ILLINOIS TAX FACTS

Taxpayers' Federation of Illinois 64 • 5 ■ September/October 2011

CROWDING OUT -- SERVICING ILLINOIS' PENSION DEBT

By Thom Walstrum

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The Illinois State Retirement System has an unfunded liability of $85.6 billion (CGFA(b), 2011, p23). The number is eye-catching, but what does it actually mean? In this article I explain where the number comes from and why it will likely crowd out spending on other state priorities.

The Illinois State Retirement System is divided into five pension funds: Teachers, State Employees, State Universities, Judges, and General Assembly. While each fund has its own set of rules, such as how much employees and the State contribute or when benefits can begin, from the taxpayer's perspective what matters are the liabilities, the assets, and the difference between them – the unfunded liability – added up across the five funds.

One way to think of the pension funds is as a collection of individual retirement savings accounts. The State manages the accounts and tries to get a good return on them. Each year both the participating employee and the

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NOTES FROM THE INSIDE. . .

By J. Thomas Johnson

This issue of Tax Facts deals with the most significant fiscal issue facing Illinois State government, the daunting level of the State's unfunded pension liability, the most of any state in the nation. Thom Walstrum explores in his article how the required funding payments will crowd out spending for other programs including education, human services, and healthcare for the most vulnerable in our society. In our opinion, states must compete on two fronts, a responsible tax structure that is competitive with other states for investment and job creation and current government services, paid for by those taxes, that are valued by the taxpayers. Thom's analysis suggests that Illinois' tax burden will have to be used to pay down our pension debt rather than being available to provide current services. Our next task will be to undertake this type of analysis for the states that border Illinois to see how well we will be able to compete in terms of providing current government services. Given their pension funding levels compared to ours we do not expect this analysis to reflect well on our state.

Kirsten Carroll's article explains the provisions of SB 512, which would reform our pension benefit structure and the current funding plan for our pension debt. We believe it is a responsible and fair approach to the challenges facing our State. As a result of the tax increase this past January, Illinois currently has the 7th highest tax burden in the country as measured by percentage of gross tax product. Bottom line, we do not have time to debate the issue infinitum, we need to act in order to compete for our economic future.

State contribute to the employee's savings account. Upon retirement, the employee receives a monthly defined benefit (fixed payment) that is paid out of the account. The longer the employee works, the more she pays in, and the greater the monthly defined benefit earned.

The State's yearly contribution to the employee's account is calculated as the difference between the additional benefits the employee earned that year and the amount the employee contributed. The State's overall yearly contribution to the pension system is added up across all participating employees. The contribution is called the "normal cost" of the pension in the state budget. In principle, if the State pays the normal cost of the pension every year, the system will be fully funded and have enough to pay the promised benefits.

There are four primary ways a pension system could fall short of being fully funded. First, participants could receive salary or benefit increases. Such increases raise the value of the defined benefits that will be paid upon retirement. Contributions from previous years that were based on lower salaries and benefits would not be enough to cover the new, higher defined benefit. Second, actuarial assumptions about the pool of participants could be incorrect. When calculating the liability of the pension funds, actuaries must make assumptions about participant characteristics such as the retirement rate and life expectancies. If the assumptions turn out to be incorrect, the pension funds may not have enough saved. Third, the value of the pension funds fluctuates with business cycles. The money put into the pension funds is managed by the State as a portfolio of investments, some of which are stocks, bonds, or other more risky investments. Riskier investments have a higher average return, but the return is also in greater danger of being negative. Thus, during good times, the pension funds may appear overfunded and during bad times the pension funds may appear underfunded. Finally, the State could fail to pay the normal cost of the pension. Employees' contributions to their pensions are automatically removed from their paychecks (except in the case of some downstate teachers, where school districts may "pick up" all or a portion of the employee contribution as part of their labor contract). On the other hand, the State must allocate funds to the pension system out of its budget. Because an unfunded pension liability is not an immediate problem, forgoing paying the normal cost is a tempting short-term solution to a budget deficit.

Table 1: Unfunded Liability Increase FY1996 - FY2010

Category	Amount ($Millions)	Percent of Increase
Unpaid Normal Cost[1]	24,709.7	43.3%
Returns Below Expectations	11,673.2	20.5%
Benefit Increases	5,797.2	10.2%
Actuarial Assumptions	3,549.0	6.2%
Salary Increases	662.9	1.2%
Other	10,633.3	18.6%

Source: CGFA(b) 2011.

[1] CGFA calls this number normal cost plus interest. If the unfunded liability is thought of as a loan, the unpaid normal cost is the principal and the expected return the unpaid normal cost would have earned is the interest.

For the five Illinois pension funds combined, the fiscal year 2010 estimate of future benefits to be paid was $138.8 billion and the amount in the funds was $53.2 billion (CGFA(b), 2011, p23). The difference leaves the State with an unfunded liability of $85.6 billion. What happened in Illinois?

The FY2010 CGFA report on the Illinois pension funds includes an assessment of how Illinois' unfunded liability grew from FY1995 through FY2010 (CFGA(a), 2011, p103-104). In that period the unfunded liability grew by $57 billion, which encompasses 67 percent of the total unfunded liability. **Table 1** shows the breakdown of the increase. Unpaid normal cost and the foregone returns on that normal cost contribution – called "interest" on the unfunded liability – contributed the most, followed by below expected investment returns, then benefit increases. It is worth noting that if FY2008 – FY2010 were excluded, investment returns would actually have reduced the unfunded liability. It is too soon to know whether investment returns will eventually catch up to expectations.

Regardless of where the shortfall comes from, Illinois is now in a position where the savings accounts hold far less than they need to ensure that retirees will receive their benefits. The State must make up the gap. There is already a law that has scheduled the payments for the system to be 90% funded by 2045 (CGFA(b) 2011, p91). But because the hole is so big, the State must make payments into the pension funds that dwarf their normal cost.

Our concern is that the payments required to cover the unfunded pension liability will crowd out spending on other priorities.

To assess the impact of the unfunded liability, we projected the State's revenues and expenses out to 2045, the year when the pension system is targeted to be 90% funded. The State's budget is quite complex; it involves hundreds of special spending funds that are earmarked for specific purposes. Funding for the special funds comes from both federal and state sources. None of these sources are available for spending on general operations, such as annual pension contributions. To focus our analysis on the true choices facing the Governor and General Assembly, we analyzed the major revenue sources for the General Funds, excluding federal receipts.

Figure 1 shows the projected pension obligation the State faces under current law as a percent of the Big Three General Funds revenues. The Big Three revenues are the personal and corporate income taxes and the sales tax. As **Table 2** shows, the three taxes comprise 78.3% of General Funds revenue. Our revenue projections make two important assumptions: 1) revenues for the three taxes grow at 2.3% annually and 2) the recent personal and corporate income tax increases sunset as scheduled. The pension obligations estimates come from the fiscal year 2010 *Report on the Financial Condition of the*

Figure 1. Projected Pension Obligations as a Percent of "Big Three" General Funds Revenue

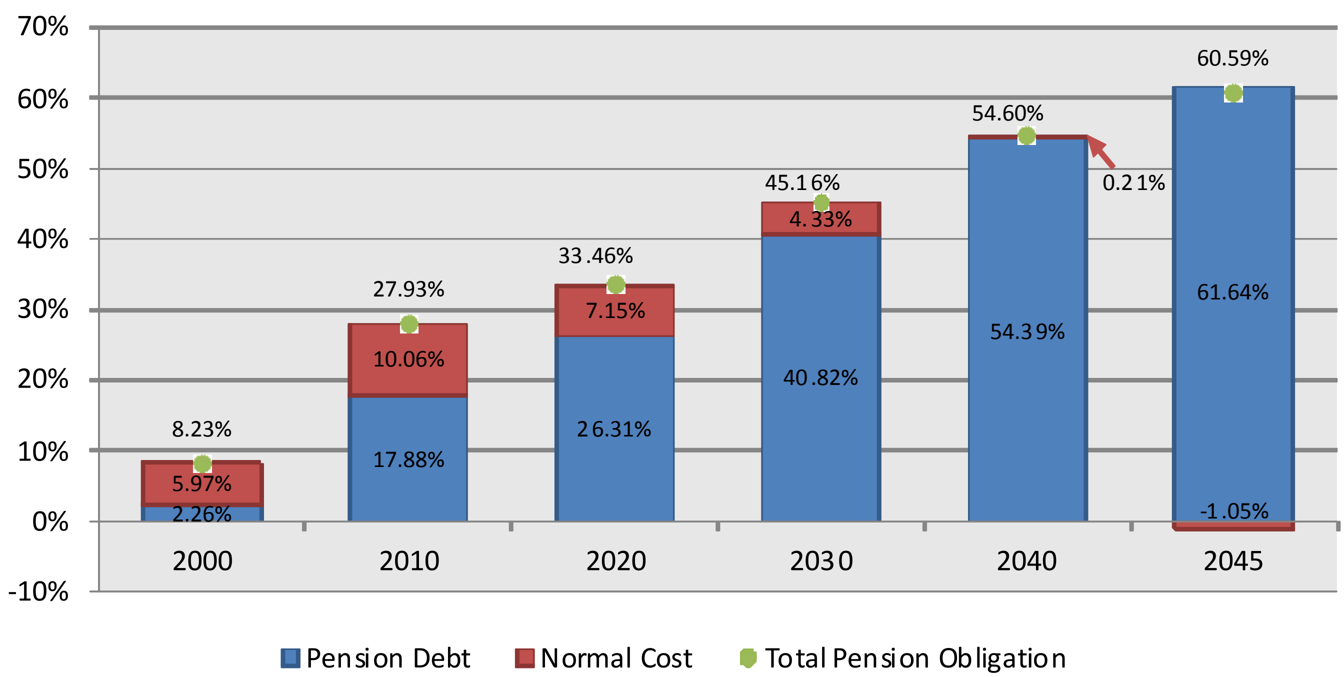

Table 2: Composition of the Big Three Taxes Fiscal Year 2010		
The Big Three Taxes	General Funds Revenue ($Millions)	Percentage of General Funds Revenue
Personal Income	8,511	40.2%
Corporate Income	1,360	6.4%
Sales	6,704	31.7%
Total	16,575	78.3%
Source: CGFA(c), p26. Sales Tax Revenues include Build Illinois and Illinois Tax Increment funds, which were not included in the CGFA numbers. Data for those funds taken is from the Illinois Comptroller's website under Financial Inquiries -> Revenues.		

Illinois State Retirement Systems by the Commission on Government Forecasting and Accountability (CGFA(b), 2011).

We split the pension obligation into pension debt and normal cost to highlight the impact of the $85.6 billion unfunded liability. We called it "Pension Debt" instead of "Unfunded Liability Payments" because the debt includes payments for bonds sold in 2003, 2010, and 2011 whose proceeds were contributed to the pension funds. Selling pension bonds allowed the State to contribute cash to the pension funds that counted toward its obligations, but it did nothing to solve the problem; it simply created two categories of pension debt.

If the pension system were fully funded, the blue bars would not be present and payments to the pension system would have little impact on the budget. Instead, the State is in a situation where an increasing percentage of its spending will go toward funding pension obligations. Under our assumptions, spending on pensions will crowd out spending on other priorities.

A couple notes on Figure 1. First, notice how the blue bars steadily increase in size. They increase because the current law puts more of the payment burden on later decades. Second, notice how the normal cost steadily decreases. It decreases because retirement plans for new employees are projected to have much lower normal costs and these plans will come to dominate the systems as a larger proportion of employees are enrolled in the new plans in the future. The projected normal cost in 2045 is negative because new hires would pay more into the system than their normal cost in that year (CGFA(a), 2011, p23).

What will the pension obligations crowd out? **Table 3** shows the other main spending

Table 3: Other General Funds Spending Priorities		
	2010 General Funds Spending	Percent of Big Three
Human Services	5,126	30.9%
K-12 Education	7,272	43.9%
Higher Education	2,216	13.4%
Medicaid	3,620	21.8%
Total	18,234	110.0%
Source: State of Illinois Comptroller: In-Depth Analysis of Expenditures, 2011.		

categories in the General Funds for fiscal year 2010.[1] The only way to maintain the 2010 proportions is to adjust our revenue assumptions. Either revenue must grow at a greater rate than 2.3% or tax rates must be higher. We believe the State has little power to change either of these assumptions.

Revenue growth is the result of economic growth. While the State can try implementing “pro-growth” policies, there is little agreement between political parties or economists as to what such policies are. Given substantial disagreement about what constitutes a pro-growth policy, it would be foolish to count on revenue growth large enough to cover the unfunded pension liability.

The State also has little room to rely on further tax increases. Unlike at the national level, states directly compete with each other for economic development. Thus states cannot afford to have a tax structure that is much different than other states. With the 2011 tax increase, Illinois is now arguably a “high tax” state (Nowlan & Aprill, 2011). High taxes do not necessarily hurt a state’s competitiveness if they correspond with high levels of government services. Unfortunately, we doubt that few taxpayers consider paying pension debt a government service. Illinois is not in a position where it can raise taxes to cover the unfunded pension liability without creating an uncompetitive tax structure.

[1] They add to greater than 100% because the Big Three account for 78.3% of General Funds revenue.

The State has few other options. It could restructure the liability to be paid off over a longer period. Extending the repayment period is possible because new employees receive a much less generous plan. But there are a couple problems with extending the pay off period. First, in spreading the liability over extra decades, the total cost of the liability would be significantly higher because of interest payments. Second, it may strike many as unfair that the younger generation (who will receive much less in benefits) would be paying for past pension costs.

A final option is to reduce the pension debt by reforming the system for current employees. Reform is not easy because it will modify the benefit structure that many employees have been counting on. In addition, the employees may believe the benefit modifications are unfair because they have “kept their end of the bargain” by faithfully paying their portion into the pension funds.

Still, reform may be the least bad of all the options. In the private sector, a business with too much debt must consider bankruptcy. In such circumstances, usually both investors and workers make concessions to get the business back on firm footing. The State is a public entity and cannot realistically declare bankruptcy. But it can restructure its debt, which is what pension reform would amount to.

What could reform look like? The Taxpayers’ Federation supports Senate Bill 512 (SB512), which is described in the following article.

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Senate Bill 512: Restructuring Pensions for Current Employees

By Kirsten Carroll

Kirsten Carroll is a Public Policy Consultant at the Civic Committee of the Commercial Club of Chicago, where she has focused on the issue of pension reform for the last five years. Kirsten holds a Masters of Business Administration and Masters of Public Policy from the University of Chicago.

Thom Walstrum has outlined many of the issues associated with the State's current plan for addressing its pension crisis. Chief among them is the "crowding out" of essential State programs as future required pension contributions overtake the State's revenues, leaving less and less for critical services such as education, public safety and health care for the poor.

Senate Bill 512 (SB512) offers a reasonable alternative to the current, unsustainable plan. SB 512 restructures the benefits for current State employees going forward, protecting all benefits that have already been earned by retirees and employees, and puts in place a more responsible pension contribution schedule. SB 512 balances the interests of *all* stakeholders in the pension plans – retirees, current employees, new employees *and* the State's taxpayers. The restructuring allows the State to stabilize its pension contributions and avoid the massive crowding out of essential State programs, while at the same time improving the fiscal health of the pension funds themselves.

KEY PROVISIONS OF SENATE BILL 512

SB 512 protects all benefits that have already been earned by retirees and current employees; retirees will see no change in their pension benefits after the implementation of SB 512 and current employees will see no "impairment" of their already-accrued benefits. In fact, SB 512 makes benefits that have already been earned by retirees and employees *more secure* by putting in place a more conservative funding schedule to amortize the current unfunded pension liability. One of the key provisions of the bill is that the State takes on the full burden of amortizing the current $80+ Billion unfunded liability – even though less than half of the growth in the unfunded liability over the last 15 years was the result of inadequate funding by the State (as discussed in Thom Walstrum's analysis).

SB 512 also restructures future pension benefits and contributions for current and new employees.

Current employees are offered 3 choices in their pension plan going forward:

> 1) the current generous defined benefit plan, but with a higher employee contribution;
>
> 2) the reformed defined benefit plan now offered to new employees, but with a lower employee contribution; or
>
> 3) a new defined contribution plan, with the same employee contribution as the reformed defined benefit plan.

New employees are offered the reformed defined benefit plan or the new defined contribution plan. In both cases, new employees will contribute less to the plans than their current pension contribution, even if they remain in the reformed defined benefit plan that they are currently offered. Therefore, new employees are unequivocally better off under SB 512 than under the State's current plan.

Regardless of the choices made by employees, the State makes the same contribution toward future pension accruals – 6% of payroll (this payment is in addition to the State's amortization payment on the current unfunded liability). The employee is responsible for the remaining annual cost of the plan they choose (normal cost as defined in Thom Walstrum's article), with a minimum employee contribution of 6% of payroll. These contribution levels, as well as other provisions in the bill, are included to ensure that the relevant State pension plans maintain their current exemption from participation in Social Security.

IMPACT OF SENATE BILL 512: EMPLOYEE CONTRIBUTIONS

How will these provisions impact public employee contributions toward their future pension benefits? Downstate teachers comprise the largest of the five state plans –the Teachers' Retirement System – and provide a good example. Today, teachers are required to contribute 9.4% of salary for the *current defined benefit* plan.

Under SB 512, teachers who switch from the current plan to the *reformed defined benefit* plan or the new *defined contribution* plan will see their required contributions decline from 9.4% to 6% of salary – reflecting the lower annual cost of these plans.

Teachers who choose to remain in the *current defined benefit* plan will see their contributions rise from 9.4% to 13.77% of salary (employee contributions will then be recalculated every three years to reflect the ongoing cost of the plan).

This increased contribution reflects the higher cost of the current plan, which allows for retirement at age 60 with 10 years of service and a 3% compounded annual cost-of-living adjustment. In addition, data from the Illinois State Board of Education indicates that over 60% of Illinois school districts "pick up" some portion of their teachers' retirement-related contributions as part of their negotiated contract, with an average "pick up" of about 9.2%. For these teachers, maintaining their current generous plan will cost them only about 5% of salary – less than what private sector workers contribute to Social Security (and the Social Security benefits that these private sector workers will receive are much less generous than the current teachers' plan).

To sum up, under SB 512 employees contribute less to the plans if they choose the reformed defined benefit plan or the new defined contribution plan. Current employees who choose to remain in the current generous plan contribute more – reflecting the greater annual cost of that plan. (The state also pays more into the pension funds than under the current plan for the next 10 years or so – because of the more conservative amortization of the unfunded liability – but this contribution grows slowly, tracking the growth in tax revenues.)

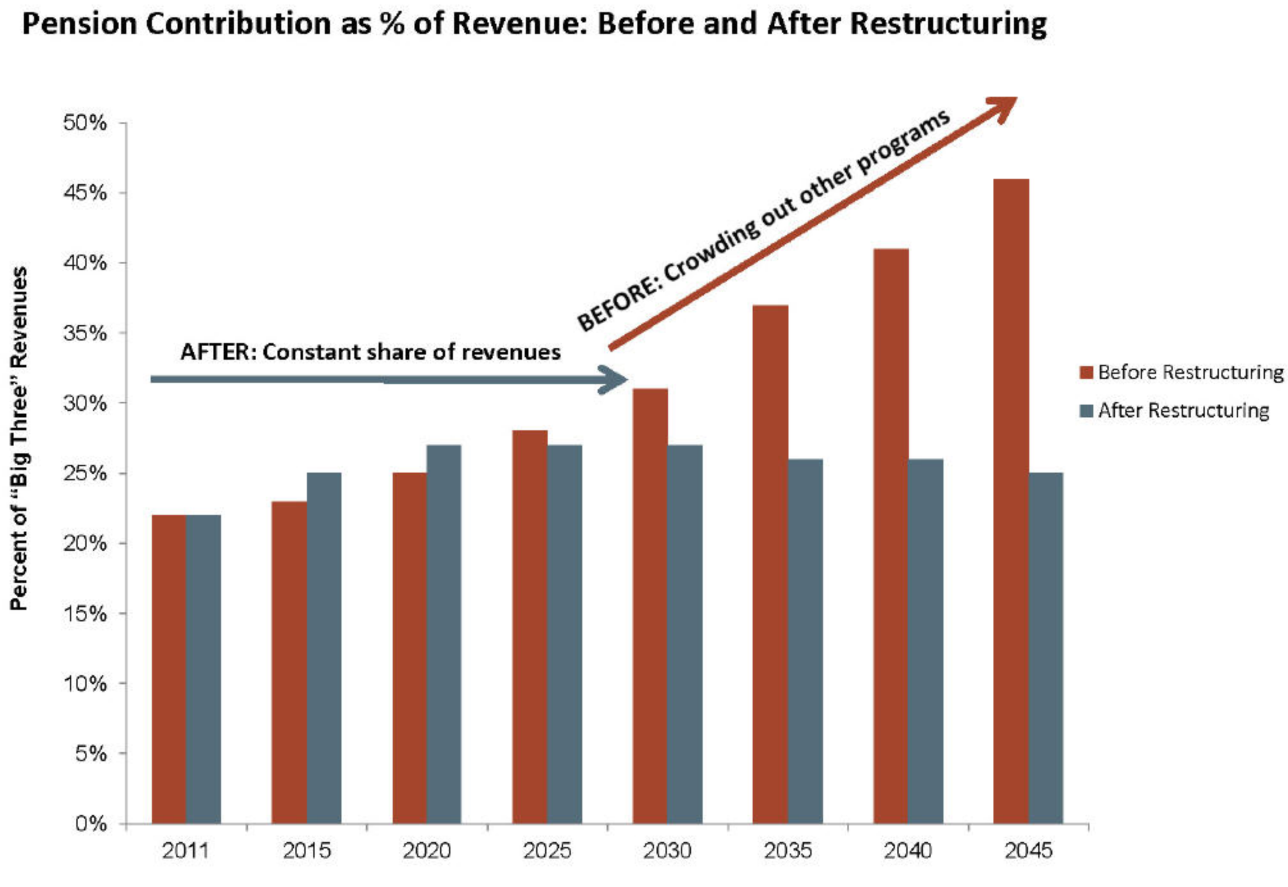
IMPACT OF SENATE BILL 512: STATE CONTRIBUTIONS AND THE HEALTH OF THE PENSION FUNDS

Restructuring the pension plans has two critical and positive impacts.

First, increased state contributions over the next 10 years and restructured benefits mean that the state will have lower required contributions in later years. Instead of consuming almost half of Big Three tax revenues by 2045, the state's pension contributions are estimated to hold steady at 25-30% of these revenues through 2045.

(Note: There are several differences between this crowding out analysis and that which appears in Thom Walstrum's article. The

Figure 1. Pension Restructuring
Impact on "Crowding Out"



Source: Commission on Government Forecasting and Accountability; Taxpayers' Federation of Illinois; data from the State pension systems

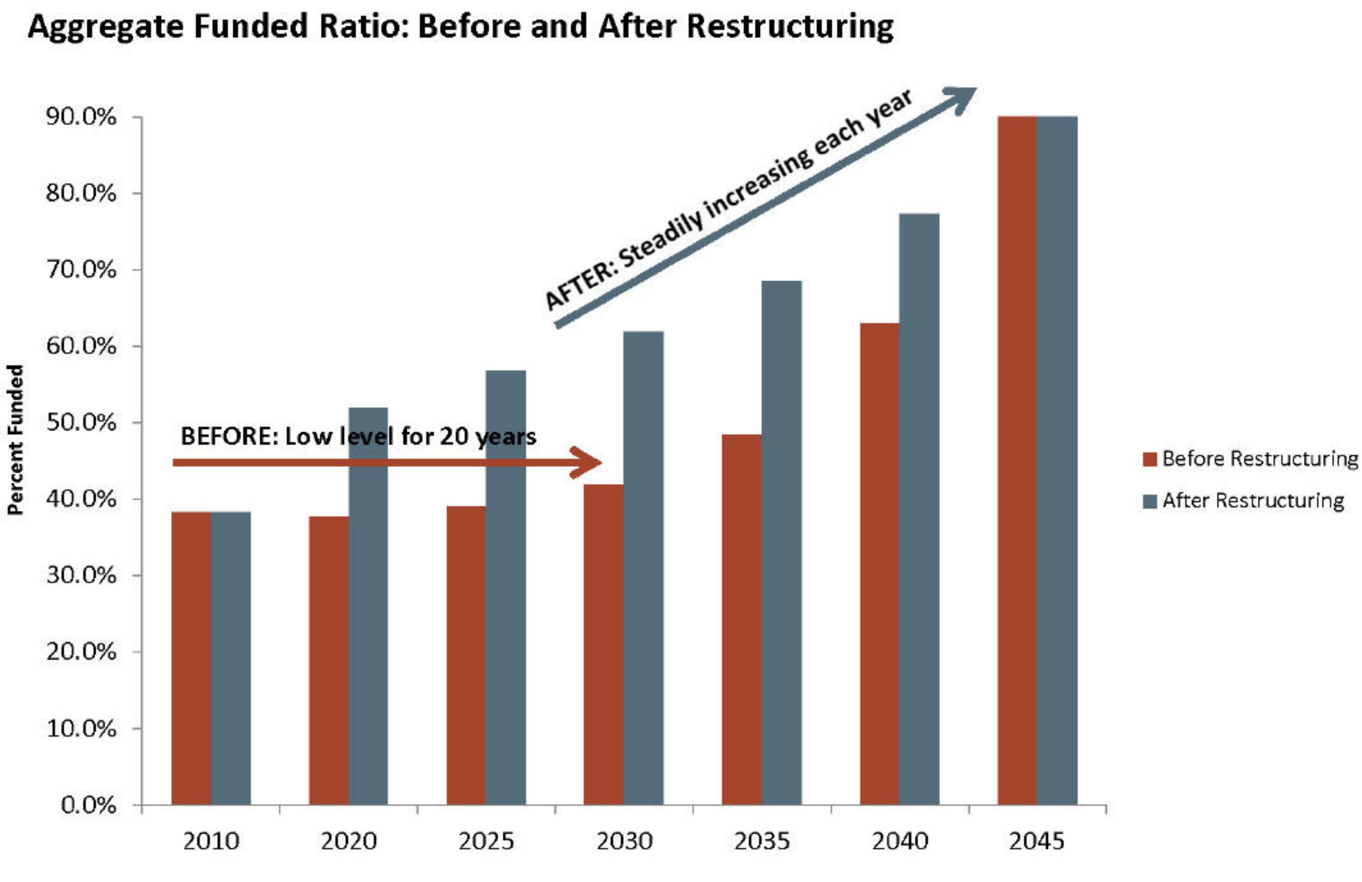
analysis in the chart on page 10 includes only the state's pension contribution to the funds, not required payments on the pension obligation bonds. It also assumes that the current tax increase remains in effect, i.e., it does not sunset.)

In addition, SB 512 improves the fiscal health of the pension funds themselves. Under the State's current plan, the required pension contributions are not sufficient to keep the unfunded pension liability from growing for the next two decades. Only after 2032 are contributions large enough to begin to reduce the plans' aggregate unfunded liability. As a result, the aggregate funding level of the State's five pension plans is expected to remain at dangerously low levels – about 40% or less – for almost 20 years. Such low funding levels put the funds at serious risk in the event of a double-dip recession or another market downturn in the next two decades.

Under SB 512, improved early funding (largely as a result of the conservative amortization of the current unfunded liability) means that the aggregate funding level of the State's five pension plans increases every year. The aggregate funding level is estimated to surpass

Figure 2. Pension Restructuring

Impact on Aggregate Funded Ratio



Sources: Commission on Government Forecasting and Accountability; data from the State pension systems

60% by 2030 and steadily rise to 90% by 2045 based on a more responsible funding schedule.

Senate Bill 512 is a fair and reasonable proposal to achieve the twin goals of reducing the crowding out of critical State services while improving the financial health of the pension funds. These goals are both achieved because SB512 restructures pension benefits going forward *and* improves the immediate funding of the plans.

For more information and to support Senate Bill 512, go to: www.**illinoisisbroke**.com/

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