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Chicago's Fiscal Storm.

The deeply indebted city, with bonds already rated as junk, considers borrowing billions to cover its pension costs.

When Chicago issued half a billion dollars in new bonds late last year, some investors balked, though the offering was designed to protect them by guaranteeing that they would be paid with tax revenues that Illinois sends to its biggest city. "It's an untested model," the research head at Gurtin, a municipal bond firm, said of the offering—Chicago's first under a new state law. Ominously, he worried that if Chicago defaults, it was unclear how much protection holders of the new debt would really get.

Even as Chicago grapples with nightmarish violent crime, the city faces imposing fiscal challenges. The city, which says that it will collect about $8.5 billion in local revenues this year, is burdened by an astounding $28 billion in unfunded pension liabilities and another $9 billion or so in money that it owes to general-obligation bondholders, as well as billions more in other debts. Chicago's bonds, graded as "junk" by analysts, are among the lowest-rated of any major municipality. That forces the city to stretch the limits of municipal finance, seeking innovative techniques that might get new borrowers on board, but at the potential expense of taxpayers and holders of Chicago's other debts. It's becoming increasingly difficult to see how this ends well in the Windy City.

Chicago's latest fiscal scheme is already making headlines at home and in municipal-finance circles. Late last week, Chicago's chief financial officer and a financier close to Mayor Rahm Emanuel proposed the idea that the city would borrow $10 billion through a bond offering to shore up its pension system, using a dedicated revenue stream in order to persuade investors to come on board. The plan would seek to offset the pressure that the city faces from accelerating pension payments that it must make in coming years. Chicago's pension costs have doubled in the last decade—from $416 million in 2008 to $1 billion last year—and that's just 42 percent of what it should be paying to fund new retirement credits that workers are earning, and to wipe out its debt. Under a long-term plan, the city must double its pension payments again over the next five years, and then keep increasing payments steadily every year for the next 30 years. Even then, the plan would get the system back to only 80 percent funded, if everything else about the system's projections stays on course.

Chicago's bond offering would raise money for the pension system, where the money can then be deposited in financial markets to earn returns. The idea sounds simple. Chicago could borrow the cash, officials predict, by issuing bonds that pay between 5 percent and 5.5 percent annually. The city's pension system, meanwhile, projects that it will earn between 7 percent and 7.5 percent annually in the market over the long term. By simple math, earning 7 percent on money that costs you just 5 percent is a winner. "It would be irresponsible for me not to look at it," Chicago CFO Carole Brown told the press last week.

The problem is that those kinds of returns are far from a sure thing. That's why pension bonds have been behind some of the biggest fiscal meltdowns in recent years. Stockton, California, for instance, borrowed $125 million in 2007 to bolster its underfunded retirement plans and gave the money to

California's public-pension system to invest. The system's investment professionals promptly lost more than a quarter of the principal, exacerbating an already-emerging crisis, which provoked city officials to file for bankruptcy. Detroit, eyeing the same kind of sharp increases in pension payments that Chicago faces, created a complex pension-financing scheme in 2005 to raise money by circumventing Michigan's limits on municipal debt. After the market crashed in 2008, the deal blew up. A financial manager brought in to clean up the mess took one look at Detroit's retirement obligations and hauled the city into federal bankruptcy court.

Brown justified considering the maneuver because the city can't reasonably dig its way out of its pension mess with taxpayer dollars. She's right: Chicago has already raised taxes by more than $800 million in the last few years to bolster pension payments. Even so, the system's funded ratio keeps dropping. If the $28 billion that Chicago is missing from its pension system existed, and was earning 7 percent in the market, the city would be garnering nearly $2 billion a year in new capital. That's money that—based on the design of the pension system—it's supposed to be earning. The missing investment returns, however, amount to far more than taxpayers can make up, so despite Chicago's best efforts, its pension situation keeps deteriorating. Brown said that the city needs to replace some of that missing money; if it can't, then Chicago's pension-funding status will fall even lower when the next market downturn occurs. But the Detroit and Stockton examples illustrate how things can get even worse with a big loan and a bad market bet.

The big losers in all this may be taxpayers and borrowers of previous Chicago debt, who should be looking with panic at the city's maneuvering. Chicago is now guaranteeing the debt of its newest bondholders by dedicating specific tax dollars to repay them. Detroit did the same thing, pledging revenues from casino taxes to reimburse some lenders. Those lenders did get paid in full during the bankruptcy, but other Detroit bondholders, including some who held Detroit's general-obligation debt, previously thought to be among the most secure forms of municipal debt, took a big loss, or "haircut," when the city went bust. With every new, secured deal that Chicago engineers, the risks for holders of the city's older debt grows.

Taxpayers face their own risks. Loans secured by dedicated revenue streams tie up tax proceeds. The more a municipality borrows in these kinds of transactions, locking up future revenues, the more it reduces its fiscal flexibility. Detroit eventually wound up in what fiscal experts call "service insolvency," that is, it didn't have enough money left over to spend on basic municipal services. Chicago has a far more vibrant economy than Detroit's, but it also has more pension debt, and Illinois judges have granted public workers extraordinary pension protections. The city isn't even allowed to reduce the rate at which workers earn benefits for work that they haven't done yet, so the pension system just keeps racking up new debt at alarming rates.

There's little precedent for what's happening in Chicago, and no clear path out. Illinois doesn't let cities file for federal bankruptcy protection, and that's unlikely to change because the municipal unions that have so much political power in the Land of Lincoln hate bankruptcy, where contracts can be busted and pension debt cancelled. Still, as economist Herb Stein famously observed, "If something cannot go on forever, it will stop." But when, and how?

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