July 2013

Illinois Needs to Pass Public Pension Reform

If nothing is done, everybody loses

Overview

The Illinois public pension system is on an unsustainable course that threatens the delivery of essential government services. Approximately 20 cents of every taxpayer dollar is now dedicated to pensions—a 400 percent increase over the past 20 years. Without reform, pension costs could consume a staggering 40 percent of Illinois' revenue by 2045.

As a result of chronic underfunding, the state has $95 billion in pension debt and has set aside only 40 percent of the money needed to pay for retirement promises it has made to workers. In 2013, almost two-thirds of each dollar put into the State Employees' Retirement System of Illinois went to pay for pension debt from past years rather than for benefits earned that year. This share will continue to grow, crowding out important public investments in order to pay for mistakes of the past. The state's four other pension plans are in similar shape.

The bill for kicking the can down the road has already come due, placing pension promises at risk and leading to lower bond ratings, less money for teachers and police officers, and unpaid bills for cash-starved nonprofits. Without reform, everyone will lose.

The Rising Cost of Public Pensions

Portion of each taxpayer dollar that supports public pension financing, 1995-2013

1995 | $0.04   2005 | $0.09   2013 | $0.20

October Three and Maeva Municipal Solutions, 2013

Paying down the state's pension debt will require difficult decisions on tax increases, service cuts, and benefit reductions. But further delay will only increase the burden borne by future generations of workers and taxpayers. Interest on the state's pension debt is expected to be more than $7 billion over the next year, or $19 million a day.

The recently formed conference committee—made up of Democrats and Republicans from the Illinois House and Senate—has the opportunity to recommend comprehensive pension reform that would fully fund employee benefits and make the state's retirement promises sustainable in the long term. Policymakers' next step is to reach an agreement and move the state toward fiscal sustainability.

The consequences of inaction are severe. They include:

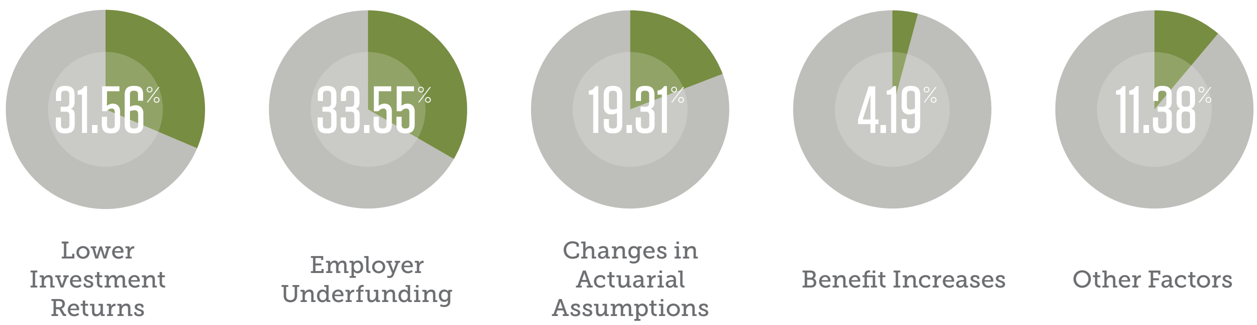
- **Continued deterioration of the state's credit rating and higher borrowing costs.** In April, Illinois sold $450 million in tax-exempt bonds. The yield on the state's 10-year bonds sold at a 1.29 percentage point premium. After the Legislature's failure to enact pension reform resulted in further credit downgrades, the state sold $1.3 billion in tax-exempt bonds in June. This time, the yield on its 10-year maturities increased by 17 percent,[1] an additional cost of $130 million over the life of the bonds.[2] If the state continues to mismanage its finances, this trend will continue, costing Illinois' public workers and taxpayers needless billions.
- **Additional deficit spending at high interest rates, costing the state billions.** Contributing less than the amount necessary to cover the benefits that workers earn each year and reduce the standing pension debt equates to borrowing money from workers and taxpayers. Pension debt has an interest rate equal to the plan's assumed rate of return, roughly 8 percent in Illinois. Carrying a pension debt of any size at this rate for 30 or more years will significantly increase retirement costs. The $1.6 billion in pension debt the state accumulated by shortchanging its payment in 2012 will end up costing close to $4.5 billion over the 30 years that it will take to fully pay it off. If the state had made the full contribution in 2012, policymakers could have added approximately 2,500 teachers to Illinois' classrooms over the 30-year period instead of making payments on this additional pension debt.[3]
- **A cash flow problem that threatens the state's social safety net.** Two months into fiscal year 2013, the state comptroller and other agencies reported a backlog of more than $9 billion owed to nonprofits, businesses, and school districts for unpaid bills dating back nearly a year.[4] Many of these nonprofit organizations provide part of the social safety net to the state's most vulnerable citizens. As of October 2011, nearly $454 million was owed to tax-exempt organizations alone.[5] This lack of payment, coupled with state budget cuts, has delivered a blow to many groups operating after-school programs and providing food and shelter for the poor and services for the elderly and disabled. Continued fiscal constraints and late payments will further threaten the state's safety net.

What caused this pension problem?

Illinois' pension debt has grown by $79 billion since 2001. Approximately one-third of the growth is attributable to employer contribution shortfalls, another third is due to unanticipated investment losses, and the remainder is caused by other factors, including actuarial assumption changes and benefit increases. (See Figure 2.) The state must begin making responsible payments that will fully pay down the pension debt over a reasonable time frame. It also must take steps to fix the structural problems that allowed the pension debt to grow so large in the first place.

The Reasons for Public Pension Funding Shortfalls

Sources of increases in the unfunded liability of the Illinois Employees' Retirement System, 2001-2012



Illinois State Retirement Systems, Financial Condition as of June 30, 2012

The price of inaction

Illinois put more than $5 billion into its pension funds in 2012 and still fell short of what it should have contributed. But that is just the tip of the iceberg. If Illinois sticks to its current path, and if markets deliver the hoped-for returns, pension payments will take up 22 percent of all tax revenue in 2025.

Even if investments by the public pension plans deliver returns well above the historical average, yielding 9.25 percent, pension costs in 2025 would still consume one of every five taxpayer dollars. And if plan investments fall short of expectations, yielding 6.25 percent rather than the plans' assumption of approximately 8 percent, then the state's fiscal picture gets substantially worse: Pension costs would consume one-quarter of all tax revenue in 2025 and 40 percent in 2045, crowding out other discretionary spending. (See Figure 3.)

Furthermore, these estimates do not include the more than $17 billion in bonds that Illinois has issued to shore up its pension plans. Payments on those will require $1.6 billion in 2014 alone.

The danger of not meeting public pension funding expectations

Pension expenses projected as a percent of state tax revenues, 2005-2045

October Three and Maeva Municipal Solutions, 2013

Making responsible pension payments that lead to full funding of benefit promises is the right way to treat Illinois public employees and would save the state money. Making the full payment recommended by the plans' actuaries would cost more initially but would save Illinois an estimated $38 billion over 30 years.

What needs to be done?

There is no one-size-fits-all solution to this challenge. Illinois' policymakers will need to come up with a set of comprehensive reforms that works for the state. Successful reform includes the following steps:

Develop a plan to responsibly pay down the unfunded liability over a reasonable period

The payment plan must balance the three sources of funds available to governments to pay down the pension debt: tax revenue, service cuts, and changes to benefits. The pension plans' funding targets should be based on actuarial best practices to achieve 100 percent funding within 30 years. Anything less would increase long-term costs, improperly burden the next generation of Illinois citizens, and leave the pension system and benefit promises vulnerable to future economic downturns.

Adopt a reformed retirement system that is affordable, sustainable, and secure

The state's retirement system should offer a secure retirement for workers while also reducing the potential for unforeseen cost increases that lead to huge debt accumulation and skyrocketing payments. Paying down the current pension debt without protecting against future funding crises would leave future workers and taxpayers at risk. Any new plan should not penalize workers with excessive vesting periods or back-loaded benefits and should include professionally managed investments and access to annuities.

Ensure that retirement benefits enhance the state's ability to recruit and retain a talented public-sector workforce

Retirement savings are just one piece of a worker's total compensation package. Policymakers must be thoughtful about how they allocate their limited dollars. If nothing is done to correct the situation in Illinois, salary freezes and hiring slowdowns could significantly harm the public workforce and impede state employers' ability to recruit and retain the workers they need.

The bottom line

If policymakers can focus on the policy rather than the politics, this will remain a solvable problem. Illinois needs a fair set of solutions, and it is time for its policymakers to deliver it.

Endnotes

1 Chappatta, Brian, "Illinois Pays 17% More Than in April for $1.3 Billion Muni Sale," Bloomberg News, June 26, 2013., at http://www.bloomberg.com/news/2013-06-26/illinois-offers-1-3-billion-of-munis-in-worst-market-since-2008.html

2 Illinois Government News Network, "Quinn Administration Sells $1.3 Billion in Bonds to Continue Illinois Jobs Now! Projects," June 26, 2013., at http://www3.illinois.gov/PressReleases/ShowPressRelease.cfm?SubjectID=2&RecNum=11299

3 Debt service on $1.6 billion of unfunded liabilities was estimated to be $87 million in the first year—growing proportionally to payroll in subsequent years. Starting teacher salaries in Illinois were reported to be $36,636 based on data compiled by TeacherPortal.com. http://www.teacherportal.com/salary/Illinois-teacher-salary

4 Comptroller's Quarterly, Judy Baar Topinka, Comptroller, Edition 8, February 2013., at http://www.ioc.state.il.us/index.cfm/linkservid/B6F75215-A621-06BA-164E324617E77E1E/showMeta/0/

5 Social IMPACT Research Center at Heartland Alliance, Contracts with Tax Exempt Organizations Awaiting State Payment as of October 12,2012., at http://illinoispartners.org/sites/default/files/Tax_Exempt_Orgs_Awaiting_Payment_as_of_October_12_2011.pdf

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