ILLINOIS TAX FACTS

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Illinois' Pension Crisis and Recommendations for Reform

By R. Eden Martin and Kirsten Carroll

This summary of the pension crisis facing the State of Illinois was written by R. Eden Martin, President of the Civic Committee of The Commercial Club of Chicago and Kirsten Carroll, Public Policy Consultant to the Civic Committee. A series of graphs, which are referenced throughout the text, are located at the end of the summary.

INSIDE THIS ISSUE

INTRODUCTION

Imagine that you are the head of a family and that the family owns a small business. Further imagine that over the past decade you have had trouble paying the bills. So you have run up your credit card debt and put off paying the mortgages on your business and home, with the result that you now have debts amounting to over four times your annual revenue. The unpaid interest on these debts keeps adding to the total. You could cut your business and household expenses, but it would be hard on certain members of the family, who would have to reduce their standard of living. You cannot raise prices because if you did, your customers would leave.

What do you do? Cutting costs would be unpleasant. You can't raise revenue. So what's left to do? You borrow. And you keep doing it – year after year – as long as the banks continue to defer foreclosure on your business and home.

Prudent?

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NOTES FROM THE INSIDE....

By J. Thomas Johnson

This issue of Tax Facts is again focused on the staggering pension debt that is facing the state of Illinois. The Civic Committee of the Commercial Club of Chicago, along with other public policy organizations, has invested extraordinary energy into bringing more sunshine to this continuing problem. The Civic Federation of Chicago has brought focus on the fact that the local government pension debt is as bad or in some cases worse than the state situation. Failure to deposit funds into the pension funds when actuarial studies showed us we should have, has largely been the focus of the critics. However, other contributors have been the underlying costs associated with longer lives and earlier retirements resulting in lifetime benefit projections far greater than when the pension programs were initially designed. Failure to modify employee contributions that would support in part this larger lifetime benefit has put more burden on the employer/taxpayer to fund these benefit programs.

The end result is these unfunded costs will put pressure on the state in two ways, increased tax burdens and an inability to finance other government programs such as education and healthcare. States' tax structures must be competitive with each other in order to encourage investment and job creation. If a state has to devote an extraordinary portion of its future resources to paying off this "old" debt, then it will crowd out "other spending" that will support that job creation.

I want to thank Eden Martin and Kirsten Carroll from the Civic Committee in contributing this article to further our, and our policy makers' education regarding this daunting financial burden facing our state.

In December 2006, the Civic Committee of The Commercial Club of Chicago released a task force report, entitled *Facing Facts*, on the condition of the State of Illinois' finances. The task force, chaired by Jim Farrell, former Chairman and CEO of Illinois Tool Works, concluded then that unless the State brought its budget under control, Illinois was headed toward fiscal implosion. A few months ago, in February 2009 – following the economic collapse of last fall – the Civic Committee published an updated report, *Facing Facts 2009*, on the deteriorating condition of the State's finances.

How did the State get into this fix? Largely by being unwilling to reform expensive pension and benefit programs, or to cut significantly other areas of the State's budget. Lacking the will to cut and fearing the political consequences of raising taxes, the State has failed adequately to fund its pensions. Over the past decade, the State has allowed its pension obligations to mushroom – from about $16 Billion in FY2000 to around $90 Billion in pension-related obligations at the end of FY2009 (Figure 1).

PENSION DEBT AND THE NORMAL COST PLUS INTEREST PAYMENT

Each year, the State's five pension plans report an estimate of the amount that the plans will be obligated to pay in the future for the pensions their employees have earned up to that point in time – called the "accrued pension liability." The accrued pension liability is an estimate of the "present value" (discounted) of the sum of all pension payments that will be due retirees in future years. This liability is then compared to the actual value of the assets that are in the pension funds as of that date. If the liability is greater than the assets, the pension plans have an unfunded liability.

The combined unfunded liability of the State's five pension plans is essentially the pension plans' debt – those benefits that have already been earned, but for which no assets have been set aside. When the State fails to fund its pensions sufficiently each year, this unfunded liability – the pension debt – grows from year to year as the "interest" on this debt (reversal of the discount rate used to present-value the pension liability) is added to the total.

In order to keep the unfunded pension liability from growing, actuaries recommend that the annual pension contribution should cover "Normal Cost Plus Interest," which consists of two parts.

First, there is the "normal" annual cost of pension obligations. This is the amount (present-valued) of the increase in the pension liability taken on during the year as a result of the work performed by employees during that year. This "normal" cost can be thought of as the value of benefits earned during the year; this cost would be incurred even if the State's pension funds were fully funded.

Second, the State must also contribute an amount equal to "interest" on any unfunded liabilities. The pension liability is "brought back" to a present value by "discounting" the totals, using a discount rate. Illinois uses a discount rate of 8.5% because that is the amount the State assumes investments in the pension fund will grow over time. So each year, as we move closer to the time when payments must be made, the discount is in effect reversed for one year – which is what the State means by "paying interest" on the unfunded liabilities. This reversing the discount – "paying interest" – means the State incurs a cost of 8.5% times the unfunded balance each year. If the State does not cover that cost with its annual pension contribution, the "interest" is added to the total unfunded liability.

These two elements, added together, produce the Normal Cost Plus Interest contribution that actuaries recommend each year to keep from adding to the unfunded liability. The State's failure, over many years, to appropriate and fund this Normal Cost Plus Interest contribution into the State's pension plans is partly responsible for the tremendous growth of the State's unfunded liability over the last decade.

CURRENT STATUTORY SCHEDULE VS. NORMAL COST PLUS INTEREST

In 1995 the State legislature enacted Public Act 88-593 to deal with pension underfunding. This law created a 50-year payment plan to bring funding ratios to 90% by 2045 (an estimated unfunded liability of $54 Billion on a total accrued pension liability of around $540 Billion). The 1995 law required the State to make contributions at a level percent of payroll, but with an initial "ramp-up" phase-in from 1996-2010.

The 1995 plan was structurally flawed from the beginning because it did not require State contributions to cover Normal Cost Plus Interest until after 2030 – thereby substantially "back-end loading" the State's pension funding and guaranteeing that the unfunded liability would continue to grow for many years. In addition, the State has failed to make its required statutory contributions in recent years, leading to even further growth in the unfunded liability. The net result of this underfunding has been a quadrupling of the unfunded liability – from $16 Billion in FY2000 to $79 Billion at the end of FY2009 (Figure 1).

As shown in Figure 2, even if the State makes its required statutory contribution in the future, the unfunded liability is projected to grow to more than $144 Billion by 2033 – when it is projected to peak and then begin to decline (as the statutory contribution in those later years surpasses Normal Cost Plus Interest).[1]

The problem with this massive and growing unfunded liability, reflecting the significant underfunding in the early years of the statutory schedule, is that huge contributions from the State will be required in later years to reduce the unfunded liability to $54 Billion by 2045 (Figure 3). From 2034-2045, the statutory schedule shows the State making annual pension contributions equal to *more than 33% of the State's payroll* in each of those years. Given the State's inability to make its pension contributions in recent years – when those payments were less than 20% of payroll – the required contributions from 2034-2045 are impossibly high. And with each year that the State fails to make its statutory contribution now, the required payments in those later years go up even higher.

As the statutory pension contribution rises and consumes a larger and larger share of annual revenues, the State will be faced with two equally unattractive choices: either slashing other State programs – such as health care for the poor or support for public education – or raising taxes to such a high level that some businesses and residents will flee the State.

By contrast, if the State were to begin making the Normal Cost Plus Interest contribution in FY2010, and continue that practice until 2045, then – everything else being equal – the State's unfunded liability would remain flat at the FY2009 level of $79 Billion (Figure 4). (In order to reach the 2045 goal of an unfunded liability of $54 Billion, the State would have to make additional payments totaling $25 Billion during that timeframe as well.)

The annual Normal Cost Plus Interest contribution would also remain fairly constant over time (Figure 5), because the "interest" part of the Normal Cost Plus Interest contribution would remain constant in each year ($79 Billion X .085). Increasing Normal Costs cause some increase in the contribution over time, but these increasing costs are appropriately allocated to taxpayers in the year in which those benefits are earned.

1 The graphs in this document use the most recent projections published by COGFA – a pension briefing published in April 2009 and a report on the pension funds published in February 2009 – and therefore do not include the impact of pension asset smoothing (SB1292). Pension asset smoothing reduces the FY2011 statutory contribution from $5.4 Billion to $4.5 Billion – further back-end loading the State's pension funding.

A comparison of the Normal Cost Plus Interest contribution to the statutory contribution (Figure 6) shows that ending the State's practice of back-end loading its pension costs would require greater contributions in earlier years, but substantially lower contributions in later years. The *statutory* schedule requires total pension contributions from 2010-2045 of $457 Billion; paying *Normal Cost Plus Interest* would save almost $100 Billion in pension contributions over that same period.

THE STATE'S FY2010 PENSION SOLUTION: PENSION NOTES

In the special session held July 14, 2009, the State legislature chose to fund the statutory FY2010 pension contribution by paying only $500 Million out of operating revenues (thereby freeing up more operating revenues for other State programs), and issuing $3.5 Billion in five-year pension notes to cover the remainder. While this "solution" allows the State to put the full $4 Billion FY2010 statutory contribution into the pension funds, it essentially trades one form of pension debt for another. It's like paying one's MasterCard bill with a Visa card.

Figure 7 shows the impact on the State's total pension-related debt if the State continues to follow this practice through 2045 (assuming that for FY2011-2045 only the normal cost is paid out of operating revenues, and the remainder of the statutory contribution is funded using five-year pension notes).

The end result of funding the statutory contribution in this manner would be that in 2045 the State would have a $54 Billion unfunded liability, but it would also have an *additional $56 Billion* in pension note debt. By taking into account *all* pension-related debt, it becomes clear that the practice of using pension notes more than doubles the State's pension debt in 2045 compared to the initial intent of the 1995 law.

Moreover, such a "pension note policy" would do little to relieve the State's perennial cash shortages. The major goal of the State legislature in issuing the pension notes for the FY2010 contribution was to free-up those monies in the operating budget for other State programs. If the State were to continue this practice going forward, Figure 8 shows that the budget-relieving impact of this practice would last only through the first five years of its implementation.

Every year, the State must pay one-fifth of the principal of any five-year pension notes that remain outstanding from previous years. After the fifth year of this practice, the State would be paying one-fifth of the pension note principal from each of the previous five years. Assuming that the statutory contribution rises slowly from year to year, the sum of the principal payments required on five years worth of previous pension notes (plus interest on the outstanding pension note principal) would approximate the current year's pension note – the State would reach a "steady state" and the pension notes would provide no significant budgetary relief.

The use of pension notes therefore does not avert the longer-term problem of pension costs "eating up" more and more tax revenues. The share of the State's total resources devoted to paying off pension "debt" will still rise to unsustainable levels, and the State will eventually have to choose between draconian cuts to vital agencies and programs or substantial tax increases that will leave Illinois uncompetitive with surrounding states.

The FY2010 "solution" to funding the pension contributions is simply another way to borrow to provide budgetary relief in the current fiscal year. Because money is fungible, one might just as well label these borrowings "payroll notes" – or "general expense notes." This borrowing to cover current operating costs shifts today's costs onto tomorrow's taxpayers, creates an additional "pension debt" that is larger than the projected unfunded liability in 2045, and fails even to provide the desired budgetary relief after five years.

Borrowing to cover current operating costs is not a policy. It is the *absence* of a policy. Illinois must find a more responsible way to fund its pensions.

PENSION REFORMS

State retirees currently receive more generous pension benefits than those available to Illinois taxpayers. In the private sector, employee pensions have in recent years become less generous – and less costly – as a result of competitive pressures on employers. Many companies have shifted away from defined benefit plans to defined contribution plans, and others have retained those plans but trimmed benefits. Still others have adopted two-tier plans – one for existing employees whose rights have vested, and new ones for new employees. Illinois should also make significant pension benefit reforms to reduce its pension liabilities and to bring its pension benefits into line with those of most of the taxpayers who pay the State's bills.

The Civic Committee recommends that the State create a 2nd tier of pension benefits for new employees – preferably a defined contribution plan, but at a minimum a defined benefit plan with less-costly benefits – and require increased contributions from both new and current employees. We also recommend substantially increased State funding of the pension plans.

The detailed recommendations below parallel the recommendations of the Governor's Taxpayer Action Board, and would retain a defined benefit pension plan structure for the State's retirees, but would make substantial changes to benefits, required employee contributions (including current employee contributions), and State contributions.

- **Increase normal and early retirement age for new employees.**
  Increase normal retirement age for new employees to 67 years with 10 years of service (*currently at or before age 60*).
  Increase age for early retirement for new employees to 62 years with 10 years of service, with a 6% reduction per year for benefit commencement before age 67 (*currently at age 55*).

- **Reduce benefit accrual rate for new employees.**
  Reduce the benefit accrual rate for new employees to 2.0% of pay for employees

not covered by Social Security and 1.5% of pay for employees covered by Social Security (*for most plans, current accrual rate is 2.2% of pay for employees not covered by Social Security and 1.67% for employees covered by Social Security*) .

- **Increase required pension contribution for all employees (new and current).**
  - TRS: 11.0% of salary (*currently 9.4%)*
  - SERS: 10.0% of salary for employees not covered by SS (*currently 8.0%)* 6.0% of salary for employees covered by SS (*currently 4.0%)*
  - SURS: 10.0% of salary (*currently 8.0%)*
  - JRS: 13.0% of salary (*currently 11.0%)*
  - GARS: 13.5% of salary (*currently 11.5%)*
- **Limit cost-of-living adjustments (COLA) for new employees.**
  Limit COLA to the lesser of 3% or ½ of the Consumer Price Index (*currently 3% compounded*).
- **Institute other reforms to the provisions of the benefit formula for new employees.**
  Base benefits solely on base salary up to the Social Security Covered Wage Base, calculate final average salary on average of highest consecutive eight years out of the last ten years, and limit raises recognized by the plans to 3%.
- **Consider legal options for applying reforms described above to benefits of current employees.**
  While many have pointed to court decisions holding that such reforms would violate the State Constitution's pension benefit "impairment" provision, the courts might now take a different view in light of the enormity of the State's fiscal problems.
- **Fully fund the pension funds at a level that includes the annual normal cost, "interest" on the unfunded liability and some amortization of the unfunded liability.**

CONCLUSION

Addressing the State's pensions responsibly requires both funding reform and benefit reform. In the area of funding, the State must stop issuing pension bonds or notes to cover its statutory contribution. It must end the practice of back-end loading pension contributions and pushing today's pension costs onto future taxpayers. Otherwise, at some point in the future, the State will be forced to choose between slashing vital programs and raising taxes to uncompetitive levels.

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Illinois Tax Facts

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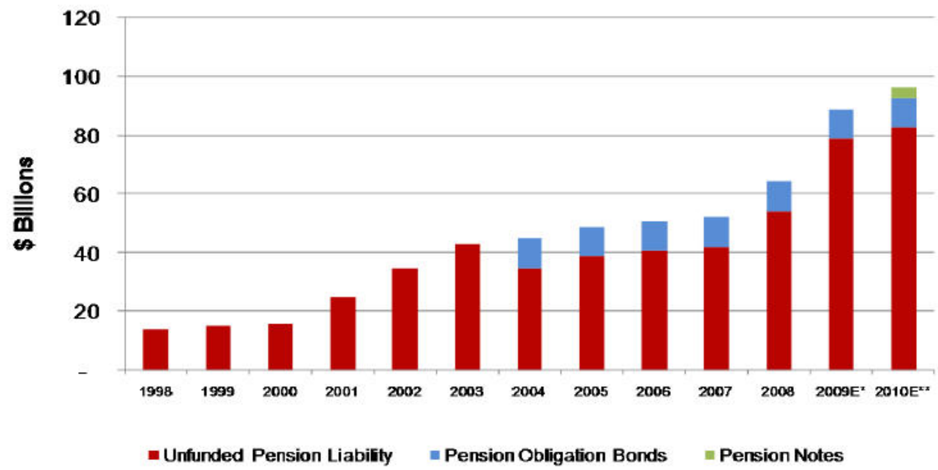
FIGURE 1

State Unfunded Pension Liability and Other Pension Debt



*Estimate is based on COGFA April 2009 Pension Briefing projection of $78.9 B unfunded liability at the end of FY2009.
**Estimate is based on COGFA April 2009 Pension Briefing projection of $83 B unfunded liability at the end of FY2010 and $3.5 B in pension notes issued in FY2010.

Source: "2008 Bonded Indebtedness Report of the State of Illinois," January 2009, Commission on Government Forecasting and Accountability; Commission on Government Forecasting and Accountability Monthly Briefing, April 2009; "Report on the Financial Condition of the State Retirement Systems," February 2009, Commission on Government Forecasting and Accountability; Commission on Government Forecasting and Accountability Monthly Briefing, February 2009; "Report on the Financial Condition of the State Retirement Systems," February 2008, Commission on Government Forecasting and Accountability; "Report on the Financial Condition of the State Retirement Systems," July 2007, Commission on Government Forecasting and Accountability; Historical unfunded liability data from Senate GOP staff.

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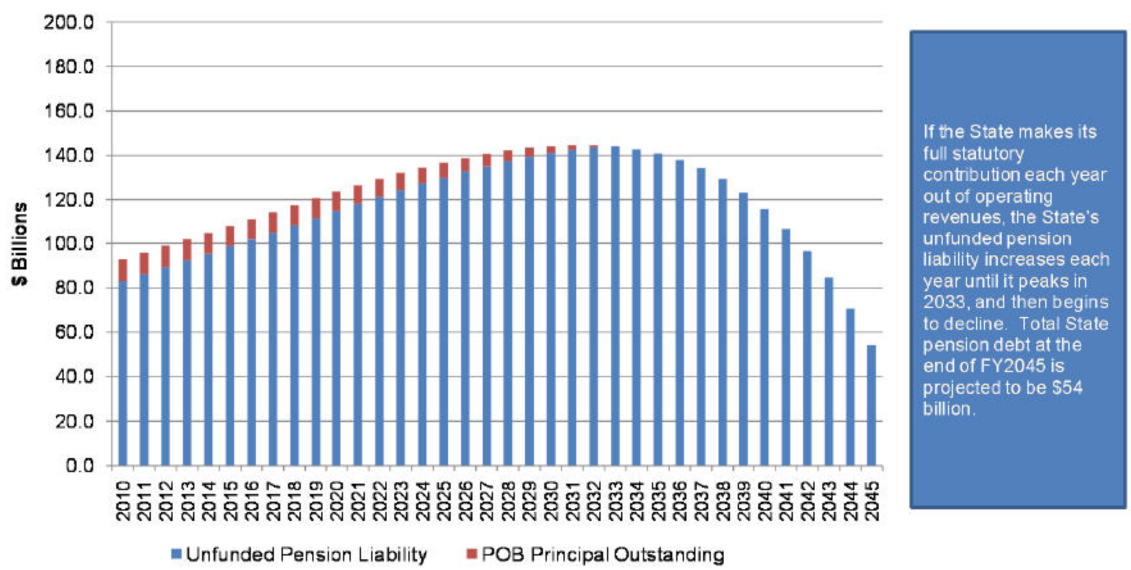
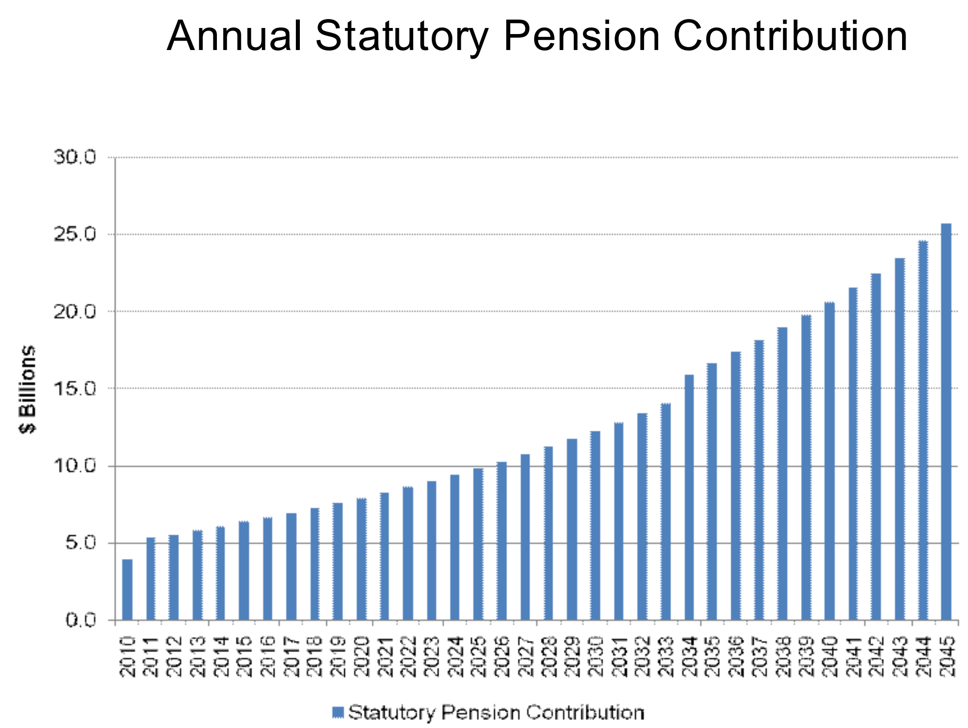
FIGURE 2

Total Pension Debt:
Statutory Contribution From Operating Revenue



Source: "2008 Bonded Indebtedness Report of the State of Illinois," January 2009, Commission on Government Forecasting and Accountability; Commission on Government Forecasting and Accountability Monthly Briefing, April 2009.

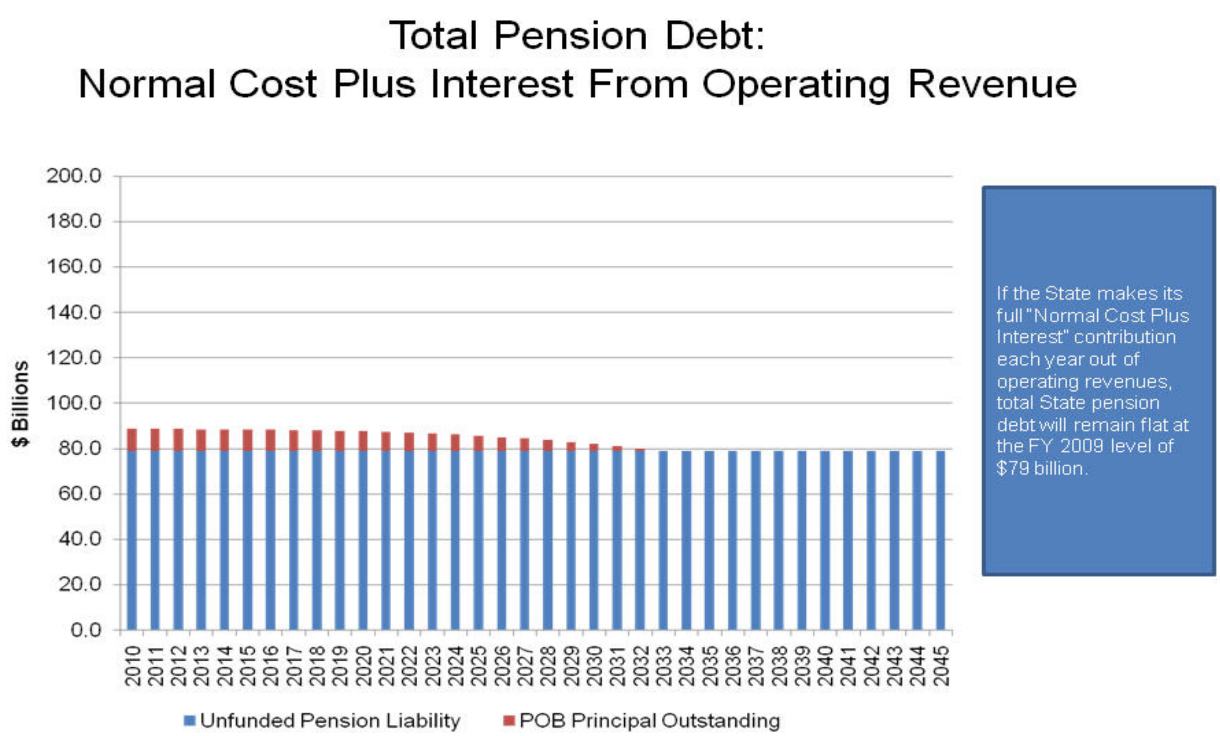
FIGURE 3



Note: Provisions regarding the valuation of the State's pension fund assets were recently changed to allow for asset-smoothing. The projections used in the graph above do not incorporate asset-smoothing, which is expected to reduce the FY 2011 statutory contribution from about $5.4 B to about $4.5 B.

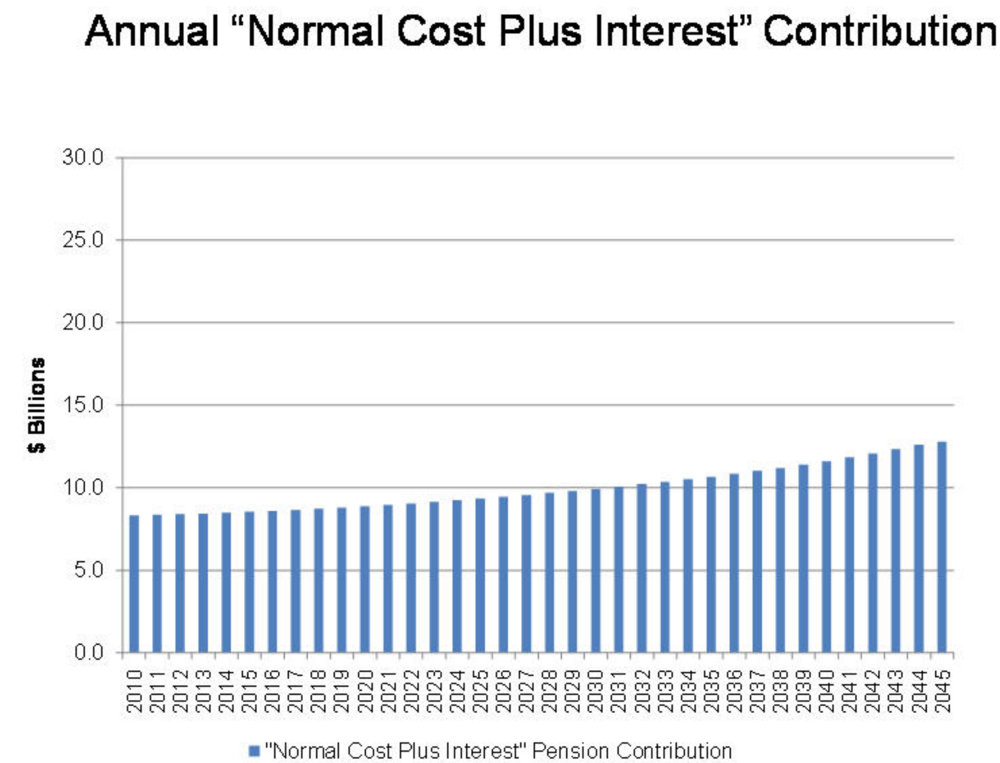
Source: Commission on Government Forecasting and Accountability Monthly Briefing, April 2009.

FIGURE 4



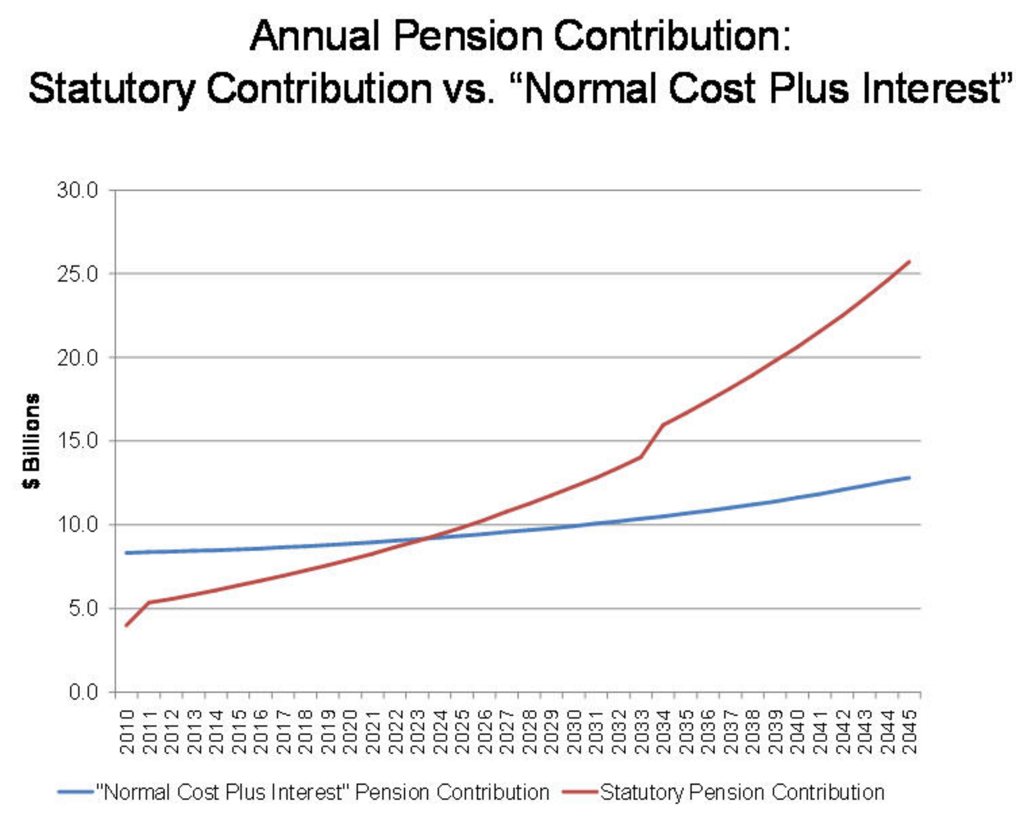
Source: "2008 Bonded Indebtedness Report of the State of Illinois," January 2009, Commission on Government Forecasting and Accountability; Commission on Government Forecasting and Accountability Monthly Briefing, April 2009; Civic Committee analysis.

FIGURE 5



Source: Commission on Government Forecasting and Accountability Monthly Briefing, April 2009; "Report on the Financial Condition of the State Retirement Systems," February 2009, Commission on Government Forecasting and Accountability; Civic Committee analysis.

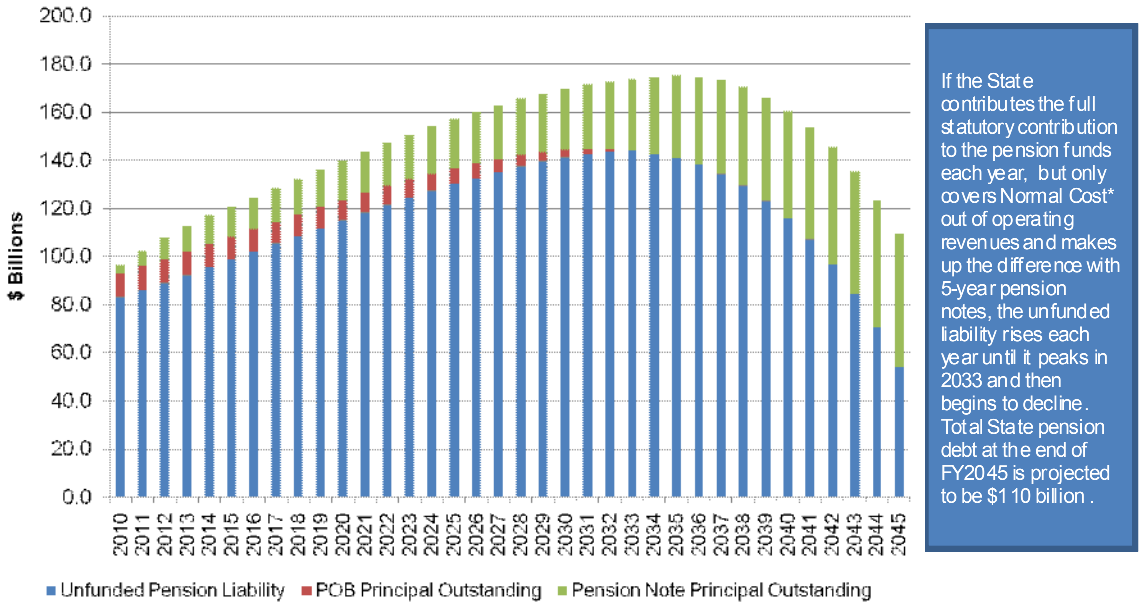
FIGURE 6



Source: Commission on Government Forecasting and Accountability Monthly Briefing, April 2009; "Report on the Financial Condition of the State Retirement Systems," February 2009, Commission on Government Forecasting and Accountability; Civic Committee analysis.

FIGURE 7

Total Pension Debt: Normal Cost Only From Operating Revenue (Assuming Pension Notes)

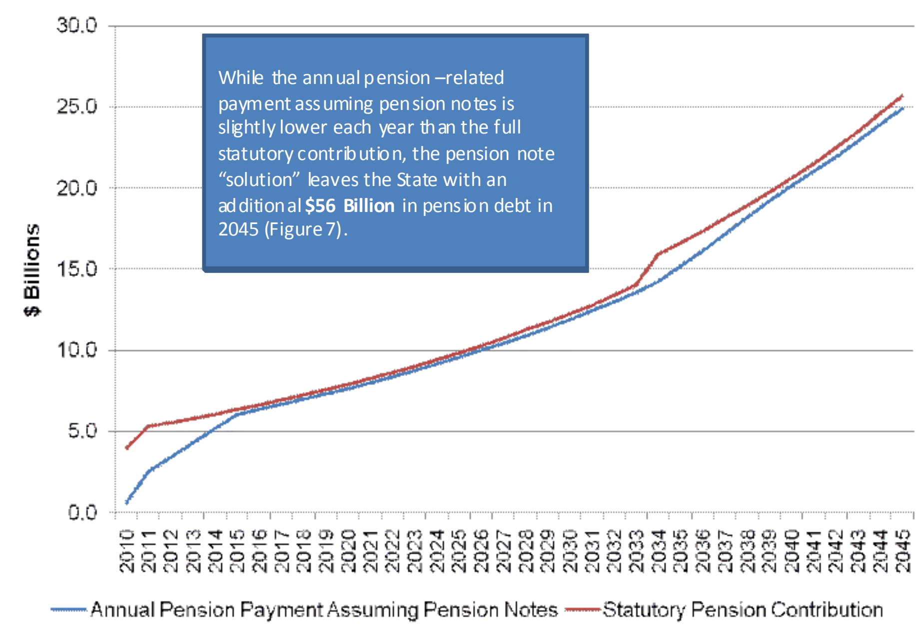


*In FY2010, the State did not even cover the Normal Cost out of Operating Revenue. Instead, the State issued $3.5 billion in pension notes and covered only $.5 billion out of Operating Revenue.

Source: "2008 Bonded Indebtedness Report of the State of Illinois," January 2009, Commission on Government Forecasting and Accountability; Commission on Government Forecasting and Accountability Monthly Briefing, April 2009; "Report on the Financial Condition of the State Retirement Systems," February 2009, Commission on Government Forecasting and Accountability; Civic Committee analysis.

FIGURE 8

Annual Pension-Related Payment: Statutory Contribution vs. Payment Assuming Pension Notes



Source: Commission on Government Forecasting and Accountability Monthly Briefing, April 2009; "Report on the Financial Condition of the State Retirement Systems," February 2009, Commission on Government Forecasting and Accountability; Civic Committee analysis.

(CONTINUED FROM PAGE 7)

To avert such a fiscal implosion, the State must act responsibly now. It must find a way – primarily through budget cuts and pension reforms – to increase its pension contributions to cover the annual normal cost, interest on the unfunded liability, and some amortization of the unfunded liability.

In addition, the State must slow or even reverse the growth of its future liabilities and bring State employee benefits more into line with the benefits available to taxpayers. The State should require greater pension contributions from all active members and should create a second-tier of less-costly pension benefits for new employees.

The State's leaders know what is needed in order to bring our pension crisis under control. Over the past few years, the issues have received a substantial amount of attention and study. The question now is whether we have the political will to do what needs to be done, or whether we will continue to duck our responsibility and shift much larger burdens and more difficult choices onto our children and grandchildren.

FUTURE ISSUES OF TAX FACTS by Tom Johnson

As many of you know, Governor Pat Quinn created the Taxpayers' Action Board which was charged to identify cost efficiency opportunities in state government programs. The Governor asked me to serve as the Chairman. We issued our report in June of this year. You can access the Executive Summary and the full report at http://www.budget.illinois.gov/documents/TABreport.pdf. One of the take aways from my experience serving on the Board was a better understanding of the variances in the annual growth rates of various spending programs. In some cases they grew at a rate slower than the growth rate of the state's revenues. In other cases, they grew at a faster rate and in some a much faster rate than revenues. As a result we have decided to do more in depth study on specific Illinois' state government programs that are growing at those exceptional rates and to bring more sunshine on the causes and policy implications of future program growth. The results of these analyses will be the subject of future Tax Facts articles.

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