TESTIMONY OF R. EDEN MARTIN
WITH RESPECT TO ILLINOIS FINANCE
STATE PENSIONS
MARCH 17, 2009

Good morning. My name is R. Eden Martin. I am President of the Civic Committee of The Commercial Club of Chicago. The Civic Committee consists of approximately 90 senior business leaders in the Chicago area, and works to make the region a better place to live and work.

The topic today is pensions – which may be divided into two parts: (1) what is the problem, and (2) what we propose should be done about it.

First the facts:

## I. What is the Problem?

When the Civic Committee issued its updated report on State finance in February 2009, we included a chart that showed what the budget imbalance appeared to be at the beginning of the current fiscal year – back in July 2008. On a cash basis, it appeared that the budget was out-of-balance to the extent of about $2.4 billion.

The problem is that the original estimate assumed that revenues this year would be up over last fiscal year to the extent of $500 million. According to Governor Quinn's spokesman last week, it is now expected that State revenues this year will be down "a combined $1.8 billion from the previous" year. (*Tribune*, March 14, Section l, p. 9.) If everything else stayed the same, this would mean the cash gap would widen from $2.4 billion to $4.7 billion.

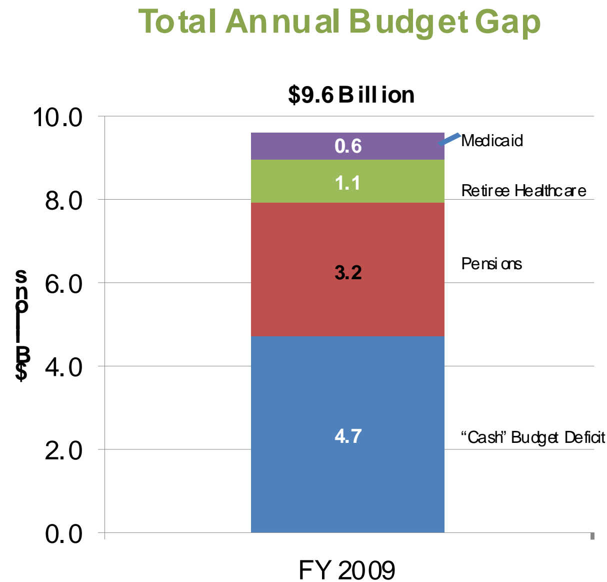
But that isn't the whole story. As you know, the State has not properly funded its pension costs for many years. The original formula adopted back in the 1990's deliberately provided for annual funding in the early years in amounts less than what would be required under normal actuarial standards. In other words, the formula back-end-loaded the costs – putting them off to future years, to be borne by future taxpayers.

Another reason for the growth in State pension costs is that State retirees have received – and receive today – more generous benefits than most Illinois taxpayers. Competition has forced most private-sector companies to cut benefits and/or adopt defined contribution plans prospectively. It has forced them to increase contributions from workers. And the current economic crisis has forced many employers to discontinue accrual of additional benefits altogether. The State has not been subject to these same competitive forces.

To compound the under-funding problem, during many years the State did not even follow the formula – it funded less than what the formula would have required.

During the current fiscal year, Illinois is funding the pension systems to the extent of $2.8 billion (with an additional $500 million or so payment on the State’s pension bonds). That seems like a lot. But if you were adhering to actuarial standards – which require recognizing and funding current costs this year, not putting them off to future years – you would be funding pensions to the extent of an *additional $3.2 billion*.

If you look at the State’s budget gap not just from the standpoint of cash, but from the standpoint of accrual concepts – recognizing obligations incurred this year, even though they won’t be paid until the future –the total gap goes up to $9.6 billion.



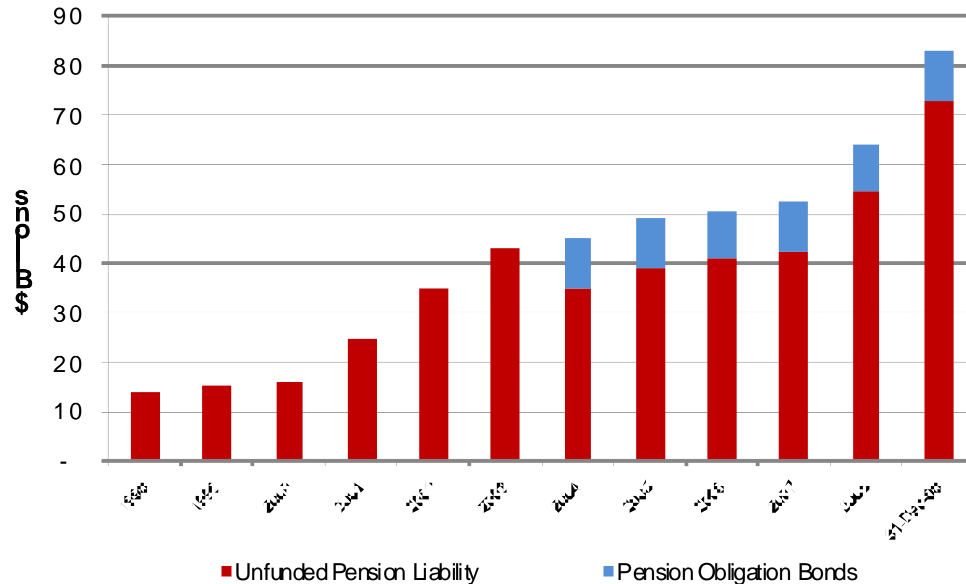

Note: Cash budget deficit assumes State revenues for FY 2009 will be down $1.8 billion from the previous year (*Tribune*, March 14, Section 1, p. 9). Pension gap is equal to Normal Cost Plus Interest payment in FY2009 of $6.1 billion minus Total Employer Contribution of $2.9 billion. Retiree healthcare gap is equal to FY2008 ARC of $1.7 billion minus FY2008 State healthcare payments for retirees of $.6 billion. Medicaid gap is equal to forecasted increase in State share of unpaid Medicaid bills from FY2008 to FY2009 ($.3 billion) plus amortization of State’s share of FY2008 Section 25 liabilities (assuming $1.3 billion in State Section 25 liabilities are amortized over 4 years).

Source: “Report on the Financial Condition of the State Retirement Systems,” February 2009, Commission on Government Forecasting and Accountability; Governor’s office estimates; Taxpayers’ Federation of Illinois analysis; Chicago *Tribune*.

This systematic underfunding of pensions, along with the underfunding of retiree health costs, has led to a massive build-up in the State’s unfunded obligations.

Here is a chart that shows the buildup in pension obligations.

## State Unfunded Pension Liability and Pension Obligation Bonds

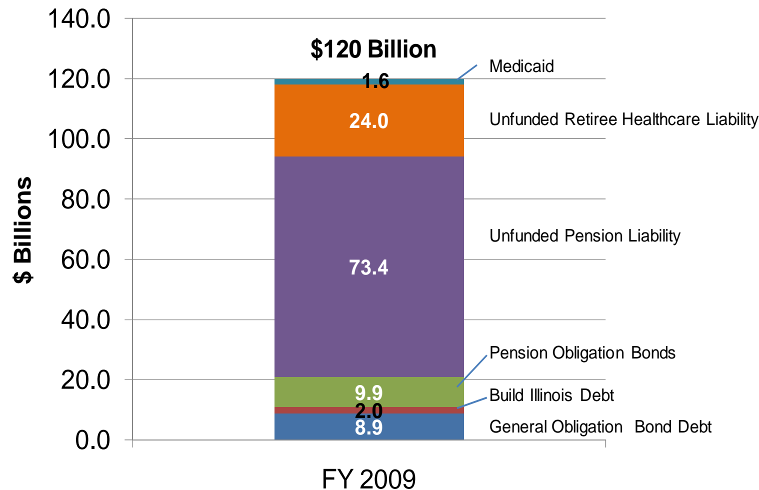



Source: "2007 Bonded Indebtedness Report of the State of Illinois," January 2008, Commission on Government Forecasting and Accountability; "Report on the Financial Condition of the State Retirement Systems," February 2009, Commission on Government Forecasting and Accountability; Commission on Government Forecasting and Accountability Monthly Briefing, February 2009; "Report on the Financial Condition of the State Retirement Systems," February 2008, Commission on Government Forecasting and Accountability; "Report on the Financial Condition of the State Retirement Systems," July 2007, Commission on Government Forecasting and Accountability; Historical unfunded liability data from Senate GOP staff.

When we put out our update report a month ago, based on the most current information then available, we estimated the unfunded pension liability alone to be $70 billion. Since then, more current information as to the liabilities has led to an increase in that total *to $73.4 billion.*

That's well over half of the State's total state debt and unfunded obligations.

## Total State Debt and Unfunded Obligations




Note: GO bond debt and Build Illinois debt are COGFA forecasts of June 30, 2009 amounts outstanding. Pension Obligation Bond debt is forecast of June 30, 2009 debt based on POB principal repayment schedule from COGFA. Unfunded pension liability estimate is December 31, 2008 unfunded liability estimate from COGFA February 2009 briefing. Unfunded retiree healthcare liability estimate is point estimate from the Governor's office of the 2008 unfunded retiree health care liability. Medicaid debt assumes that half of projected unpaid Medicaid bills at the end of FY 2009 are the responsibility of the State (based on 50% federal match).

Source: Various reports of the Commission on Government Forecasting and Accountability; Governor's office estimates; Taxpayers' Federation of Illinois analysis.

And that $73.4 billion number does not reflect the drop in value of the assets in the pension funds since December 31, 2008 – a drop that is probably in the range of 15% or more of the assets in the funds.

It also does not reflect the fact that the present value of the liabilities are way understated because the State uses an unrealistically high discount rate – 8.5% instead of something closer to 6%.

What does this mean in terms of annual costs? Think of it like a house mortgage that you have to pay off over a long period – say 40 years. What would you have to pay a bank – or a big consortium of banks – to take this unfunded pension liability off your hands – each year, in constant dollars – over the next 40 years.

The answer is roughly $6 billion per year. By the way – that's just to pay off the $70 plus billion. It doesn't count the additional $1.5 billion or so of additional liability we add each year for current pension costs. (Nor does it count the additional dollars needed to pay off the unfunded retiree health care obligation.)

These unfunded obligations are so huge in relation to the total State budget that they threaten to overwhelm it in the future unless we get the growth in these obligations under control – that is, unless we (a) stop the growth, and (b) start to pay down the piled-up obligations.

## II. Our Proposal

In our updated report, we recommend that the State do two things related to pensions: (a) reduce the benefit levels and costs, and (b) start to fund them adequately. The reductions and cuts are compelled by both the State's fiscal realities and considerations of fairness vis-à-vis taxpayers. The funding is required by considerations of fairness to State workers and retirees. It is a cruel hoax on workers to lead them to believe that when they retire, they will be protected by a State pension – only to find as they near retirement, that the pension funds are running out of money.

Suppose the funds did run out of money. What then? Would the State be contractually liable to take over the unfunded obligation? Not clear. What is clear is that if the State attempted to make these payments on a pay-as-you-go basis – writing the checks each year out of current operating revenues – the pension payments would soon overwhelm the rest of the budget. This would lead to further – and far more dramatic – cuts in State services and in funding local governments and school districts, or massive increases in taxes. The likely consequences of such events – including the probability of businesses, investments and jobs fleeing the State – may be left for a different hearing. Or perhaps to your imaginations.

How can the State reduce benefit levels and costs in light of the current Constitutional provision that arguably prevents cutting "benefits" to current employees?

First, we propose that the State create a new pension system for State employees who are hired after the effective date. Such a new system could be a defined contribution system – which would both eliminate the risk of underfunding to the State going forward, and also create greater political pressure to fund adequately on an ongoing basis. Many employers in the private sector have adopted such plans.

A less-desirable alternative would be to adopt a new defined benefit plan with less-costly benefit levels going forward. Any such new plan should be aligned with private sector standards. For example:

1 The retirement age should be raised to 67 (same as Social Security) with 10 years of service for full pension benefits. (Early reduced benefits should be made available only upon reaching the age of 62 with 10 years of service.)

2 The pension benefit formula – the percent of salary that active employees accrue toward their pension each year – should be lower than the previous pension systems, with members covered by Social Security receiving 1.4% of final

average salary for each year of service, and non-covered members receiving 2% of final average salary for each year of service.

3 Annual cost of living increases should be set at lower levels – for example, the lesser of 2.4% or 60% of the CPI.

Second, the required percentage of compensation that all employees – including current employees – must contribute to fund their own pensions should be increased. We suggesting increasing employee contributions to 7% for members covered by Social Security and 11% for members not covered by Social Security. The State Constitution may preclude reductions in benefit levels; but it does not preclude increasing employee contributions.

Unfortunately, the hard reality is that – from a pure cash-only standpoint – cutting pensions costs going forward and properly funding the growing liability will not save the State much money in the immediate future. The cost-savings will come only over time, as new employees enter the State's work force. The proper funding will require more cash – not less.

But when you think economics – not just cash – and when you take into account the huge growth in the State's unfunded obligation – than the reforms and cuts and the proper funding are all necessary to bring the piling-up of obligations under control.

The risk is that the State will leap to a tax-only solution – rather than (a) reforming the plans, (b) cutting the costs going forward, and (c) using tax proceeds to support new commitments.

Although the economic contraction that hit in 2008 has made our fiscal problems worse, those problems existed long before October 2008. In December 2006 we reported that the State was headed toward fiscal implosion unless it started to deal with its growing mass of unfunded liabilities. We reported then that Illinois was among the worst in the country in terms of funding its State pensions. The folks who now want a tax-only solution won't be able to blame the 2008 economic downturn for our massively under-funded pensions.

We think if you jump to taxes – *without* the reforms – *without* the cuts – and if any new tax revenues are *not used* to stop the snowball of debt from getting even bigger as it rolls downhill – then it's likely you'll have a taxpayer revolt on your hands.