hired after its effective date from using sick or vacation time towards pensionable salary or years of service. *See* 40 ILL. COMP. STAT. 5/7-114(a) (2012); *id.* at 5/7-116(d)(7); *id.* at 5/7-139(a)(8); *id.* at 5/9-220(a)(5).

accumulated vacation and sick days to extend their term of service, as their right to do so is part of the Pension Code and is thus protected against impairment or distribution, but steps can be taken to reduce their ability to accumulate additional days in future years. For example, the terms of the employment contracts may be changed to prevent the accumulation of vacation (and sick) days for more than a four- or five-year period, reducing the number of such days that would be available to provide additional retirement credits when employees neared retirement age.[210] Such days could be provided under a "use it or lose it" system, much like the system applicable to health benefit accounts in cafeteria plans; employees would be allowed to use those days within four or five years of when earned, or they would disappear.

Such a change would be justifiable from a policy perspective. The rationale for granting sick days, for example, is to encourage sick employees to stay home to recover and to avoid infecting co-workers.[211] Treating such days as indistinguishable from vacation days undermines that purpose and provides employees with a financial incentive to come to work when sick, as every sick day they do not use shows up as a day of compensated leisure at the end of their career. Likewise, the justification for vacation days presumably is to allow employees to avoid burning out from excess work; that purpose is not served if they fail to use the days until after their period of employment has ended. Again, these changes would be to terms of service, not strictly speaking the formula for calculating pension benefits, and should be allowable and effective under *Peters*.

Finally, limits can be placed on the amount of overtime any one employee can accumulate in a given year. Again, this may create some inconvenience or unhappiness, as it may lead to either less flexibility in the provision of services and to some mismatch between employees

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210. Currently, this use is ubiquitous. *See* Op-Ed, *Sick, Sick, Sick*, CHI. TRIB., Feb. 7, 2012, at 1.18 ("More than 300 CPS principals and administrators each grabbed more than $100,000, cashing out unused sick days and vacation days, from 2006 to 2011 . . . [while] members of the Teachers Retirement System . . . allowed to accumulate as many as 340 uncompensated sick days for up to two years of credit . . . . That allows those teachers to retire two years early with full pension benefits.").

211. *See, e.g.*, Joyce Rosenberg, *Businesses Are Split on Issue of Paid Sick Time*, SPOKESMAN REV., Apr. 7, 2013, at E-1 (stating that supporters of paid sick leave argue it "encourages employees to stay home instead of coming to work and infecting everyone around them"); *Leaders Push for Earned-Sick-Time Benefits at Hearing*, THE LOWELL SUN (Sept. 25, 2013, 6:37 AM), http://www.lowellsun.com/news/ci_24171078/leaders-push-earned-sick-time-benefits-at-hearing ("Dr. Anita Barry, director of the City of Boston's Infections Disease Bureau, said not guaranteeing paid sick leave runs counter to the advice public officials give flu patients and others infected with contagious diseases to stay at home to avoid the spread of infection. 'I would plead with you for the sake of public health to please pass this bill' . . . .").

who have to perform overtime and those who want to perform overtime. But controlling overtime can prevent excessive amounts from appearing in a worker's salary in the years in which salary is used as the basis for determining his or her pension.

These modest and dull measures can be applied to current employees in an effort to hold down—and rationalize—their pension costs. But these changes, like the inclusion of retirement benefits in the income tax base, are both too small and (perhaps) too unlikely to be adopted to provide anything close to a full solution to the Illinois pension crisis for current employees, let alone provide a solution for how to structure the employment contracts of future employees. While some state governments can successfully operate defined benefit pension plans, it is clear that Illinois' government is too dysfunctional to exercise the fiscal discipline necessary to operate such a plan. Its plans have always been grossly underfunded; indeed, a major impetus for the state constitution's Pension Protection Clause was the then current underfunding of the plans.[212] Moreover, the clause was only adopted after its supporters assured other members of the Constitutional Convention that it did not require that the affected pension plans be funded in advance.[213] But as the citizens of Illinois (and other states and localities) are learning, whether funded in advance or deferred until pension benefits have to be paid out, pension obligations require the use of funds that could otherwise be spent on providing desired (and even necessary) services. Pushing payment into the future does not lessen the pain, it breeds misconceptions about the cost of providing government services, and it interferes with the development of budgetary and political discipline. But how can Illinois get out of the defined benefit business without placing the retirement security of its employees at risk? That is the subject of the following Part.

IV. THE ALLURE OF JOINING THE SOCIAL SECURITY SYSTEM

The appeal to politicians of underfunding pension promises—like other forms of government debt—is obvious. They can claim credit for providing government services without raising taxes. That taxes will

212. *See* Shields, *supra* note 48 ("In 1970, the state's unfunded liabilities were $2.5 billion and the [retirement] system just 41.8% funded.").

213. *See* People *ex rel.* Ill. Fed'n of Teachers v. Lindberg, 326 N.E.2d 749, 752 (Ill. 1975) (citing 4 SIXTH ILLINOIS CONSTITUTIONAL CONVENTION, RECORD OF PROCEEDINGS 2893, 2929 (1972)) (responding to a question, Delegate Kinney stated: "[The Pension Protection Clause] was not intended to require 100 per cent funding or 50 per cent or 30 per cent funding or get into any of those problems, aside from the very slim area where a court might judicially determine that imminent bankruptcy would really be impairment").

have to be raised, or some other sources of government revenue found, to pay off the debt might not matter to politicians at all, so long as the unpleasantness can be deferred to a time period beyond their term of office. The short-sighted behavior of politicians is sometimes matched by the long-sighted behavior of unions, which understand that it can be easier to gain pay increases in the form of pension benefits than higher salaries, which require the outlay of current dollars funded either through immediate tax increases or more obvious forms of indebtedness.[214] The resulting moral hazard, argues at least one academic, Maria O'Brien Hylton, is grounds for eliminating the defined benefit pension plan as an option for government employers.[215] Most private employers have already switched to defined contribution plans,[216] and governmental entities should follow suit, it is argued,[217] at least to the extent legally permissible.[218]

However, there is a difference between employees of private companies and employees of state and local governments. Employees of private companies are covered by social security, which provides them with a backstop against destitution.[219] A quarter of state and local

214. In fairness to the unions representing Illinois state employees, it should be pointed out that they tried over the years to force the Illinois state government to fully fund its pension promises, which would have brought the cost of these promises to public attention. However, the courts have held that the Pension Protection Clause did not provide them with grounds for such a suit. *See supra* note 66 and accompanying text (listing cases).

215. Maria O'Brien Hylton, *Combating Moral Hazard: The Case for Rationalizing Public Employee Benefits*, 45 IND. L. REV. 413, 464 (2012) ("[I]t combats the moral hazard problem directly.").

216. BARBARA A. BUTRICA & NADIA S. KARAMCHEVA, CTR. FOR RETIREMENT RESEARCH AT B.C., AUTOMATIC ENROLLMENT, EMPLOYEE COMPENSATION, AND RETIREMENT SECURITY 2 (2012), *available at* http://crr.bc.edu/wp-content/uploads/2012/11/wp_2012-25-508.pdf ("Between 1989 and 2012, the proportion of private industry full-time workers participating in DB pension plans declined from 42 to 20 percent, while the share participating in DC plans increased from 40 to 51 percent . . . ."); *FAQs About Benefits—Retirement Issues*, EMP. BENEFIT RESEARCH INST., http://www.ebri.org/publications/benfaq/index.cfm?fa=retfaq14 (last visited Apr. 26, 2015) (discussing that in 2011, thirty-one percent of all private-sector workers participated only in a defined contribution plan and three percent participated only in a defined benefit pension plan; eleven percent had both a defined benefit and defined contribution plan).

217. Hylton, *supra* note 215, at 482 ("[T]he elimination of DB plans in favor of DC plans . . . may be the only viable solution[].").

218. In Illinois, of course, that would mean new employees would be restricted to such plans. The recently enacted pension reform bill provides a limited opportunity for a small number of employees to voluntarily elect into such a defined contribution alternative. *See* 40 ILL. COMP. STAT. 5/14-155 (2014) (explaining the voluntary defined contribution plan).

219. *See Policy Basics: Top Ten Facts About Social Security*, CTR. ON BUDGET & POL'Y PRIORITIES, http://www.cbpp.org/cms/?fa=view&id=3261 (last updated Nov. 6, 2012) ("[F]or most workers, Social Security will be their only source of guaranteed retirement income that is not subject to investment risk or financial market fluctuations . . . helping to ensure that people do not fall into poverty as they age. . . . Social Security provides a foundation of retirement

government employees, by contrast, including most employees of state (and local) governments in Illinois, are not so covered.[220] The absence of social security coverage renders the well-known flaws of defined contribution plans more critical. Thus, governments should be required to opt-in to the social security system for any employees relegated to defined contribution plans.[221] This requirement would not compromise the fiscal discipline states and localities need,[222] as social security requires employers and employees to make regular payments to the system, while protecting the financial interests of state and local employees.

An additional advantage of mandating the extension of social security

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protection for people at all earnings levels."); *see also* Munnell & Muldoon, *supra* note 157, at 5 ("Social Security is an extremely valuable source of retirement income. It is payable for life and benefits are adjusted to keep pace with inflation."); April Yanyuan Wu et al., *How Does Women Working Affect Social Security Replacement Rates?*, CTR. FOR RETIREMENT RESEARCH AT B.C., June 2013, at 3–4, (showing social security replacement rate declining from forty-five to thirty-nine percent of preretirement wages).

220. David Dayen, *Robbing Illinois's Public Employees*, AM. PROSPECT (Dec. 9, 2013), http://prospect.org/article/robbing-illinoiss-public-employees ("80 percent of state workers affected [by the pension reforms] do not participate in Social Security . . . ."); *see Illinois Public Employee Retirement Systems*, ILL. RETIREMENT SEC. INITIATIVE 1–2 (2009) (describing various Illinois pension plans and integration or lack thereof with social security).

221. One question is whether such a mandate would be constitutional. In 1990, Congress mandated the inclusion in social security of all state and local employees not otherwise covered by retirement plans, but this act was never challenged in court and at least one commentator believes that "[t]he constitutional issues involved have not been fully resolved." ALICIA H. MUNNELL, CTR. FOR RETIREMENT RESEARCH AT B.C., MANDATORY SOCIAL SECURITY COVERAGE OF STATE AND LOCAL WORKERS: A PERENNIAL HOT BUTTON 6 n.3 (2005), *available at* http://crr.bc.edu/wp-content/uploads/2005/06/ib_32_508.pdf. Others disagree. *E.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, SOCIAL SECURITY: IMPLICATIONS OF EXTENDING MANDATORY COVERAGE TO STATE AND LOCAL EMPLOYEES (1998), *available at* http://www.gpo.gov/fdsys/pkg/GAOREPORTS-HEHS-98-196/html/GAOREPORTS-HEHS-98-196.htm ("GAO believes that mandatory coverage is likely to be upheld under current Supreme Court decisions . . . ."). Certainly Congress' authority to mandate such action under the Commerce Clause seems more likely when the applicable precedent is *Garcia v. San Antonio Metro. Transit Authority*, 469 U.S. 528 (1985), *reh'g denied*, 471 U.S. 1049 (1985) (upholding application of the minimum-wage and overtime provisions of the Fair Labor Standards Act against the states), than it was when the precedent was *National League of Cities v. Usery*, 426 U.S. 833 (1976) (holding the opposite of the *Garcia* court), *overruled by Garcia v. San Antonio Metro. Transit Authority*, 469 U.S. 528 (1985). The State of Illinois may find itself with standing to challenge a portion of the current social security mandate around 2027, when some experts believe that the retirement benefits payable to Tier 2 employees—those hired after 2011—will start falling below federal minimum standards. *See* Bob Secter & Kim Geiger, *Experts: Pension Fix Could Backfire, Reductions May Not Meet Federal Standards by 2027*, CHI. TRIB., Apr. 15, 2015, at 1.4 (describing possible impact of the "Safe Harbor Act").

222. *See* Hylton, *supra* note 215, at 464 (arguing that the DC arrangements "forc[ing] legislat[ures] to budget *now* for contributions that will be made in the very near future . . . impose[] precisely the kind of fiscal discipline that has been missing in the public sector for decades").

coverage to state (and local) employees is that it would remove any justification for the continuation of pension rules that leave room for abusive behavior and that, thus far, have remained impervious to various Illinois reform proposals. For example, Illinois law allows some employees to "buy" years of service credit towards state pensions for amounts far below the costs those years of "service" impose on the system.[223] Some employees remain able to "double dip"—changing jobs when hitting the maximum benefit accrual under one retirement plan in order to begin accruing benefits under another plan.[224] These opportunities stem from pension rules enacted to counterbalance the adverse effects of the non-portability of traditionally structured defined benefit plans on short-term employees. Rapid accruals of maximum benefit percentages protect workers against the possibility of excessive benefit loss through involuntary job loss, but leave open possibilities for double dipping. Social security, by contrast, is completely portable across all U.S. jobs (except some state and local government jobs) and offers few, if any, opportunities to "game" the system to duplicate pension coverage.[225]

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223. *E.g.*, 40 ILL. COMP. STAT. 5/20-118 (2012) (allowing employees to reinstate service credit by repaying refunds of previously distributed contributions); Jason Grotto, *How Daley Fattened Pension*, CHI. TRIB., May 2, 2012, at 1.1 (describing misuse of pension plan); Ray Long, *$100K Pension for Ex-Teachers Union Lobbyist*, CHI. TRIB., Sept. 23, 2012, at 1.1 (describing abusive buy in arrangements); *Retirement Systems Reciprocal Act*, RET. SYS. RECIPROCAL CONFERENCE (2015), https://www.srs.illinois.gov/PDFILES/brochures/recip.pdf (describing benefits of service credit purchase option); *State Universities Retirement System*, S. ILL. U., http://policies.siu.edu/employees_handbook/chapter8/surs.html (last visited Apr. 26, 2015) ("In addition, it may be possible to purchase service credit. This is true for prior employment (half-time or more, including student work and graduate assistantships) at an Illinois employer covered by SURS and/or for employment with a previous public employer."). Illinois is not the only state with this problem. *See* Beermann, *supra* note 4, at 22–24 (addressing examples from other states).

224. *See, e.g.*, *A Model for Good Government*, CHI. SUN TIMES, Oct. 8, 2013, at 17 (providing examples of double-dipping); Brian Costin, *Naperville Considers Pension Double-Dipping Transparency Reform*, ILL. POL'Y (Nov. 4, 2013), http://ipweb-lb-1885590254.us-east-1.elb.amazonaws.com/naperville-considers-pension-double-dipping-transparency-reform/ ("[S]ome workers don't just get one pension—they get two or three."); John Gregory, *Illinois Lawmaker Aims to Stop Pension 'Double-dipping,'* WJBC (Nov. 15, 2013, 7:19 AM), http://www.wjbc.com/common/page.php?feed=21&pt=Illinois+lawmaker+aims+to+stop+pension+%27double-dipping%27&id=96343&is_corp= (listing examples); Dave Savini, *Some University Employees Double Dipping for State Paychecks*, CBS CHI. (Feb. 8, 2012, 10:00 PM), http://chicago.cbslocal.com/2012/02/08/some-university-employees-double-dipping-for-state-paychecks/ (stating that university employees are "retiring" and then are re-hired to perform same job).

225. Indeed, federal law prevents state and local government employees from "double dipping" with respect to social security benefits. Some government employees work part-time jobs in the private sector or after taking advantage of the early-retirement ages set under state and local governmental retirement plans to work enough quarters at jobs covered by social security to entitle them to pensions from both sources. Because of the way social security benefits are

In theory, defined contribution plans can provide employees with the financial security of a defined benefit plan, but, in practice, few workers seem capable of the self-discipline and investment acumen necessary to achieve this result.[226] Defined contribution plans offer many more options to employees than do defined benefit plans. For example, they allow employees to choose how much pay to invest in the plan,[227] and whether to leave the money so invested there until retirement.[228]

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figured (averaging thirty years of covered salaries, but with a minimum), these employees became entitled to social security benefits designed for long-term, low wage employees (approximately ninety-percent of that average wage) in addition to their generous state or local pensions. In 1983, Congress passed the Windfall Elimination Provision, Pub. L. 98-21, which reduces the factor by which average wages are multiplied to determine social security benefits for workers who have spent a minimum number of years in non-covered employment. CHRISTINE SCOTT, SOCIAL SECURITY: THE WINDFALL ELIMINATION PROVISION (WEP) 1–3 (2013), *available at* http://fas.org/sgp/crs/misc/98-35.pdf. This disallowance affects all such employees who have spent fewer than thirty years in social security eligible employment. *Id.* at 3. Some modification of the Windfall Elimination Provision, such as pro-rating the disallowance percentage according to the years of social security coverage, would be warranted in the event Congress mandated immediate inclusion of state and local government employees in the social security system.

226. *See* BARBARA A BUTRICA & KAREN E. SMITH, CTR. FOR RETIREMENT RESEARCH AT B.C., 401(K) PARTICIPANT BEHAVIOR IN A VOLATILE ECONOMY 3 (2012), http://crr.bc.edu/wp-content/uploads/2012/10/wp_2012-24-5081.pdf ("But recent studies have revealed less than encouraging information about retirees' ability to adequately plan for retirement. While DC plans have the potential to provide retirees with substantial retirement wealth, a typical household approaching retirement had 410(k)/IRA balances of only $42,000 in 2010." (citation omitted)).

227. Typically, employees fail to elect to put aside enough money into defined contribution plans. *See* Susan J. Stabile, *Is It Time to Admit the Failure of an Employer-Based Pension System?*, 11 LEWIS & CLARK L. REV. 305, 311–12 (2007) (describing extent of failures to participate and to make sufficient contributions to 401(k) plans). "According to one estimate, 'a participant earning $50,000 per year and covered only by a defined contribution plan would need to save fifteen percent of income . . . over thirty years to ensure adequate retirement savings.' Yet the average estimate is less than half of that rate." *Id.* at 312 (footnote omitted). These pessimistic statistics have led scholars to develop (and many employers to implement) strategies aimed at nudging participation and contributions levels upward. *See* James J. Choi et al., *Defined Contribution Pensions: Plan Rules, Participant Choices, and the Path of Least Resistance*, *in* 16 TAX POLICY AND THE ECONOMY 67, 98–99 (James M. Poterba ed., 2002) (encouraging employers to choose default rules which will lead to optimal behavior); Butrica & Karamcheva, *supra* note 216, at 3 (citing studies suggesting that automatic enrollment "has succeeded in dramatically increasing 401(k) participation").

228. Many defined contribution plans allow employees to withdraw the money in their retirement accounts prior to reaching retirement age, albeit subject to a tax penalty, and numerous employees imperil their retirement security by taking advantage of this option. Ron Lieber, *Combating a Flood of Early 401(k) Withdrawals*, N.Y. TIMES, Oct. 25, 2014, at B1 ("Over a quarter of households that use one of these plans take out money for purposes other than retirement expenses at some point. . . . [I]ndustry veterans tend to refer to these retirement withdrawals as 'leakage.' But . . . it's really more like a breach."); Alicia H. Munnell et al., *An Update on 401(k) Plans: Insights From the 2007 Survey of Consumer Finances* 8–9 (Ctr. for Ret. Research at B.C., Working Paper No. 2009-26), *available at* http://crr.bc.edu/wp-content/uploads/2009/11/wp_2009-26-508.pdf ("To discourage cashing out, the federal government has imposed a 10 percent penalty in addition to regular income taxes on any withdrawal before age 59 ½. . . .

Employees are also responsible for choosing where the accumulated funds will be invested,[229] and bear the financial risk attendant on those investment choices.[230] Finally, and perhaps most importantly, most defined benefit plans pay lifelong annuities, ensuring that no covered employee outlives his or her retirement income. Although an annuity might be one of the options offered to participants in defined contribution plans, employees can (and often do) opt under these plans for lump-sum distributions of their account balances, "creating concern about post-distribution conservation of savings."[231]

These flaws are less serious—and may be outweighed by the benefits of the fiscal discipline imposed by their use—when defined contribution plans are secondary plans, provided in addition to a guaranteed retirement annuity that is adjusted for inflation. Private workers have such an annuity provided by the social security system. Many government workers—and particularly Illinois workers—do not.

There is something counterintuitive about advocating the movement of state and local government employees from one set of governmental defined benefit plans to another such plan. After all, the federal government is subject to the same pressures that led to the underfunding of state and local pension plans. And the federal government seems to have wildly underfunded some aspects of the protections it has promised to provide seniors, in particular Medicare.[232] However, because of its wider scope, the social security system is more closely

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40 percent of participants who received a lump sum did not roll the money over into another tax-deferred savings vehicle.").

229. Stabile, *supra* note 227, at 312 ("401(k) plans . . . put[] investment decisions in the hands of employees."). Unfortunately, many employees lack the knowledge to make intelligent investment choices. *Id.* "Many, if not most, employees lack the knowledge to make the necessary financial decisions." *Id.* at 313. It is unclear how to convey the necessary knowledge to them. *Id.* at 319 ("There is little to suggest that education would have very positive effects; employees simply do not seem to hear the messages education attempts to convey. . . . I have argued elsewhere that education is unlikely to be effective in addressing the cognitive biases that influence participant investment decisions." (footnotes omitted)); William G. Gale & Ruth Levine, *Financial Literacy: What Works? How Could It Be More Effective?* 3 (Fin. Sec. Project at B.C., Working Paper No. 2011-1), *available at* http://crr.bc.edu/wp-content/uploads/2011/03/FSP-2011-1.pdf ("None of the four traditional approaches has generated unambiguous evidence that financial literacy efforts have had positive and substantial impacts.").

230. Stabile, *supra* note 227, at 312.

231. *Id.* at 315.

232. For example, in 2014 alone, "the projected difference between Social Security's expenditures and dedicated tax income is $80 billion. For [Medicare Hospital Insurance], the projected difference between expenditures and dedicated tax and premium income is $25 billion. The projected general revenue demands of [Medicare Parts B and D] are $248 billion." Soc. Sec. & Medicare Bds. of Trs., *A Summary of the 2014 Annual Reports*, SOC. SEC. ADMIN., http://www.ssa.gov/oact/trsum/ (last visited Apr. 26, 2015) (footnote omitted).

regulated and monitored than most state systems, and certainly more so than the system Illinois maintains. Nor is its benefit formula, which is based on lifetime earnings, subject to the sort of abusive manipulation that seems to be typical of state systems.[233] Moreover, both the formula and the contribution rates are subject to periodic revisions that take into account changes in economic and social conditions.[234]

Ultimately, of course, no pension system is perfectly safe in the face of economic or political devastation. However, such dire circumstances are less likely to arise at the national than at the state level. Just as importantly, state (and local) employees will have more political protection against being singled out for concessions in such a situation if their economic fate is tied to all other retirees than if they are in a class by themselves, the beneficiaries of (perhaps) especially favorable retirement rules.

Social security need not, and should not, be the only source of retirement income for Illinois employees, any more than it is the only source of retirement income for many private retirees. It was not designed to be the sole source of retirement income;[235] its average "replacement rate" of pre-retirement income falls short of that necessary to enable beneficiaries to fully finance a lifestyle equivalent to their pre-retirement lifestyle.[236] Social security benefits should be topped up by benefits provided under a defined contribution plan, funded by some combination of employee and employer contributions. As noted above, that pattern would be consistent with trends in the private sector. Social

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233. SOC. SECURITY ADMIN., SEE YOUR RETIREMENT BENEFIT: HOW IT'S FIGURED (2015), *available at* http://www.ssa.gov/pubs/EN-05-10070.pdf (explaining retirement benefit calculations). Short-term earning increases, for example, have little effect on the amount of a retiree's annuity, eliminating the benefit of pre-retirement "earning spikes." No formula is perfect, of course, and many have found certain elements of the social security benefit formula problematic—even elements specifically desired by Congress. *See* William Baldwin, *11 Ways Your Social Security Benefit Calculation Can Shortchange You*, FORBES (Jan. 7, 2014, 5:17 PM), http://www.forbes.com/sites/baldwin/2014/01/07/11-ways-your-social-security-benefit-calculation-can-shortchange-you/ (describing alleged flaws in benefit calculation).

234. It is highly unlikely that the Supreme Court of Illinois would find that changes in social security rules violate the Pension Protection Clause and thus require additional state funding to make up losses to adversely affected employees. Not only would changes not be due to actions taken by state officials, but also, the promise made by the state to its employees could be interpreted as merely obligating it to continue participating in the social security system, rather than to a particular quantum of benefits under the system.

235. Andrew G. Biggs & Glenn R. Springstead, *Alternate Measures of Replacement Rates for Social Security Benefits and Retirement Income*, 68 SOC. SEC. BULL. 1, 3 (2008) ("Social Security was not designed to be the sole source of retirement income.").

236. *Id.* (stating that "conventional wisdom" is that social security replaces about forty percent of the average worker's pre-retirement earnings and that such workers need seventy percent or more to continue their pre-retirement lifestyle).

security can, and should, be a floor rather than a ceiling on retirement benefits. The goal is to provide a combination of adequate retirement support and transparent retirement costs. Such transparency would lead to a meaningful conversation about the reasonableness of the overall compensation package of public employees (not to mention the reasonableness of the size of the public sector). Such a conversation is impossible when the costs of a large component of that compensation are effectively hidden.

V. GETTING FROM HERE TO THERE

As detailed above, under the Supreme Court of Illinois' likely interpretation of the Illinois Constitution, even if the Illinois state legislature agreed to shift from its state-defined benefit pension plan to participation in social security, or some combination of social security and a defined contribution plan, the shift could affect only newly hired employees. Current employees would have to remain under the current system. They may well prefer that outcome, though of course it would depend on the trade-off between current compensation and pension benefits. If state politics and state budget constraints together result either in massive job losses among state employees or significant reductions in cash salaries, even current state employees may decide that the state constitution's protection of pension benefits provides less protection than they imagined, and that they would be better off trading it for some combination of social security and defined contribution plan eligibility and cash salary.[237] The question is how, if it is deemed desirable, one can move towards this goal in fewer than two generations.

One option would involve amending the Pension Protection Clause.[238] The Clause could be amended to protect only accrued

237. There is no constitutional bar to a voluntary exchange of a salary package containing higher cash salaries and lower (or different) pension arrangements with one providing a lower cash salary and the current pension arrangement. It is the unilateral imposition of a new pension arrangement that creates legal issues. Eric M. Madiar, *Public Pension Benefits Under Siege: Does State Law Facilitate or Block Recent Efforts to Cut the Pension Benefits of Public Servants?*, 27 A.B.A. J. LAB. & EMP. L. 179, 182 (2012).

238. Amending the Illinois Constitution is not easy. The procedure set out in Article XIV, Section 2 of the Illinois Constitution is a two-step process. First, the amendment must be passed by a three-fifths vote of "the members elected to each house." Then the amendment must be submitted to "the electors at the general election next occurring at least six months after such legislative approval"; an amendment becomes effective only if approved "by either three-fifths of those voting on the question or a majority of those voting in the election." This burden is not insuperable. Eleven amendments have been adopted since the constitution went into force in July, 1971, with the last such amendment in 2010.

pension benefits, consistent with the federal standard set by ERISA.[239] However, although such a constitutional change would grant the state the flexibility to make changes to the pension benefit packages of new employees, such an amendment may not allow changes to be made to the pension benefits of current employees, even the benefits earned through the future performance of personal services. A constitutional amendment would not necessarily enable the state to force current employees to shift from their current pension plans to a combination of social security and defined contribution plan coverage.

There is little doubt that such a constitutional change could overcome challenges made under the Illinois Constitution under the later in time rule. Pension changes enacted by the legislature after the effective date of a state constitutional amendment would be permissible despite the existence of bars against governmental takings[240] and governmental impairments of contracts[241] found in the Illinois Constitution, because any reasonably drafted amendment would be interpreted as implicitly (or explicitly) amending any prior, conflicting constitutional provisions.[242]

However, that might not be enough to allow the State to reduce future pension accruals of existing employees. Such changes could still be considered to constitute breaches of the employees' contracts, which would generate damage awards that would eliminate any savings from the changed pension arrangements, and, less likely, to be violations of the Takings[243] or Contracts Clauses[244] found in the federal Bill of Rights.

Doctrinally, the question would be whether, because of the existence of the Pension Protection Clause, the pre-2013 pension provisions would be construed as having created "unilateral contracts" which were

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239. It is possible that it could be changed retroactively as well. *See supra* note 46 and accompanying text (discussion of Contracts and Takings Clause limitations on pension reductions).

240. ILL. CONST. art. I, § 15 ("Private property shall not be taken or damaged for public use without compensation as provided by law. Such compensation shall be determined by a jury as provided by law.").

241. ILL. CONST. art. I, § 16 ("No ex post facto law, or law impairing the obligation of contracts or making an irrevocable grant of special privileges or immunities, shall be passed.").

242. Ultimately, the interpretation of the amendment would lie in the province of the Supreme Court of Illinois, and a court hostile to the amendment might come up with a narrower interpretation of its scope. Presumably, clear drafting of the amendment would reduce the likelihood of this outcome.

243. U.S. CONST. amend. V. As discussed *supra* note 46, the Takings Clause claim largely follows the Contracts Clause claim; hence, the following discussion concentrates on the Contracts Clause issues.

244. U.S. CONST. art. I, § 10, cl. 1.

accepted by employees upon starting employment with the state, and whether the terms of those contracts provide employees the right to continue to earn benefits under the formula established at the time they entered into the contract for the duration of their employment with the state. In short, the question would be whether the state intended, when it hired state employees, to bind itself to providing employees with undiminished opportunities to earn retirement benefits over their entire career, or whether it intended some lesser standard of protection.

As discussed earlier, the language of the Pension Benefit Clause is sufficiently ambiguous that the Supreme Court of Illinois could, if it so desired, interpret it to protect only already-accrued benefits. The judicial interpretations of the Pension Benefit Clause described in Part I.B of this Article suggest quite strongly, however, that the Supreme Court of Illinois would not do so if the change were instantiated solely by legislative action.[245] The Pension Protection Clause, like other limiting features of state constitutions, is intended as limitations on state legislative behavior.[246]

However, the Court may not be quite as resistant to changes adopted through a state constitutional amendment, as such amendments must survive a more extensive and demanding political process than ordinary legislation. The Supreme Court of Illinois might reasonably find that while the protection conferred by the Pension Protection Clause was meant to bind the state legislature, and protect state employees against mere legislative changes, it was not designed to impede the freedom of constitutional drafters or to hold employees harmless against changes effectuated through constitutional mandates. The existence of mechanisms for amending the Illinois Constitution—and thus repealing

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245. In theory, federal courts reviewing federal constitutional challenges "look to state law to determine the existence of a contract, [but] federal rather than state law controls as to whether state or local statutes or ordinances create contractual rights protected by the Contracts Clause." San Diego Police Officers' Ass'n v. San Diego Emps.' Ret. Sys., 568 F.3d 725, 737 (9th Cir. 2009). As a practical matter, however, federal courts follow state court decisions on the second issue as well. *See* Monahan, *supra* note 77, at 1045 ("My research, however, identified no federal cases where a federal court ruled in direct opposition to a state court's finding that a contract existed under federal law.").

246. While the federal constitution is a "document of grant"—a document that authorizes the exercise of limited governmental powers—states are deemed to have "plenary" governmental powers, limited only by specific constraints found in their state constitutions or the federal constitution. LYNN A. BAKER & CLAYTON P. GILLETTE, LOCAL GOVERNMENT LAW: CASES & MATERIALS 254–55 (5th ed. 2015) ("Our court regards the language in the constitution as a limitation upon the legislature's authority, not as a grant of power. Based on that view, our court has held that the General Assembly is free to enact any legislation that the constitution does not expressly prohibit." (citing City of Chi. v. Holland, 795 N.E.2d 240, 246 (Ill. 2003) (internal quotations omitted)).

or revising the Pension Protection Clause—could be read as providing an implicit authorization for changing state employee pension plans mid-stream when authorized by a constitutional amendment and only by a constitutional amendment. Instead of being a complete bar to such changes, the Pension Protection Clause could be interpreted as providing a (heavy) procedural bar to such changes. Once the State manages to overcome the procedural bar attendant on constitutional amendments, it would be able to amend the terms of its pension plans pursuant to this reservation without violating the terms of the original pension contracts. Courts have routinely upheld governments against Contracts and Takings Clause challenges to mid-career pension revisions when either the terms of the plan or the underlying legislation implicitly or explicitly allowed for such revisions, reasoning that such revisions did not violate the underlying pension contract.[247]

There is no particular reason to believe that the Supreme Court of Illinois would so interpret the Pension Protection Clause, however.[248] If it does not, and instead interprets the Pension Protection Clause as protecting current employees' pension benefits earned with respect to as-yet-to be performed services under a unilateral contract theory—a unilateral contract which does not include an allowance for Constitutional changes—the state would find itself subject to liability in a breach of contract suit, if not suits brought under the federal Contracts or Takings Clauses. The result, once again, would be complete protection of current employees' ability to continue to accrue pension benefits under pre-existing law.

Contracts Clause jurisprudence protects against "substantial impairments" of contractual obligations unless those impairments are justified by a significant and legitimate public purpose.[249] There is little doubt that the changes described above would adversely impact at least some current employees. Even a revenue-neutral move from the current

247. *See* Madiar, *supra* note 237, at 187–91 (describing differential interpretations of pension contracts in Colorado, Minnesota, and New Hampshire); *infra* note 260 and accompanying text (listing cases).

248. The Supreme Court of Illinois' opinion in *Kanerva v. Weems*, 13 N.E.3d 1228 (Ill. 2014), does not suggest it will be particularly amenable to any argument that would have the effect of lowering benefits provided to current workers or retirees. In the one case in which a court confronted the question of the legality of a state constitutional amendment reducing pension benefits, the Supreme Court of Oregon struck the amendment down as a violation of the Contracts Clause without any discussion of a possible distinction between statutory and constitutional amendment mechanisms. Or. State Police Officers' Ass'n v. Oregon, 918 P.2d 765 (Or. 1996).

249. Monahan, *supra* note 77, at 1041. Or, to put the same test another way, the Contracts Clause protects against any "substantial impairment" of contractual rights.

pension arrangement to one involving a combination of social security coverage and a defined contribution plan would inevitably hurt some current employees. In particular, long-time workers close to retirement age would lose the large benefit accruals that would come to them under the terms of their current pension plans, which employ backloaded benefits formulas;[250] neither social security nor most defined contribution benefit formulas would be similarly backloaded.[251] Although relatively young employees and short-term employees could come out ahead as a result of such changes,[252] it is unclear whether the gains to some employees would offset the losses caused to other employees for purposes of determining whether employees' contractual rights were "substantially impaired."[253] The argument becomes even less tenable should pension reform include, as Illinois state legislators desire, a significant overall reduction in pension benefits.[254]

Nor is Illinois' argument that its substantial impairment is "reasonable and necessary to serve an important public purpose"[255] particularly strong. The United States Supreme Court has made clear that states' attempts to impair their own financial obligations should be disfavored, stating:

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250. A backloaded benefit formula is one in which pension benefits, viewed in terms of actuarial value, do not accrue ratably over the course of an employee's career, but instead rise in value over the service value. For example, the actuarial value of benefits earned in the first year an employee works for an employer may amount to five percent of her cash salary, while the benefits earned by an employee in the last year of a thirty-year career may amount to twelve percent of her cash salary for the year. *See* Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683, 688 (2000) (defining backloading and explaining its causes); Laurence J. Kotlikoff & David A. Wise, *Pension Backloading, Wage Taxes, and Work Disincentives* 50 (Nat'l Bureau Econ. Of Research, Working Paper No. 2463, 1987), *available at* http://www.nber.org/papers/w2463.pdf ("Most defined benefit plans are strongly backloaded . . . .").

251. *See* Julie A. Roin, *The Limits of Textualism:* Cooper v. IBM *Personal Pension Plan*, 77 U. CHI. L. REV. 1195, 1200 (2010) ("[F]inal pay plans deliver the bulk of their benefits to long-term employees."); Richard C. Shea et al., *Age Discrimination in Cash Balance Plans: Another View*, 19 VA. TAX REV. 763, 763–64 (2000) (making the same argument). The loss of these anticipated benefits was one of the objections employees raised when private employers began replacing traditional defined benefit plans with cash balance or defined contribution plans—replacements which were allowed by ERISA. *See* Zelinsky, *supra* note 250, at 707–08 (providing numerical examples). Long-term government employees would suffer similarly.

252. *See* Roin, *supra* note 251, at 1200 ("Cash balance plans, like defined contribution plans, distribute their benefits more evenly among long- and short-term employees with the gains enjoyed by the short-term employees coming at the expense of the long-term employees . . . .").

253. Beermann, *supra* note 4, at 60.

254. *See* Balt. Teachers Union v. Mayor of Balt., 6 F.3d 1012 (4th Cir. 1993) (holding that a one percent decrease in employee salary is a "substantial impairment" of their contract; "[i]n the employment context, there likely is no right both more central to the contract's inducement and on the existence of which the parties more especially rely, than the right to compensation at the contractually specified level").

255. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 25 (1977).

> A governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all. . . . [A] State cannot refuse to meet its legitimate financial obligations simply because it would prefer to spend the money to promote the public good rather than the private welfare of its creditors.[256]

Although Illinois faces substantial fiscal challenges, its taxpayers are far from the most heavily taxed in the nation.[257] It faces a less immediate and substantial challenge than that posed by the Great Depression, when the Supreme Court allowed Minnesota to modify home-loan payment schedules to prevent foreclosures,[258] nor is this crisis a sudden and unexpected one such as the "eleventh-hour, second round of cuts in state aid to the City" that the Fourth Circuit held justified allowing the City of Baltimore to impose a temporary, one-percent cut in employee pay.[259] More generally, governments have not fared well in court when claiming that their contractual impairments were "reasonable and necessary to effectuate an important government purpose."[260] When they have prevailed in cases challenging their

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256. *Id.* at 26, 29; Cont'l Ill. Nat'l Bank & Trust Co. of Chi. v. Washington, 696 F.2d 692, 701 (9th Cir. 1983), *appeal dismissed*, 460 U.S. 1077 (1983) ("Because the State is a contracting party, we give *less* deference to its claims of justification for impairment." (emphasis added) (citing *U.S. Trust*, 431 U.S. at 25–26)). Nor have other states' attempts to use this excuse to justify reductions in pension obligations been particularly successful. *See, e.g.*, Welch v. Brown, 551 F. App'x 804, 812 (6th Cir. 2014) (upholding the issuance of a preliminary injunction against modifications in employee and retiree health benefits when "the record does not establish that bankruptcy was imminent, nor does it show that Defendants contemplated filing for bankruptcy. . . . [And] the record also fails to demonstrate that Defendants considered alternative strategies before modifying retiree benefits"); Or. State Police Officers' Ass'n v. Oregon, 918 P.2d 765, 779 (Or. 1996) ("[T]he impairment is not justified by any significant and legitimate public purpose.").

257. With the temporary income tax increases, Illinois' state and local tax burden was the fifteenth highest in the nation; now that they have expired, the tax burden is the twenty-eighth highest. Kurt Fowler & Mike Klemens, *Illinois' Relative Tax Burden Jumps After the 2011 Income Tax Rate Increases*, TAX FACTS, Sept.–Oct. 2013, at 1, 2. Illinois' problem, historically, was that it spent like a high tax state but failed to tax like one.

258. Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934). And, of course, in that case Minnesota was not reducing its own financial obligations, so its legislative decisions were entitled to more deference.

259. *Balt. Teachers Union*, 6 F.3d at 1020.

260. *See Welch*, 551 F. App'x at 812 (upholding issuance of preliminary injunction against modifications in employee and retiree health benefits when "the record does not establish that bankruptcy was imminent, nor does it show that Defendants contemplated filing for bankruptcy. . . . [And] the record also fails to demonstrate that Defendants considered alternative strategies before modifying retiree benefits"); *Or. State Police Officers' Ass'n*, 918 P.2d at 779 (holding Ballot Measure 8, amending the Oregon Constitution to decrease pension rights of

unilateral reduction of salary or retirement or health benefits, generally it has been on the grounds that the terms of the underlying contracts allowed such reductions, or that they had no contract to begin with.[261]

That said, current employees' claim for relief under the federal Contracts Clause—at least if brought in federal court—will likely fail because they have another remedy for their loss: a state breach of

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public sector employees with respect to future earnings, violated the Contracts Clause of the United States Constitution). *But see* United Auto., Aerospace, Agric. Implement Workers of Am. Int'l Union. v. Fortuño, 633 F.3d 37, 46–47 (1st Cir. 2011) (dismissing Contracts Clause claim against Puerto Rican law reducing government payroll in violation of collective bargaining agreements because the plaintiffs "failed to plead any factual content to undermine the credibility of Act No. 7's statement that it was enacted to remedy a $3.2 billion deficit . . . [and] the complaint did not show how Act No. 7 was '[un]reasonable in light of the surrounding circumstances' or 'impose[d] a drastic impairment when an evident and more moderate course would serve its purposes equally well'" (quoting Mercado-Boneta v. Administración del Fondo de Compensación al Paciente, 125 F.3d 9, 15 (1st Cir. 1997) (second and third alteration in original))).

261. For example, the impact of *Oregon State Police Officers' Association* was limited subsequently by another case holding that the "unilateral contract" formed by state employees did not extend to the formulas used to determine the value of the annuities to be received by annuitants, allowing the state legislature to eliminate by statute certain alternative investment accounts for future contributions. Strunk v. Pub. Emps. Ret. Bd., 108 P.3d 1058 (Or. 2005) (en banc); *see* Taylor v. City of Gadsden, 767 F.3d 1124, 1135 (11th Cir. 2014) (upholding the dismissal of a Contracts Clause claim challenging an increase in rate of employee pension contributions because plaintiffs "have no contractual right to a static, inviolable 6% contribution rate"); Me. Ass'n of Retirees v. Bd. of Trs. of the Me. Pub. Emps. Ret. Sys., 758 F.3d 23, 32 (1st Cir. 2014) (affirming grant of summary judgment against plaintiffs on their claims that amendments to Maine's public employee retirement system violated the Contract and Takings Clauses of the United States Constitution because "[the] Plaintiffs, regardless of whether they retired before or after the 1999 amendments, ha[d] no contractual entitlement to COLA benefits calculated under pre-2011 law"); N.J. Educ. Ass'n v. New Jersey, No. 11-5024, 2012 WL 715284, at *4 (D.N.J. Mar. 5, 2012) (holding that redress sought is barred by the Eleventh Amendment because it is retroactive in nature); Scott v. Williams, 107 So. 3d 379, 389 (Fla. 2013) ("We again hold . . . that the preservation of rights statute was not intended to bind future legislatures from prospectively altering benefits for future services performed" so that "the actions of the Legislature have not impaired any statutorily created contract rights."); Swanson v. Minnesota, No. 62-CV-10-05285 (Minn. D.C. June 29, 2011) (mem.) (dismissing contracts and takings clause challenges to reductions in COLA for retirement benefits because "[t]he relevant statutory language does not encompass a legislative contract or promise to refrain from amending the statutory formula," concluding that the Legislature neither contracted to use, nor promised to use, the formula in effect on the date of retirement for future post-retirement adjustments to retirement annuities, and finding that "the challenged legislation was reasonable and appropriate exercise of legislative authority and responsibility to maintain the Plans' fiscal stability for the benefit of all members"); Tice v. South Dakota, No. 10-225, at 12 (S.D. Cir. Ct. 2012) (mem.) ("[T]he establishment of the SDRS through SDCL ch. 3-12 does not contain any language or any clear indication that would entitle Plaintiff to a private contractual right to a 'forever 3.1% COLA.' . . . Plaintiff does not have a contract right to a forever COLA at the rate which was in effect at the time of Plaintiff's retirement."); Wash. Educ. Ass'n v. Dep't of Ret. Sys., 332 P.3d 428, 431 (Wash. 2014) (overturning order granting summary judgment to plaintiffs because "the legislature reserved its right to repeal a benefit in the original enactment of that benefit and the enactment did not impair any preexisting contractual right").

contract suit.[262] Several Circuits,[263] including the Seventh Circuit,[264] distinguish between a "mere breach of contract . . . that leaves the promissee with a remedy in damages for breach of contract" and "one that extinguishes the remedy."[265] Only the latter creates an "impairment" that gives rise to Contracts Clause relief.[266]

262. Additionally, any suit brought in a federal court may confront an Eleventh Amendment challenge because the remedy would require the court to order a payment of money from the state treasury. Council 31 of the Am. Fed'n of State, Cnty. & Mun. Emps. v. Quinn, 680 F.3d 875, 884 (7th Cir. 2012) (denying a request for injunction under a Contracts Clause claim because "the injunction would force the defendants, acting in their official capacities, to extract funds from the State's treasury for the ultimate benefit of the plaintiffs"); N.J. Educ. Ass'n v. New Jersey, No. 11-5024, 2012 WL 715284, at *5 (D.N.J. Mar. 5, 2012) (finding that the court lacked subject matter jurisdiction over case challenging changes to state's retirement system because "[u]ltimately, however, enjoining the enforcement of Chapter 78 is nothing more than an indirect way of forcing the State to abide by its obligations as they existed prior to the enactment of Chapter 78. Therefore the relief requested by Plaintiffs is, in both substance and practical effect, a request for specific performance of the alleged pre-Chapter 78 contract existing between Plaintiffs and the State of New Jersey. Under controlling Supreme Court precedent, such relief is not permitted.").

263. *See, e.g.*, *Taylor*, 767 F.3d at 1136 ("Even assuming the existence of a contractual provision not to raise the employee contribution rate, plaintiffs still cannot succeed on their Contract Clause challenge because—at most—the City has breached a contract, not impaired one."); Cherry v. Mayor & Balt. City, 762 F.3d 366 (4th Cir. 2014) (dismissing the constitutional challenge to the City's reduction of cost-of-living increases in pension benefits); *Council 31*, 680 F.3d at 886 (holding that a Contracts Clause action will not lie in suit for violation of collective bargaining contracts because "the Rules do not foreclose a remedy for breach of contract, and no impairment of a contractual obligation exists"); Redondo Constr. Corp. v. Izquierdo, 662 F.3d 42, 48 (1st Cir. 2011) (dismissing a Contracts Clause claim raised by developer because "[n]o action of the defendants, and nothing in Law 458, prevents Redondo from obtaining a remedy for a demonstrated breach of the settlement agreements"); Crosby v. City of Gastonia, 635 F.3d 634, 642 (4th Cir. 2011) (upholding the dismissal of a § 1983 claim because "the district court correctly analyzed the alleged acts of the City as establishing nothing more than a mere breach of contract, not rising to the level of a constitutional impairment of obligation"); TM Park Ave. Assocs. v. Pataki, 214 F.3d 344, 350 (2d Cir. 2000) (vacating the district court ruling on a Contracts Clause claim involving the breach of long-term lease between the plaintiff building owner and a state university when "resolution of the contract action in the New York Court of Claims will likely moot [the] case"); Jackson Sawmill Co. v. United States, 580 F.2d 302, 312 (8th Cir. 1978) (rejecting a Contracts Clause claim when the holders of municipal bonds were "all defendants . . . open to a suit for breach of contract").

264. Horwitz-Matthews, Inc. v. City of Chi., 78 F.3d 1248, 1250 (7th Cir. 1996) (dismissing a constitutional challenge to the City's refusal to honor a development contract). Illinois lies within the Seventh Circuit.

265. *Id.*

266. The Ninth and Sixth Circuits have rejected this doctrinal rule; both allow § 1983 cases grounded in Contract Clause claims without regard to the existence (or not) of state breach of contracts remedies. *E.g.*, Welch v. Brown, 551 F. App'x 804 (6th Cir. 2014) (upholding a grant of preliminary injunction against an order by Flint's Emergency Manager modifying the terms of health-care benefits provided under collective bargaining agreements); S. Cal. Gas Co. v. City of Santa Ana, 336 F.3d 885, 897 (9th Cir. 2003) (mem.). Some District Courts—including one in the Eighth Circuit, which follows the Seventh Circuit rule—have explicitly rejected the requirement that no breach of contract remedy be available. *E.g.*, Prof'l Firefighters Ass'n of

Relying on Oliver Wendell Holmes' "vivid formulation" of a contract as "an obligation to perform or pay damages for nonperformance,"[267] the Seventh Circuit has stated that the "essence" of a contract "is that it triggers a duty to pay damages for the reasonably foreseeable consequences of . . . [a] breach."[268] When that duty is unimpaired, the court continued, "the obligation of the contract cannot be said to have been impaired."[269] The Seventh Circuit has made clear its underlying concern: that "[i]t would be absurd to turn every breach of contract by a state or municipality into a violation of the federal Constitution."[270] Although the Seventh Circuit has not been faced with the impairment issue in the context of a pension claim (it has applied this doctrine in a case involving a breach of a collective bargaining agreement[271]), the Fourth Circuit recently rejected a Contracts Clause challenge to pension reductions instituted by the City of Baltimore on grounds that "the plaintiffs have an opportunity to litigate a breach of contract claim under state law."[272]

Although one commentator believes otherwise,[273] it is far from clear that employees and retirees will be worse off by being relegated to a state-law breach of contract suit. Contract damages are intended to place the injured parties in the same position as they would have been in had the contract been completed in accordance with its terms. Employees and retirees should, in short, walk away with as much money after a breach of contract suit as under a Contracts Clause suit.

Omaha, Local 385 v. City of Omaha, No. 8:10CV198, 2011 WL 2293155, at *1–3 (D.C. Neb. June 7, 2011) (upholding an award of attorneys fees when a § 1983 claim for violation of Contracts Clause is alleged, disagreeing with the holding in *Crosby* that contract cases are not subject to § 1983, and following the reasoning of *Higgins*, *Larsen*, and *City of Santa Ana*, "absent a directive from the Eighth Circuit to do otherwise").

267. *Horwitz-Matthews*, 78 F.3d at 1251.

268. *Id.*

269. *Id.*

270. *Id.* at 1250. This argument is reminiscent of one found in *Snowden v. Hughes*, 321 U.S. 1 (1944), in which the Supreme Court expressed concern about turning every "denial of a right conferred by state law . . . [into] a denial of the equal protection of the laws." *Id.* at 8. The majority in *Snowden* held that "[t]he unlawful administration by state officers of a state statute . . . is not a denial of equal protection unless there is shown to be present in it an element of intentional or purposeful discrimination." *Id.* Both decisions stem from a reluctance to involve federal courts in disputes (perhaps) better dealt with in state courts.

271. Council 31 of the Am. Fed'n of State, Cnty & Mun. Emps. v. Quinn, 680 F.3d 875, 884 (7th Cir. 2012).

272. Cherry v. Mayor & Balt. City, 762 F.3d 366, 372 (4th Cir. 2014).

273. Thomas McDonell, *Reevaluating the Seventh Circuit's Approach to Contract Clause Claims in an Age of Pension Reform*, 2014 WIS. L. REV. 659, 670–71 (explaining why "[t]he ability of plaintiffs to bring constitutional claims rather than mere breach of contract actions" is important).

Further, a sympathetic court could order injunctive relief, and/or specific performance of the contract if it found (as it might) that the purpose of the damage remedy would be frustrated by forcing plaintiffs to sue after the fact for their actual losses, [274] or that the damages are impossible to calculate at the time of trial.[275] Finally, losing access to a federal forum (since in the absence of a federal cause of action in the form of a federal constitutional claim under 42 U.S.C. § 1983, federal courts would have no jurisdiction), at least in the circumstances here, is unlikely to be prejudicial. The Illinois state courts have an unbroken track record of favoring the interests of state employees in retirement disputes.[276] Thus, there likely would be little or no difference in outcome should the federal Contracts and Takings Clause causes of action be eliminated in favor of a state breach of contracts suit.

In sum, if Illinois employees' pension arrangements are determined to be unilateral contracts, the terms of which were intended to survive enactment of a constitutional provision allowing the amendment of prospective changes in that arrangement, an attempt to impose a unilateral change on those arrangements, even one backed by a constitutional amendment, will be ineffective. Such a result would not be unprecedented; a reduction of future pension benefit accruals by constitutional amendment (enacted by referendum) was attempted in Oregon and struck down by its court.[277] That does not mean that such a

274. Although specific-performance remedies are disfavored in contracts cases, they remain available. Numerous courts have provided injunctive relief against proposed alterations in retiree medical coverage despite the availability of monetary damages because of the especially difficult financial situations of many retirees. *See* Welch v. Brown, 551 F. App'x 804, 814 (6th Cir. 2014) (granting a preliminary injunction against alterations in medical coverage and listing cases). The same arguments about the irreparability of damages caused by delay can be made in the case of pension benefits.

275. Given the impossibility of determining each individual's life span and other factors necessary to calculate monetary damages, plaintiffs would have a strong basis for arguing that determining loss at the time of trial is impracticable. *See* E. ALLEN FARNSWORTH, CONTRACTS 859 (2d ed. 1990) ("If the breach occurs when the contract still has many years to run, it may not be possible at the time of the trial to forecast loss that will result in the future. In such situations equitable relief has often been granted.").

276. *See supra* note 78 and accompanying text (discussing the significance of *Kanerva v. Weems*).

277. Or. State Police Officers' Ass'n v. Oregon, 918 P.2d 765, 779 (Or. 1996) (holding that Ballot Measure 8, amending the Oregon Constitution to decrease pension rights of public sector employees with respect to future earnings, violated the Contracts Clause of the United States Constitution). Oregon falls within the Ninth Circuit, which does not follow the "breach of contract" exception to the definition of "substantial impairment" for Contracts Clause purposes. Although the impact of this decision was limited subsequently by another case holding that the "unilateral contract" formed by state employees did not extend to the formulas used to determine the value of the annuities to be received by annuitants, allowing the state legislature by statute to eliminate certain alternative investment accounts for future contributions, Strunk v. Pub. Emps.

constitutional amendment would be useless; at the very least, it would prevent the Illinois government from facing the same situation in later years. Moreover, it remains possible that the Illinois pension contracts might be interpreted to confer protection only up to the point at which the Pension Protection Clause was repealed.

However, it is hard to imagine the Illinois legislature passing a constitutional amendment revoking the Pension Protection Clause or enrolling even its new employees in the social security system without some sort of outside pressure. It took several years for it to cobble together and pass the almost certainly unconstitutional pension reform package, and a skeptic, or cynic, might believe some legislators were willing to vote for that plan only because they believed that the courts would strike it down.

The federal government might be able to provide the Illinois legislature (and public) with an impetus for change. If the federal government, operating under its Commerce Clause authority, mandated the immediate inclusion of all state and local government employees in the social security system, Illinois would be placed in the "intolerable" position of providing social security coverage to its employees in addition to the current state plan. The combined fiscal weight would be unsupportable—and eminently unreasonable as many state employees would qualify for pensions that far exceeded their pre-retirement salaries. The state government would have no alternative but to act, and state voters would likely follow through with an approving vote. The gravity of the imposed (and not self-imposed) changes in the pension arrangements would also make courts more sympathetic to the state in any Contracts Clause challenges to offsetting pension reductions.[278]

But why would the federal government agree to play this role? Why might Congress expend the time and energy—and perhaps political capital—necessary to pass such a proposal? Although in the short run adding state and local government employees to the social security system would increase that system's notional revenue base, it is far from clear that over the long term[279] the social security system would

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Ret. Bd., 108 P.3d 1058 (Or. 2004), the original case remains good law in Oregon and is widely cited.

278. Readjustments in the pension arrangement may be regarded as "reasonable and necessary to serve an important public purpose" of avoiding duplicative pension coverage.

279. In the short term, federal government outlays would be reduced as a result of the Windfall Elimination Provision, which reduces social security benefits for workers with pensions derived "from work where Social Security taxes were not taken out of your pay." SOC. SECURITY ADMIN., WINDFALL ELIMINATION PROVISION (2014), *available at* www.ssa.gov/pubs/EN-05-10045.pdf (describing the operation of this provision). The operation of this law has a deleterious

enjoy a net benefit from their participation. Moreover, some senators and representatives may come from states in which employees are not covered by social security and that would prefer to maintain wholly state-based systems. Even if the legislative language were structured to apply only to states whose pension funding ratios fell below a certain percentage, a considerable amount of opposition could be expected.

On the other hand, there may be enough concern about the financial implosion of Illinois and other similarly situated states to impel Congress to take action, particularly if Congressional members from those states took the lead on such legislation. Whether they would be successful would depend on who, besides residents and employees of the state, would be hurt by the financial turmoil that is likely to result from continued state legislative dysfunction. The more members of Congress fear (or could be made to fear) that residents of other states will bear the burden of this dysfunction, the more eager they will be to take action that might ameliorate it.

Illinois' fiscal woes may adversely impact residents of other states in a number of different ways, depending on how the crisis plays out. If Illinois finds itself unable to reduce its pension obligations and lacks the political will to raise enough revenue to pay its accumulated (pension and non-pension) debts and current expenses, it may decide to conserve its cash by defaulting on its outstanding bonds.[280] Although such an action will adversely affect the State, inasmuch as its government will be hard-pressed to borrow funds in the future, it will also impose costs on all the holders of existing bonds, many of whom may come from out-of-state.[281] Further, such a default may adversely affect the cost of borrowing by other state and local governments because it may be taken "as a signal of imminent distress elsewhere."[282]

The mere threat of taking such an action may be used as leverage to

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effect on workers transitioning from uncovered to covered employment in mid-career, which may be a reason either for forcing only newly hired state and local employees into the social security system or for amending its terms in the event of their forced entry into the social security system.

280. As discussed *supra* note 67, no court would be open to the defaulted-upon creditors, preventing them from obtaining an effective remedy against such an action.

281. *See* Skeel, Jr., *supra* note 46, at 725 ("The real holders of state bonds, unlike with Greek debt, are wealthy individuals who hold them, either directly or through mutual or money market funds, because of their tax-favored status. State bonds are especially attractive to wealthy individuals who live in the state of issuance . . . ."). The political power of those wealthy individuals may, of course, make the default alternative less likely to occur.

282. Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 286 (2012) ("Ideally, markets would distinguish between distressed and nondistressed entities; nevertheless, there appears to be substantial evidence of contagion that flows from distressed to healthy debtors.").

obtain a federal bailout.[283] The costs of such a bailout, of course, would be borne largely by residents of other states.[284] Whether state politicians (and the Illinois public) would prefer a bailout to a default may depend on the extent and content of any strings that come attached to the bailout money. The federal government can exert much more power over the behavior of state governments when packaged under its spending power than under, say, the Commerce Clause.[285] It might, for example, tie the receipt of grant money to increases in state revenue obtainable only through state tax increases.[286]

Whether it would impose onerous (or even reasonable) conditions is of course unknown. Although there is precedent for the provision of a federal bailout of a fiscally distressed state like Illinois, there certainly is no guarantee that one will be provided. Congress may be more sensitive to moral hazard concerns than it was when it provided limited relief to New York City in 1975; certainly, its relatively hands-off response to Detroit's 2013 bankruptcy indicates that it may not be inclined to intervene.[287] The federal government has its own fiscal woes, and may be disinclined to add to them, particularly if it regards the state government as behaving irresponsibly. And the less the fear of a bailout, the less likely Congress will be to intervene at all.

Indeed, aside from the bailout and contagion possibilities, it is unclear whether most states have more to fear or to benefit from financial turmoil in sister states. Nearby states may hope that the

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283. *See id.* at 302 (describing how municipal defaults can "trigger demands for centralized intervention out of fear that an unresolved default would have contagion effects that threaten the stability of neighboring jurisdictions . . . or even the nation"); *id.* at 304–05 ("Recall that, notwithstanding President Gerald Ford's much-publicized antipathy toward federal relief during New York City's financial crisis in 1975, the federal government ultimately responded to the city's impending filing for bankruptcy by extending loans with presidential approval in order to avoid the implications of default.").

284. The beneficiaries of such a bailout may also come from out-of-state; it would depend on the identity of the creditors who would be paid as a result of the bailout.

285. Skeel, Jr., *supra* note 46, at 731 ("Congress has considerable scope for intervention before it runs up against the state sovereignty constraints . . .[r]elying on . . . financial invitation rather than coercion."); *see* Lynn A. Baker, *The Spending Power and the Federalist Revival*, 4 CHAP. L. REV. 195, 195–97 (2001) ("No matter how narrowly the Court might read Congress's powers under the Commerce Clause and section 5 of the Fourteenth Amendment, . . . the states will be at the mercy of Congress so long as there are no meaningful limits on its spending power. . . . [T]he Supreme Court . . . has historically declined to review Congress's spending decisions . . . [and] crafted standing doctrine to severely restrict the ability of taxpayers to challenge Congress's spending decisions in *any* federal court.").

286. Skeel, Jr., *supra* note 46, at 731–32 (discussing the powers that might be granted to a federal oversight board when coupled with "financial invitation rather than coercion").

287. Detroit had the option of relying on the federal courts and their interpretation of the Bankruptcy Code. There is no such obvious alternative for states.

necessary Illinois tax increases will drive profitable businesses, not to mention retirees from private companies covered by social security and employer plans, into their jurisdictions. Such relocations could well benefit other jurisdictions while leaving poorer and less mobile Illinois residents trapped and facing a "death spiral" of increased taxes and decreased services.[288] Nor is it clear how many of the state's bonds are held by nonresidents, another potential source of pressure in favor of federal relief.

There is, of course, another alternative open to Congress. It could, as some have suggested, create a bankruptcy regime for state governments.[289] A federal bankruptcy regime might provide Illinois with a legal end-run around its Pension Protection Clause,[290] and if upheld likely would allow reductions in accrued pension benefits in addition to those earned by current employees from the performance of future services.[291] Although the creation of such a regime would add to states' "toolkit" for dealing with financial distress,[292] it would do nothing to protect employees who would remain totally reliant on state funding for their pensions;[293] further, it would not necessarily require a

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288. Whether retirees would actually move is problematic. *See supra* note 167 and accompanying text (discussing interstate moves).

289. Skeel, Jr., *supra* note 46, at 679–80 ("Starting in late 2010, a few politicians and commentators insisted that state bankruptcy was an idea whose time had now come . . . . Advocates argued that bankruptcy would be preferable to either a complete default or a federal bailout.").

290. One of the issues raised by Detroit's bankruptcy is whether the municipal bankruptcy rules take precedence over Michigan's constitutional protections against pension reductions. The city tried to finesse this question through a negotiated settlement. One of the provisions of the "grand deal" (which had to be ratified by a vote of individual retirees and active vested pensioners to become effective) requires city employees and retirees to give up "their right to pursue lawsuits over pension cuts against the State of Michigan." Nathan Bomey & Joe Guillen, *City Close to Pension Deal*, DETROIT FREE PRESS, April 15, 2014, at 1A; Nathan Bomey, *Detroit Forcefully Defends Bankruptcy in Filing*, USA TODAY (May 27, 2015, 7:44 PM), http://www.usatoday.com/story/news/nation/2014/05/27/detroit-bankruptcy-plan-of-adjustment-defense/9646417/. Although retirees voted overwhelmingly in favor of this deal, Chad Livengood & David Shepardson, *Detroit's Debt-Cutting Plan Gets Big But Not Complete Support*, THE DETROIT NEWS (July 21, 2014, 12:40 PM), http://newsinmi.com/detroits-debt-cutting-plan-gets-big-but-not-complete-support/ (eighty-two percent of retired and active Detroit police and firefighters approved the plan as did seventy-three percent of members of the General Retirement System), it remains unclear whether the dissenters will have standing to pursue lawsuits challenging the pension reductions. Michigan's Attorney General announced that he will not "further litigate the issue." *Id.*

291. Skeel, Jr., *supra* note 46, at 711–12.

292. *Id.* at 712.

293. It is worth noting that Illinois' annual increase, which appears generous now, will fall short of protecting retirees against cost of living increases in inflationary times. Unlike social security benefits, which are explicitly tied to a cost-of-living index, the Illinois increase is a stable, flat amount.

state to take future actions—such as fully funding pension obligations—that would force them to correctly internalize the costs of their labor agreements on a current basis.

It is unclear whether the Congressional delegations of burdened states will be eager to get Congress to take action. They are tied to local political parties, and political actors, who despite the situations in which they currently find themselves, may be reluctant to cede further power to the federal government. After all, it is not as though the transition to the social security system would be painless. The contributions the state would have to make to the system on behalf of its employees would be substantial, and it is not clear that such a transition would decrease overall pension costs in either the short term or the long term. Unfortunately, while taxpayers (and perhaps state employees) benefit when politicians internalize the full cost of employment arrangements, politicians do not.

CONCLUSION

There is no easy, nor simple, answer to the long-foretold, but equally long-ignored, crisis in state pension obligations. None of the affected parties will likely escape unscathed; from a financial and political standpoint, the only question is how the inevitable losses will be allocated. However, some good might come out of this financial disaster. It may provide the impetus for a rational restructuring of governmental pension arrangements, and more generally, for an intelligent discussion of the necessary linkage between the cost of providing government services and the need to raise revenues to defray that cost. For far too long, the voting public has been willing to let politicians pretend that additional services can be provided at no additional tax cost by creatively hiding debt through stratagems such as underfunding pension plans and "leasing" public assets such as parking meter revenues and tollways.

This Article has attempted to show some mechanisms for preventing the systemic underfunding of future pension obligations, and to provide some suggestions for equitably splitting the costs of rectifying past underfunding. Unfortunately, the various dysfunctions responsible for the development of the crisis may forestall adoption of even these small measures.