Illinois Public Pension Compendium

A Five Part Series
Part Five: Conclusion

Justin Formas, CAIA
Director of Municipal Bond Credit Research

Dan Simpson
Credit Analyst

May 20th, 2015

“Pay what is sustainable and affordable. What is needed is a mechanism that provides an independent and neutral determination of what is affordable and sustainable so the debate of unwillingness or inability can be transcended to what increased funding or adjustment to what can be afforded as pension benefits without eroding infrastructure and essential governmental service at an acceptable level.” James Spiotto, Lessons Learned from Financially Distressed Municipalities and Coming Attractions January 15th, 2015.

Our series on the condition of the Illinois pension systems has hopefully provided considerable insight into the retirement system's history, actuarial assumptions, and proposed reforms. In our conclusion we will survey the pension reform landscape, examine major pension overhauls occurring in other states, and contemplate possible next steps for the State of Illinois.

As we have presented, pension systems are complicated structures involving a multitude of correlated variables, each one sensitive to subtle change. Added complexity is derived from each state's constitutional provisions, statutes, and case law. This individuality makes reasonable comparisons a challenge. Legal precedent in one state may have little bearing over reforms in other states. That said, for all the differences across pension systems, two underlying themes remain constant: a state's limited financial resources in the face of endless needs and ardent stakeholders on both sides of the issue. To that end, we find it necessary to study and understand other states' pension reforms.

We begin our discussion by highlighting states that have specific constitutional provisions prohibiting impairment of public employee pensions: Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, and New York. These states may face significant legal challenges in order to pass comprehensive pension reform legislation. Other states have general constitutional provisions prohibiting the impairment of contracts or rely on the Contract Clause of the US Constitution: Georgia, Nebraska, New Jersey, Oklahoma, Rhode Island, Tennessee, and West Virginia. Legislators in these states will likely have to rely on existing case law to first determine how their state's courts view pension obligations (i.e. gratuities vs. contractual obligations). A majority of the remaining states rely on a combination of state statutes and case laws to determine whether pension impairment is prohibited.

Regardless of a state's provisions on prohibition of pension impairment, legislators have taken strides in reforming pension laws, particularly in 2013 and 2014. According to a legislative database compiled by the

BERNARDI SECURITIES INC.
MUNICIPAL BOND SPECIALISTS

National Conference of State Legislatures (NCSL), 44 states enacted 247 pension reform bills in 2013. Those figures increased slightly in 2014 when 45 states enacted 296 bills. In contrast, 36 states enacted 93 pension reform bills in 2012. The 2012 general election is in part the source of the sizable disparity. More precisely, it's probable certain legislators find the political environment during general elections unconducive to taking on politically untenable reforms that could jeopardize their campaigns.

Additionally, given the number of states and the volume of pension reform bills enacted in 2013 and 2014, it's easy to misinterpret the figures. Pension reform was certainly a hot topic the last several years, but the figures suggest each state enacted on averaged 5 to 7 pension reform bills. A majority did not involve complete overhauls. In fact, the small sample size of successfully enacted pension reform bills we reviewed during that two-year period involved minor changes. Furthermore, adjustments to pension benefits might appear more reasonable and easier to enact as the economy improves. As further evidence, funded ratios, particularly from those states that implemented investment return smoothing, will see investment losses stemming from 2008 and 2009 roll off from calculations. These phenomena are best exemplified by considering the enacted bills as well as the failed bills. During 2013, 179 pension reform bills failed to pass in 20 different states. Another 113 reform bills failed to pass in 17 states the following year. Eight States outright vetoed 12 pension reform bills in 2013, another eight vetoed 13 bills a year later.

The NCSL database does not take into account proposed reforms that failed to make it to a vote. For example, the California Pension Reform Initiative of 2014 (#13-0043), would have added language to the California Constitution that, according to the initiative's supporters, would "enable the people of California to take those actions necessary to attain fiscal sustainability and provide fiscally responsible and adequately funded pension and retiree healthcare benefits for all-government employees and retirees." The initiative, ostensibly allowed municipalities to reduce benefits and/or require additional employee contributions if the retirement systems were substantially underfunded or the municipality declared a fiscal emergency. Several administrative and judicial setbacks forced the bill's supporters to remove the referendum from the ballot.

The volume, successful pass rate, and the number of failed bills are evidence that state governments have attempted to tackle their respective pension issues.

Upon further examination of state retirement system reforms we find several notable examples. Compromises and concessions from both sides are inherent in instances where meaningful reforms have occurred.

In Utah, a state with statutes that prohibits pension benefit impairment for current employees, a reform bill passed directed at new hires. Senate Bill 63 and Senate Bill 43 of 2010 replaced the State's defined benefit pension system with a 401(k)-style plan for new hires. Further, the state increased and capped employer contributions at 10% of each worker's salary (12% for public safety workers and firefighters). The state also maintained the option for new hires to choose the defined benefit plan, but the state contribution to such plan was similarly capped at 10%.

Wisconsin Pension Reform of 2011 (Act 10) is well-known for triggering a month long protest by public employees. Notably Act 10 held wage increases to the rate of inflation and required public employees to contribute approximately 50% of the retirement system's annual pension contribution. That figure was estimated to be 5.8% of salary in 2011. Prior to Act 10, covered employees paid a very small portion toward their pensions. The bill also required state employees to pay at least 12.6% of the average cost of annual healthcare premiums. As we've noted on several occasions throughout our series, Illinois' neighbor to the north has maintained a pension funded ratio at or near 100% for the last several years.

New Jersey's pension reform of 2011 eliminated cost-of-living adjustments (COLA) for current and future retirees until at least 2040. The bill increased the retirement age for new teachers and other non-uniformed employees by five years to 65 and increased the years of service eligible for early retirement to 30 years. For new police and firefighters, pensions would be 65% of salary at 30 years of service, and 60% at 25 years. The existing law was 65% of salary at 25 years of service.

Public employees did broker some concessions including a mandate that the state make its annual pension payment or face possible legal action by the collective bargaining units. Additionally, an employee-manager board was established to set contribution rates, retirement ages and other benefit levels, but only when the funds become stable and as long as the changes don't have an adverse effect.

Rhode Island, despite its physical size, provides one of the better parallels to Illinois in terms of pension conditions. The state's total budget is small, projected to be approximately $8.6 billion for FY2016. Its retirement system has ranked alongside Illinois near the bottom of worst-funded pensions. In 2010, the funded ratios for Rhode Island's state employees and teacher retirement funds were each 48.4% with a combined unfunded liability near $6.9 billion. The system's poor condition and a spate of high-profile municipal bankruptcy filings in the state were the impetus behind the state's significant pension reform legislation in late 2011. The state was able to pass pension reform legislation that included temporary suspension of COLAs, increased retirement age for all non-vested employees and new hires, and creation of a new hybrid defined benefit/defined contribution retirement plan. Vested employees had their existing defined benefit plans frozen with future benefits accruing at a lower rate. According to the State's 2013 actuarial valuation report, upon passage of the bill, the State's combined unfunded pension liability of the employee and teacher's retirement fund declined by $2.7 billion adding more than 10% to the funded ratios of each system.

Not unexpectedly, the state's collective bargaining units and retirees filed corresponding lawsuits under the principle that Rhode Island courts provide protection from impairment for contractual pension rights. Rhode Island's constitution does not explicitly prohibit impairment of pension right; rather it relies on contract law. This fact lowers the legal hurdle for Rhode Island to pass comprehensive pension reform. According to the judicial opinion rendered by state's Supreme Court in *Nonnenmacher v. City of Warwick 722 A.2d 1199* (R.I. 1999), within the framework of Rhode Island contract law vested contractual rights might not be violated where the impairment caused by a change in benefits is determined not to be "substantial".

The bargaining units and retirees were unsuccessful in obtaining a restraining order and while the lawsuits were allowed to proceed, the reforms went into effect. After several years, multiple revisions, and court appointed mediation, the state and a majority of its bargaining units and retirees recently agreed on a settlement, which according to the governor preserved 92% of the savings the state projected in February 2014.

As discussed in part four of our series, Illinois' 2013 pension reform law was ruled unconstitutional by a circuit court judge in 2014. That ruling was subsequently appealed to the Illinois Supreme Court and ultimately upheld. In the state Supreme Court's opinion from May 2015, the presiding justices concurred with the lower court, concluding: "The circuit court was therefore correct when it concluded that Public Act 98-599 is void and unenforceable in its entirety."

The 2013 pension reform bill sought to trim the state's pension contribution by nearly $150 billion over the next 30 years while reducing the unfunded liability by 20%. It included a reduction in the state's contribution of approximately $1.2 billion for fiscal 2016. The bill took several cues from some of the successful reforms mentioned earlier including raising the retirement age for some, capping salaries eligible for pension benefits, limiting COLA increases, and lowering employee contributions.

The state's statutorily required pension contribution for FY2016 is $6.82 billion, up 12.8% from the prior year. The current administration has presented a pension reform proposal that saves $2.2 billion in FY16. Similar to the 2013 reform plan, the current reform bill seeks to reduce $100 billion from the state's pension contribution over the next three decades. Under the proposal the savings would be derived by freezing pension benefits for employees hired before 2011 and in turn offering a transition to a 401(k)-style plan with a lower COLA. The administration believes the proposal is within the constitutional framework because the proposed changes do not impair accrued benefits. This asserts the administration's position that changes are prospective on unearned future benefits. Public safety employees would be excluded from the changes. Given the recent ruling on Public Act 98-599, unions will undoubtedly consider legal challenges.

In Illinois' 2011 pension reforms, the state created a two-tiered benefit system, with those hired after the 2011 cutoff accruing pension benefits with lower COLAs, higher retirement ages, and capped salaries eligible for benefits. The current pension proposal would effectively apply the same Tier 2 benefit structure to employees hired prior to 2011.

Separate from the possible legal challenges, the proposed changes may find traction because as we have highlighted in part four of our series, the normal cost of the Tier 2 benefits is less than the Tier 2 contribution rate members pay for their own pensions. According to an analysis by the Civic Federation, through FY2045, Tier 2 employees are projected to contribute $26.2 billion to fund their own benefits and $6.9 billion to pay for the state's unfunded liability, while Tier 1 employees are projected to contribute $19.8 billion during the same period, all of which will be used to fund their own benefits. A transition to a benefit structure that is equal among all current employees could provide the necessary foundation to negotiate such changes.

It is important to point out that the current two-tiered system is not without its own shortcomings. According to a recent article in The Bond Buyer, Illinois lawmakers raised concerns "…whether the Tier 2 benefit level will eventually fail a federal requirement that the state provide a retirement plan with benefits comparable to Social Security which state employees don't pay into or receive any benefit from. Some experts have suggested the Tier 2 plan may fail the test, so increasing the number of employees receiving those benefits would only serve to drive up future costs…"

An actuarial analysis performed for TRS indicates that current Tier 2 benefits meet the federal requirements and are projected to remain in compliance through 2027. Under the current pension proposal transitioning higher salaried workers from the Tier 1 to Tier 2 benefit structure may accelerate the plan toward non-compliance.

The Illinois Supreme Court's ruling has left the state's retirement systems in a familiar and precarious position. Quite simply the solution cannot be found in adjusting a single side of the equation. Tax revenues are not infinite, at a point taxation tempers economic growth. Retirement expenses must be constrained within the parameters of providing basic public services to all citizens. The majority of every government dollar spent cannot be utilized for any one purpose.

There exists an abundance of innovative alternatives. The Civic Federation, in its analysis of the state's FY2016 budget, makes two reasonable revenue enhancement recommendations.

First, it recommends that the state "increase the individual income tax to 4.25% from 3.75% and the corporate income tax rate to 6.0% from 5.25% on January 1, 2016." The Federation estimates that an increase to those levels would generate an additional $1.7 billion in revenues before their proposed gradually reduction to 4.0% for individuals and 5.6% for corporations as the state's finances stabilize.

The proposition is attractive in that the increase itself is less than the initial increase in 2011 and it integrates a formula correlated to the state's financial results. Further, legislators could supplement the

increase by specifically earmarking a percentage of the proposed increase to go towards pensions and the state's backlog of unpaid bills.

Second, the Civic Federation recommends that the State of Illinois broaden its income tax base by eliminating the tax exemption for retirement income. The Federation's proposal excludes Social Security income and all retirement income from individuals with taxable income of less than $50,000.

According to the Federation's report: "Unlike the federal government, which taxes certain levels of Social Security and other retirement income, Illinois exempts all retirement income from the State's income tax base. Out of the 41 states that impose an income tax, Illinois is only one of three that exempts all pension income and one of 27 that excludes all federally taxable Social Security income."

The Illinois Comptroller reports that this exemption of federally taxable retirement income reduced individual income tax revenues by $2.2 billion in FY2013. The Federation estimates that by repealing this tax expenditure the state could generate an additional $1.5 billion to $2.0 billion annually.

When combined with the current administration's estimated annual pension savings of $2.7 billion through 2045, there are nearly $3 billion in revenue and expenditure concessions from each side. It is critical that these and any other additional revenues or expenditure reductions be specifically earmarked to strengthen the pension systems and improve the state's financial health. Transparency and accountability are important to develop a workable solution for the state, its taxpayers, employees, and retirees.

Admittedly such proposals are not the type of grand bargain we wish to see, but the plausible $6 billion in total annual revenue enhancements and pension cost savings could provide an ample foundation for a sustainable and affordable public pension system.

DISCLAIMER

The information contained in this report has been compiled by Bernardi Securities, Inc. from sources that are believed to be reliable, but Bernardi Securities, Inc. makes no warranty as to the accuracy, completeness or correctness of the research. The views expressed herein are the views of the authors only and are accurately expressed. All opinions and estimates contained in this report are subject to change.

All opinions and estimates are made in good faith but without legal responsibility. This report is prepared for general circulation in the investment and political community. The examples seen in this report are used for illustrative purposes. To the full extent permitted by law Bernardi Securities, Inc. does not hold any liability for consequential decisions arising from use of this report. Nothing contained in this report may be copied without the prior consent of Bernardi Securities, Inc.

References

Supreme Court of Illinois. Doris Heaton et al. v. Pat Quinn, Governor, State of Illinois, et al. Decided: May 8th, 2015
http://www.illinoiscourts.gov/Opinions/SupremeCourt/2015/118585.pdf

Supreme Court of Rhode Island. Harold J. NONNENMACHER v. The CITY OF WARWICK, et al. Donald E. Sjogren v. The City of Warwick, et al. Nos. 97-528-Appeal, 97-529-Appeal. Decided: January 25, 1999
http://caselaw.findlaw.com/ri-supreme-court/1385835.html#sthash.0sXjyYJN.dpuf

State of Rhode Island, Actuarial Valuation Report for FYE June 30th 2013
http://content.ersri.org/actuarial-valuations-1/ersri-actuarial-valuations-1/#gsc.tab=0

State of Illinois, Commission on Government Forecasting and Accountability FY2015 Budget Summary, September 2014,
http://cgfa.ilga.gov/Upload/FY2015BudgetSummary.pdf

State of Illinois, Commission on Government Forecasting and Accountability Special November, 2014
http://cgfa.ilga.gov/Resource.aspx?id=1583

The State of Illinois Retirement Systems: Funding History and Reform Proposals, A Civic Federation Issue Brief. September 2008
http://www.civicfed.org/sites/default/files/civicfed_279.pdf

Lessons Learned from Financially Distressed Municipalities & Coming Attractions, Presentation by James Spiotto, Chapman Strategic Adviosrs, January 15th, 2015

State Constitutional Protections for Public Sector Retirement Benefits, National Conference on Public Employee Retirement Systems (NCPERS)
http://ncpers.org/Files/News/03152007RetireBenefitProtections.pdf

National Conference of State Legislators, Pension Research Database
http://www.ncsl.org/research/fiscal-policy/pensions.aspx

What are the Rhode Island Pension Reforms? A Civic Federation Brief, April 19th, 2012,
http://www.civicfed.org/iifs/blog/what-are-rhode-island-pension-reforms

Rhode Island Pension Reform: Two Years Later, A Civic Federation Brief, February 6th, 2014,
http://www.civicfed.org/iifs/blog/rhode-island-pension-reform-two-years-later

State of Illinois FY2016 Recommended Operating and Capital Budgets: Analysis and Recommendations, A Civic Federation Brief, May 7th, 2015
http://www.civicfed.org/iifs/publications/FY16_ILRecommendedBudget

Pace of Pension Reform Ebbs After 49 States Change Laws, Pension & Investments Magazine, April 14th, 2014, By Hazel Bradford
http://www.pionline.com/article/20140414/PRINT/304149975/pace-of-pension-reform-ebbs-after-49-states-change-laws

Illinois Pension Arguments Aired, The Bond Buyer, By Yvette Shields, March 11th, 2015
http://www.bondbuyer.com/news/regionalnews/illinois-pension-arguments-aired-1071279-1.html

Legislative Roadblock Goes Up on Ill. Gov.'s Pension Reforms, The Bond Buyer, By Yvette Shields, April 15th, 2015
http://www.bondbuyer.com/news/regionalnews/illinois-pension-arguments-aired-1071279-1.html

Emanuel hopeful Chicago pension reforms will survive even though state's didn't , Chicago Sun Times, By Fran Spielman, May 8th, 2015
http://chicago.suntimes.com/chicago-politics/7/71/589677/emanuel-hopeful-chicago-pension-reforms-will-survive-even-though-states-didnt

MUNICIPAL BOND SPECIALISTS