
Illinois Scrambles for Solutions to a Mounting Pension Crisis.

CHICAGO — Illinois is facing one of the worst fiscal crises of any state in recent decades, largely because it has mismanaged its pension system.

The shortfalls could potentially mean sharply higher taxes and cuts in spending. And even though the state's highest court just this month threw out a landmark plan to cut worker and retiree benefits, some lawmakers say they may have to find another way to make those reductions as well.

Illinois's problems resonate well beyond its borders. Pennsylvania, New Jersey and Kentucky are among the states confronting similar problems, and to them, Illinois is a model of what can go wrong — with political intransigence, mounting costs and a complicated legal terrain.

So elected officials, union leaders, investors, fiscal hawks and even bankruptcy lawyers across the country are watching Illinois closely to see how it addresses the crisis. In Washington, some Republicans have even raised pointed concerns that President Obama's home state might someday seek federal help.

The state faces a range of problems. Illinois has one of the worst-funded pension systems in the nation. Chicago also has a pension crisis, leading Moody's Investors Service to downgrade its credit rating to junk status on May 12, potentially threatening the city's ability to borrow.

And the state faces an expected budget deficit of $6 billion, which it needs to address quickly. With just days before a legislative deadline, the new Republican governor, who ran on cutting costs and holding down taxes, is at odds with Democrats who hold a veto-proof supermajority in the legislature.

"Really, it's not a clear road map at this point," the governor, Bruce Rauner, said of solving the pension crisis.

"We have to make big decisions," Mr. Rauner told reporters. "The state is in dire financial straits. Chicago is in big, big challenges. And everybody's a little bit on edge."

Courts in other states, including Colorado and Minnesota, have sometimes approved measured pension cuts for public workers, especially for the benefits that current workers have not yet earned. And in Detroit and Stockton, Calif., federal judges have said pensions could be cut in a bankruptcy.

But Illinois has one of the most explicit constitutional pension guarantees of any state. The State Supreme Court found that the landmark plan was unconstitutional, and interpreted the clause in a way that protects even benefits that current public workers have not yet earned, as well as cost-o--living adjustments for retirees.

That has made a dire situation worse and raised the possibility that Illinois, its biggest city and Chicago's schools must all simultaneously find a way to keep running pension systems that are already unsustainable.

“What has happened is the loudest wake-up call possible,” said Laurence J. Msall, president of the Civic Federation, a watchdog group. “This is a financial tsunami for the City of Chicago and the State of Illinois that will not be fixed without politically painful changes.

Many states and cities around the country have been doing what Illinois did — promising pensions without calculating the costs correctly or really preparing to pay them — but to a lesser degree.

Other states have pulled back from the brink of fiscal disaster through extraordinary measures, including New York in 1975, to deal with the threat of bankruptcy in New York City, and California in 2012, when Gov. Jerry Brown talked his famously tax-averse voters into approving a tax raise.

But the Illinois public pension system is at or near the bottom of national rankings. Standard & Poor’s Rating Services said in 2014 that the Illinois system was last among state systems, with just 40 cents available for every dollar of promised benefits.

The pension system sank over decades, as officials promised pensions without setting aside enough money to pay them. In its unanimous opinion on May 8, the State Supreme Court cited commissions dating to 1917 that had warned of a crisis as more retired workers started drawing benefits.

Warnings were ignored, though, and shortfalls accumulated. It was easy for officials to let that happen, because actuarial calculations can understate the true cost of a pension plan, and Illinois had some of the biggest actuarial distortions of any state. In 2013, Illinois became the second state in history, after New Jersey, to be accused of fraud by the Securities and Exchange Commission, which found that it had misled the public about the condition of its pension system.

In recent years, with the system estimated to be more than $100 billion short and Illinois’s yearly pension payments consuming more and more of the state’s budget, Democratic leaders broke with unions that had traditionally been their allies.

In late 2013, Gov. Pat Quinn signed what was considered a landmark bill that claimed to bring the state’s pensions up to full funding, in part by curtailing cost-of-living increases for workers, capping salary levels used to calculate pension benefits and raising the retirement age for some.

The state argued that the changes did not violate the provision in the State Constitution banning the reduction of pensions, because a financial emergency had taken hold. But the Illinois Supreme Court said that any emergency was of the state’s own making and that the cuts could not stand.

That has left officials scrambling at a moment when the state has a divided government for the first time in a decade and the political differences between Mr. Rauner and the Democratic-controlled legislature make compromise difficult. A splintered set of political leaders is now debating options including tax increases, large spending cuts, new pension reductions, changes to the State Constitution and even legislation to permit Illinois municipalities to file for bankruptcy.

Some in Illinois assert that changes to pension benefits remain possible under certain conditions, and various deals are being discussed in the State Capitol in Springfield, though cuts are all but certain to draw more legal challenges.

Mr. Rauner has proposed switching workers into a pension plan that would let them earn less generous benefits starting in July, but he has acknowledged that even he is uncertain whether his idea would hold up in court.

Some leaders want to amend the State Constitution so benefit changes for future years of service can be made — an idea that other states are closely watching. But that path is long and uncertain: An amendment would need support from three-fifths of the House and Senate, then approval from voters.

“I do think there should be attempts to amend constitutions for current employees, not just in Illinois but probably other states, including California,” said Joshua D. Rauh, a finance professor at Stanford University who has written about public pensions.

Others say the State Supreme Court ruling takes benefit changes off the table and means that the government must pay what has been promised even if it means sharp increases in taxes and spending cuts.

“This will present major challenges for any policy maker, and they really have no other alternative,” said Richard C. Dreyfuss, an actuary and senior fellow at the Commonwealth Foundation, a public policy research organization in Harrisburg, Pa.

For Chicago, the state pension ruling could not have come at a worse time. The city is facing about $20 billion in unfunded pension liabilities, an additional $550 million yearly pension payment it must start making next year, and a school system that has a $1 billion deficit of its own, underfunded pensions and a new contract for teachers under negotiation.

Only a few American cities have shakier pension systems than Chicago’s, according to a 2013 Pew Charitable Trusts report on 61 major city pension systems.

The State Supreme Court ruling raised new doubts about efforts Chicago has made to shore up two of its four main pension funds. Last year, after discussions with some unions, Mayor Rahm Emanuel pressed state lawmakers to approve an overhaul that would require some workers in the two funds to pay more for retirement benefits, and would slow cost-of-living increases for retirees.

That overhaul is also being challenged in court, but city officials have argued that, over the long term, it would protect the existence of the pensions rather than unconstitutionally diminish them. Talks are underway with those tied to the city’s remaining pension funds, and Mr. Emanuel has sought permission for a Chicago-based casino to help fund those systems.

Facing debts including unfunded pensions, Detroit in 2013 became the largest city ever to seek federal bankruptcy protection. But bankruptcy is not an option available to any state, and legislators would need to pass a law to allow an Illinois city to take such a step. Some here, including Mr. Rauner, have said they support such a notion.

Mr. Emanuel, who was sworn in on May 18 for a second term, disputed Moody’s downgrades as outliers and said Chicago, despite its pension problems, still had a vibrant economy. Asked what the developments all bode for a property tax increase in Chicago, Mr. Emanuel told WTTW television’s “Chicago Tonight” this month that revenue “has to be part of any solution.” Yet Mr. Emanuel said a tax increase would be a last option, not the first one, adding, “You cannot put all the burden on the taxpayers alone.”

Illinois is racing to settle on a budget for the fiscal year that starts July 1, and pension costs are estimated to consume as much as a quarter of general fund spending — an unusually high share and a sign of real trouble.

In a State Capitol that had grown accustomed to being run by Democrats, the election of Mr. Rauner has complicated hopes for a budget solution by Sunday, after which the number of votes required for passage will increase.

He opposed an extension of a temporary income tax increase enacted four years earlier and has demanded billions in spending cuts. Democrats accuse him of trying to use the budget impasse to leverage concessions on other elements of his agenda to shrink union power and help businesses. Republicans assert that the state's Democratic leaders are not genuinely negotiating.

By Friday, there was talk of the Democrats drawing up their own budget, and Mr. Rauner's allies were offering new legislation featuring his priorities, including property tax freezes and term limits for legislators.

"So far, it looks like partisan bickering is the dominant theme," said Bob Reed, director of programming for the Better Government Association, a watchdog group based in Chicago. "Governor Rauner and House Speaker Michael Madigan talk about compromise and negotiation, but there's no evidence of that happening, and time is running out."

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