DEDICATED REVENUE SOURCES FOR STATE PENSION FUNDS

A Civic Federation Issue Brief

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OVERVIEW

This issue brief describes dedicated revenue sources for state pension funds and recent proposals for dedicated revenue sources in Illinois. It then discusses important features of an effective dedicated pension revenue source.

DEFINITION

A dedicated revenue source for a public pension plan is an ongoing or one-time revenue source that must, by law, be contributed to the pension fund.[1]

For example, many local pension funds in Illinois have a dedicated property tax levy that provides the annual employer contribution to the fund.[2] The employer contribution for these funds is fixed in state statute as a multiple of the total employee contribution made two years prior, and thus relates neither to the funded level of the pension plan nor to the overall property tax levy of the local government.

Receipts from a one-time revenue source, such as an asset sale or lease, may be dedicated to a pension fund. Pension obligation bonds are also considered one-time dedicated revenues.

PURPOSE OF DEDICATED REVENUE SOURCES

The purpose of dedicating a revenue source for a specific government program is to insure that the funding stream for that program cannot be impaired by the changing priorities of elected officials—it is an attempt to insulate a government function from the vagaries of the appropriations process. Dedicated revenue proposals commonly emerge in reaction to a public perception that a government is not appropriating sufficient revenues for a given function.

While a dedicated revenue source may ensure that money from a certain source is appropriated for a specific function, it does not necessarily ensure a <u>sufficient</u> revenue stream for that function. This is clear in the case of the local Illinois pension funds whose statutory property tax levies are unrelated to their funding requirements.

Using longitudinal data on over 100 state and local pension plans in the U.S., a recent statistical analysis by the Pension Research Council of the University of Pennsylvania found that dedicated revenue streams appear to have a negative effect on pension funding

[1] The term "ongoing" is meant to distinguish one-time revenues from multi-year revenue streams. However, ongoing revenue streams are subject to the annual appropriations process and thus may be ended at any time by the will of the General Assembly.
[2] See The Civic Federation, *Status of Local Pension Funding: Fiscal Year 2004*, (Chicago: The Civic Federation) February 27, 2006. http://www.civicfed.org/articles/civicfed_205.pdf

levels.[3] The authors speculate that this could be because state or local governments fail to contribute additional funds when the dedicated stream is insufficient to meet the pension plan's funding needs.

DEDICATED REVENUE SOURCES FOR STATE RETIREMENT SYSTEMS IN OTHER STATES

Although a number of states have used one-time revenues such as pension obligation bonds to shore up their state pension funds, few have ongoing dedicated revenue streams for those funds. For the vast majority of state retirement systems, annual state contributions are funded through appropriations from general funds.[4] The State of Oklahoma is one exception, described below.

State of Oklahoma

The State of Oklahoma administers seven pension systems: Teachers, Oklahoma Public Employee Retirement System (OPERS), Fire, Police, Law, Judges, and Wildlife. Each state agency or local employer makes an employer contribution to the pension fund expressed as a percent of salary and paid from the agency's budget as an employee benefit expense. For example, school districts make an employer contribution of 7.05% of salary to the Teachers' fund out of their general revenues, some of which are state aid monies.

Four Oklahoma pension funds receive additional dedicated state revenues. The Teachers' fund receives, in additional to school district employer contributions, 4.5% of state income and sales/use tax revenues, and 5% of lottery revenues. The income and sales taxes were instituted in 2000 and replaced dedicated revenue from a gross production tax on natural and casinghead gas, which had become too volatile a revenue source and now goes into the general fund. In addition, 5% of revenues from a new state lottery started in 2005 are dedicated to the Teachers' retirement fund. The lottery revenue is expected to generate $3.1 million for the Teachers' fund in 2006.

The Police, Fire, and Law funds each receive a portion of receipts from the state's insurance premium tax. The insurance premium tax rate is 2.5% of the premium cost for all insurance policies except workers' compensation, which is taxed separately. The Police, Fire, and Law funds have received insurance premium tax revenues since at least

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[3] Tongzuan Yang and Olivia S. Mitchell, "Public Pension Governance, Funding, and Performance: A Longitudinal Appraisal," (working paper PRC WP 2005-2, Pension Research Council, The Wharton School, University of Pennsylvania, 2005). http://rider.wharton.upenn.edu/~prc/PRC/WP/WP2005-2.pdf
[4] Keith Brainard, Research Director of the National Association of State Retirement Administrators, personal communication, May 17, 2006.

1981. The Oklahoma Pension Oversight Commission notes that recent tax credits have eroded the base for the insurance premium tax.[5]

The following table shows the dedicated revenue sources, employee and employer contributions, and funded ratios for the seven Oklahoma pension funds.

Oklahoma State Pension Systems
Dedicated Revenues, Contributions, and Funded Ratios

	Dedicated State Revenue	Employee Contribution	Employer Contribution	Funded Ratio FY2005
Teachers	4.5% of Income and Sales Taxes; 5% of Lottery	7.0%	7.05%	49.5%
OPERS	none	3 to 3.5%	10.0%	72.0%
Fire	41% of Insurance Premium Tax	8.0%	13.0%	63.7%
Police	41% of Insurance Premium Tax	8.0%	13.0%	78.6%
Law	6% of Insurance Premium Tax	8.0%	10.0%	83.8%
Judges	none	8.0%	3.0%	108.7%
Wildlife	none	3.0%	18.0%	81.4%

Source: Oklahoma Pension Oversight Commission, *Crisis in the Oklahoma State Pension Systems: 2006 Status Report of the Oklahoma Pension Systems* , March 24, 2006.

It is noteworthy that most of Oklahoma's pension funds are poorly funded. According to a recent Standard & Poor's report, the combined Oklahoma funded ratio of 57.0% ranked 49th in the nation, second only to West Virginia's 43.9% ratio for FY2004 (Illinois tied with Connecticut for 46th place, with a funded ratio of 59.9%).[6] As in Illinois, Oklahoma's low funded ratio reflects decades of chronic underfunding. The Oklahoma Pension Oversight Commission has recommended that state funding for pensions be increased through the following measures: increasing the share of income and sales taxes dedicated to the Teachers' fund; protecting the insurance premium tax base from erosion; dedicating a portion of surplus reserve fund revenues to the pension funds; and seeking other one-time dedicated sources such as pension obligation bonds.[7]

Other States

Some other states, including Colorado, Florida, Idaho, and Washington, dedicate portions of insurance premium taxes to police and/or fire funds. In Illinois, police and fire funds are supported by dedicated property tax levies. Insurance premium taxes collected in

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[5] Oklahoma Pension Oversight Commission, "Crisis in the Oklahoma State Pension Systems: 2006 Status Report of the Oklahoma Pension Systems," March 24, 2006, p. 12.
[6] Parry Young, "Rising U.S. State Unfunded Pension Liabilities are Causing Budgetary Stress," Standard & Poor's, February 22, 2006.
[7] Oklahoma Pension Oversight Commission, "Crisis in the Oklahoma State Pension Systems: 2006 Status Report of the Oklahoma Pension Systems," March 24, 2006, pp. 12-13.

Illinois are primarily deposited in the state's general fund, with the exception of premiums of fire-related insurance policies, which are directed to the Fire Prevention Fund.[8]

The Rhode Island Pension Review Team recommended in 2005 that 50% of any state general fund operating surplus over $30 million be set aside as an additional contribution to the state pension funds.[9] The Team's labor representatives also endorsed dedicating a number of other revenue sources to the retirement systems, including: a portion of any state asset sales; any gaming revenues in excess of projected FY2005 receipts; proceeds from bond refinancing; Sinking Fund Commission revenues; Capital Fund assets; and surplus assets of well-funded municipal retirement plans.

PROPOSALS FOR DEDICATING REVENUE SOURCES TO ILLINOIS STATE RETIREMENT SYSTEMS

Second Blue Ribbon Pension Commission

The Governor's second Blue Ribbon Commission on Pensions, which met in 2005, made a number of pension reform recommendations.[10] In its analysis of the proposed FY2007 State Budget, The Civic Federation agreed with three of the Commission's findings that focus on dedicating either one-time or ongoing revenues to the retirement systems:[11]

1. The State should dedicate revenues in excess of a targeted percentage of growth toward the additional funding of the pension systems when those targets are met and establish a minimum when they are not met.
2. If the state sells certain assets, 100% of the proceeds should be dedicated toward reducing pension liabilities.
3. The General Assembly should explore new dedicated revenue sources for the retirement systems.

House Bill 5237 / Senate Bill 2851

HB 5237, sponsored by Representative Robert Molaro (D-Chicago) and SB 2851, sponsored by Senator Jeff Schoenberg (D-Evanston), proposed creating a special Pension Reserve Fund to receive any additional moneys remaining in the **Riverboat Gambling Fund** after local distributions had been made. The Pension Reserve Fund monies would be used to fund the unfunded liabilities of the five state retirement systems and would be distributed according to their total share of the five systems' combined unfunded liability.

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[8] Illinois Legislative Research Unit, *Illinois Tax Handbook for Legislators, 20th Edition*, May 2004.
[9] State of Rhode Island Pension Review Team, *ERSRI Evaluation Report*, February 2005, p.62.
[10] See http://www.state.il.us/budget/ADVISORY%20COMMISSION%20FINAL%20REPORT.110105.pdf
[11] The Civic Federation, *State of Illinois Pension Systems: Analysis and Recommendations (FY2007)*, (Chicago: The Civic Federation) March 17, 2006. http://www.civicfed.org/articles/civicfed_207.pdf

The bills specify that the Pension Reserve Fund distributions would be **in addition to, not in lieu of**, the regular state contributions required by the Pension Code.

These bills both remained in their respective Rules Committees after having been introduced in January 2006.

Public Act 94-0893

Public Act 94-0893, signed into law by Governor Blagojevich on June 6, 2006, contained a number of new pension provisions including the creation of a Pension Stabilization Fund. The Act specifies that the Pension Stabilization Fund is to receive 0.5% of general fund revenues if fiscal year general revenues increase by more than 4% over the previous year. Likewise, the Pension Stabilization Fund is to receive 1% of general fund revenues when general revenues increase by over 4% for two or more consecutive years. The Pension Note to the bill (Senate Bill 1977) stated that FY2007 general revenues receipts were projected to exceed FY2006 revenues by only 2.7%, thus no transfer to the Pension Stabilization Fund would be made in FY2007. However, the Act does permit the Governor to transfer up to $25 million of any FY2006 surplus to the Pension Stabilization Fund on or before August 31, 2006.

Pension Stabilization Funds are to be proportionately distributed to the five state retirement funds according to their unfunded liabilities. The Act specifies that such transfers must serve only to reduce the funds' unfunded liabilities, and cannot be used to reduce required state contributions.

REQUIREMENTS FOR EFFECTIVE PUBLIC PENSION DEDICATED REVENUE STREAMS

An effective dedicated revenue stream for a public retirement system is one that ensures a sufficient revenue stream for the fund. Unfortunately, several local pension funds in Illinois with dedicated property tax levies fail to ensure sufficient revenues because their levies are unrelated to actuarial funding requirements, but rather are simply multiples of the employee contribution made two years prior.[12]

In contrast, the statutory provisions of the Illinois Municipal Retirement Fund, the downstate police and the downstate firefighter retirement systems remedy this problem by requiring that the annual property tax levy be related to the fund's actuarially required contribution (ARC).[13]

[12] These funds include the pension funds of Cook County, Cook County Forest Preserve, Chicago Park District, Metropolitan Water Reclamation District, and the four funds of the City of Chicago.

[13] See The Civic Federation, "Pension Fund Actuarially Required Contributions (ARC): A Civic Federation Issue Brief," forthcoming.

Clearly, an effective dedicated revenue stream for a public retirement system, whether state or local, must link revenues to actuarially determined funding needs to ensure adequate employer contributions to the fund.