CTBA | Center For Tax and Budget Accountability

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Analysis

Asset transfers to the state pension systems: Six questions to be answered

Background

Illinois' five state public pension systems pose a significant problem for state budgeting. The systems have just 40.1 percent of the assets needed to pay for the retirement benefits earned by state employees, well below the 80 percent level considered healthy according to the federal Government Accountability Office.[1] In dollars, Illinois' pension shortfall, or debt, is $133.7 billion, among the worst in the nation.[2] [3]

To close this gap, state law requires increasingly large annual contributions from the state budget to the pension systems between now and fiscal year (**FY**) 2045. The FY2019 budget appropriated $7.26 billion from General Funds to the pension systems, or nearly 19 percent of the entire General Funds budget.[4] About three-quarters of this amount is a payment on pension debt, rather than newly earned benefits by current employees.[5]

In FY1996, the proportion of General Funds spent on the state's pension contribution was just three percent, but that figure has grown dramatically under a law passed in 1995 known as the "Pension Ramp."[6] The increase in pension contributions, driven by a back-loaded debt repayment schedule laid out in the Ramp, has crowded out funding for core public services such as higher education and human services.[7] As a result, lawmakers have looked for ways to reduce the state's contributions to its pension systems to avoid both spending cuts to current services and tax increases.

Asset transfers

One idea that has been proposed by a number of observers to repay some of Illinois' pension debt is an "asset transfer."[8] Under this proposal, the state (or the City of Chicago, which is also facing a large pension debt problem) would make a contribution to the pension systems in the form of a publicly owned property, such as a tollway or lottery, rather than in the form of cash.

Proponents point to a number of advantages from such a move. First, the value of the asset would be added to the pension systems' balance sheets, immediately reducing the systems' debt, or "unfunded liability." Second, as in the case of a tollway or lottery, the asset might produce its own revenue stream, which would provide an ongoing source of funding for the pension systems into the future. Finally, because annual state contributions to the pension systems are driven largely by the need to repay pension debt, if the asset transfer significantly reduced the amount of that debt, it could also reduce the state's annual contribution, freeing up revenue for other current services.

Two recent examples of public pension asset transfers in New Jersey and Queensland, Australia are valuable case studies for Illinois. Each represents a distinct model of how to use asset transfers to direct funds to pension systems.

New Jersey: A revenue-generating asset creates a dedicated funding stream.

In 2017, the New Jersey legislature transferred the state lottery to its pension systems. Valued at $13.5 billion by a state-hired actuary, the lottery immediately boosted New Jersey's state pension "funded ratio"—the proportion of earned benefits covered by existing assets—from 45 percent to 59 percent.[9] The lottery's $1 billion in annual net revenue would also be dedicated to the pension systems for 30 years, allowing the state to reduce its FY2018 contribution from $2.5 billion to $1.5 billion.[10] In other words, the asset transfer did not immediately increase annual funding for New Jersey's pension systems.

Some analysts also raised concerns that the state's lottery proceeds had previously been dedicated to education funding, and it was not clear where revenue would be found to make up for the loss of that education funding in the future.[11] Moreover, if lottery revenues did not meet projections, other state revenue would have to make up the difference.[12] And the asset transfer did not change the fact that New Jersey's total FY2018 contribution of $2.5 billion was far below the actuarially required contribution of $5 billion, which is what would be required to avoid increasing the state's pension debt.[13]

Queensland, Australia: A one-time windfall through privatization.

In 2011, the state of Queensland transferred the Queensland Motorways (**QML**), a toll road network, to the state's public pension fund.[14] At the time of the transfer, QML was valued at $3.1 billion. (All dollar figures in this example are in Australian dollars.) Under the pension fund's management, QML underwent a series of reforms, and it was sold to a private entity in 2014 for $7.1 billion.[15]

After accounting for the Queensland pension fund's up-front costs and capital investments, the asset transfer and privatization provided a net of $3.8 billion in cash to boost pension holdings.[16] However, management of the toll roads was placed permanently outside of public control, although toll increases would not be allowed.[17]

Six questions for an asset transfer policy in Illinois

The bottom line: Asset transfers raise a number of potential concerns. Before moving forward on any such proposal in Illinois, lawmakers should be sure to address these questions, and any others that may arise.

1. **What assets can be transferred, and what restrictions would the state face in transferring them?**

No specific properties have yet been proposed for asset transfer by the state of Illinois, but some potential options pose challenges. For example, revenue from the Illinois Tollway, perhaps the largest potential asset transfer, may be subject to at least two restrictions. First, there is the Transportation Lockbox Amendment to the state constitution approved in November of 2016, which requires that all transportation-related revenues be used for transportation-related expenditures.[18] Transferring the Tollway to the pension systems—and allowing Tollway revenue to be allocated to pension contributions—would be likely to provoke a legal challenge. Second, the Tollway has issued $6.6 billion of outstanding revenue bonds backed by tolls and other revenue.[19] How these bonds might be affected by the transfer would need to be clarified.

2. **Will the asset include a revenue stream currently used for other purposes? If so, how will the state replace that revenue?**

In New Jersey, lottery revenues dedicated to pension payments as part of the asset transfer had previously supported education and other services. To make up for the lost funding, the state redirected other general revenue that had been used to make pension contributions. In other words, the asset transfer effectively amounted to a revenue source swap, with pension contributions and service funding neither gaining nor losing total funding from the deal in its first year.[20]

3. **Will the transfer be an implicit promise to privatize the asset?**

Because an illiquid asset such as a lottery system or tollway cannot be used to pay retirement benefits, the pension systems may need to sell, or privatize, whatever asset they receive to realize its value. As we have seen, this is what took place in the Queensland asset transfer. Privatization itself raises concerns, including the removal of public oversight over the maintenance and operation of infrastructure and services. Private sector, for-profit owners face very different incentives in fee structures and service delivery than do public managers accountable to voters. Making sure both elected officials and taxpayers understand the privatization-related implications and possibilities of an asset transfer is crucial.

4. **How will the asset transfer affect the state's overall pension contribution levels?**

For some observers, the possibility that an asset transfer will reduce the pension systems' debt—and therefore the size of the current debt payments the state has to make—is a primary advantage of the policy, because it frees up current revenue that was used to pay pension debt to fund public services. This could be a positive, given how significantly public services have been cut in Illinois over the last decade. That said, given its extremely high level of pension debt, Illinois decision makers should be very wary of any policy that reduces contributions to the pension systems in the near term. Short-term reductions often result in longer-term costs—indeed, making that tradeoff is why Illinois is in its current fiscal mess.

Notably, to avoid this very problem, the New Jersey asset transfer did *not* reduce total pension contributions for the first five years, and actually *increased* total scheduled contributions after that.

5. **How would an asset transfer affect management of the asset itself?**

How the transferred asset would be managed going forward—whether directly by the pension systems, or by a hired third-party operator, including possibly a lease-back to the state—is an important issue. Ending direct ownership by the state may also have important legal implications. For example, an asset owned by the pension systems may no longer be able to issue tax-free debt, increasing borrowing costs and limiting its ability to raise funds for capital needs.[21]

6. **How will the asset transfer affect the pension funds' anticipated investment returns, and how will that affect the size of current liabilities and the state's required contributions?**

The pension systems use an anticipated investment return rate to calculate both the present value of accrued liabilities, and the state's required annual contribution. If an asset is deposited into the pension systems' funds, actuaries will need to estimate the rate at which its value will increase. If that estimate is below the systems' current anticipated rates of return, that may affect the calculation of current liabilities and the state's required contribution.

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Endnotes

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[5] Actuarial valuation reports of Illinois' five state pension systems.

[6] Speech by Dan Hynes to the City Club of Chicago, February 14, 2019.

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