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Navigating pension reform in Illinois

by Richard H. Mattoon, senior economist and economic advisor, and Sarah Wetmore, vice president and director of research, Civic Federation

Illinois is one of several states facing severe state and local public pension crises, but it is uniquely constrained in its ability to address the problem due to recent judicial rulings that all but prohibit pension benefit changes for current and retired public employees. A conference cosponsored by the Federal Reserve Bank of Chicago and the Civic Federation on April 17, 2018, examined the state's options.

The Civic Federation announced the opening of a new initiative to demonstrate and advance opportunities for public pension reform in Illinois at the conference. Lew Collens, president and professor of law emeritus, Illinois Institute of Technology, and Civic Federation trustee, said the new Kearney Center for Public Pensions at the Civic Federation was funded by a generous donation from Chicago civic and business leader Daniel P. Kearney. Collens then highlighted examples from around the state of governments experiencing financial distress due to significant unfunded pension obligations.

Sarah Wetmore, Civic Federation, provided a back-to-basics history of the current pension situation in Illinois and what the state has done to try to address it. She explained the pension terminology used to describe funded status and then reviewed article XIII, section 5 of the Illinois Constitution, which is often called the "pension protection clause." The clause states that membership in any public pension fund in the state is a contractual relationship and its benefits shall not be diminished or impaired. The pension protection clause and its interpretation by the courts are the reasons why Illinois (like New York and Arizona) is considered to have some of the most stringent public pension protections in the United States.

Conference presentations are available online, https://www.civicfed.org/civic-federation/events/navigating-pension-reform.

Wetmore discussed several waves of pension reform initiatives implemented by the Illinois General Assembly following the financial crisis in 2007–09, which had severely reduced already low pension funding levels for state and local public pension funds. The legislature first created a less generous tier of benefits for new employees starting in 2011, aimed at lowering the cost of pension benefits across the state over the long term. However, this did not address employer funding shortfalls and the immediate solvency of the pension funds. Therefore, two bills were passed in 2013 and 2014 to change the funding schedules and reduce benefit levels for a portion of current state and Chicago municipal employees and retirees. Both bills focused on reducing the automatic annual increases to pension benefits granted after retirement from a compound basis to a simple interest basis. Both were challenged in the courts and were struck down by the Illinois Supreme Court as violations of the Illinois Constitution in 2015 and 2016.

Since then, the City of Chicago and Cook County have focused on implementing increases to required taxpayer funding, while the State of Illinois has backslid into some of its worst previous practices, including finding ways to postpone funding.

Pension reform in other states

What can Illinois learn from the experience of other states? Civic Federation board member Lois Scott, Epoch Advisors, introduced a panel of representatives from Georgia, Arizona, and Michigan.

The Honorable Kasim Reed, past mayor of the City of Atlanta, Georgia, explained how he immediately became involved in solving pension funding issues upon being sworn into office as the city was facing a cash shortfall and other financial difficulties, including sharply increasing pension costs. Reed said it was essential to focus on pensions immediately because they were threatening to crowd out public services, which were already poor in quality. He brought together labor leaders and the city's financial partners to find a solution and ended up choosing the most aggressive plan developed by the group. This plan, he said, has resulted in credit rating upgrades and much-improved financial stability for the city. Reed emphasized the importance of open communication with employees and retirees. Pensions are complicated, he said, and it is important to communicate the issues clearly and explain funding concepts in simple terms. Reed said he likened the city's pension promises to a bad check when speaking directly to stakeholders and, crucially, never stopped explaining the problem. As a result, Reed argued, he was able to reshape public thinking about the issue. Finally, he said that the public pension issues Illinois and other states and localities face represent a "passion" problem—solving these problems requires leadership and a willingness to put one's career on the line to do what is right.

Bryan Jeffries, president of the Professional Fire Fighters of Arizona, described how his organization became involved with a successful initiative to improve the sustainability of the public safety employees' pension fund. Jeffries explained that the public safety pension funds had three problems hampering their financial sustainability: 1) underperforming investment returns; 2) unrealistic expected rates of return on investment; and 3) permanent 4% compound benefit increases to retiree pensions. He explained that the Arizona legislature had passed a pension reform package in 2011, but it was struck down by the Arizona Supreme Court in 2014 as a violation of the state's constitutional pension protections. The ruling resulted in sharply increased employer funding requirements, which threatened municipalities' ability to maintain staffing levels and provide salary increases to current public safety officers.

In response, the firefighters convened a stakeholders' group to develop a new plan to reform benefits. Jeffries agreed with Reed that clear communication is key to a successful pension reform initiative. His group focused on educating firefighters across the state about pension issues and eventually helped develop and pass both pension reform legislation and an amendment to the Arizona Constitution that permitted the benefit reforms to be implemented.

Carol O'Cleireacain, former deputy mayor of the City of Detroit, provided a history of how Detroit ended up in bankruptcy court in 2013 and the steps the city and its creditors took to develop a plan to exit bankruptcy 17 months later. The City of Detroit in 2013 was service-delivery insolvent, unable to effectively deliver basic municipal services, while also facing $18 billion in debt, pension, and retiree health care obligations. O'Cleireacain said that the bankruptcy judges were able to do something that the city was not able to do on its own: get all of its stakeholders and creditors around one table to acknowledge that the city had made promises it was not going to be able to keep and hash out a plan that would divide the pain of making the city's debts—including pension obligations—more affordable as fairly as possible. O'Cleireacain said that while bondholders generally took larger haircuts than current and retired city workers, one must not lose sight of the fact that there was a real and ongoing human cost to the changes to pension and retiree health benefits for municipal and public safety employees and retirees. While Detroit has many remaining challenges, she argued that its multiyear financial plan has set the city up to succeed.

Identifying paths to reform for Illinois

How might Illinois either pay or modify its unfunded pension liability? Tracy Gordon, Urban Institute, presented her research on states' revenue capacity and expenditure needs. How much does it cost a state to provide the services residents want and how well positioned is that state to generate the necessary revenue to cover these costs? Gordon provided a specific example for Illinois in 2012. She found that the state's actual own-source revenue collections exceeded its calculated revenue capacity by $68 per person ($6,753–$6,685). While its actual direct expenditures were less than its calculated expenditure need ($8,272 versus $8,472), the state was left with a gap of –$1,787 to fully fund expenditures using only own-source revenue. To help fill this gap, the state received federal grants of $1,482 per person, leaving a gap of –$305 per person for 2012. The bad news for Illinois is that even in 2012, Gordon pointed out, only the general sales tax and charges and fees areas of the state's balance sheet seemed to offer any additional revenue-generating capacity.

According to economists Richard Mattoon, Thomas Haasl, and Thomas Walstrum, Federal Reserve Bank of Chicago, Illinois may need to consider new sources of revenue to pay for its $129 billion unfunded pension liability. One such source would be a statewide property tax. Mattoon presented their preliminary research results, which assume that the state's full liability cannot be reduced and that it must pay the full outstanding amount. Mattoon argued that a property tax would be a relatively efficient way to divide the burden of the state's unfunded liability. Specifically, higher property taxes are capitalized into house prices. Once the tax is imposed, a house price will fall, reflecting this new liability. If an owner is selling their house, they have to accept a lower price, and the purchaser knows that the price reflects the future liabilities attached to the property. This means that simply leaving the state would not relieve an Illinois resident of paying for part of this accrued debt. Mattoon further argued that in addition to transparency and predictability, a special property tax whose receipts could only be used to pay off the pension liability would be generationally fair and would limit the state's need to pay for pensions by reducing spending on important services (such as health care and education) that use existing state tax bases.

> For more information about the statewide property tax calculations, read our recent blog, http://midwest.chicagofedblogs.org/?p=3096.

Mattoon presented a back-of-the-envelope calculation to illustrate the potential impact of such a tax. For example, if the state were to charge an average tax rate of 0.35% against the market value of all Illinois homes, it would take 30 years to pay off the unfunded pension balance.[1] A house in Chicago with a market value of $221,000 (the median home price) would incur an additional property tax of $782 per year, which would be a roughly 22% increase above the current tax bill. In view of this apparently large percentage increase, it may not be feasible for the state to use only a statewide property tax to fund its liability. Mattoon argued that the property tax could potentially be packaged with some type of tax swap, whereby certain state taxes would be raised (for example, by broadening the sales and income tax bases) and the additional revenue would be used to lower existing local property taxes, and thus reduce the impact of the new tax on homeowners overall.

Eric Madiar, Madiar Government Relations and former staff to Illinois Senate president John Cullerton, explained the Senate president's proposal to reduce state pension obligations through new contractual arrangements with state employees. The key concept is that given the state's strict constitutional provision that pension benefits cannot be reduced or impaired, a state employee can only agree to a lower future payment if they receive some sort of "consideration" in return for the agreement. The Cullerton proposal provides two choices to state employees. In the first, the employee could agree to give up the 3% annual compound cost-of-living increase in exchange for a delayed and lower rate of increase in retirement. In exchange, the employee would receive a lump-sum payment equal to 10% of the prior employee pension contribution as well as a 10% reduction in pension contributions going forward. In addition, all future raises the employee would receive would be included in calculating final pension payments. The second choice would allow employees to retain their 3% annual compound cost-of-living increase but would exclude all future raises as being included in the calculation of future pensionable earnings. Madiar estimated that this measure would reduce the state's pension costs by $1 billion per year.

James Spiotto, Chapman Strategic Advisors, offered four legal strategies governments could pursue in situations where pension liabilities are crippling the government's ability to provide essential services. The goal should be to understand the revenue path of the government, he said, while maximizing the value of service provided to residents and ensuring that pensioners are paid the maximum amounts feasible. The first strategy is Chapter 9 bankruptcy. Spiotto cautioned that Chapter 9 can be a lengthy and difficult process unless it follows the path of Detroit, where a tight timeline and negotiations between the affected parties allowed them to reach consensus quickly.

The second strategy is to create a special federal bankruptcy court. Such a court should have the expertise to establish sustainable and affordable government funding levels and determine the government's capacity to raise revenues or reduce services. Based on findings of fact, the court could modify existing contracts.

The third strategy is to create a state-based, quasi-judicial body where troubled governments could receive mediation services and develop recovery plans. This body would have limited judicial authority to modify contracts.

And the fourth strategy, Spiotto said, is to develop model guidelines for a constitutional amendment, which in Illinois's case would seek to alter the nonimpairment clause as it applies to pensions. Spiotto suggested a starting place would be to require a government to pay the pension ARC (actuarially required contribution). If the government was unable to pay the ARC, it would have to modify pension payments in order to fully fund essential services in a reasonable way. The goal would be to first modify future benefits and then reduce accrued benefits only based on a legal determination.

Jeffrey Johnson, Municipal Employees' Annuity and Benefit Fund of Chicago, provided his perspective on the nature of the pension problem and some of the proposed solutions. He suggested that chronic underfunding of pension plans has been at the root of the issue. He noted that when the Illinois Supreme Court struck down a pension reform bill, it said that "crisis is not an excuse to abandon the rule of law."[2] Johnson illustrated the pattern of underfunding in the case of Harvey, Illinois. Over the past eight years, he said, the town has paid 12% of its ARC. This underpayment led the state comptroller to withhold state aid to Harvey in order to ensure that pension payments are made; in response, Harvey has had to lay off a significant number of firefighters and police officers.

Johnson questioned whether a constitutional convention would ever be approved by voters and even if it were, whether pension arrangements could be modified retroactively. He also argued that reform bills that are premised on offering "consideration" in return for lower pension payouts would face legal challenges. Finally, he noted that while Illinois has had some success in issuing pension obligation bonds in the past, the bond proceeds were often used to take pension holidays or reduce annual contributions rather than being solely applied to the unfunded liability.

The program concluded with remarks from former Illinois governor James Edgar and former Illinois state representative Elaine Nekritz. During Edgar's first term in office, he instituted a 50-year pension funding structure in recognition of previous underfunding of state pensions. However, he argued, later governors and legislatures chose to either skip or reduce necessary pension payments or acted to increase pension benefits without funding them. In the end, Edgar said that lasting pension reform must have bipartisan support and clear commitments from the governor and legislative leaders. In addition, he said, policymakers must be willing to make changes if conditions worsen and be disciplined about maintaining payments even in difficult times.

Nekritz was a proponent of the 2013 pension reform bill that was struck down by the Illinois Supreme Court. She said pension funding must be viewed in the context of the full range of services the state supplies. The ever-increasing pension contribution from the state's general fund limits its ability to fund services. This year alone, $6 billion will be needed to fund the state's current K–12 education formula out of a total state budget of $38 billion. Ever-increasing pension payments are competing for this money. Nekritz said her greatest disappointment in the action of the Supreme Court is that it prioritized pension payments over the other services of government. She noted that the pension reform that was passed only reduced the size of future cost-of-living increases and required workers under the age of 45 to work longer to receive full pension benefits. The changes, she argued, were reasonable and would have reduced the burden that future taxpayers would have to pay for a debt that they did not create.

Conclusion

Illinois's underfunded pension liability is clearly the largest fiscal problem facing the state. The remedies for improving the state's fiscal health will require sacrifices by taxpayers, state workers, and state government.

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[1] We have since revised our state property tax rate estimate to 1%. For more details, see our blog, http://midwest.chicagofedblogs.org/?p=3096.

[2] More details are available online, http://www.illinoiscourts.gov/Opinions/SupremeCourt/2015/118585.pdf.

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