Illinois's Magic Pension Trick.

Close your eyes, issue 27-year bonds and watch liabilities disappear.

Democratic politicians in left-leaning states have been brainstorming ideas to avoid serious pension and tax reforms. The creative financial geniuses in Illinois have come up with a doozy: a magic bond that would save the state as much as it borrows.

Democrats in the state House have proposed issuing $107 billion in bonds to backfill the state's pension funds, which are short $129 billion. Annual state pension payments are projected to increase to $20 billion in 2045 from $8.5 billion—not including interest on $17 billion in debt the state previously issued to pay for pensions.

At the request of state retirees, a University of Illinois math professor performed a crack analysis showing how the state could use interest-rate arbitrage to shave its pension costs. Under the professor's math, the state could sell 27-year, fixed-rate taxable bonds and invest the proceeds into its pension funds. This would supposedly stabilize the state's pension payments at $8.5 billion annually, save taxpayers $103 billion over three decades and increase the state retirement system's funding level to 90% from 40%. Can the mathemagician make House Speaker Michael Madigan disappear too?

The professor based his analysis on pension obligation bonds issued under former Gov. Rod Blagojevich in 2003 with a 5.05% coupon that have earned on average 7.62% in the pension system. But that period included two bull equity markets, and even the state pension funds project only a 7% long-term return.

Illinois's borrowing costs have also increased as its credit rating has slipped to a notch above junk from double-A. Last year the state's taxable bonds due in 2035 traded at yields up to 7.2%. Investors may demand even higher rates because of the substantial interest-rate and credit risk given rising rates and the length of the 27-year bonds.

These magic bonds wouldn't carry the state's "full faith and credit" protection, for whatever that's worth nowadays in Springfield. In effect, public workers' pensions would be the bond security.

Two relevant precedents are the cities of Detroit and Stockton, California. Both borrowed to finance pensions and then later defaulted. Creditors had no recourse when the cities went bankrupt. States can't file for bankruptcy under federal law, but Illinois lawmakers could seek to extend maturities or reduce interest payments on the bonds. Good luck to creditors in court.

The real goal with these bonds is to shift the pension-liability risk from public workers and retirees to investors and taxpayers. This would liberate politicians to spend more and remove any incentive unions have to reform pensions. After borrowing for pensions in 2003, state lawmakers skipped payments, increased spending and scrapped retirement reforms for new workers.

Republican Gov. Bruce Rauner won't fall for this ruse. But if a Democrat defeats him this fall, unions may pull this magic bond out of their bag of political tricks.

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