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A Simple (But Hard) Way for Governments to Stay Out of Pension Trouble.

Chicago's fiscal 2016 budget is like a cautionary tale about what happens when state and local governments fail to deal with long-festering pension problems. A policy brief published in September by the libertarian Reason Foundation offers sound advice about one of the ways to avoid Chicago's fate.

The city's $7.8 billion spending blueprint includes an historic $543 million property-tax increase to be phased in over four years, along with fee increases and spending cuts. The fact that Mayor Rahm Emanuel would propose such a budget and that the City Council would approve it — and by a 35-15 margin — is testament to the lack of viable options in the face of a state-mandated $550 million payment to Chicago's police and firefighter pension systems, each of which is less than 30 percent funded.

Draconian as it may seem, Chicago's budget may not go far enough. It assumes that the Illinois Supreme Court will find the city's 2014 pension reforms constitutional when it takes up the matter this month. It also assumes that the state will pass legislation allowing the city to spread out the mandated pension payment over a longer period.

There's no silver bullet when it comes to helping state and local governments avoid what has happened to Chicago, but one thing that would certainly help would be for them to base their pension contributions on more realistic investment assumptions. The Reason brief proposes several options, such as tying assumed pension-fund returns to the yield on the jurisdiction's own bonds or on the expected rates of return on municipal or high-grade corporate bond indexes.

As I have written previously, another reasonable approach would be to base assumed returns on actual long-term pension-fund returns; to avoid manipulation, the period on which historical returns are calculated should include at least two economic downturns.

Whichever approach is used, the Reason brief wisely recommends phasing in the change in anticipated returns over a period of years. A typical assumed rate of return for pension investments is around 8 percent. Cutting that to 5 or 6 percent, as one of the approaches mentioned above would likely do, would require state and local governments to significantly increase their pension contributions.

Calculating reasonable pension investment return assumptions is simple. Actually adopting them is hard because it runs contrary to human nature. Why should an elected official make painful budgetary decisions now when the benefits — or the harm from kicking the can down the road — won't likely be felt until he or she is long out of office?

Yes, the solution is simple. The hard part is finding courageous public officials who will implement it.

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