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Illinois Court's Rejection of Pension Benefit Cuts Is Credit Negative

From Credit Outlook

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Last Friday, the Supreme Court of Illinois (A3 negative) unanimously ruled that 2013 pension reform legislation violates the state constitution. This development is credit negative for the state because the reforms would have reduced Illinois' reported pension liability by about $21 billion. Rejection of the pension benefit legislation puts the state under increased pressure to devise a way to pay for liabilities created through decades of insufficient contributions.

The reforms included measures to reduce the state's accrued pension liability on its largest pension plans through cost-of-living adjustment reductions, caps on final salary for benefit calculation and higher minimum retirement ages. The state, which operates under a 1970 constitution that includes a specific protection for public pension benefits, argued that even if such measures amounted to benefit cuts, they were legally justified to avert a fiscal crisis and maintain core services.

In its opinion, the seven-member court rejected the notion that the state had a legal basis to break a contractual commitment to public pension participants, upholding a November 2014 lower court ruling that invalidated the reforms. This ruling was widely expected following comments last summer by the state's highest court in a case that dealt with healthcare benefits provided through the pension systems.

Illinois Governor Bruce Rauner has proposed alternate legislation to reduce pension costs as a part of his plan to address a general fund deficit of $6.7 billion in the fiscal year starting 1 July. The governor's approach, which has yet to be incorporated in legislation, would force employees' future benefit accruals to follow a less-generous plan devised for workers who were hired after 2010. Although Mr. Rauner asserts that these pension plan changes would not violate the state's constitutional protections, we believe they will at least be subject to litigation and delay. Moreover, the court's latest ruling raises doubt that they can be implemented at all.

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Given these facts, the state will come under increasing pressure to manage its pension liabilities through other means. One initiative the state has already considered is shifting the funding burden for teachers and public university employees to their employers, a strategy that is likely to be controversial. A funding burden shift to school districts and universities would alleviate the pension burden on the state, which now shoulders the bulk of employer contributions for school teachers outside Chicago and for university employees statewide. A shift in the funding burden would be negative for the credit standing of state universities and for many local governments, which would have to bear a much greater share of the employer contributions for their workers.

Another approach to satisfying the state's outsize pension liabilities is cutting spending on other services or raising taxes to pay for the growing funding requirements. To date, the state has not tried to orchestrate a funding strategy that assumes it will need to satisfy the existing pension liabilities over an extended period.

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