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"The right to criticize government is also an obligation to know what you're talking about."
Lent Upson, First Director of the Citizens Research Council

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Detroit's Finances Would Be Affected by Even a Minor Recession

In a Nutshell

- The City of Detroit's reliance on income tax makes it especially vulnerable to the aftereffect of job losses in a recession.
- Short-term losses in income tax revenue may be compounded by further remote work defections that will depress income tax revenue and demand for commercial development.
- If city pension funds incur investment losses, those cost will increase the strain on the General Fund and Retiree Protection Fund.

Last week, the U.S. Labor Department announced that employers added 253,000 jobs in April, far above expectations. The national unemployment rate has stayed at or below 3.6 percent this year. Likewise, the state's unemployment rate has stayed at or below 4.3 percent between January and March (the latest month for which data is available), and Wayne County's unemployment rate has stayed at or below 4.9 percent.

Yet, popular sentiment has been dominated by talk of recession. The National Association of Business Economics polled 48 economists in February, 58 percent of whom predicted that the national economy would be in a recession before yearend. Likewise, Consumer Confidence Survey responses showed a decline in consumer confidence between March and April. Neither are perfectly predictive. Still, it is worthwhile to contemplate how Detroit would be harmed by even a minor recession. Joblessness would likely increase, and tax revenues and returns on city investments could decrease. These three broad economic factors would create myriad difficulties for a city ten years out from bankruptcy.

Job loss, income loss, and depressed development

One remarkable aspect of the current economic expansion has been the effect on black unemployment. For the first time since the unemployment rate has been measured, the unemployment rate for black Americans fell below 5 percent (to 4.7 percent precisely). The majority (77.9 percent) of Detroit's population is black. And the same inequities and injustices that are observed at the national and state-level are true for the city and metropolitan area. Black Americans are often "last hired, first fired." If the current economic expansion comes to an end, city unemployment may rise sharply. In past recessions, city unemployment has far exceeded the level of unemployment in the country, in the state, and in Wayne County.

Income loss—a result of job loss—will consequently decrease city revenues, most directly city income tax revenue. Detroit taxes personal income at different rates for residents (2.4 percent) and non-residents (1.2 percent). It also levies a 2 percent corporate income tax on firms located in the city. Of the $1.2 billion in General Fund revenue collected in Fiscal Year (FY)2022, income tax revenue made up 33 percent (or $402.3 million). The income tax is the city's most important source of revenue and one of the tax revenues most responsive to job loss.

In addition to the immediate effect of a recession on income tax revenue, there is the potential that a recession may further attenuate white-collar work from office spaces in the city. Prior to the COVID-19 pandemic, people from outside Detroit commuted to the city for work. Since people needed to distance from each other to prevent the spread of COVID-19, remote work became popular. And despite the ebb of the pandemic, the trend has continued. Based on the city's February 2023 Revenue Estimating Conference, the city projects that between FY2023 and FY2027 the city income tax will yield a cumulative $139.6 million less revenue due to remote work.

The tax on non-residents is levied at one-half the tax rate levied on residents, yet the city raises more revenue from non-residents. This is because non-resident taxpayers are more likely to be a part of the white-collar workforce that is better educated and better paid. There is a risk that white-collar employment may become unmoored from the city, that the jobs lost in a recession, the jobs where people reported to office spaces within Detroit, may be replaced with remotely held jobs outside the city.

Based on the University of Toronto's School of Cities analysis of mobile service and location data, economic activity in downtown Detroit is down 48 percent compared to pre-pandemic level. Further, if white-collar employment is reduced in the city, so will the need for office space. The city is dependent on new commercial development to make up for an impoverished residential real estate market.

Detroit is unique in that the taxable value of commercial property ($2.5 billion) exceeds the taxable value of residential property ($2.3 billion). In fact, between 2012 and 2021, commercial taxable value increased by 18.9 percent, even as residential taxable value declined by 45.5 percent. A recession may hasten the adoption of remote work (or simply work outside of city boundaries), that will, in turn, make commercial development less lucrative. In a recession, income tax revenue will fall immediately, and property tax revenue may soon after trend downward as well.

Irrespective of local economic conditions, a statewide recession could further reduce municipal income. In lieu of sales taxes levied at the local level, the state collects sales tax and redistributes a portion to its constituent municipalities based on constitutional and statutory formulas. Lower sales mean less sales tax revenue, which in turn means less revenue is shared with Detroit and other local entities. State revenue sharing is the city's third most important source of revenue. In FY2022, state revenue sharing made up 18.1 percent (or $219.5 million).

Investment returns and pension cost

From the first two effects alone, there is substantial downward pressure on tax revenues. But there are two other less visible effects, both related to pension costs. Both the assets held within the city's two closed pension plans and assets held within a secondary trust (Retiree Protection Fund or RPF) are broadly invested across various asset classes that could lose value in a recession.

Pension funds earn income via three means: (1) employer contributions, (2) employee contributions, and (3) investment income. Market turbulence has direct ramifications on investment income of the city's two closed pension plans, the assets of which are invested in stocks, bonds, and other alternative asset classes such as real estate and private equity.

In recent decades, pension funds have become more dependent on investment income to accrue the assets needed to make payouts to retirees. This is doubly true for the city's two closed pension plans. As the two pension plans, GRS II and PFRS II, are closed, these pension funds do not receive employee contributions. Pension fund income is therefore dependent on employer contributions from the city and investment income. If investments underperform or incur losses, by default the city must make up the difference.

Pension cost could increase substantially—even as results are "smoothed" or phased-in over multiple years for purposes of the city's annual required contribution calculation. Between FY2015 and FY2022, the projected FY2024 pension payment (as borne by the General Fund) has increased by as much as $26.9 million and decreased by as much as $55.4 million. The mean year-over-year increase in the projected FY2024 pension

payment over those fiscal years was $16.2 million, and the mean year-over-year decrease was $18.5 million.

In the ten years since the city's bankruptcy, where the city closed its two pension plans and received a decade reprieve from pension payments, the city has prepared for increased pension cost. The RPF was set up in 2017 by the city to reduce the General Fund burden once pension payments resumed in FY2024. By the end of FY2023, the city will have contributed $473 million to the RPF. Nevertheless, increased pension payments, the potential consequence of poor investment returns, still can strain city finances.

Under the city's current schedule to spend down the RPF assets, which assumes pension payments of $130.7 million, the RPF will exhaust in FY2040. The city's initial RPF withdrawal amount of $57 million is decreased by approximately $3 million to $5 million per year until FY2040 when the RPF is exhausted and the full cost of the pension payment is borne by the General Fund. Initially, the General Fund burden in FY2024 is $73.7 million ($130.7 million pension payment – $57 million RPF withdrawal = $73.7 million General Fund burden).

If poor investment returns cause pension payments to increase by $16.2 million and the city maintained the same level of General Fund burden, it is estimated that the RPF would instead be exhausted by FY2032, nearly a decade ahead of schedule. Moreover, RPF assets are invested, and the city expects to earn investment income to supplement the city's direct contributions. If there is a recession, investment returns may not materialize as expected. Or, the value of the portfolio may fall, which will lessen the amount of money available in the RPF to make pension payments. So, an economic downturn and turbulence in financial markets could both increase city pension cost and decrease the amount of money the city has set aside to meet those cost.

Conclusion

Inflation, war, scarcity of supplies and materials, let alone a scarcity of workers—none of these phenomena has felled the American economy thus far. Meanwhile, the city has prepared for recession. The city's rainy-day fund measured at $138 million, or 10 percent of General Fund expenditures, as of FY2023. Nonetheless, elected officials and citizens should take seriously these economic risks and the consequences of recession: income tax and potential property tax loss, increased pension payments, and the decreased value of reserves set aside to make pension payments.

ABOUT THE AUTHOR

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