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Chicago’s Shockingly Bad Finances.

You’ve probably read headlines about the Windy City’s financial woes. About how Chicago’s years of borrowing to pay for its operations has finally caught up to it. About how inadequate funding of its pensions has saddled it with huge annual payments.

But unless you’ve been paying close attention, chances are Chicago is worse off than you think.

The numbers are staggering. The city has about $34 billion in outstanding debt, with roughly $20 billion of that coming from its five pension plans. That’s compared with a little more than $9 billion total annual budget. The teachers’ retirement fund is short about $9.6 billion and owes an additional $6 billion to bondholders. The outstanding bonds alone exceed the system’s annual $5.8 billion budget. Overall, Chicago Public Schools has struggled to sell enough bond debt to get through the current year, and the system is even facing a possible state takeover. Both the city and the school system’s credit ratings have been downgraded to junk status.

It’s an overwhelming set of problems, but not an unsolvable one. Chicago has a stable and growing economy. It is not Detroit, whose bonds are also rated as junk, with a shrinking population and a declining job base. In the coming years, Chicago’s chief challenge will be figuring out how to end its decades-long tradition of charging city expenses to future generations of taxpayers.

That will be hard, particularly when it comes to pensions. Until recently, Chicago funded its pensions based on a state law that required it to pony up a certain dollar amount each year. But that amount had nothing to do with actuarial funding, which is how most plans determine what governments should contribute annually to keep the pension system solvent. Chicago’s contributions were essentially arbitrary. In 2004, for example, the city paid in $345 million to its five pension plans, but the actuarially recommended payment was about $567 million, according to Merritt Research Services. Ten years later, the city paid in $447 million, but the actual pension cost was more than three times that amount, or $1.8 billion.

The city played similar games with paying off its debt. Officials would “scoop and toss,” meaning they sold long-term bonds and used the proceeds to pay off debt coming due in the short term. “The city’s problems, when you get right down to it,” says Merritt Research President Richard Ciccarone, “were many years in the making because of all the debt and pension deferrals.”

Right-sizing Chicago’s debt at this late stage is no easy task. Last year, freshly re-elected Mayor Rahm Emanuel pushed through the largest property tax hike in decades. It’s expected to raise more than $588 million annually after it is fully implemented over four years, and the proceeds will go toward the city’s pension payments.

But many say the half-billion-dollar infusion is just one step on the road to recovery. For one, the tax increase, which represents a 70 percent hike in city property taxes, won’t completely shore up the city’s pension funds. And in March, the state Supreme Court struck down the city’s attempt to increase employee pension contributions and reduce cost-of-living increases for retirees. Without those in place, Chicago will likely face hundreds of millions more in pension costs.

The city could raise more revenue through additional tax increases. But that would be a big feat, given the controversy over last year's property tax hike. Chicago has long prided itself on being a lower-tax city: Even with last year's increase, Chicago homeowners still pay less in property taxes than their counterparts in the suburbs, according to a Chicago Tribune analysis. Raise taxes too much, and the middle class could flee.

As Chicago fully addresses its spending mismatch, says Matt Fabian, a partner at Municipal Market Analytics, the city could face some serious soul-searching. "Keeping the middle class in the city might be an old-fashioned idea," says Fabian. "If they keep workers local, [officials] have more people voting for them — that's how the political machine works. But maybe that's not the way anymore."

**This story has been updated from the version that ran in the April print magazine to reflect the Illinois Supreme Court ruling on the state's pension reform.*

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