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Reducing benefits, raising taxes among proposed pension fixes

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Imagine borrowing money to pay your mortgage every year. That's right, actually going deeper into hock to pay your debt.

Now, try to explain this arrangement to your family: "Don't worry, most of the money's not due for 10 or 20 years. By then, kids, you can pay for it."

That's what Illinois lawmakers are doing to taxpayers.

By the end of this fiscal year, taxpayers will owe state pension funds $78 billion - $44 billion to pensions covering public school teachers and administrators alone.

That's about $6,000 for each of the 13 million people living in the state.

To pay it, the state keeps borrowing money - $3.5 billion so far this fiscal year.

"Borrowing is just a tax on the future," said R. Eden Martin, president of the Civic Committee of the Commercial Club of Chicago, one of several groups proposing change.

The problem has been put off for so long - an audit called the system "actuarially unsound" back in 1950s - that money managers say the state risks financial ruin.

The pension debt results primarily from legislators shirking their obligation to pay into the system for decades. To make matters worse, pension fund investments took a big hit in the recent market downtown, according to the Center for Tax and Budget Accountability, leaving the state with funding for only 38 percent of its obligation to teachers, university and state employees, judges and lawmakers.

The debt can't simply be wiped away, as some corporations have done with their pensions. The Illinois

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Constitution says benefits of state and local public employees "cannot be diminished."

That leaves only two main options, experts say: decrease future benefits or increase funding - likely by raising taxes.

Both options are politically unpopular, the first with public employees and their influential unions, the second with taxpayers and their rising backlash against public spending.

And many argue there's really no choice - that the state Constitution protects not just benefits accumulated by state employees, but also benefits those state workers will get between now and their retirement.

In the debate over how to pay the debt, those future benefits of current workers loom as a key point of contention.

'Fiscal disaster'

For now, Illinois remains in a state of dysfunctional denial.

A recent survey by the Pew Center on the States found Illinois' pension debt is the largest in the nation.

Partly as a consequence, the state has the second-lowest credit rating in the country, behind only California, according to the bond evaluators Fitch Ratings. That makes it more difficult to get loans and increases the cost of borrowing.

It's an "ongoing fiscal disaster," said the state comptroller, Dan Hynes.

Lawmakers took a stab at the pension crisis last month, crafting a solution in 12 hours for a problem decades in the making. But the Democrat-led measure, signed by Gov. Pat Quinn April 14, does nothing to reverse the state's failure to fund pensions.

It raises the retirement age to 67, caps the amount of salary that can be counted toward a pension at $106,800, and limits pension cost-of-living increases - but only for future workers who won't be hired until after Jan. 1, 2011, and won't retire for decades.

Critics like the National Taxpayers United of Illinois say the new pension law doesn't go far enough and delays a remedy too long.

Others argue the state has a moral and legal obligation to pay what it promised to people who provide vital services.

Among them: 94,000 retired public school teachers and administrators making an average pension of $43,164, the Teachers' Retirement System reports. But some make much more: 131 retired school administrators got pensions over $150,000 last year.

The Civic Committee of the Commercial Club of Chicago, a pro-business public policy group, contends the state Constitution leaves the door open to change pension benefits for those currently employed.

The committee cites a 1974 Illinois Supreme Court decision which states that benefits "which had been earned" should not be diminished. An analysis by business law firm Sidley Austin, where Martin is a lawyer, interprets that to mean future benefits - even of existing employees - can be changed.

But court rulings have protected current employees. Former federal judge and former state legislator Abner Mikva has written that the meaning of the Constitution is clear, and that all existing employees' benefits are protected.

Citing that hurdle, Gov. Quinn and House Democratic leader Michael Madigan have not supported changing pension benefits for current employees.

"We're not interested in going through a torturous legal situation," Quinn said. "We have to focus on what's doable."

Debate over cutting benefits misses the root cause of the debt, which is the state's failure to pay what it owes, said Dave Comerford, spokesman for the Illinois Federation of Teachers.

"The only way to deal with the unfunded liability is to pay it," Comerford said. "Changing (future workers') benefits doesn't change that liability by one penny."

Debt underestimated

Yet, removing that options makes the search for solutions more difficult.

Last year, a state pension modernization task force, split by various interest groups, failed to make a recommendation on how to solve the pension crisis.

But a subcommittee concluded that "pension funding reform is not possible without enhancing state revenue" - in other words, raising taxes.

The task force did include some findings, such as a proposal to combine the five state pension funds into one, that would save some of the $243 million in annual management fees.

Even proponents of reducing benefits, like the Civic Committee's Martin, concede a tax hike will likely be needed to pay the debt. but he says more state budget cuts must come first.

"Cutting costs is the place to start," he said.

The Illinois Education Association and American Federation of State, County and Municipal Employees, or AFSCME, both support a proposal to increase the state income tax to 5 percent from the current 3 percent.

The measure would raise up to $6 billion a year - still less than half the state's current annual $13 billion budget deficit.

To make matters worse, the real pension debt is much larger than the state recognizes, by the calculations of researchers at the University of Chicago and Northwestern University.

Rather than using the state's anticipated 8.5 percent discount rate to calculate the debt, based on risky market rates, the researchers used more conservative but dependable Treasury yields to calculate the debt.

By that method, Northwestern University Associate Professor Joshua Rauh said, the debt is more than $200 billion, or seven times the state's annual revenue.

Even if Illinois earns the higher interest rate, Rauh projects it will run out of money to pay the $15 billion in annual pensions due by 2018.

"Taxes would have to jump 50 percent to pay this," Rauh said. "That's catastrophic. The day we're going to actually have to pay for these liabilities is coming soon."

"Either we need to limit benefits going forward... including current employees," he said, "or we need to dramatically increase our contributions to the pensions."

Crisis management

The Civic Committee suggested the most drastic change of all: dropping all future pensions in favor of a 401(k) retirement plan.

Under that proposal, the changes would not effect pensions already earned, but would affect any benefits earned from here on out, for both current and future employees.

Such moves would cut the debt roughly in half, saving an estimated $2 billion a year, by Civic Committee estimates. However, a 2007 study by the Center for Tax and Budget Accountability, a bipartisan, not-for-profit organization that studies public spending in Illinois, concluded that moving public employees to a 401(k) or similar plan would actually cost the state more.

At the same time, the Civic Committee recommends the state reform retiree health care, which pays 100 percent of premiums, to save another $1 billion a year.

Pension reform must go hand-in-hand with major budget cuts to close the $13 billion annual gap between what Illinois spends and what it takes in, Martin said.

What's at stake, he warned, is much more than the pension system, because if the state continues its unsustainable path, it won't be able to pay its bills.

"This is not just about pensions but about breaking state government open," he said. "Welfare systems, schools, municipalities all get money from the state. All those revenue streams are jeopardized when the state runs out of money."