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Can Chicago Ever Dig Itself Out of Its Pension Hole?

Incoming Chicago Treasurer Kurt Summers is pledging to improve investment returns for the city's pension funds and reduce investment-management fees. Both are worthy goals, but he's the first to admit that they "aren't going to change the kinds of holes we have."

As treasurer, Summers will sit on the boards of all four Chicago pension funds, which are a mess. Combined, they have less than 33 percent of the funds needed to meet pension obligations. Two of them — the police and fire systems — are less than 30 percent funded.

In fiscal 2013, Chicago contributed $476 million toward its pension obligations while it paid out $1.8 billion in benefits. The city's $23.1 billion in total unfunded liability is nearly three times its $7.8 billion in 2013 revenue.

Chicago's pension debacle was largely precipitated by the fact that the payment schedule is determined by the state legislature rather than by complying with Government Accounting Standards Board (GASB) requirements. The state has a long history of exempting itself and Chicago from annual pension-contribution requirements.

According to a recent Pioneer Institute study that I mentioned in my last post here, "It is hard to imagine how Chicago can avoid a full-blown Detroit scenario … within the next 10-15 years unless the city both 1) finds a way to cut existing benefits and obligations and 2) starts contributing substantially more to its pension plans right away."

Under state law, Chicago will be required to more than double that $476 million pension contribution by 2016, and the annual tab is scheduled to continue rising rapidly after that. The city says it can't afford the higher contribution, but even the new payment is barely half of the $2.2 billion payment Chicago should make according to GASB rules.

The city plans to delay increasing its contributions in hopes that the legislature will enact changes to reduce the required payments. But while it's important for the city to take the time needed to craft a comprehensive solution to its pension problem, waiting for state help doesn't make much sense. Illinois faces the biggest pension crisis of any state, with $100 billion of its own unfunded obligations.

To make matters worse, arguments are scheduled for later this month in a legal challenge to the state pension-reform law enacted last December. The Illinois constitution prohibits diminishing or impairing public employees' retirement benefits, but the new state law raises the retirement age, reduces and suspends retiree cost-of-living adjustments, and limits the salaries on which pension benefits are calculated. Ominously, in an unrelated case, the state Supreme Court ruled this summer that retired state workers' health care is a pension benefit that is protected by the state constitution.

The moral of the story is that when you allow something to get as bad as Chicago's pension system has, there rarely are any good options for fixing it. Improving the Chicago pensions' investment performance and reducing fees — though important — will be the least of Kurt Summers' problems.

Together with radical pension contribution increases, the city will need to significantly cut the cost of its existing obligations. If the courts find that such a move runs afoul of the Illinois constitution, Chicago will find itself a long way down the frightening path that leads to becoming the next Detroit.

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