CTBA | Center for Tax and Budget Accountability

70 East Lake Street, Suite 1700
Chicago, IL • 60601
direct: 312.332.1049 fax: 312.578.9258
rmartire@ctbaonline.org

Ralph M. Martire, Esq.
Executive Director

Bukola M. Bello, M.A.
Director, Illinois Retirement Security Initiative

SUMMARY OF TESTIMONY PROVIDED TO THE PENSION MODERNIZATION TASK FORCE – FUNDING SUBCOMMITTEE

FROM: The Center for Tax and Budget Accountability

I. Executive Summary:

Illinois' Decades Long Practice of Not Making Its Full Employer Contribution is the Primary Cause of the State's Unfunded Pension Liability.

The Center for Tax and Budget Accountability appreciates this opportunity to assist the Pension Modernization Task Force and its Fund Subcommittee (collectively, the **"Task Force"**) in the Task Force's mission of developing potential solutions to the state's aggregate $73.4 billion unfunded pension liability, that exists across all five public employee retirement systems the state has the responsibility to fund. Given the dire condition of Illinois' state budget, resolving the state's outsized unfunded liability will go a long way to putting Illinois' fiscal house in order.

Of course, the necessary first step to resolving any significant structural problem is accurately identifying its primary cause. In this regard, the data are clear. Despite oft-repeated claims to the contrary, the primary cause of the state's pension funding woes have very little, if anything, to do with the over-generous benefits, high employee head counts or inflated costs. Consider, for instance, the popular belief that Illinois has an overly large public workforce. Nothing could be further from the truth. Despite having the fifth largest population of any state, Illinois ranks 49th among the states, next to last, in number of state employees per capita.[1] This is nothing new, as historically, Illinois has not been a high public employee head count state. In fact, the number of workers employed by state government declined by 4532 from 1997-2007.[2]

Illinois also does not have overly generous benefits. The pension benefits provided to Illinois teachers, firefighters, police officers and all other public employees are average when compared to other states.[3] According to the Illinois State Comptroller, pension benefits paid to regular state employees in Illinois are low relative to benefits provided by other states. Illinois ranks in the bottom one fifth of all states for retirement benefits paid to an average state worker. [4] New York State, which has a five tier pension system, provides a greater benefit in its lowest fifth tier, than Illinois does in its one tier system. Moreover, 76 percent of Illinois' state retirement plan participants are not coordinated with Social Security, and hence do not get that benefit on retirement. This is unlike workers in the private sector, who receive both Social Security and private retirement benefits. Illinois similarly has a low-cost pension

[1] United States Census Bureau, Statistical Abstract of the United States, 1993-2006.
[2] U.S. Department of Commerce, Bureau of Economic Analysis.
[3] United States Census Bureau, Employee Retirement Systems of State and Local Governments. 2001-2002
[4] State of Illinois FY08 Budget Book

system. The weighted average normal cost across all five systems is 9.3% of payroll, which is 26% less than the national average.[5]

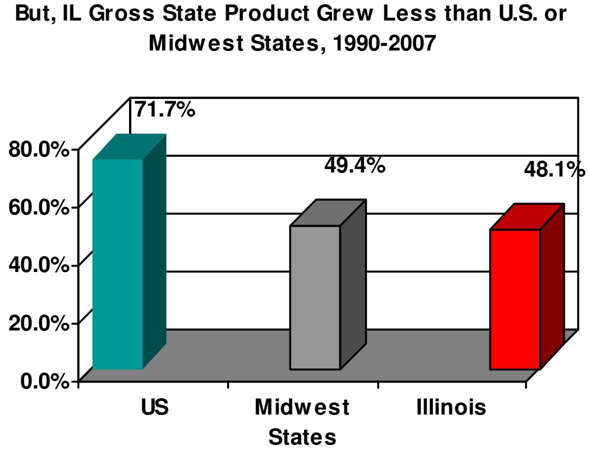
The reality is that the primary cause of the state's unfunded pension liability is Illinois' decades-long failure to make its full, actuarially required employer contribution to the five pension systems. This poor fiscal practice was even codified in the 1995 pension funding bill "P.A. 88-0593", known commonly as the **"Pension Ramp"** bill. During the first 15 years of the Pension Ramp, the state's employer contribution was set at levels which continued the practice of not making the full actuarially required employer contribution, thereby increasing the unfunded liability amount. The deadly combination of nearly 30 years of systematic state underfunding of its employer contributions to the pension systems, followed by the cataclysmic decline in asset values caused by the national meltdown in financial markets over the last year, combined to create an all-time high in the state's unfunded pension liability.

The state's failure to make its required employer contributions to the five pension systems can in turn be traced to one, simple cause: a state fiscal system that is so poorly designed it, for decades, failed to generate enough revenue growth to both maintain service levels from one year to the next, and cover the state's actuarially required employer contribution to its five pension systems. This ongoing "structural deficit" imposed a tough fiscal/political choice on state elected officials—fully fund pensions and dramatically cut services, or skip a portion of the pension payment and maintain as many services as possible. Not wanting to implement dramatic cuts in spending on essential services, the legislature and various governors elected to instead divert revenue from making the required employer pension contribution to maintaining services like education, healthcare, public safety and caring for disadvantaged populations. Effectively, the state used the pension systems as a credit card to fund ongoing service operations.

Given that the state's poorly designed revenue system created the structural deficit that in turn incentivized elected officials to shortchange the state's employer contributions to its pension systems, pension funding reform is not possible without enhancing state revenue. If state revenue is to be enhanced, it should be done in a manner that: (i) reforms major aspects of Illinois flawed revenue system; and (ii) modernizes the fiscal system to both comport with the state's economy and support long-term economic growth. As a final note, the unfunded liability has grown to such a significant size—$73.4 billion—that a new, rational payment schedule, one that front loads costs, should also be considered.

II. Illinois Economy as it Relates to Budget:

- Illinois has the fifth largest population (12,831,970) of any state in the nation.[6] According to the Bureau of Economic Analysis (BEA), in 2008, Illinois also had the fifth largest state economy with a Gross Domestic Product in excess of $633 billion. With that said, since 1990, economic growth in Illinois has lagged both the Midwest region and the nation as a whole.



[5] Weighted average based on data provided by each of the five retirement systems.
[6] Bureau of Economic Analysis, News Release, June 5, 2008.

-

- Moreover, the state of Michigan is included in the Midwest – and its economy has been on the downturn over this entire period. If Michigan is taken out, the other Midwestern states significantly outpace Illinois in long-term growth.
- High tax burden cannot be blamed for this long-term, poor economic track record. **Overall, total state and local tax burden as a percentage of income in Illinois ranks 41st in the country.**[7] This tax burden figure isolates and includes every tax and fee charged by any unit of state or local government in Illinois, versus those charged by every unit of state or local government in every other state. Illinois also has the second lowest tax burden in the Midwest to Missouri (Missouri is only one-tenth of one percent lower). **When state taxes as a percentage of income are considered in isolation, Illinois drops to 43rd in tax burden.**

III. Out of Control Spending is not the Problem:

- In fact, after adjusting for inflation, Illinois' General Fund spending is anywhere from $1.344 billion to $4.451 billion less in the current fiscal year 2010, than it was a decade ago in FY 2000.

Real Changes General Fund Spending
FY 2000 - FY 2010

Category	FY 2000 Actual	FY 2000 Adj to FY 2010 (MW CPI) *	FY 2010 Enacted	Diff FY 2000 - FY 2010 (MW CPI)	FY 2000 Adj to FY 2010 (ECI) **	Diff FY 2000 - FY 2010 (ECI)
General Fund	$21,294	$27,429	$26,085	($1,344)	$30,536	($4,451)
Education	$7,957	$10,250	$9,309	($941)	$11,411	($2,102)
Health Care	$5,022	$6,469	$7,896	$1,427	$7,202	$694
Pension	$1,230	$1,584	$121	($1,463)	$1,764	($1,643)
Human Services	$3,456	$4,452	$3,934	($518)	$4,956	($1,022)
All Other	$3,629	$4,675	$4,825	$150	$5,204	($379)

*MWCPI – Midwest Consumer Price Index, Published by the Bureau of Labor Statistics ("BLS")

**ECI – Employment Cost Index, Published by BLS.

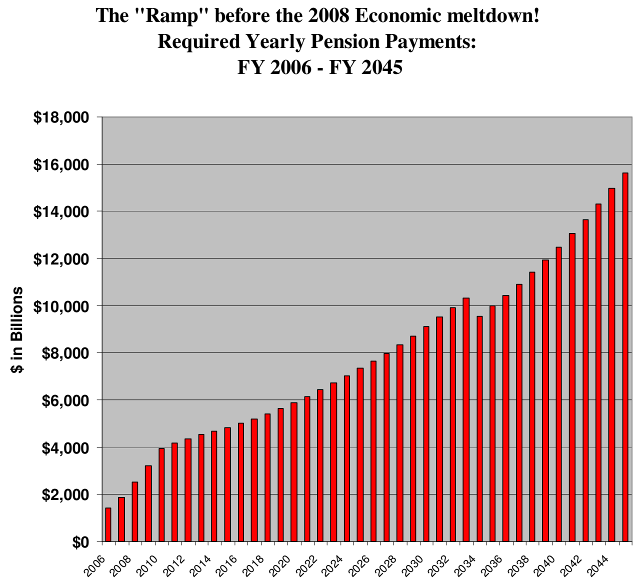
- Focusing on state spending during the 10 years before the recession hit still indicates Illinois is very low spending overall. According to the BEA, in 2007, Illinois had a Gross Domestic Product of $609.9 billion. The General Fund of the State of Illinois in 2007 was $28.4 billion (rounding up, based on the Comptroller's annual report). That means General Fund spending accounted for just 4.6 percent of the Illinois state GDP.

- According to the same BEA data, the Illinois GDP was $403.9 billion ten years earlier, in 1997. In 1997, the Illinois General Fund was $17.3 billion (rounding up, using the Comptroller's final annual report). That means General Fund spending accounted for 4.3 percent of the Illinois GDP in 1997. Hence, General Fund spending as a percentage of GDP increased by just three-tenths of one percent during that 10 year period. This, despite the shift of responsibility to cover healthcare costs from the private sector to the public sector (today, over 40% of Illinois workers do not have employer-provided health insurance and over 30% of the state's population is uninsured or on Medicaid), plus the phase-in of the pension ramp, which imposed annual cost increases on state government to cover decades of underfunding. According to the BEA, Illinois ranks 45th in state spending as a percentage of state GDP, despite having the fifth largest population.

[7] Federation of Tax Administrators, www.taxadmin.org.

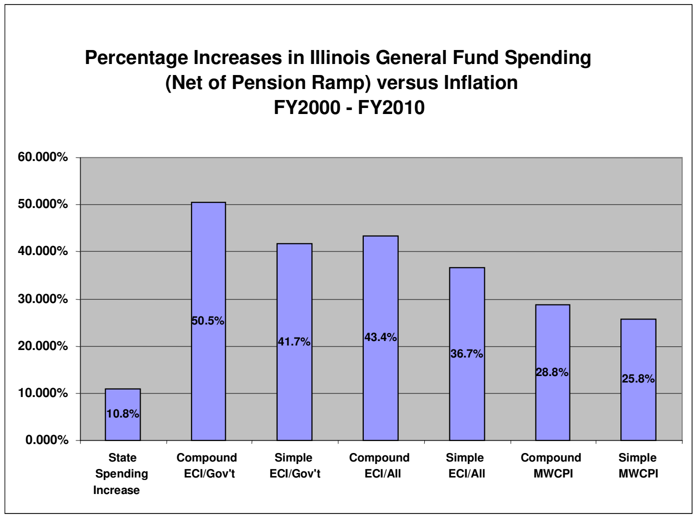
- Funding the five state retirement systems for public employees has challenged Illinois state government for decades. As state decision makers continually found themselves short of the revenue needed to cover both maintaining essential services from one year to the next, and making the full, actuarially determined employer contribution required to fund the pension systems, they consistently opted to skip full funding of the retirement systems to maintain spending on services.

- The state's historic underfunding of the pension systems led to the 1995 Pension Ramp legislation. The following chart shows the ramp schedule from FY 2006 forward – before the impact of the 2008-2009 market crash.



- In fact, increased funding the state contributed to the pension systems over the last 10 years should not be counted when considering whether state spending over time has increased or decreased in real terms. This is because enhanced funding of the pensions is not an increase in spending on services, but rather payment of over due debt.

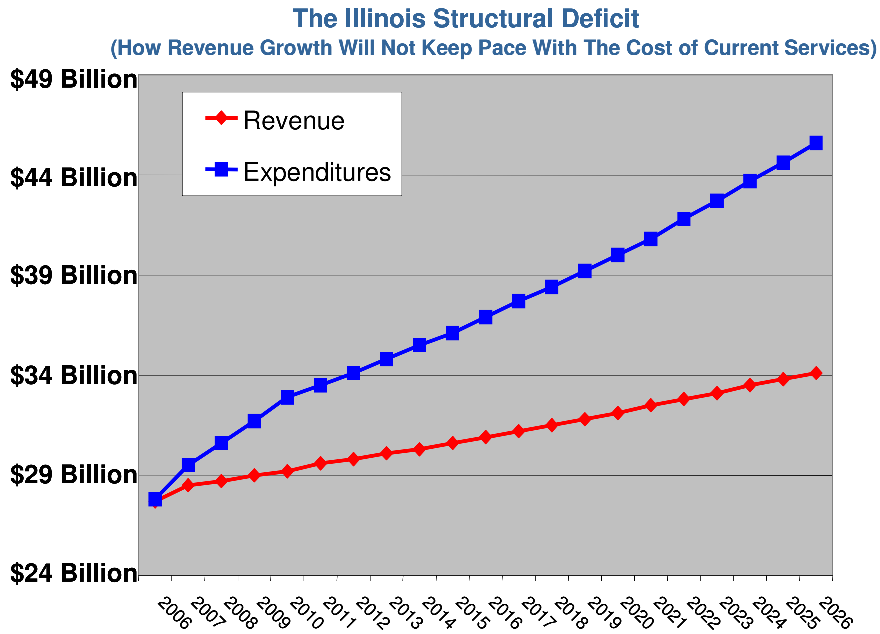
- The following chart shows the percentage increase in state spending on services, expressed in nominal dollars, from FY 2000 – FY 2010, compared to changes in inflation over that period.



- When state spending over the last decade is analyzed honestly, it is quite clear that under any data-based analysis, Illinois is cutting spending to levels that clearly cannot meet needs.

Item	Amount
FY 2010 Appropriations	$ 26.085 B
FY 2000 Appropriations	$ 21.294 B
Nominal Dollar Increase	$ 4.791 B
Scheduled FY 2010 Pension Ramp increase over 2000 levels	**-($ 3.422 B)**
Nominal difference in Appropriations for Services in FY 2010 over FY 2000, Net of Pension Increase	**$ 1.369 B**

- The main reason Illinois has run up a large unfunded liability is simple – the state's revenue system has historically underperformed over time, creating a structural deficit.



*Note, this structural deficit model was designed for CTBA by Fred Giertz, PhD., economist at the University of Illinois. It follows the Congressional Budget Office's methodology of: (i) assuming continuation solely of existing law, no new or expanded services of any type; and (ii) adjusting growth in service cost and revenue solely for estimated population changes and historic rates of inflation.

IV. The Deficit

- Today, Illinois state government is facing a significant, multibillion dollar deficit, caused in large part by the structural deficit outlined above, but certainly exacerbated by the deep and long lasting national recession that started over 18 months ago, in December 2007.

- The size of the state's deficit can be identified by reviewing the one-time revenue used to support the FY 2010 budget.

Illinois' State FY2010 Budget Breakdown	
APPROPRIATIONS	$26.08 B*
ONE-TIME, NONRECURRING REVENUES	
Debt Proceeds from issuance of five-year Pension Notes	$3.466 B
Federal Stimulus	$1.843 B
Fund Sweeps	$ .356 B
Debt Restructuring	$ .600 B
TOTAL NONRECURRING REVENUE	$6.265 B**

* Note: The FY2010 budget figure does NOT include at least $3.2 B in past due, unpaid bills carried forward from FY2009—and there is NO revenue source to pay this amount.

**Note: That means over 21% of the FY2010 budget is covered with one-time, nonrecurring revenues not available in FY2011.

- The preceding chart does not include the $4 billion in unpaid bills the state currently owes providers that was carried forward into FY 2010.

- The Governor's Office of Management and Budget just announced that it is reducing its revenue estimates for FY 2010 by $900 million—$850 million of which is projected lower income tax receipts, and $50 million of which is projected lower gaming revenue.

- This creates a huge problem in FY 2011, when the state will have to replace one-time revenue and cover the $4 billion in unpaid bills, if it wants to maintain the General Fund at the $26.085 billion level of FY 2010.

Illinois' FY2011 Starting Budget Shortfall —Minimum	
Replacement of one-time FY2010 revenues and debt	$6.265 B
First installment of five-year Debt Service on Pension Notes	$ .800 B
Carry Forward of Operating Deficits from FY2009/2010	$4.0 B
Increase in required pension contribution under the Pension Ramp*	$1.2 B
TOTAL MIMIMUM FY2011 STARTING DEFICIT	**$12.265 B**

* In 1995, Illinois passed a pension ramp bill requiring significant, annual increases in the state's contribution to its public employee retirement systems, to make up for a decades long practice of failing to make the full, employer contribution into the system. That is why the pension contribution escalates by $1.2 billion next year.
*Note, this chart does not include the $900 M revenue shortfall the Governor's Office of Management and Budget now estimates for FY 2010.

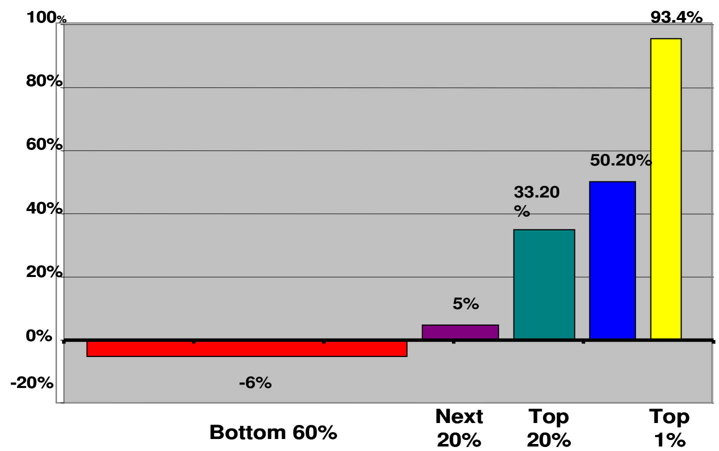
V. Attacking the Problem with a Responsible Solution: Raise Revenue + Re-think the Ramp:

- Illinois cannot fund its pension obligations without raising revenue. However, a poorly designed tax increase is not the answer, since the state's fiscal system is so flawed to begin with.
- Instead, Illinois should take this opportunity to reform its fiscal system comprehensively, to make it work in a modern economy and comport with the four, fundamental principles of sound tax policy, which are that the system be:

FAIR	➔	**PROGRESSIVE**
RESPONSIVE	➔	**TO MODERN ECONOMY**
STABLE	➔	**DURING POOR ECONOMIES**
EFFICIENT	➔	**DOESN'T DISTORT PRIVATE MARKETS**

- A **"fair"** tax system in a capitalist economy is a "progressive" tax system, that is, one that imposes a greater tax burden on affluent, than low and middle income earners, when tax burden is measured as a percentage of income.
- The reason a "progressive" tax is fair in a capitalist economy is that upper income families receive a disproportionate share of income growth over time in capitalist economy, as shown by the chart below. Also, because of this unequal share in income growth over time, a progressive tax system is also "responsive" that is, it responds to how the economy actually grows over time, helping revenue growth keep pace with economic growth.

Income Growth in the United States 1979-1999
(Real 1999 Dollars)
***Source U.S. Census Data**

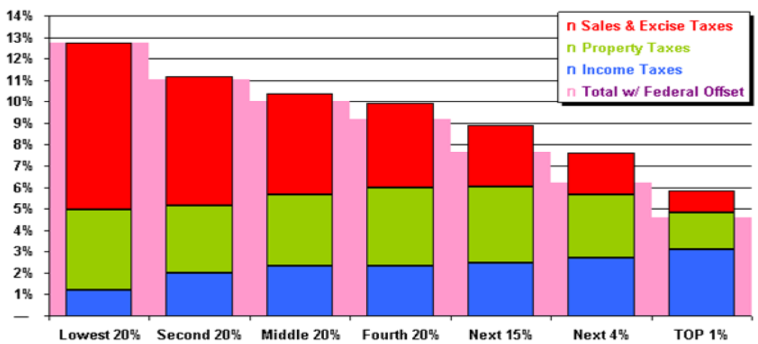


- The easiest way to create a fair, responsive, progressive tax system is through a progressive income tax rate structure, like the federal government's. Illinois is constitutionally prohibited from having a progressive income tax rate structure.[8]

- Illinois is one of only 6 states with an income tax that has a flat tax rate that applies to all taxpayers. The other five states are: Colorado (4.63%), Indiana (3.4%), Massachusetts (5.3%), Michigan (4.35%), and Pennsylvania (3.07%). Every other state has some progressivity built into the rate structure.

- This flat rate has helped make Illinois a regressive, unresponsive, unfair taxing state.

State & Local Tax Burden as a Percentage of Income



Income Range	Less than $16,000	$16,000 – $30,000	$30,000 – $48,000	$48,000 – $77,000	$77,000 – $148,000	$148,000 – $295,000	$295,000 or more
Average Income	$8,900	$22,600	$38,500	$61,100	$101,400	$203,600	$1,322,100
Tax Burden	**12.7 %**	**11%**	**10%**	**9.2%**	**7.7%**	**6.2%**	**4.6%**

- Illinois, with its 3% rate, has the lowest flat rate of all states with a flat income tax, and the lowest overall effective rate of all states with an income tax—(note, some states with progressive rate structures have a lower initial rate for very low income folks, but have a much greater overall rate after taking the progressivity into account.)

- Following are the top income tax rates in certain states:
  (A) The Midwest
    Ohio - 6.24%
    Missouri - 6.0%
    Kentucky - 6.0%
    Indiana - 3.4%
    Wisconsin - 6.75%
    Iowa - 8.98%
    Michigan - 4.35%
    Minnesota - 7.85%

  (B) Other Big States
    New York - 6.85%

[8] Illinois Constitution, Article 9, subsections, 3 (a), 3(b) (1970).

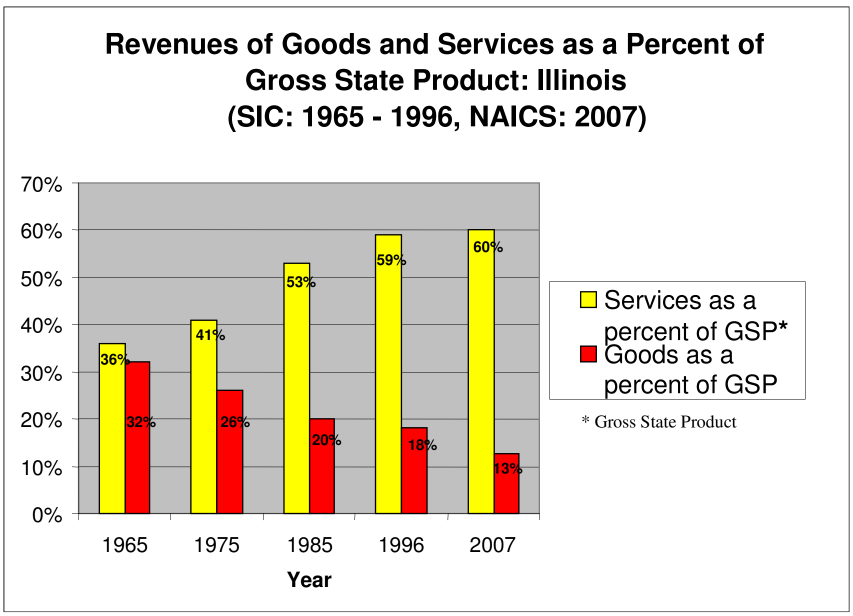
New Jersey - 8.97%
California - 9.3%

- As the preceding demonstrates, Illinois has plenty of room to increase its income tax rate and remain low tax overall. For instance, a personal income tax rate of 5% would tie Illinois with Mississippi for the seventh lowest personal income tax rate of the 41 states with an income tax.

- To be fair, any tax increases in Illinois, whether based on the income or sales tax, should be accompanied by tax relief targeted to low and middle income families, preferably in the form of refundable tax credits. The Earned Income Tax Credit is a good example.

- To further modernize its tax system and generate some stable revenue, Illinois also must expand its sales tax base to include services.

- This is because a broad based sales tax is very stable – even during economic downturns. Unfortunately, of the 46 state with a sales tax, Illinois' sales tax base is the third most narrow, because it excludes most services. As the following Figure demonstrates, this is a prescription for fiscal failure. Illinois cannot afford to leave the largest and fastest growing segment of its economy out of its tax base and expect to balance its budget or pay its pension debt.

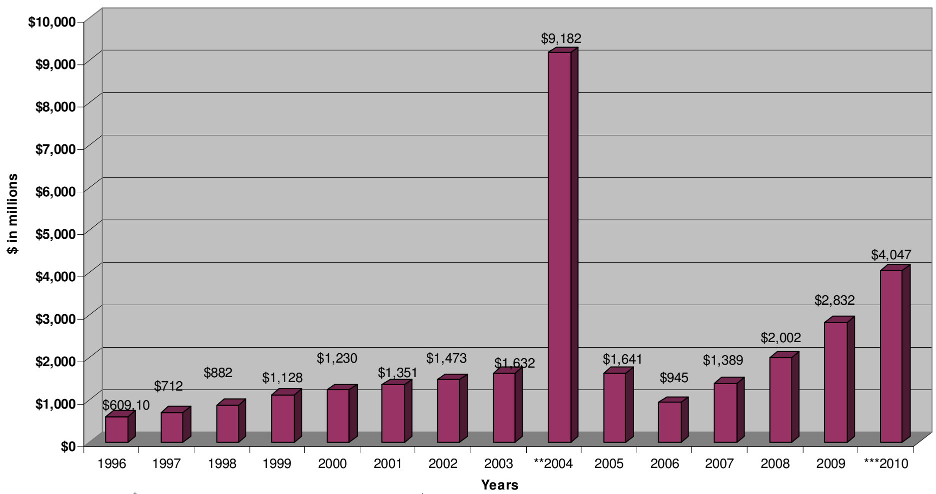


- The current mix of state revenues simply cannot meet the cost of existing human services, education, and pension obligations. Illinois must modernize the state tax system in order to raise enough money to pay its bills – this requires a comprehensive package of fiscal solutions. HB 174 raises approximately $5-$6 billion in new, recurring revenue while modernizing the state's tax system and making it fairer; doubles the state income tax credit Illinois homeowners receive for property taxes paid on their principal residence; increases the corporate income tax rate from 4.8% to 5%; and makes meaningful new investments in education.

VI. "Amortization" the Responsible Funding Solution:

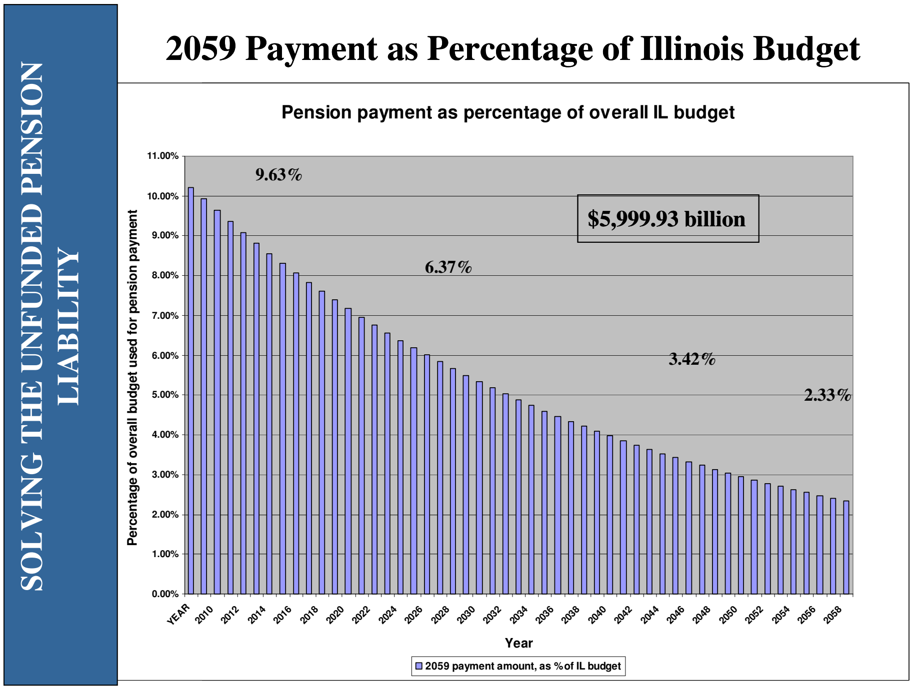
- The creation of the "Pension Ramp" under P.A. 88-0593 (1994) was an attempt to address the unfunded pension liability. Intended to force increased payments to the retirement systems over time, the Pension Ramp established a time-frame during which Illinois was required to fund both: (i) the actuarially determined employer contribution the state owed for retirement benefits accruing to existing employees (the "**Normal Cost**"); plus (ii) make up a portion of previously unpaid employer contributions and the associated return thereon. The Pension Ramp amortized this payment schedule over 50 years, with a target of funding 90% of total actuarial liabilities by 2045. The Pension Ramp created a framework that established a 15 year ramp period, during which the newly mandated contributions Illinois had to make for current and past employees increased in annual increments. Unfortunately, there was a deficiency within the ramp – a lack of revenue to fully fund the employer contributions.

State Contributions Annually since the 1995 Pension Ramp Passed

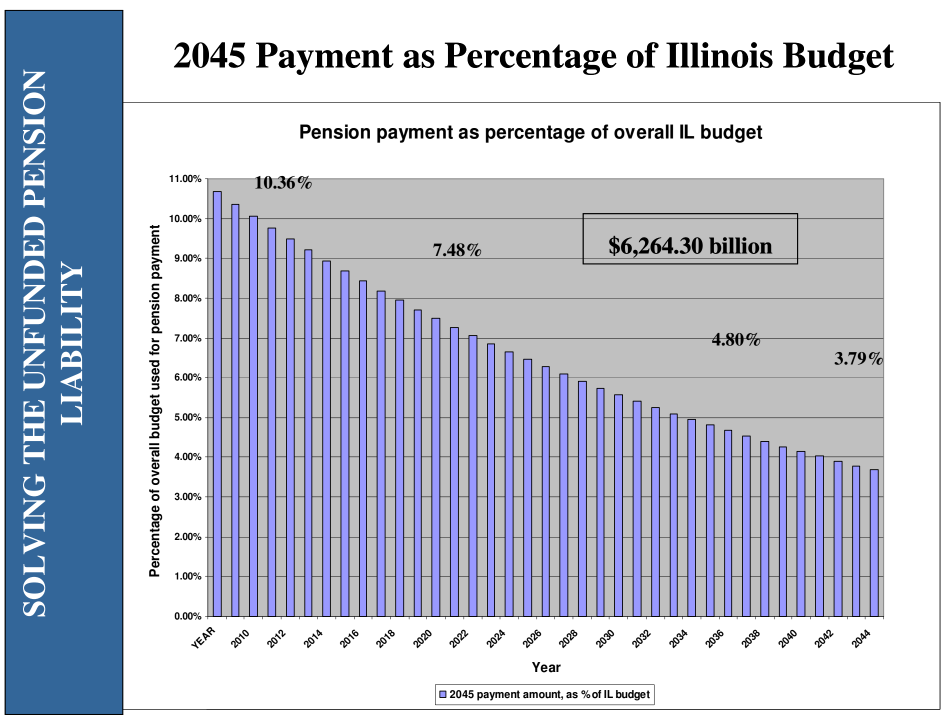


**FY 2004 State appropriations authorized include $7.3 billion in proceeds from the sale of the pension obligation bonds.
***Scheduled future payment per P.A. 88-593
Source: Commission on Government Forecasting & Accountability

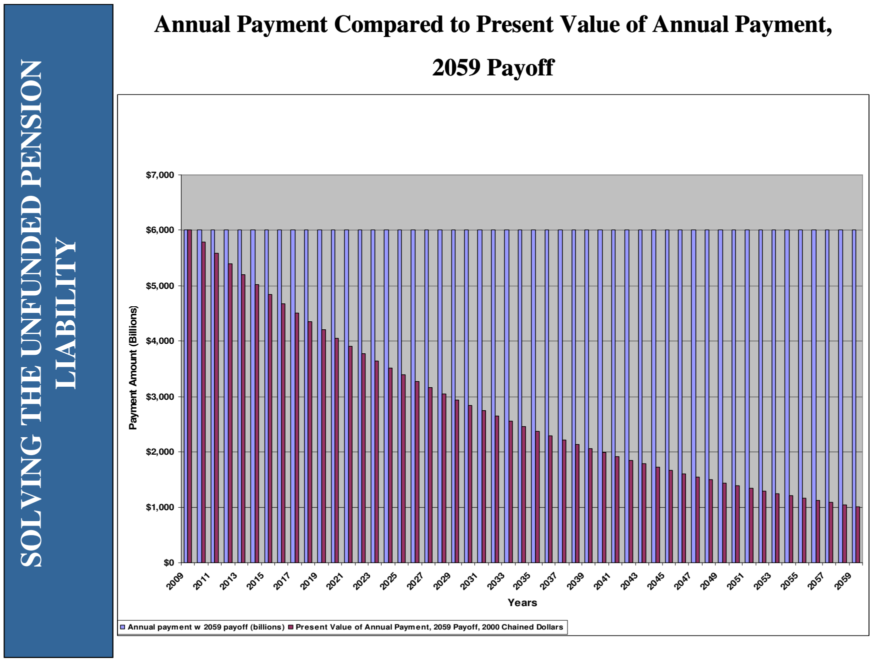
- In order to solve the long-term unfunded pension liability the ramp could be re-amortized with a new payoff date of 2059. Payment amounts assume an unfunded liability of $73.4 billion and a flat interest rate of 8.0% over a 36 and 50 year period, respectively. In moving forward, we must assume that the Illinois budget will keep pace with inflation, increasing at an average rate of 3% per year.

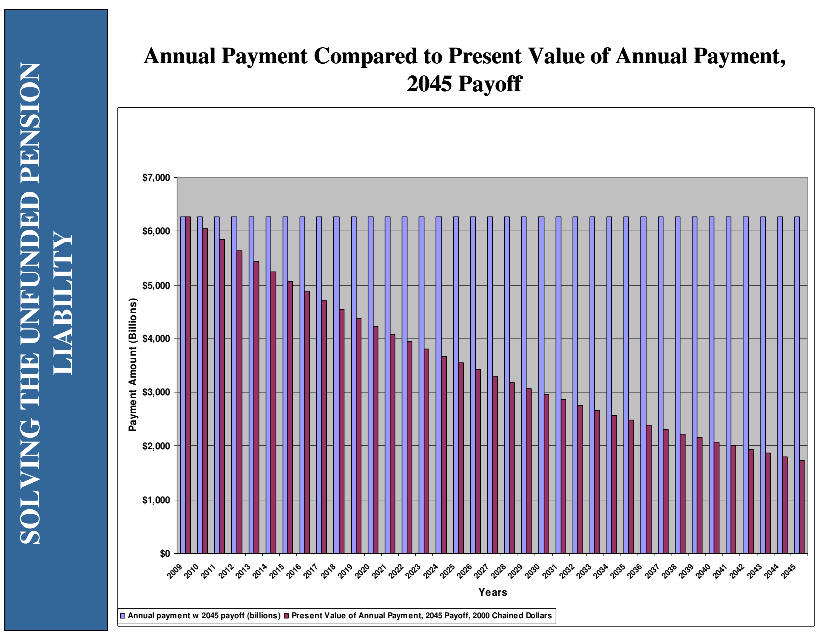


- These budget projections are based upon the average annual historic CPI (consumer price index) of 3.0% for a 15 year period of 1983-2008.



- The annual proposed payment schedules in comparison with the present value payment schedule front loads the amount that is needed to pay down the unfunded liability.





- Instead of unattainable, increasing payments that “ramp-up” over time, the proposed payoff schedule requires level and realistic payments.

VII. One Size Does Not Fit All – When it Come s to Pension Reform!

- Based upon the presentation, "Comparison of Public and Private Retirement Benefits", assessments were submitted to the Funding Committee of the Pension Modernization Task Force:

  - "Must Change Cash Flows in Short Time"
  - "New Tiers Won't Help"
  - "Time is of the Essence"
  - "Cash infusion from other revenue sources"
  - "Due to lack of revenue the 5-state funded retirement systems are in danger of becoming insolvent."

- CTBA agrees with those assessments and stresses that unless the unfunded liability is dealt with in a fiscally responsible manner the problem will only get worse.

- On the flipside, we disagree with AON Consulting when it recommends that Illinois cut benefits for current workers and current recipients as a means to solving the pension crisis, for the simple reason that the state cannot constitutionally implement those changes. Under Section 5 of Article XIII of the Illinois Constitution, "membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." This clause is commonly referred to as the "Pension Protection Clause.

- AON Consulting also recommended that Illinois may be able to attain a cash infusion through borrowing. Borrowing simply prolongs the inevitable tanking of the retirement systems and takes an already debilitating debt from bad to worse. Far better to create a recurring revenue source, such as under HB 174, to permit the state to pay its pension obligations.

VIII. Illinois Cannot Afford to Make the Same Mistake Twice:

- Under current law, P.A. 88-0593 (Funding Plan for State-Funded Retirement Systems), Illinois would have to contribute $437.6 billion through 2045. This averages $12.2 billion a year – an already unattainable amount proven by the growing unfunded liability. The Pension Ramp failed, in large part, due to the absence of a revenue stream to support it, and its irresponsible back loading of costs.

- Under the Governor's proposed Stair Step Funding Plan and Two-Tier proposal, Illinois would have to pay substantially more, $532.3 billion through 2045 than under current law. This would ultimately cost the state an additional $94.7 billion between now and 2045.[9] The Commission on Government Forecasting and Accountability's actuary concluded that the Governor's proposal to reduce benefits for new employees is not appropriate for reducing costs. CTBA agrees. The state of Illinois needs responsible comprehensive revenue enhancements and a revised re-amortized pension ramp.

[9] Stair Step Funding Proposal, Governor's Office, 5/8/2009.