

## Detroit Executive Summary

*“If the municipality doesn’t develop a recovery plan that will stimulate the economy to create new jobs, then there really isn’t much of a future.”*  
– Attorney and municipal bankruptcy specialist James Spiotto.



Detroit, once the third largest city in the United States, filed for municipal bankruptcy protection on July 19, 2013; months after the Governor appointed an Emergency Manager. Voters are scheduled to elect a new mayor and council in November—a leadership team to reassume governance in a post-bankruptcy municipality, after the emergency manager’s term and expires. The municipal bankruptcy filing reflected a continuum of the outmigration of industry, white flight, incompetence and government corruption, and deindustrialization. The filing is a critical step to ensuring continuity of essential services and critical to rebuilding an economy for this heartland city.

Detroit cannot stay on its current path and survive. 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.”

Among the most difficult challenges before the city will be addressing its legacy liabilities. As jobs and the city workforce have precipitously declined, there are fewer contributions to meet the city’s pension and post-retirement health care promises—issues which promise to be central in the coming judicial decisions that will eventually have to be incorporated in any plan to emerge from bankruptcy. Whether the city can even continue to exist at its current geographical size, but severely reduced tax base is an open question.

Whether Detroit emerges from chapter 9 federal bankruptcy with a viable plan for the future or not, its trials and efforts yield several important lessons for other leaders facing fiscal crisis:

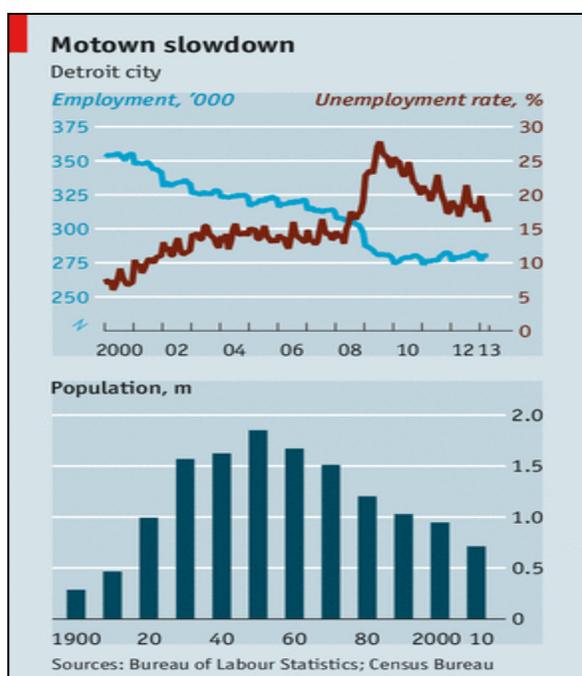
- **Know your state.** Lack of a supportive relationship between city officials and state lawmakers was an issue that lingered too long.
- **When necessary, create a crisis.** The state’s intervention and the bankruptcy filing allow for a critical time out, as well as for the certainty of the provision of essential services.
- **Identify the problem.** The emergency manager’s report and the bankruptcy filing laid bare the extent of the problem, and its causes.
- **Pick your allies.** The threat of a long, drawn out battle in the U.S. Bankruptcy court could consume critical resources vital to any long-term recovery.

- **Have a way out.** Engage in working on a plan which would allow the city to emerge from bankruptcy—and to rethink the physical dimensions of the future Detroit.

\*\*\*\*\*

## Introduction

Detroit, once the third largest city in the United States, 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 reflects a continuum of the outmigration of industry, white flight, incompetence and government corruption, and deindustrialization. The filing is a critical step to ensuring continuity of essential services and critical to rebuilding an economy for this heartland city. Michigan Governor Rick Snyder appointed an Emergency Manager in March,<sup>1</sup> 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. Indeed, its fiscal plight is so perilous that one expert asks: "How could such an economic powerhouse, a uniquely American city, so utterly collapse?"<sup>2</sup> After decades of population decline (In 1950, there were 1,849,568 people in Detroit. In 2010, there were 713,777<sup>3</sup>), 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.<sup>4</sup> 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.<sup>5</sup> As industry moved out, it left empty factories, contaminated

land, and unemployment.<sup>6</sup> The city now has 8 people per acre, down from 21 per acre in 1950, and 65,000 vacant homes, many slated for eventual demolition. Detroit, once a sprawling city of single-family homes is one that "[T]oday has produced vast patches of urban blight, full of boarded-up homes and weed-choked, rat infested vacant lots."<sup>7</sup> By some estimates, there are 30,000 to 45,000 empty homes in the city, so that roughly 40 square miles or a little less than one-third of the city consists of unused and unoccupied land—an area larger than Manhattan. Writer Billy Hamilton calls the city "either the ghost of a lost time and place in America, or a resource of enormous potential."<sup>8</sup>

In just over a decade, Detroit has experienced the loss of a third of its population, the largest exodus from any city in the developed world. The exodus has emptied its public schools, devastated assessed property values, and drained revenues; but it has not reduced the epic crime and violence. The potential legacy – should Mr. Orr fail – is, if anything, more staggering. Vested pensions and health care for retirees are likely to be imperiled in any bankruptcy. The city's most prized assets will be eyed by creditors who do not care where the money to pay them comes from so long as it's green.

The reckoning, as Daniel Howes wrote, is here.<sup>9</sup>

\*\*\*\*\*

### *A 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 many 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. Less than a quarter of the jobs on offer in the Detroit metropolitan area lie within 10 miles of the traditional central business district. The city’s population loss slowed last year, barely keeping the state’s largest city above 700,000 people, according to Census estimates: it was the only city among the nation’s top 25 to lose population last year, falling 0.7 percent.

Detroit has added jobs and retail offerings downtown, but that has yet to translate into population growth. White flight was followed by black flight; there were fewer black residents in 2010 than there were 20 years before. Motown had lost its mojo: its 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. Last year, there were 12,103 babies born in Detroit in the 12 months prior to the Census Bureau survey: more than three quarters (75.4%) were born to unmarried women.

**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. “The City’s credit ratings (S&P – B/B; Fitch – CCC/CC; and Moody’s – Caa1/Caa2) have been deteriorating rapidly and are at historical lows, reflecting the distressed financial condition of the City. These low credit ratings inhibit the City’s ability to borrow. The City has suffered multiple credit downgrades in recent years, resulting in credit ratings that are lower than any other major US City and below investment grade (i.e., junk status). Further, due to legal debt limits, the City has effectively exhausted its ability to borrow.”

**Fiscal Circumstances.** 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.<sup>10</sup>

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.

**The 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 as of March 25, 2013. The law, the Local Financial Stability and Choice Act, is intended to safeguard and assure the financial accountability of local units of government and school districts. From a fiscal distress perspective, the 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)).

### *Events Leading Up to Bankruptcy*

The city's decline predates the housing crisis. The Citizens Research Council reports that 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 the globalization of the industry. 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. The city, which peaked at 1.85 million residents in 1950, has lost a quarter of its residents since 2000. The population fell to 701,475 people last year, according to U.S. Census estimates.

Two months after his appointment to serve as the Emergency Manager,<sup>11</sup> Mr. Orr issued a report and declared the city insolvent. Motown had lost its mojo: its ability to borrow was exhausted after years of issuing long-term debt to pay its operating bills. His report determined that Detroit had liabilities in excess of \$17 billion—equal to \$25,000 for every remaining resident.<sup>12</sup> 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.”<sup>13</sup> Residents can escape these debts simply by moving away; many have done just that. By the summer of 2013, “Detroit ha[d] ineffective public services and overwhelming public obligations. Bankruptcy looms. The big unit model doesn’t work anymore,”<sup>14</sup> or, as *Detroit News* columnist Daniel Howes describes Mr. Orr’s extraordinary meeting in June with 150 representatives of banks, bondholders, unions, and pension funds: “[They] will learn how much they will be asked to give in the service of saving Detroit from itself — or become cogs in the largest municipal bankruptcy in American history...They are unambiguous confirmation of the city’s epic financial collapse, the culmination of serial disinvestment, population flight, declining tax revenue, chronic mismanagement, political dysfunction and good ol’ fashioned corruption.”<sup>15</sup>

On June 14<sup>th</sup>, Mr. Orr announced a moratorium on the repayment of all unsecured debt, starting with a \$40m payment due that day. The announcement was compared by some to a default. The Emergency Manager offered to pay some creditors a mere ten cents on the dollar. At the same time, a report to creditors set out the scale of the problem: Property-tax revenues have fallen by almost 20% over the past five years as homes in Detroit have lost value. Unemployment has led to a 30% decline in income-tax revenues since 2002. High tax rates are already speeding the exodus of taxpayers, so there is little scope to raise them further. And whatever the rates are, many of the taxes to which the city is entitled are not being collected properly.

Bettie Buss, an expert on Detroit who works for the Citizens Research Council of Michigan and who is a former Budget Director for the city, noted that Mr. Orr’s proposal to creditors was quite new. For the first time, general-obligation debt and pension obligations were to be treated in the same way, meaning that bondholders, as well as city employees and pensioners, were being asked to share the pain of restructuring. On June 17<sup>th</sup> Moody’s, a credit-rating agency, agreed that the plan was ground-breaking, “girding the city for a tough fight with creditors of all types:” It will mean severe cuts in pensions, benefits and services, making “staggering” demands on city staff and residents, according to Mr. Orr’s

spokesman. *But if this unconventional approach is accepted, other distressed cities across America may want to try the same thing* (author's emphasis).<sup>16</sup>

### *How Did the Wheels Fall Off?*

Detroit has experienced periodic episodes of mismanagement and corruption dating back to the 1900's. Wells Fargo notes this is the "third time in recent history that the city is rated below investment grade."<sup>17</sup> The question is how did this happen to Detroit, but not other, older U.S. cities that experienced similar fiscal, racial, and economic trials and tribulations? Or, as Detroit urban planner Pete Saunders wrote:

"Buffalo and Cleveland have suffered the same kind of economic loss, but have not (quite) fallen to the same depths as Detroit. In fact, Pittsburgh suffered as much economically as Detroit, and is now poised for an amazing Rust Belt comeback. Any number of cities has had as troubled a racial legacy as Detroit, without being as adversely impacted."<sup>18</sup>

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.<sup>19</sup> Jobs left Detroit as auto plants moved to the suburbs and to other countries with the globalization of the industry. 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. The city, which peaked at 1.85 million residents in 1950, has lost a quarter of its residents since 2000. The population fell to 701,475 people last year, according to U.S. Census estimates.

A total of 413,146 properties in Detroit had at least one foreclosure filing in the seven years from 2006 through 2012, representing 22 percent of all households in the metropolitan area, according to RealtyTrac. Foreclosures made up 30 percent of the sales in the Detroit area in the first quarter, according to RealtyTrac, and there were just 578 mortgages for purchases last year, also according to RealtyTrac. In Pittsburgh, which has less than half the population but healthier finances, there were 5,513 mortgages.<sup>20</sup>

One cannot analyze or consider city fiscal conditions in Detroit without considering race. As *The Economist* notes: "Race aggravates matters. The city is 83% black. Adjacent Oakland County is 77% white, and more than twice as rich,"<sup>21</sup> noting there is an undeniable racial element. Detroit has an all-black city council and an uninterrupted line of black mayors going back to 1974. With Detroit now under emergency management, the calculus demonstrates that nearly half of Michigan's African-American population lives under leaders who were not democratically elected; only 1.3 percent of whites live in the affected areas, according to a May press release from the Detroit chapter of the NAACP, which is challenging Gov. Snyder's right to appoint emergency managers.<sup>22</sup> The lawsuit claims that the law violates the 14th amendment. Numerous prominent civil rights leaders have denounced the law and Orr's appointment in particular. Jesse Jackson called it "a dangerous precedent for our nation."<sup>23</sup>

**State Takeover.** State-appointed bankruptcy attorney Kevyn Orr began his 18-month tenure as emergency manager on March 25. Although Moody's Fitch Ratings and Standard & Poor's maintain junk-

level ratings on the city, Standard & Poor's raised the outlook to positive from stable on its B rating after the state took over the city. In its report, Moody's said Detroit has budgeted for at least four of the five debt-service payments scheduled for 2013 and warned it could downgrade the city if its expenditures continue to outstrip revenues or if the city takes on additional debt. Any weakening of the state's authority over distressed local governments tied to court challenges to its current law could also prompt a downgrade.<sup>24</sup>

**Detroit Insolvency.** Detroit filed the largest municipal bankruptcy case in U.S. history with a 16-page petition in the U.S. Bankruptcy Court in Northern Michigan, as authorized by Gov. Rick Snyder (under Michigan law, the governor is required to authorize a Chapter 9 municipal bankruptcy filing). The filing puts the responsibility for restructuring to Detroit Emergency Manager Orr and a federal bankruptcy judge—a process that could take years, as has happened in Jefferson County, Alabama. Mr. Orr, as the receiver, is likely to adhere to his restructuring proposal he had already issued, where he offered paying most of the money owed to secured creditors, but as little as 10 percent to pension funds and unsecured bondholders. The filing immediately triggered what is certain to be a long and costly legal battle—a battle that will not only consume dwindling funds critical to the city's sustainable future, but also to the pension funds and other creditors. Unsecured creditors could end up taking the biggest hit: Mr. Orr has proposed they receive only \$2 billion of some \$11.5 billion worth of debt, which includes an estimated \$9.2 billion in health and pension benefits and \$530 million in general-obligation bonds; he intends to dedicate \$1.25 billion over the next decade to buy police cars and fire trucks, replace broken street lights, tear down burned-out homes, fight blight and improve city services—in an effort to provide for essential services and sustainability.

Mr. Orr has indicated his plan would aim for exiting in six to eight months—during which time he would seek to restructure not only some \$20 billion in creditor liabilities, but also provide \$1.25 billion in new spending. The goal is not just to exit municipal bankruptcy, but to ensure a sustainable future.<sup>25</sup> The decision was complicated by two suits in Ingham County seeking to deny legal authority to the governor to approve a Detroit bankruptcy: a Chapter 9 filing would invoke an automatic stay against lawsuits or actions demanding repayment of debt. Many believe that federal bankruptcy protection would strengthen the city's ability to execute the restructuring, provided Mr. Orr and his team can get a bankruptcy judge to agree. To some degree, there is a non-Detroit casino gamble at stake for both sides: is Mr. Orr's to swap a \$2 billion "nonrecourse participation note" for \$11.45 billion in unsecured claims, a payout that equals less than 20 cents on the dollar, better than bringing in a federal bankruptcy judge to act as a single referee?

In June, Mr. Orr issued a report saying Detroit will be insolvent by December. In his quarterly report to Michigan Treasurer Andy Dillon, Mr. Orr reported the city, which in July reported a \$55.9 million cash balance, will have a negative cash balance of \$11.6 million by the end of December, unless Detroit defers payments or takes steps to conserve cash. Concurrently, Michigan Attorney General Bill Schuette's office sought to halt two lawsuits filed earlier in July by current and retired city workers who are trying to stop Gov. Rick Snyder from authorizing a bankruptcy. The plaintiffs claimed the emergency manager's power to alter or wipe out vested pensioners in a bankruptcy violates Michigan's constitutional protection of accrued pension benefits.

The report also found that there was as much as \$226 million from accounting gimmicks and delayed payments owed to vendors and the city's pension liabilities—the city is paying just \$31 million of its required \$139 million towards its pensions this fiscal year—addressing apprehensions about the health of the city's two employee pension programs.

**Municipal Services.** Municipal services are failing. In his report,<sup>26</sup> Mr. Orr described Detroit's operations as "dysfunctional and wasteful after years of budgetary restrictions, mismanagement, crippling operational practices and, in some cases, indifference or corruption..." making clear that "outdated policies, work practices, procedures and systems must be improved consistent with best practices of 21<sup>st</sup> century government." The city's 78,000 vacant structures and 60,000 vacant land parcels "present an ongoing public safety and public health concern." Moreover, despite the signal loss of population, the city still must 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, as well as driving down property values. The electricity grid is in disrepair, most of the parks are closed, and some fire-station chiefs complain that their engines are operating on "bubble gum and duct tape." About 40 percent of the city's lights do not work, and those that do tend not to be in the places where people live. Adding to the general peril, the homicide rate for Detroit in 2011 was more than 48 per 100,000. The comparable figure for St. Louis was 35 per 100,000; for Cleveland 19 per 100,000. Detroit has the highest rate of violent crime of any American city with more than 200,000 people. Emergency-response times are snail-slow and the police have a dismal 8.7 percent case-clearance rate. Put another way: blight has made Detroit virtually unmanageable: as the tax base shrinks, the cost of municipal services such as police and fire protection, bus service and garbage collection, stays the same or even rises. Sparsely populated neighborhoods see increases in crime and fires, including arson.

In recent years, city officials have made deep cuts in staff and operations, leaving residents complaining of darkened streetlights, slow police response times and bus delays. But while cutting workers can help reduce the current year's costs, it moves many of those people into the ranks of retirees, putting heavy long-term pressure on Detroit's two public pension funds.

Orr recommends getting more police officers on the street and hiring civilian workers to do administrative jobs. The cost of simply reconstructing a functioning police department is estimated in Orr's report to amount to \$95 million between fiscal 2014 and fiscal 2018. Crime remains the top barrier to the revitalization of the city. Unless it is tamed, the Detroit's future remains grim.<sup>27</sup>

### *Who Is in Charge?*

Part of the problem relates to blurred lines of services responsibilities. Detroit retains control of several functions that are provided by regional authorities in other metropolitan areas, including its general-fund supported bus system and a regional water and sewer system. Likewise, the city provides services such as public health, workforce development, and human services that are usually the responsibility of county governments.<sup>28</sup>

Clearly one of the issues that State Treasurer Andy Dillon and the Emergency Manager are considering is whether Detroit can afford public services or should hand them to other localities. In the suburb Pontiac, an emergency manager disbanded the police and fire departments. The city pays the surrounding county and a neighboring township to provide police and fire protection, using many of Pontiac's former officers. Yet Detroit, with its vast area, sits at its region's center.<sup>29</sup>

One option to address services the state is considering is shared services.<sup>30</sup> A bipartisan pair of Michigan lawmakers have introduced legislation to allow the State to dissolve districts that have run out of cash and send the students to neighboring districts. Now they are working on a revision under which state officials would be given authority to dissolve a school district that is unable to implement its deficit reduction plan or a district that cannot operate for an entire school year. Under the proposed bill, students would be sent to other districts within their respective county's Intermediate School District, but the dissolved district's debt would remain with local taxpayers. The insolvent district would retain its taxing authority until the debt is paid. Michigan School Superintendent Mike Flanagan has provided the legislature with a quarterly report on Michigan school districts in deficit in an effort to demonstrate which districts are progressing toward solvency and which districts are falling deeper into debt. Some forty-nine Michigan school districts have deficits that have placed them on a state watch list, requiring local leaders to slash costs and follow strict deficit elimination plans. Across the state, the number of school districts with growing debt and deficits has risen from 10 in 2002-03 to the current 49. Of those, at least 27 districts have deficits of more than \$1 million. In 2003, only one district did. Albion Public Schools, in Calhoun County, reports it can only afford to educate its K-8 students, so the district is closing its only high school this month, forcing those students to attend neighboring districts. The Flint school district is slashing its faculty by 139 teachers as it tries to eliminate a \$15.6 million deficit in three years. Mr. Flanagan notes that 90% of Michigan's school districts are making fiscal progress—or moving towards shared services: Avondale Schools Superintendent (in Oakland County), where enrollment has declined in the last decade, said closing a school and sharing services with other districts and employee concessions are helping the district eliminate its deficit on schedule in 2014. Michigan currently has more than 860 schools districts and 1.5 million students. This year, the Michigan Department of Education awarded \$10 million in state grants to local and intermediate school districts to help cover the costs of consolidating districts or services.

While the consolidation of school districts is, politically, far different than local governments, the mix of services Detroit currently provides—many with blurred jurisdictional lines, make this a candidate for consideration.

A key initiative underway in Detroit to address the services issue is to address blight, or as William Pulte describes it: the only way to truly save Detroit and get the housing market functioning properly again is to destroy large swaths of the city as quickly as possible. Mr. Pulte's efforts have already succeeded in knocking down 10 blocks on Detroit's Southeast as part of the proposed nonprofit Detroit Blight Authority program—an effort he describes as a preview of the effort he says is needed to get ahead of the metal strippers and arsonists devastating the city's property values.<sup>31</sup> Mr. Pulte reports he is collaborating with the Detroit Future City plan, an effort to transform Detroit into a sustainable city by 2030 by focusing on increasing the density and improving city services in healthy residential areas. Less stable areas of the city, such as those where Pulte would like to level blocks of dwellings, are converted to other uses such as parks or open spaces, according to the plan.<sup>32</sup> Dan Gilbert, the founder of mortgage lender Quicken Loans Inc., and owner of the Cleveland Cavaliers basketball team, is leading an effort to encourage development in Detroit's downtown, buying up buildings and moving thousands of jobs and new ventures to the area. That effort, in turn, appears to be increasing demand for downtown housing.<sup>33</sup>

### *Learning How to Learn*

While the Detroit Public School system is separate from the city, it is integrally related and equally fiscally distressed. The fate of the public school system is intertwined with the city's future. Not only is the quality of the system essential to attracting families to the region and to ensuring opportunities for the children of families who reside in the city, but also to attracting city employees for whatever the "new" Detroit is. That is, any new, post-bankruptcy leaders would be expected—if not required—to put their children into the public school system. Consequently, its financial soundness and integrity cannot be separated from Detroit's future.

But just as Detroit has been spiraling down, so too has its school system. Gov. Rick Snyder appointed Jack Martin to serve as Emergency Manager of Detroit Public Schools effective July 15, 2013. This is a school system with below average graduation rates, historically-low standardized test scores, rapidly declining enrollment, and a deficit that has grown from \$200 million to \$327 since the state took over the district two years ago. It is a system termed "A national disgrace," by Dan Rather,<sup>34</sup> beset by massive deficits and widespread corruption. Based upon the prior approval of the electors, the District is authorized by law to levy \$18 million for school operating purposes on all taxable non-homestead property—in effect sharing or competing over a recession-wracked tax base with the city. It expects to have outstanding \$140 million in school building and site bonds as previously authorized by law and approved by the electors, requiring to tax levy of \$13 million on all taxable property, including homesteads, for its bonded debt retirement funds.

### *Pensions & Long Term Obligations*

The city's pension system serves 18,500 retired and 10,000 active workers. The city's total long-term obligations and retiree health care liabilities total \$5.27 billion, accounting for some 38 percent of the city's long-term obligations. Because Detroit has been understating its liability and deferring annual contributions, costs are projected to more than double next year. Mr. Orr has called for "significant cuts on accrued, vested pension amounts for both active and currently retired persons." In the case of Detroit, legacy costs associated with former employees, as well as debt service on money borrowed in the past to pay for operating costs, must be paid regardless of the city's shrinking income.<sup>35</sup> There are 48 employee unions in the city; there is no way Detroit will reach consensus with all of them. Thus, with retirees outnumbering current employees by nearly two to one, retiree benefits are one of Detroit's greatest drags on its operating budget.

Mr. Orr's report to creditors, on an issue which will surely be tightly scrutinized and fought over in both Michigan courts and the U.S. Bankruptcy Court as part of the federal bankruptcy proceedings, notes that the city's actuarial valuation of its unfunded actuarial accrued liability (UAAL) is substantially understated, stating that rather than \$644 million as calculated in the city's last actuarial report (2011), the liability presented in the Emergency Manager's report is \$3.5 billion. The report finds that other post-employment benefits are assessed to be \$5.7 billion. The EM's report states that there was a reduction of 1% in the discount rate to arrive at the \$3.5 billion. Clearly there are two issues: the apparent intransparency in how these numbers have been reached that took a city-reported liability from \$644 million to \$3.5 billion, and second, how the U.S. Bankruptcy court construes the provisions of the state's Act 436 which gives an emergency manager authority to take over management of a pension fund that is not actuarially funded at a level of 80 percent or more.<sup>36</sup>

It is almost like an upside down pyramid—one which the Emergency Manager notes means the city's \$20 billion debt load cannot be reduced without "shared sacrifice" from all stakeholders, including retirees.<sup>37</sup> Pension and retiree-health-care obligations make up the bulk of the city's unsecured debt, and their costs are rising rapidly. On a per-household basis, the city owes more for retiree health care than any of the cities at the center of the 30 largest U.S. metropolitan areas except for Boston and New York. Retiree costs make up two-thirds of the city's annual health-care bill, swamping those for current workers.<sup>38</sup> Moreover, the city's estimated \$5.7 billion (2011) post-retirement benefit obligations are expected to grow (Detroit has no fund for OPEBs and no way to pay for starting one anytime soon.)<sup>39</sup> after Mr. Orr's office completes its revaluation of the costs: they already surpass most of Detroit's other liabilities, including general-obligation debt (\$1.1 billion) and pensions (recently revised higher to \$3.5 billion).

Emergency Manager Orr has opened a probe of the city's pension funds<sup>40</sup> in response to apprehensions about corruption, spending, and management—a probe which could lead to freezing pensions or ousting the current trustees of the city's two retirement funds—and which are also caught up in a federal probe. The high stakes action come as pension officials, who have amassed a \$5 million war chest, seek to prevent any successful takeover effort of a retirement system worth more than \$5 billion. Mr. Orr announced the probe ahead of May's closed-door meeting at the Coleman Young Municipal Center with about 125 union officials to discuss proposed health-care and pension changes.

There is some anticipation that the investigation could open the door to a possible takeover by the Emergency Manager of the pension funds—especially in response to failed investments involved in a bribery and kickback scandal that has led to federal indictments of five businessmen and former pension officials, including Jeffrey Beasley, the ex-Detroit treasurer. Detroit's pension funds have lost more than \$84 million on corrupt investments given to companies during former Mayor Kilpatrick's tenure, according to the U.S. Attorney's Office.<sup>41</sup> The general counsel of a Detroit pension fund, Ronald Zajac, has been suspended without pay after being charged with bribery and conspiracy involving more than \$200 million in investment. The General Retirement System board members voted to remove Mr. Zajac. U.S. Attorney Barbara L. McQuade added Mr. Zajac and Paul Stewart, a former trustee of Detroit's Police and Fire Retirement System, as defendants in a superseding indictment that already had charged former city Treasurer Jeffrey Beasley and investment sponsor Roy Dixon with the bribery and kickback conspiracy.<sup>42</sup>

The Emergency Manager expects the investigation to take up to two months and result in a report from the auditor and inspector general. But, the possible corruption is not the only focus; retirement health care benefits are a key plank of Mr. Orr's restructuring plan—in which he is proposing to replace the city's current system with one that relies on the Patient Protection and Affordable Health Care Act and Medicare (According to the Emergency Manager, the city's unfunded retiree medical costs are more than \$5.7 billion.) Detroit is expected to spend approximately \$200 million on health care benefits this fiscal year alone, more than two-thirds of which is for retirement benefits. That amount is scheduled to increase by more than 30 percent next year to \$263 million for the city-provided health benefits to more than 28,500 active workers, retirees, and dependents.

### *Not Just the City of Detroit. Reverberations.*

The negotiations and actions in Detroit could well impose costs on Hamtramck and other Michigan municipalities under an emergency manager, such as Pontiac and Flint. All could confront greater budget pressures because of investor-perceived penalties as investors anticipate a similar threat, in the wake of Detroit, of non-payment of general-obligation debt, and the June meeting in Detroit between Mr. Orr and the unions and creditors—a meeting intended to frame negotiations over \$17 billion in debt and obligations. On the outcome’s success or failure may hinge the largest U.S. municipal bankruptcy ever, but also on the fiscal distress of other Michigan municipalities.

A single paragraph in the Michigan Constitution could have statewide repercussions: “The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof and shall not be diminished or impaired thereby,” reads §24 of Article IX: The constitution says it protects the vested pension benefits of public employees. Yet Emergency Manager Orr’s restructuring proposal, the likely template for any Chapter 9 bankruptcy filing, proposes to cut benefits because he says the city cannot afford them nor raise taxes to honor them. Who’s right? That depends, say bankruptcy experts and Michigan’s attorney general. The wording may appear to be clear, but if bankruptcy by definition is a venue where debtors can restructure or reject contracts, wouldn’t the “contractual obligation” protecting pension also be vulnerable? “The federal bankruptcy judge will make a decision,” Attorney General Bill Schuette told *The Detroit News*. He declined to say whether the constitutional protection could — or could not — be pierced in bankruptcy, adding: “There is no doubt the financial hardship that everyone is going to feel is going to be severe.”

Those 32 words in Article IX are 32 reasons why union leaders and the city’s pension funds vow to fight any attempt outside of bankruptcy to cut benefits for retirees and vested active workers, a prospect that all but guarantees Detroit likely will become home to the largest municipal bankruptcy in American history. Who can blame them? The constitutional protection, enshrined in 1963, is a cornerstone for public-sector unions. It guarantees the state, its municipalities and its school districts would honor their commitments, effectively ensuring any effort to settle with Orr outside of bankruptcy would invite a flood of lawsuits from pensioners. As much as Orr says a settlement outside bankruptcy likely would be more financially advantageous to unions and pension funds, the political calculation is that the least bad of an awful set of choices is to precipitate a Chapter 9 to shift blame from leadership to a federal court.

That kind of thinking represents an understandable instinct for self-preservation, a time-honored characteristic of Detroit’s political dysfunction. But it’s not at all clear that it would be in the best interests of vested pensioners who could lose even more inside Chapter 9. “I’m trying to avoid it because I think it does afford me more power,” Mr. Orr has said: “I’d hope we can work this out collegially.”

### *Hamtrack Fiscal Emergency*

As in many metropolitan areas across the United States, there is a question with regard to symbiosis within such areas. In the Detroit metropolitan area, the issues is conflicted by racial contrasts (see above) between Oakland County and Detroit, and no studies appear to have analyzed the interactions between Detroit and Hamtramck—a nearly wholly enveloped municipality by Detroit—of fiscal distress.

Michigan Governor Rick Snyder Monday, June 3rd, declared a financial emergency in Hamtramck after receiving the report of a review team appointed to scrutinize the troubled city's finances—a step that could lead to the appointment of an emergency manager for the city virtually surrounded by Detroit. Mayor Karen Majewski said the step was not a surprise, as the city has been working with the state Department of Treasury for more than a year, noting: “The governor is agreeing with the findings of his review team. I would have been very surprised if he had taken a different stance from the report.” The Hamtramck report listed key items that triggered its findings, including a projected \$3.3 million general fund deficit for the current fiscal year (The deficit is more than 5% of the general fund revenue for fiscal year 2013), deficits in the previous three years, and delays by city officials in making required pension contributions each month to the Municipal Employees Retirement System of Michigan. (Under the state's new emergency manager law, Public Act 436, with the Governor's affirmation of his finding of a financial emergency, Hamtramck has four options: a consent agreement with the state, appointment of an emergency manager, a neutral evaluation of city finances, or federal bankruptcy protection under Chapter 9.)

Hamtramck, a 2.1 square mile city that borders Detroit and Highland Park with about 22,000 residents, is no stranger to financial hardship. For the last few years, officials have laid off city employees and in October, the Hamtramck Fire Department lost 12 firefighters, shrinking the force by 44%. In 2001, then-Gov. John Engler appointed an emergency financial manager in Hamtramck. The city regained local control in 2007.

The Hamtramck City Council voted 6-0 at its June 11 meeting to bring in an emergency manager, just hours after Gov. Rick Snyder's office released a statement that confirmed his determination on May 3 that Hamtramck is in a financial emergency. Governor Snyder determined there was a financial emergency in the city after considering a report from an independent, five-member financial review team. The team cited several conditions including a general fund decrease from \$2.7 million in June 2011 to a negative \$582,365 a year later.

After Gov. Snyder confirmed the financial emergency, city officials had seven days to pass a resolution selecting one of four options to address the problems. In addition to an emergency manager, the options included a consent agreement, a neutral evaluation process and Chapter 9 bankruptcy. Hamtramck Mayor Karen Majewski believes many of the city's financial issues stem from retirement costs and rising health care costs. The city also lost \$600,000 in income tax revenues when the American Axle plant closed in 2011. (Tax revenues from General Motors' Detroit-Hamtramck Assembly Plant dropped substantially last year because of declining property values and tax appeals. The city once received \$1.7 million in revenue from GM, but revenues dropped by \$1 million to \$700,000 a year).

Mayor Majewski notes: “These are problems most cities are having. Until the state looks seriously at the mechanism in which municipalities are funded, we are going to see more and more cities go through this.”

## *Revenues*

Detroit has one of the broadest tax bases of any U.S. city. 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 Motor 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.<sup>43</sup>

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. Perhaps, more than any other city, Detroit's property tax collections were assaulted by the recession, with assessed valuations declining nearly 46 percent from 2007 to 2012. But the Detroit property tax revenue problem is also adversely affected by state limitations<sup>44</sup> as well as a city property tax administration system described as “riddled with errors and waste, and overseen by a pair of double-dipping officials who work just two days a week,”<sup>45</sup> and a singular inability to address delinquencies. The *Detroit News* in February reported that 47 percent of property owners were delinquent on their property taxes and fees in 2012—with some delinquency “so pervasive that 77 blocks had only one owner who paid taxes last year.”<sup>46</sup> The *Detroit News* also found yet another property tax problem: high taxes and low values. In the 2011 50-state property tax comparison study, Detroit ranked first among the 50 largest cities in taxes - and last among property values. Detroit taxes on a \$150,000 house were \$4,885, twice the national average of \$1,983. The city's average house price, \$16,800, was nearly 10 times lower than the next lowest, Mesa, Ariz.

Detroit leads U.S. cities in homes that the Census Bureau says lack basic plumbing as vandals strip homes of pipes and fixtures almost as soon as they go vacant. With about 19 percent of its 360,951 units lacking complete plumbing, Detroit trailed only Gary, Indiana in the concentration of bathroom-deficient housing among large U.S. cities, according to the census.<sup>47</sup> One out of about every three mortgages is a land contract in the predominantly Hispanic neighborhood in Southwest Detroit, according to Timothy Thorland, executive director of Southwest Housing Solutions, which is trying to stabilize housing and improve neighborhoods. Within a mile of the neatly kept lawns and sprawling houses of Rosedale are the burned out blocks of Detroit's Brightmoor neighborhood, where many streets have only one occupied home, surrounded by burned structures, garbage and weed-choked lots.

Clearly a significant cause of the delinquency comes from exasperated residents who are surrounded by broken streetlights and overgrown parks. Their non-payments fuel a vicious circle: they do not pay, because they do not believe the city will respond; but their non-payment further syphons away revenues the city desperately needs to finance services: “Detroit needs to begin its restoration process by collecting unpaid property taxes. The city is desperate for cash, and if it does enter Chapter 9

bankruptcy, a move to collect unpaid property taxes will show the bankruptcy judge that the city made all efforts to right itself financially.”<sup>48</sup>

The perception of the lack of services undoubtedly contributes to the paucity of demand: there were only 578 mortgages for purchases last year in Detroit, with an average sales price of \$53,285 and an average loan amount of \$49,176, according to RealtyTrac. In Pittsburgh, which has roughly the same population, there were 5,513 mortgages, with an average sales price of \$182,614 and an average loan amount of \$157,240, RealtyTrac said.<sup>49</sup> With so many homes in foreclosure and so few appraisers familiar with Detroit neighborhoods, the disconnect is paralyzing traditional lending and further eroding the property tax base.

While Detroit has had some success reviving its Midtown and Downtown areas, where a consortium of employers are offering workers \$20,000 in purchase assistance to move in, though there is still very little lending, as banks remain wary and appraisals lag behind the market. Even with \$20,000 subsidies available for a mortgage, most people are still renting in Midtown and Downtown: about 92 mortgages have been financed in the targeted areas among about 900 total people participating.

Detroit has had some success reviving its Midtown and Downtown areas, where a consortium of employers are offering workers \$20,000 in purchase assistance to move in; nevertheless, there is still very little lending, as banks remain wary and appraisals lag behind the market. With so many homes in foreclosure and so few appraisers familiar with Detroit neighborhoods, the disconnect is paralyzing traditional lending. Even with \$20,000 subsidies available for a mortgage, most people are still renting in Midtown and Downtown.

### *Fiscal Hard Times & Debt*

Detroit Emergency Manager Kevyn Orr’s plan to suspend payments on \$2 billion of Detroit’s municipal debt could have far reaching impacts and costs for cities, counties, and school districts across the country. Mr. Orr, at a meeting he called with creditors of the city in May, proposed that, in order to avoid filing for Chapter 9 municipal bankruptcy, Detroit would skip a \$39.7 million payment on pension-obligation debt. He also stated the city is set to default on unsecured unlimited-tax and limited-tax general-obligation bonds.<sup>50</sup> What most surprised attendees at the meeting was the Emergency Manager’s apparent willingness to skip payments on interest and principal owed on general-obligation or G.O. bonds—that is bonds issued by the City of Detroit and backed by its full faith and credit. After Mr. Orr aired his plan with creditors, Standard and Poor’s lowered its rating on the city’s general-obligation debt a step to CC from CCC- with a negative outlook.

Matt Fabian, a Managing Director of Municipal Market Advisors noted: “You could make the case for downgrading every G.O. bond in Michigan.” Mr. Orr, in effect, is proposing to unsecured creditors (such as owners of Detroit’s G.O. bonds), who are owed at least \$5.85 billion to trade their debt for \$2 billion in new, 20-year notes that carry an interest rate of 1.5%. While muni investors in Detroit’s debt who hold insured debt would be likely to be repaid in full, the question would be the implications for those holding unsecured the city’s debt—not to mention the potential ripple effect for every state, local government, and school district in the country. This is, mostly, unvisited territory. Jim Spiotto, perhaps the most eminent municipal bankruptcy attorney in the country, suggests that neither issuing governments nor bondholders should panic, because suspended payments do not necessarily mean

they will be forced to take principal reductions, noting that in 1975, New York City suspended payments on debt. After a lawsuit, negotiations, and state and federal aid, creditors were fully repaid; rather, he notes: “The devil is in the dialogue,” referring to the unsuccessful one which Mr. Orr held in June and early July. But Detroit is between a rock and a hard place. As Emergency Manager Orr has made clear: cutting Detroit income and property taxes so that they are competitive with surrounding areas is critical to reversing crippling population and job losses. Something will have to give. Bart Mosley, co-president of Trident Municipal Research in New York, said an issuing state or local government’s “full faith and credit” pledge must give way to facts: “Economic reality, such as Detroit’s shrinking population and tax base, does impose a limit: Once all the blood is squeezed from the stone, you are unsecured.”

Detroit missed a \$39.7 million payment on debt issued to bolster its pensions that was due June 14th, its first failure to repay bondholders. The city has about \$1.5 billion of such obligations, which Fitch Ratings has reduced to D, its lowest credit grade. Under Mr. Orr’s spurned proposal, the city offered to pay creditors no more than 10 cents on the dollar for \$2 billion in unsecured debt, and the same for unfunded pension liabilities (liabilities which the Emergency Manager estimates at \$3.5 billion). The non-acceptance of the offer almost certainly triggered the chapter 9 federal bankruptcy, under which one of the most difficult issues has proven to be not just the conflict between the Michigan constitution and federal law (Chapter 9), but also over whether bond obligations and debt owed to vendors has more protection than pension claims.

Concurrently, Mr. Orr has ordered an investigation into employee benefit programs, including the insurance and pension systems, directing the city’s inspector and auditor general, agencies that both have subpoena power, to report within 60 days in an order dated yesterday—directing that said document should cover “next steps, and any corrective, prospective, legal, additional investigatory or other action designed to address any waste, abuse, fraud or corruption uncovered.” He has made clear he intends to reduce payments toward unfunded pension liabilities, which would result in unspecified cuts for retirees. According to Mr. Orr’s report, wages, benefits, and pensions account for 41% of the city’s total expenditures this fiscal year, finding that benefit and pension costs per employee increased to \$24,000 from \$18,000 in 2000.

\*\*\*\*\*

### *Looking Ahead*

The Detroit of tomorrow will be different. The state takeover and the declaration of bankruptcy guarantee that. The old guard is out: Mayor Dave Bing is a lame duck; the president of City Council, Charles Pugh, has been stripped of his pay. The council’s president pro tem, Gary Brown, tripled his salary to quit and become chief compliance officer for Emergency Manager Kevyn Orr. Kwame Kenyatta resigned from the council, and several others will not seek re-election. So, leadership change in Detroit already is under way, four months ahead of the general election, and a federal bankruptcy judge will play a critical role in ruling on and shaping the city’s fiscal future. How and what those decisions are will likely reshape federalism and the fiscal relationships in this country between the three levels of government, will reshape long-term financing by states and municipalities, and clarify legal and constitutional lines of authority.

The process, as Detroit enters its journey into the largest municipal bankruptcy in American history, will not be in isolation. Even as the emergency manager and the state attorney general are working to

create the fiscal foundation for a revitalized Detroit, Mr. Orr is also pressing outside traditional municipal boundaries to lay the foundation to ensure better governance as an outcome of any restructuring and to create a sustainable future. The emergency manager is working with the Ford Foundation and New York University's Marron Institute on Cities and the Urban Environment, among others, for concepts and practices to improve the city's governance structure and operations, including potential revisions to the city's charter that could be proposed to voters in the future, telling the *Detroit News*: "We're looking at practices that are inefficient and don't help us," Orr told The Detroit News. "What makes sense for 21st-century cities — not just now, but in the future?" That is, the Emergency Manager is pressing for a profoundly different outcome: to utilize the bankruptcy process not just to restructure the city's \$18 billion in long-term liabilities, but also to restructure its dysfunctional political culture.

Perhaps most importantly, Mr. Orr appears to have the strong commitment and support of the Governor and State Treasurer—not to mention his spouse. This is a critical trifecta.

The most critical part is perhaps best illustrated in comparison with Central Falls, Rhode Island—where the receiver appointed by the Governor understood his role as one to implement a plan to get the city out of bankruptcy and with a balanced budget. But, when pressed, if that plan would produce a sustainable future, the receiver demurred. That, after all, is not a requirement of exiting chapter 9.

In contrast, Mr. Orr was exceptionally clear: he understands his mission and responsibility to the Governor and to Detroit to lay the foundation for a sustainable fiscal future.<sup>51</sup>

As the astute columnist, Daniel Howes, of the *Detroit News*, notes: "What and when the workout will deliver is uncertain, because the process is fraught with threats of litigation, political pushback and the unknowns of a historic municipal bankruptcy that could last years. But the appointment of Orr, armed with unprecedented power, is combining with a wide-open race for mayor and council elections by district for the first time since the end of World War I to reshape the city's leadership.

"Into what nobody knows. An assumption among business leaders is that the appointment of an emergency manager is an unqualified positive for the city's direction. Orr should be able to produce, the thinking goes, a leaner, smaller, more financially sustainable municipal government less tightly connected to a retrograde political culture that favors power and control over competence and accountability."

The challenge is likely to be harder than perhaps for any previous municipal fiscal crisis in U.S. history, but there appears to be a growing consensus that Mr. Orr and his team can deliver, especially given his power under Public Act 436 and Chapter 9 of the federal bankruptcy code. But the greater fiscal challenge will occur in the wake of November's election: when the Emergency Manager's time expires, what will be the action of the new political leadership elected in November? Or, as Howes writes: "By the time newly elected leaders take office in January, Orr would be approaching the half-way point in what he and Gov. Rick Snyder call an 18-month term. At that point, two-thirds of council could vote to remove the emergency manager. But under Public Act 436, if the financial emergency persists the governor could appoint another manager or council could revert to a consent agreement, structured settlement or bankruptcy — if the city is not already there."<sup>52</sup>

Detroit's severe fiscal distress would not end with an ouster of Mr. Orr; rather it would more likely lead to a new phase of state-ordered requirements on elected officials who would benefit politically from instituting the changes — not fighting them like Mayor Bing and the current council mostly did — because doing so would speed the end of state oversight.

That's why the new leadership taking office next year could be critical to sustaining the restructuring. That, in effect, is the most difficult and delicate part of Mr. Orr's and the state's job—not to put together a balanced budget, but rather to create a sustainable municipal economy.

As Daniel Howes writes: "It's no longer debatable that Detroit is a financial basket-case. Or that many years of chronic mismanagement and political dysfunction combined to create a web of promises to employees, retirees and residents the city can no longer keep absent radical restructuring. Anyone who's been paying attention knows the contours of Detroit's collapse. The task for the new leaders who will replace the old is to heed the lessons of the past and break the cycle of self-deception and inaction — or risk living the municipal nightmare all over again."<sup>53</sup>

While the team has assembled considerable information about the Motor City and have Mr. Orr's report, it is a very different matter to both see and hear from those directly involved to better appreciate the challenges, options, and most critical vulnerabilities. Among the kinds of questions of greatest interest in this effort are:

- What options might be available for physically reducing the boundaries of Detroit?
- What are the implications of the fiscal crisis in Hamtramck to Detroit?
- How can a municipality realize benefits of shared services if the adjacent municipalities are also in distress?
- Given the new efforts to consolidate and share services for Michigan school districts, is there any similar consideration of sharing municipal services?
- Having devoted so much focus on Detroit's fiscal crisis, what considerations are there with regard to potential changes in state laws?
- If the clock could be set back five years, what might have been the three most critical steps that would have helped to prevent the current fiscal crisis?

### *The Research Team*

Report Author:  
**Frank Shafroth**

Project Team:

**Frank Shafroth**, George Mason University, Principal Investigator

**Sarah Emmans**, George Mason University, Research Manager

**Mike Lawson**, George Mason Affiliate, Researcher

**Dr. Paul Posner**, George Mason University, Director, Public Administration Program

**Dr. Tim Conlan**, George Mason University, University Professor

**Andrew Armstrong**, George Mason University, Research Assistant

### *A Token of Appreciation*

In putting together this paper, the author notes his exceptional good fortune and gratitude to have received the benefit of being able to spend time in Detroit with:

- **Andy Dillon**, State Treasurer
- **Sheila Cockrel**, Former Detroit City Council Member
- **Bettie Buss**, Michigan Citizens Research Council & former Detroit Budget Director
- **Kevyn Orr**, Emergency Manager
- **Stacie Clayton**, Assistant to the Director
- **Harvey Hollins III**, director of Governor's Office of Urban Metropolitan Initiatives

<sup>1</sup> The Emergency Manager was appointed by the Local Emergency Financial Assistance Loan Board as the emergency financial manager under Public Act 72 of 1990 on March 14, 2013, and this appointment became effective as of March 25, 2013. On March 28, 2013, PA 436 replaced Public Act 72, and the Emergency Manager became the emergency manager under the new statute.

<sup>2</sup> Billy Hamilton, "Motown Meltdown: Can Detroit Be Saved?" *State Tax Notes*, Vol. 68, #13, June 24, 2013.

<sup>3</sup> Jeff Green, "Detroit Homes Rot as Appraisals Stopping Sales: Mortgages," *Bloomberg*, April 9, 2013.

<sup>4</sup> Personal conversation with the author, May 14, 2013.

<sup>5</sup> Citizens Research Council of Michigan, "Detroit City Government Revenues, Report 382, April 2013.

<sup>6</sup> Citizens Research Council of Michigan, "Detroit City Government Revenues, Report 382, April 2013.

<sup>7</sup> Andrew O'Hehir, "'Detropia': Can Detroit Be Saved?" *Salon*, Sept. 7, 2012.

<sup>8</sup> Billy Hamilton, *op. cit.*, p. 995.

<sup>9</sup> Howes, *op. cit.*

<sup>10</sup> Caitlin Devitt, "Bond Insurance Could Benefit Detroit as City Begins Restructuring," *Bond Buyer*, April 23, 2013.

<sup>11</sup> The Emergency Manager was appointed by the Local Emergency Financial Assistance Loan Board as the emergency financial manager under Public Act 72 of 1990 on March 14, 2013, and this appointment became effective as of March 25, 2013. On March 28, 2013, PA 436 replaced Public Act 72, and the Emergency Manager became the emergency manager under the new statute.

<sup>12</sup> 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. "The City's credit ratings (S&P – B/B; Fitch – CCC/CC; and Moody's – Caa1/Caa2) have been deteriorating rapidly and are at historical lows, reflecting the distressed financial condition of the City. These low credit ratings inhibit the City's ability to borrow. The City has suffered multiple credit downgrades in recent years, resulting in credit ratings that are lower than any other major US City and below investment grade (i.e., junk status). Further, due to legal debt limits, the City has effectively exhausted its ability to borrow."

<sup>13</sup> City of Detroit, Office of the Emergency Manager, "Financial and Operating Plan," May 12, 2013. The Emergency Manager submitted his Financial and Operating Plan on May 12, 2013 to the State Treasurer as required by section 11(2) of Public Act 436 of 2012 ("PA 436"). Consistent with §11(1) of PA 436, the objectives of this Plan are to ensure that the City of Detroit is able to provide or procure governmental services essential to the public health, safety and welfare of its citizens and to assure the fiscal accountability and stability of the City. In doing so, it is imperative that a stable financial foundation for the City be established in a manner that also promotes private investment in the City and revitalization of the community in a sustainable fashion.

<sup>14</sup> Michael Barone, "In Detroit, the death of 'Big Unit America,'" *The Detroit News*, June 11, 2013.

<sup>15</sup> Daniel Howes, "Orr's plan will be defining moment for Detroit," *Detroit News*, June 13, 2013.

<sup>16</sup> Personal conversation, Detroit, May 14, 2013.

<sup>17</sup> Natalie Cohen, "On Detroit, General Obligations and Public Pensions," Wells Fargo Securities, July 19, 2013.

<sup>18</sup> Pete Saunders, "The Reasons Behind Detroit's Decline," <http://www.urbanophile.com/2012/02/21/the-reasons-behind-detroits-decline-by-pete-saunders/>

<sup>19</sup> Citizens, *op. cit.* at p. 19.

<sup>20</sup> Marilyn Lewis, "Detroit takes huge risk with clean-slate plan," *MSN Money*, June 6, 2013. With the mayor's blessing, urban decay is being eliminated by way of the wrecking ball. Other cities have tried the tactic with disappointing results.

<sup>21</sup> "Motown steps on Degas," *The Economist*, July 6, 2013.

<sup>22</sup> Christine Ferretti, "NAACP in Detroit sues over EM law, offers its own revenue recommendations," *Detroit News*, May 13, 2013.

<sup>23</sup> <http://detroit.cbslocal.com/2013/03/22/jesse-jackson-detroit-efm-sets-dangerous-precedent/>

<sup>24</sup> Matt Helms and Susan Tompor, "Moody's: Detroit's risk of bond default higher," *Detroit Free Press*, May 16, 2013.

<sup>25</sup> Personal conversation in Detroit with the author.

<sup>26</sup> *Op. cit.*

<sup>27</sup> Jeff Hadden, "Crime remains Detroit's biggest enemy" *Detroit News*, June 19, 2013.

<sup>28</sup> Billy Hamilton, "Motown Meltdown: Can Detroit Be Saved?" *State Tax Notes*, June 24, 2013.

<sup>29</sup> Before Orr's appointment, Detroit was trying to muster a response to crime. A joint city, state, and federal effort to get habitual criminals off the streets resulted in 245 arrests and 41 confiscated guns in the first week of March, according to Mayor

Bing. The same month, 89 police were reassigned to neighborhood patrols and homicide investigations. The department can hire recruits to replenish a force losing 25 people each month to retirement, Interim Chief Chester Logan said. The number of uniformed officers has dropped to about 2,500 from 3,350 in 2009. Fetid Firehouse Ambulance crews are quitting, too, because of the workload and danger, said paramedic Joe Barney, a union representative. About 150 paramedics and technicians operate 19 ambulances, though a half-dozen trucks routinely are out for repairs, Barney said. The emergency medical services division answered 127,000 calls in 2012, according to Mayor Bing's office. About 14 percent were handled by private ambulance companies. The city hopes to improve response times with a new GPS system. The paramedics operate from fire stations that embody the plight. At Engine 40, near Detroit's center, raw sewage backs up near the kitchen despite pleas from firefighters to the city to fix it. They take up collections among themselves for the station's cable television and Internet service, a lawnmower, snow blower and to fix broken toilets. They use space heaters and there are no smoke detectors.

<sup>30</sup> Personal conversation with a state leader, Detroit, May 14, 2013.

<sup>31</sup> Jeff Green and Prashant Gopal, "Detroit Survival Depends on Speed of Destruction," *Bloomberg*, May 30, 2013.

<sup>32</sup> *Ibid.* Housing markets in Detroit and other rustbelt cities such as Cleveland and Buffalo are hampered by decaying, vacant homes even as sales of existing homes hover around a three-year high nationally. Pilfering of vacant units in urban areas cut the number of U.S. homes with complete plumbing by about 10.4 percent from 2008 to 2011, according to U.S. Census data compiled by Bloomberg, including 66,722 such homes alone in Detroit.

<sup>33</sup> Marilyn Lewis, "Detroit takes huge risk with clean-slate plan," *MSN Money*, June 6, 2013.

<sup>34</sup> Dan Rather, "A National Disgrace," *HDNet*, May 10, 2011

<sup>35</sup> Citizen's Research Council, *op. cit.*, p. V.

<sup>36</sup> Cohen, *op. cit.* at p. 3.

<sup>37</sup> Stephen Eide, "Retirees' Medical Bills Are Bringing Down Detroit," *Bloomberg*, July 2, 2013.

<sup>38</sup> *Ibid.*

<sup>39</sup> In Michigan, legal protections for post-employment benefits are much weaker than for pensions. The Michigan Supreme Court has ruled that Article IX, Section 24, of the Michigan constitution, which confers strong restrictions on cutting pensions, does not apply to OPEBs. In contrast, the city would face a protracted and expensive legal process if it took on pension funds, which have already set aside \$5 million for potential litigation.

<sup>40</sup> The Detroit General Retirement System and Police & Fire Retirement System claim to have been, respectively, 83 and 100% funded as of last June, but the report questions those claims. While the City's financial report for FY'11 purport to demonstrate \$646 million in accrued unfunded liabilities, Mr. Orr wrote that the market value of the two pensions' assets were more than \$1 billion less than the actuarial assumptions; Mr. Orr has requested 56,000 pages in documents from the two pension boards, noting that: "Utilizing more current data and or conservative assumptions could cause that deficiency to rise into the billions of dollars." The pension issue could prove especially sensitive, as retirees currently outnumber active employees paying into the plans—and the police and fire plan is closed to new employees, potentially accelerating the drain. Debt service, according to the report, on \$1.8 billion in Pension Obligation Certificates and related swaps the city owes is projected to escalate: the principal alone is expected to double to over \$56 million by 2023; interest on the pension-related debt will be \$83.8 million of Detroit's \$139.9 million in debt interest this year.

<sup>41</sup> "Under Scrutiny: EM Looks More Closely At Pension Funds' Management," *Deadline Detroit*, June 20th, 2013.

<sup>42</sup> On March 20, 2013, the general counsel of Detroit's two pension funds, and Paul Stewart, a former trustee of Detroit's Police and Fire Retirement System were both charged in an indictment with participating in a bribery and kickback conspiracy involving over \$200 million in investments.

<sup>43</sup> The Citizens Research Council of Michigan under the indefatigable guidance of Ms. Betty Buss, a former Budget Director for the city of Detroit, and its publication (*op. cit.*) on Detroit City Government Resources is an invaluable resource for anyone seeking to comprehend the complex revenue issues of the Motor City.

<sup>44</sup> Timothy Hodge et al, "Tax Base Erosion and Inequity from Michigan's Assessment Growth Limit: The Case of Detroit," CES ifo Working Paper No. 4098, January 2013.

<sup>45</sup> Christine MacDonald, "Detroit's Property Tax System Plagued by Mistakes, Waste," *The Detroit News*, Feb. 22, 2013.

<sup>46</sup> MacDonald, "Half of Detroit Property Owners Don't Pay Taxes," *The Detroit News*, Feb. 21, 2013.

<sup>47</sup> Jeff Green, "Detroit Homes Rot as Appraisals Stopping Sales: Mortgages," *Bloomberg*, April 9, 2013.

<sup>48</sup> Cate Long, "Time to begin fixing Detroit's fiscal problems," *Muniland*, February 21, 2013.

<sup>49</sup> Jeff Green, "Detroit Homes Rot as Appraisals Stopping Sales: Mortgages," *Bloomberg*, April 9, 2013.

<sup>50</sup> The city must address some \$17 billion in liabilities to avoid a record municipal bankruptcy.

<sup>51</sup> Personal conversations, May 14, 2013.

<sup>52</sup> *Ibid.*

<sup>53</sup> Daniel Howes, "New elected leaders in Detroit will be critical in turnaround," *Detroit News*, July 2, 2013.