

Case Study Overview: Detroit

Detroit filed for municipal bankruptcy protection on July 19, 2013. The city is in dire fiscal straits and now in a U.S. bankruptcy court for what the city's emergency manager termed "the Olympics of restructuring." The filing is a critical step to ensuring continuity of essential services and critical to rebuilding an economy for the city. Michigan Governor Rick Snyder appointed an Emergency Manager in March, who in June announced a moratorium on repayment of all unsecured municipal debt. The emergency manager, Kevyn Orr, issued a report and declared the city insolvent. Detroit cannot stay on its current path and survive, and now its fate will be determined in a federal court, where the city's financing and operations must be completely restructured. After decades of population decline (In 1950, there were 1,849,568 people in Detroit. In 2010, there were 713,777), the city today is home to an estimated 40,000 abandoned lots and structures. Between 1978 and 2007, Detroit lost 67 percent of its business establishments and 80 percent of its manufacturing base. The city has spent \$100 million more, on average, than its revenues since 2008. According to the census, 36 percent of its citizens are below the poverty level, and, last year the city reported the highest violent crime rate for any U.S. city with a population over 200,000. Writer Billy Hamilton calls the city "either the ghost of a lost time and place in America, or a resource of enormous potential."

City Snapshot. Detroit is the former automobile capital of the U.S. and one-time Motown music capital which today, beset by a loss of more than a million residents, cuts in state aid, and collapsing real estate values has been reduced to borrowing to meet its operating costs. The city has experienced periodic episodes of corruption and mismanagement for years—this year marks the third time in recent history that Detroit has been rated below investment grade. One consequence of this former great American industrial city's dysfunction has been its erosion as a core for jobs: employment has been fleeing the urban core, but rising in the metropolitan area—even as other cities were seeing something of a city-center revival. Detroit has added jobs and retail offerings downtown, but that has yet to translate into population growth. Detroit's ability to borrow was exhausted after years of issuing long-term debt to pay its operating bills; Detroit has listed liabilities in excess of \$17 billion—equal to \$25,000 for every remaining resident. In his report, Mr. Orr described the city as "dysfunctional and wasteful after years of budgetary restrictions, mismanagement, crippling operational practices and, in some cases, indifference or corruption." Residents can escape these debts simply by moving away; many have done just that. Of the 264,209 households in Detroit, only 9.2% are married couple families with children under 18. Another 78,438 households — or 29.7% of the total — are families headed by women—of which families more than half have children under 18.

Fiscal Structure. Detroit's revenues, from taxes and state-shared revenues are higher than those of any other large Michigan municipality on a per capita basis, accounting for \$1,289 per capita in FY2010 from its property tax, income tax, utility tax, casino wagering tax, and state-shared revenues. Nevertheless, the city's revenues have declined over the last decade by 22 percent. Detroit has nearly \$15 billion of long-term debt, of which \$5.7 billion is made up of other post-employment benefits, generally considered the least-secured debt. On the bond side, the city carries \$963 million of unlimited-tax and limited-tax general obligation bonds. Of that, roughly \$205 million of bonds issued in 2008 are uninsured. There is additional debt issued in 2010 and 2012 that

is also uninsured -- the junk-rated city could not buy insurance by that point -- though those are backed by a pledge of state aid payments. The city also has \$5.9 billion of water and sewer bonds, all of which is insured except for \$476 million with a 2041 maturity. Another roughly \$200 million of insured revenue bonds, including parking and convention center debt, is outstanding, as well as the \$1.5 billion of pension certificates. Detroit has liabilities in excess of \$17 billion—equal to \$25,000 for every remaining resident. As of April 26, 2013, the City had actual cash on hand of \$64 million but had current obligations of \$226 million to other funds and entities in the form of loans, property tax distributions, and deferred pension contributions and other payments. Therefore, the City's net cash position was actually negative \$162 million as of April 26, 2013. The City has been deferring, and will need to continue to defer, payments to avoid running out of cash.

Fiscal Circumstances. The city's decline predates the housing crisis, or, as the Citizens Research Council reports: the overall loss of 15,648 business establishments from 1972 until 2007 does not capture the effects of the severe 2008 recession, or the bankruptcies and subsequent recovery of General Motors and Chrysler and the restructuring of the automotive supplier network, on the number of businesses in the city. Jobs left Detroit as auto plants moved to the suburbs and to other countries with globalization. Manufacturing jobs in the city fell to fewer than 27,000 in 2011 from about 296,000 in 1950. Detroit now has eight people per acre, down from 21 per acre in 1950.

Detroit has one of the broadest tax bases of any city in the U.S. Municipal income taxes constitute the city's largest single source, contributing about 21 percent of total revenue in 2012, or \$323.5 million in 2002, the last year in which the city realized a general fund surplus. Thereafter, receipts declined each year through 2010, reflecting both a rate reduction mandated by the state and the recession. The declining revenues also reflect not just the significant population decline, but also the make-up of the decline: the census reports that one-third of current residents are under the poverty line and that the composition of businesses—unlike any other major city in the nation—are primarily made up of public organizations. The reduction also reflects state mandates. Only Chrysler and DTE Energy pay business taxes. Detroit's revenues have been declining year-over-year. While spending has declined, spending has exceeded revenues, on average, by more than \$100 million every year since 2008. Moreover, state law prohibits cities from increasing revenues by adding a sales tax or raising residential property tax rates more than inflation. The revenue also suffers from non-collection. A city-commissioned study by McKinsey and Company reported last year that an estimated \$6.6 million of municipal income taxes on commuters who work in Detroit, \$21.8 million in corporate taxes, and \$155 million of income taxes on residents were not collected in 2009—or nearly 50 percent of the taxes owed from people living in or working in the city. The report also determined that 54 percent of city residents who worked outside the city did not pay; in Michigan their employers are not required to withhold city taxes—resulting in a shortfall of an estimated \$142.3 million. The property tax accounted for 13.3 percent of Detroit's revenues in 2012, even though the city has the highest property taxes among big cities in the U.S.

Role of the State. Michigan's Emergency Manager Law (Act 436) is unique to the state of Michigan. It allows the governor to appoint emergency managers with near-absolute power in cash-strapped cities, towns, and school districts; it authorizes such emergency managers to supersede local ordinances, sell city assets, and break union contracts; it leaves local elected officials without real authority. It provides that an Emergency Manager may be appointed by the Local Emergency Financial Assistance Loan Board, acting as the authorization for Governor Rick Snyder to appoint

Kevyn Orr as Detroit's emergency financial manager. The law, the Local Financial Stability and Choice Act reads: "The financial and operating plan shall provide for all of the following:....The payment in full of the scheduled debt service requirement on all bonds and notes, and municipal securities of the local government, contract obligations in anticipation of which bonds, notes, and municipal securities are issued, and all other uncontested legal obligations (See §141.155§11(1)(B)).

Analysis. Filing for municipal bankruptcy is a critical step for Detroit to stop its hemorrhaging and to develop, in concert with the state, a realistic plan to overcome its insolvency. Without either radically changed physical boundaries or governance and shared services, however, such an effort is unlikely to succeed. The appointment of an emergency manager who recognizes that a plan to resolve the city's municipal bankruptcy will require not just balancing the city's books going forward, but also investing in the development of a strong growth strategy is critical.

- **Redesign Municipal Services.** Municipal services are failing. The Detroit metropolitan region is ranked 10th worst of 942 metro regions in the U.S.¹ in a measure which considers both the number of units administering common services and each government's related expenditures. A new Detroit, nearly encircling two failing municipalities, must redesign and coordinate and share services with other jurisdictions in the metropolitan area to both reduce costs and ensure far more effective delivery of essential services.
- **Redesign boundaries.** Michigan, Wayne County, and Detroit must address the city's physical boundaries. The city's 78,000 vacant structures and 60,000 vacant land parcels "present an ongoing public safety and public health concern," forcing the city, despite the signal loss of population, to provide and maintain services over its 139 square miles—and area that contains 78,000 abandoned and blighted structures, nearly half of which are thought dangerous, and 66,000 blighted and vacant lots which encourage fires and crime.
- **Develop a strategy for future growth.** It is not enough to design a plan to exit bankruptcy. Detroit, in concert not only with the state, but also with a consortium of philanthropies, civic, corporate, and community leaders to not only match the proposed investment in the Orr plan, but also to ensure a post-bankruptcy growth plan.

¹ David Miller, Director of the Center for Metropolitan Studies at the University of Pittsburgh, has developed a "metropolitan power diffusion index," which measures both the number of units administering common services and each government's related expenditures, thereby factoring in the distribution of spending to provide a more complete picture of how authority is divided within a region, and letting him assign a score to each metro area, with higher scores representing more "fragmented" regions. The study compiles scores for 942 metropolitan and micropolitan statistical areas.