

## THE ILLINOIS PENSION FUNDING PROBLEM Why It Matters

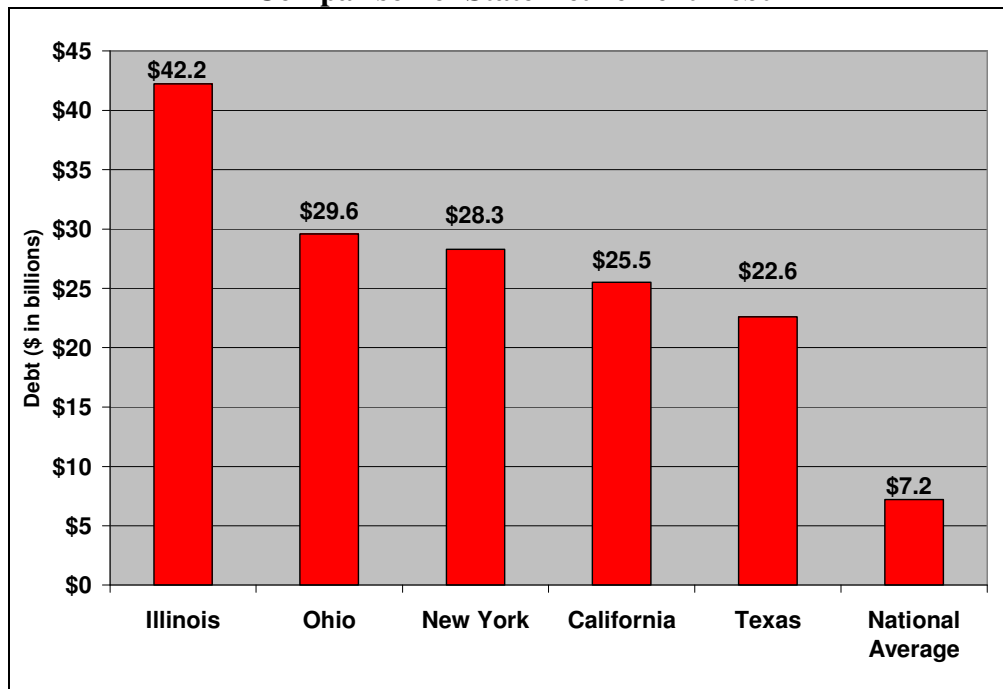
### Executive Summary

#### **Illinois: Largest Pension Debt in the Nation at \$42.2 Billion**

After decades of neglect, Illinois now has the greatest total unfunded pension liability in the nation. The debt affects everything from the revenue available to fund public services like education and healthcare, to the state's bond rating and ability to pursue capital improvement projects.

Illinois state government's funding of, or more accurately stated, failure to fund, its required pension contributions has generated significant interest lately, even receiving the attention of some candidates for public office and the media. This new found attention is welcome, because after decades of neglect, Illinois now has the greatest total unfunded pension liability in the nation. As Figure 1 below illustrates, Illinois' unfunded pension obligation dwarfs the next worst state, Ohio, by more than \$11 billion, is significantly greater than the state of California, which has three times the population, more than three times the state budget and 310,000 more public employees than Illinois. Illinois unfunded pension liability is almost six times greater than the national average.

**Figure 1**  
**Comparison of State Retirement Debt**



### **Key Findings of the report:**

- At the end of FY 2006, Illinois had the worst unfunded pension liability in the nation, totaling a projected \$42.2 billion.
- At the end of FY 2006, Illinois had funded only a projected 58.7% of what it owes to its pension systems. The national average is 87 percent.
- Even after the infusion of \$10 billion in pension obligation bonds that decreased the state's unfunded liability and despite no increases in retirement benefits and enacting pension reforms that produce long term cost savings for the state, the partial pension holidays (SB 27) taken in FY 2006 and FY 2007 contributed to increasing the state's total unfunded liability by \$7.1 billion just since 2004.
- For FY 2007, the interest payment on the unfunded liability is an estimated \$3.4 billion. This means the state must make this \$3.4 billion interest payment plus make the "normal cost" payment just to keep the unfunded liability from growing.
- Decades of failing to make the required, employer contribution to the systems is the primary cause of the state's current unfunded pension liability, rather than either the type of pension plan in place or the level of benefits offered, which hover around the national average. According to U.S. Census Bureau data, the average monthly pension payment to state government employees nationally was \$1,374 in 2001-2002. At the same time, the average Illinois payment was \$1,426, a difference of just 3.7 percent. The normal cost for the five retirement systems as a percentage of active members payroll is between 8.0% and 16 percent. The national average is 12.5 percent.
- The longer the state defers its obligation to pay its pensions, the worse the problem becomes, because the aggregate unpaid liability amount compounds annually, at an investment return rate that currently ranges from 8.0% to 8.5%.
- The state's current tax system cannot generate enough revenue to maintain current levels of public services, fund the "normal cost" of the pension contributions the state owes for its current employees and fund the state's unpaid pension liability.
- Illinois' unfunded pension debt is, on a stand-alone basis, over two times greater than all other Illinois state debt, *combined*. This is worrisome, because state debt—excluding the pension liability—is already considered to be at an "unmanageable" level, under the standards of the National Association of State Budget Officers.
- The Illinois Constitution mandates that the state satisfy the pension benefits earned by its employees and retirees—without diminution. That means no change in current pension law can diminish the state's responsibility to provide benefits to either former public employees who have retired or to current employees when they retire.
- The current pension system would be affordable, if the state had the fiscal discipline (and revenue) to have made required yearly payments for benefits earned each year, (the "normal cost") plus make interest payments on accrued unfunded liability.

### **The Second Worst Funded Ratio in the Nation**

The total unfunded liability amount is only one measure of a pension system's health. The other is its "Funded Ratio". The "**Funded Ratio**" of a pension system identifies the portion of what is owed to a pension that has actually been contributed. It is a percentage, calculated by dividing the pension system's total assets by that pension system's total liabilities.

In 2006, Wilshire Associates analyzed state pension systems across the country. That study found that the average national Funded Ratio for a state pension system was 87%. Illinois'

Funded Ratio of only 58.7% is significantly below the national average. Illinois' Funded Ratio is the second worst in the nation, trailing only West Virginia. Although West Virginia has a worse funded ratio than Illinois, the total unfunded pension liability in West Virginia of \$6.5 billion is significantly less than in Illinois.

### **Why Illinois Has the Largest Pension Debt in the Nation**

Funding the five pension systems for public employees has challenged Illinois state government for decades. The main reason the state has such a large pension unfunded liability does not stem from generous benefits or overspending on workers. The main reason is because Illinois revenue system has historically underperformed inflation, causing the state to continually find itself short of the revenue needed to cover both essential services and its required pension contributions. Illinois frequently opted to skirt full funding of the pensions to maintain spending on services.

This means Illinois was borrowing against the pension system just to cover the cost of providing current public services. When the state fails to pay its required pension contributions, the amount it ultimately must contribute grows substantially over time. That is because under state law, any funding shortfall must be paid back with interest, compounded at each retirement system's target rate of return, currently pegged at 8.0% to 8.5% per year, depending on the pension fund. Each year a pension obligation remains unpaid, the investment return the state must make up on the unpaid contribution *compounds*.

### **Defined Benefit System Did Not Cause Pension Unfunded Liability**

The benefits offered to public employees in Illinois under the state's pension systems are around the national average. According to U.S. Census data, the average monthly pension payment to state government employees nationally was \$1,374 in 2001-2002. At the same time, the average Illinois payment was \$1,426, a difference of just 3.7 percent.

Additionally, the normal cost for the five retirement systems as a percentage of active members payroll is between 8.0% and 16 percent. The national average is 12.5 percent. Hence, the normal cost of the state's current defined benefit program is well within national averages. The data indicates Illinois' existing unfunded liability is not due to either the generosity or cost of the benefits provided, but rather the state's repeated decision to not contribute the full, required amount it owed to the pension systems, and the concomitant compounding of that debt over time.

### **Changing to a Defined Contribution System Does Not Solve the Funding Problem**

If Illinois were to switch to a defined contribution plan it would result in little immediate savings to the state or help reduce the unfunded liability. Under the state constitution, present employees are guaranteed a set income under the defined benefit plan, so only new hires would take part in a new defined contribution plan. The state would not realize material savings until those hires become a significant percentage of the workforce. Switching to a defined contribution plan does absolutely nothing to eliminate the \$42.2 billion unfunded liability the state is required to pay.

### **Administration Costs and Risk Associated with a Defined Contribution Plan**

Switching to a defined contribution plan would cost the state more in the short-term than maintaining its current defined benefit plans. A defined contribution plan must be designed, set up, put into place. Separate administrative and bookkeeping systems must be established for the different plans and employees will have to be trained on how to manage their investments. .

Further, defined benefit plans lower overall retirement costs by pooling the risk associated with the market over a large number of participants. This means defined benefit plans, unlike defined contribution plans, can maintain a mix of investments, which likely will provide a higher return and lower contributions over time, when fully funded.

Additionally, unlike a defined benefit plan where investments are selected by experienced professionals, employees, who do not have professional investment experience, would be

directing their own investments under a defined contribution plan. Moreover, given the size of the assets available to invest, opportunities will be available to the defined benefit investment trustees that would not be available to employees investing in their personal account. The lack of investment experience coupled with reduced investment opportunities creates the probability that individual employees will not, for the most part, fare as well with their investment returns as will the fiduciaries making investment decisions for the assets of the defined benefit systems.

### **How Does Funding the Pension Affect the State's Ability to Fund Public Services**

Illinois gets the revenue to fund its contributions primarily from general taxes, like income and sales. These are the same revenue sources that constitute the bulk of the General Fund. In addition to covering pensions, the General Fund is the source for funding the vast majority of public services the state provides, including everything from education, healthcare, human services and public safety.

While the cost of providing public services grows normally with the economy over time, the state's poorly designed tax system does not grow with the economy, and hence generates less revenue than needed to maintain current public service levels and make the required pension payments from year to year, adjusting solely for inflation. The Illinois Constitution requires that the state produce a balanced budget each year. Hence, the state's unfunded pension liability competes directly with public services for the revenues the state's tax system generates annually.

Policymakers consistently have been confronted with the politically difficult choice of either significantly reducing the level of public services to pay pension contributions, or modernizing how the state taxes to raise adequate current revenue for the state to pay its bills. Instead of confronting this politically difficult dilemma head-on, policymakers have generally made a fiscally unsound, third choice year after year: defer making the full employer pension contributions then due, just to maintain current services.

However, the state's pension debt is now so large that it simply cannot be put off to future generations. Making these payments is highly unlikely under the current tax system, without drastically cutting public services for future generations. For example, in FY 2006, the state was unable to meet the required contribution of \$2.1 billion, actually paying less than half that amount. Under this new ramp, next year (FY 2008) the state will owe over \$2.5 billion and just three years later, over \$4 billion. In later years the state will owe between \$11 and 15 billion.

### **Solutions to Paying off the Unfunded Liability**

There are few viable revenue options available that will allow Illinois to pay its unfunded pension contribution liability, and no one option will be sufficient on its own to solve the problem.

1. The first and best option is modernizing the state's tax system to comport with today's economy. This option requires the political will to implement comprehensive reform of the Illinois tax systems, like the framework of SB/HB750, introduced by Senator Meeks in 2004.
  - Under that bill, Illinois would generate renewable revenue that grows with the modern economy, sufficient in amount to fund current service levels, plus the Normal Costs of the five pension systems, some of the accrued but unpaid pension liability, plus enhance education funding and provide property tax relief.
  - That proposal would increase the state's income tax, expand the sales tax base to include consumer (not business) services, and provide tax relief targeted to 60% of Illinois taxpayers.

2. Another alternative is a long-term payment program—like issuing pension obligation bonds to refinance the over \$40 billion unpaid liability. However,
  - the rates for the bond issuance must be set at appropriate levels;
  - all bond proceeds must be used to refinance pension debt;
  - the bond payment levels must save the state money over the long term and be attainable; and
  - the state must have the recurring revenue to fund the debt service.
  
3. Finally, the state should also consider implementing a new revenue source targeted to repaying pension liabilities, that is independent of base revenue streams from income, sales, excise and utility taxes, which should be devoted primarily to paying for current services.
  - One such potential new revenue source that has promise as both good public and fiscal policy, is implementing a carbon discharge permit/tax system in Illinois.

Without modernizing current revenue streams, the state simply will not have the financial capacity to pay its unfunded pension liability plus maintain current services.

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