Lessons from the Edgar plan: why defined benefits can't work

Ted Dabrowski, Vice President of Policy

Introduction

One of the most common narratives regarding the pension crisis in Illinois is that the state's five pension systems are underfunded because politicians "skipped" pension payments. This narrative has prompted legislators to add to pension reform proposals a "funding guarantee" they say will prevent the pension crisis from repeating itself in the future.

However, the numbers tell a different story.

Overall the state – and by extension taxpayers – has actually paid $8 billion more into the pension funds than was required under laws passed in 1995. This extra funding occurred despite the Illinois General Assembly's two-year, $2.3 billion pension "holiday" in 2006.

Skipped payments are not the root cause of the state's nearly $100 billion in pension debt. The fault lies in the very nature of the state's defined benefit system: it's unmanageable, unaffordable and unpredictable.

The problem

The Securities and Exchange Commission's recent indictment of Illinois for securities fraud revealed the structural failures of Illinois' pension system and its irresponsible payment ramp.[1] The SEC critiqued the state's current pension scheme, often dubbed the "Edgar ramp" after the designer of the 1994 reform plan, former Gov. Jim Edgar:

> "The statutory plan structurally underfunded the state's pension obligations and backloaded the majority of pension contributions far into the future. This structure imposed significant stress on the pension systems and the state's ability to meet its competing obligations – a condition that worsened over time."

The SEC is the latest institution to condemn Illinois' pension system, following credit downgrades by both Standard & Poor's Ratings Services and Moody's Investors Service.[2]

Legislators are finally reacting to fiscal and political pressure by introducing various reform plans. Unfortunately, most "fixes" to emerge from Springfield retain the same defined benefit structure as the current system – and another payment ramp. The most prominent of these reforms is the Cross-Nekritz bill. It's the Edgar plan all over again.

Cross-Nekritz isn't reform; the bill doesn't alter the failures of the pension system or end the crisis. Rather, it indulges in the myth that skipped payments are the sole cause of the pension crisis and that a funding guarantee will solve the problem.

The state is destined to experience this same pension crisis in the near future unless it pushes for real reform.

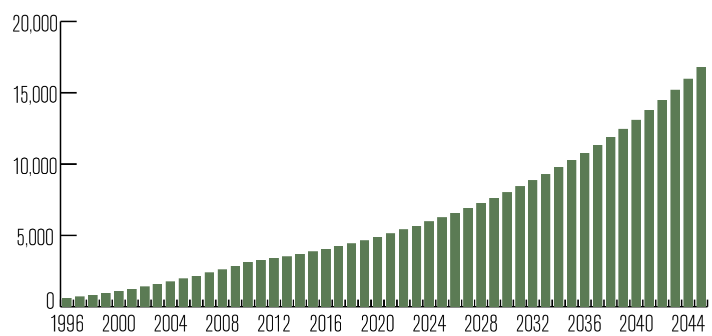
To understand why, it's important to recognize the failures of the Edgar plan.

The Edgar ramp

In 1994, then-Gov. Jim Edgar proposed the reform that was meant to end the state's pension crisis. The reform, which had bipartisan and government union support, aimed to reach a 90 percent funding target and to pay down the systems' unfunded pension liabilities, then at about $20 billion, by 2045.[3]

Edgar's payment "ramp" required the state, and by extension taxpayers, to pay ever-increasing contributions to the pension systems each year. The plan's first scheduled payment totaled $607 million in 1996 and ended with a $16.8 billion contribution in 2045.[4]

Graphic 1. The Edgar ramp: A plan with skyrocketing taxpayer pension payments Original 1996 projected employer contributions to all five state retirement systems (in millions of dollars)



Source: Commission on Government Forecasting and Accountability, Illinois Policy Institute.

By keeping state contributions low in the early years, the Edgar ramp took immediate pressure off of the budget. But in the long term, the ramp created problems by pushing billions in pension payments onto the backs of future generations. And just like the pre-housing crisis homebuyers who agreed to low initial payments on adjustable rate mortgages, Illinois has been suckered into an unsustainable situation.

Indeed, the state has already reached the point in the Edgar ramp where pension payments are becoming unaffordable.

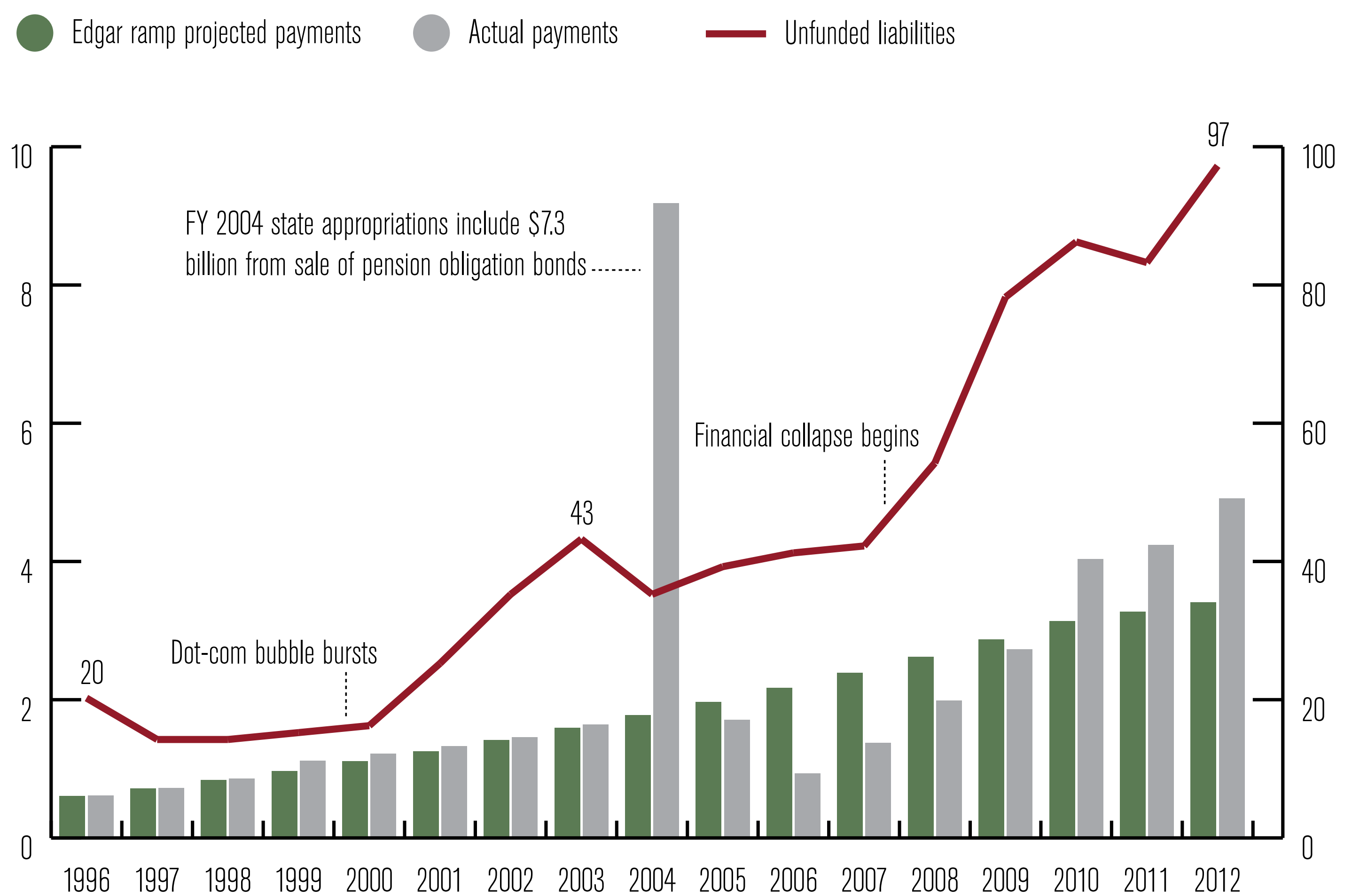
In fiscal year 2010, the state borrowed $3.5 billion to pay for pensions. The following fiscal year, the state borrowed $3.7 billion more. And in late 2011, the state passed a massive $7 billion income tax hike. Eighty cents of every dollar raised from that tax hike went to pay down pension liabilities.

The core problem: the defined benefit system

While it may be easy to place all the blame for the state's current pension woes on the Edgar ramp, it would be wrong to do so. The Edgar ramp is just a payment schedule; it is not actually responsible for the pension systems' skyrocketing unfunded liability. Instead, the flaws of the current defined benefit system are really at the core of the state's pension problems.

The result of those flaws is visible in the massive unfunded liability increase that has occurred since the Edgar plan was implemented in 1996. Graphic 2 shows that despite the state contributing $8 billion more into the pension systems than the Edgar ramp originally called for,[5] the unfunded liability grew by $76 billion over that time period.[6] Today the unfunded liability, at $97 billion, is nearly five times higher than it was in 1996.[7,8]

Graphic 2. Taxpayers contributed $8 billion more to pensions than required over 16-year period, but shortfall jumped by $76 billion* Annual state pension contributions and unfunded liability 1996 – 2012 (in billions of dollars)



**Increase not equal to $77 billion due to differences in COGFA reports.*
Source: Commission on Government Forecasting and Accountability, Illinois Policy Institute.

Illinois' politicians often get the blame for this increase, and certainly their unwillingness to address reforms has contributed. But in reality, it's the defined benefit system that's at the root of the pension crisis.

The flaws of the defined benefit system

Politicians can't manage defined benefit systems for the same reasons corporations can't – they're simply unmanageable. Nearly 85 percent of the private sector[9] already has abandoned these plans because of their unpredictability and instability.

And the problems of the defined benefit pension system are not unique to Illinois: state pension systems across the nation are underfunded by more than $2.5 trillion, while many municipalities are at the brink of insolvency.[10] It's a national crisis, and Illinois is the state with the largest problem.

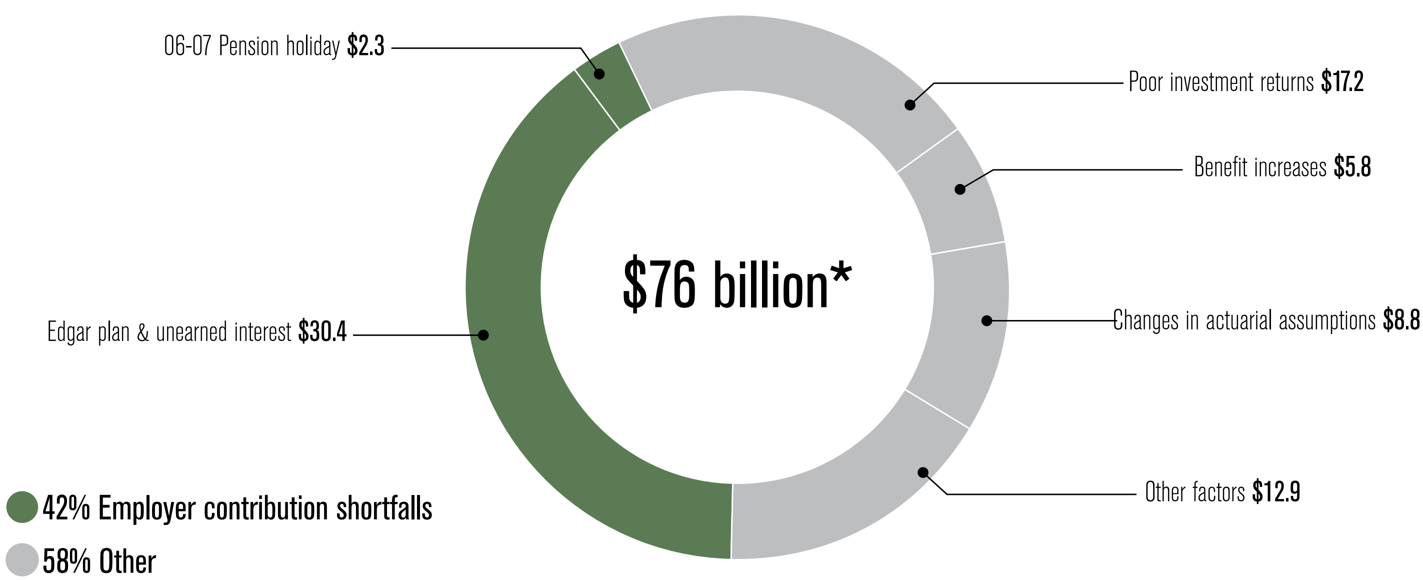
Defined benefit plans force governments to make promises to retirees based on assumptions politicians simply can't deliver. When those assumptions fail, the result is an underfunded pension system.

Here's why bureaucrats can't run a pension system:

1. **They can't predict what investment returns will be in the future – though they optimistically assume returns will average 8 percent a year.** Shortfalls in investment returns create massive holes in the pension funds. In fiscal year 2012 alone, near-zero investment returns increased the unfunded liability by more than $5 billion.[11]
2. **They have no idea how assumptions like mortality rates will change in the future.** People are living longer and collecting more benefits than originally planned for. Changed actuarial assumptions have increased the unfunded liability by nearly $9 billion since 1996.[12]
3. **Today's bureaucrats can't control what salary and benefit increases will be given away by future legislatures.** For example, in 2003 the Illinois General Assembly boosted benefits for government workers without putting additional funds into the systems to pay for them. That boost alone increased the unfunded liability by $2.4 billion.[13]
4. **It's difficult to predict the reasons for and amounts of future pension underfunding.** But once the unfunded liability starts snowballing, it becomes difficult to stop. Shortfalls in the pension system due to missed investment returns, poor actuarial assumptions, overly generous benefits and structural underpayments means the state also loses out on future investment income – it can't earn money on investments it doesn't have. With $97 billion missing from the pension fund investment pool, it costs the funds $21 million per day[14] – the result of foregone investment income. That means over an entire year, the state's underfunding will grow by more than $7.6 billion.

Faulty assumptions and a retirement system that politicians can't manage caused the state's jump in unfunded liabilities since the Edgar plan was implemented. Since 1996, the state's unfunded liability has increased nearly $80 billion. Graphic 3 shows that the majority of the growth in the unfunded liability came from factors unrelated to skipped payments or employer contribution shortfalls.

Graphic 3. Underfunding not the major cause of Illinois' unfunded pension liabilities
Nearly 60% due to flaws of defined benefit plans 1996-2012 (in billions of dollars)



**Salary increases less than assumed reduced the unfunded pension liability by $1.5 billion * Totals are for the state's five retirement systems*
**Increase not equal to $77 billion due to differences in COGFA reports. Source: The Commission on Government Forecasting and Accountability.*

The current pension structure has already required the state, and by extension taxpayers, to contribute 25 percent more to the state's pension systems than Edgar's original projections called for. While Edgar's ramp projected contributions of $32 billion from 1996 through 2012, taxpayers have put in more than $40 billion.[15]

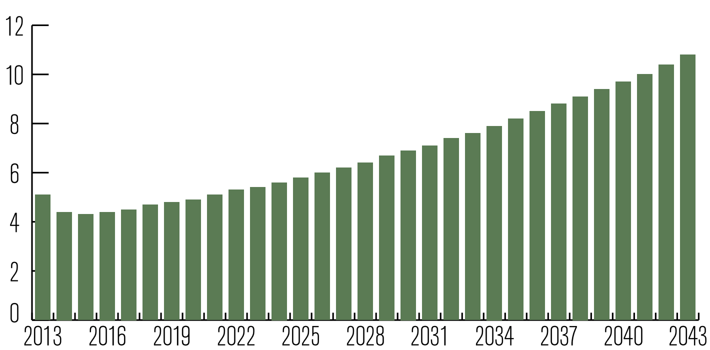
What is worse, current law projects that taxpayers will contribute nearly $105 billion more during 2014 to 2045 than the Edgar plan originally projected.[16] And that assumes the state actuaries get their assumptions right going forward. If not, those required payments will only go up, just as they've done in the past.

Illinois can't afford another failed reform

The Edgar reform was a failure because it made no changes to the fundamentally broken defined benefit system. Unfortunately, Cross-Nekritz, like so many other potential reform bills, keeps the defined benefit system at the core of its plan.[17] And the plan's proposed ramp, though less steep, follows the same pattern as the Edgar ramp. The bill essentially repeats the same structure that has failed the state for the past 20 years.

Graphic 4. The Cross-Nekritz plan – still centered on a payment ramp and defined benefit system*

Projected employer contributions to the three main state retirement systems 2013-2043 (in billions of dollars)



**Note: Numbers based on original Nekritz-Biss proposal*
Source: Commission on Government Forecasting and Accountability, Illinois Policy Institute.

The fundamental problems that plagued the Edgar reform plan are also inherent in the Cross-Nekritz plan.

That's why sponsors of the Cross-Nekritz plan can't guarantee that Illinois' unfunded liability won't grow uncontrollably in the near future. They can't promise investment returns won't fall short or that another market crisis won't occur. They can't be sure actuarial assumptions won't change the unfunded liabilities for the worse. And the plan's ramp means that if they are wrong, taxpayers will be making even larger payments in the future.

As long as the defined benefit model is the lynchpin of the state's retirement system, the pension plans unfunded liabilities will continue to grow just as they did under the Edgar plan.

Cross-Nekritz's new feature: The dangerous funding guarantee

There is an additional feature in the Cross-Nekritz bill that makes it more dangerous than the Edgar plan: a funding guarantee. A funding guarantee would force the state to put pension payments at the front of the line for state funding. Pensions for state workers would be prioritized over funding for education, Medicaid, public safety and all other core services. This would create a privileged class of beneficiaries at the expense of all other Illinoisans, especially the poor and disadvantaged, who are the first to lose when core services are cut.

A guarantee also could threaten future pension reform. The courts may interpret the funding guarantee as consideration for any benefit reforms passed in Cross-Nekritz, thereby prohibiting future reforms to key components of state pensions.

It's not a question of whether Illinois *should* fund the pension system; it's a question of whether or not it *can* fund the pension system. It is irresponsible for the state to guarantee an obligation over which it has no real control. It's like providing a blank check to politicians that taxpayers will have to pay going forward.

And as long as Illinois maintains the unaffordable, unpredictable and unmanageable defined benefit pension structure, Illinois' pension costs will remain uncontrollable.

The solution: A defined contribution plan for all future work

House Bill 3303, sponsored by state Reps., Tom Morrison (R-Palatine) and Jeanne Ives (R-Wheaton), promotes real reform by implementing a defined contribution model based on the 401(a) plans in the State Universities Retirement System, which already serves about 10,000 state workers. A defined contribution plan is the best option for both government workers and taxpayers.

Through the use of 401(k)-style plans for current workers, HB3303, while preserving benefits already earned, ends the defined benefit plan going forward and eliminates the irresponsible pension ramp. This plan manages to do that without resorting to a funding guarantee.

This reform plan cuts the pension system's unfunded liabilities by nearly half[18] and saves the state nearly $230 billion through 2045. HB 3303 is the only plan that keeps Illinois from repeating the failures of the past 20 years.

A defined contribution plan in Illinois means that:

- The unfunded liabilities will no longer grow uncontrollably as they do under a defined benefit system. In fact, no new and unmanageable defined benefit liabilities will be created in future years.
- Politicians will no longer have their hands in state worker retirements going forward. They won't have the ability to offer more pension sweeteners and end-of-career salary spikes, make more faulty investment assumptions or miss making payments to the pension funds.
- A funding guarantee, like the one proposed by Cross-Nekritz, is not needed. A better commitment to funding state worker retirements – one that can be seen in every paycheck – is an employer match in a defined contribution retirement savings plan.
- Taxpayers will no longer be responsible for continuously bailing out a failed defined benefit system.

This is the only proposal that ultimately solves Illinois' pension crisis. Ultimately, the reforms in HB 3303 can restore fiscal order to the state by eliminating unsustainable pensions and unfunded liabilities. This paves the way for the economy to flourish, fostering an environment where businesses can thrive and create the jobs Illinoisans need.

Conclusion: Illinois needs fundamental retirement reform

The myth that politicians underfunded the pension system is moving the debate in Springfield toward dangerous funding guarantees.

This is unfortunate, as the fault lies instead with the current defined benefit system, which is unpredictable, unaffordable and unmanageable.

As long as Illinois politicians continue to put forth plans like Cross-Nekritz, which perpetuate the flaws of the current system, the state's pension crisis will continue to deepen.

The fact is, only a fundamental transformation from the defined benefit model to a defined contribution plan will finally put an end to Illinois' pension problems.

[1] Ted Dabrowski, “SEC charges Illinois with securities fraud,” Illinois Policy Institute (March 15, 2013), http://illinoispolicy.org/blog/blog.asp?ArticleSource=5609.

[2] Ted Dabrowski, “Without real reforms, Illinois’ credit downgrades will just keep coming,” Illinois Policy Institute. (Jan. 28, 2013), http://illinoispolicy.org/blog/blog.asp?articlesource=5470.

[3] “Report on the 90% Funding Target of Public Act 88-0593,” Commission on Government Forecasting and Accountability (January 2006), http://cgfa.ilga.gov/Upload/Funding_PA_88-0593.pdf.
Paul Kersey, “Laying blame – union bosses also culpable for pension crisis,” Illinois Policy Institute (March 21, 2013), http://illinoispolicy.org/blog/blog.asp?ArticleSource=5647.

[4] Ibid.

[5] The 1996-2012 state pension contributions included additional funding derived from Gov. Rod Blagojevich’s FY 2004 $10 billion sale of pension obligation bonds. The bond sale, which burdened Illinois with additional long term debt, contributed $7.3 billion in additional funding to the pension systems in FY 2014.

[6] Jonathan Ingram, “Illinois pensions: a dangerous game of guesswork,” Illinois Policy Institute (Dec. 19, 2012), http://illinoispolicy.org/blog/blog.asp?ArticleSource=5360.

[7] $96.8 billion is COFGA’s calculated 2013 unfunded liability at market value without asset smoothing. COGFA’s also calculates unfunded liability at actuarial value with asset smoothing, which equals $94.6 billion.

[8] “Financial Condition of the Illinois State Retirement Systems,” Commission on Government Forecasting and Accountability (June 30, 2012), http://cgfa.ilga.gov/Upload/FinCondILStateRetirementSysFY2012Feb2013.pdf.

[9] “State and Local Government Pension Plans: Economic Downturn Spurs Efforts to Address Costs and Sustainability,” Government Accountability Office (March 2012), http://www.gao.gov/assets/590/589043.pdf.

[10] J. Scott Moody et al., “A federal bailout of state pensions systems will reward failure,” Illinois Policy Institute (Sept. 20, 2012), https://dl.dropboxusercontent.com/u/67671012/No_bailout.pdf.

[11] Jonathan Ingram, “Two of Illinois’ five pension systems lost money in 2012,” Illinois Policy Institute (Feb. 19, 2013), http://illinoispolicy.org/blog/blog.asp?ArticleSource=5546.

[12] “Financial Condition of the Illinois State Retirement Systems,” Commission on Government Forecasting and Accountability (June 30, 2012), http://cgfa.ilga.gov/Upload/FinCondILStateRetirementSysFY2012Feb2013.pdf.

“Report on the 90% Funding Target of Public Act 88-0593,” Commission on Government Forecasting and Accountability (January 2006), http://cgfa.ilga.gov/Upload/Funding_PA_88-0593.pdf.

[13] Ibid.

[14] Jonathan Ingram, “The Illinois pension pot: the less you put in, the less you earn,” Illinois Policy Institute (Dec. 27, 2012), http://illinoispolicy.org/blog/blog.asp?ArticleSource=5367.

[15] Jonathan Ingram, “Illinois pensions: a dangerous game of guesswork,” Illinois Policy Institute (Dec. 19, 2012), http://illinoispolicy.org/blog/blog.asp?ArticleSource=5360.

[16] “Financial Condition of the Illinois State Retirement Systems,” Commission on Government Forecasting and Accountability (June 30, 2012), http://cgfa.ilga.gov/Upload/FinCondILStateRetirementSysFY2012Feb2013.pdf.

“Report on the 90% Funding Target of Public Act 88-0593,” Commission on Government Forecasting and Accountability (January 2006), http://cgfa.ilga.gov/Upload/Funding_PA_88-0593.pdf.

[17] Actuarial valuations on impact of HB6258 prepared for Teachers’, Employees’ and Universities Retirement Systems, (December 2012)

[18] Data obtained from an extrapolation of Commission on Government Forecasting and Accountability’s (COGFA) scoring of the Illinois Policy Institute’s Teachers Retirement System (TRS) reform to include the other two main pension systems, the State Employees Retirement System (SERS) and the State Universities Retirement System (SURS).
Ted Dabrowski et al., “Budget Solutions 2014: Pension reform and responsible spending for state and local governments,” Illinois Policy Institute (March 13, 2013), http://illinoispolicy.org/blog/blog.asp?ArticleSource=5590.

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