



## Illinois burgeoning unfunded liability, more than a pension problem!

The three primary sources of contributions which finance Illinois state retirement systems are employee contributions, employer (the state) contributions and investment returns. According to the most recent state comparison of unfunded pension liabilities by Wilshire Research Associates, at \$40.7 billion, Illinois has the worst unfunded pension liability in the nation. Moreover, when compared to Illinois FY06 total general revenue fund of \$28.65 billion, Illinois \$40.7 billion dollar unfunded liability represents 142% of FY 2006 total general fund.

What is the source of Illinois immense unfunded liability? Each year employees have continuously made their contributions and investment returns have been quite successful. However, employee contributions and excellent investment returns have not been enough to counter thirty-plus years of the state failing to fund the full normal cost owed to the pension systems.

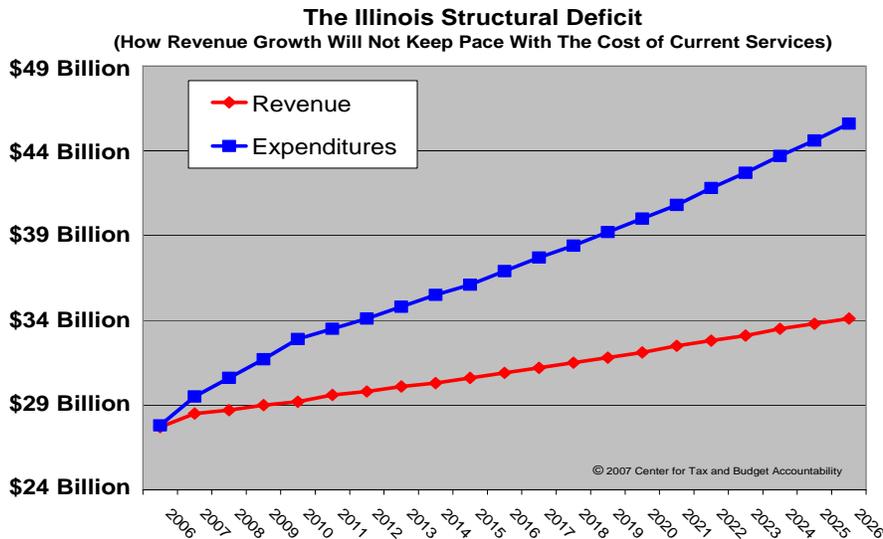
Why has Illinois historically shorted the pension system? Illinois gets the revenue to fund its contributions primarily from general taxes, like income and sales. These are the same revenue sources that, together with fees, excise and utility taxes and federal government transfers, constitute the bulk 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 and human services, public safety, environmental protection and affordable housing.

Unfortunately since 2000, actual state tax revenue growth in Illinois has failed to keep pace with inflation. In fact, in the aggregate, state tax revenue has fallen short of inflation by over \$7 billion since 2000. That is 27% of total FY 2007 General Fund appropriations for all public services, from education to public safety.

Not only does revenue growth fail to keep pace with inflation when comparing revenue from one year to the next, but it also fails to cover the increase in the cost of public services caused by inflation annually. The net result is that every year, the cost of just continuing the prior year's level of public services is more than what natural revenue growth can cover.

According to the Illinois Constitution the state must produce a balanced budget each year. If revenue growth from taxes and fees fails to keep pace with both the inflationary cost of funding public services and the growth in pension liabilities, something has to give to balance the budget. Policymakers effectively have three options, cut spending on services, under fund the required pension contribution, or raise taxes and fees. Public officials in Illinois have made the decision to underfund the pension contributions for the last decade.

What Illinois suffers from is a 'structural deficit', the inability of a tax system to generate enough revenue to maintain funding the same level of public services from year to year. The figure below illustrates the Illinois structural deficit. The graph assumes that: the economy is healthy and grows by a robust four percent per year over the next decade and no new programs and no program expansions are passed, only current programs are maintained. The graph then measures the projected costs of maintaining current services over the next decade against projected state revenue increases, adjusting solely for inflation based on the CPI and population growth.



So, even without adding any new programs, the costs to Illinois of providing essential public services like education, transportation, public safety and environmental protection, increase due to economic factors outside the state’s control, such as inflation, population growth, healthcare costs etc. Since Illinois is required by law to balance its budget, and the state's structural deficit has meant there was never enough revenue to cover inflationary costs in the first place, 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.

For the most part, the Illinois structural deficit is not caused by the state continually adding programs or engaging in wasteful spending. Instead, it is caused primarily by an antiquated, regressive state tax system that simultaneously overtaxes low and middle-income working families while failing to respond to the modern economy. In fact, on an inflation adjusted basis, over the last decade Illinois has cut aggregate spending on all public services other than education, healthcare and the pension system. Put another way, paying for the state's prior deferment of its obligation to fund pensions has cut into Illinois' ability to fund current public services, and has exacerbated Illinois' ongoing fiscal problems.

Recognizing Illinois extreme fiscal problems, in April 2006 Fitch assigned Illinois an ‘AA’ and ‘Negative Rating Outlook’. Reductions in bond ratings have real world consequences. When a state’s credit rating is lowered, it faces higher interest and insurance costs when it borrows money. Thirteen states rank similar to Illinois and only three have credit ratings lower than Illinois.

Factors that contributed to Illinois receiving a low bond rating, include poor revenue performance, the pension obligation bond issuance, the state's increasing GAAP deficit, overall budget uncertainty and an increase in state debt ratios. Fitch emphasized Illinois had, “above-average debt levels, a large unfunded pension liability, and constrained finances marked by pension and Medicaid fund pressures.” Fitch went on to say, “Persistent sizeable accounts payable liabilities remain and large required pension contributions beginning in fiscal 2008 will pose a challenge [for Illinois].” Noting that Illinois has not raised broad-based taxes for many years, Fitch concluded the state has had to rely on one-time revenue sources, deficit spending, under funding the pension and delaying payments to health care providers, poor fiscal practices all.

Illinois must not only address its burgeoning unfunded pension liability, but also the sources of its financial problems, its structural deficit. This is not only a pension problem but affects everyone. Unlike many other

services, the state's duty to pay the unfunded liability for its public employee retirement system is directly mandated in the Illinois Constitution. The absolute nature of this responsibility means the ***pension unfunded liability cannot be legislated away***; the debt must be repaid. This means that when Illinois eventually decides to deal with the burgeoning unfunded liability, money will have to be taken from elsewhere, i.e education, transportation, human services, etc.

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*Visit the IRSI website for more information about state worker's pensions at <http://www.ctbaonline.org/pensions.htm>*

*"The Illinois Retirement Security Initiative is a project of the Center for Tax and Budget Accountability. The goal of the Illinois Retirement Security Initiative is to ensure public retirement benefits in the state are adequately financed and designed to attract high quality employees to the public sector. The Initiative will research, formulate and advocate for public policies towards that end."*