Pension Policy & the Decline in Fiscal Democracy

University of Chicago Policy Forum
The Pension Crisis: State and Local Pension Challenges

Eugene Steuerle
Introduction
Summary

A time of extraordinary possibility, not austerity

Yet constrained by a disease unique to our time:
A huge decline in fiscal democracy

- Culmination of decades of effort to control an uncertain future
- Deficits only one symptom

Real reform requires looking far beyond deficits to the purposes of policy
How today really is different

Traditional Budget

*Revenues increase with economic growth.*
*Spending increases only with new legislation.*

Real Dollars

Future Years

Spending

Long-run surpluses

Revenues

Short-term deficits

Future Years

Today’s Budget

*Spending scheduled to grow automatically faster than revenues.*

Real Dollars

Future Years

Spending

Widening long-run deficits

Revenues
Many Deadly Consequences

Economic
Budget for a declining nation, abandoning children & investment

Look not just to what is growing automatically but what is getting squeezed

Lack of flexibility to meet new economic conditions & needs

Political
Decline in our democratic institutions

Real reform difficult when politicians must renege on promises
Measuring the Decline in Federal Fiscal Democracy
Decline in Fiscal Democracy at the Federal Level

‘Fiscal democracy’ is vanishing

After paying interest on the debt and accounting for mandatory spending, the percentage of federal receipts left to spend each year has been shrinking rapidly.

Steuerle-Roeper Index of Fiscal Democracy

Source: Calculations based on data from OMB and CBO
Health, Social Security and interest payments will dominate future budgets

Increase over 2018 budget by 2029 under current law, in billions of 2018 dollars

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount (2018)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>1,189</td>
</tr>
<tr>
<td>Social Security, Medicare and other major health costs</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1,147</td>
</tr>
<tr>
<td>Social Security</td>
<td>482</td>
</tr>
<tr>
<td>Medicare</td>
<td>490</td>
</tr>
<tr>
<td>Medicaid/other</td>
<td>175</td>
</tr>
<tr>
<td>Net interest</td>
<td>324</td>
</tr>
<tr>
<td>Other</td>
<td>47</td>
</tr>
</tbody>
</table>

Notes: Other major health programs include CHIP and Affordable Care Act subsidies.

Source: Author’s calculations from August 2019 Congressional Budget Office data. THE WASHINGTON POST
Measuring the Decline in Fiscal Democracy in Illinois
From Decrying to Measuring Declines in State Fiscal Democracy

• Governors & lawmakers have long decried their lack of flexibility

  • “… the way the formulas now work, we will never catch up. No matter how well we do, the current system is programmed to spend even more.”

    2005, Governor Arnold Schwarzenegger

  • “…I don’t think folks understand how limited you are in what you can cut. Everything that you can cut, we already have.”

    Illinois State Senator Heather Steans

• But states rarely systematically evaluate

  • how much is out of current decision makers’ control

  • how budget pre-commitments are changing over time
Restricted Spending, Share of **Real Spending Growth** (FY2015 vs. FY 2000)

<table>
<thead>
<tr>
<th>State</th>
<th>Medicaid and CHIP</th>
<th>Pension and OPEB contributions</th>
<th>Correctional operations</th>
<th>Other dedicated spending</th>
<th>TANF maintenance of effort</th>
<th>Debt service</th>
<th>Formula-driven K–12 education</th>
<th>Dedicated transportation funds</th>
<th>Budget stabilization fund deposits</th>
<th>Federal receipts (non–Medicaid and CHIP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>25%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>0%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Florida</td>
<td>25%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>0%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
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</tr>
<tr>
<td>Illinois</td>
<td>25%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>0%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
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</tr>
<tr>
<td>New York</td>
<td>25%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>0%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
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<tr>
<td>Texas</td>
<td>25%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>0%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Virginia</td>
<td>25%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>0%</td>
<td>5%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
</tbody>
</table>
Illinois Growth in Restricted Spending (FY2015 vs FY2000)

- Unrestricted
- Federal receipts (non-Medicaid and CHIP)
- Other dedicated spending
- TANF maintenance of effort
- Budget stabilization fund deposits
- Dedicated transportation funds
- Correctional operations
- Formula-driven K–12 education
- Pension and OPEB contributions
- Debt service
- Medicaid and CHIP

Share of Total Real Spending Growth
Illinois State Pension Policy
Pension Plans Should be Assessed by Multiple Criteria

Most reports focus on
  Funding ratio
  Making required contributions

But the purpose of pensions should be related to outcomes
  Rewarding and attracting the best young, workers
  Promoting a dynamic workforce
  Encouraging work at older ages, especially given population aging
  Retirement income for short-term employees
  Retirement income for long-term employees

  Equal pay for equal work
# Grading Illinois State & Local Pension Plans

## Illinois

<table>
<thead>
<tr>
<th>Overall</th>
<th>Overall Grade</th>
<th>Rewarding Younger Workers</th>
<th>Promoting a Dynamic Workforce</th>
<th>Encouraging Work at Older Ages</th>
<th>Retirement Income for Short-Term Employees</th>
<th>Retirement Income for Long-Term Employees</th>
<th>Making Required Contributions</th>
<th>Funding Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
<td>C</td>
<td>C</td>
<td>B</td>
<td>F</td>
<td>C</td>
<td>B</td>
<td>D</td>
<td>D</td>
</tr>
<tr>
<td>Only new hires</td>
<td>D</td>
<td>F</td>
<td>B</td>
<td>C</td>
<td>F</td>
<td>B</td>
<td>D</td>
<td>D</td>
</tr>
<tr>
<td>Excludes new hires</td>
<td>C</td>
<td>C</td>
<td>B</td>
<td>F</td>
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<td>B</td>
<td>D</td>
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## General State

<table>
<thead>
<tr>
<th>Overall</th>
<th>Overall Grade</th>
<th>Rewarding Younger Workers</th>
<th>Promoting a Dynamic Workforce</th>
<th>Encouraging Work at Older Ages</th>
<th>Retirement Income for Short-Term Employees</th>
<th>Retirement Income for Long-Term Employees</th>
<th>Making Required Contributions</th>
<th>Funding Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>D</td>
<td>B</td>
<td>A</td>
<td>C</td>
<td>F</td>
</tr>
<tr>
<td>Only new hires</td>
<td>D</td>
<td>F</td>
<td>B</td>
<td>A</td>
<td>F</td>
<td>A</td>
<td>A</td>
<td>C</td>
</tr>
<tr>
<td>Excludes new hires</td>
<td>C</td>
<td>C</td>
<td>B</td>
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<td>[IL02] Hired on or after Jan. 1, 2011 (Tier 2)</td>
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## General Local

<table>
<thead>
<tr>
<th>Overall</th>
<th>Overall Grade</th>
<th>Rewarding Younger Workers</th>
<th>Promoting a Dynamic Workforce</th>
<th>Encouraging Work at Older Ages</th>
<th>Retirement Income for Short-Term Employees</th>
<th>Retirement Income for Long-Term Employees</th>
<th>Making Required Contributions</th>
<th>Funding Ratio</th>
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<tr>
<td>All</td>
<td>C</td>
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<td>B</td>
<td>F</td>
<td>B</td>
<td>A</td>
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<td>C</td>
</tr>
<tr>
<td>Only new hires</td>
<td>D</td>
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<td>B</td>
<td>D</td>
<td>A</td>
<td>A</td>
<td>F</td>
<td>C</td>
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<tr>
<td>Excludes new hires</td>
<td>C</td>
<td>B</td>
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### Grading Illinois State & Local Pension Plans (cont.)

#### Teachers

<table>
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<tr>
<th>Overall Grade</th>
<th>Rewarding Younger Workers</th>
<th>Promoting a Dynamic Workforce</th>
<th>Encouraging Work at Older Ages</th>
<th>Retirement Income for Short-Term Employees</th>
<th>Retirement Income for Long-Term Employees</th>
<th>Making Required Contributions</th>
<th>Funding Ratio</th>
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</thead>
<tbody>
<tr>
<td>All</td>
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<td>D</td>
<td>B</td>
<td>F</td>
<td>D</td>
<td>C</td>
<td>C</td>
</tr>
<tr>
<td>Only now hires</td>
<td>D</td>
<td>F</td>
<td>B</td>
<td>D</td>
<td>F</td>
<td>D</td>
<td>C</td>
</tr>
<tr>
<td>Excludes new hires</td>
<td>D</td>
<td>D</td>
<td>B</td>
<td>F</td>
<td>D</td>
<td>C</td>
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<tr>
<td>(IL09) Hired before Jan. 1, 2011 (Tier 1)</td>
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<td>D</td>
<td>B</td>
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<td>D</td>
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<td>D</td>
<td>F</td>
<td>D</td>
<td>C</td>
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#### Police and Fire

<table>
<thead>
<tr>
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<th>Rewarding Younger Workers</th>
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<th>Encouraging Work at Older Ages</th>
<th>Retirement Income for Short-Term Employees</th>
<th>Retirement Income for Long-Term Employees</th>
<th>Making Required Contributions</th>
<th>Funding Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
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<td>F</td>
<td>D</td>
<td>D</td>
<td>B</td>
<td>D</td>
<td>D</td>
</tr>
<tr>
<td>Only now hires</td>
<td>D</td>
<td>C</td>
<td>C</td>
<td>B</td>
<td>F</td>
<td>D</td>
<td>C</td>
</tr>
<tr>
<td>Excludes new hires</td>
<td>F</td>
<td>F</td>
<td>C</td>
<td>B</td>
<td>F</td>
<td>D</td>
<td>D</td>
</tr>
<tr>
<td>(IL03) State police and firefighters hired before Jan. 1, 2011 (SRS) (Tier 1)</td>
<td>F</td>
<td>F</td>
<td>D</td>
<td>D</td>
<td>F</td>
<td>F</td>
<td>A</td>
</tr>
<tr>
<td>(IL04) State police and firefighters hired on or after Jan. 1, 2011 (SRS) (Tier 2)</td>
<td>F</td>
<td>F</td>
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<td>F</td>
<td>F</td>
<td>F</td>
<td>B</td>
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<tr>
<td>(IL07) Local sheriffs and deputies hired before Jan. 1, 2011 (IMRF) (Tier 1)</td>
<td>F</td>
<td>F</td>
<td>F</td>
<td>D</td>
<td>F</td>
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</tr>
<tr>
<td>(IL08) Local sheriffs and deputies hired on or after Jan. 1, 2011 (IMRF) (Tier 2)</td>
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<td>C</td>
<td>F</td>
<td>A</td>
<td>F</td>
</tr>
</tbody>
</table>
Underfunding of State Pension Plans

### Pension Funding Status in Six States, 2016

*Funding ratio estimates, share contributed, and net amortization*

<table>
<thead>
<tr>
<th></th>
<th>US state total</th>
<th>CA</th>
<th>FL</th>
<th>IL</th>
<th>NY</th>
<th>TX</th>
<th>VA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funded ratio (%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pew</td>
<td>66</td>
<td>69</td>
<td>79</td>
<td>36</td>
<td>91</td>
<td>73</td>
<td>72</td>
</tr>
<tr>
<td>BEA</td>
<td>48</td>
<td>51</td>
<td>58</td>
<td>25</td>
<td>60</td>
<td>51</td>
<td>52</td>
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<tr>
<td>Share contributed (%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Pew</td>
<td>88</td>
<td>82</td>
<td>101</td>
<td>75</td>
<td>152</td>
<td>71</td>
<td>101</td>
</tr>
<tr>
<td>BEA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net amortization (millions $)</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Pew</td>
<td>-13.2</td>
<td>-2.9</td>
<td>0.0</td>
<td>-2.6</td>
<td>1.8</td>
<td>-1.6</td>
<td>0.0</td>
</tr>
<tr>
<td>BEA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


**Notes:**
- “Funded ratio” is actuarial assets divided by actuarial accrued liabilities; differences between Pew and BEA estimates are based on the discount rates used in calculations.
- “Share contributed” is actual employer payments (state or other) toward current benefits plus unfunded liabilities divided by the recommended payment for the current year (i.e., the actuarially determined contribution) (Pew 2018).
- “Net amortization” is all contributions (employer, employee, and other, with interest) minus the net service cost and interest on the prior year’s debt. Plans with negative net amortization can expect to see their funding gap increase (Pew 2018).
Do Budgeteers & Actuaries Bear Some Responsibility?

For basing funding estimates on optimistic assumptions?
    Do not account adequately for the “cost” of downside risks
    Do not “insure” against downside risks
        But doing so means earning Treasury rates of return
    Count on market crashes to improve rates of return

For failing to reveal effective pension compensation to workers?
    ...Examples to follow for Illinois public school teachers
Tier 1, 25-Year-Old Hires, Constant 2014 Dollars

- Lifetime pension benefits
- Value of employee contributions
- Value of refunded employee contributions
Tier 2, 25-Year-Old Hires, Constant 2014 Dollars

- Lifetime pension benefits
- Value of employee contributions
- Value of refunded employee contributions

Years of Service

$0
$100,000
$200,000
$300,000
$400,000
$500,000
$600,000
$700,000
$800,000
$900,000
$1,000,000
Expected Value of Lifetime Pension Benefits, net of employee contribs
(age 25 hire)

Years of Service

Tier 1

Tier 2
Annual Increment to Lifetime Benefits, net of employee contributions (age 25)
Summary
Common Elements to Federal, State & State Pension Policy

For current federal and state budget policy
Almost all spending growth going for pensions, health & interest payments
Explains failure to invest in children, workers, infrastructure, basic government

For future generations
Huge shift of burdens to younger generations
Whether through higher taxes, fewer benefits, or negative state employer pension contributions for new workers

For transparency
Continual political pressure to hide who will pay
Need for much better budgeting and actuarial accounting
No government entity reports on where net growth has gone or is going
No pension plan reports well how benefits relate to work in any one year

For our future
A rich nation growing richer ...
That must first restore fiscal democracy to take advantage of its opportunities
Reports on Fiscal Democracy & State Pension Plans

Washington Post Article on 125% of Federal Revenue Growth Pre-Committed Dead Men Ruling-Book

Fiscal Democracy in the States: How Much Spending is on Auto-Pilot

Public pension simulator
Urban Institute State and Local Employee Pension Plan Database
The State of Retirement: Grading America’s State and Local Pension Plans,
Build Your Own Pension Plan,
Evaluating Retirement Income Security for Illinois Public School Teachers