



A “Pension Crisis” Mentality Won’t Help: Thinking Differently About Illinois’ Retirement Systems

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EXECUTIVE SUMMARY

The near ubiquitous claim that Illinois is facing a “pension crisis” has rarely been challenged. The failure to examine this customary framing of the fiscal condition of Illinois’ five state pension systems limits how policymakers conceptualize their funding strategy. This white paper, jointly authored by researchers from the Project for Middle Class Renewal at the School of Labor and Employment Relations, the Government Finance Research Center and the Institute of Government and Public Affairs (all at the University of Illinois), argues that the “pension crisis” framework negatively influences discussions of policy options.

Our goal with this paper is to rethink the conversation about pensions and the state’s finances in several ways. First, we argue that the funded ratio and unfunded liabilities, conventional ways of assessing a pension system’s fiscal health, are inadequate metrics that reinforce short-term thinking. We argue that the focus should be on long-term trends and peer comparison. In addition, attention should be paid to identifying what the drivers are of negative trends and carefully assessing whether action is needed.

Second, we argue that a “pension crisis” is a situation in which the pension system is insolvent and unable to make benefit payments to current retirees. This is not the present scenario in Illinois. Nonetheless, we recognize that both the state and the pension systems face significant fiscal challenges. Third, rather than a singular problem, we contend that there are actually two, interrelated and in-conflict issues:

- concern over the pension systems’ finances, and
- operating budgets where expenses regularly exceed revenues.

We note that a tension exists between a desire to rapidly improve the finances of the pension systems (which would necessitate higher state contributions), and an interest in preventing pension contributions from crowding out other areas of the state budget.

Illinois lawmakers have long sought a silver bullet solution that will not increase (or even lower) the state’s required contributions while simultaneously shoring up the pension systems’ finances. We view such a scenario as unattainable and its pursuit as a distraction from the job of responsible policymaking. Moreover, because the two issues are interrelated, a policy designed to address one issue will necessarily worsen the other.

In this paper, we recommend abandoning the “crisis” narrative and moving away from only assessing the pension systems’ finances with a single point-in-time measurement. Last, we urge lawmakers to shed the common practice of reducing the state’s pension payments to balance the operating budget.

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I. INTRODUCTION

By now it has become almost mandatory to describe Illinois as facing a “pension crisis” (e.g., *Chicago Tribune*, 2012; Davey and Walsh, 2015; *USA Today*, 2018). Only occasionally is there a word of protest to this substantive claim (*Chicago Tribune*, 2013). While this might seem, to some like an issue of semantics, we believe that the framing of Illinois’ pension problems is inextricably linked to how we conceptualize their solutions. The crisis narrative makes a broad claim about public pension systems writ large in Illinois. But Illinois has nearly 700 state and local pension funds, and their issues and challenges vary widely. This white paper focuses on just the five state systems,¹ and challenges the pension crisis framework.

In Illinois, discussions of a “pension crisis” are common, but an exact definition of that phrase is rarely offered. We argue that a “pension crisis” is a situation in which a pension system is insolvent (meaning its assets are depleted), and as a result benefit payments to current retirees are halted. Although that is not the current situation in Illinois, some are concerned that could happen because of the present state of the pension systems’ finances. While we are not dismissive of that concern, we argue that the pension crisis narrative is problematic because it obscures underlying issues and creates the unattainable expectation that the “crisis” must, and can be solved immediately.

The phrase “pension crisis” is often invoked in discussions about the state’s current and future pension contributions, with many seeing those contributions as crowding out other aspects of the state’s budget. While recent cuts to other areas of state spending (like higher education and human services) are a concern, we argue that those cuts

are not a *pension* crisis. Some tie the budget cuts to the state’s pension contributions; however, when faced with budget shortfalls lawmakers have a range of options, one of which is spending cuts. The state pension contributions in isolation do not lead to a direct decline in other areas of the budget.

Our goal with this paper is to change the conversation about pensions and the state’s finances. We believe this is important for addressing the challenges facing the state in a calm, thoughtful and deliberate manner. We need to understand the nature of the actual problems, the context in which they arose, and fully consider the consequences of alternatives. We aim to show that beneath the crisis narrative is actually two, interrelated and in-conflict issues: (a) concern over the pension systems’ finances; and (b) operating budgets where expenses regularly exceed revenues. A tension exists between a desire to rapidly increase the finances of the pension systems (which would necessitate higher state contributions), and the concern that the state’s pension contributions are already crowding out other areas of the state’s budget.

“...beneath the crisis narrative is actually two, interrelated and in-conflict issues”

In addition, the crisis framework is harmful because it facilitates reactive policies that focus on short-term solutions and metrics. Illinois lawmakers have long sought a silver bullet solution that will simultaneously shore up the pension systems’ finances while not increasing the state’s required contributions (and in some instances even lowering the payments). In this paper, we recommend abandoning the “crisis” narrative and urge lawmakers to shed the common practice of reducing the state’s pension payments to balance the operating budget.

¹ The five state systems are: the Teachers’ Retirement System, the State Universities Retirement System (SURS), the State Employees’ Retirement System (SERS), the General Assembly Retirement System, and the Judges’ Retirement System.

Fiscal sustainability of the pension systems and structurally balanced budgets are determined by political will and economic fundamentals. Governments can only raise revenue and control spending when political leaders are able to justify hard choices and gain their constituents’ trust and support. Political will requires that lawmakers understand the challenges that they face and explain them to voters in a way to garner their support for appropriate policies. The more scarce economic resources are, the more difficult it is for elected leaders to devote resources to expenditures (like pension funding) that bring few immediate benefits to the vast majority of constituents. Better economic fundamentals (e.g. growing economic output and widely distributed economic gains) make it easier for lawmakers to garner political support for policies that increase fiscal burdens.

We offer this white paper as a critique of the rarely challenged and ill-defined “crisis” narrative. We begin with conceptual critiques of the crisis framework. Next, we unpack the crisis framing to show how instead of a singular concern there are actually several, interrelated issues. Moreover, we show that these issues are in tension with one another. A fourth section provides three examples of how a “crisis bias” approach has largely failed to reduce unfunded liabilities and kept Illinois locked in a seemingly endless “pension crisis”. We conclude with recommendations about how to approach the state’s pension systems.

II. WHY IS THE CRISIS FRAMEWORK BAD?

The crisis framing was captured in a recent *Crain’s Chicago Business* piece that criticized newly sworn-in Governor J.B. Pritzker’s inaugural speech (Cahill, 2019). Cahill’s piece was headlined, “Pritzker’s pension silence speaks

volumes”, and in it Cahill critiqued Governor Pritzker for having “nothing to say about \$130 billion in unfunded pension obligations to state employees, a yawning black hole of debt that threatens to swallow the state budget and suffocate Illinois’ economy” (Cahill, 2019). This crisis narrative implies that drastic action is needed to immediately extinguish \$130 billion worth of debt. Such a framing incorrectly presents the issue as one that can be resolved in the short-term and misunderstands the very nature of financial condition.

One problem with the pension crisis narrative is that it creates a temporal mismatch between the framing of how the problem should be addressed and the actual nature of unfunded pension liabilities. This is because unfunded liabilities represent a long-term form of debt, and are not something that could be eliminated in a year (or even a few

years). However, in the crisis framing, unfunded pension liabilities are often put in context of how much money is needed today to fully pay off the debt. A *Bloomberg* headline from last spring succinctly captures this misguided perspective: “Every Illinoisan Owes \$11,000 for Pensions With No Fix in Sight” (Campbell, 2018). Stating how much every Illinoisan would need to pay today to wipe out unfunded liabilities in one year reinforces a short-term thinking that is disconnected from the nature of pension liabilities. It also ignores the fact that a pension system’s finances are in constant flux. Since assets and liabilities constantly change, the elimination of all unfunded liabilities today (even if possible) does not prevent unfunded liabilities from arising tomorrow.

The short-term thinking of the crisis narrative also implies that there is an acute threat of benefits not being paid to retirees. A pension fund’s liabilities are the estimated cost of pension benefits being paid out now and benefits that will be paid out decades in the future. Unfunded liabilities are

“...unfunded liabilities represent a long-term form of debt, and are not something that could be eliminated in a year”

liabilities that are currently not matched to assets. A pension system’s fundamental obligation is to pay claims to retirees and other claimants such as beneficiaries. As currently structured and funded Illinois’ pensions systems are not projected to go insolvent, meaning there is not an immediate risk that retirees will stop receiving their benefits. Unfunded liabilities are a form of long-term debt, and there is a plan in place to manage this debt. By the very design of this plan, the systems’ unfunded liabilities will continue to increase for the next decade and then start to decrease after 2029.

The crisis framework obscures that A) unfunded liabilities are a long-term debt to be paid off over decades, and B) Illinois has a payment schedule for its unfunded liabilities already in place. This is not, however, to say that the existing funding plan is perfect. The current funding plan is a back-loaded debt repayment schedule in which unfunded liabilities increase for another decade before beginning to decrease. The structure of the funding plan also requires the state’s contributions to increase from year-to-year by an average of 3 percent under current projections. Last, future contributions could be much higher than current projections because actual contributions are determined each year and are impacted by changes in assumptions, investment performance, and the accuracy of actuaries’ assumptions. In Section 3 we discuss criticism of that funding plan and highlight budgetary challenges it creates.

Another issue with the crisis framework is that it conceives of financial condition as a singular thing that can be “solved.” A pension fund’s fiscal health is often represented by one or two metrics, most commonly its unfunded liabilities or funded ratio (the ratio of pension assets to liabilities). A funded ratio of 100 percent means assets are sufficient to pay estimated current and future liabilities. While a funded ratio below 100 percent is often used as an indicator of a poorly financed system, there is no single threshold that

distinguishes a healthy versus unhealthy retirement system (*American Academy of Actuaries*, 2012). More broadly, financial condition is multidimensional and cannot be assessed with one point of data at one point in time. Instead, financial condition is something to consistently monitor and attend to over time. The pension crisis framework simplifies the complexity of financial condition and gives the false impression that it is something to move on from once solved.

“Another issue with the crisis framework is that it conceives of a financial condition as a singular thing that can be ‘solved’”

Focusing on one metric also obscures legitimate debate concerning the optimal level of funding for a retirement system. A funded ratio target is commonly used in a funding policy that sets a government’s annual pension contribution. In many cases, a government’s required annual pension contribution equals the employer portion of the normal cost plus the expected cost to retire any unfunded liabilities. The “normal cost” is the cost of benefits earned that year by current employees. Employees’ contributions typically cover a portion of the normal cost, and the remainder is the employer’s share of the normal cost. The “expected cost to retire any unfunded liabilities” is determined by a combination of policy choices and actuarial assumptions. Policy choices include what is an acceptable level of debt (in the form of unfunded liabilities), how debt repayment should be structured, and over what time period all (or a portion) of unfunded liabilities should be paid. In Illinois, lawmakers enacted a plan that requires each state retirement system to achieve a 90 percent funded ratio by 2045. Pension fund actuaries calculate the state’s required contributions each year to achieve that goal.

Many observers advocate a funded ratio target of 100 percent, and this is often treated as a fundamental principle in actuarial science but it is

not necessarily required by conventional economic theories of public finance and has little evidentiary support (e.g. Bohn, 2011). Economic analysis suggests that unfunded pension liabilities represent a governmental debt and should be no more, or less, privileged than any other debt. Public finance scholars and practitioners generally recommend incurring state or local government debt only for capital expenditures but not for operating expenditures such as compensation of current workers. This suggests that government ought to fully fund the normal cost of its pension obligation each year but says nothing about how unfunded pension liabilities should be retired. The rate at which debt acquired in the past should be retired is a political choice and a funded ratio of 90 percent or 100 percent or even 110 percent may represent a legitimate goal of the peoples’ elected representatives.

“...focusing on just the funded ratio target misdirects attention away from the larger issue of funding discipline.”

While what level of unfunded liabilities is acceptable is debatable, focusing on just the funded ratio target misdirects attention away from the larger issue of funding discipline. Illinois exhibits a lack of funding discipline with a long

legislative history of reducing the state’s pension contributions through pension holidays, changes to actuarial assumptions, tweaks to the funding policy and benefit reductions. Rather than focus on a funded ratio target in isolation, it is crucial to contextualize the target within the context of existing policies, and interrogate whether the goal of any proposed change is ultimately to reduce a government’s required pension contributions. The same level of scrutiny is needed for any proposed changes. Changing pension laws to cut required contributions shows a lack of funding discipline, and this has been a key issue in Illinois, as we highlight throughout this white paper.

III. WHAT ARE THE UNDERLYING ISSUES?

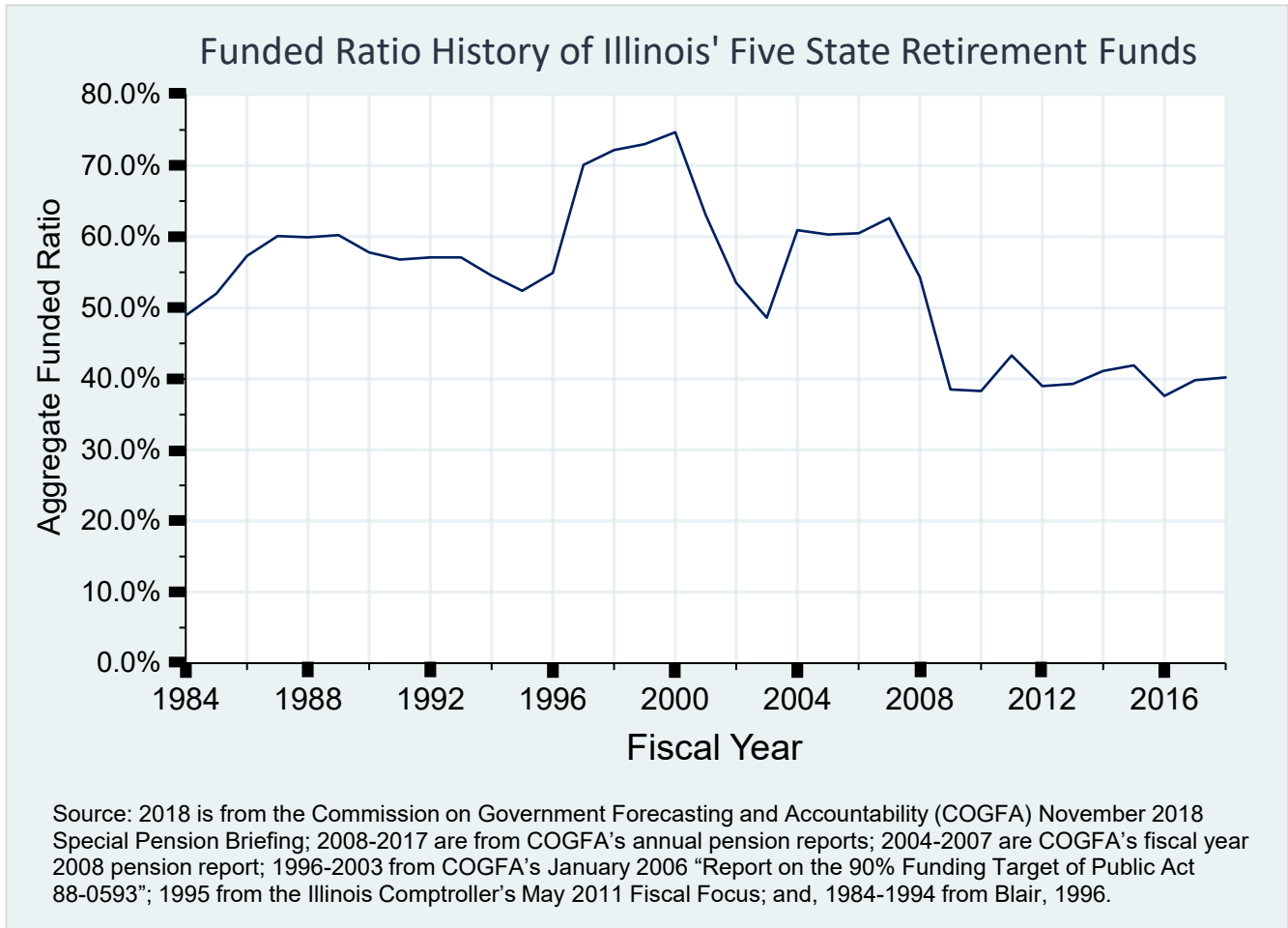
In addition to the conceptual flaws of the pension crisis framework, it has also been problematic because it masks what are actually two interrelated, yet conflicting issues: restoring the financial condition of the pension systems and alleviating budgetary pressure. We detail these two issues in the following subsections and highlight how the solution to one of the issues can exacerbate the other issue. Unfortunately, the crisis framework obscures these distinctions and leaves lawmakers searching for a silver bullet solution.

a. Restoring the Retirement Systems’ Fiscal Health

From one perspective, the central issue facing the State of Illinois is restoring the financial condition of the pension systems. While Illinois’ pension systems are able to pay out benefits to current retirees some are concerned that given their current finances and the state’s contribution history, this may not be the case in the future. This perspective highlights how the state’s history of insufficient contributions and lack of funding discipline have eroded the retirement systems’ finances over time. From this perspective, the optimal solution is getting the systems 100 percent funded in the actuarially recommended time period of 20-30 years. Adopting such a funding target would require the state’s contributions to be much higher than they currently are, and those increased payments would exacerbate the state’s already existing fiscal challenges (which are discussed in subsection b).

While the funded ratio in isolation tells us little, the funded ratio history provides meaningful insight into the finances of a pension system over time. Figure 1 shows the aggregate funded ratio

Figure 1: Funded Ratio History of Illinois' Five State Retirement Funds



for Illinois' pension systems.² The long-term downward trend in Illinois' aggregate funded ratio is cause for concern. While the state pension systems have never been 100 percent funded, their aggregate funded ratio declined sharply in the wake of the 2007-2009 recession, falling from 63 percent in 2007 to 39 percent in 2009, as shown in Figure 1. Since the aggregate funded ratio fell sharply in the wake of the recession it has generally remained around 40 percent.

Illinois' pension systems are also less funded than their peers. As of FY2018, Illinois' five state

funds had a combined funded ratio of 40 percent, which is low in relation to other public pension systems in the United States. In 2017, the aggregate funded ratio for state and local pension funds in the United States was 72 percent according to the Center for Retirement Research (Aubry, Crawford and Wandrei, 2018). Illinois' funded ratio puts it in the bottom third of 180 plans examined by the Center for Retirement Research (CRR). In addition, CRR's analysis finds that the gap between the systems with the highest and lowest levels of funding has been increasing over time. While the majority of state

² The funded ratios shown in Figure 1 for 1984-1994 are based on the cost method and 1995-2018 are based on the market value of assets. State law required that in fiscal year 2009, the actuarial value of assets be determined using a smoothing technique, and the state's required pension contributions are determined using the actuarial value of assets.

and local pension systems have funded ratios below 100 percent, Illinois stands out as having pension funds that are significantly less funded than others.

Boosting a pension fund’s finances requires decreasing liabilities (e.g. cutting retirement benefits), increasing assets, or a combination of the two. The majority (65 percent) of the aggregate liability for Illinois’ state pension systems is associated with current retirees.³ Illinois’ state constitution has a provision that prohibits cutting retirement benefits for current employees and retirees (i.e., Illinois Constitution, Article XIII, Section 5). The meaning of that provision was tested in recent years when state lawmakers passed two different pieces of legislation that cut pension benefits for current employees and retirees.⁴

Both pieces of legislation were found to be unconstitutional by the Illinois Supreme Court. The court interpreted the constitutional provision to require that once an employee is hired under a particular public pension plan they are entitled to remain within that plan and to accrue benefits under the plan provisions that were in place once they joined the retirement system for the remainder of their work life (*In re Pension Reform Litigation*, 2015; *Jones v. Municipal Employees’ Annuity and Benefit Fund of Chicago*, 2016). These rulings suggest that it is extremely unlikely that the Illinois Supreme Court will allow any diminution of pension benefits for current employees or retirees. Additionally, near term benefit cuts seem politically unlikely given comments by newly sworn-in Governor Pritzker (Bryne and Ruthhart, 2018).

Another way to improve the pension funds’ finances is by increasing assets, and a main way to do that is via employer contributions. A

longstanding issue, however, has been the state’s lack of funding discipline and low contributions. The Teachers’ Retirement System’s (TRS) Executive Director, Dick Ingram, captures this perspective in TRS’ summer 2018 newsletter, and links concern over the pension fund’s fiscal health explicitly to the state’s contributions. He writes that there “are no signs that [TRS’] funded status is going to improve in the near future, especially when state government keeps reducing its annual contribution to TRS” (2018). In other words, TRS is concerned about its current financial condition as well as further deterioration if lawmakers reduce state pension contributions.

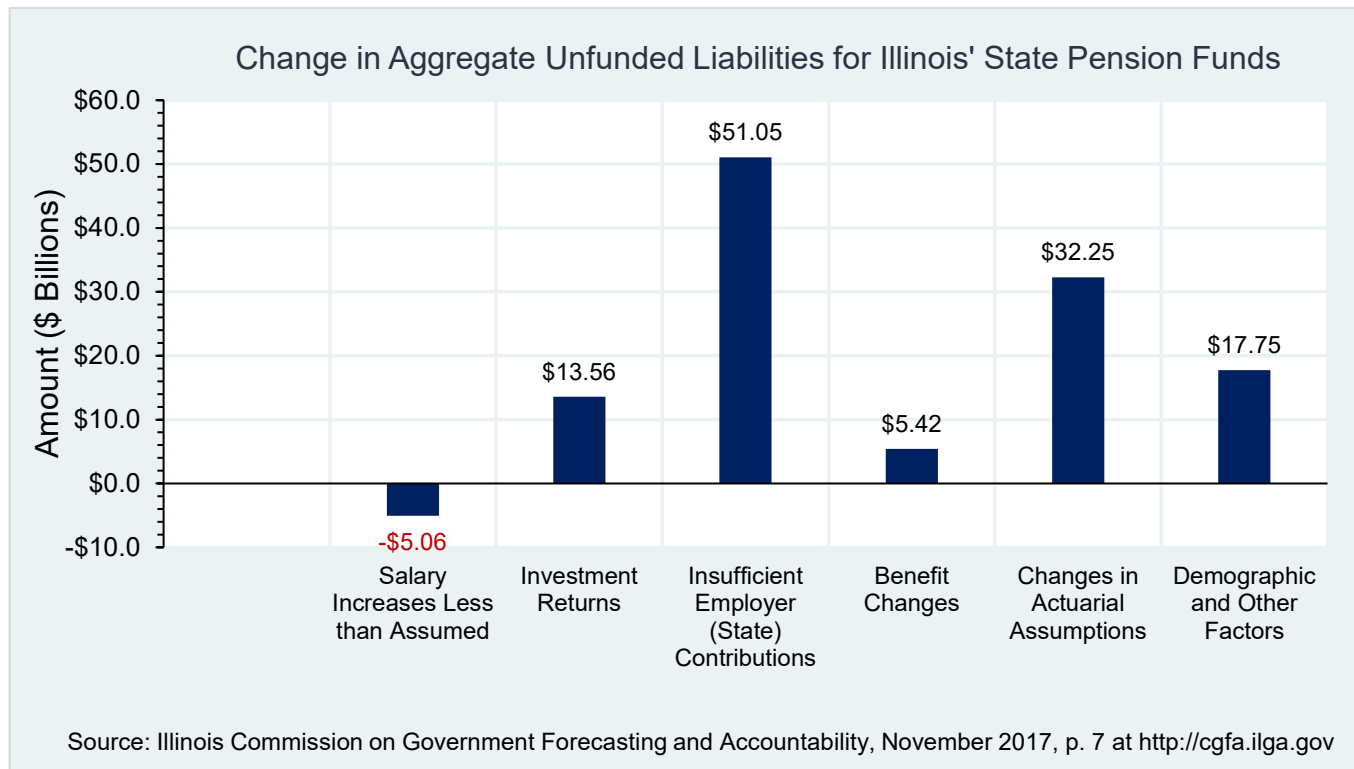
Illinois has historically made contributions that are insufficient to maintain or decrease unfunded liabilities from year-to-year. Between 1996 and 2018, Illinois’ unfunded liabilities increased by \$115 billion. Figure 2 shows that insufficient state contributions were the largest factor in that growth while changes in actuarial assumptions was the second largest factor. Other factors include retirement systems’ investment gains being less than predicted by actuaries and variance between actuarial assumptions and actual experience concerning things like retirement rates, disability rates, and mortality rates. Benefit increases account for only a small portion of the growth in unfunded liabilities, and salary increases were smaller than assumed by actuaries and thus *decreased* unfunded liabilities relative to projections.

From this view, and as highlighted by Figure 2, insufficient state contributions are a main reason for the deterioration of the pension systems’ financial conditions.

³ The 65 percent figure was calculated by the authors, using the liability data in each of the five retirement systems’ Comprehensive Annual Financial Reports for 2017.

⁴ The relevant laws were Public Act 98-599, which impacted the state retirement systems (except for the Judges’ Retirement System), and Public Act 98-641, which impacted Chicago’s municipal and labor pension funds.

Figure 2: Change in Aggregate Unfunded Liabilities for Illinois' Five State Pension Funds, Fiscal Years 1996-2018 (\$ Billions)



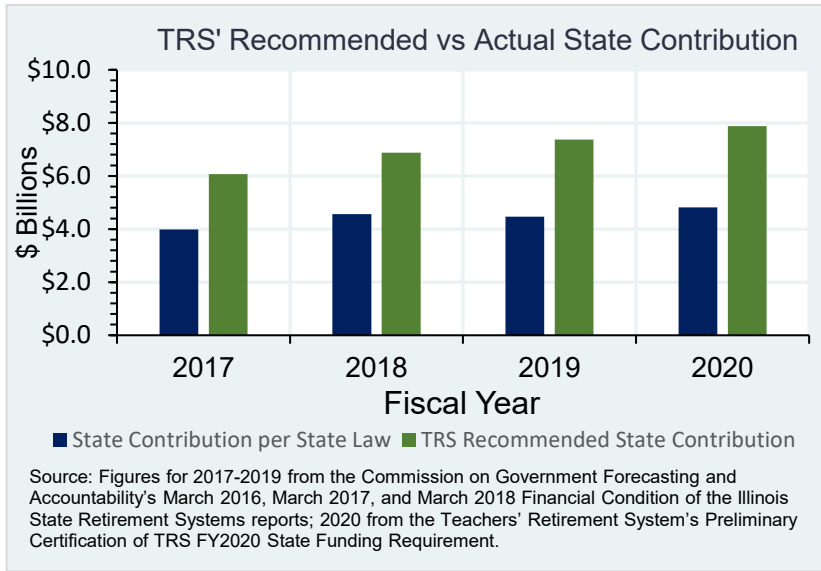
A second concern is the state’s funding policy, which is perceived as inadequate for restoring the health of the retirement systems’ finances. The Teachers’ Retirement System succinctly captures this position in its *2017 Comprehensive Annual Financial Report*:

Since TRS was founded in 1939, the State of Illinois has never, in any year, funded the System at a level that standard actuarial practice would define as sufficient (2017, p. 7).

Under current law the state’s annual pension contributions must be sufficient to bring each pension fund to a 90 percent funded ratio by the end of FY2045. Under the state law’s design, the pension funds will always have some amount of unfunded liabilities. The state’s funding laws differ from actuarial standards, which require a funded ratio target of 100 percent and amortizing unfunded liabilities over a period of 20-30 years.

The difference between Illinois’ funding policy and actuarial best practice is cited as a continuing issue for some. Each year the pension funds have to certify the statutorily required annual state payment to the retirement systems. In 2012, TRS’ Board of Trustees passed a resolution that actuarial principles and standards would be used to determine future certifications of the state’s required contribution. As a result, in its certification letters, TRS includes both the actuarial recommendation for the state’s pension contribution and the (lower) payment required by state law. TRS’ explicit purpose for including the actuarial recommendation is to “illustrate the gap between sound funding policy and current practice” (*Teachers’ Retirement System, 2017 Comprehensive Annual Financial Report, 2017*). Figure 3 compares the state’s actual contributions to TRS’ recommended contributions for years 2017 through 2020.

Figure 3: Comparison of TRS’ Recommended State Contribution vs. State Contribution Required Under State Law (\$ Billions)



TRS’s recommended state contributions for 2017-2020 would be \$10.4 billion more than the payments required by state law. From TRS’ perspective, this gap between the state’s payments under current law and the contributions the state would pay in accordance with actuarial best practices is an issue. From this perspective, the main issues are the state’s lack of funding discipline and an inadequate funding plan.

b. Pension Payment in Context of the State Budget

While TRS sees the state’s pension contributions under current law as deficient, a contrasting viewpoint is that the payments are already too high and are crowding out other aspects of the state budget. Governor Rauner’s FY2019 proposed operating budget expressed this view:

The funding of public pensions has been, and continues to be, Illinois’ most challenging fiscal concern. Over the last decade, the

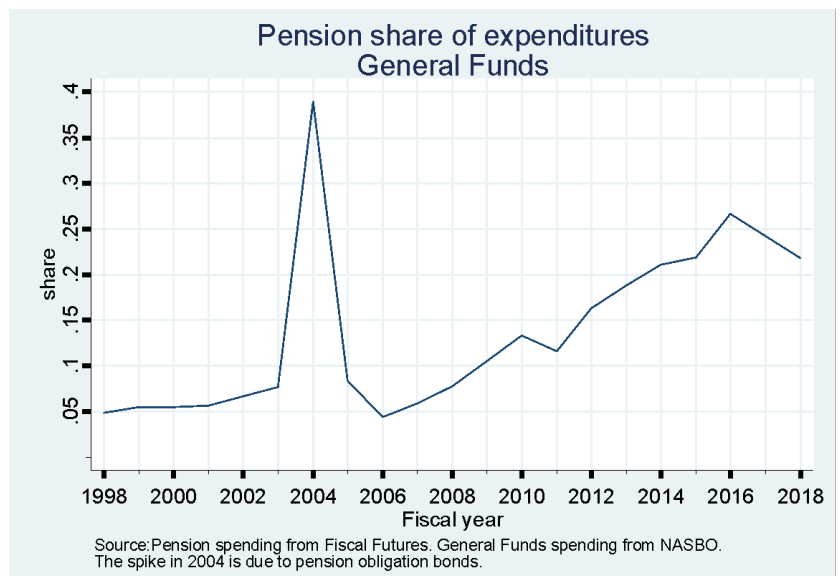
state’s pension costs have grown far faster than its revenues, putting pressure on the rest of the state budget and leading to structural deficits... high pension costs siphon public funds that deliver actual public services used by taxpayers...the state's expenditure on pensions have steadily risen over the years. Meanwhile, expenditure on all other services, such as health care and education, has stagnated... (Illinois State Proposed FY19 Operating Budget).

While Illinois does face fiscal challenges, this is a separate (but related) issue to the pension systems’ finances and concern of their potential insolvency. While we argue that the state faces budgetary pressures, the pension contributions are not the only source.

Statements like former Governor Rauner’s are often bolstered by graphs like Figure 4 that show the share of the state’s General Funds expenditures on pension contributions rising to very high levels over the past few decades.

There has been a general upward trend in the state’s annual pension contributions as a share of

Figure 4: Pension share of expenditures – General Funds



General Funds and, in recent years, it has been more than 20 percent.

We argue however, that only looking at General Funds gives an incomplete picture. This is because the state’s General Funds are merely one portion of Illinois’ spending (about 46 percent in 2018). In addition, what is in the General Funds category has changed over time. For example, two new special state funds were created in 2015, and income tax revenue that previously was deposited into the General Fund was instead deposited into those funds.⁵ Expenditures from those two funds, however, were for the same spending (education and human services) that had previously occurred via the General Funds. With the creation of the new funds, an accurate assessment of spending on those programs requires comparing General Funds spending prior to 2015 with General Funds

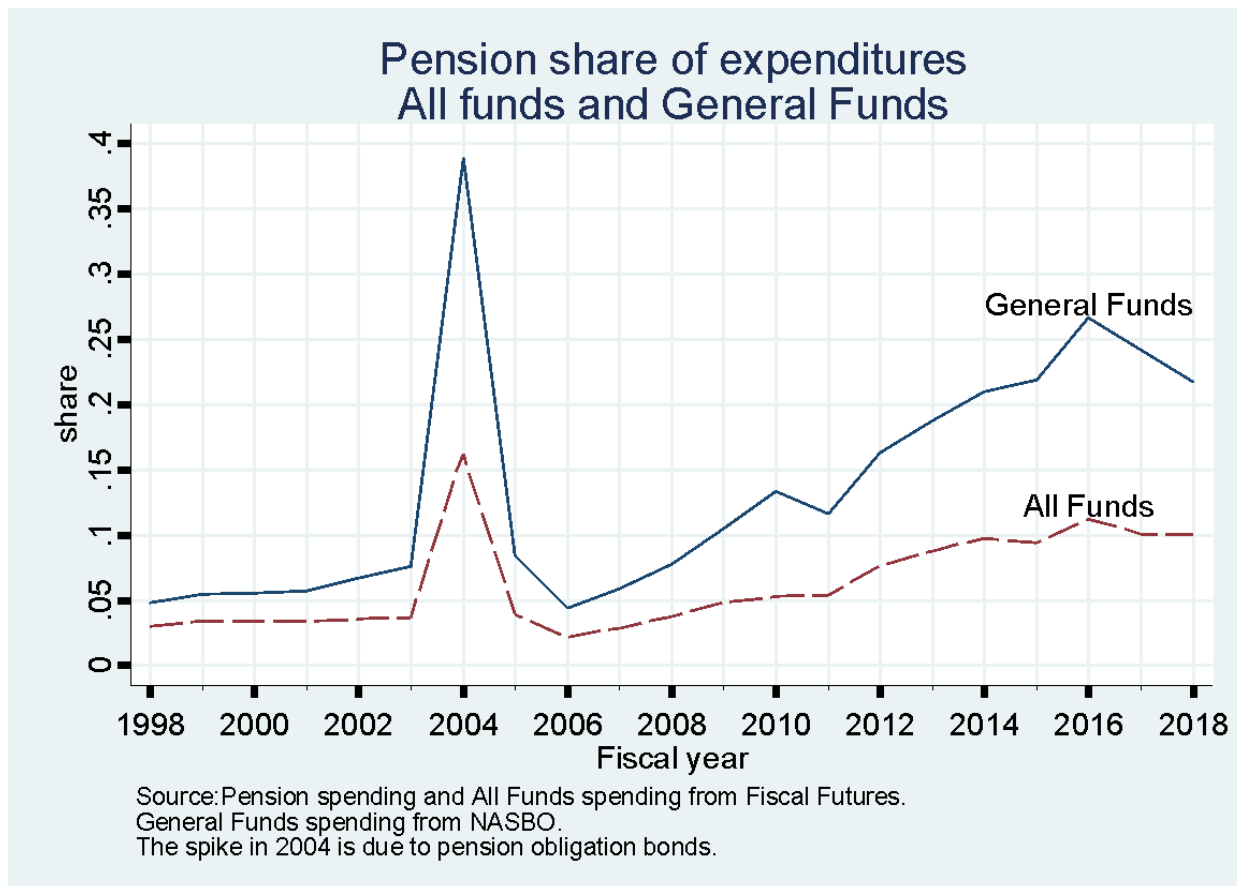
“...only looking at General Funds gives an incomplete picture.”

plus the special revenue funds spending today. In addition, monies from non-General Funds have periodically been swept and/or borrowed as non-recurring revenue sources for the General Funds.

[See box on page 14 titled, *General Funds Versus All Funds* for further discussion.] Figure 5 adds pension spending as a share of “all funds” spending to the graph above, where “all funds” spending includes a variety of items not included in General Funds (like transportation spending), but also significant portions of spending for education, human services, public health and safety and other categories (Dye, Merriman and Hudspeth 2011).

When all funds are examined there is still a general upward trend in pension spending (as shown in Figure 5), but the peak is about ten percent and the line slopes upward somewhat

Figure 5: Pension share of expenditures – All funds and General Funds



⁵ The specific funds are the Advancement of Education and the Commitment to Human Services Fund.

more gently compared to pension contributions as a share of General Funds.

The point here is that, regardless of whether General or all funds are used as the denominator, recent Illinois budgets have accommodated large shares of pension spending. Many analyses suggest that Illinois faces a persistent structural budget imbalance (Illinois State Proposed FY19 Operating Budget, 2019) and will need to make changes in spending and/or revenues to become fiscally sustainable. Careful analyses suggest that necessary policy changes will take years of fiscal discipline across a broad range of policies (Merriman, David, Chuanyi Guo and Di Qiao, 2018).

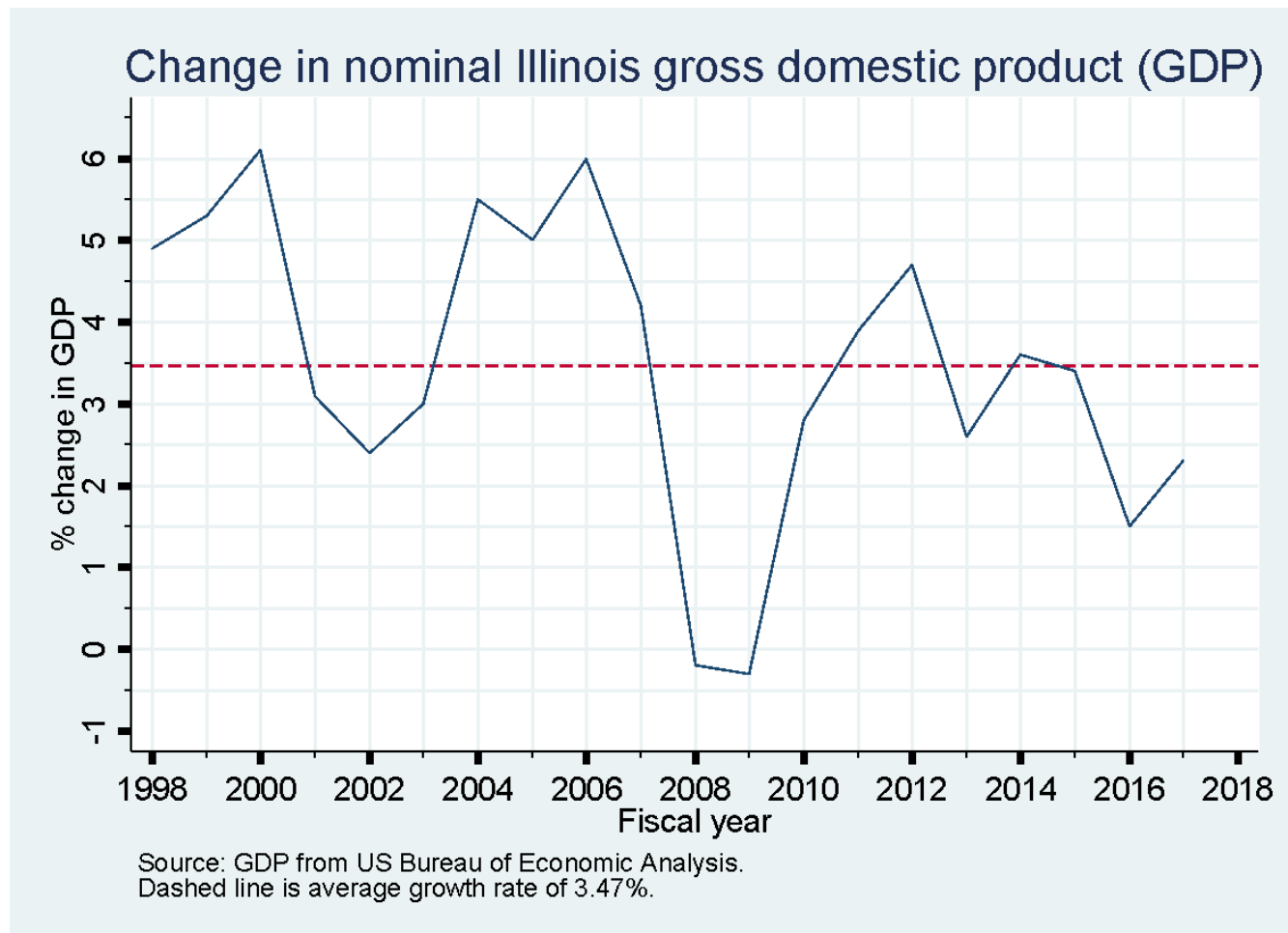
In November 2018 the Commission on Government Forecasting and Accountability

(COGFA) published the most recent estimates of the state’s annual pension contributions through 2045 (Bae and Versweyveld, 2018). This publication gives the best current estimates of the required future state payments to bring the five pension systems to a 90 percent level of funding by 2045. Between 2019 and 2045, annual payments are projected to rise from \$8.5 billion to \$19.1 billion.

Is the pension contribution schedule fiscally sustainable? While many would look at the estimated 2045 payment and reflexively answer no, we argue the future pension projections need to be examined in conjunction with estimates about future economic and budgetary conditions.

Any claim that a particular level of spending on a government good or service is “not sustainable”

Figure 6: Change in nominal Illinois gross domestic product



implicitly asserts that elected officials cannot or will not be able to retain office if they support such an expenditure. We know of no analytical method or evidence base that allows us to directly determine whether any level of pension spending is "fiscally sustainable" because we do not know how to determine what level of expenditures or taxation constituents will support. However, we can bring evidence to bear on the economic and budgetary burden that projected increases in future pension payments may impose.

The broadest measure of a state's capacity to fund public service is the total economic output it produces which is commonly measured by a state's gross domestic product or GDP. As shown in Figure 6, Illinois' GDP like that of the U.S. as a whole and particularly like other states in the Midwest, has been volatile but nevertheless

averaged nominal growth of almost 3.5 percent over the 20 year period from 1997 to 2017.

Figure 7 provides some evidence about how much growing state pension contributions will burden the Illinois economy if GDP continues to grow at historical rates.

Figure 7 shows that the state's annual pension contributions reached nearly one percent of Illinois GDP in 2018. If future Illinois GDP growth is similar to growth over the past 20 years and if pension contributions increase in-line with the current actuarial projections, then the state's annual pension payments will stabilize at about one percent of state GDP over the next several decades.

In terms of future budgetary conditions, we examine the share of future General Funds and all

Figure 7 Historical and projected Illinois pension spending as a share of GDP

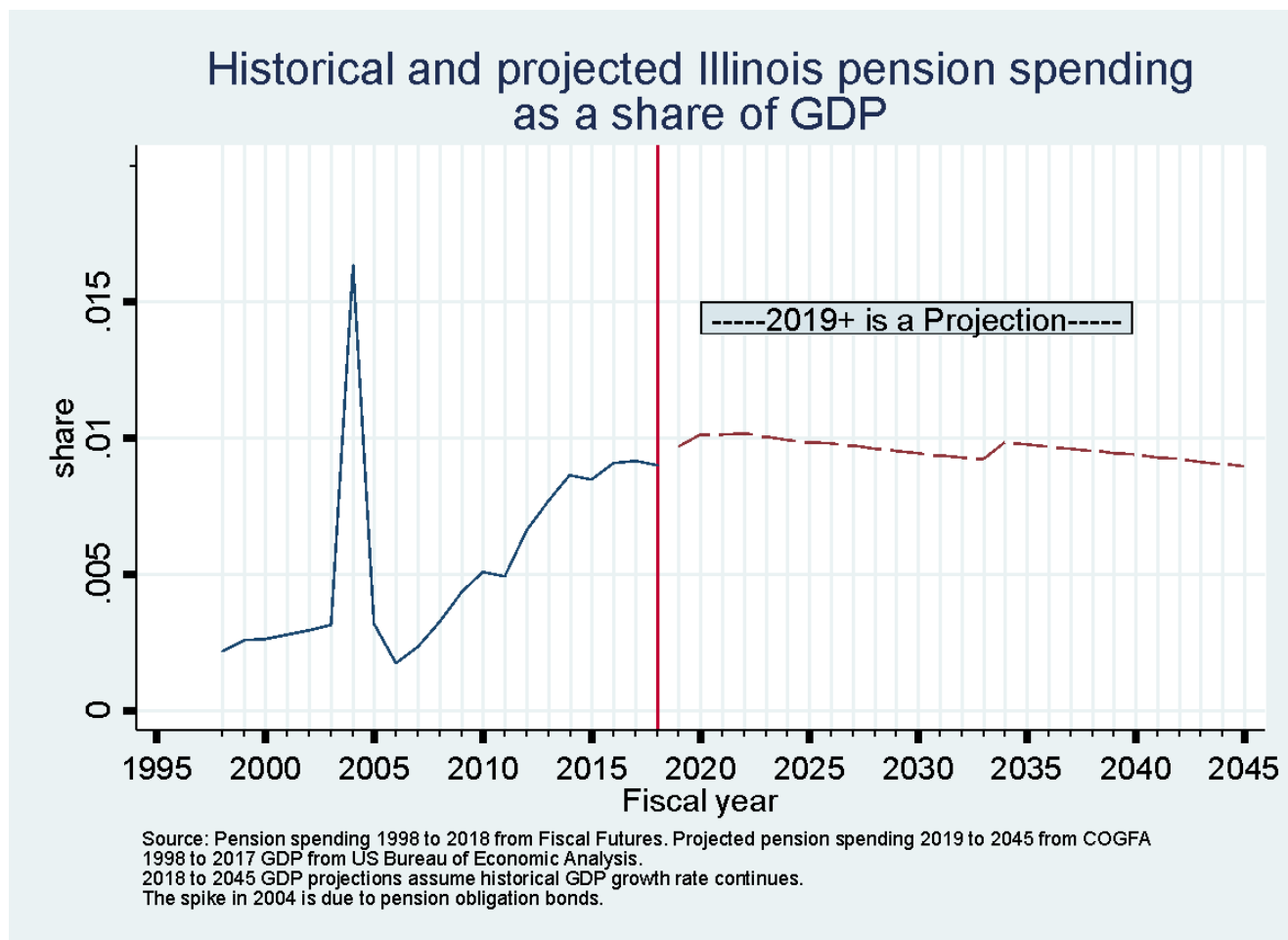
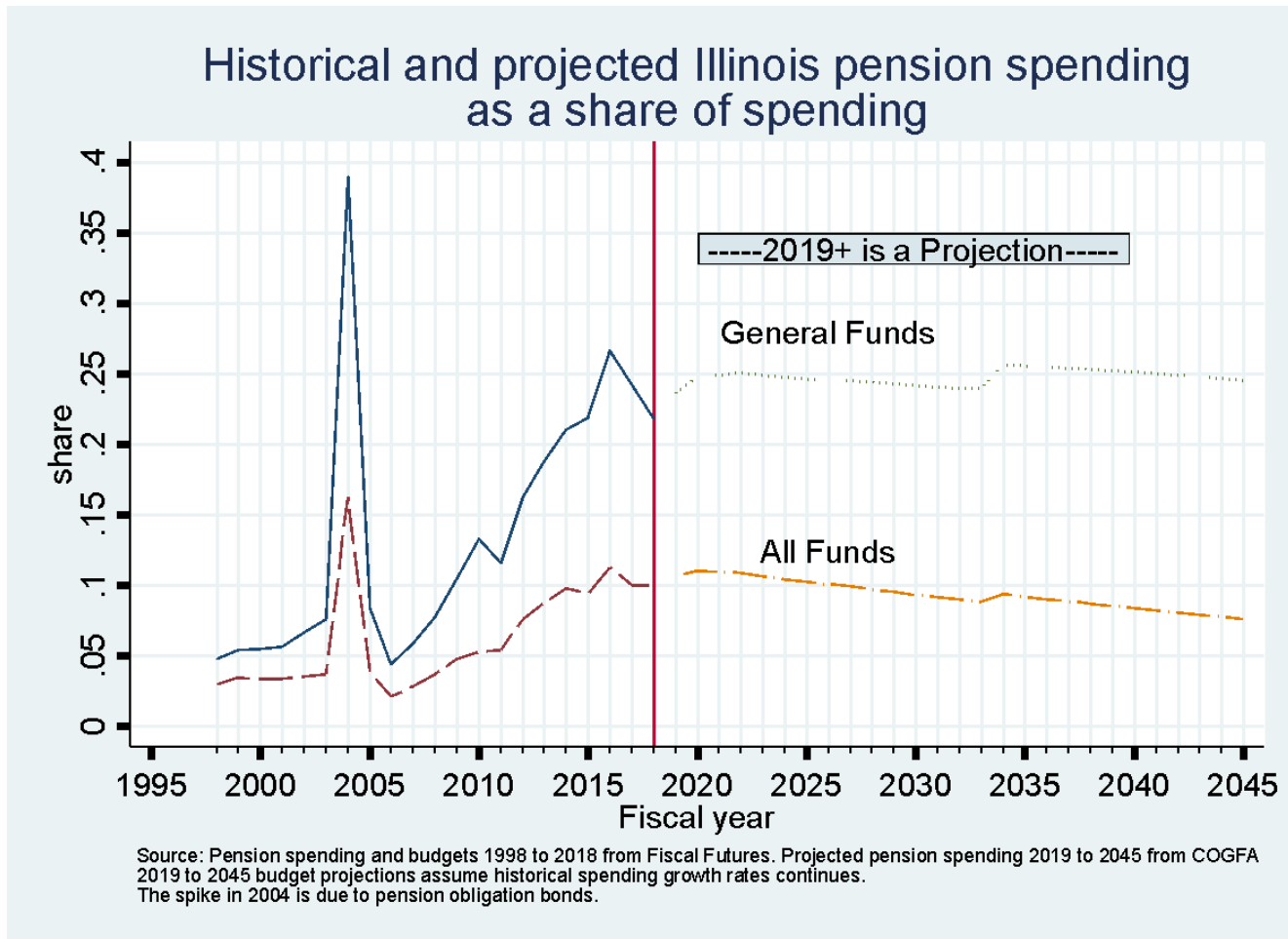


Figure 8: Historical and projected Illinois pension spending as a share of spending



fund spending that will be consumed by the state's future pension contributions should current trends in spending continue. Figure 8 extends Figure 5 to show the expected future shares of state spending going to pensions assuming that pension spending grows as forecast by the retirement systems and General Funds and all funds spending grow at their historical (1998 to 2018) respective nominal growth rates of 3.0 and 4.5 percent.

Figure 8 shows that, under current law and current actuarial assumptions the share of state spending on annual pension contributions peaked in recent years and is expected to be stable or declining over the next several decades. Of course, whether this scenario is sustainable or acceptable depends upon whether one sees the current budgetary allocation as tolerable.

Illinois' current fiscal situation is almost universally viewed as perilous. Its bond rating, which determines the interest rate at which it can borrow, is the lowest of any state in the nation, an indication of the widely held view of Illinois as fiscally troubled.

Importantly, Illinois' pension contributions are not the sole source of its fiscal stress. The state went two years without a formal budget, which created several fiscal pressures. During that two-year period significant cuts were made to areas of the budget like human services and funding for higher education, and there has been a push to reverse those cuts and restore spending to at least prior levels. In addition, during the budget impasse the state incurred a large amount of unpaid bills, which are subject to interest penalty payments. Between January and November 2018,

the state paid more than \$600 million in interest penalties (State of Illinois Comptroller, 2018). The state continues to pay down outstanding bills, but as of mid-January 2019, backlogged bills totaled \$8.1 billion (State of Illinois Comptroller, 2019). Other budgetary pressures include back pay owed to state workers (Finke, 2018; Buchman, 2019) and increasing state spending on K-12 education to meet the Illinois State Board of Education’s recommended level of funding.⁶

Pension contributions under current law constitute an important part of the state’s overall budget. Given that and the other budgetary pressures already facing Illinois, it is clear that dramatically increasing the payments to a level like TRS’s recommendation, which would require a near doubling of the contributions, is not feasible absent significant increases in revenue and/or cuts to other areas of the budget. Even absent changing the state’s pension funding policy, some adjustments to spending and/or

General Funds Versus All Funds

Revenues received and expended by Illinois state government are deposited into, or drawn from one of more than 700 funds. The use of “fund accounting” is a common practice in state governments and is intended to assure accountability and, in some cases, to facilitate earmarking so that revenues raised for a particular purpose are spent only on designated functions (e.g. state lottery revenues may be expended only for education finance in some cases). Major categories of funds in Illinois include 1) General Funds 2) Special State funds 3) Highway Funds 4) Trust Funds, etc. There are currently six funds that compose the Illinois General Funds. These six funds receive revenue from a variety of sources, make expenditures on a variety of government goods and services and frequently are the recipients or source of large transfers to, or from, funds that are not included in the General Funds. The decision about whether to include a revenue or expenditure in the General Funds is determined legislatively and is not governed by any accounting rule or principle. The inclusion of particular categories of revenues or expenditures within the General Funds varies from year to year. Because of this, trends in general fund spending or revenue are difficult to clearly interpret and can be misleading (Dye, Merriman and Hudspeth, 2011).

Despite this, many analytical reports focus attention almost exclusively on activity within Illinois’ General Funds (Commission on Government Forecasting and Accountability 2017; Civic Federation, 2018). Both the US Census and the Fiscal Futures Project have developed broader budgetary concepts that are designed to capture government revenue from, and spending on, all state functions (Dye, 2016; K Pierson, 2015).

These data sources are comparable across states and over time, while looking only at General Funds totals may be misleading. In this white paper we use Fiscal Futures (rather than Census) measures of “all funds” spending since Fiscal Futures data is more up-to-date. Analyses using Census’ measures of “general expenditures” would likely yield similar insights to those gained from the Fiscal Futures “all funds” expenditure measure used here.

⁶ On January 15 Pritzker signed an order to begin paying step increases to more than 20,000 state employees. The step increases had been halted by former Governor Rauner after the contract between the state and the American Federation of State, County and Municipal Employees, the union that represents about 38,000 state workers, expired in 2015. However, a state appeals court had ruled that the Rauner administration was wrong when it stopped awarding the increases. The source of the revenue to make the payments was not immediately identified.

revenue may be required. This is because some analyses show that Illinois has a large structural imbalance with expenditures under current law and practice greater than revenues under current law and practice (Merriman, Guo and Di Qiao, 2018). If these analyses are correct Illinois will have to make some adjustments, but nothing in the analyses suggests that pension spending should be singled out for more, or less, scrutiny than other categories of spending.

In order to manage its fiscal challenges in the most productive manner Illinois should act deliberately with forethought and long-term planning. Whenever proposals that claim to solve the “pension crisis” crop up they should be scrutinized to identify what the actual goals are. Is the goal to improve the financial condition of the pension systems in a shorter timeframe than the current funding plan? Or is the ultimate goal to create short-term budgetary relief? Unfortunately, as we illustrate in the next section, the rhetoric of crisis often impedes clear-eyed, holistic analyses and inhibits sound decision-making.

IV. THE PENSION “CRISIS BIAS”

Assuming a “pension crisis” narrative has costs that are evident in Illinois’ legislative history. Not only in how it impacts the finances of the pension systems but also in the way it predetermines approaches to the subject. As Section III highlighted there are two main issues that are interrelated, yet in-conflict: (1) the financial condition of the pension funds, and (2) the state’s annual pension contributions as burdensome for the state budget. Importantly, in moments of political pressure to do *something* about pensions, what often materializes is legislation that alleviates the short-term pressure with the

creation of a future, long-term problem. As a result, Illinois is stuck in a seemingly endless cycle of pension crises and problematic legislation. In this section, we highlight three examples in which Illinois lawmakers have taken a “crisis” orientation to pension solvency and the state’s annual pension contributions. We use these examples to show how this crisis mentality leads lawmakers to attempt the impossible: improve the finances of the retirement systems without increasing (or even lowering) the state’s annual contributions.

Take for example, the “Pension Ramp.” In 1994 Governor Edgar signed into law a funding plan to improve the financial condition of the state’s retirement systems over 50 years. At the time, the state pension funds had \$17 billion in unfunded

“...the rhetoric of crisis often impedes clear-eyed, holistic analyses and inhibits sound decision-making.”

liabilities and an aggregate funded ratio of 54.5 percent. The plan was designed to ameliorate a long-standing and growing problem of having inadequate financial provisions in the state pension funds to pay future retirees, but importantly did so without dramatically increasing the state’s annual pension contributions in the short term and putting off paying down unfunded liabilities for decades.

Moreover, the Pension Ramp reduced the state’s contributions from what they would have been under a previous funding law enacted in 1989, Public Act 86-273.⁷ Under that law, the state’s contributions were supposed to increase steadily for seven years and then the state was supposed to begin paying down unfunded pension liabilities starting in FY1996. However, lawmakers failed to make the payments required by that seven year ramp. Rather than simply sticking to the existing funding plan, lawmakers elected in 1994 to create a new one (the Pension Ramp). Importantly, had lawmakers kept the old funding law (Public Act 86-273), the state’s contribution to TRS in

⁷ Importantly that legislation also increased pension benefits.

FY1996 would have been nearly \$400 million more than it was under the Pension Ramp (*Teachers' Retirement System of the State of Illinois, Actuarial Valuation, 1993*; *Teachers' Retirement System, 1996*). Even though the new Pension Ramp reduced the state's contributions and pushed off paying down unfunded liabilities into the future, the governor confidently claimed, "We had a time bomb in our retirement system that was going to go off sometime in the first part of the 21st Century. This legislation defuses that time bomb" (Pearson, 1994).

Despite such positive proclamations, the plan was flawed from the outset. The scheduled payments for the first 15 years (FY1996-FY2010) were a ramp period (replacing the previously existing ramp). During the ramp period, the state's contributions increased incrementally from year-to-year, but were not directly based on the cost of benefits earned or existing unfunded liabilities. Moreover, by its very design, the Pension Ramp grew unfunded liabilities for years before ever before ever beginning to pay them down.

In March 2013, the Securities and Exchange Commission charged that the pension ramp was the "primary driver" of Illinois' unfunded pension liability because its insufficient investments in the first 15 years merely shifted "costs to the future and, as a result, created significant financial stress and risks for the state" (Zorn, 2016). In hindsight, the plan appears badly misguided but at the time many observers were no doubt persuaded to act because they, like the Illinois Pension Laws Commission, had concluded the problem was "moving toward crisis" (Zorn, 2016).

A crisis mind-set also fathered a second example. Faced in 2003 with over \$40 billion in unfunded pension obligations and a pressing budget deficit

when the governor signed off on the sale of \$10 billion of pension obligation bonds. The plan authorized Illinois to issue general obligation bonds and give the proceeds of the issuance to the pension systems. Doing so would immediately increase the pension systems' assets, in-turn decreasing unfunded liabilities. In addition, the retirement systems would invest the proceeds in the financial markets, with the goal that the investment performance would exceed the interest payments on the bonds. In executing this plan the state was betting that the retirement systems' investments would outperform the cost of the bonds, creating overall lower costs for the state in the long run.⁸

Driving the bond sale were dire predictions of pension systems that were on "life support" (Schneyer, 2003). Adding to the General Assembly's financial worries was an expected five billion dollar state budget deficit. In the previous year, the budget director graphically warned that the budget was "probably going to be the bloodiest budget that the state has seen introduced since 1992" (Finke, 2002).

A major shortcoming of the plan was that not all of the bond proceeds were used to pay down unfunded pension liabilities. Instead, a portion was used to plug budget deficits. Of the \$10 billion borrowed, only \$7.3 billion was used to reduce the unfunded liabilities of the retirement systems. The remaining \$2.3 billion was used to pay part of the regular state contributions to the retirement systems for 2003 and all of the 2004 required contributions. Instead of supplementing the required payments, the \$2.3 billion *replaced* payments that would otherwise have come from general tax revenue (Civic Federation, 2018). Using a portion of the \$10 billion bond for operating expenses indicates that the state's

⁸ As of 2017, the pension funds' annualized investment returns have exceeded the 5.07 percent interest rate Illinois paid to borrow the \$10 billion (*Illinois State Retirement Systems: Financial Condition as of June 30, 2017*, 2018; Hinz, 2014). It is important to note that the bonds are still outstanding and will not be retired until FY2033, at which point it will be possible to determine whether the arbitrage worked.

budget was out of balance. Using debt proceeds to fill an operating budget shortfall allowed the state to pay for other areas of the budget without raising taxes. While this resolved the budget challenges for a short period of time, it did not lead to a long-term resolution because the state's pension contributions are on-going and the bond issuance was not a recurring revenue source.

A third case of crisis decision-making is the state's 2010 pension legislation. In the wake of the Great Recession, the financial condition of the pension systems decreased significantly and unfunded liabilities increased. Under the design of the Pension Ramp, the 15-year ramp ended in FY2010 and FY2011 was going to be the first year in which the state's annual pension contributions were directly tied to unfunded liabilities. Specifically, for FY2011-FY2045 the state's contributions have to be sufficient so each fund reaches a 90 percent funded ratio at the end of FY2045. Since the pension funds' unfunded liabilities sharply increased in the wake of the Great Recession this meant that the state's contributions in the second phase of the Pension Ramp would be higher than previously predicted. Confronting frantic warnings of a "financial implosion," lawmakers passed sweeping legislation that created a second, lower level of pension benefits for all state and local pensions (known as Tier II). Employees hired on or after January 1, 2011 became Tier II pension participants with much less generous retirement benefits than state employees hired prior to the law going into effect, now known as Tier I participants. The move was projected to lower the state's contributions over the following three decades by more than \$70 billion and cut total pension liabilities nearly in half, by \$256 billion (Grotto and Long, 2011).

However, the new law created several problems. The benefit differences between the two tiers are substantial. For those in the Teachers' Retirement System, Tier I members' pension costs are roughly 20 percent of an active member's salary.

But a Tier II member's pension is worth just seven percent of an active member's salary (Ingram, 2015). Over a career, pension benefits of Tier II TRS participants would be hundreds of thousands of dollars less than a similar Tier I worker. This is true despite the fact that active Tier II members pay the same 9.4 percent salary contribution to the system that active Tier I members pay. A Tier II TRS member's employee pension contribution pays the entire cost of his or her pension plus an extra 2.4 percent. That extra 2.4 percent subsidizes the pensions of Tier I members (Ingram, 2015).

There is also a potentially serious and costly flaw in the Tier II plan. If the rate of inflation is high enough, Tier II benefits will be so low that they will violate federal law, which requires that they be at least equivalent to social security benefits. Consequently, Illinois could be required to increase the benefit of approximately 78 percent of the employees not currently enrolled in Social Security (*State of Illinois Report of the Pension Modernization Task Force, House Joint Resolution 65*, 2009).

The "crisis" framework led lawmakers to create Tier II without much consideration of its potential pitfalls. A belief that something needed to be done in the present led to too little time and consideration of the future implications of what was being implemented. The Tier II plan passed through both state chambers in a single day. Lawmakers never saw detailed projections from pension system actuaries of the plan's impact. Sara Wetmore, vice president and research director at The Civic Federation, pointed out "They passed this so quickly that there really wasn't any way for anybody to know if there would be any problems in the future" (Mathewson, 2016). A few short years after its creation, the problems of Tier II are widely acknowledged (Secter and Geiger, 2015).

This crisis mind-set is illustrated by the 2015 debate on yet another potential pension "fix"

(called SB1) that would have pushed Tier I pension members into Tier II. It was pointed out during debate over that legislation that such a change could lead to still more state workers having pension benefits that were less than social security and therefore violating federal law. The legislative point person's response to this concern was "an issue that's not immediate - probably 10-12 years down the road - and could be addressed later. It shouldn't stand in the way of a real solution" (*Capitol Fax*, 2013).

The *Daily Herald* headline "Seeking Solutions to the Pension Crisis: Reducing Benefits, Raising Taxes Among the Proposals," represents a common narrative for how opinion leaders, elected officials and residents have conceptualized the state's pension systems (McCoppin, 2010). But it has not well served the state. Crisis thinking has produced short-term adjustments that have satisfied political needs and

"Crisis thinking has produced short-term adjustments that have satisfied political needs"

reduced the state's required contributions, created the illusion of problem-solving, provided political cover for elected leaders, aggravated material conditions and forestalled development of

effective ideas to strengthen the financial condition of Illinois' retirement systems.

V. CONCLUSION

Illinois has not designed a strategic approach to funding its pensions systems. Addressing the need to appropriately fund the pension systems has focused largely on ratios, unfunded liabilities and budgetary impacts. Policy debates and outcomes on pensions have occurred inextricably with concerns about state spending and revenue. The history of lawmaker attention to the state's retirement systems has featured a series of misfired measures that at the time were claimed by many to have resolved the crisis.

As we have discussed, the crisis mentality is problematic and conceals what are actually two conflicting and interrelated issues. The state has long had a lack of funding discipline, which has contributed to the deterioration of the pension funds' finances. Some see the state's funded ratio target of 90 percent as emblematic of that issue, and the ultimate resolution from that perspective is for the state's annual pension payments to be in accordance with actuarial best practices. Such action would require dramatically increasing the state's contributions, which would exacerbate the state's already existing fiscal issues. Some state elected leaders see the problem as the pension systems demanding an increasing share of revenues that crowd out other funding needs, and many see the pension contributions under current law as already burdensome. Those focused on the pension contributions as a budgetary issue seek a solution that would reduce the state's annual pension contributions.

In this white paper we offer two additional perspectives. First, as we have noted, the current funded ratio matters only insofar as it hampers a pension fund's ability to meet its obligation to pay benefits now and in the future. A pension system's funded ratio should not be viewed in isolation but should be viewed in the context of the overall credibility of the commitment to make the necessary contributions. In assessing the finances of a pension system, rather than looking at just the current year's funded ratio in isolation, it is important to examine the funded ratio history and compare it to other systems. Second, whether lawmakers see current projections of the state's pension contributions as feasible and how they respond to budgetary challenges as they arise are largely determined by political will, rather than some objective metric of financial feasibility. The state's pension contributions are one aspect of the state's budget, but too often lawmakers have chosen to remedy budget deficits by reducing the state's required pension contributions. Such

action creates short-term budgetary relief, while worsening the pension systems' finances.

In 1970 Illinois demonstrated an almost ironclad political will to guarantee pension benefits by including a constitutional provision that explicitly required that pension benefits "shall not be diminished or impaired". While we have argued above that there is no fundamental economic principle that requires pensions to be 100 percent (or 90 or 120 percent) funded we are mindful that policymakers often lower funded ratio targets for the sole purpose of reducing required contributions, and as such (and given Illinois' history) we do not advocate lowering the target for the state's funding policy. Statutory goals (and plans) are tangible manifestations of political will and increase the probability that pension funds will remain solvent throughout the life of those enrolled in the system. Other demonstrations of political commitment could include earmarking of certain revenues exclusively for pension funding. Such demonstrations of political will are designed to strengthen the resolve of future lawmakers who may want to defer pension funding. These mechanisms also are designed to encourage the loyalty of employees.

Attracting and retaining talented public servants is critical to providing services to Illinois residents and to the state's functioning order. We recommend therefore that policymakers properly understand pension contributions in the context of budgetary spending and the state's gross domestic product.

Most importantly, we further strongly encourage lawmakers to resist the siren cries of a "pension crisis" fix. Political and public pressure on the new administration to do something - anything - quickly will create fertile grounds for pension fixes to flourish. But if history is any guide, it will also likely lead to bad or insufficient outcomes. At

a minimum Illinois should rid itself of its "pension crisis" outlook. Only then can thoughtful decision-making occur which can generate effective and long-term strategies for funding the state pension system and determining acceptable levels of other state expenditures.

"...we further strongly encourage lawmakers to resist the siren cries of a 'pension crisis' fix."

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