CITIZENS RESEARCH COUNCIL OF MICHIGAN

“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 Pension Benefit Restoration Should Remain Limited

In a Nutshell

- Detroit cut benefits to pensioners as part of its bankruptcy settlement. Pension benefits, already modest pre-bankruptcy, have become meager in recent years due to inflation, and that has made life harder for pensioners.
- The FY2025–FY2028 Four-Year Financial Plan appropriates $10 million for supplementary payments to pensioners.
- The one-time appropriation for supplementary payments to pensioners should indeed remain one-time, and should not mark a return to “13th checks” that previously drained the city’s pension funds.

One element of the City of Detroit’s bankruptcy and settlement with creditors was a reduction in pension benefits and subsequent cost-of-living adjustments (COLAs). Now that the city is ten years removed from bankruptcy and in much better financial condition, it plans to make up for some of what was done in bankruptcy. Per the Fiscal Year (FY)2025–FY2028 Four-Year Financial Plan, $10 million has been appropriated for supplementary payments to pensioners.

While the spartan amounts of some pension benefits can justify the supplementary payments, these payments should remain one-time as intended. Previous attempts to assist pensioners, the “13th checks” issued, drained the city’s pension funds.

Retiree benefits and pension liabilities

Pensions, or defined benefit plans, represent a contractual promise by employers to provide employees with post-retirement income. These contractual promises are supported by a trust, a pension fund. Employers that provide pensions contribute to pension funds annually, to set aside assets in the present to account for what will be paid out to retirees in the future.

In 2013, Detroit filed for bankruptcy, a process played out in federal courts that allows debtors to settle claims with creditors. Detroit’s creditors included vendors, bondholders, and pensioners. The latter of the three were retirees, promised pensions as a form of deferred compensation, who, like other parties to the city’s bankruptcy, came away with cents on the dollar for their claims.

When Detroit filed for bankruptcy there was a deficit between pension liabilities—i.e., the actuarially-determined value of promises the city had made to employees—and the assets the city had set aside to honor those promises. The pension funds were underfunded. The chasm in the city’s two pension funds, the General Retirement System (GRS) and the Police and Fire Retirement System (PFRS), amounted to $3.5 billion. Pension liabilities represented 19 percent of the $18.3 billion in total liabilities that the city had accrued by July 18, 2013, the day it filed for bankruptcy.

In bankruptcy, the city broke its promises. Both pension plans were frozen, no further benefits could be accrued to the pension plans nor could newly hired employees join. GRS plan benefits were cut by 4.5 percent, and 2.25 percent COLAs were eliminated. PFRS plan beneficiaries had COLAs reduced from 2.25 percent to just 1 percent. PFRS plan beneficiaries avoided steeper benefit cuts because police and fire employees do not participate in Social Security, as is common at the state and local levels.

The city's pension liabilities were considerable but on an individual basis, the benefits afforded to pensioners were modest. Pre-bankruptcy, GRS and PFRS beneficiaries received a mean of $20,922 per year and $28,455 per year, respectively. (Pension benefits are determined by the amount of compensation each employee earned and the years of service, which, of course, varies by employee.) Modest has become meager. In FY2022 actuarial reports reveal GRS beneficiaries received a mean of $19,981 and PFRS beneficiaries $31,149. Had GRS and PFRS benefits received COLA adjustments to keep pace with inflation, those benefits would amount to $28,377 and $38,594, respectively.

13th checks

There are multiple factors that explain the chasm between what the city had set aside in GRS, and what was owed to retirees—fiduciary malfeasance, inadequate contributions, poor investment returns, a mismatch between active employees who paid into the system and retirees to whom benefits were paid out, and lastly, 13th checks.

Generally, pensions are paid monthly. So, pensioners can expect to receive twelve payments in a year. The so-called "13th check" was an extra payment made to pensioners, issued whenever pension fund investment returns outperformed expectations. Why did this deplete GRS? Pension funds receive income from three sources: employer contributions, employee contributions, and investment returns. Pension fund assets are not just held in bank accounts that earn little interest, those monies are invested. In fact, the ability to make payments to retirees depends on a return on investment.

In the case of GRS, the pension fund was projected to earn 7.9 percent annually. There are market upturns and downturns. The hope was that at the very least the mean investment return earned over the broad investment horizon was 7.9 percent. However, the results of those 13th checks was that when the pension fund did poorly, those investment losses were incurred by the pension fund, and when it did well, rather than enjoy the upside, those investment returns were spent. In short, in bad years, GRS did poorly, and in good years, it did well but not as well as it could have had it retained those excess earnings. This pattern, repeating for years and years, led to the underfunded status of the plan.

FY2025–FY2028 Four-Year Financial Plan and supplementary payments to pensioners

More than ten years removed from bankruptcy, Detroit is in much better fiscal health. Rather than two days' worth of cash on hand, as was the case in FY2013, the city's General Fund had $1.1 billion (or 216 days' worth of cash on hand) as of FY2023. General Fund revenue has trended upward—FY2020 and the COVID-19 pandemic excepted.

The city has previously entertained ideas to restore benefits but has never before allocated resources to that end. As a result of this financial turnaround and need on the part of pensioners, the city's FY2025–FY2028 Four-Year Financial Plan appropriates $10 million from the General Fund toward supplementary payments to those shorted in bankruptcy. The appropriation is voluntary and does not fully restore benefits—that would require that the two pension funds closed in bankruptcy be far better funded than they currently are and potentially action by the bankruptcy court.

Pension liabilities

Pension liabilities were not eliminated when the pension plans were frozen. In FY2023, the city had $1.7 billion in net pension liabilities attributable to GRS and PFRS.

Pension contributions to the two closed pension funds were paused for ten years as a result of the bankruptcy settlement, and have since resumed. In the interim, the city created a separate trust in preparation for resumed pension contributions. That trust, the so-called Retiree Protection Trust Fund (RPTF), had a balance of $455 million as of FY2023. Between FY2024, the first year of resumed pension contributions, and FY2034, $19 million will be withdrawn per year and transferred to the two closed pension funds until it is exhausted.

Between FY2024 and FY2053, Detroit will contribute between $64 million and $171 million annually to its two closed pension funds, until the final payments to beneficiaries are made. In FY2024, required contributions to the two closed pension funds equals $171 million—12.5 percent of General Fund appropriations. Nineteen million dollars will be offset by withdrawals from the RPTF, the rest will be paid from the General Fund, however.

Conclusion

Detroit is financially positioned to provide relief to pensioners. The inflation rate has been elevated in recent years, above the two percent favored by the Federal Reserve. Inflation has made food, fuel, and shelter more expensive, and has made what were already modest pension benefits spartan. Detroit's attempts to alleviate financial stress experienced by pensioners should remain voluntary and limited. Any attempts to expand or restore benefits to pensioners would sacrifice the present and the future for the past, a choice Detroit can ill afford.

ABOUT THE AUTHOR

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James L. Tatum III is the Researcher for the Detroit Bureau of the Citizens Research Council. Previously, he served as an analyst in the City of Detroit's Office of the Chief Financial Officer (OCFO) where he prepared cost-benefit analyses of City projects, asset sales and labor contracts, forecasted city revenues and expenditures, and conducted scenario analyses for the City's pension plans. In addition to his practical experience, he is an accomplished academic. His research on debt, pensions, insolvency, Chapter 9 bankruptcy, and dissolution has been published in trade, law, and academic journals.

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