

Potential unintended consequences of public pension restructuring in HB0149

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Background and Introduction

The state of Illinois faces both a short-term fiscal crisis (more than \$8 billion of unpaid bills) and a severe long-term structural imbalance. One important element in the long-term imbalance is the very large unfunded liability embodied in Illinois' public pension systems. These pensions systems have promised benefits to current and future annuitants far in excess of the amount projected to be available in their trust funds.

Recognizing this impending fiscal disaster there have been numerous calls for legislative remedies. In 2010, the legislature took major action with Public Act 96-889, which greatly reduced the potential value of the

defined benefit plan offered to state employees hired after January 1, 2011. PA 96-889 reduced the potential increase in unfunded pension liabilities but did not address either current unfunded liabilities or the potential growth in pension liabilities due to benefits accrued by continuing state employees hired before January 1, 2011.

House Minority Leader Tom Cross and several co-sponsors introduced HB0149 on Jan. 18, 2011. Although, so far as I am aware, HB0149's sponsors have never publicly explained its goals, it seems clear that it is intended to greatly reduce public sector compensation and to provide a plan to dispose of unfunded pension liability in Illinois.

The synopsis of HB0149 as introduced reads:

"Amends the Illinois Pension Code. Requires current participants in the State-funded pension and retirement systems to make a one-time, irrevocable election of one of the following: (i) the traditional benefit package under the applicable Article of the Pension Code, (ii) the existing benefit package for new hires, or (iii) a self-managed plan (if made available by the participant's employer). Authorizes persons who became or become participants on or after January 1, 2011 to irrevocably elect either: (i) the benefit package for new hires or (ii) the self-managed plan (if made available by the participant's employer). Sets forth the requirements for the self-managed plan and provides that if such a plan is available it is the default plan if a participant fails to make an election. In the Articles creating the State-funded pension and retirement systems, provides: (i) that, beginning in fiscal year 2013, the State's required contribution is the greater of 6% of the applicable employee payroll or one-half of the actuarially-determined normal cost of the benefit package for new hires and (ii) that the required employee contribution will be based on the benefit package elected by the participant. Amends the Illinois Public Labor Relations Act to provide that the changes made by the amendatory Act control when there is a conflict with the Illinois Public Labor Relations Act."

While there has not yet been much official legislative activity—such as hearings or committee votes—there have been increasingly intense rumors, as well as indications in the mass media, that at least some legislative leaders are committed to major further action on public pensions in the 97th general assembly. Although the exact form the legislation might take is the subject of much speculation it now appears that the Illinois house Personnel and Pensions Committee will soon vote on SB0512 which will eventually be amended and take HB0149 as its foundation. This essay address HB0149 as introduced, unfortunately, there is insufficient public information to include discussion of potential amendments in this analysis at this time.

HB0149 is an extremely long (80 page), technical and complex bill. The legislation is complex due to the inherent complexity of pensions systems covering thousands of employees in scores of workplaces hired over many past decades and promising benefits to be paid over many future decades. The legislation is made still more complex because its provisions often vary for employees hired at different points in time. In addition, many provisions stem from past federal actions (e.g. provisions of the stimulus to ameliorate the recession that began in 2007) or state actions (e.g. borrowing for the pension fund in previous years).

An additional factor that leads to complexity in HB0149 is that in order to maintain the right to opt out of Social Security for its employees Illinois' public pension must meet certain standards. Since HB0149 introduces a system in which both participant payments and gross returns are variable the legislation contains mechanisms intended to assure that the system does not run afoul of federal social security law.

Despite its length and precision, in spots, HB0149 is incomplete and does not explicitly explain many important details. For example, the legislation does not make clear how to calculate the accrued benefit of a traditional benefit package participant who elects to move to the revised benefit package or self-managed plan. Ambiguity in HB0149 and the lack of publicly available data about the distribution of employees by age, earnings and service make it extremely difficult to do careful empirical analyses of its fiscal effect.

Despite the intense public interest in this issue and the dramatic nature of the changes being discussed, to my knowledge, there are no publicly or privately available comprehensive studies of the potential fiscal

impact of the law. Thus, we do not know how much (or how quickly) sponsors of HB0149 believe it would reduce Illinois unfunded pension liability. We do not know how Illinois' required pension payments would compare with its currently scheduled payments. We do not know what share of participants would be expected to opt for each of the three types of pension plans offered under HB0149. Nor are there any studies of HB0149 that predict its (likely very important) impact on Illinois' public-sector labor market. We do not know how much participants' compensation would be reduced under HB0149 nor how the reduced compensation would compare with compensation in other public sector and private sector workplaces. We do not know how HB0149 might be expected to alter the experience profile of the public sector workforce. Will there be a wave of retirements? If so, how will this alter average worker compensation?

Potential for unintended consequences

It is very important that legislation as complex and dramatic as HB0149 be thoroughly studied and debated because it is very easy to overlook features that can have important unintended effects. There is a large scholarly literature that makes this clear. The potential for unintended consequences of HB0149 should be seriously considered. There may be flaws that could lead individuals to make irrevocable, life-altering choices such as retirement or rejection of a public-sector job offer.

The goal of this essay is to raise concern about some of the potential unintended consequences of HB0149. Given the limited time and data available, the list of potential consequences discussed here is neither exhaustive nor fully analyzed. Rather, the intent is to provide a sampling of the kind of questions that should be asked, and more fully analyzed. The consequences are discussed in roughly chronological order of their potential occurrence and are not necessarily in order of their potential importance.

A. Retirements out of an “abundance of caution”—Legislative discussion of cuts in accrued retirement benefits could stimulate some public-sector workers to retire out of an “abundance of caution” even if the legislature never takes action. If workers feel they face a choice between a certain retirement benefit if they retire now but an uncertain benefit if they continue, some may opt for retirement in an attempt to lock-in previously accrued promises. The workers that are mostly likely to opt for early retirement, of course, are

those with attractive options elsewhere. For example, able, successful public school teachers who might find high demand for their skills in private schools or in another state.

B. Reputational damage to Illinois as an employer—

If HB0149 passes, some people may believe that Illinois has reneged on a legal or ethical contract. Some may view this as a breach of trust—or simply a lack of fiscal responsibility—and may lose some confidence in the state. When a private firm goes bankrupt and does not fulfill all of its obligations to creditors, it typically suffers reputational damage. If the firm is able to reorganize and emerge from bankruptcy, it will typically need to provide more than the usual amount of evidence of fiscal soundness to potential employees, suppliers, and lenders. In the public sector, reneging on a debt might have even more serious consequences since it is clear that Illinois does have the financial capacity to service its debts but lacks the political will. While it is relatively easy to document financial capacity, it is difficult or impossible to document political will. Thus, emerging from a politically-induced financial breach may require years (or decades) of reputational repair. In the meantime, Illinois may bear excessive costs for a large variety of contracts.

On the other hand, to the extent that HB0149 is viewed as reducing Illinois' structural imbalance the fiscal reputation of the state could improve, making it less costly to contract for some goods and services,

C. Necessity for wage increases to compensate for pension cuts—

if HB0149 goes into effect some current employees will experience a significant cut in their total compensation. As explained in Public Pension Policy in Illinois (<http://igpa.uillinois.edu/pensions>), such cuts in compensation will make it more difficult to retain these employees in the future. Because of this, and because of PA 96-889, which had already offered reduced pension benefits to Illinois public employees hired after January 1, 2011, Illinois will find it more difficult to recruit and retain able employees. Illinois can compensate either by raising the non-pension portions of compensation or by adjusting to lower labor quality and higher turnover. This is potentially the most important consequence HB0149.

D. Potential for excessive risk-taking by some participants in the self-managed plan—

Sec. 1-163 (2) of HB0149 says "If the employee is participating in the self-managed plan...the employee shall receive a

minimum allocation equal to 7.5% of the employee's compensation for service during the period." Because the exact terms under which the self-managed plan would be offered are unclear (e.g. would there be a limit on earnings eligible for the match?) it is unclear to what extent this clause would potentially be relevant.

However, to the extent that the clause is relevant—that is to the extent that some self-managed plan participants could end up with an allocation of less than 7.5% of compensation—it could limit the downside risk of some participants and promote excessive risk-taking. Suppose that a self-managed plan participant near retirement had an accumulation sufficient to provide less than 7.5% of their compensation. The rational thing to do in that situation would be to invest all of the allocation in a risky investment with a high upside even if it also had a large downside risk. In the worst case, the investment loses money but the participant is guaranteed an allocation of 7.5%--Illinois covers any losses but the participant gets to keep any gains.

E. Flight of low-cost participants from the defined benefit plans—

HB0149 specifies that participants who elect the traditional benefit plan shall contribute a percentage of salary that rises dollar-for-dollar with the "normal cost" averaged over all participants in the traditional plan. Roughly speaking, normal cost is the present value of benefits, as of the valuation date, that accrue during, are earned during, or are otherwise allocated to service for the plan year. Normal cost is also a rough estimate of the benefit the participant gains by remaining in the plan. Normal cost varies greatly among plan participants. According to a recent draft of an unpublished but credible analysis, the "normal cost" of current participants in Illinois' public-sector defined benefit plans could range from about 6.5% to about 42% of payroll if they choose to remain in the traditional benefit plan under the HB0149. According to this analysis, the premium required for those in the traditional plan could be about 26% of payroll.

From a purely economic standpoint, it makes sense for any participant whose normal cost is less than the average normal cost in the traditional defined benefit plan to exit the plan by either retiring immediately or moving to one of the other retirement plans. However, this would set up a downward spiral for the traditional defined benefit plan. Once participants with relatively low normal costs exit the plan, the average normal cost (and premiums of participants) will rise. The rise

in premiums will induce more participants to leave the plan (in the first round individuals can opt to leave by quitting, retiring or electing one of the other plans, in the second round electing one of the other plans is not an option), which further increases the average normal cost, etc. In the end, the traditional defined benefit plan could have insufficient contributions to support the benefits it owes to participants. Thus, the sequences of events set off by HB0149 is essentially equivalent to closing the traditional benefit plan except that it could take place gradually over time and could leave some individuals unable to collect even the benefits earned thus far.

Conclusion

The Illinois legislature is clearly considering dramatic change in the Illinois' woefully underfunded public pension systems. The proposed alterations, as embodied in HB0149, involve highly technical and complex calculations whose implications are difficult to predict without detailed analysis by experts. It is quite possible that some provisions of the proposed policy changes could have dramatic and irrevocable unintended consequences. This essay has discussed a small sampling of such potential consequences. More focused and complete analysis will be required to fully understand the potential implications of the proposed changes.

For more about public pension policy in Illinois, visit igpa.uillinois.edu/pensions.

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