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New Details Emerge on Illinois' "Tier 3" Pension Plan

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Two of the primary causes of Illinois' poor fiscal health are easy to identify:

- First, there is Illinois' significant unfunded pension liability of some $130 billion, which has largely been created through the state's decades-long practice of borrowing against the benefits earned by teachers and other public employees to pay for current services, and
- Second, there is the unrealistic, unaffordable plan created to repay that debt under the now infamous "Pension Ramp" legislation that passed back in 1994. Indeed, the Pension Ramp is so backloaded that it now grows in annual increments that are simply unaffordable.

Due to the significant strain the Pension Ramp creates for the state's fiscal system, decision makers have recently tried to manufacture legislative approaches to reduce pension payments—which have mostly failed. The General Fund budget passed for FY2018 is no exception.

Two major changes to the pension systems were included in the FY2018 budget that finally passed. First, the impact of reducing the investment return actuaries assumed for the pension system's assets, which significantly increased pension contributions required in FY2018, will instead be phased in over five years. This does effectively lower the FY2018 contribution, but it will unfortunately drive up long-term costs.

Second, all employees hired since 2011 will be eligible for a new type of pension benefits called "Tier 3." Unlike the existing Tier 1 and Tier 2 pension systems which provide employees a "defined benefit" package that guarantees a certain dollar value of retirement annuities over their lifetimes, Tier 3 employees will receive a much smaller "defined benefit" pension that will be supplemented with a "defined contribution" plan, the ultimate value of which will be determined by investment returns.

Another cost savings the state will realize from the creation of Tier 3 involves shifting the responsibility for the "employer contribution" to the pension systems from state government to local public sector employers, like universities, community colleges, and school districts. The state will retain its current responsibilities for Tier 1 and 2 employees.

Earlier this month, the best projection of exactly what those Tier 3 changes will do was made public when the State Universities Retirement System (**SURS**) released its new long-term actuarial analysis. SURS represents some 78,000 current employees of Illinois' public colleges and universities, and along with the State Employees Retirement System and Teachers Retirement System is one of the three pension funds affected by the creation of the Tier 3 system with the passage of the FY2018 budget.

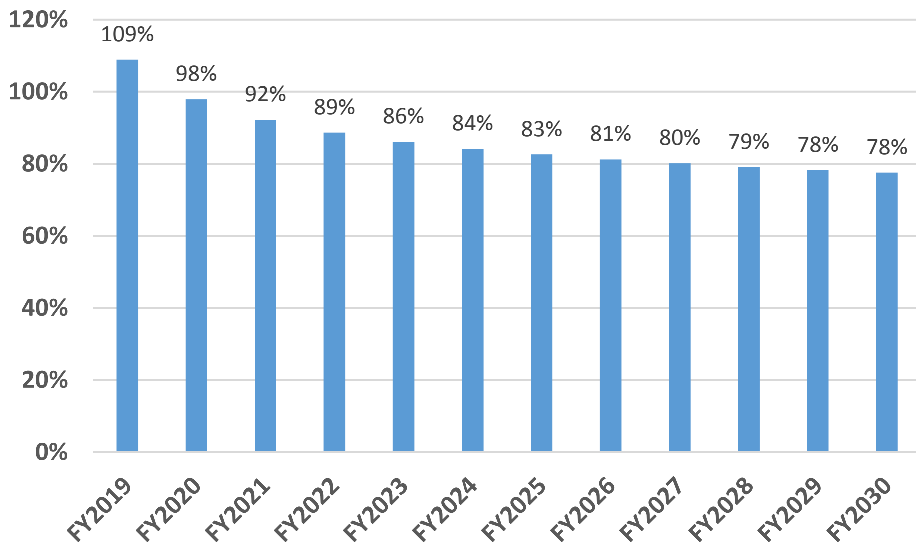
CTBA identified three major takeaways from SURS' analysis of Tier 3:

1. Public employers, such as colleges and universities, will be hit with major additional costs.

The previously referenced cost shift was a key part of the state's FY2018 pension changes. Unlike with other workers, if Tier 3 employees' contributions don't cover all the costs associated with their benefits, local employers—and not the state—will be responsible for making up the difference.

Many observers had assumed that Tier 3's much smaller benefits package would be entirely paid for by employee contributions. That's not what SURS' analysis found, however. Its actuaries concluded that Tier 3's "normal cost"—the amount of money the system would need to invest each year to pay for the benefits its employees earn—will become larger than employee contributions in FY2020, with the gap widening over the next decade. By FY2027, Tier 3 employee contributions cover just 80 percent of Tier 3 normal costs. Local employers—that is, public colleges and universities—will have to make up the difference.

Figure 1: Proportion of SURS Tier 3 Normal Cost Covered by Tier 3 Member Contributions



This means that local employers' Tier 3 costs may become substantially higher than anticipated. Previously, it had appeared that employers would need to make pension contributions in an amount equal to 4 percent of the total wages of their Tier 3 employees: at least 2 percent towards the defined contribution plan, and another 2 percent towards the defined benefit plan beginning in FY2021. (The purpose of the DB employer contribution is not entirely clear, because it is in addition to the Tier 3 normal cost. The most likely explanation is that it is meant to help pay down already accrued pension debt.)

But SURS' projections suggest that these employers will also need to pay an additional amount to cover Tier 3's normal cost. This amount reaches a full additional percent of pay in FY2024—for a total of 5 percent of Tier 3 pay—and continues to grow thereafter.

2. Tier 3 employees will pay a significantly higher proportion of their salary towards pensions than current employees.

Workers covered by SURS today pay 8 percent of their paychecks to the pension system. Those who opt into Tier 3, however, may see their pension contributions increase significantly. That's because the 6.2 percent cap on employee contributions only applies to the defined benefit portion of their retirement plans. Workers will also contribute 4 percent of their earnings towards the defined contribution portion. In other words, Tier 3 employees could be paying up to 10.2 percent of their wages on their pensions. That may make Tier 3 a less attractive proposition to either existing employees hired since 2011 or all new employees, which happen to be the two employee groups with the option to join Tier 3 or remain in the defined-benefit Tier 2 plan. To state the obvious, if fewer employees choose Tier 3—which pays a lesser benefit and requires a greater employee contribution than the alternative—state government will not ultimately gain the savings from Tier 3 it initially predicted.

3. The state will reap some Tier 3 savings in FY2018—but long-term savings are not transformational.

Recent reports about Tier 3 have concluded that the pension systems will need at least a year or two to set up the defined contribution portion of the plan. In other words, Tier 3 will not be implemented for any employees in FY2018. Many observers assumed that meant that the state could not see any of the $500 million in General Fund budget savings that were projected by both Republicans and Democrats from Tier 3.

But the SURS analysis suggests that isn't quite the case. Indeed, it finds that Tier 3 will produce $61 million in savings for SURS in FY2018. According to SURS' report, these savings come from two sources: a reduction in anticipated benefits for Tier 2 employees expected to switch to Tier 3 when that option becomes available, and a technical change to the Tier 3 payroll cap.

For a variety of reasons, it is difficult to extrapolate from SURS' Tier 3 savings in FY2018 to make predictions about savings that TRS and SERS will be able to realize. But if the other two state systems affected by Tier 3 see proportional reductions in their FY2018 contributions, then the total Tier 3 savings to the state's General Fund budget would be about $300 million. That would increase the FY2018 General Fund deficit by about $200 million compared to the savings claimed by lawmakers.

Figure 2: SURS Pension Contribution, Before and After FY2018 Budget Changes ($ billions)

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Importantly, even once Tier 3 is fully implemented, SURS' actuaries do not project that the new benefit package will result in substantial long-term change in the state's pension liabilities. As Figure 2 shows, anticipated state contributions to SURS remain only modestly lower than levels projected before the changes contained in the FY2018 budget throughout the 2020s. In FY2030, the total state contribution is projected to fall just $83 million, from $2.386 billion to $2.303 billion.

While savings of $83 million are not meaningless, they also do not change the overall shape of Illinois' pension problem. Just like prior legislative attempts to reduce the fiscal pressure created by the Pension Ramp, Tier 3 still leaves Illinois well short of resolving its pension debt problems in a meaningful way. That makes it even more crucial that decision makers take more significant action to address pension debt. One such approach is reamortization, which CTBA outlined in a presentation to the Illinois Pension Conference Committee in 2013. CTBA's reamortization plan would replace the Pension Ramp's unsustainable backloading with a more responsible approach that begins paying the real cost of pensions up front, and so avoids creating ballooning debt payments in future years.