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Lessons From the Detroit Bankruptcy

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BACKGROUND

In March 2013, acting under a controversial statute that authorized extraordinary action, Michigan Governor Rick Snyder appointed Emergency Manager Kevyn Orr to replace the elected government of Detroit. By July, the emergency manager had filed for bankruptcy of the city.

In November, anticipating a ruling on the largest municipal bankruptcy filing in the country's history, Demos Senior Fellow Wallace Turbeville published a 70-page report, entitled The Detroit Bankruptcy, challenging the bankruptcy filing and the emergency manager's central claims regarding the city's financial situation. Turbeville told the true story of the city's finances and helped disrupt the perception that the public sector and the relatively modest pay, pensions, and benefits of municipal workers are to blame for the crisis. The report amounted to the first substantial critique, from an expert perspective, of the emergency manager's appointed mission to take the city through bankruptcy.

Recently, the bankruptcy case shifted in a big way. In December, the judge rejected a settlement made prior to the bankruptcy proceedings by the emergency manager and two banks to resolve a complex financial deal dating back to 2005. This challenge was one of the key recommendations in Turbeville's report. The banks were forced back to the table. Then, in February, the emergency manager reversed course completely and filed a lawsuit challenging the validity of the original 2005 deal. Again, this very challenge was recommended in detail by Turbeville in his report. Finally, in April, the bankruptcy court dramatically reduced the amount the city would pay big banks by hundreds of millions of dollars ($85 million down from $230 million), thus freeing up much needed cash to invest back into Detroit.

To date, court proceedings are unresolved as controversies rage on. Every hearing requires the presence of dozens of lawyers representing banks, insurance companies, vendors, retired city workers, citizen groups and the city. Detroit is paying more than $10 million per month on bankruptcy expenses, mostly legal and advisory fees, and the current target for a final resolution is October 2014. If the direct expenses of the bankruptcy continue at the current rate, if this target schedule is met, the city will have incurred around $170 million in costs. The indirect costs, in terms of damage to the already weakened economy of Detroit, are undoubtedly more.

It is true that the city of Detroit's circumstances are unique and, in some ways, extraordinary. Detroit's economy has been weak for decades and its population has declined from 1.8 million in 1950 to 700,000 in 2010, leaving a city with a scattered population that is difficult to serve. The city suffered under poor leadership, specifically the administration of Kwame Kilpatrick who resigned in 2008 after 12 years in office, and is now serving 24 years in the penitentiary for corruption. The Great Recession was extraordinarily devastating for Detroit, which has experienced massive numbers of foreclosures and tremendous housing blight.

Nonetheless, Detroit's experiences are vitally important for many other urban areas in the United States for some time to come. The effects of the Great Recession on city and state governments have been delayed and will linger for years. The following lessons describe some of the factors that can be useful as cities work their way through the fiscal difficulties that will dominate their immediate futures.

The Detroit experience is likely to be echoed for many cities. It presages a number of important issues that will be the center of discussion for any given city, including:

- Are the city's fiscal woes a spending problem or a revenue problem?
- What does an unfunded pension liability mean and what is the best way to remedy it?
- What is the effect of existing financial deals, including derivatives, on the current circumstances of the city and its prospects?
- Have economic development transactions delivered what they promised and will future transactions help with the solutions, or is it all just crony capitalism?

These issues are discussed briefly in the Detroit context below.

Basic Message: Spending vs Revenue

In the city of Detroit, the emergency manager was able to create the perception that the city's travails were a consequence of spending and poor management rather than a decline of revenue sources. This messaging was in his interest in that it enhanced the legitimacy of his position, but it is also reflective of the likely discourse between cities experiencing fiscal difficulties and their state governments. This is heightened by the political and ideological divisions between state and city administrations.

The consequences of the Great Recession are extraordinarily dire for many municipalities. Their tax bases are primarily dependent on real estate (ad valorem property taxes), consumption (sales taxes) and income of urban residents (income taxes).

The effect on real estate taxes has been delayed and will linger because revaluation is a slow process. Declining property values have taken time to work their way through the system and any recovery will be reflected on a delayed basis.

Sales taxes suffer from the same thing that has hampered the entire economy, namely that there has been a de-linkage of corporate profits, reflected in GDP and the stock market, and family incomes important to consumption. Urban incomes have been particularly affected. Similarly, urban incomes have been slower to recover than ex-urban incomes. The highest income cohorts are more likely to live in the suburbs.

This is multiplied by the increasing practice of relying on revenue sharing from the state and transfers from the federal government. Austerity at the federal level and budget squeezes at the state level mean that cities are likely to suffer disproportionately. They are simply at the lowest end of the governmental food chain. Detroit, in particular, was damaged by a substantial reduction in State revenue sharing that kicked in fully in the year preceding its bankruptcy.

These factors were the proximate cause of the Detroit bankruptcy and they are problems for many local governments. The revenue impact of general economic conditions is multiplied because municipal budgets are inflexible. Cash demands for things like debt payments are fixed, and these can make up a large percentage of the budget. Public safety and education are high priorities and they are largely the responsibility of municipalities. Detroit cut its operating budget by 40% in the Great Recession (reducing services to dangerously low levels), but operations were only half of its cast demands meaning that the overall cash demand and was insufficient to make up for the greater than 20% decline in revenue.

Misinterpreted Pension Obligation Numbers

One of the first things that the Detroit emergency manager did was to frame the issue of the city's pension fund obligations.

The fund trustees had calculated the unfunded obligations at around $800 million using aggressive (in the sense of reducing the number) but not unprecedented assumptions. The emergency manager had the number recalculated using far more conservative (and in fact non-standard in terms of common practice) assumptions. He published a figure of $3.5 billion and this became the number used in public discourse. The emergency manager also included this number in lists of city debt obligations suggesting that it was comparable to the principal amount of bonds outstanding.

This illustrates a continuing problem of public understanding of unfunded pension liabilities. The obligation to fund future pension payments to employees is real and must be taken very seriously. But it is simply not immediate and the ultimate amount is very uncertain.

If a city's fiscal position is stressed, it can forego a planned contribution to a pension fund in order to achieve some relief. It is said that this is the same as borrowing at a high interest rate, but that is far too simplistic. It is somewhere in between a borrowing and the deferral of an infrastructure project that could improve the economic health of the city in amounts that are uncertain.

If one wants to discipline a city to make payments into the retirement funds responsibly, the unfunded amount will be presented as large and certain for public consumption. This can easily slip into policy debate suggesting that pension benefits are unfairly high for public workers. In fact, the issue of fairness has to be assessed in the context of the comprehensive public employee compensation. This discussion can easily lead to poor policy decisions because of misinformation and bias based on a desired outcome.

Complex and Risky Financial Transactions

Many municipalities have entered into complex financial transactions that were poorly understood at inception and carry embedded risks that can be realized at times of fiscal stress. This is precisely what happened in Detroit. It had entered into hundreds of millions of dollars of extremely long term interest rate swaps that were subject to immediate termination as the credit of the city deteriorated. Termination required immediate payment of all projected profits that would be earned by the city's bank counterparties had the swaps not been terminated, common swap termination requirement. The problem was that payment of these projected profits in a lump sum would make the cash flow position of the city completely untenable.

While derivatives such as interest rate swaps are common and risky, municipal finance is notorious for other forms of complex transactions. The simple fact that the interest on municipal debt is exempt from federal income taxation provides tremendous opportunity for complexity. Moreover, for political and governance purposes, municipalities often work through independent or affiliated authorities and agencies that are authorized to issue their own debt. This further adds to complexity.

Municipalities need to have an informed analysis of the risks associated with their capital financing structures. Financings are generally done one at a time with insufficient consideration of the overall set of risks taken on by the municipality. In addition, at the time of the financing, the party that is best positioned to understand the risks of the financing is most often the bank selling the idea to the municipality that is incented to make certain the deal goes through. This is true even when the municipality has an outside advisor because the level of sophistication of the banks so far exceeds that of the advisory profession. This analysis is also not accomplished through the audit process, which proceeds according to rules that could not possibly accommodate disclosure of complex risks.

Economic Development

Detroit, like many cities, gave large incentives such as tax breaks to procure investment in the downtown area. In times of stress, the overall effectiveness of such incentives can become a tremendous concern. Often, this is a legitimate criticism. Understanding what has worked to accomplish the policy goals and what has not is a difficult and perhaps impossible task. Moreover, whether or not the endeavor has had the hoped for simulative effects, public opinion will be suspicious of the potential for prior crony capitalism. ■

—*Wallace C. Turbeville,* SENIOR FELLOW

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