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The Illinois Unfunded Pension Liability in Context: Isolating its actual cause and implementing solutions designed to work given the extant fiscal system

1. **CTBA's goal is to design a resolution to the state's unfunded pension liability that would:**

   - Be unquestionably constitutional;
   - Work in context of the state's fiscal system;
   - Accommodate the state's responsibility to continue funding current services over time, adjusting at a minimum for historic rates of inflation and population growth;
   - Create a repayment structure that is sufficient for the state to satisfy its retirement benefit payment obligations under the five pension systems as those obligations become due over time; and
   - Continually increase the aggregate funded ratio of the five pension systems, moving them to a position of fiscal health as soon as practical.

2. **The unfunded liability the state owes to its five pension systems is significant, but the primary cause of that unfunded liability, and hence the fiscal strain it imposes on state resources, remains poorly understood.**

   - Illinois incurred its pension debt, which now stands in excess of $95 billion over decades, by diverting what it should have contributed to fund benefits to instead subsidize the cost of providing public services. Through this process, the state effectively borrowed billions of dollars from the pension systems. It is primarily this borrowing—and more specifically the amortization schedule passed into law in FY1995 that delineates how it is to be repaid—that is straining state resources today.
   - This year's General Fund budget clearly shows how debt service is the driver of the fiscal problems generated by the unfunded liability. The total pension contribution to all five systems identified in the FY2014 General Fund budget is $6.19 billion, a significant year-to-year increase of $1.08 billion or 21% from the FY2013 contribution of $5.11 billion.
   - Of the total $6.19 billion General Fund contribution for FY2014, over 80%, or $5.17 billion, is the debt service payment owed to the pensions to cover past borrowings. The FY2014 debt service is up from the $4.01 billion in debt service paid in FY2013.
   - Hence, the entire $1.08 billion in year-to-year increase in the state's General Fund pension contribution called for in FY2014 is caused by debt service, not the cost of benefits being earned.
   - The current debt service plan is so aggressive that, over four out of every five dollars of the state's pension contribution scheduled for FY2014 constitutes repayment of debt, rather than a contribution for the cost of funding benefits being earned.

- Benefits, on the other hand, are not the driver of the fiscal pressure created by the unfunded liability. Just $1.02 billion of the scheduled FY2014 General Fund pension contribution is made up of the employer's "normal cost" to the state for covering benefits being earned by public sector workers.

No problem exists in a vacuum. To understand what motivated decision makers to engage in the decades-long practice of borrowing against what was owed to the pension systems to instead maintain service levels, a quick review of the inherent flaws in the state's overall fiscal system is necessary.

3. Illinois' Structural Deficit—the Primary Cause of the Current Pension Crisis.

- The General Fund will end FY2014 with an accumulated deficit that will range from $8.35 billion (based on GOMB's revenue estimates), to $8.9 billion (using the House's revenue estimates). That means anywhere from 34.05% to 36.29% of the scheduled spending on services in FY2014 will be deficit spending.

- The projected General Fund deficit for FY2014 is significant, but it is also nothing new. According to the Illinois Comptroller's Office, Illinois has had a deficit in its General Fund for at least 22 consecutive fiscal years, dating back to 1991 (the records do not cover years prior to that date).

- **Spending on services has not been the primary reason for the state's recurring deficits.**

- Despite increases for some aspects of the General Fund budget, aggregate spending on services will be nearly $214 million less in FY2014 in nominal dollars and $922 million less in real, inflation-adjusted dollars than in FY2013.

- This marks the fourth, consecutive fiscal year in which overall spending on services will be cut in nominal dollars from prior year levels.

- In real, inflation-adjusted terms, total spending on services in FY2014 will be either 23.7% (using the Consumer Price Index) or 28% (using the Employment Cost Index) less than in FY2000.

- General Fund expenditures for services in FY2014 are scheduled to be $4.7 billion less in nominal dollars than they were in FY2009, a mere five years ago.

- Compared to the rest of the nation, Illinois is a very low spending and small government state.

    - In calendar year 2012, Illinois had the fifth highest overall state Gross Domestic Product (GDP) and 17th highest state GDP per capita in the nation.

    - Despite that, in FY2012 Illinois ranked 28th in General Fund spending per capita, and 37th in General Fund spending as a share of GDP.

    - In 2011, (the most recent year for which there is data) Illinois had the lowest number of state workers per 1,000 residents of all 50 states.

- For over a decade CTBA has pointed out that the data consistently indicate that the Illinois tax system does not generate enough General Fund revenue to maintain delivery of the same level of public services from year-to-year after adjusting for inflation. This remains the case in FY2014.

- This ongoing mismatch in the state's General Fund between the lower rates of growth for revenue than the pace of increase in the cost of maintaining service levels is commonly called a "structural deficit." The state's structural deficit was recently cited by the Institute of Government and Public Affairs.[1]

- A structural deficit occurs when a tax system fails to satisfy the four principals of sound tax policy, which are: [2]

    - First, it must be **FAIR** to taxpayers, by assessing tax burden in a manner that corresponds to ability to pay;

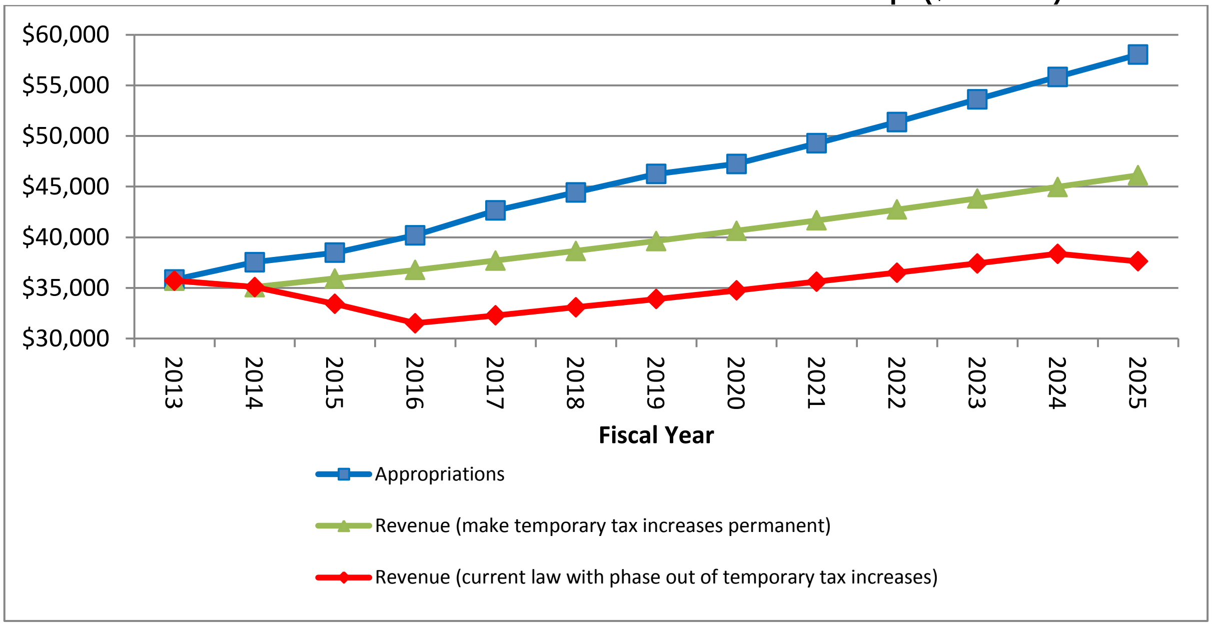
    - Second, it must be **RESPONSIVE** to growth in the private sector economy;

- Third, it must be **STABLE,** by continuing to generate adequate revenue even during poor economic cycles; and
- Fourth, it must be **EFFICIENT**, by minimizing the impact it has on important, private sector economic decisions.

- Illinois' tax system fails to satisfy any of those four principles.

- Note, structural tax reforms remain necessary to eliminate the structural deficit. Even if the temporary tax increases from the Taxpayer Accountability and Budget Stabilization Act were made permanent, Illinois would continue to face a structural deficit in its General Fund budget. Figure 1 is a graphic depiction of the structural deficit in the Illinois General Fund with and without making those increased income tax rates permanent.

Figure 1
Illinois State General Fund Structural Deficit with Tax Increase Kept ($ Millions)

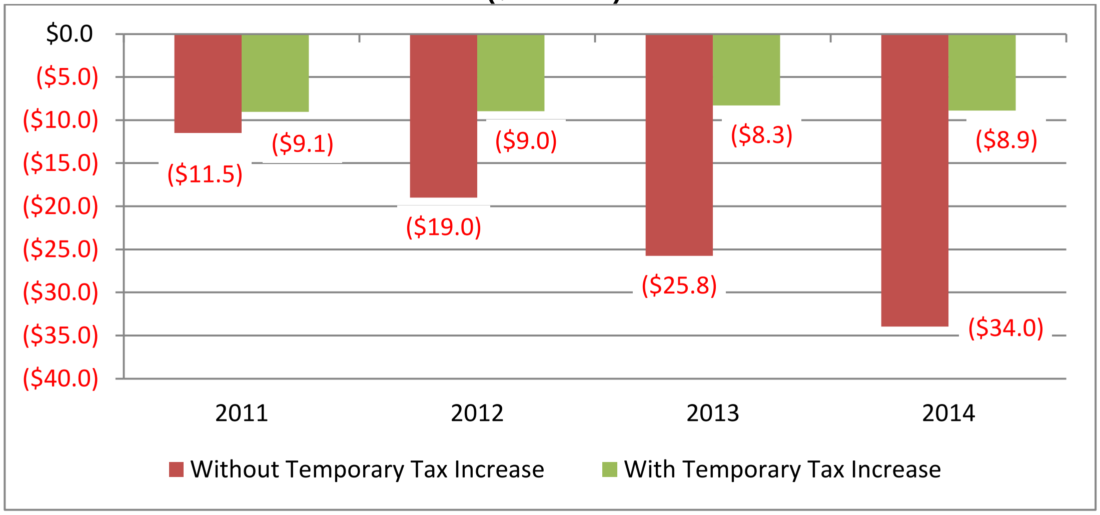


- **Flawed tax policy that generates insufficient revenue, on the other hand, has been a primary driver of the state's fiscal problems that led to the unfunded pension liability that currently exists.**

- However, the Taxpayer Accountability and Budget Stabilization Act has made a positive difference. That Act raised revenue by making some temporary adjustments to Illinois tax policy, the most important of which involved increasing the personal and corporate income tax rates from 3% to 5% and 4.8% to 7%, respectively.

  While these temporary tax increases did not completely resolve the state's financial problems, they effectively stabilized the state's overall fiscal condition, as shown in Figure 2. Figure 2 compares the state's actual, General Fund budget deficits for the FY2011-FY2014 sequence, to what those annual deficits would have been without the temporary tax increases under Taxpayer Accountability and Budget Stabilization Act, but including all spending cuts made to services.

Figure 2
Comparison of Accumulated Deficits With and Without Temporary Tax Increase
($ Billions)[3]



4. Decades of Underfunding and the Pension Ramp

- **Decades of underfunding are the source of Illinois' pension problem.**

- At the end of FY1994, Illinois lawmakers had borrowed so much against the pension systems to fund services that combined the five systems were just 54.5% funded—meaning that just over half of all liabilities were covered by assets—and had an aggregate unfunded liability of $17 billion.

- This was almost twice the unfunded liability of $8.6 billion that existed just five years previously, in FY1989.

- In FY1995, the General Assembly passed and Governor Jim Edgar signed into law PA 88-593, which is commonly referred to as the "Pension Ramp."

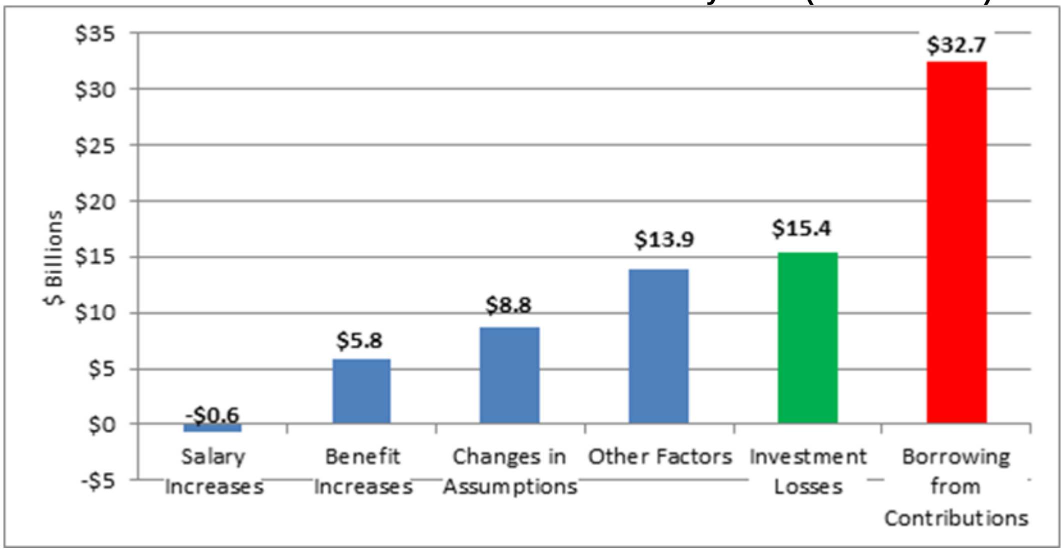
- Even though PA 88-593 was ostensibly created to repay the debt owed to and resolve the underfunding of the pension systems, the legislation—by law—actually continued the practice of borrowing against contributions owed to the pension systems to subsidize the cost of delivering public services for 15 years after its passage. PA 88-593 accomplished this by creating the following two-phase repayment schedule:

    - Part 1—Fiscal Years 1996-2010—during this "15-year phase-in period", the state's annual contributions were calculated as a very low percentage of payroll, which was steadily increased from year-to-year so that by FY2011 the annual contribution would finally reach a point that the state could begin paying debt owed to the retirement systems. This phase underfunded the systems because the state's contributions required by law were often not enough to cover the cost of funding benefits earned by current workers much less pay principle or interest on the debt. The state's insufficient contributions during Part 1 effectively increased the unfunded liability of the five pension systems by $24.7 billion.[4]

    - Part 2—Fiscal Years 2011-2045—during this phase the state is annually required to pay a level percent of payroll that is sufficient, when added to employee contributions, investment income and other income, to bring the systems to a 90% funded ratio by the end of FY2045. A level percent of pay is one way to amortize an unfunded liability. Under this method of amortization, the debt service contribution in dollar amounts increases from year-to-year, creating a backloaded repayment schedule.

- Figure 3 shows the sources of growth in the combined unfunded liability across all five systems from FY1996-FY2012. As Figure 3 demonstrates, the greatest cause of the state's unfunded liability has been borrowing against the pension systems. This meant that the state's contributions were not sufficient to pay for both benefits earned by current employees and interest on the pre-existing unfunded liability. Without sufficient contributions, an unfunded liability annually grows by a retirement system's investment rate assumption (which ranges from 7% to 8% among Illinois' five state systems).

Figure 3
Growth in Unfunded Liabilities for the Five State Systems (FY 1996-2012)



- **Pension benefits are not the primary problem**.

- The state's annual contribution to the retirement systems for debt service can be thought of as having two components: one part goes to pay down principal and the other is for interest on the principal.

- Figure 4 distinguishes between normal cost and debt service components of the annual General Fund payments to the pension systems for FY2012-FY2014. Over four out of five taxpayer dollars paid as part of the state's annual pension contribution go to paying down pension debt, not to funding benefits being earned by current workers. Indeed, the entire 20.99% year-to-year growth in the pension contribution from FY2013 to FY2014 is due to increasing debt service under the existing repayment schedule.

Figure 4
Normal Cost vs. Debt
General Fund Pension Contributions FY2012-FY2014 ($ Billions)[5]

	FY2012	FY2013	FY2014
Total	$4.14 B	$5.11 B	$6.19 B
Normal Cost	$1.17 B	$1.10 B	$1.02 B
Debt Service	**$2.97 B**	**$4.01 B**	**$5.17 B**

Source: CTBA analysis of Operating Budget Detail GOMB, FY2014 Operating Budget Detail (March 6, 2013), http://www2.illinois.gov/gov/budget/Pages/BudgetBooks.aspx; HB 206 of the 98th General Assembly; and COGFA, IL State Retirement Systems: Financial Condition as of June 30, 2012 (Springfield, IL: February 2013).

5. Current Legislation and Persistent Problems

- Senate Bill 1, as amended by Speaker Madigan's House amendment, reduces the pension benefit significantly for current workers in Tier-I (those hired before 1/1/2011)—to a level similar to that of those in Tier-II (those hired on or after 1/1/2011). For instance, the Tier-II benefit for a non-Chicago teacher is roughly one-third the benefit of a Tier-I teacher.
  - The increased employee contribution rates combined with the decreased benefits implemented under this initiative mean that current employees will be paying for some of the debt owed to the retirement systems—which the state incurred by not funding its employer normal cost over the years. Essentially, part of the responsibility for paying for the state's debt owed to the retirement systems is being shifted from the state to employees.
  - Benefits are reduced so significantly that they are projected to run afoul of federal Social Security laws, which happens to be the same issue that will have to be addressed in the future regarding Tier-II. In either case, resolving the Social Security problems created by these initiatives' approach to creating pension savings for the state will require the state to increase pension benefits—and hence funding costs—in the future.
- SB1 is reported to save $187 billion over the FY2013-FY2045 sequence, and SB2404 is estimated to save approximately $47 billion over that same sequence. While these savings would be significant, it is important to keep in mind that they are based on actuarial projections that contain a number of assumptions that may or may not turn out to be true. Like what occurred with the Tier-II savings,[6] future changes in assumptions and/or assumptions turning out not to capture reality will offset savings. **Estimated savings should be considered the "best-case" scenarios and actual savings will likely be less than initial projections.**
- Figure 5 provides a summary of the savings and liability reductions estimated for the two primary pieces of pension legislation (SB2404 and SB1) previously considered.

Figure 5
Fiscal Impact of Pension Legislation ($ Millions)

		Reductions from Current Law	
	Current Law	SB2404 (including Supplemental Payments)	SB1
FY2013 Unfunded Liability	$100,828.2	$5,485.7	$20,848.7
FY2015 Total State Pension Contribution	$7,033.2	$550.5	$1,995.8
Total State Pension Contributions FY2013-FY2045	$385,832.1	$47,004.6	$187,668.8

Sources: Current law figures from COGFA, *IL State Retirement Systems: Financial Condition as of June 30, 2012* (Springfield, IL: February 2013), 97; and COGFA, Pension Impact Note for SB1 as amended by HA 1 & 3 (from May 29, 2013) and Pension Impact Note for SB2404, engrossed (from June 14, 2013).

- There is also a material question about the constitutionality of some of the benefit reductions proposed, given Illinois' very strong constitutional protection of pension benefits.
  - Arizona has a pension protection clause in its state constitution that is very similar to Article XIII, Section 5 of the Illinois Constitution, which protects public pension benefits. In 2011, Arizona lawmakers passed legislation increasing contribution rates for current employees. That legislation was challenged, and in early 2012, Maricopa County Superior Court Judge Eileen Willett ruled that it was unconstitutional because it impaired the obligation of a contract because employees would have had to contribute more money without receiving

any additional benefits. As a result, the state had to pay back those increased contributions plus interest to employees.

- Savings to the state from cutting pension benefits will be offset by the phase out of the personal and corporate income tax rates as required by the Taxpayer Accountability and Budget Stabilization Act (Public Act 96-1496, effective January 13, 2011). The loss in revenue from that Act is as follows:
  - $2.5 billion in FY2015
  - $5.3 billion in FY2016
  - $63.4 billion over the FY2013-FY2025 sequence.[7]
- Despite the savings estimated for both pieces of legislation, a recent study done by the Institute of Government and Public Affairs (IGPA) states that neither piece of legislation will eliminate the state's budget deficits over the next 10 years, and that, "**Illinois will continue to have serious fiscal problems even if efforts to reduce pension obligations are successful**."[8]

6. CTBA Re-amortization

- There are two ways to amortize an unfunded liability. A level percent of pay is one method. Under level percent of pay, the debt service contribution in dollar amounts increases from year-to-year, creating a backloaded repayment schedule—making it a favorite of elected officials. The other amortization method is level dollar, which is akin to a traditional, fixed rate mortgage. Under a level dollar approach, the debt service contribution stays the same from year-to-year in nominal dollars, meaning that in real, inflation-adjusted dollars the amortization contribution is a declining financial obligation over time.
- CTBA recommends that a step-level dollar amortization schedule be used rather than traditional level dollar so that for the next several years the state's contributions under this re-amortization plan are comparable to what they are projected to be under current law. Under this approach the state's annual pension contributions would be:
  - The step-level dollar schedule for the debt contribution portion of the state's annual payments to the five state retirement systems is as follows:
    - FY2015 - $5.5 B
    - FY2016 - $5.7 B
    - FY2017 - $5.9 B
    - FY2018 - $6.1 B
    - FY2019 - $6.3 B
    - FY2020 - $6.5 B
    - FY2021 - $6.7 B
    - FY2022 through FY2059 -$6.9 B
  - The employer normal cost is fully paid.
  - Debt service from previous pension obligation bonds become additional contributions to the pension systems once those bonds are retired. In FY2020 and each fiscal year thereafter until the funding target is reached, $1 billion would be transferred from the General Revenue Fund to the Pension Stabilization Fund to pay down unfunded liabilities.

- By FY2045, the systems would be approximately 72% funded. This puts the systems on a path to be well over 80% funded by FY2059.[9]

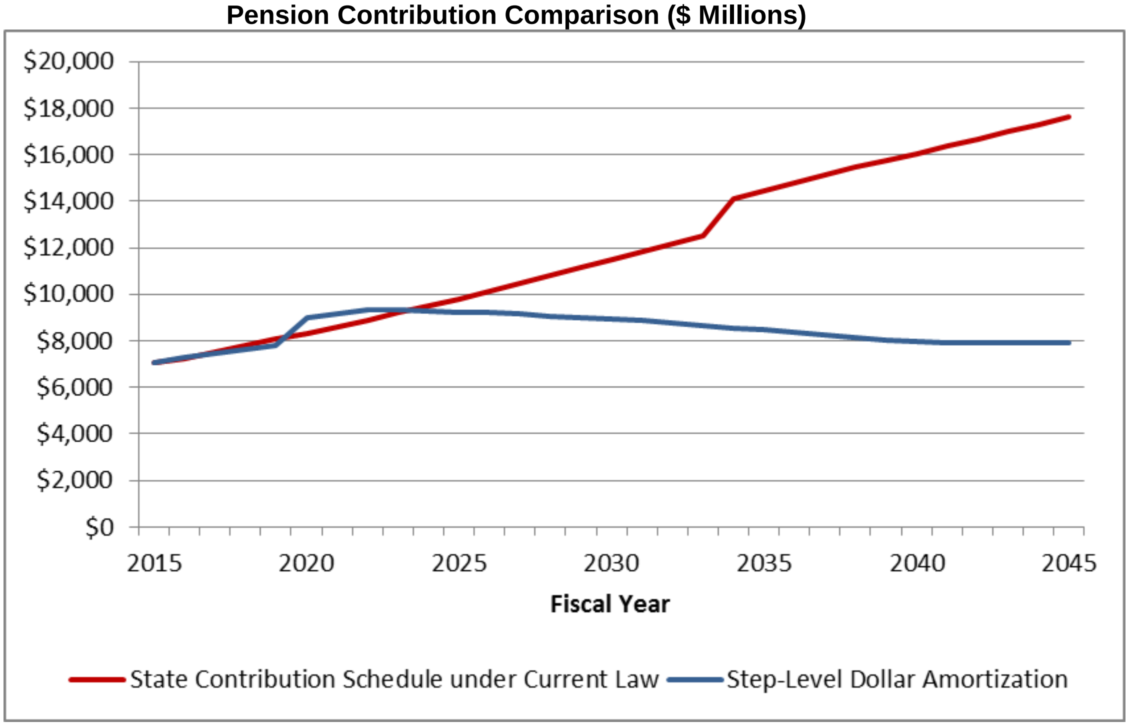
- Under this re-amortization plan, contributions from FY2015-FY2045 would total $261.6 billion (including Pension Stabilization Fund transfers), a savings of $111.5 billion over the state's total contributions over that sequence under current law of $373.1 billion.

    - The pension re-amortization plan would save the state more than $110 billion over the next thirty-one years.

    - Even taking the state's pension payments out to FY2059, the re-amortization schedule is not more expensive than the current plan. From FY2015-FY2059, under the pension re-amortization plan contributions would total $372.2 billion (including Pension Stabilization Fund transfers).

- Figure 6 compares the state's required contributions under current law with the contribution schedule under this pension re-amortization schedule.

Figure 6
Pension Contribution Comparison ($ Millions)



Note: step-level dollar amortization line, in blue, includes in-flow contributions from debt service of retired pension obligation bonds, which is why the re-amortization line spikes in FY2020.

Respectfully submitted,

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Center for Tax and Budget Accountability

ENDNOTES

[1] Dye, Richard and Andrew Crosby, *Pension Reform Roadmap: How do SB1 and SB2404 affect Illinois' 10-year budget outlook?* (Chicago: Institute of Government and Public Affairs, June 2013), 3.

[2] Hugh Stretton, *Economics: a New Introduction* (London: Pluto Press, 1999), 623.

[3] CTBA calculations using total spending figures for FY2011 and FY2012 as reported in GOMB, FY2013 Budget Book (Springfield, IL: February 2012 2013), Ch. 2-18; total spending for FY2013 includes all supplementals; and spending for FY2014 as reported in GOMB, FY2014 Budget Book (Springfield, IL: March 2013) for hard costs and SB 2555, SB 2556, HB 206, HB 208, HB 213, HB 214, HB 215, passed by the 98th General Assembly; actual revenue for FY2011-FY2012 as reported by COGFA; FY2013 based off of revised personal income tax, corporate income tax and federal sources updated presented during the closing week of the spring 2013 legislative session, which took into account the April 2013 revenue spike and estimated revenue for FY2013-FY2014 as reported and estimated by COGFA in FY2014 Economic Forecast and Revenue Estimate and FY2013 Revenue Update (Springfield, IL: March 12, 2013).

[4] COGFA, *A Report on the Appropriateness of the 90% Funding Target of Public Act 88-593* (Springfield, IL: COGFA, June 2011), 9.

[5] Figures exclude contributions made to CTPF and for retiree insurance; figure for SERS includes pension contributions made by both the state and agencies; and figures for SERS and SURS exclude contributions made via other state and federal funds. Approximately 90% of the state's required pension contribution is made via the General Fund.

[6] The creation of Tier-II was estimated to save the state approximately $71.1 billion over FY2010-FY2045 sequence (from COGFA, *A Report on the Appropriateness of the 90% Funding Target of Public Act 88-593* from June 2011). However, these savings were nearly cut in half when the pension systems reduced their investment rate assumptions in 2011 and 2012.

[7] Estimates for tax rates expire from COGFA, 3-Year Budget Forecast FY2014-FY2016 (Springfield, IL: April 2013), 13; estimates for tax rates kept done by CTBA using historic revenue growth rates (2.63% personal and 3.92% corporate).

[8] Dye, Richard and Andrew Crosby, *Pension Reform Roadmap: How do SB1 and SB2404 affect Illinois' 10-year budget outlook?* (Chicago: Institute of Government and Public Affairs, June 2013).

[9] In general, a funded ratio of at least 80% indicates a retirement system is in sound fiscal shape. See: U.S. Government Accountability Office, State and Local Government Retiree Benefits— Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs (Washington DC: September 2007), http://www.gao.gov/assets/270/267150.pdf