VIEWPOINT
ON PUBLIC ISSUES

April 7, 2014 No. 2014-11 ISSN 1093-2240
Available online at mackinac.org/v2014-11

Pension Debt: Not Just a Problem in Detroit

By James Hohman

Summary

Detroit's bankruptcy proceedings have garnered national attention, and a big factor in the city's insolvency is its pension debt. But data shows that the 35 largest cities in Michigan have a combined pension underfunding problem of $2.1 billion.

Main text word count: 557

Detroit's pension woes may be in the news, but municipal employees around Michigan should not presume that their pension systems are secure. Indeed, in most Michigan cities the underfunding problems are worse than those in Detroit.

On paper, the unfunded liabilities for Detroit's police and fire system are $147 million, and its general employee pension system underfunding comes to $838 million. That translates into 96 percent and 77 percent funded, respectively. That is, for every dollar in pension benefits earned by an employee, the city has an average of 87 cents saved.

That's not good, but the 2012 financial statements of Michigan's 35 largest cities found that 90 percent of municipal pension plans were underfunded, with total underfunding stated at $2.1 billion.

It may be even worse. Pension funding policies can mask the magnitude of underfunding. For example, to prevent a single very good or very bad year in the stock market from skewing the value of their investments, pension systems typically use a "smoothing" method to average out the values over a period of several years.

Detroit isn't the only municipality in Michigan facing a pension crisis. To see where your city stands, please see http://goo.gl/axaTaz.

Detroit uses an eight-year smoothing window. This lengthy period means that its pension fund valuations do not yet fully incorporate the effects of the great recession. At current market prices, the system's assets are $1.35 billion below their "smoothed" values.

Moreover, Michigan's cities also tend to offer retiree health care benefits to employees, even though few private-sector employers provide such coverage. Unlike pensions, these benefits are not protected by the state constitution; they amount to gratuities that can be revoked at any time. Importantly, these "other post-employment benefits" are rarely prefunded.

With prefunding, employees know there's some money set aside to pay for what they were promised. Just as important, the cost of each year's service is largely paid for during the same year. When benefits go without prefunding, the certainty that benefits will be provided as advertised is diminished. This is especially the case in the Michigan cities that have lost residents and jobs. Without prefunding, the costs of long-gone government employees' service must be paid by a shrinking tax base.

continued on back

MACKINAC CENTER
FOR PUBLIC POLICY

Underfunding is not the only reason Detroit is seeking to trim the pensions of retirees. The city is also insolvent. That is, it lacks the cash to pay its bills when they come due — including constitutionally-mandated pension prefunding contributions. Insolvency coupled with underfunding risks pensions, and the increasing costs of catching up on unfunded liabilities can drive some governments to insolvency.

It wasn't supposed to be like this. Delegates to Michigan's 1962 constitutional convention wanted cities to pay for pensions as they are earned, and not defer the costs of current employees to future taxpayers. The provision they wrote into our current state constitution amounts to an instruction to city managers to make good, reasonable assumptions about the future value of investments made today, and deposit enough each year to cover the future costs of another year's worth of benefits earned. The reality of underfunding shows that they have not made good assumptions, and are still assuming excessively rosy scenarios. As a first step, this should change.

Delegates to Michigan's 1962 constitutional convention wanted cities to pay for pensions as they are earned, and not defer the costs of current employees to future taxpayers.

Beyond that, the only sure way to avoid digging even deeper holes in the future is to follow the lead of a handful of municipalities that have closed their conventional defined-benefit pension systems to new members and offer defined-contribution retirement instead.

#####

James Hohman is assistant director for fiscal policy at the Mackinac Center for Public Policy, a research and educational institute headquartered in Midland, Mich. Permission to reprint in whole or in part is hereby granted, provided that the author and the Center are properly cited.

Attention Editors and Producers

Viewpoint commentaries are provided for reprint in newspapers and other publications. Authors are available for print or broadcast interviews. Electronic text is available for this Viewpoint at mackinac.org/pubs/viewpoints.

Please contact:
TED O'NEIL
Media Relations Manager
140 West Main Street
P.O. Box 568
Midland, Mich. 48640

Phone: 989-631-0900
Fax: 989-631-0964
Oneil@mackinac.org

www.mackinac.org

facebook.com/MackinacCenter

twitter.com/MackinacCenter

pinterest.com/MackinacCenter