Pension debt more than doubles under new rules

by Jonathan Ingram and Ted Dabrowski

The problem

Illinois reports that it owes $83 billion to its five public pension funds. That amount represents the chronic failure of the state to fully fund its pension systems, overly generous retirement benefits for state workers, and the inability of those funds to meet their investment targets. Unfortunately, this $83 billion figure grossly understates the pension crisis facing Illinois.

New reporting requirements by both the Governmental Accounting Standards Board and Moody's Investment Services reveal hundreds of billions more in state and local pension liabilities for pension and other retirement debt.

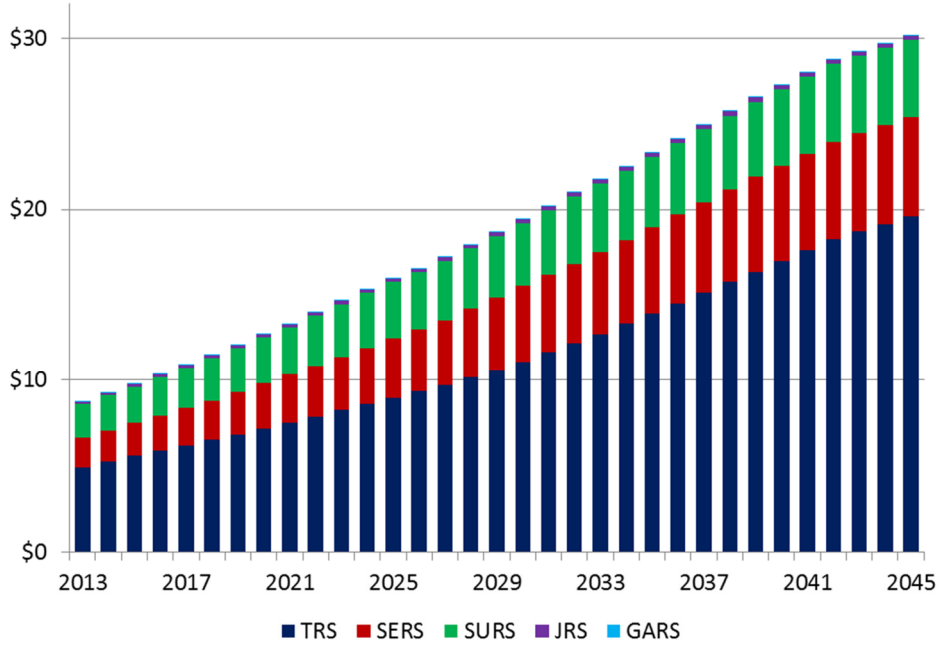
Pension payouts

The state's five pension funds officially report $146 billion in accrued liabilities for earned benefits.[1] But $146 billion is not the amount of money that the state will actually pay out for those benefits. Instead, $146 billion is the money that the state should have in the bank *today* to earn enough investment income to pay out earned benefits.

The amount of money the state will actually spend on pensions is far greater. Altogether, the state will pay more than $632 billion for pension benefits between now and 2045.[2]

Annual state pension payouts will more than triple

(in billions of dollars)



Source: Commission on Government Forecasting and Accountability

Investment targets

The state should have already set aside enough money so that the funds' assets can grow over time to cover the required payouts. Unfortunately, the state has only set aside $63 billion to pay for these future benefits.[3] Because the pension plans are so underfunded, they would need to see average investment returns of nearly 19 percent per year to cover future payouts.[4] The state predicts its pension funds will earn investment returns between 7 and 8.5 percent per year.[5] Even these returns may be overly optimistic.

Over the last decade, the pension funds have earned average investment returns of only 4.5 to 6 percent per year.[6] The funds' unrealistic investment targets have already increased the state's total pension debt by more than $14.3 billion since 1996.[7]

All five pension funds have underperformed investment targets

	Assumed Rate of Return	Actual 5-Year Average Return	Actual 10-Year Average Return
TRS	8.5%	4.1%	6.0%
SERS	7.75%	3.1%	4.5%
SURS	7.75%	5.3%	6.1%
JRS	7.0%	3.1%	4.5%
GARS	7.0%	3.1%	4.5%

Source: Governor's Office of Management and Budget

State and local governments all over the country have used inflated return predictions to hide billions of dollars of retirement debt. A recent report by Moody's Investment Services found that, using more realistic investment targets, state and local governments owe three times the total pension debt that they officially report.[8]

New reporting rules

In response to growing concerns over public pension debt, the Governmental Accounting Standards Board, GASB, and Moody's have both revised government reporting rules to make state and local governments acknowledge the real scope of their pension problems.

Under the new GASB rules, governments will be required to use more appropriate investment targets than most public pension plans have been using, bringing them more in line with accounting rules for private sector plans.[9] Pension plans can continue to use current investment targets for the amounts the plans are actually funded. But for the unfunded amounts, pension plans must use more reasonable investment forecasts, such as the yield on high-grade municipal bonds, currently between 3 and 4 percent.[10] Under these new rules, the five pension funds will see their combined unfunded liabilities more than double.[11-12]

Moody's has also proposed new rules to require states to use more appropriate investment targets.[13] The new rules require pension plans to use investment targets based on the yield of high-grade, long-term corporate bonds, currently just over 4 percent.[14-15] Under Moody's new reporting rules, the five pensions funds will see their combined unfunded liabilities grow to more than $200 billion.[16]

State's unfunded pension debt will grow to more than $200 billion under new reporting rules

	Unfunded liability as currently reported	Unfunded liability under Moody's
TRS	$43.5 billion	$120.6 billion
SERS	$20.2 billion	$46.2 billion
SURS	$17.6 billion	$39.3 billion
JRS	$1.3 billion	$2.6 billion
GARS	$0.2 billion	$0.4 billion
Combined	**$82.9 billion**	**$209.0 billion**

Source: Commission on Government Forecasting and Accountability; Illinois Policy Institute

New reporting rules show the state's funded ratios are much lower than reported

	Funded ratio as currently reported	Funded ratio under Moody's
TRS	46.5%	24.3%
SERS	35.5%	20.2%
SURS	44.3%	26.5%
JRS	31.5%	19.1%
GARS	21.2%	13.6%
Combined	**43.4%**	**23.8%**

Source: Commission on Government Forecasting and Accountability; Illinois Policy Institute

More to retirement debt than just state pensions

State and local taxpayers are on the hook for far more than the pension debt owed by the state's five pension funds. The state also owes $54 billion in unfunded retiree health benefits and another $15 billion the state borrowed to make its annual pension payments and shore up investment losses.[17]

Taxpayers are also on the hook for at least $50.9 billion in local retirement debt. Like the state's pension plans, local pension funds will see their unfunded liabilities skyrocket under the new reporting rules. Under the new GASB rules, for example, the pension fund for Chicago Teachers would see its pension debt grow to $20 billion, nearly four times the $5.4 billion it officially reports.[18-19]

Our solution

Pension reform cannot merely tinker at the margins. If Illinois is ever to get its fiscal house in order, serious long-term changes are needed to the structure, incentives and accountability within government retirement systems. Any serious solution to Illinois' pension crisis must:

Move to defined contribution plans for future work

Each year of service means additional pension benefits – but state and local governments cannot afford to keep awarding benefits as currently structured. Pensions should be frozen at their current levels, and future retirement savings should be structured differently.

The only sustainable solution is one heavily centered on defined contribution plans, similar to the 401(k) plans used in the private sector.

Freeze cost-of-living increases for all retirees

Most Illinois government pensioners receive a 3 percent compounded, annual increase to their pensions. This cost-of-living adjustment, or COLA, becomes an automatic raise, provided at taxpayer expense. The COLA, as currently structured, doubles the annual value of a pension over 25 years, making pensions even more unaffordable.

State lawmakers recognized this fact when they enacted changes to pension COLAs for future employees, or "Tier 2" employees, reducing the COLA to one-half of the inflation rate or 3 percent, whichever is lower.

Given the severity of the crisis, all COLAs should be frozen until the pension funds are sufficiently funded. Thereafter, the COLA formula should be restructured in line with inflation and actual pension fund returns.

Raise retirement age for future retirees

Workers are living longer and the labor force's demographics are changing, meaning that retired workers are collecting more retirement benefits for longer periods than in the past. State lawmakers recognized the need for increasing the retirement age when they enacted changes to the pension program for Tier 2 employees.

The retirement age was raised to 67 for all Tier 2 employees. Further pension reforms should adopt similar requirements for those not covered under Tier 2, while protecting near-retirees.

Why this works

Tinkering at the margins, as some pension reform proposals would do, cannot solve the state's retirement debt crisis. The state has already tried to tax and borrow its way out of its pension debt, failing disastrously. The only way to rescue the finances of state and local governments is to dramatically reform the structure, incentives and accountability within Illinois' government retirement systems.

Government employees were promised security in retirement. The financial picture of Illinois' pension funds tells a difficult story: their retirements are deeply in danger. If lawmakers act swiftly, it is possible to maintain a reasonable system of benefits for government retirees. If lawmakers fail to act, the retirement systems could become insolvent. The longer the state waits to reform its massive retirement debt problem, the more likely the state will fail to meet its obligations to government retirees.

Endnotes

[1] *Gregg Scott, "A report on the financial condition of the IL state retirement systems," Commission on Government Forecasting and Accountability (2012), http://www.ilga.gov/commission/cgfa2006/Upload/FinCondILStateRetirementSysFY%202011Mar2012.pdf.*

[2] *Gregg Scott, "A report on the financial condition of the IL state retirement systems," Commission on Government Forecasting and Accountability (2012), http://www.ilga.gov/commission/cgfa2006/Upload/FinCondILStateRetirementSysFY%202011Mar2012.pdf.*

[3] *Gregg Scott, "A report on the financial condition of the IL state retirement systems," Commission on Government Forecasting and Accountability (2012), http://www.ilga.gov/commission/cgfa2006/Upload/FinCondILStateRetirementSysFY%202011Mar2012.pdf.*

[4] *Authors' calculations based upon current market assets and future payouts as reported by the Commission on Government Forecasting and Accountability.*

[5] *The Teachers' Retirement System predicts 8.5 percent annual returns. The State Employees' Retirement System and State Universities Retirement System predict 7.75 percent annual returns. The Judges' Retirement System and General Assembly Retirement System predict 7 percent annual returns.*

[6] *David Vaught et al., "Official notice of bond sale and bid form," Governor's Office of Management and Budget (2012), https://client.schwab.com/FIDocProvider/668605_Pos.pdf.*

[7] *Gregg Scott, "A report on the financial condition of the IL state retirement systems," Commission on Government Forecasting and Accountability (2012), http://www.ilga.gov/commission/cgfa2006/Upload/FinCondILStateRetirementSysFY%202011Mar2012.pdf.*

[8] *Moody's Global Credit Research, "Moody's proposes adjustments to US public sector pension data," Moody's Investors Service (2012), http://www.moodys.com/research/Moodys-proposes-adjustments-to-US-public-sector-pension-data--PR_249988.*

[9] *Governmental Accounting Standards Board, "Statement No. 68 of the Governmental Accounting Standards Board: Accounting and Financial Reporting for Pensions," Financial Accounting Foundations (2012), http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160220621.*

[10] *The current yield on 20 year tax-free municipal bonds rated AA is 3.45 percent. See, e.g., FMSbonds, "Bond Market Yields," FMS Bonds, Inc. (2012), http://www.fmsbonds.com/Market_Yields/index.asp.*

[11] *Authors' calculations based upon estimated fiscal year 2013 assets and future payouts for fiscal years 2013-2042. Under these new rules, Illinois' five pension systems could see their unfunded liabilities grow to a whopping $190 billion in fiscal year 2013.*

[12] *Had the new GASB rules been in effect in fiscal year 2010, Illinois' three largest public pension systems would have seen their unfunded liabilities total more than $183 billion, compared to the $74.3 billion officially reported for those three systems. See, e.g., Jonathan Ingram, "Retirement debt: It's worse than you imagined," Illinois Policy Institute (2012), http://illinoispolicy.org/blog/blog.asp?ArticleSource=4930. See also Alicia H. Munnell et al., "How would GASB proposals affect state and local pension reporting?" Center for Retirement Research at Boston College (2012), http://crr.bc.edu/wp-content/uploads/2012/06/wp_2012-17-508.pdf.*

[13] *Moody's Global Credit Research, "Adjustments to US State and Local Government Reported Pension Data," Moody's Investors Service (2012), http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_PBM143254.*

[14] *Moody's proposes to use Citigroup's Pension Discount Curve and Liability Index, which is based on high-quality corporate bonds, to set public pension investment targets. This target is to be set by averaging the May, June and July discount rates. In fiscal years 2010 and 2011, the investment target would have been roughly 5.5 percent. See, e.g., Moody's Global Credit Research, "Adjustments to US State and Local Government Reported Pension Data," Moody's Investors Service (2012), http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_PBM143254.*

[15] *The average May, June and July discount rates in Citigroup's Pension Discount Curve and Liability Index would set the fiscal year 2012 investment target at 4.1 percent. See, e.g., Citigroup Pension Risk Analysis Group, "Citigroup's Pension Discount Curve and Liability Index," Citigroup Global Capital Markets (2012), http://www.soa.org/Files/Xls/pen-discount-curve.xls.*

[16] *Authors' calculations based upon estimated fiscal year 2013 assets, future payouts for fiscal years 2013-2042 and a revised discount rate of 4.1 percent.*

[17] *Collin Hitt et al., "$203 billion and counting: Total debt for state and local retirement benefits in Illinois," Illinois Policy Institute (2012), https://dl.dropbox.com/u/67671012/203_billion.pdf.*

[18] *Jonathan Ingram, "Retirement debt: It's worse than you imagined," Illinois Policy Institute (2012), http://illinoispolicy.org/blog/blog.asp?ArticleSource=4930.*

[19] *Alicia H. Munnell et al., "How would GASB proposals affect state and local pension reporting?" Center for Retirement Research at Boston College (2012), http://crr.bc.edu/wp-content/uploads/2012/06/wp_2012-17-508.pdf.*

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