

# Illinois State Finance – A Study in Failure

## COMMERCIAL CLUB MEETING

Tuesday, January 12, 2010

**W. James Farrell**

Chairman, The Commercial Club of Chicago  
Retired Chairman and CEO, Illinois Tool Works Inc.

**R. Eden Martin**

President, The Commercial Club of Chicago

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### Opening Remarks

**W. James Farrell**

Good afternoon ladies and gentlemen and welcome to the 973<sup>rd</sup> regular meeting of The Commercial Club.

Our topic today is the financial crisis facing the State of Illinois. As you know, the Club's State Finance Task Force issued a report in late 2006 entitled: "Facing Facts" which warned that if the State did not tackle its financial problems it was headed for "financial implosion". Unfortunately, the State has not addressed the problems. To the contrary, the State's leaders have exacerbated the issues through borrowing increasing amounts and pushing off the state's obligations to future generations. When you combine these actions with the worst economy in many decades, Illinois hangs on a financial precipice with over \$130 billion in unfunded debt and liabilities – primarily related to pensions -- and a growing annual structural budget deficit which is approaching \$15 billion. In effect, we're spending about \$3 for every \$2 of revenues (apart from federal subsidies and borrowing).

At the most recent meeting of the Civic Committee, our members agreed that this has to STOP. Continued borrowing to cover current costs will severely undermine the future of our State, our citizens and the companies that employ them. So in the middle of this primary season, with 150 candidates on both sides of the aisle and the critical job of governor up for election, we have decided to launch a public information campaign which will extend through the general election. Taking a page from our successful O'Hare playbook several years ago, we will seek to inform voters of the current situation so that they can press candidates on this issue and make informed voting decisions. In addition, we will engage in a number of other activities which will make the financial situation the focus of the electorate – the taxpayers.

Today's meeting is to brief you on the current financial situation and seek your input and support for this important effort.

For our program today, Eden Martin, our Club President, will provide an overview of Illinois' financial situation, show us where Illinois stands in comparison to other states and the implications of our situation on our long-term competitiveness, and outline the steps that we will take to put a big spotlight on this issue this election year.

I want to thank our members and their teams who have worked with us on this effort, especially Julian Mack at McKinsey, Tom Bernardin at Leo Burnett, Tom Wilson at Allstate, Russ Fradin at Hewitt, and Greg Case at Aon – as well as Tom Johnson, President of the Taxpayers' Federation of Illinois and Laurence Msall, President, Civic Federation of Chicago, who are both with us today.

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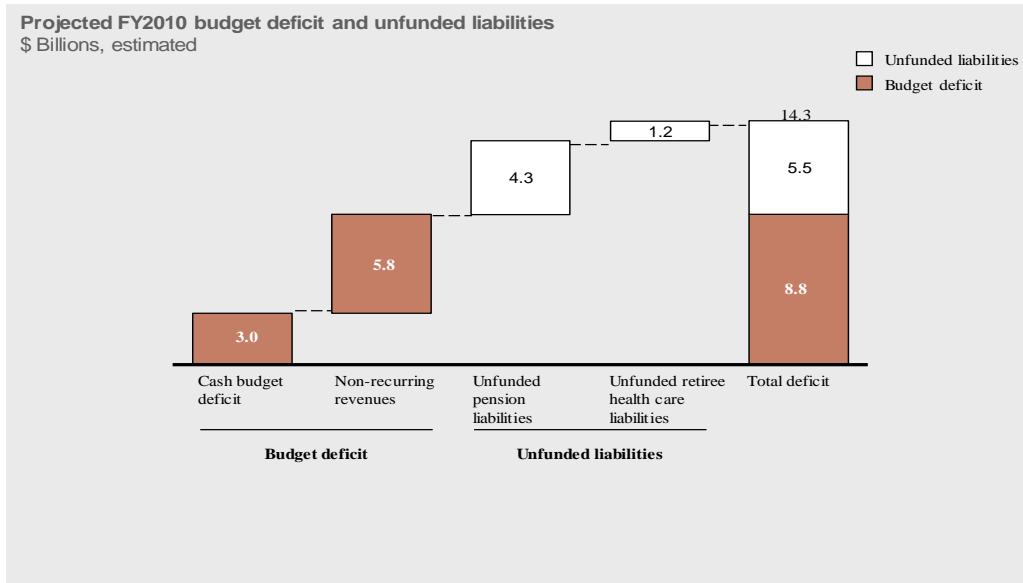
## OVERVIEW OF ILLINOIS' FINANCIAL SITUATION

### Eden Martin, President

For those of you who have been following our various State Finance task force reports, going back over three years to December 2006, and then again last February, the State's fiscal mess is not a surprise. It's just become a much bigger mess than it was three years ago.

We're now half-way through FY2010, which will end June 30. Let's start with the first chart:

#### Illinois' budget deficit and build-up of unfunded liabilities produce an annual embedded deficit of \$14-15 billion for FY2010



This shows that the State's annual embedded deficit is \$14-15 Billion.

The State prepares its budgets on a cash basis. Borrowed money counts the same as revenues generated by taxes. The State's fiscal year begins July 1 and ends the following June 30 – so we're now midway through FY2010.

At this point, it looks like FY2010 expenditures will be about \$2 billion more than originally budgeted; and revenues will be about \$1 billion less. So the cash deficit would be about \$3 billion.

But that reflects lots of one-time and non-recurring revenues – such as federal stimulus dollars, and borrowing to fund pensions, and fund sweeps. If you take those out, you have a budget with an **embedded** annual deficit of about \$9 billion.

That's still just cash - not accrual. When you add in two big additional items - (1) the non-cash growth in pension liability under actuarial standards - which adds about \$4.3 billion and (2) the growth in liability for retiree health care costs, another \$1.2 billion - those bring the total annual deficit to something in the range of \$14-15 billion.

In other words, the State is spending roughly 3 dollars for every 2 dollars of operating revenue.

Pension costs are a huge part of the problem. When you calculate annual pension costs the way actuaries do it - the total is about \$8.3 billion. \$4 billion of that is funded by the State - this year mostly with **borrowed** money. And \$4.3 billion is not funded at all - just added to the total unfunded liability.

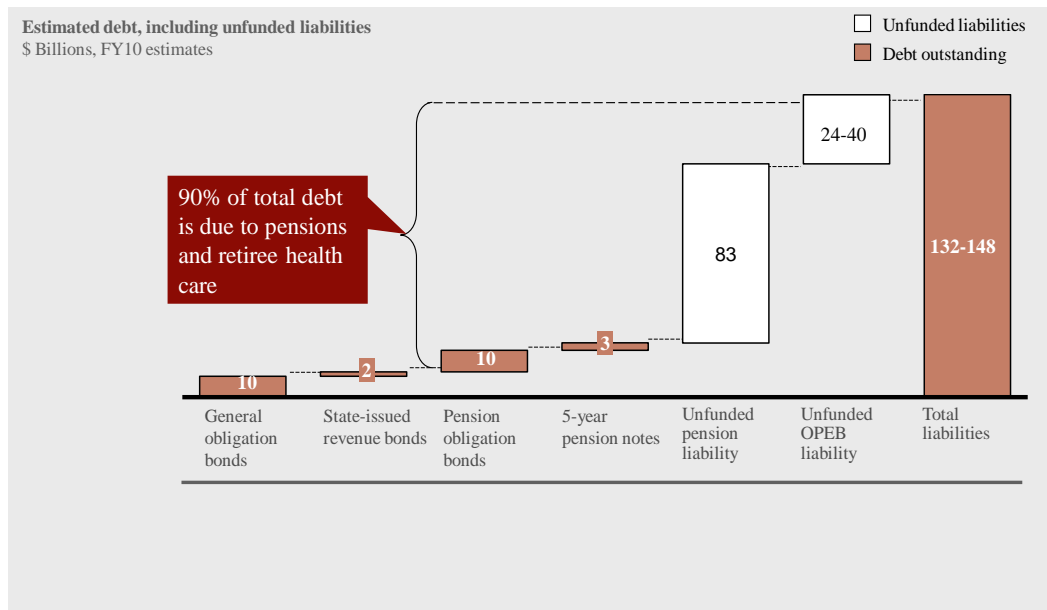
Then there's another \$1.7 billion of State retiree health care cost.

So - that totals \$10 billion in annual retirement benefit costs for people in the State's pension funds - State employees, university teachers, suburban and downstate K-12 teachers, legislators, and judges.

## II.

That's the annual picture. What about the balance sheet view - the accumulation of liabilities? Here again, retirement-related obligations are at the heart of the problem. Let me call your attention to the next chart:

### Illinois' cumulative debt and unfunded liabilities are projected to grow to over \$130 billion by end of FY2010, largely comprised of unfunded liabilities



The most recent State estimate is that the unfunded pension liability will be \$83 billion at the end of the current fiscal year. The market has come back since that estimate was made, so the current net unfunded liability would be somewhat lower.

Add another \$10 billion in pension bonds - this is Blagojevich's borrowing five years ago to fund the pensions.

Add another \$3.5 billion in pension notes sold by the Quinn Administration last week - again borrowing to fund the pensions.

Add another \$24-to-40 billion in retiree health care liability.

You get unfunded retirement obligations by the State in the range of \$120 billion. That's about \$25,000 per household in Illinois.

The State has another \$12 billion of long-term debt outstanding - but the \$120 billion or so of retirement-related debt is the elephant in the room.

Let me pause a minute over that \$120 billion of retirement-related debt.

The biggest chunk by far is the \$83 billion or so in unfunded pension obligations.

That's really the net of two things: the overall liability, and the stocks and bonds in the pension funds, which are projected to be about \$49 billion.

The main problem is the liability itself. It's stated on a present value basis. The way actuaries estimate that is to look out to all future years and add up the amounts the funds will owe people - to Sam and Mary in 2016, and John and Sally in 2035. These amounts are due in different years, so you can't just add them up. The actuaries have to first discount them back to today's "present value."

The State uses an 8.5% discount rate - which is probably way too high – and that means the liability number is too small. A realistic discount rate, comparable to what private-sector companies would use, would result in a present value of the unfunded liability a lot higher than \$83 billion.

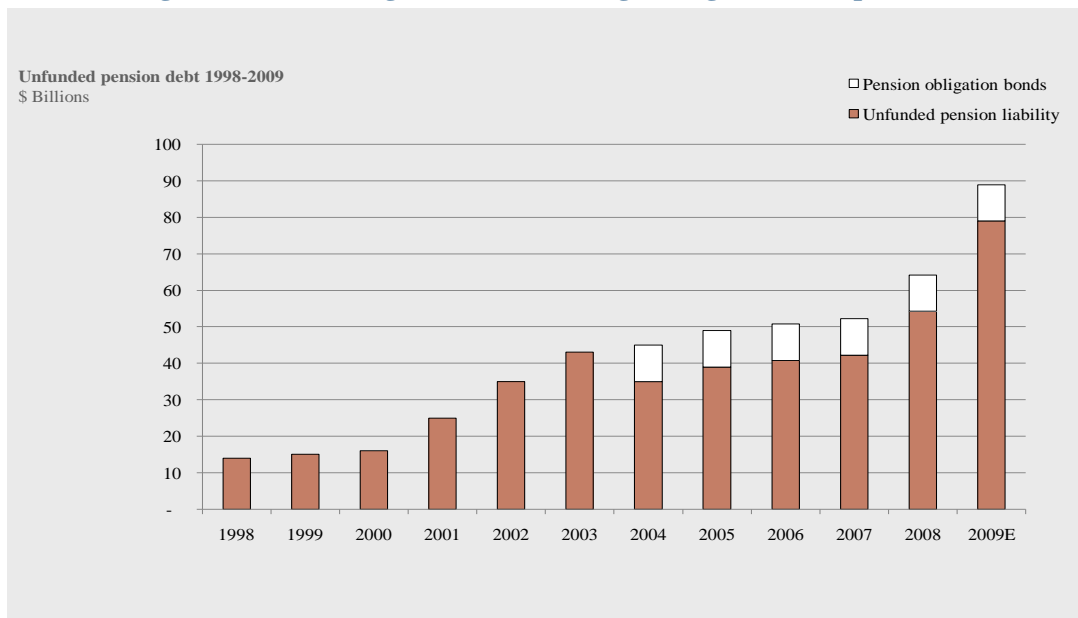
In other words, Illinois would have to pay a big consortium of Chinese banks a lot more than \$83 billion – plus the \$49 billion or so of assets in the pension funds -- to take this liability off our hands.

### III.

Let's go back to the unfunded pension liability -- \$83 or so billion. Why is it such a big problem?

The answer is - - because it is growing so fast. It isn't just where we are; it's where we are headed. Here's the final chart:

#### **The State has historically underfunded its pension costs as a means of covering its annual budget deficits, leading to a massive and growing unfunded pension debt**



You've seen versions of this in our State Task Force reports. Many of you saw this updated version in the *Tribune's* excellent editorial a week ago last Sunday (January 3, 2010).

The unfunded liabilities are going up for a lot of reasons. Part of the problem is State underfunding. Part of it is that the realities turn out to vary from actuarial assumptions. But the biggest part is that the liabilities go up at 8.5% every year just because of the reversal of the annual discount.

And it compounds every year.

If the assets in the pension funds don't earn at least 8.5% each year, the unfunded liabilities will grow even more.

#### IV.

There's one more important point: This isn't just a State of Illinois problem.

It's a City of Chicago problem -- a CPS problem - and a problem for all the municipalities, school districts and units of local government throughout the State.

Take **Chicago**. Chicago gets a big chunk of its revenue from a share of the state income tax. When the State's tax revenues are down, that impacts Chicago.

On an accrual basis -- taking into account the growth in its pension liability -- the City's **embedded** annual budget deficit appears to be more than \$1 billion. The last time they were reported, Chicago's unfunded pension liabilities were reportedly in the range of \$15 billion. Like the State, Chicago has consistently underfunded its pensions in recent years - compared to actuarial standards.

Or consider **CPS**. If you sort out the federal stimulus money and other one-time revenues, its embedded deficit is probably about \$500 million - on a cash basis.

That assumes it gets its money from the State -- which is currently behind in its payments to CPS to the extent of about \$200 million.

Next year, starting next September, CPS is facing a \$900 million deficit.

The State's fiscal problems are already starting to hurt a wide variety of other entities that depend on the State for money - social service agencies, early childhood development programs, hospitals and health centers, the museums in the park, our Universities and community colleges - and on and on. The *Tribune's* front-page news article yesterday provided some of the details.

Stan Ikenberry -- the acting President of the University of Illinois -- could give you some details. The State is behind in sending the University \$436 million.

#### V.

What is to be done? -- It's a question Lenin once asked in a different historical context -- but in a similar mood.

First, we have got to have State budget discipline. We haven't had it in recent years - from either party.

Medicaid is a huge and growing area of the budget - and a major candidate for cuts and controls. Such cuts will not make those of you on hospital boards happy.

Cuts can be made in other areas.

We estimated back in our February 2009 report that annual cost savings in the range of \$2.5 billion were achievable - apart from pension reform.

Second, we must have State-wide pension reform - not just for the State's employees but for municipal employees as well. Today, after they've worked enough years, State workers can retire with full pensions at the age of 60 - and in some cases, 55. They then get Cadillac health care plans - and the State pays 100% of the premium.

In Chicago, after they have enough years of service, workers can retire with full pensions at the age of 50. Then they can go to work in another state or municipal job - earn a salary, and accrue more pension benefits.

A reformed, less-costly second-tier plan for only new employees as they enter State employment would be a good thing years from now, but it wouldn't save significant money anytime soon. However, if a second-tier of retirement benefits were put in place prospectively - for current as well as new State employees - we could reduce the unfunded liability down from \$83 billion to about \$60 billion. That would represent annual savings in the range of \$2 billion at the State level - and more at the City level. This would lead to World War III in the legislature in Springfield; and a huge legal fight in the courts. But it's the only place where you can make a significant dent in the pension liability problem.

In each case - pensions and retiree health care - we would be putting State employees on a level of benefits closer to what prevails in the private sector.

Finally, we have to stop the borrowing - the cost shifting to future generations. Pension underfunding and borrowing - and retiree health care underfunding - are what created this terrible problem. State Government couldn't cut - and nobody could stand the thought of a tax increase. So each year that passed, the budget shortfall got harder to deal with - more burdensome to bear. And the tax burden we have shifted to future years has become enormous.

If we don't get control of this mess now, more and more businesses will leave the State and take their jobs with them. More and more individuals will leave. The downward spiral will put greater tax burdens on those who remain.

If any do.

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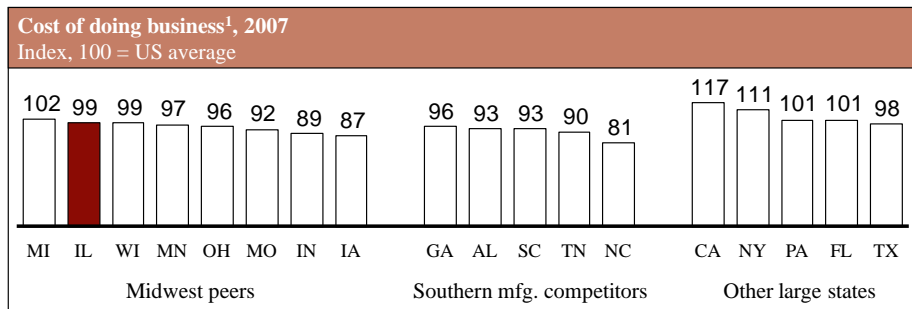
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## ILLINOIS IN COMPARISON TO OTHER STATES AND THE IMPLICATION OF OUR SITUATION ON LONG TERM COMPETITIVENESS

The State Finance Task Force compared Illinois' financial situation to that of other states. Based on its review of recent metrics on the cost of doing business by state (the most recent data available is for 2007), Illinois appears to be well-positioned relative to many of its peers. On an indexed basis, Illinois' overall cost of doing business measures 99 compared to the U.S. average of 100. While higher than some Midwest peers such as Ohio and Indiana, it is lower than Michigan and on par with Wisconsin.

In a national comparison, Illinois' cost of doing business is higher than several Southern states with which it competes for manufacturing jobs but lower than other large states such as California, New York, Pennsylvania, and Florida. In particular, Illinois scores better than the U.S. average on energy costs and overall tax burden. However, its labor costs are higher than the U.S. average, although this could be partly explained by the higher skill base of Illinois' work force.

### Based on recent metrics for cost of doing business, Illinois appears to be positioned for success



- Illinois' **energy costs**<sup>2</sup> are far below the US average (83 vs. 100)
- Illinois' **overall tax burden**<sup>3</sup> is below the US average (95 vs. 100), while Illinois' corporate tax environment is at the US average
- Illinois' **labor costs**<sup>4</sup> are well above the US average (104 vs. 100), making Illinois the 9th costliest in the country

<sup>1</sup> Cost of doing business is a weighted average of the unit labor cost (75%), the energy cost index (15%), and the state and local tax index (10%)

<sup>2</sup> Energy cost is calculated as state quantity-adjusted price of commercial and industrial energy relative to the US price

<sup>3</sup> Tax burden measures all taxes, including personal, property, and corporate taxes and charges

<sup>4</sup> Labor cost is calculated as labor compensation per dollar of output. Labor compensation is measured as wages and salaries per employee while output is calculated as gross output per employee

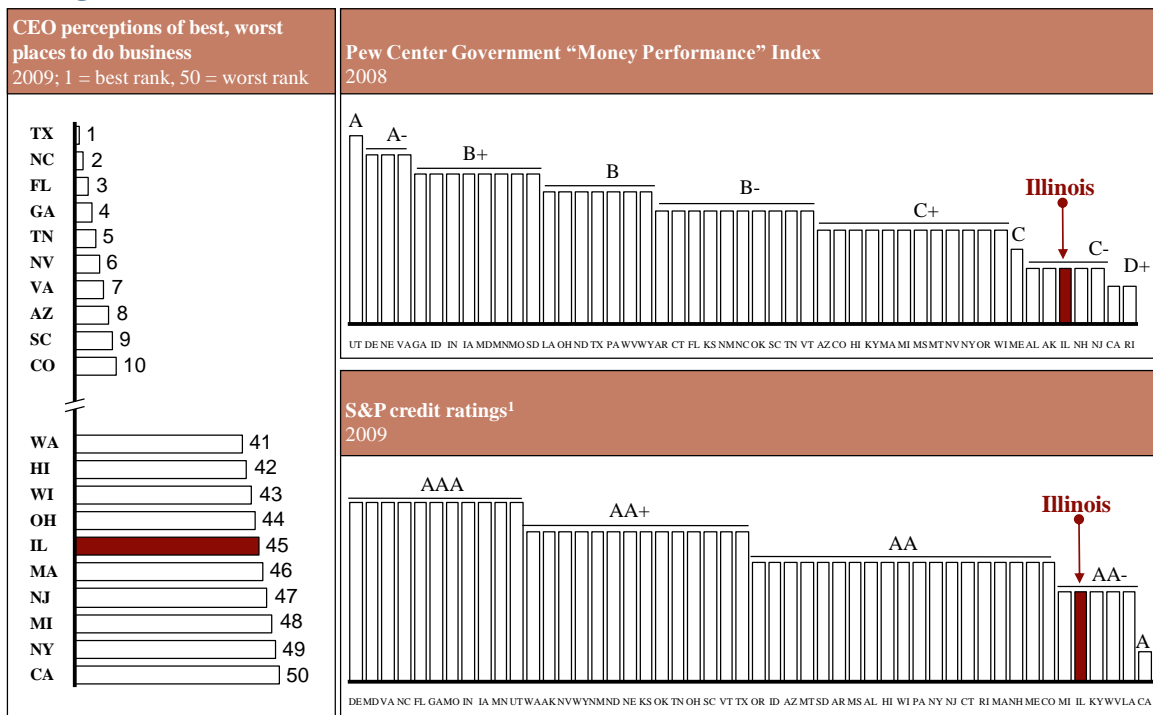
Source: U.S. Bureau of Labor Statistics, North American Business Cost Review 2009; Moody's Economy.com

However, Illinois ranks among the bottom 5-6 states when scored subjectively by business leaders, government watchdogs and credit ratings agencies. For example, a 2009 survey of CEOs by *CEO Magazine* rated Illinois as the 6th-worst place to do business in the U.S.

The Pew Center, which calculates a “Money Performance” Index based on government fiscal responsibility, gave Illinois a C- grade, placing it higher than only two states (California and Rhode Island). Credit ratings agencies such as S&P recently downgraded Illinois to the 2nd-lowest rating of any state (AA-, higher than only California).

These ratings organizations cite, in part, Illinois’ inability to structurally balance its budget and its accumulation of significant unfunded pension and health care liabilities as rationale for these low ratings.

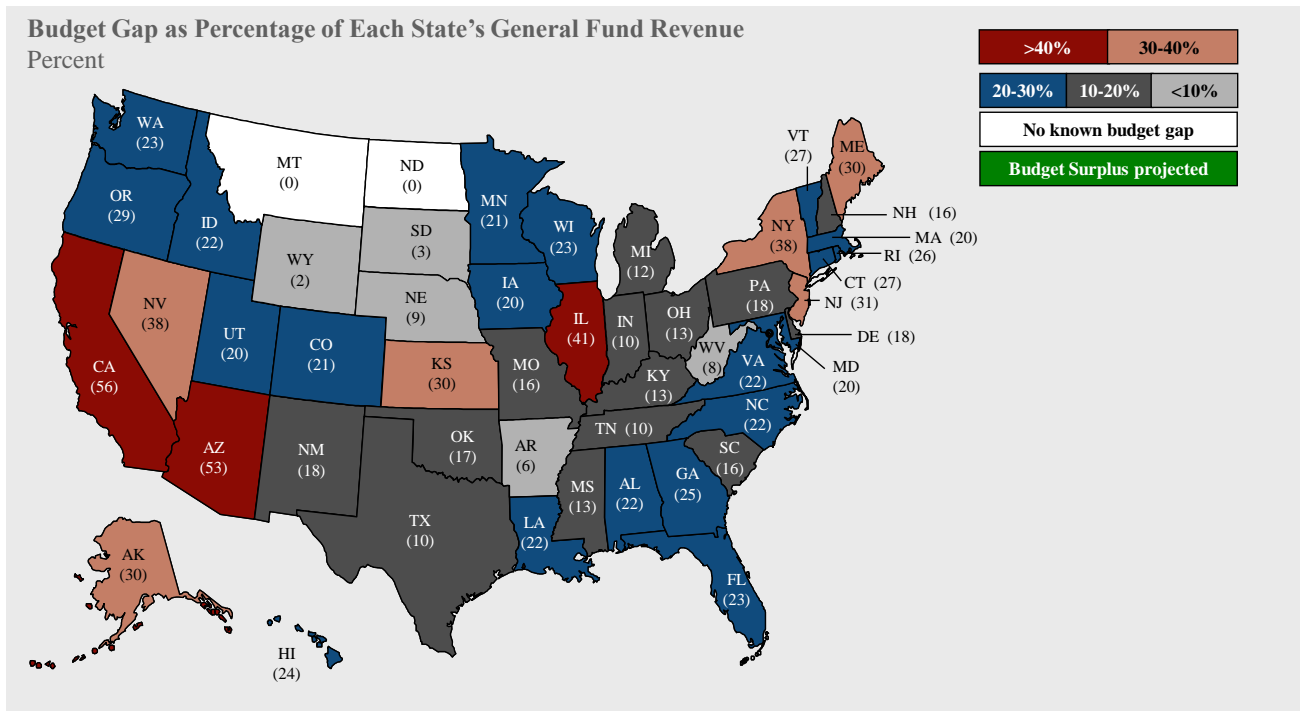
### Illinois ranks near the bottom 5 among all states on fiscal management, credit rating, and attractiveness to business



<sup>1</sup> Refers to ratings on state general obligation bonds only  
 Source: CEO Magazine, Pew Center, S&P

Illinois' budget gap is 41% of its general fund revenues. Comparatively, only California and Arizona have larger gaps, and only 4 other states have budget gaps above 30%.

## Illinois' budget gap is one of the largest in the nation and is significantly larger than that of its neighbors



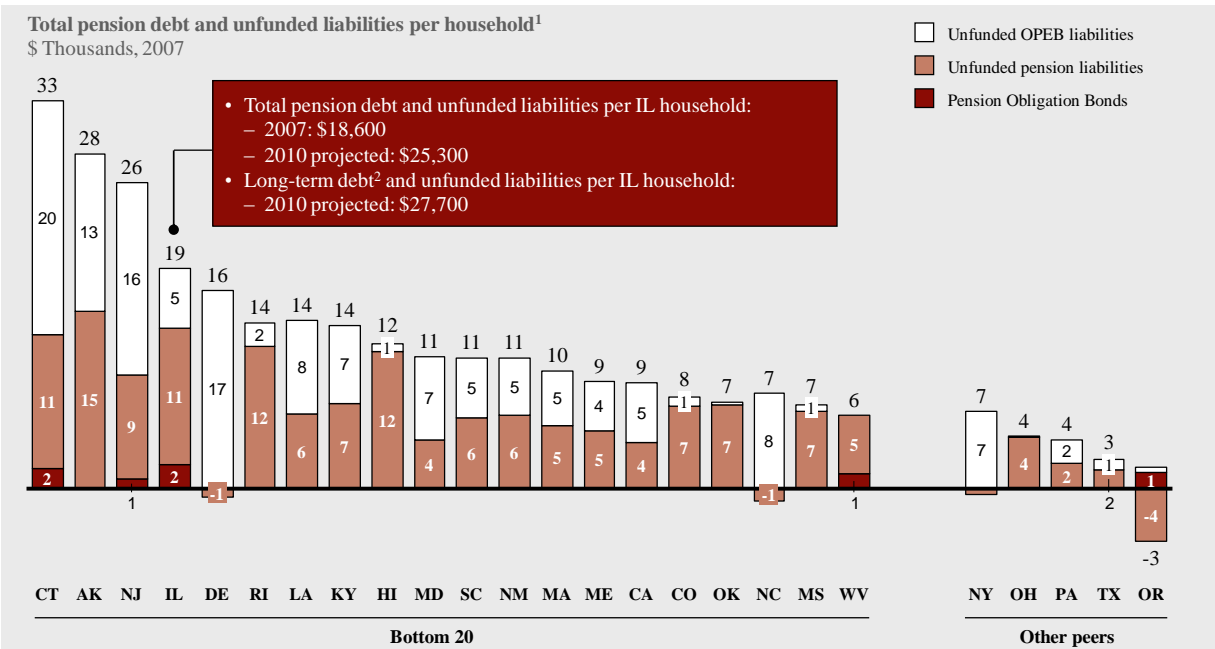
Source: Center on Budget and Policy Priorities (Nov 2009)

As of 2007 (the latest year for which comparable figures are available), Illinois had the highest unfunded pension liabilities of any state in absolute dollar terms.

On a per household basis, this translates to approximately \$19,000 for every Illinois household, which is 4th-highest among all states. Using the previously noted 2010 fiscal year figures for Illinois, the amount increases to over \$25,000 per household. This is the amount each Illinois household would have to cover in order to fully fund the state’s retirement liabilities.

These amounts were determined by comparing the sum of each state’s unfunded pension and other post-employment benefit liabilities (largely retiree health care) plus pension obligation bonds debt issued, divided by the total number of households in that state.

### Illinois’ total pension debt plus unfunded liabilities per household is among the highest across states



<sup>1</sup> Estimated unfunded obligation from Illinois’ FY2010 state budget and FY2008 CAFR, estimated number of households from 2008 American Community Survey (with an average of 2.7 members per household)  
<sup>2</sup> Long-term debt includes General Obligation Bonds, State-issued Revenue Bonds, Pension Obligation Bonds, and Pension Notes  
 Source: www.census.gov; Pew Center; Standard&Poor’s RatingsDirect (Feb 2009), Illinois 2008 CAFR, Illinois FY2010 state budget

A number of other states have also faced – or are facing – large unfunded pension liabilities and they have taken a variety of actions to address the situation.

Some states have begun to change the manner in which public pension liabilities accrue on a prospective basis. Several, including Michigan and Kentucky, have started by creating a new benefits structure, such as a second-tier plan, to cover new public employees. However, the impact of this change takes many years to realize given that new employees represent only a small portion of the total employment base.

Oregon has taken the additional step to change the way in which prospective benefits accrue to current employees as well as new employees. The impact of this type of change on the accrual of future liabilities is more significant. Some states have also increased contribution levels to pension plans to reduce their unfunded liabilities. Kentucky recently made significant budgetary cuts in order to increase state contributions to its public pension plan. In 2002, Pennsylvania mandated increased employee contributions to their pension plans.

Conversely, some states have deferred their pension obligations, as Illinois has done. Pennsylvania deferred state pension contributions for many years before making its more recent changes. New Jersey, like Illinois, has issued pension obligation bonds to cover its near-term contributions, essentially deferring the situation to future years.

### Other states with large unfunded pension liabilities have taken various actions

	Approaches to managing pension liabilities	Long-term solution?	Case examples
Change prospective pension benefit accruals	• Create a lesser benefit structure for new employees on a prospective basis (“two-tier” or “hybrid”)	✓	• Michigan and Kentucky, among others, have moved to a two-tier program covering new employees
	• Reduce the benefit structure for current employees on a prospective basis	✓	• Oregon has changed pension benefits prospectively for both new and existing employees
Change pension contribution levels	• Increase employer (state) contribution levels	✓	• Kentucky has funded a pension contribution increase through significant budget cuts
	• Increase employee contribution levels	✓	• Pennsylvania increased contribution levels for new employees in 2002
Defer the problem	• Defer payments into pension funds	✗	• Pennsylvania deferred pension payments, but it now has a spike in funding requirements
	• Float pension obligation bonds	✗	• New Jersey has frequently issued bonds to fund its obligations

Source: Various publications from Pew Center, PensionTsunami.com, Kentucky Pension Reform Work Group, Public Employees Retirement Association of Minnesota, Commonwealth of Pennsylvania Governor’s Budget Office

## WHAT CAN WE DO?

The Commercial Club - throughout its long history - has been more than a luncheon group - a place where people could talk about business -- or political or civic issues. The published history of the Club sets out the dozens of projects the Club has undertaken over the years to improve the City and Region. During the last 30 years, the Civic Committee has been at the core of many of the efforts to improve our City - as have the Civic Consulting Alliance, Metropolis 2020, and, more recently, The Renaissance Schools Fund.

The impending implosion of the State's finances will have a major impact on Chicago. It's a problem – or set of problems – well worth tackling.

But what can we do? Nobody elected us to anything. We don't even have a PAC.

What we **can** do is what all groups in a Democracy can do. We can advocate. We can put a brighter spotlight on a problem -- support candidates who are serious about dealing with it -- put pressure on elected officials and candidates to deal with it in a serious way.

As individuals, we can get politically active. We can work with other business and civic groups throughout the State who agree with us.

As a Club, it's probably best to stick to the things that most of us would agree on.

There are basically three ways to solve a budget deficit: (a) cut costs, (b) raise taxes, and (c) borrow.

Most of us would probably agree that **costs** have to be cut out of the State's budget – big time cuts. We've issued reports to that effect – and identified cuts totaling about \$5 billion. The problem is that cuts only get you so far. If you fired all of the 53,000 State employees and hired no replacements, you would only save in the range of \$4 billion per year. And the budget hole is about \$15 billion.

As to **taxes**, most of us would agree that cost-cutting must be the first step. Most would agree that talking about tax increases at this stage would detract from the effort to get reforms and cuts.

There will be time later to consider the need for a tax increase if and when - and **only** if and when - the reforms and cuts are in place.

As to **borrowing** - that's what got us here. The inability to balance the budget - the failure of State leadership to make the hard choices and compromises inherent in living within our means - is what has led to the enormous buildup of unfunded liabilities. That's what now threatens our State's future. We have to stop the borrowing.

We hope to get an ad in the newspapers sometime next week. It will urge people to consider the candidates' positions as they vote in the primary – and it will point them to web sites where they can get information.

We also plan to undertake a public relations campaign after the primary and to keep at it through the November election and into the Legislative session in early 2011.

- We will spotlight the State's fiscal problems - and urge concrete solutions.
- We'll work to develop a coalition with people and organizations throughout the State who will push for the same things.
- We'll meet with candidates - write to candidates - send our stuff to candidates.
- We ask you and your businesses and firms - and business colleagues and partners - to do the same.
- We are creating a new web site to help folks find out what districts they're in, who the candidates are, and how to get in touch with them. It will suggest draft letters and themes. Dea says we're even setting up a special Twitter account for Jim Farrell.
- We'll prepare special information "kits" for you and affiliated groups to use.
- We plan to meet with reporters and editorial boards in Chicago and throughout the State. We'll try to get on free media - TV and radio.
- We will travel around the State to meet with business groups, and candidates, and newspapers in major cities.

We can't do all this ourselves, so we're working with some outside experts to help us.

We will not be partisan. We do not plan to endorse any party or any candidate. We'll work with anyone who is serious about solving these problems.

We expect a lot of pushback. Some of it may not be pleasant. There are plenty of vested interests who like things just the way they are. They are smart, experienced, and politically active - and they are well-heeled.

The truth is - this is going to be very hard, and the odds of success are not great. Getting a second-tier pension plan even for both current and new state employees will be very tough.

But if the Commercial Club and its Civic Committee – and other organizations like the Taxpayers' Federation and the Civic Federation -- don't take this on - who will? This seems to us to fit in the category of "Make No Little Plans."

In closing – I'd like to make one more point: This isn't just about money, or balancing the budget, or even avoiding the implosion of State government - or City government. It's about something a great Illinoisian said a long time ago – at a time when the country was being seriously tested. He said the question was whether a nation, conceived in Liberty and dedicated to the proposition that all men are created equal, can long endure.

It's ultimately about whether Democracy -- self-government -- can be successful.

So - we have a primary election on February 2. Consider which candidates you think are most serious about dealing with the State's fiscal problems. If you're not sure, look at the *Tribune's* Web site.

And - as we say in Chicago - vote early and often.

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## Closing Remarks

**W. James Farrell**

Thank you all for your attendance today and your thoughts. It is clear that there are difficult choices that have to be made to keep the State from collapsing under these fiscal pressures.

Quoting from a popular 1976 movie "*Network*", "**I'M MAD AS HELL AND I'M NOT GONNA TAKE IT ANYMORE.**"

Decades of politicians, including current office holders, have squandered our future and our children's future. **WE HAVE TO HOLD THEM ACCOUNTABLE!** Now is the time to demand fiscal responsibility. Everyone in this room balances their budget. Every one of you should be mad as hell and that anger should be focused on which one of the candidates of the several hundred offices that are up for election will seriously address our financial dilemma. This is not a Republican or Democratic issue.

We have no time for political squabbling. The big elephant in the room is the pension obligation that we cannot afford. The reforms we're suggesting are not draconian. We have a duty to honor a reasonable level of pensions. You should leave here today fixed on the thought that your vote and the vote of your family, friends and employees are needed to put the financial house of Illinois back in order.

We will keep you informed as we move forward and look ahead to your engagement.