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A Better Way to Measure Pension Debt's Danger.

'Overlapping' is often ignored, resulting in misleading assumptions about government liabilities.

Last year, I wrote about an emerging theory among investors known as the “new neutral.” The theory holds that for the next several years we’ll see an unprecedented combination of slow economic growth, low interest rates and paltry returns on investments. So far, the new neutral has been spot on.

To see this theory in action, look no further than state and local pensions. Investment returns have lagged, and as a result, so too have pension fund balances. Pension critics have renewed their calls for reform, saying that pensions are an existential threat to many local governments’ financial health. This is true, but it’s also incomplete.

Consider this example. At the end of fiscal year 2015, Dallas had an unfunded pension obligation of \$1,371 per capita. Denver’s was barely half that at \$709 per capita. From that number alone we might conclude that Denver is in much better financial shape.

But now let’s add a few crucial layers of complexity. First count up each city’s “overlapping” pension obligations. Overlapping means two or more jurisdictions share some portion of their respective property tax bases. We can think of a region’s property tax base like money in a shared savings account: When one jurisdiction takes money out, there’s less for everyone else.

Dallas shares parts of its property tax base with 20 other governments, including counties, schools, hospitals and community colleges. These other entities’ unfunded pension obligations add up to \$1,362 per capita. Denver shares its tax base with just one other entity — the Denver School District — but that district’s pension obligation is a comparatively high \$4,876 per capita. So Dallas’ total direct and overlapping pension obligation is \$2,733 per capita; Denver’s is \$5,585. Maybe Dallas is in better shape after all?

These per capita figures are basically the norm for large cities. While Chicago’s overlapping pensions alone were almost \$20,000 per capita at the end of fiscal 2015, the median for the 25 largest cities (based on 2014 data) was about \$3,550, according to Morningstar, a credit research company.

OK, so now that we’ve counted up all the overlapping pension obligations, let’s add in long-term debt that’s supported by a shared property tax base. Dallas has a modest \$1,700 per capita of tax-supported debt. At the same time, most of its 20 neighbors can also borrow against that shared tax base. That brings its total direct and overlapping debt up to \$5,520 per capita. Add in its pension liabilities and Dallas’ total obligations are \$8,235 per capita. Denver has just over \$1,500 per capita of its own property tax-backed debt, and its neighboring school district has around \$1,200. Add that to its pensions, and Denver’s total obligations are \$8,285 per capita.

Which city is in better financial shape? It depends. And that’s the point.

It's important to think about how cities will cover their unfunded pension liabilities. But when we talk about how pensions affect financial health, the far more important question is how does a region decide to manage its tax base and the overlaps that inevitably exist?

Here Dallas and Denver are instructive. Both cities grew tremendously over the past few decades. Dallas has dealt with that growth mostly by allowing new special local districts to crop up and expand as necessary. Now it must find a way to coordinate tax policy decisions across all those governments. To do so, it will have to find a way to deal with one of the laws of local political physics: Voters live in districts, not regions.

By contrast, Denver is a comprehensive, consolidated city/county government. It can manage liabilities in a coordinated way. As a result, all of those liabilities appear on its balance sheet, and that can make investors and elected officials a bit queasy.

There are lots of regional coordination mechanisms, usually in specific policy or infrastructure areas like transit, airports and homeland security. States like California and Texas even have agencies within state government that track and occasionally coordinate when and how local governments issue debt. If we want to understand what pensions mean for our financial future, we have to account for how well those mechanisms work. To address pensions and other long-term liabilities, we need to strengthen those mechanisms.

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