

TESTIMONY OF R. EDEN MARTIN  
WITH RESPECT TO ILLINOIS FINANCE  
RETIREE HEALTH CARE  
MARCH 10, 2009

My name is R. Eden Martin. I am President of the Civic Committee of The Commercial Club of Chicago. The Civic Committee consists of approximately 90 senior business leaders in the Chicago area, and works to make the region a better place to live and work.

In December 2006, the Civic Committee issued its report on Illinois State finance – *Facing Facts*. This report showed that Illinois was headed toward financial implosion – largely because of its failure to recognize and/or fund its growing liabilities for pensions and retiree health care. When these were recognized, the State’s annual operating budget was shown to be seriously imbalanced; and the mass of unfunded debts and obligations amounted to in the range of \$100 billion.

In the case of pensions, the problem was that pension liabilities had been improperly funded. In the case of retiree health care, the problem was that the liabilities were not even recognized – and not funded at all – let alone inadequately funded. The State’s practice had been – and was at that time – to pay health care claims for employees and retirees as they were presented. The State did not accrue and recognize on its operating statements the real, economic cost of the growth in its liability to cover health care costs of retirees. And the State’s balance sheet did not show the accumulation of these unfunded obligations as a liability.

As of Fiscal Year 2007, the Civic Committee’s outside experts – without access to the State’s human-resources data – estimated the total unfunded liability for retiree health care. This is the liability the State has – based on the practice it has applied over the past several years – of paying all or part of the cost of health insurance for people who worked for Illinois State government or for other entities for which Illinois has assumed some responsibility for pensions and/or retiree benefits.

To illustrate: suppose someone went to work for the State at the age of 35 and continued to work two decades, and then retired at the age of 55. The retired worker is entitled under today’s plans to a generous retiree health care program from the State. After 20 years of service, Illinois pays 100% of the retiree’s health insurance premium, and the retiree pays zero part of the premium. The worker who started at 35 and worked 20 years was thus 55 when this retiree health insurance commenced – and would be entitled to continue under the State’s plan for the next 10 years, with the State assuming 100% of the premium cost. Once the retiree became eligible for Medicare at age 65,

Medicare would assume part of the retiree's health care costs, with the State continuing to make up the difference.

This is a very generous benefit for retired State workers, and it is very costly for the State. The benefit is "earned" by the worker during the 20 years in which he worked for the State; but during those years, the State did not recognize this annual growth in the obligation as an operating cost; and it did not recognize the accumulated pile of these obligations – to this worker and others – in its balance sheets. It goes without saying that the State likewise did not fund – or make any other provision – for this growing obligation to make future payments.

Applicable government accounting standards then changed, effective with FY2008. And for the first time Illinois began to estimate and recognize (a) the real, economic cost of the growth of retiree health care liability in its annual operating statements, and (b) the accumulated amount of this liability – piled up over past years – in its balance sheet.

Three issues are presented:

1. How large is the retiree health care liability?
2. Why is it as large as it is?
3. What should now be done about it?

#### **I. How Large Is Illinois' Retiree Health Care Liability?**

The first question is whether the State's practice of paying for health insurance for its retirees is a "liability" at all. The answer seems to be – no. The State's Constitution has a provision interpreted to prevent reduction in "benefits" under its pension plans; but there is no similar provision with respect to retiree health care.

The State has had a practice for years of paying for health insurance for retirees. But a practice, even a consistent one, does not – without more – create a contractual liability, one enforceable in a court. It does not appear that Illinois has contractually committed to provide health care insurance to retirees – either at a particular level or at all. Indeed, the State seems to have modified its retiree health insurance programs and benefits in past years – suggesting that such adjustments were not precluded by any contract.

Moreover, some of the retirees who have enjoyed the benefit of health insurance under the State's programs were not, during their working years, employees of the State at all. They were, rather, employees of other entities – for example, the University of Illinois and other State universities.

So why have the State's accountants included this "liability" for retiree health care coverage in the State's financial statements? The answer seems to be that

accountants do not make a judgment as to whether such payments are a contractual requirement; but as long as the State has a practice of making such payments, the accountants treat them as if they were a liability. If the State were to change its policy, the reporting would or might also change.

Assuming for purposes of discussion that retiree health care is a “liability,” or something in the nature of a “liability” (at least unless and until the State’s practice changes), how large is it?

In December 2006, upon the advice of its outside experts who did not have access to the State’s personnel files but did have experience with comparable programs in other states, we estimated that the total accumulated unfunded liability on the part of the State was in the range of \$43 to \$53 billion.

During the following year, the State’s actuaries – with access to the State’s files and data – calculated the amount of the liability to be only \$24 billion. However, as applicable governmental accounting did not then require the liability to be included as such in the State’s financial statements, it was not included. Moreover, no provision was made by the State to start funding this liability.

It appears that one reason for the difference between our 2006 estimate and the State actuarial calculations is that the State’s actuaries did *not* include in their calculations any liabilities for (a) the employees of the State’s community colleges, or (b) the employees of the K-12 school districts throughout the State. The theory appears to be that because these employees were not employees of the State of Illinois (but were rather employees of their respective colleges and schools), therefore the State has no “liability” for their retiree health care.

The unanswered question is why the State reports (as part of its “liability”) amounts for retirees from the University of Illinois and other State universities, but omits comparable liabilities to retirees from the community colleges and schools? In both cases, retiree health care is made available by plans established under State law and administered by the State. In both cases, the State has a practice of funding all or part of these payments.

In any event, in its recent updated report, issued in March 2009, on Illinois State finance, the Civic Committee used the lower number provided by the State’s actuaries, although we also noted that if the retirees from the Community College Insurance Program and the Teachers’ Retirement Insurance Program were included, the State’s liability for retiree health care would rise from \$24 billion to about \$40 billion.

Also using the State-provided lower number for developing the amount to be taken into account in the State’s annual operations, we estimate that for the current fiscal year – FY2009 – if the operating statement were adjusted to include not only (a) the amount of payments actually being made on a “pay as you go” basis to cover bills as they are submitted, but also (b) the increasing obligation this year to pay those bills in some

future year, then the annual cost of retiree health care rises from about \$600 million (cash basis) to a total of \$1.7 billion

The additional amount – roughly \$1.1 billion – is a part of the State’s real budget deficit, though it does not appear in the State’s operating statements developed on a cash basis. (See attached exhibits.)

## **II. Why Is Illinois’ Retiree Health Care Liability So Large?**

There are several reasons why the State’s total retiree health care liability is very large. One is that the State has done nothing to fund the growth of this liability – but has only paid the bills as they came due (“pay as you go”).

Another reason is that the State’s plans are very generous – and thus very costly. A retiree from State government in Illinois can retire after 20 years service with the right to participate fully in the retiree health program. Because retirees may start to benefit at age 55, they may enjoy these benefits for many years before becoming eligible for the federal Medicare program. If an employee/retiree could qualify for this benefit only after more years of service, and/or only after attaining a certain age – e.g. 65 – the cost of the benefit to the State would be much less.

Still another reason is that retirees in Illinois need not use the “managed care” option offered under the State’s health care programs. Retirees may choose to use any doctor they wish – which is more costly.

A further reason is that retirees with 20 years of service or more pay no part of their health insurance premium. The State of Illinois pays 100% of the premium. (However, the retiree may be liable for certain deductible amounts.)

There may have been a time when employees of private-sector firms had access to such generous retiree health care programs. But the pressures of competition have forced most firms to trim back on such benefits – incentivizing employees and retirees to use managed care programs, and requiring them to share in the insurance premiums as well as to pay deductible amounts. These measures have combined to incentivize employees and retirees to be careful in the use of available health care, and to bear a greater share of the costs.

The State’s retiree health program should likewise be trimmed and made more economical. Although the State is not subject to the same competitive pressures that have forced such measures on private-sector firms, it should impose similar pressures through internal management and discipline. The State has not been able to afford these plans in recent years – as is evident when one examines the growth in the State’s budget generally, and its health care costs in particular. Moreover, it is unsustainable – either politically or as a matter of basic fairness – for retirees from State government to enjoy such benefit levels when they are unavailable to most citizens and taxpayers.

Fiscal realities and considerations of fairness thus combine to require that the State of Illinois fundamentally restructure its retiree health arrangements.

### **III. What Should Be Done to Reform the State's Retiree Health Programs and Cut the Cost of these Programs?**

The State should recognize that the basic program guaranteeing retiree health care for all retirement-age Americans is Medicare. Citizens become available for Medicare at age 65.

The State should limit its exposure to retiree health costs by requiring that State workers must (a) work more years for the State, and (b) attain an age nearer normal retirement age, in order to become eligible for State-provided retiree health care. A reasonable requirement would be that workers/retirees must have worked at least 30 years for the State, and attained at least 65 years of age, in order to qualify for full benefits. Workers/retirees who work fewer years or retire at earlier ages, would have less benefits.

The benefits themselves should be reduced for those who fully qualify. Retiree health should be offered only through "managed care" options, which are generally less costly.

Also, the cost of the health insurance premiums should be borne in larger measure by the retirees. There is no justification based on private-sector comparisons for the State's continuing to bear 100% of the premium costs for retirees who qualify for full benefits. Nor can the State of Illinois afford any longer to bear all of these costs.

An alternative which we strongly recommend is suggested by the plan recently adopted by the Chicago CTA, with the approval of the Illinois legislature. The CTA basically negotiated an arrangement with its unions by which the CTA took itself out of the business of providing – or being liable for – retiree health care by creating an independent retiree health care trust. The State "seeded" the trust fund with about \$500 million. Active employees are responsible for contributing at least 3% of compensation to the fund; retirees and their dependents are expected to contribute up to 45% of the cost of coverage. If the fiduciaries responsible for the plan determine that the trust fund is not properly funded, they may require contribution increases or benefit decreases. But it is the fund – not the CTA itself – that is responsible for covering the future health care costs of retirees.

The State of Illinois should create a similar trust arrangement to help fund the costs of its retirees. The State should provide a fixed annual contribution to the trust, taking as a starting point its current expenditures of around \$600 million on retiree health care. State retirees and their dependents should be expected to cover a significant part of their health care costs (similar to the CTA's plan) and active employees could also be

required to contribute. Based on these contributions, the trust should offer a retiree health care program that is more in line with those offered in the private sector.

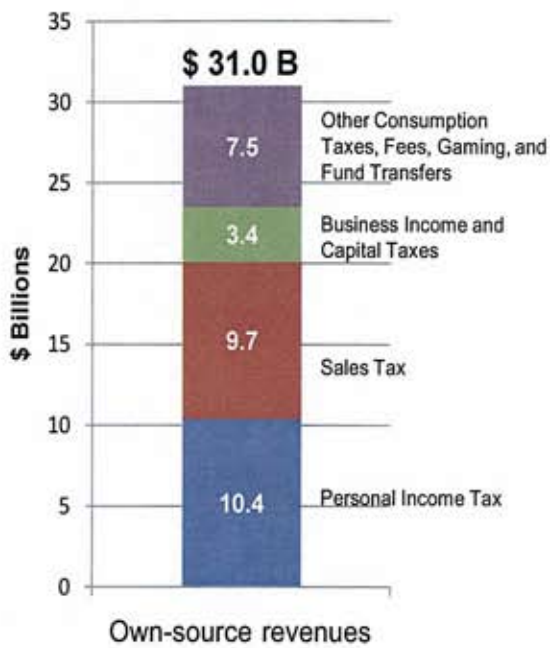
State employees should only be able to access full retiree health care benefits at the age of 65 and after 30 years of service. Retirees who are not yet eligible for Medicare should be expected to cover a significant part of their health care costs. The amounts available to retirees from such a trust should be used only for “managed care” plans, and only subject to cost-sharing requirements to create proper incentives to insure proper care while not wasting valuable resources.

In its recent updated report on State finance, the Civic Committee has estimated that the State of Illinois could significantly reduce its retiree health care costs – annually – by reforming its plans as suggested above. We believe the potential annual savings could be in the range of \$1.1 billion per year – essentially by eliminating the growing unfunded “liability.”

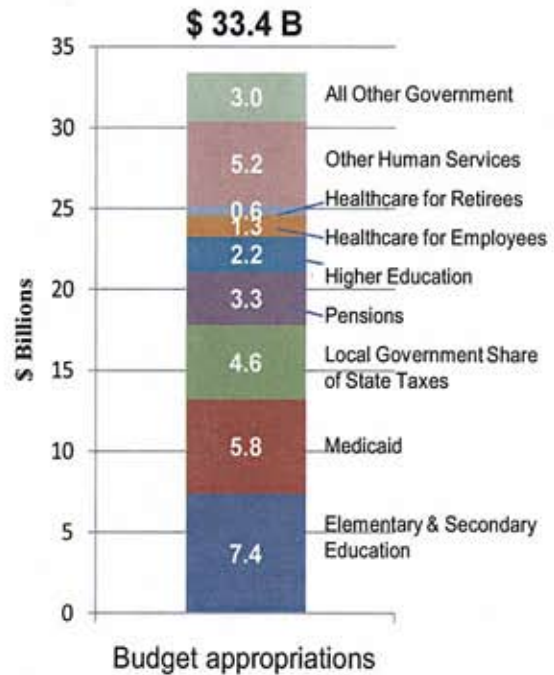
EXHIBIT A

Illinois Own-Source Revenues and Spending  
2009 Budget

Own-Source Revenues



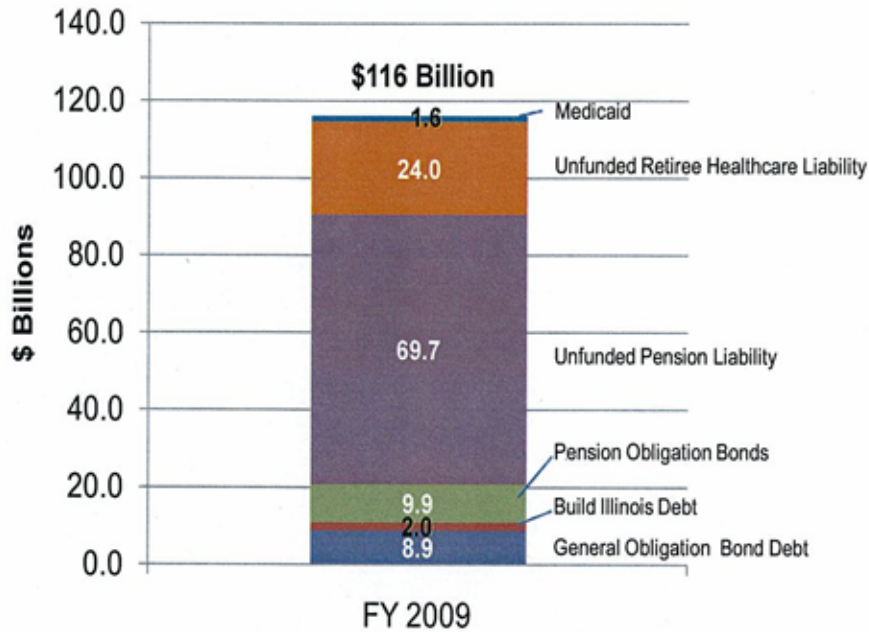
Budget Appropriations



Source: Taxpayers' Federation of Illinois.

## EXHIBIT B

### Total State Debt and Unfunded Obligations



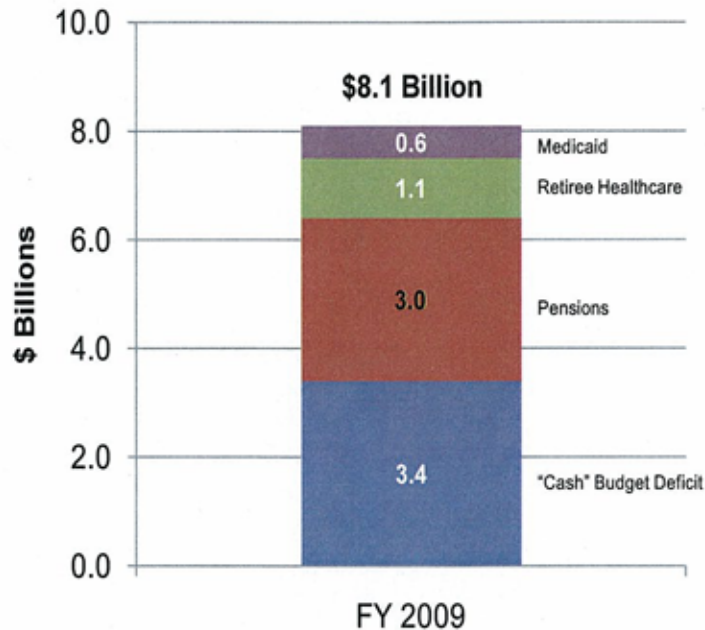
Note: GO bond debt and Build Illinois debt are COGFA forecasts of June 30, 2009 amounts outstanding. Pension Obligation Bond debt is forecast of June 30, 2009 debt based on POB principal repayment schedule from COGFA. Unfunded pension liability estimate is based on estimated State pension fund asset values as of December 31, 2008 and a recent COGFA estimate of the total pension liability at the end of FY2008. Unfunded retiree healthcare liability estimate is the point estimate from the Governor's office of the 2008 unfunded retiree health care liability. Medicaid debt assumes that half of projected unpaid Medicaid bills at the end of FY2009 are the responsibility of the State (based on 50% federal match).

Source: Various reports of the Commission on Government Forecasting and Accountability; Pension fund estimates; Governor's office estimates; Taxpayers' Federation of Illinois analysis.



## EXHIBIT C

### Total Annual Budget Gap



Note: Pension gap is equal to Normal Cost Plus Interest payment in FY2009 of \$5.9 billion minus Total Employer Contribution of \$2.9 billion. Retiree healthcare gap is equal to FY2008 ARC of \$1.7 billion minus FY2008 State healthcare payments for retirees of \$0.6 billion. Medicaid gap is equal to forecasted increase in State share of unpaid Medicaid bills from FY2008 to FY2009 (\$0.3 billion) plus amortization of State's share of FY2008 Section 25 liabilities (assuming \$1.3 billion in State Section 25 liabilities are amortized over 4 years).

Source: Various reports of the Commission on Government Forecasting and Accountability; Governor's office estimates; Taxpayers' Federation of Illinois analysis.