How the Puerto Rico rescue makes state pensioners the big winner

Ike Brannon

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In many states, the public pension plans have deeper problem than most taxpayers realize. The money that was supposed to have been set aside to pay for future pension obligations is simply not there. It's more than just a simple miscalculation — this is very much a sin of commission in most states.

It's a problem that's developed over decades: It's always been easier for politicians to boost pension benefits to grumbling state government workers — most of whom are members of their government employees' union, an extremely potent political force in every state — in lieu of higher wages today, and leaving it to a future government to ensure that these promises would be adequately funded.

The booming stock market of the 1990s led numerous states to believe their funding problems were solved and then some, inducing several of them to skip their required pension payments for various years. The ostensible budget savings allowed states to spend money and buy votes elsewhere — in turn, often increasing future obligations — or else by cutting taxes. The inevitable stock market corrections proved these holidays to be foolhardy.

These days, the ineluctable forces of demographics and longevity gains are forcing states to confront their underfunded pension largesse of the past, and for most it's not terribly pleasant. The prospect of states having to pay their large baby boomer cohort pensions that can exceed $100,000 a year per retiree for the remaining 30 or 40 years of their lives is a daunting tab.

For a state like Illinois, which has been making ill-advised short-term patches of its budget for more than a decade, it's simply impossible for it to honor its pension promises in the long run without a dramatic change.

One possibility would be to reduce the pension benefit, but that's a nonstarter: The state's Constitution guarantees that a promise made to current retirees and government workers must be honored, and the courts have ruled that this precludes making current retirees pay more of their healthcare costs or current employees work longer before receiving their benefit.

Another possibility would be to simply increase the state's income tax, which is currently a relatively low 3.75 percent. The current budget stasis in the state revolves around the amount of

concessions that Republican Gov. Bruce Rauner wants from the Democratic supermajorities in the State House of Representatives and Senate for signing such an increase.

But even a 2 percentage point increase in the income tax — something the last governor did temporarily to shore up the budget — isn't going to be enough to fully pay the billions of past-due bills, the postponed infrastructure investment and also cover the looming pension shortfall.

To fully fund the state pension fund — which could go broke in a decade, according to some analyses — it's going to take a New Jersey-style personal income tax system, where everyone is paying more money than they are now and the wealthy are paying a lot more, like in the ballpark of 10 percent.

And if that were to pass, the second that taxpayers realized their tax rates had doubled or tripled solely to pay for the generous pensions of state employees that dwarf their own, riots will ensue, and the world that Speaker Mike Madigan (D) of the Illinois House of Representatives has created would be ruled by a new set of politicians. Since politicians are loath to lose their jobs, a brutal tax increase probably isn't in the cards, at least not in the near term.

The political path of least resistance is to make the hedge funds and other investors who lent to the state of Illinois pay for the state's pension shortfall, and the apparent Puerto Rico solution being debated by Congress provides a viable path to make that happen.

Right now, states cannot declare bankruptcy, which is one reason why states have traditionally been able to borrow at such low rates of interest. However, financial markets have come to realize, belatedly, that Illinois (along with other states) is making promises to its lenders that it will have trouble keeping.

Puerto Rico was not supposed to be eligible for bankruptcy either, but the legislation before Congress will allow the territory to reduce its debt, both general-obligation and non-general-obligation debt.

If the bill does become law, the island will promptly cease making payments to its bondholders for the indefinite future: The proposed 2017 Puerto Rican budget — which assumes as much — sets aside no money to pay general obligation bondholders. Since the legislation also stays creditor lawsuits, the island can proceed to use the funds freed up by stiffing the creditors to hire more workers, build infrastructure and put money into its nearly bankrupt pension fund.

Any money that does gets stashed in the pension fund will be well-nigh impossible to disgorge when the stay is lifted. The Puerto Rican government can pull out its pockets and plead poverty and any creditor that lost money during the stay will likely be out of luck.

This is the blueprint Illinois will almost surely follow. It will request that Congress extend it some sort of bankruptcy protection and it will present Congress with a facile choice: Does it want to protect the evil vulture funds from Wall Street that lent it money or the hardworking state employees who just want the pension promised to them? Congress may want to pretend otherwise, but the current legislation before it favors one set of pensioners ahead of other pensioners whose money happens to be invested in Puerto Rican debt.

The safe bet is that before too long, Illinois will be allowed to stiff its creditors at a propitious moment — not before trashing them avaricious or immoral, no doubt — and their pensioners will be held harmless, too.

And before too long, the next state will take its cue from Illinois, and the pattern will be set, if not by law then by custom: State employees on a defined benefit pension will always come before investors who foolishly lent money to their state. And no one will care one whit if that money represents the retirement funds of other U.S. citizens, either.

It wouldn't be a blow for income inequality; state workers have a higher income and better pensions than most other Americans whose retirements savings will suffer because of this reordering. It's certainly not a just outcome, given that the states borrowed that money at a low interest rate in no small part because law and custom dictated their payments would supersede other creditors. The new normal will merely represent an ex post reordering of priorities in a way that comports with the allies of the current administration.

And investors will stop treating the muni market as being a safe bet, and the borrowing rates for townships and cities and parks will reflect the new reality of caveat creditor. Left on the hook will be the taxpayer, whose governments will pay sharply higher interest rates going forward.

Brannon is a visiting fellow at the Cato Institute.