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Can the Illinois pension catastrophe be stopped?

By Robert Novy-Marx and Joshua Rauh

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Public pension systems in Illinois have long served as vehicles for the government to borrow money out of the view of taxpayers. In place of even higher public employee salaries, politicians have made unfunded pension promises extending far beyond their own terms in office. These debts are coming due, placing a massive burden on state and local budgets.

Government accounting standards have facilitated this surreptitious borrowing by grossly undervaluing the state's pension liabilities. A true financial valuation of unfunded pension liabilities reveals a debt of more than $200 billion for the state and local governments. That is around $42,000 per Illinois household and only counts benefits that public employees can claim based on today's pay and work history.

The April legislation that trims benefits for new hires doesn't reduce your $42,000 debt by one penny. It may gradually slow the growth of your debt to public employees, but only if the state fully funds the benefits earned under the new tier. In fact, it is quite possible that the giveaways of the past will be repeated in the future. As soon as there is the smallest economic recovery, benefits could again be raised or contributions reduced.

What can be done now? First, we need to end the covert borrowing and the hidden pledges that governments make with taxpayer money. Fundamental reforms of public employee compensation are imperative. New public employees should be placed in a 401(k)-type plan and enrolled in Social Security. Their compensation structure should be more like that of new hires at successful corporations.

To avoid some of the pitfalls of 401(k) plans in the private sector, the state should look to the Federal Thrift Savings Program, a cost-efficient 401(k)-type plan for federal government employees that has automatic enrollment, matching employer contributions, low fees and good investment choices.

There is no doubt that this kind of plan would be less expensive for Illinois. Social Security costs 12.4 percent of pay, and a typical federal plan costs around 9 percent, for a total of 22 percent of pay to be shared by employers and employees. The Illinois Teachers Retirement System cost 27 percent of pay in 2009, a rate certain to rise as pension promises made over the last decade come due.

Illinois should also test the legality of moving future work for existing employees onto the same 401(k)-type plan.

Those measures would stop your $42,000 from growing. But the question remains, who is going to pay the

$42,000? Here is your menu of choices. Most of them will be unpleasant.

•Taxpayers pay for it all in higher taxes and reduced public services. But it is hard to see us finding an extra $200 billion anytime soon. State and local government tax revenues in Illinois are around $55 billion annually, and budget shortfalls are colossal.

•Continue to borrow to fund pensions. This tactic restructures the debt to employees so that it becomes debt to investors. Unfortunately, future generations of taxpayers would shoulder the burden. Illinois has already made $13 billion of pension bond issues, which are expensive as they enjoy no tax subsidies. The silver lining is that to keep borrowing, Illinois will soon need to credibly show capital markets a reform of its entire budgetary process.

•If the state could increase retirement ages for existing employees to 67 and eliminate openhanded early retirement deals, your $42,000 would be cut in half. The Illinois Constitution states that public employee pension benefits may not be diminished or impaired. But if we are putting all options on the table, this one also has to be there, even if it involves changing the constitution.

•We could do nothing and end up like Greece. If so, Illinois will eventually default on some of its $26 billion of outstanding general obligation and pension bond debt. The depletion of the state's pension funds, which is quite likely within the next 10 years, will provide a catalyst. Illinois will then end up at the federal government's doorstep, hat in hand. This should be avoided at all costs. Markets already are charging more for insurance on Illinois bonds than for bonds issued by Spain, Portugal or California.

None of these options is particularly appealing, but there are no other choices.

Any politician wanting to reduce your $42,000 in unpaid debts to public employees must unfortunately pick from these poisons.

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