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Pension Changes in the FY2018 Budget: Short-Term Savings and Long-Term Costs

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1. INTRODUCTION

The changes made to Illinois public pension systems in Public Act (PA) 100-0023 (introduced as Senate Bill 42), the Budget Implementation Act, or BIMP, passed on July 6, 2017, and include two primary elements. First, the BIMP creates a new Tier 3 level of benefits for public sector workers. Second, the BIMP permits the state to smooth out the fiscal impact of the actuarial reduction in the assumed rate of return generated by the state's five pension systems.

While proponents of the changes suggest they will give the state immediate and long-term fiscal relief from growing pension costs, this analysis of the changes indicates that the hoped for fiscal relief may not materialize.

Following is a summary of how Illinois created its significant unfunded pension liability in the first place; previous attempts to reduce the unfunded liability; and an analysis of the major pension provisions of the BIMP and their likely outcomes.

2. BACKGROUND: THE GROWTH OF ILLINOIS PENSION OBLIGATIONS

Illinois has five state pensions systems: the Teachers Retirement System (**TRS**), State University Retirement System (**SURS**), State Employees Retirement System (**SERS**), General Assembly Retirement System (**GARS**), and the Judges Retirement System (**JRS**).

These systems are primarily "defined benefit" systems. As the name implies, a defined benefit pension system provides members with a specified annual retirement benefit, usually based on a formula that factors in elements such as years of service, salary, and cost of living or "COLA" adjustments.

Together, these systems cover more than 270,000 current workers and pay benefits to nearly 220,000 retirees. Nearly half of all members in the state's five pension systems belong to TRS, with most of the remaining membership in either SURS or SERS. JRS and GARS combined have scarcely over a thousand current workers and a thousand member retirees.

Traditionally, defined benefit pension systems are funded over time from three primary sources: employer contributions, employee contributions, and investment returns from assets in the pension systems. In properly designed defined benefit systems, actuaries set the annual amount of the contributions made by the employer and employees so that over 30 years, those contributions plus their investment returns will be sufficient to cover the retirement benefits being earned by current workers. This payment, plus any additional funds to make up for previous shortfalls, is called the "actuarially required contribution," or ARC.

In practice, Illinois has consistently contributed significantly less than the ARC. Since 1995, Illinois has followed a legislative pension payment plan signed by Governor James Edgar as PA 88-0593 that supporters claimed would bring the pension systems up to a healthy funding level by 2045. However, this plan, often called the "Pension Ramp," began with a 15-year period in which pension payments were dramatically below the ARC. Hence by law, the Pension Ramp simply continued the prior practice of intentionally underfunding public pensions, and diverting what should have gone to cover the ARC to instead pay for current service delivery. Effectively, this meant the state was borrowing from the pensions to pay for services. The Pension Ramp then provided for the repayment of this debt by substantially "ramping-up" the annual pension payments from FY2011-2045.[1]

In FY1996, the debt owed by the state to the pension systems, also called its "unfunded liability," stood at $22 billion. By FY2016, it had increased by nearly six times to $129.8 billion.[2] About 80 percent of this growth in the unfunded liability has accrued since FY2007.

An analysis by the Commission for Government Forecasting and Accountability (**COGFA**) found that by far the largest single cause of the growth in Illinois' pension debt, accounting for over 41 percent or some $44 billion of the increase, was caused by the legislatively mandated under funding of the ARC under the Pension Ramp. An additional 29 percent of the growth was due to changes in actuarial assumptions, such as reductions in estimated investment returns. Roughly 14 percent of the increase was due to investment losses, particularly during the 2007-08 Recession. Less than one percent was a result of salary and benefit increases.[3]

Figure 1: Growth of Total Unfunded Liability ($ Billions)

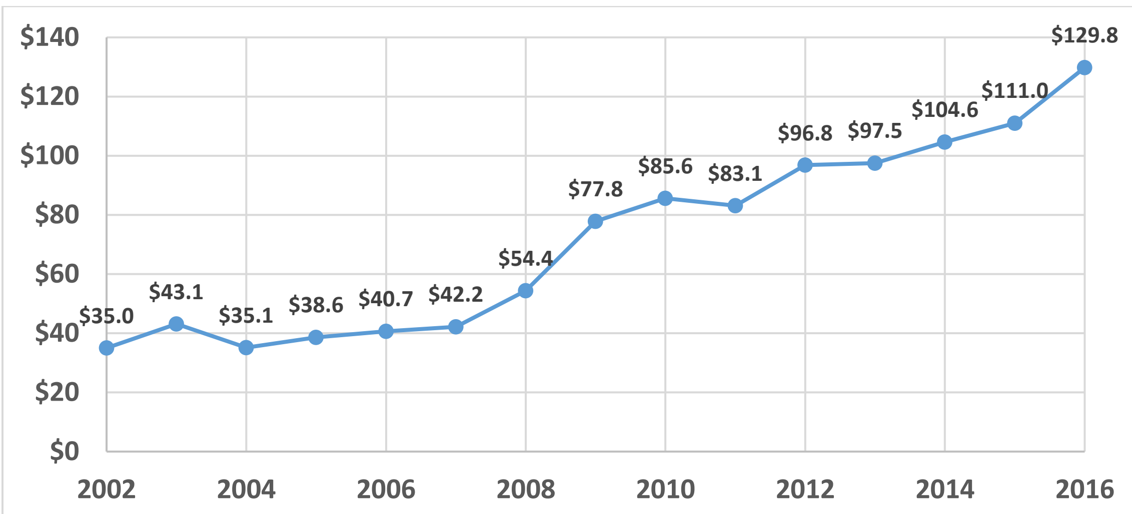
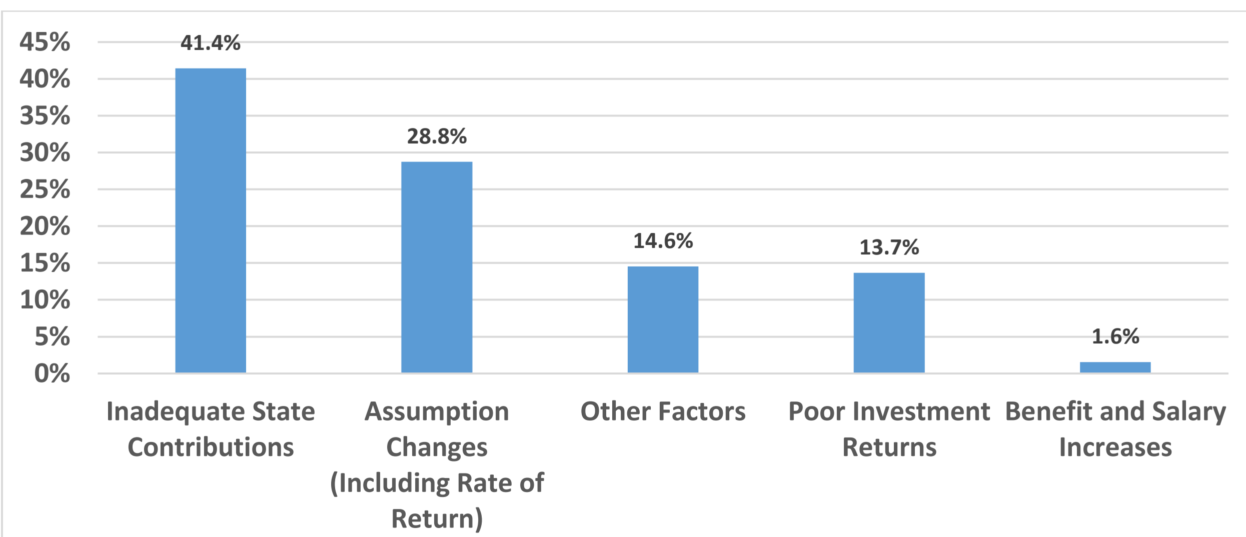


Figure 2: Causes of the Growth of Unfunded Pension Liabilities, FY1996 – FY2016



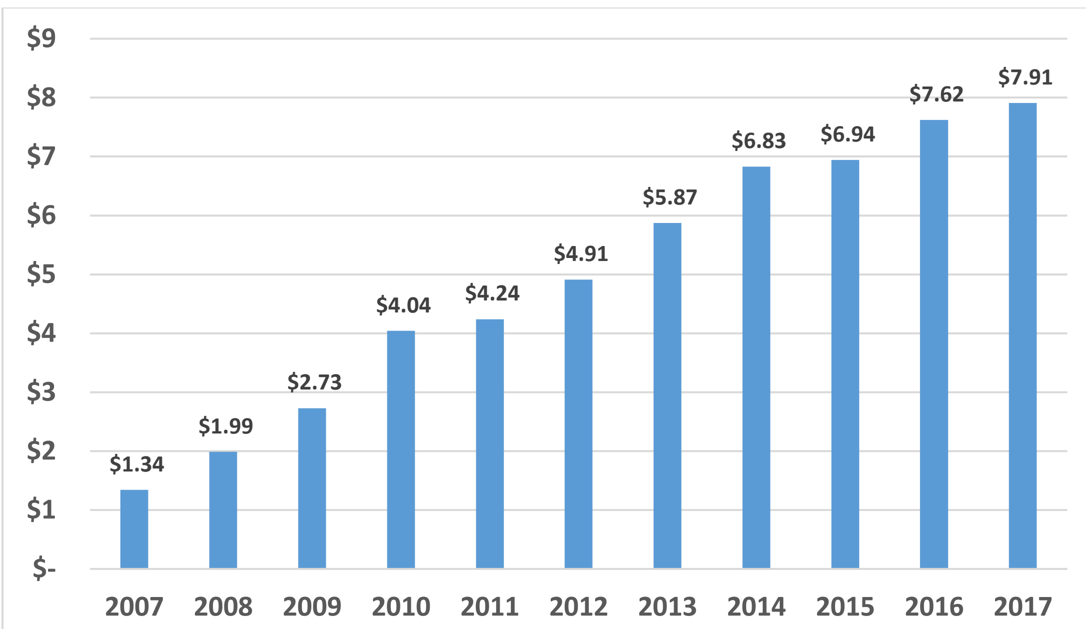
Typically, the health of a pension system is determined by what is known as its “funded ratio,” or the percentage of future benefits that could be paid with current assets. While experts disagree on what a healthy funded ratio is, many use 80 percent as a rule of thumb. Between FY2007 and FY2016, the Illinois pension systems’ funded ratio declined from 62.6 percent to 37.6 percent.[4] And that, by any standard, is not healthy.

As indicated previously, the heavily backloaded repayment of debt under the Pension Ramp has created significant fiscal pressure on Illinois’ General Fund since FY2010, as shown in Figure 3. Consider that, in FY2007, the total state payment to all five pension funds was $1.37 billion. In FY2017, it had grown by over five and a half times to reach $7.91 billion. In March of 2017, COGFA projected that FY2027 pension contributions would be $11.25 billion. As will be explained below, however, the pension changes made in the BIMP may cause these future payments to be even larger.[5]

Importantly, the growth of these payments is driven entirely by pension debt, rather than the cost of benefits earned by current workers, or “normal cost.” Between FY2017 and FY2027, COGFA projected that total normal costs will actually *fall* from $3.67 billion to $3.60 billion. The debt payments, however, will rise from $4.24 billion to $7.65 billion.[6] In other words, the proportion of the state’s total pension payment that is for debt will grow from 54 percent to 68 percent over this period.

The bottom line is clear. The artificially backloaded debt repayment scheduled contained in the Pension Ramp continues to put increasing pressure on the state’s General Fund budget, requiring billions of dollars in new revenue or cuts to the public services paid for by the General Fund—over 90 percent of which are for the four core areas of education, healthcare, social services, and public safety.

Figure 3: Total State Pension Appropriations ($ Billions)



3. PREVIOUS REFORM EFFORTS

3.1 Public Act (PA) 96-0889

Passed in 2010, PA 96-0889 created a new defined benefit for public sector workers that provides a lesser retirement benefit than under prior law. All employees hired through December 31, 2010, remained in the preexisting, higher-benefit “Tier 1” system, while all employees hired on January 1, 2011, or after are in the “Tier 2” system.

Pension benefits for Tier 2 employees are significantly less than for Tier 1 employees. For instance, normal retirement age increased from 60 to 67, and early retirement from 55 to 62. Cost of living increases were reduced from 3 percent annually to the lesser of 3 percent or one-half of the rate of inflation. In addition, Tier 2 employees are required to contribute a greater percentage of their salary to the pension system than Tier 1 employees.

By providing a lower level of benefits, PA 96-0889 did reduce future normal costs for the state—that is, the contributions required to fund benefits being earned by Tier 2 employees. That in turn meant that PA 96-0889 was completely ineffective in addressing the state's unfunded liability and the fiscal pressure it is generating, because as previously shown in Figure 2, less than one percent of the growth in the unfunded liability was driven by benefits. Since all PA 96-0889 really did was cut benefits, it only impacted a negligible part of the problem, while leaving the real challenge—an unaffordable, highly backloaded debt repayment schedule—untouched.

Moreover, in addition, it appears likely that some Tier 2 employees, including those of TRS, the largest system, pay more into the system than they will receive as benefits. In essence, they are both paying for their own benefits and for the unfunded benefits of Tier 1 employees. This arrangement may be contrary to federal law. If it is, the state could be required to provide Social Security benefits to Tier 2 members, who, like other members of Illinois pension systems, are not currently eligible for Social Security.

3.2 PA 98-0599

Passed in December 2013, PA 98-0599 directly addressed the pension debt that Illinois had already accrued. However, it was never implemented, as a successful court challenge led to an injunction and then a finding that the legislation violated the Illinois constitution.

The core problem with PA 98-0599 was that it reduced benefits that had already been promised to Tier 1 employees. These benefit reductions included lower cost of living increases, with some increases eliminated altogether; an increase of the retirement age by up to five years; and a cap on pensionable salary. In exchange, Tier 1 employees would pay one percent less of their salary towards their pension contribution.[7] COGFA estimated that the benefit cuts in PA 98-0599 would have immediately eliminated $21.1 billion in state pension debt, reduced the state's annual payments by $1.2 billion in FY2016, and by $137.4 billion over 30 years.[8]

Of course, those benefit cuts are prohibited by the Illinois state constitution, which expressly provides that pension benefits, once granted to existing workers, cannot be "diminished or impaired." [9] In May of 2015, the Illinois Supreme Court ruled that PA 98-0599 violated the pension protection clause of the state's constitution.

The pension reform provisions contained in the the FY2018 BIMP were significantly shaped by this ruling, and are intended to pass constitutional muster.

4. THE FY2018 BUDGET IMPLEMENTATION ACT

4.1 Basics of the BIMP

The BIMP included two significant changes to Illinois' pension systems. First, the legislation mandates that the effects of changes in actuarial assumptions on the state's annual contributions be phased in over five years. Most immediately and importantly, this will apply to the recent decisions by all state pension systems except SURS to reduce their estimated investment return rates.[10] When a pension system reduces its anticipated rate of return on investments, the unfunded liability of the system grows significantly. By smoothing that impact over five years, this aspect of the BIMP is expected to save approximately $900 million in FY2018, although it will add significantly to long-term costs.

Second, the BIMP creates a new class of pension benefits, Tier 3, which will be a hybrid Defined Benefit/Defined Contribution plan, available to employees hired in 2011 or thereafter. The Governor's Office of Management and Budget has estimated Tier 3 to save $500 million in FY2018, but it appears that the pension systems will not be able to implement the plan during this fiscal year, which means those savings—although in the FY2018 General Fund budget—won't actually materialize.[11] The effects of Tier 3 on the state's long-term finances are unclear.

4.2 Smoothing Changes in Actuarial Assumptions

To determine necessary contributions in any given year, actuaries for every pension system must make a series of estimates, such as when employees will retire and how long they will live. One of the most important estimates is the rate of return that a pension system's investments will earn. Because of compounding and the long-term nature of pension plans, small differences in the assumed rate of return can dramatically affect the amount of money required today for long-term financial stability.

Over the last several years, many pension systems around the country have concluded that their estimated rates of return too high. Last year, four of Illinois' five pension systems—TRS, SERS, JRS, and GARS—reached the same conclusion and lowered their estimated rates of return.

Figure 4: Recent Changes in Estimated Rates of Return

System	Old Estimated Rate of Return	New Estimated Rate of Return
TRS	7.5%	7.0%
SERS	7.25%	7.0%
JRS	7.0%	6.75%
GARS	7.0%	6.75%

These reductions, along with some other assumption changes, had the effect of increasing Illinois' total pension debt by $9.67 billion, or 8.6 percent.[12] Under previous law, this change would have been immediately and fully incorporated into the state's required contribution to the pension systems, adding more than a billion dollars to its annual payment. Each of the pension systems had certified an FY2018 contribution accordingly.

The BIMP, however, requires that the state's FY2018 pension payments be recertified in order to phase in the effects of the actuarial assumptions over five years. In total, this is expected to reduce the state's FY2018 pension payment by about $900 million.

So far, TRS is the only pension system to have officially recertified its required contribution for FY2018. Its new required contribution from the state is $4.034 billion, a reduction of $531 million from the previous required contribution of $4.564 billion.[13]

These savings, however, essentially represent more pension debt, as the state fails to immediately contribute the full amount required by the new estimated rates of return. In other words, once the phase-in is complete, Illinois will have to make larger pension contributions than it would have if it had not created the five-year phase-in under the BIMP.

TRS estimates that each dollar the phase-in saves in up-front costs will result in a future additional payment of three dollars. If that is the case, and estimates of $900 million of savings in the first year are accurate, then the BIMP's full five-year phase-in could add over $6.5 billion in future pension payments.[14]

4.3 Tier 3

As described above, in 2010, lawmakers attempted to bring down the long-term costs of state pensions by placing all new employees on a new, reduced benefit schedule called "Tier 2." Then, in 2013, lawmakers again attempted to bring down long-term costs by unilaterally slashing benefits for existing employees, a measure that the Illinois Supreme Court ruled was unconstitutional.

Following in this line, the FY2018 BIMP creates a new class of pension benefits, Tier 3. As with the 2010 law, all new employees will be enrolled in Tier 3, although they may choose to switch to Tier 2 within 30 days of starting their employment.

In addition, all Tier 2 employees may choose to switch to Tier 3. Unlike the unconstitutional 2013 law, no existing employees will be required to change their pension plans.

Tier 3 will be a hybrid plan, with a small Defined Benefit (DB) portion as well as a Defined Contribution (DC) portion. (Tier 1 and Tier 2 are DB plans.) Tier 3 employees will pay the cost of the DB plan's normal cost, up to 6.2 percent of payroll. If normal cost exceeds 6.2 percent of payroll, the balance will be paid by an employer contribution. Employees will also pay 4 percent of payroll towards the DC portion of the plan. Employers will contribute to the DC portion at an amount between 2 percent and 6 percent of payroll. Finally, beginning in FY2021, local employers will also pay an additional 2 percent of Tier 3 payroll to the defined benefit system. The purpose of this payment is unclear, as it is not related to the normal cost of Tier 3; it appears to be a payment against the already-accrued pension debt of Tier 1.

Under Tiers 1 and 2, the state is responsible for making normal cost and debt payments beyond what is covered by employee contributions. The cost shifts to local employers represent the primary savings to the state from Tier 3, although they still represent government payments made with tax revenue from Illinois residents.

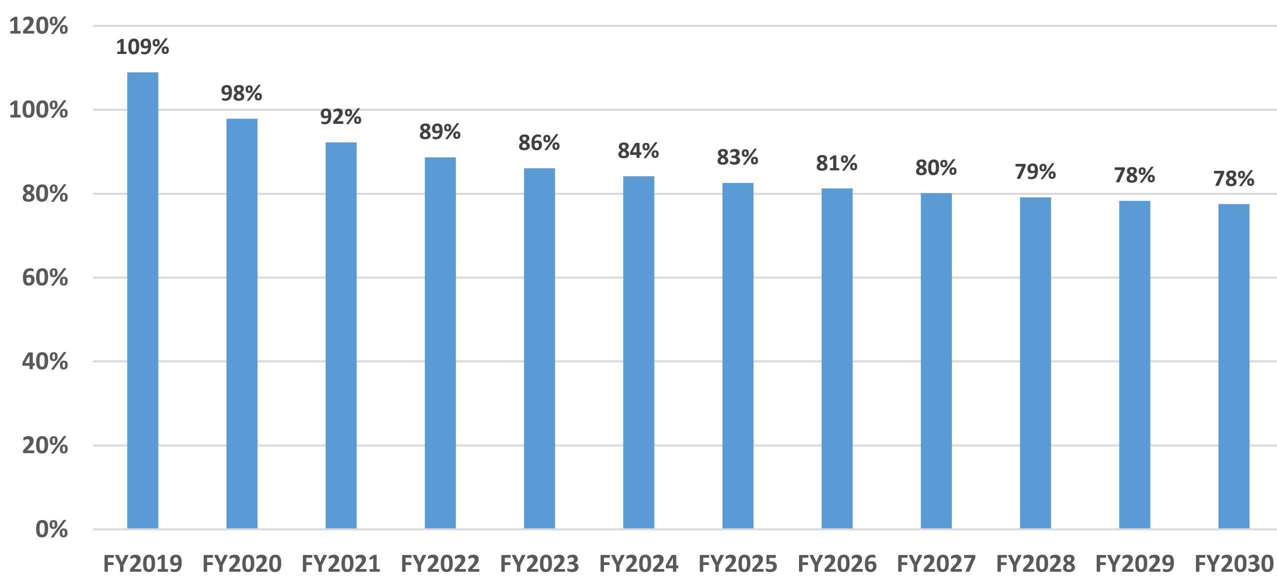
Importantly, Tier 3 will not take effect in FY2018. The IRS must approve the yet-to-be-determined terms of the DC portion of Tier 3 for each of the pension systems, a process that has historically taken over a year.

In September, SURS became the first pension system to release updated actuarial projections taking account of Tier 3 and the assumption smoothing requirements of the FY2018 BIMP. It found that even before Tier 3 takes effect, the state will be able to reduce its FY2018 SURS contribution by $61 million. These savings come from two sources: a reduction in anticipated benefits for current Tier 2 employees expected to switch to Tier 3 when that option becomes available, and a technical change to the Tier 3 payroll cap.

For a variety of reasons, it is difficult to extrapolate from SURS' projected Tier 3 savings in FY2018 to draw conclusions about savings that TRS and SERS may be able to realize for the state budget. But if each of those systems were able to reduce their state contributions by proportional amounts, then the state would save roughly $300 million in FY2018, increasing the deficit by $200 million compared to the $500 million in savings claimed by lawmakers.

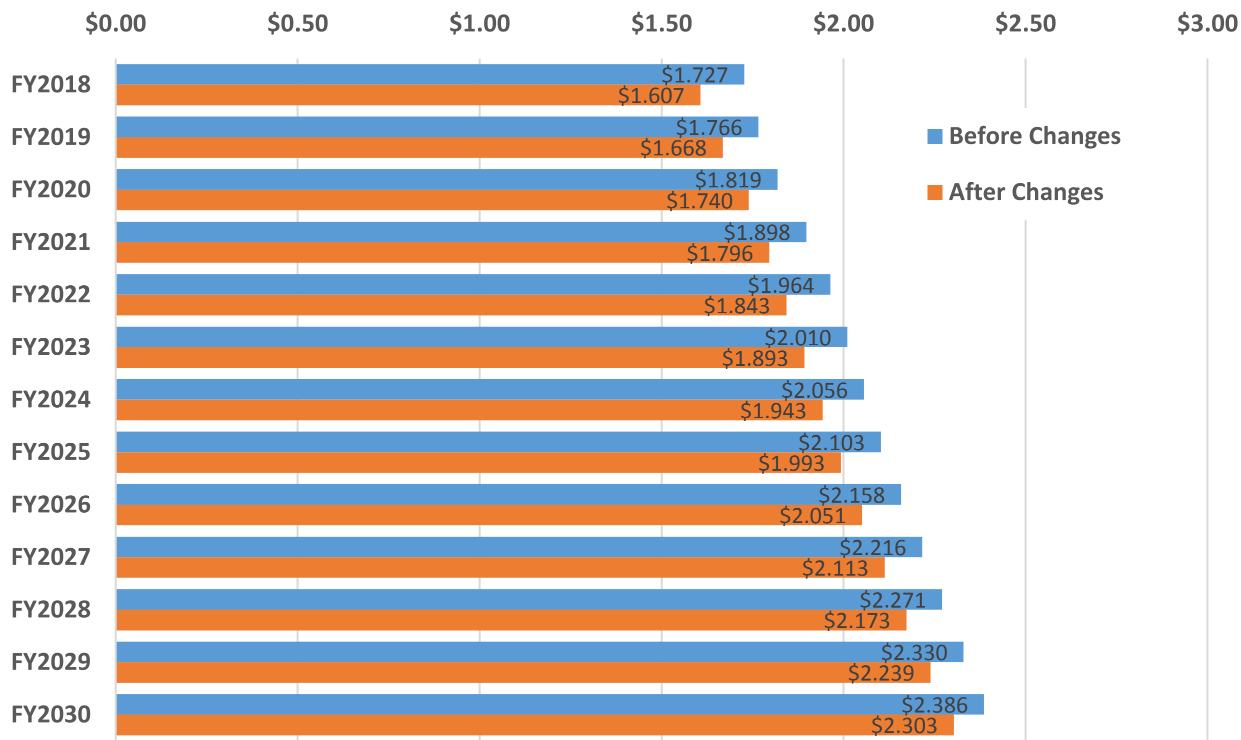
SURS' analysis also found, somewhat unexpectedly, that Tier 3's normal cost will not be entirely covered by employee contributions. As a result, local employers will need to make up the difference, which reaches a full additional percentage point of Tier 3 payroll by FY2024.

Figure 5: Proportion of SURS Tier 3 Normal Cost Covered by Tier 3 Member Contributions



Finally, SURS' analysis did not find significant long-run savings to the state from the changes contained in the FY2018 BIMP. As Figure 6 shows, anticipated state contributions to SURS remain only modestly lower than levels projected before the changes contained in the FY2018 BIMP throughout the 2020s. In FY2030, the total state contribution is projected to fall just $83 million, from $2.386 billion to $2.303 billion. At least in terms of state dollars, then, the FY2018 BIMP's pension changes leaves Illinois in much the same place over the long term.

Figure 6: SURS Pension Contribution, Before and After FY2018 Budget Changes ($ Billions)



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ENDNOTES

[1] Madiar, Eric. “Illinois Public Pension Reform: What’s Past is Prologue.” 31 Ill. Pub. Employee Labor Report, 2014.
[2] Commission on Government Forecasting and Accountability. “Illinois State Retirement Systems: Financial Condition as of June 30, 2016,” page 26.
[3] Ibid. page 28.
[4] Ibid. page 29.
[5] Ibid. page 23 and 99.
[6] Ibid.
[7] Madiar, Eric. “Illinois Public Pension Reform: What’s Past is Prologue.” 31 Ill. Pub. Employee Labor Report, 2014.
[8] The Segal Company. “Baseline Projections Using July 1, 2013 Actuarial Valuations and Cost Projections Under PA 98-0599.” March 21, 2014.
[9] Pearson, Rick and Geiger, Kim. “Illinois Supreme Court rules landmark pension law unconstitutional.” *Chicago Tribune*, May 8, 2015.
[10] Commission on Government Forecasting and Accountability. “Illinois State Retirement Systems: Financial Condition as of June 30, 2016,” page 27.
[11] Correspondence with state pension systems.
[12] Commission on Government Forecasting and Accountability. “Illinois State Retirement Systems: Financial Condition as of June 30, 2016,” page 27.
[13] Teachers Retirement System. “TRS Follows New Law and Lowers the State’s FY2018 Contribution by $531 Million.” August 23, 2017.
[14] CTBA calculation, assuming $900 million of savings in FY2018, $675 million in FY2019, $450 million in FY2020, and $225 million in FY2021, and then multiplying the total by TRS’ estimate of $3 in future costs for each $1 savings.