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Illinois's Constitutional Pension Protections, with Lessons for New Jersey

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STATE CONSTITUTIONS CAN AFFECT FISCAL policy either by acting as fiscal restraints that limit the scope of government or by imposing fiscal pressures that expand or place demands on government.[1] Seven states, including Illinois, put pressure on their finances by explicitly guaranteeing the payment of public employee pensions through their constitutions,[2] and officials in at least one other state, New Jersey, recently considered adding a pension provision to the state constitution. In this piece, we will focus on Illinois's experience and the lessons it provides for New Jersey and other states.

WHAT'S THE MATTER WITH ILLINOIS?

Some states' constitutional pension provisions protect or have been interpreted to protect only benefits that have already been earned by current employees, while others also protect future benefits these employees "expected at the time of employment."[3] Illinois's state constitution has the strongest form of pension protections, stating "membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[4]

The Illinois State Supreme Court has reinforced the stringency of this clause with a spate of court decisions striking down changes to the pension system[5] and holding that associated retirement health benefits also are constitutionally protected.[6] One of these decisions, which affected pensions for city workers, led Moody's to downgrade Chicago's credit rating, writing that "the city's options for curbing growth in its own unfunded pension liabilities have narrowed considerably."[7]

In a recent paper aptly titled, "Illinois Pensions in a Fiscal Context: A (Basket) Case Study," the authors note that Illinois's constitution mandates that benefits be paid, not that they be funded.[8] Failing to require funding reinforces political temptations to focus on short-run benefits and ignore long-term costs, often through the use of budget gimmicks, and sows the seeds for a crisis. Legislators can strike pension deals today, underfund the pensions, and leave future legislators (and taxpayers) to pick up the tab, with benefit modification being off the table.

This is exactly what happened in Illinois and is precisely how constitutional pension provisions can put fiscal pressure on states. Illinois is certainly not alone in having a broken pension system,[9] and it is unlikely that the constitutionality of the protections is what *caused* the crisis. But Illinois is different from other states because its constitutional protection of pensions limits the policy options available for *fixing* the broken system.[10] As noted before, the courts have exacerbated the problem by striking down even modest reforms, and even if the reforms had remained in place, Illinois would still have needed "substantial increases in revenues or substantial reductions in spending to restore any semblance of fiscal balance."[11]

The stringency of this constitutional provision appears to be an *intended* consequence—a feature, not a bug—of the constitutional reforms in Illinois decades earlier. One analyst who worked on the drafting of the current Illinois constitution, which was ratified in 1970, noted that the pension clause was an intentional response to concerns raised by state and local employees about underfunding of pension systems.[12]

These limits on policy options have serious consequences for fiscal policy choices. Outlays for pension benefits increased from about 5 percent of total Illinois state spending in 2000 to over 20 percent in 2015—growing 10 times faster than overall state spending during the same time period. Despite this massive increase, the state's pension system's liabilities only worsened, increasing from $16 billion to $111 billion during this same time period.[13] By taking benefit modifications for existing employees and retirees off the table, the constitution—or the courts' interpretation thereof—makes a difficult situation far worse.[14]

One option for Illinois is to amend the constitution to eliminate the pensions clause, as at least one group of state legislators have formally proposed.[15] While this does not solve the underlying fiscal problem, it creates more flexibility for the state moving forward. However, as one analyst points out, the political composition of the state (a Democractic legislature and a plurality Democratic electorate), combined with voting thresholds both in the legislature (three-fifths) and among voters (three-fifths of those voting on the amendment or a majority voting in the election) needed to amend the constitution, make this outcome unlikely in the near term.[16] It may be that the fiscal situation in Illinois needs to get even worse, with significant cuts to government services or missed debt payments, before repeal becomes a viable option.

WILL NEW JERSEY LEARN FROM ILLINOIS'S MISTAKES?

Despite the challenges facing the state of Illinois, in 2016 officials in New Jersey, which has the most chronically underfunded pension system in the country,[17] considered a constitutional amendment similar to Illinois's, but with a twist. Specifically, the proposed amendment would both mandate payments into the pension system and create an "indefeasible non-forfeitable right to receive benefits" for state employees hired before 2010 pension law changes—in other words, it would prevent benefit cuts.[18] This amendment was a response to a 2015 court decision ruling that the state government could not be forced to make annual required pension payments under the state constitution's contract clause because it amounted to the state incurring debt without seeking taxpayer approval, in violation of the state constitution's debt limit clause.[19] Ultimately, the amendment failed to make it onto the ballot in 2016, but it is nonetheless instructive to analyze the proposal.

At first glance, the New Jersey amendment appears to be an improvement over Illinois's

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provision, in that it deals with both the funding and the benefits side of pensions. But, by mandating required payments into a system that is already woefully underfunded, with little reason to believe those payments are sufficient to address the shortfall, and by ruling out benefit modifications, the constitutional amendment amounts to telling a doctor she can have a tourniquet to stanch a bleeding wound but isn't allowed to stitch up the wound.

In several 2016 polls, New Jersey voters tended to support the constitutional amendment, though sometimes by slim margins.[20] But they were also opposed to spending cuts for education, road and bridge repairs, and aid to the poor if such cuts were necessary to make the pension payments.[21] The public was also skeptical of tax increases, except on individuals making over $1 million.[22] The most popular way to solve the problem, according to one poll, was to "reform pension benefits," supported by 68 percent of respondents.[23] Yet that is precisely what the amendment rules out, at least for employees grandfathered into the current system.

Given the experience of Illinois, it would have been imprudent for New Jersey to double down on fiscal mismanagement with such an amendment. To do so would continue the states' habit of enshrining substantive policy decisions into state constitutions. As David Primo argues, "once one goes down the road of managing the allocation of spending through state constitutions, it is difficult to know where to stop."[24]

THE FUTURE FOR CONSTITUTIONAL PENSION REFORM

Illinois and New Jersey are two of the least fiscally solvent states in the country.[25] What happens when these states reach insolvency and one or both have constitutional protections in place for the very programs that are a source of the insolvency? Short of state constitutional change or perhaps a voluntary agreement by workers to see their benefits reduced, the federal government may need to pass legislation preempting state constitutions and permitting states to reform pension systems irrespective of state constitutional provisions.[26] Should this happen, it would represent perhaps the starkest example of the dangers of setting state policy constitutionally.

One way in which benefit modifications can be placed on the table may be by committing to more transparency.[27] The poll results discussed earlier suggest that if voters were aware of the sheer size of pension obligations and the tradeoffs involved in maintaining the current system, they might be more willing to support a constitutional amendment to eliminate pension protections from the state constitution or vote against misguided constitutional alterations.

Other states may also learn from the situations in Illinois and New Jersey. Promising benefits today without a sustainable funding mechanism is politically attractive but irresponsible. This temptation points to the need for state constitutions to place fiscal restraints on elected officials and limit the abilities of legislators to evade those restraints through the creation of "off-book" entities like pension funds that are not subject to balanced budget rules or debt limitations.[28] Otherwise, state governments run the risk of unanticipated interactions among provisions. As Monahan writes, "Balanced budget requirements do not in any way prevent pension underfunding. Arguably, such requirements actually contribute to the incentives to underfund pensions because they significantly constrain appropriations, and pension contributions are costs that are easy to push into the future."[29]

In closing, the fiscal challenges in Illinois have been exacerbated by constitutional pension protections, and New Jersey recently contemplated constitutional reform that could have had similar effects. Understanding the role state constitutions play in fiscal policy may help Illinois, New Jersey, and other states address current pension problems or avoid future ones.

NOTES

1. Some examples and/or concepts in this paper were first presented in David M. Primo, "State Constitutions and Fiscal Policy" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2016).
2. Other states protect pensions through nonconstitutional means, and Texas's state constitution also protects local pensions. Alicia H. Munnell and Laura Quinby, "Legal Constraints on Changes in State and Local Pensions," *State and Local Pension Plans*, no. 25 (2012).
3. Munnell and Quinby, "Legal Constraints," 2.
4. Il. Const. art. XIII, § 5.
5. In re Pension Reform Litigation, 2015 IL 118585; Jones v. Municipal Employees' Annuity & Benefit Fund, 2016 IL 119618.
6. Kanerva v. Weems, 2014 IL 115811.
7. Moody's Investors Service, "Rating Action: Moody's Downgrades Chicago, IL to Ba1, Affecting $8.9B of GO, Sales, and Motor Fuel Tax Debt; Outlook Negative," news release, May 12, 2015.
8. Jeffrey R. Brown and Richard F. Dye, "Illinois Pensions in a Fiscal Context: A (Basket) Case Study" (NBER Working Paper No. 21293, National Bureau of Economic Research, Cambridge, MA, June 2015).
9. For background on the issue of underfunded pensions, see Mark J. Warshawsky and Eileen Norcross, "Underfunded Pensions: The Expanding and Escalating Challenge," Economic Perspectives, Mercatus Center at George Mason University, September 1, 2016.
10. Daniel DiSalvo, "The Limits of Retrenchment: The Politics of Pension Reform" (Civic Report No. 103, Center for Civic Leadership, Manhattan Institute, New York, 2015).
11. Brown and Dye, "Illinois Pensions in a Fiscal Context," 20.
12. Ava Henriksen, "No Way Out: The Role of the Pension Clause in Illinois' Fiscal Crisis," *The Gate*, August 24, 2015.
13. Data for this paragraph is from The State of Illinois, *Illinois State Budget: Fiscal Year 2017: July 1, 2016–June 30, 2017*, February 17, 2016.
14. It is possible to alter benefit plans for new employees, but the major source of fiscal pressure comes from the benefits already earned (and that may be earned in the future) for employees already in the system.
15. House Joint Resolution Constitutional Amendment, HC0009, State of Illinois, 99th General Assembly, 2015 and 2016.
16. Diana Furchtgott-Roth, "Empowering Illinois' Pension Reform" (report, Manhattan Institute for Policy Research, New York, April 2016).
17. National Association of State Retirement Administrators, "Issue Brief: State and Local Government Contributions to Statewide Pension Plans: FY 14" (Lexington, KY: National Association of State Retirement Administrators, 2016).
18. Senate Concurrent Resolution No. 2, State of New Jersey, 217th Legislature, 2016.
19. Burgos v. State of New Jersey, A-55-14, 075736 (2015).
20. Farleigh Dickinson University, "Farleigh Dickinson Poll Finds Support for Quarterly Pension Payments, but Concerns over Budget Cuts and Tax Increases," news release, January 21, 2016; Rutgers Eagleton Center for Public Interest Polling, "New Jersey Voters Divided over Quarterly Pension Payments; Oppose Funding through Tax Hikes, Budget Hikes," news release, February 29, 2016; Monmouth University Polling Institute, "Voters Support Requiring State Pension Payments…Except When They Don't," news release, June 9, 2016.
21. Monmouth University Polling Institute, "Voters Support Requiring State Pension Payments."
22. Rutgers Eagleton Center for Public Interest Polling, "New Jersey Voters Divided."
23. Rutgers Eagleton Center for Public Interest Polling, "New Jersey Voters Divided."
24. Primo, "State Constitutions and Fiscal Policy," 30.
25. Eileen Norcross, "Ranking the States by Fiscal Condition" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2016).
26. Furchtgott-Roth, "Empowering Illinois' Pension Reform."
27. Primo, "State Constitutions and Fiscal Policy."
28. Amy B. Monahan, "When a Promise Is Not a Promise: Chicago-Style Pensions," *UCLA Law Review* 64, no. 2 (2017).
29. Monahan, "When a Promise Is Not a Promise," 402.

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