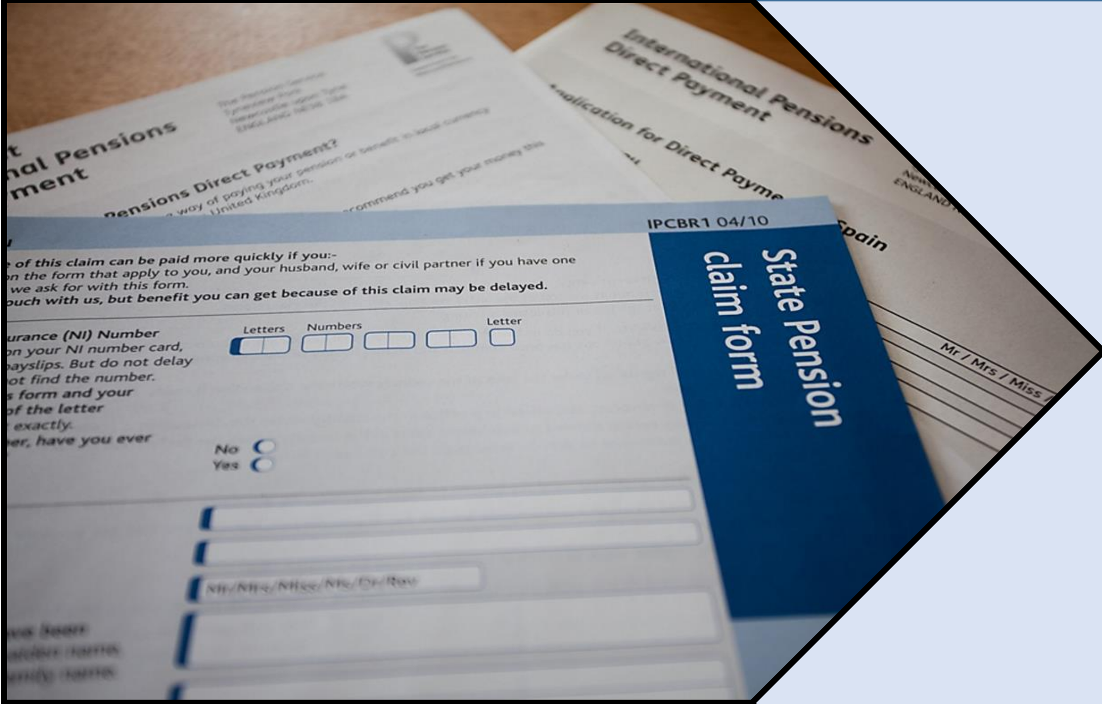


Illinois’ Two-Headed Beast:

Unfunded Pension Liabilities and Unfunded Infrastructure Needs

December 28, 2016

A Higher Road for a Better Tomorrow
ILLINOIS ECONOMIC POLICY INSTITUTE
ILEPI

Illinois' Two-Headed Beast:

Unfunded Pension Liabilities and Unfunded Infrastructure Needs

By: Mira Staykova & Frank Manzo IV, MPP

Report Summary

It is no secret that Illinois faces significant financial challenges.

Unfunded Pensions: Illinois now has $130 billion in unfunded pension liabilities. Without a change to the state's Constitution, the State will have to increase revenue by $3.03 billion annually to cover pension contributions over the next decade and beyond.

Unfunded Infrastructure: Illinois' transportation and water infrastructure deficit is nearly just as bad. Without a change in federal funding, the State will have to increase revenue by $2.75 billion annually to maintain and modernize its infrastructure over the next decade and beyond.

Sacrifices Must Be Made: Illinois must tackle its two-headed pension and infrastructure beast. The benefits exceed the costs of kicking the can farther down the road. The costs of continued inaction are economic stagnation, further job and population loss, credit rating downgrades, threats to public safety, increased environmental risks, and cuts to public education. Making necessary sacrifices today would improve Illinois' credit rating, save jobs, create new opportunities through public investments, and improve the economic prospects of the state.

Illinois' politicians must have the political courage to take actions that are in best interest of the state over the long run.

Introduction

It is no secret that Illinois faces significant financial challenges. While recent impasses have claimed the headlines, Illinois' financial issues have been compounded by decades of poor decision-making and mismanagement. The primary contributor to Illinois' deficits and debts is its massive unfunded pension liability. As pension benefits increased with inflation and economic growth, state politicians put off annual payments and miscalculated funding needs, kicking the financial can down the road. Today, fiscal strain paired with historic political polarization have fostered a broken system in which political parties have struggled to reach across the aisle to agree on a way forward.

Illinois' financial challenges have broad impacts on the state. Without a budget for all of FY2015, Illinois social services and educational institutions were among the hardest hit by recent budget problems. The Illinois Economic Policy Institute (ILEPI) recently outlined some of the consequences that the budget impasse had on Illinois residents who rely on these essential services (Staykova, 2016). Without a mix of raising sustainable revenue and making necessary cuts, Illinois will be left to regurgitate Band-Aid stopgap budgets which can exacerbate, rather than resolve, fundamental problems.

In recent short-term "fixes," legislators have swept and diverted money from Illinois' transportation infrastructure funds. Since 2002, lawmakers have diverted about $6.8 billion from transportation funds (Manzo, 2016a). Politicians have created new potholes in the state's roads in their attempts to close other unnecessary budget holes. These transportation and infrastructure funds, however, have also been historically underfunded. In fact, previous underinvestment and diversions have resulted in a massive infrastructure deficit that parallels the pension deficit in Illinois.

This Illinois Economic Policy Institute (ILEPI) Policy Brief contrasts the unfunded pension liability with the unfunded infrastructure liability in Illinois. The report begins with the pension problem and its consequences before investigating infrastructure underinvestment and future needs. The scope of each crisis is then compared. A hypothetical revenue-side solution to both problems is subsequently presented before a concluding section recaps key findings.

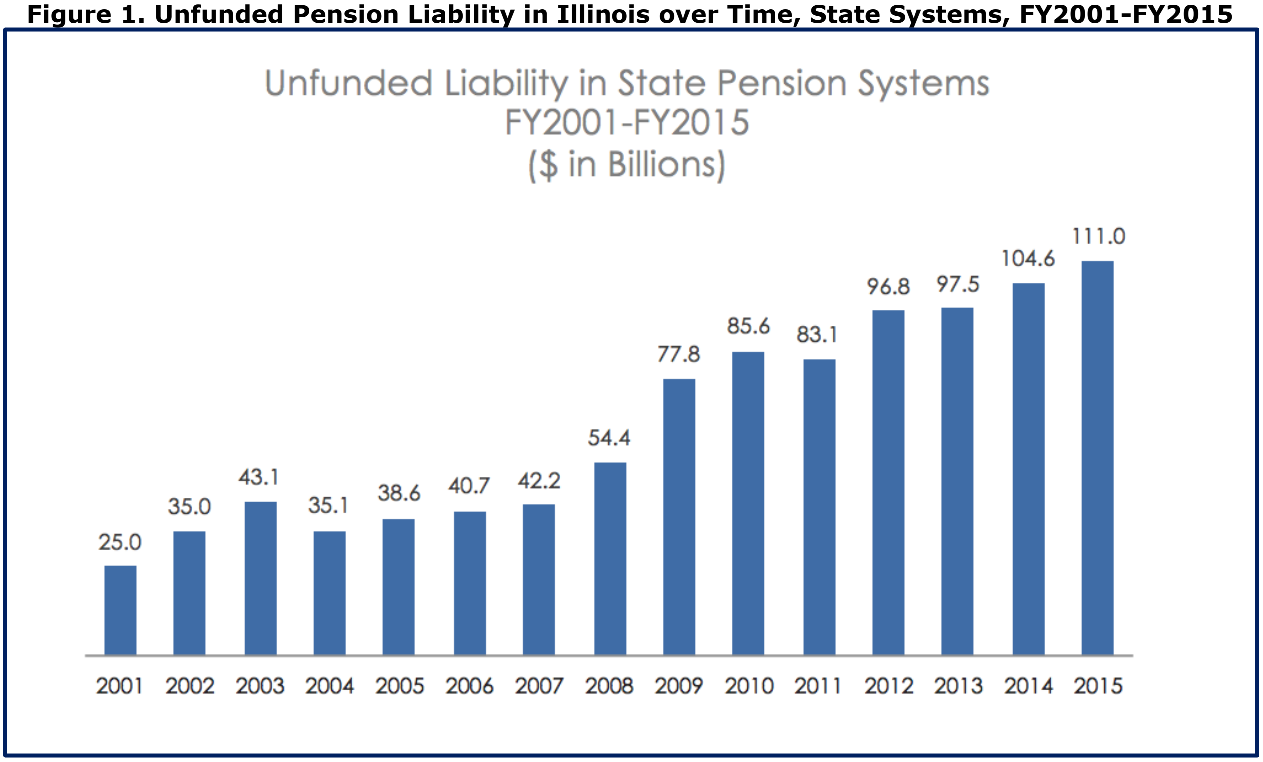
The Pension Problem at a Glance

The five state-funded pension systems cover teachers (TRS), state employees (SERS), state universities (SURS), judges (JRS), and the General Assembly (GARS). All accrued and future retirement benefits promised to these workers are protected by Article XIII, Section 5 of the Illinois Constitution. Economic theory says that a rational individual will consider all forms of expected compensation in his or her decision to accept one job over another. Without this protection, many qualified workers might have taken another position in the private or nonprofit sector, which may have resulted in lower-quality workers in important public safety and social service positions. On the other hand, the non-accrued benefits guarantee in the constitution limits the financial flexibility of the State. After decades of pushing pension responsibility further and further into the future, many analysts and politicians believe that reducing future benefits for current workers would help solve the pension crisis. These changes, however, cannot be taken under current law.

Concerns about pension underfunding date back to the 1950s. A 1959 report by the Illinois Public Employees Pension Laws Commission, for example, warned of "the accumulation of large unfunded accrued liabilities resulting for the most part from the inadequacy of government contributions in prior years to meet increases in costs due to the upward trend in salary rates and large additions to the membership of the funds" (*The State Journal-Register*, 2013). Despite these warnings, Illinois' pension problem has been exacerbated over time.

In 2015, the Center on Government Forecasting and Accountability (COGFA) reported that Illinois had $111 billion in unfunded liabilities for state pension systems (Figure 1). That estimate is now up to $130 billion (COGFA, 2016). COGFA identifies the main culprit of unfunded liabilities to be the lack of proper contributions from the State (COGFA, 2015). For years, Illinois lawmakers have funneled money into existing programs while failing to make necessary pension payments because pension payments are not as politically rewarding before the next election cycle.

Figure 1. Unfunded Pension Liability in Illinois over Time, State Systems, FY2001-FY2015



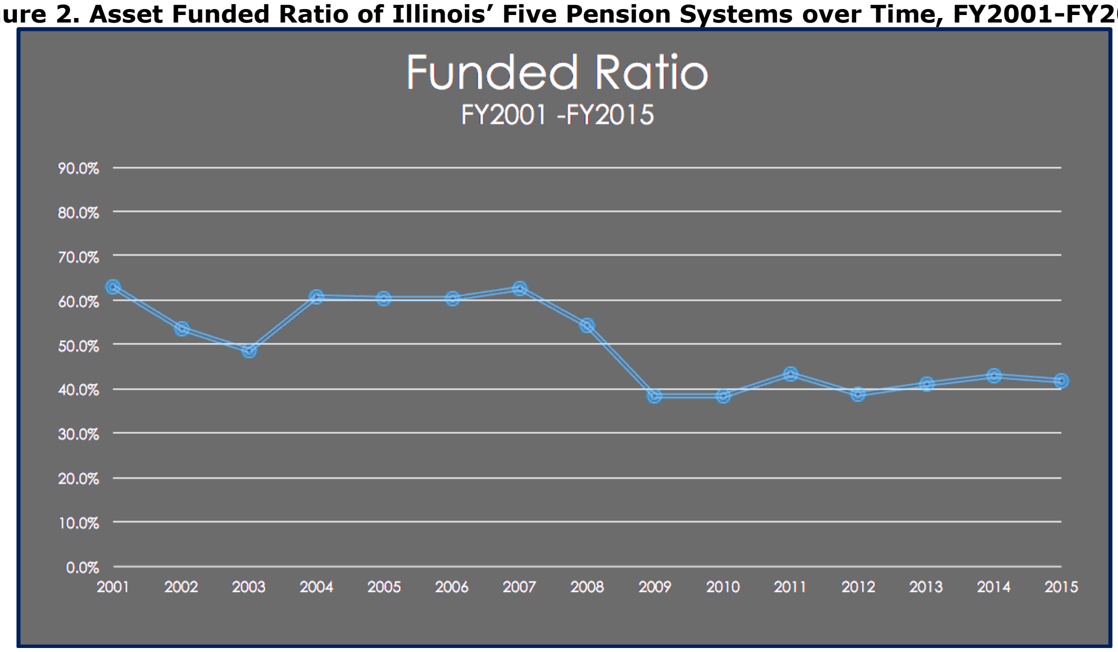
Source(s): COFGA, 2015.

The problem of inadequate government contributions was multiplied by benefit increases in 1989. Changes made by Republican Governor Jim Thompson allowed for 3 percent compounded cost-of-living adjustments (COLAs) annually instead of the 3 percent simple adjustment, which intensified the current problem without the State paying its contractual share (*Reboot Illinois*, 2015). Additionally, actuarial expectations for a 2002 early retirement plan proved out-of-whack when more workers opted to retire at a younger age with high benefits than expected. While this initially decreased payroll costs for the State, the shortsightedness resulted in pension costs that are four times higher than anticipated (Wheeler, 2010; *Crain's Chicago Business*, 2015).

Former Republican Governor Jim Edgar proposed a 50-year plan to achieve financial solvency for Illinois' pension systems in 1995. The plan, referred to as the "Edgar Ramp," moved State payments into the future by increasing the contributions over time until State assets covered 90 percent of the pension liabilities (COGFA, 2006). The ramping up of pension payments started in 2011. While the 90 percent funded ratio is achievable, the payments made in the first 15 years– before ramp increases– were insufficient. Former Democratic Governor Rod Blagojevich, for example, passed legislation that allowed the State to skip out on pension payments in 2006 and 2007. These "pension holidays" during good economic years intensified the problem. As shown in Figure 2, the funded ratio dropped significantly after FY2007. Illinois' funded ratio has hovered at around 40 percent since FY2009.

This substandard funded ratio has resulted in downgrades to Illinois' credit ratings. Illinois has had the lowest Standard & Poor's (S&P) credit rating in the nation because analyst view "the state's weakened pension funded ratios and lack of action on reform measures" as significant challenges (Malm, 2013). A poor credit rating dramatically increases borrowing costs, making it harder for Illinois to repay pension obligations and invest in future needs.

Figure 2. Asset Funded Ratio of Illinois' Five Pension Systems over Time, FY2001-FY2015



Source(s): COGFA, 2015.

In 2013, Democratic Governor Pat Quinn signed a new pension reform bill that would have cut back benefits and increased state contributions. The plan would have increased the retirement age, ended compounded COLAs, and limited the salary average on which worker pensions were based (*Crain's Chicago Business*, 2015; *Reuters*, 2015). While this plan would have saved the State $160 billion over 40 years, the Illinois Supreme Court ruled that it was unconstitutional based on the Pension Clause.

Today, the required FY2016 payment of $7.6 billion now amounts to almost one-fourth of the State's General Fund (*Crain's Chicago Business*, 2015; COGFA, 2006). Pension payments increasingly demand a larger portion of state funds at the expense of resources for other vital public services, such as education, infrastructure, and public safety. During his campaign, current Republican Governor Bruce Rauner promised "a new pension structure." His proposals to curb worker rights, however, have fostered a culture of distrust in which political compromise on pension reform has become unlikely.

The Infrastructure Deficit at a Glance

Modern, reliable infrastructure systems are necessary to ensure Illinois' economic viability and growth. The state is a hub of national transportation and commerce. Illinois has the third-largest road network and bridge inventory in the nation and is the only state in the nation that is served by all Class 1 railroads (IDOT, 2015). Instead of capitalizing on Illinois' strategic locational advantages, the State has significantly underfunded infrastructure investment, resulting in deteriorating roads, bridges, and public transit systems. The Illinois Section of the American Society of Civil Engineers (ISASCE) gives the state's infrastructure a "C-" grade (ILASCE, 2014). The Report Card assess conditions of nine infrastructure systems in the state: aviation, dams, inland waterways, drinking water, wastewater, transit, rail, roads, and bridges. While all systems are considered subpar, inland waterways, roads, transit, and wastewater received the lowest grades.

Illinois' waterways carry commodities valued at around $23 billion every year, an extremely valuable asset to the Illinois economy. However, these waterways are threatened by lock and dam systems that have exceeded their 50-year life spans and are in dire need of repair and maintenance. Inadequate waterways cause losses for farmers, transportation and logistics firms, local workers, and the tourist industry. For example, a 2003 Illinois Farm Bureau analysis estimated that delays at locks cost Midwestern farmers $100 million every year (ILASCE, 2014A).

Currently, 42 percent of Illinois' major roads are in poor condition. Unacceptable road conditions due to insufficient funding place back-end costs onto drivers and residents in the form of added vehicle repairs, congestion delays, and higher-priced goods and services. As examples, vehicle crashes cost Illinois drivers $3.7 billion a year and freight congestion annually costs the state $9.2 billion (ILASCE, 2014). The lack of state funding shifts costs onto residents while threatening their safety.

Mass transit also plays an extremely important role in Illinois' economic and social well-being. An efficient and well-maintained public transportation system decreases congestion, reduces pollution, and improves access to jobs– especially for underserved communities in the state. Transit use increased by 5 percent from 2010 through 2014, but public transportation systems have experienced significant underfunding with very little revenue growth to address current and future needs (ILASCE, 2014).

Illinois' wastewater systems also received an extremely poor ASCE grade. Proper treatment and care of water is essential to sustaining a healthy, productive population and a clean environment. Wastewater pipes typically have lifespans of 15 to 100 years; yet most of Illinois' systems currently servicing households and businesses are over 100 years old (ILASCE, 2014). As of April 2016, there were 117 wastewater systems on the Illinois

Environmental Protection Agency's (IEPA) "restricted status" list and 14 on the "critical review" list due to environmental violations (IEPA, 2016). The IEPA estimates that it will take $17.5 billion over the next 20 years to properly repair and build new wastewater systems in the state (ILASCE, 2014).

On the one hand, Illinois' "C+" grade from the American Society of Civil Engineers is a slight improvement on its previous (2010) grade of "D+." The upgrade is a reflection of the positive impact that better investments have had on the quality of the state's infrastructure, such as the Illinois Jobs Now! capital program. On the other hand, much more needs to be done in order to maintain, improve, and expand Illinois' infrastructure systems. Illinois can no longer afford to allow infrastructure systems to degrade at the expense of public safety and wellbeing. Finding stable, reliable, and sustainable funding sources is vital to that mission. Shrinking the State's pension debt to improve its credit rating and lower borrowing costs to invest in future infrastructure is also necessary.

Pension Underfunding vs. Infrastructure Underfunding

The scope of the pension crisis is well understood by financial analysts. Under the current 40-year plan to improve the funded ratio to 90 percent, the required total state contribution will increase every year until 2045. To stay on track and reduce pension debt, the State will need to make $7.91 billion in payments to the five state pension programs this year and $9.71 billion on average over the next ten years (Figure 3). By contrast, over the last fiscal year (FY2016), the State contributed $6.68 billion from the General Fund and $934 million from other sources– including Pension Obligation Bonds. To cover pension payments over the next decade without issuing more bonds, the State will need to generate at least **$3.03 billion** in additional annual revenue.

Figure 3. Funding Projections for Illinois' Five Retirement Systems, $ in Billions, FY2017-FY2026

Fiscal Year	State Contribution ($ in Billions)	Funded Ratio
2017	$7.909	39.7%
2018	$8.905	40.3%
2019	$9.048	40.3%
2020	$9.308	40.6%
2021	$9.662	41.4%
2022	$9.975	42.3%
2023	$10.215	43.1%
2024	$10.442	44.0%
2025	$10.681	44.9%
2026	$10.960	45.7%
Average	**$9.711**	**--**

Sources: COFGA, 2016.

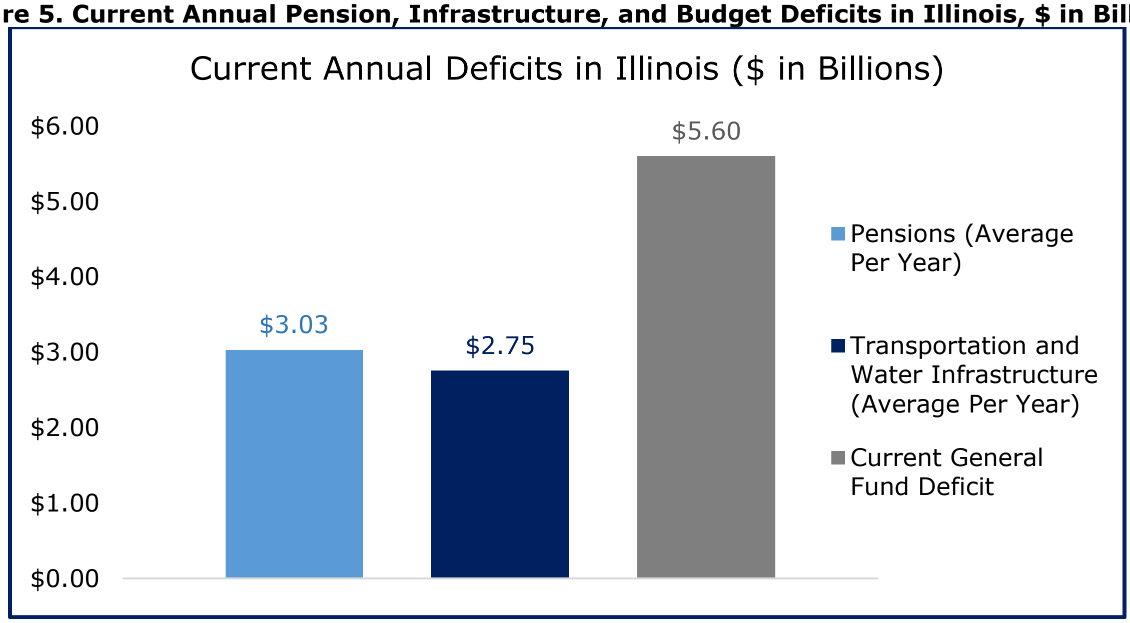
The scope of Illinois' infrastructure crisis is more difficult to ascertain because there are multiple systems with different funding sources. However, the State Budget Crisis Task Force has forecast state infrastructure *needs* of about $300 billion over the next 30 years in order to maintain and improve current systems. Figure 4 breaks down the State Budget Crisis Task Force's estimates based on Illinois agency reports. Tollway needs have increased from $12.1 billion over 15 years to $14.3 billion over 5 years based on the Illinois Department of Transportation's Highway Improvement Program (ILASCE, 2014). Furthermore, the Regional Transportation Authority (RTA), which is included in the mass transit estimates, increased its projected $24.1 billion need to $36.1 billion over 10 years to account for backlog investment (RTA, 2014).

Figure 4. Illinois' Infrastructure Needs and Annual Spending in Current Dollars, $ in Billions

Type of Infrastructure	Need ($ in Billions)	Timeline In Years	Average Need Per Year ($ in Billions)	Current Annual Spending ($ in Billions)	Current Annual Deficit ($ in Billions)
Roads and Bridges	$171.4	30 years	$5.713	$5.399	-$0.314
Toll Highways	$14.3	10 years	$2.860	$1.404	-$1.456
Freight Rail	$1.7	30 years	$0.057	$0.025	-$0.031
Mass Transit	$64.7	30 years	$2.157	$1.292	-$0.865
Water Infrastructure	$36.50	20 years	$1.825	$1.738	-$0.087
Totals	**$288.60**	**Variable**	**$12.612**	**$9.858**	**-$2.754**

Sources: Civic Federation, 2012; State Budget Crisis Task Force, 2012; IDOT, 2014; Illinois Tollway, 2016; RTA, 2013; Manzo & Bruno, 2016.

Figure 5. Current Annual Pension, Infrastructure, and Budget Deficits in Illinois, $ in Billions



Source(s): COFGA, 2016; Figure 4 (above); Civic Federation, 2016.

Each type of infrastructure is currently underfunded in Illinois (Figure 4). Comparing the average infrastructure need per year to current levels of annual spending reveals that roads, bridges, and tollways are underfunded by about $1.8 billion per year. Mass transit and freight rail systems face a combined annual deficit of $896 million and drinking water and wastewater infrastructure is underfunded by about $87 million every year. In total, the state's transportation and water infrastructure systems alone require $12.61 billion per year to maintain and achieve adequate conditions but only receive 9.86 billion in funding, a **$2.75 billion** annual deficit.

Figure 5 summarizes the annual deficits for pensions, infrastructure, and the General Fund. The State of Illinois faces a $3.03 billion gap in pension contributions compared to its current payment level. The annual deficit in transportation and water infrastructure nearly just as bad, at $2.75 billion. These pension and infrastructure deficits are *in addition to* the projected $5.60 billion budget deficit in the General Fund. Thus, to pay off pensions, invest properly in infrastructure, and continue to pay for essential public services, the State needs **$11.38 billion** in additional annual revenue.

Conclusion

Illinois must tackle its two-headed pension and infrastructure beast. The costs of continued inaction are economic stagnation, further job and population loss, threats to public safety, increased environmental risks, and cuts to essential government functions such as public education.

The annual infrastructure deficit is nearly as bad as the pension problem in Illinois. Without a significant change to the Illinois Constitution, the State of Illinois will have to raise at least $3.03 billion in average annual funding to cover pension costs over the next 10 years. Additionally, without a significant change in federal funding, the State will have to come up with $2.75 billion in annual funding to maintain and modernize its transportation and water infrastructure. If Illinois continues to underfund both pensions and infrastructure, current problems will only compound– resulting in credit rating downgrades, even higher taxes in the future, more potholes, more traffic accidents, higher auto repair costs, and increased risk of bridge collapses.

Illinois' politicians must have the political courage to take actions that are in best interest of the state over the long run. Making necessary sacrifices today would improve Illinois' credit rating, save jobs, create new opportunities through public investments, and improve the economic prospects of the state. These sacrifices must include both spending cuts and revenue-side policy changes.

References

COGFA. (2016). *Special Pension Briefing: November 2016*. Illinois Commission on Government Forecasting and Accountability.

COGFA. (2015). *Illinois State Retirement Systems: Financial Condition as of June 30, 2015*. Illinois Commission on Government Forecasting and Accountability.

COGFA. (2006). *Report on the 90% Funding Target of Public Act 88-0593*. Illinois Commission on Government Forecasting and Accountability.

Civic Federation. (2016). *State of Illinois FY2017 Budget Roadmap: State of Illinois Budget Overview, Projections and Recommendations for the Governor and the Illinois General Assembly*. The Institute for Illinois' Fiscal Sustainability at the Civic Federation.

Civic Federation. (2012). *The State of Illinois Infrastructure*. The Institute for Illinois' Fiscal Sustainability at the Civic Federation.

Crain's Chicago Business. (2015). *The Illinois Pension Disaster: What Went Wrong?* Report by Dave McKinney.

IDOT. (2015). *IDOT Annual Report: 2015*. Illinois Department of Transportation.

IDOT. (2014). *State of Illinois Department of Transportation Financial Audit For the Year Ended June 30, 2014*. Illinois Department of Transportation

IEPA. (2016). "Restricted Status / Critical Review Combined List." Illinois Environmental Protection Agency Division of Public Water Supplies.

Illinois Tollway. (2016). *2016 Budget Book*. Illinois State Toll Highway Authority. Note: the Illinois Tollway website was updated in the process of writing this report and the original link was broken.

ISASCE. (2014). *2014 Report Card for Illinois Infrastructure.* American Society of Civil Engineers – Illinois Section.

Malm, Liz. (2013). "Monday Map: State Credit Ratings." Tax Foundation.

Manzo IV, Frank. (2016). (a). *Better Roads Ahead: Vote YES on the Illinois Transportation Funds Amendment*. Illinois Economic Policy Institute.

Reboot Illinois. (2015). "Rewind to 1989: Ignoring Warning, Lawmakers Put Illinois Pension Debt on Fast Track." Written by Matt Dietrich.

Reuters. (2015). "UPDATE 3-Illinois Supreme Court Overturns State's 2013 Pension Reform Law."

RTA. (2014). *Capital Asset Condition Assessment Report: December 2014*. Regional Transportation Authority.

RTA. (2013). *Comprehensive Annual Financial Report: 2013 CAFR*. Regional Transportation Authority.

State Budget Crisis Task Force. (2012). *Illinois Report*. Prepared by the Institute of Government and Public Affairs at the University of Illinois for the MacArthur Foundation.

The State Journal-Register. (2013). "State of Illinois' Record of Shorting Pensions Goes Back Decades." Written by Doug Finke.

Staykova, Mira. (2016). "An Evaluation of the Cost of the Budget Impasse: Remember, Remember the Budget Impasse this November." Illinois Economic Policy Institute.

Wheeler III, Charles. (2010). "The Pension Chasm: Analysts Project State Retirement Systems Will Need $131 Billion to Cover Benefits, but There's Only $46 Billion in the Bank." *Illinois Issues*.

Cover Photo Credits:

Flickr User, Keith Williamson. (2011). "Yipee! Project 364(3) Day 250."

Flickr User, Romana Klee. (2010). "An Exciting New Conceptual Artwork Recently Installed on Blackstone Ave."