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What happens after Detroit's bankruptcy? Lessons in reform

by Richard H. Mattoon, senior economist and economic advisor

Detroit recently filed for bankruptcy, becoming the largest municipality to seek protection under the U.S. Bankruptcy Code's Chapter 9. In the wake of Detroit's filing, the Federal Reserve Bank of Chicago and the Citizens Research Council of Michigan convened a conference on November 7–8, 2013, to identify strategies to prevent municipalities' fiscal decline, as well as mechanisms to restore struggling cities' financial sustainability and economic growth.

Some materials presented at the conference are available at www.chicagofed.org/webpages/events/2013/bankruptcy_government_reform.cfm.

Detroit's bankruptcy filing on July 18, 2013,[1] is historic for its size and symbolism: The largest municipal bankruptcy in U.S. history represents a low point for the once-dominant American industrial icon. However, Detroit is certainly not the first U.S. city to face profound fiscal problems. To examine what lessons might be learned from other episodes of municipal fiscal stress, experts from government, academia, nonprofits, and business gathered at the conference held at the Chicago Fed's Detroit Branch. Conference participants discussed models of local governance reform and state intervention to identify the common strategies and tools that cities have relied on to emerge from their fiscal troubles and then maintain financial stability and boost economic growth.

Fiscal positions of cities today

Michael Pagano, University of Illinois at Chicago, provided an overview of cities' fiscal conditions today and focused much of his presentation on the findings from the National League of Cities' (NLC) annual survey of city finance officers.[2] The recent recession had a profound impact on the finances of cities across the nation; however, differences among their fiscal structures due to a number of factors (such as the available types of taxes and amounts of reserve funds) led to significant variation in their ability to emerge from the recession in strong fiscal shape. Turning to the NLC survey results, Pagano stated that 72% of the respondents are expecting modestly improved fiscal conditions for their cities in 2013 relative to 2012. In terms of tax revenues, those from property taxes declined in 2012 and are projected to decline again in 2013; yet this decrease is expected to be offset by continued growth in sales and local income tax revenues. That said, not all local governments are permitted to levy sales and income taxes by their state governments.

Pagano said that according to the NLC survey, the sources of fiscal stress for cities include infrastructure and public safety costs, as well as employee-related costs for health care and pensions. Another source of fiscal stress is declining federal and state aid. Cities experiencing such stress have tended to reduce employee-related costs (which make up 70% of a typical budget) to balance their budgets.

Focusing on the fiscal health of local governments in Michigan, Debra Horner, University of Michigan, discussed the results from the spring 2013 wave of the *Michigan Public Policy Survey*.[3] She noted that local governments in Michigan have faced about a decade of strained revenues. State aid was reduced cumulatively by $4.2 billion from fiscal year (FY) 2000–01 through FY2011–12.

Moreover, local property tax revenues are down 20% from their 2007 level and are not expected to fully rebound until sometime between 2023 and 2027, she said. These decreases have led to a series of expenditure actions, including drawing down general fund reserves, reducing staff levels, shifting health care costs to employees, and increasing intergovernmental cooperation to share costs. (For the most part, local governments have tried to avoid increases in debt loads and reductions in service levels.) These local government actions have resulted in a downward trend in municipal fiscal stress across Michigan since 2009–10.

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To conclude, Horner explained survey respondents' views and concerns about the future of local government funding in Michigan. First, respondents recognized that the funds needed to build new infrastructure and to improve service levels will be difficult to obtain. Second, there is broad-based support (58% of the respondents) for significantly reforming the current funding structure for local governments in order to improve their fiscal performance. This support for reform applies to all major revenue sources, including gas and sales taxes; there is even support for revisiting state constitutional amendments that set particular requirements on how certain taxes and governmental expenditures (e.g., for school funding) are to be handled.

How to emerge from fiscal crisis

Robert Inman, Wharton School, University of Pennsylvania, presented a three-step plan for cities to emerge from fiscal crisis. The first step is to recognize the components of a fiscal crisis. These components are weak demographics (e.g., 38% of Detroit's population is poor and 12% is elderly); a weak economy (e.g., Detroit experienced a 30% drop in the number of jobs over the period 2000–12); and weak government policies (e.g., not reforming inefficient and expensive labor policies, underfunding pensions, rolling over debt, and not maintaining nor improving infrastructure).

The second step has a short-run component to address the immediate fiscal problem and a long-run component to steer the city's institutions on the right path toward fiscal sustainability, said Inman. In the short run, a fiscal control board should be set up to oversee city finances, achieve a balanced budget, and draw up a five-year fiscal plan. This board—composed of state, regional, and city representatives—should be an independent and credible organization with appropriate powers to enforce its recommended changes; one of its chief aims is to signal to outside parties that the necessary steps are being taken to restore the city's fiscal stability.

In the long run, the local governmental institutions have to ensure that the marginal benefits of government services are greater than or equal to the marginal costs, said Inman. To achieve this goal, local government officials must address the following questions:

- What should cities do?
- How should cities pay for what they do?
- And how should cities decide what to do?

In answer to the first question, Inman said that city governments should provide two primary types of public services (and goods): residential services (e.g., education, public safety, sanitation, water and sewer, neighborhood and parks infrastructure, libraries, and courts and prisons, as well as services for low-income households) and business services, which are similar but somewhat narrower (e.g., commuting infrastructure). The next question is how to pay for these services. Inman discussed some important distinctions while addressing this question. First, there are "excludable" services, such as education and water. It may be possible to determine specific prices for these services based on who benefits from them. In these cases, an average variable cost for a service might be determined and then paid for through a user fee. Second, there are "nonexcludable" services, such as public safety, roads, and courts, for which broad-based taxation is the preferred method for funding, because determining a user fee would be impractical. Third, there is the special case of services for low-income households; Inman argued that it is appropriate and efficient to provide these services at the city level, although financing for them should occur at the state, regional, or federal level. Efforts to fund these services at the city level put undue stress on the local tax base, and city funding for them may crowd out funding for other vital services. In addition, Inman contended that taxes should be focused on where people live (not where people work): Residential income taxes, land value taxes, and property taxes whose revenues are largely retained by the neighborhoods that generate them (as opposed to generally distributed across the city) should be emphasized. Residents should pay for residential services, while businesses should pay for business services. The final question is how to decide what to do. Inman argued that to effectively carry out the policies he outlined, the best form of governance would be one with a mayor who has broader authority than the city's legislative body (e.g., veto powers requiring a two-thirds majority of the city council to be overridden). Also, contracts to provide services should be granted through a bidding process where government providers compete with private sector firms. Finally, Inman said that both neighborhood and business improvement districts should be set up. These special districts are areas where property and/or business owners agree to pay for expanded public services (beyond those already provided by the city)—such as more police patrols and street cleaning—or more capital improvements—such as upgrading roadways—which may raise property values (and in turn enhance property tax revenues). Their success or failure could help city leaders decide on future governmental investments.

The third and final step of Inman's plan is about getting the fiscal culture right, which for him involves gaining more stakeholders in the city's progress and empowering them. The establishment of neighborhood and business improvement districts should yield more property and business owners with a stake in the success of the city and improve long-run outcomes, Inman contended. For renters to gain a similar stake, they could be sold shares in the city (e.g., tax increment financing bonds, whose proceeds are normally used to subsidize the redevelopment of blighted areas), he said.

Responding to Inman's presentation, Anthony Minghine, Michigan Municipal League, said that a crisis facing a city like Detroit is caused by people leaving the city as the costs for services accumulate. This exodus leads to a failure of the city's financial model as service demands escalate and those best able to pay for services move outside the city's boundaries. The service crisis is precipitated at the same time as property values are falling, further eroding the tax revenue base. Minghine noted that the goal of state intervention in a fiscally distressed locality should be to create a sustainable community, not just to solve the near-term budget problem.

Communities currently in distress

Frank Shafroth, George Mason University, provided his perspective on these matters based on a MacArthur Foundation-funded study that examines the experiences of communities currently in fiscal distress.[4] Focusing on the role of the state, Shafroth noted that in some cases, state actions may precipitate a local government's funding crisis. For instance, in California, the state government's withdrawal of funds for local redevelopment agencies (following the California Supreme Court's decision to dissolve them in December 2011) created funding shortfalls in communities across the state. In other cases, state actions can determine the flexibility a community has in dealing with fiscal stress. For instance, the Rhode Island state government passed a law that gives municipal bondholders a first lien on property tax revenues. When Central Falls, Rhode Island, entered into bankruptcy in 2011, this law effectively meant that the brunt of bankruptcy adjustments would have to be borne by its local government work force and retirees (e.g., retiree benefits were reduced 55%). A more successful example of state intervention in fiscally distressed local governments has been in Maryland, Shafroth noted. Even though Baltimore has unfavorable demographics, it has done fairly well in dealing with fiscal stress, largely because the state funds the city's local social services.

The main issues facing virtually all cities are shifting demographics and pension funding, Shafroth said. As the population grows older and lives longer, demands for services for seniors will rise. In addition, as city workers reach retirement, they may face underfunded pensions. In states such as California, Michigan, and Illinois, where various types of constitutional protections are in place to preserve public pension benefits, a growing legal struggle is likely to determine if public pension payments can be reduced in order to support fiscal sustainability.

In response to Shafroth's presentation, Joyce Parker, The Municipal Group, stressed the need for outside intervention to restore fiscal balance in troubled cities. Parker explained some strategies she employed as the state-appointed emergency manager (EM) of two formerly financially distressed Michigan cities, Ecorse and Allen Park. The first one was to involve the community in the process of restoring fiscal stability—most notably by creating a transition advisory board. Establishing such a board, Parker emphasized, would make it easier to implement difficult changes, such as those to labor contracts that affect city employee and retiree health care and pensions. Another strategy is to consolidate certain government services (e.g., water and sewer); it may be possible to create cost-sharing agreements for certain services with other local governments. Finally, Parker said that based on her EM experience, simply reducing expenditures will not often restore a city's fiscal health. More revenues in the form of special assessments are usually necessary to regain fiscal stability.

Investor and business views

Lisa Washburn, Municipal Market Advisors, discussed the impact of Detroit's bankruptcy filing on the municipal bond market and strategies for improving market access for fiscally distressed communities. She noted that Detroit's filing did not surprise the market. The city's declining fiscal position was well known, and the city's debt had been rated below investment grade since 2009. What did surprise the market was Michigan's response. Historically, the state had been praised for having a system in place for intervening in fiscally distressed localities. However, when it came to Detroit, the state's lack of a direct pledge of financial support was viewed by some as a signal to the city to file for bankruptcy and default on its obligations. Moreover, the state-appointed EM suggested in a restructuring proposal (made shortly before the bankruptcy filing) that the full faith and credit pledge behind general obligation bonds did not necessarily ensure that these debts would be paid off before other debts, such as pension and health care promises. In

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response to the EM's proposal and the bankruptcy filing, yields on Detroit's secured municipal bonds spiked, prompting the yields on other Michigan municipal bonds to also rise; thus, both factors had a material effect on the borrowing costs of Michigan municipal issuers.[5]

Washburn next discussed some strategies for fiscally distressed cities to regain access to the credit markets. New York, Philadelphia, and the District of Columbia relied on comprehensive strategies that involved improving financial oversight, setting up an independent authority to refinance debt, and creating new access to funding (through either new revenues or borrowing). The State of New Jersey was allowed to intercept revenues of fiscally distressed communities and set them aside to make certain payments. In all of these cases, municipal bond investor confidence was enhanced. In closing, Washburn said that investors will evaluate communities emerging from financial distress based on the leadership in place, the support that the state is providing, and the availability of financial resources.

William Pulte, of Pulte Capital Partners (a private equity firm focused on building products), provided a business perspective on what can be done to improve economic development opportunities in Detroit. He said that one clear systemic problem facing Detroit is the estimated 100,000 vacant structures in the city. These structures place a large burden on the city's police and firefighters, reduce adjacent property values, and impair business investment. So, Pulte argued that blight removal is necessary to restore Detroit's neighborhoods and boost economic development. Thus far, $150 million in federal money has been provided for blight removal, and some large areas—including ten blocks near Eastern Market and 14 blocks in the Brightmoor area—have already been cleared. But additional funds will be needed to remove more blight. The ultimate goal of this strategy is to complement the restoration of a thriving downtown Detroit with neighborhoods that are stable and can attract residential and commercial investment.

Assessing the state's role

Stephen Fehr, Pew Charitable Trusts, presented findings from his organization's study on the state's role in responding to local government financial distress.[6] The key findings from the study are as follows:

- Nineteen states are allowed to intervene in a city, town, or county in financial crisis. However, the level and nature of intervention vary widely.
- Some states (e.g., Michigan, North Carolina, Pennsylvania, and Rhode Island) are more aggressive than others when they intervene.
- It is rare for a local government to seek bankruptcy protection.
- Local governments tend to resist state intervention.

One state with a long history of state oversight and intervention is North Carolina: The state created the Local Government Commission in 1931 after a wave of local government defaults during the Great Depression. The commission monitors local government budgets and intervenes when a local government's reserves fall below 8% of expenditures. The commission provides technical advice (such as financial management advice) to the distressed community and can take over day-to-day operations if warranted. In addition, the commission prevents cities from getting into trouble through poor debt and/or pension funding practices. All local debt has to be issued through the commission and pension contributions are centralized at the commission. These requirements provide oversight for two areas that often fall victim to improper or inept local fiscal practices.

Finally, Fehr said that states should intervene in local governments to maintain their financial safety and health, to avoid the stigma of poor fiscal management, and to prevent "fiscal contagion," where one community's poor fiscal performance impacts the ability of other communities in the state to attract investment and finance debt.

Eric Lupher, Citizens Research Council of Michigan, argued that in Michigan, state involvement comes too late for troubled localities. Detroit's fiscal crisis did not stem from a single event but rather was years in the making. Additionally, Michigan has several other cities with similar financial problems and population dynamics. Lupher said that Michigan would be better served by a state program with significant oversight of local governments' finances that would allow the state to head off severe fiscal problems before broader intervention is required. While Michigan's state intervention program has many of the features of North Carolina's Local Government Commission, it is under-resourced and does not function as effectively. Lupher also noted that pension funding is often a source of fiscal problems, and argued that the state should consider creating a guaranteed pooled pension fund for all its localities (similar to what the private sector does), which could help support pension payments in fiscally distressed communities.

Conclusion

On balance, the conference presenters maintained that improved state government oversight of local budgets—coupled with institutions that are empowered to complete fiscal restructurings with little outside political pressure—may hold the key to preventing local financial distress or mitigating its effects.

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1 For more details on the filing, see Gene Amromin and Ben Chabot, 2013, "Detroit's bankruptcy: The uncharted waters of Chapter 9," *Chicago Fed Letter*, Federal Reserve Bank of Chicago, No. 316, November.

2 For the full report (and related materials), see www.nlc.org/find-city-solutions/city-solutions-and-applied-research/2013-city-fiscal-conditions.

3 For survey results and other details, see http://closup.umich.edu/michigan-public-policy-survey/.

4 For details on the study, see http://publicservicecenters.gmu.edu/state-and-local/local-fiscal-crisis.

5 See also Amromin and Chabot (2013).

6 For the full report (and related materials), see www.pewstates.org/research/reports/the-state-role-in-local-government-financial-distress-85899492075.