Fiscal Sustainability: A Framework and the Detroit Example

• Eric Scorsone, Ph.D.
• Deputy State Treasurer and Senior Advisor, MI Department of Treasury
• Director, Center for Local government Finance and Policy
• Dept. of Agricultural, Food and Resource Economics
STATE AND LOCAL DEBT AFFORDABILITY
Debt management

• State and local debt as a percent of GDP

• 7% of GDP in 1950 and 17% of GDP in 2016
  – A large increase yes, but only one third as much as corporate and household debt
  – Local govt. is a bigger debt holder than state govt.
Net creditor status

• State and local govt. are net creditors to the U.S. economy

• Net accumulated financial assets are positive across the last fifty years
  – Rose from 10% of GDP to 35% of GDP
Great Recession

• State and local net financial wealth fell by 8.5% of GDP

• Mostly due to decline in assets values rather than accumulation of new debt
Municipal debt issuance

In millions


Pew Research Center
Retiring Americans
Municipal Fiscal Sustainability
A Municipal Fiscal Health Framework

- State Policy
- Muni Fiscal Health
  - Local Economy
  - Local D.M.
State Policy (Constitutional and Statutory)

- Budget and Accounting Standards
- Debt issuance and management policy
- Local tax options (own source revenue)
- State imposed tax restrictions
- State mandates for local spending
- Collective bargaining and labor policy
- State aid to local governments
Local Economy

- Economic factors are mediated via tax and spending policy to translate into local fiscal fiscal health
- Unemployment, income, business and industry diversification, housing, business growth
Local management and decision making

- Local policies on debt issuance and management
- Local budgeting practices and culture
- Local spending commitments and pressures
- Local reserves and rainy day fund policy
- Intergovernmental relations
- Relations with neighboring jurisdictions
Causes of Local Fiscal Stress

• **External**: economic and demographic changes drive down tax base
  – Blame lies with the state govt., federal govt., business community
  – Solution is to restore external funding

• **Internal**: mismanagement and political cycles drive poor fiscal results (esp. higher spending)
  – Blame lies with local politicians, special interests and unions
  – Change in management and adoption of best practices
## Matrix for Fiscal Assessment

<table>
<thead>
<tr>
<th></th>
<th>Strong External Conditions</th>
<th>Weak External Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strong Management</strong></td>
<td>New York City, NY (2017)</td>
<td>Detroit, MI (2015-17)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>St. Louis, MO</td>
</tr>
<tr>
<td><strong>Weak Management</strong></td>
<td>Orange County, CA (1988)</td>
<td>Detroit, MI (2012-13)</td>
</tr>
</tbody>
</table>

External= economic and social conditions in community outside of control of local govt.

Internal=management and policy decisions under control of local govt.
Strong/Weak Financial Management Examples

• Discipline in budgeting
  – Spending within budget
  – Reasonable revenue forecast
  – Balance between the two

• Internal controls
  – Control over cash in and out of the government

• Debt management
  – Reasonable debt load
Strong/Weak local Economy Example

- Local unemployment rates and labor force participation
- Personal income growth, decline or stagnation
- Small business establishments
- Real estate prices and land usage
FISCAL SUSTAINABILITY
What is Fiscal Sustainability?

• Brundtland report (1987) defined as “development that meets the needs of the present without compromising the ability of future generations to meet their own needs”

• Decision making & Governance that is future oriented and ensures that local government (county) can protect public health, safety and welfare of present and future generations
Many Definitions of “Fiscal Sustainability”

• Revenues grow at rate of inflation + population (Ulbrich, 1997)
• Revenues must grow to meet continued provision of service and capital needs (Chapman, 2008)
• Ability of government to sustain its current spending and tax policy without threatening solvency or default
Fiscal Distress vs. Fiscal Health

• Fiscal Distress
  – Generally based on cash flow and immediate short term problems
  – Cash ratios and fund balance ratios

• Fiscal Health
  – Based on long term sustainability of a governments finances and operations
  – Measured by assets, revenue and spending per capita and ability to provide services
  – Structural deficit or surplus
The Fiscal Equations

- Revenues = Spending (liquidity and budget)
- Net Assets = Assets – Liabilities (solvency)

- Over what time period?
- What sources of revenue?
- Changes in spending pressures?
Financial Stock vs. Flow

• **Stock**
  – Assets, liabilities, Net Assets
  – Measured at a point in time and two points in time (Stock and change in stock)

• **Flows**
  – Revenues, Expenditures, inter-fund transfers, other financing flows
  – Measured at two points time as the value of transactions that have occurred over that period
  – Revenue is money taken in and expenditures are transactions for goods and services
Financial Crisis

• **Stock (solvency)**
  – Net assets or net financial assets are less than zero
  – Question: can capital assets be transferred into financial values

• **Flow (liquidity)**
  – All available resources are less than money going out, deficit
  – Flows can be supplemented by:
    • Borrowing or selling assets increases inflows for a period of time
  – Positive financial stocks or rainy day funds
Inman Model (1995 AER paper)

\[ T(\text{max}) \cdot B(T_{\text{max}}) < C - \text{AID} - \text{FEES} \quad \text{fiscal crisis} \]

\[ \text{Rev (Max)} < \text{Rev (needs)} \quad \text{fiscal crisis} \]

- \( C = \) contractual costs
- \( \text{AID} = \) state and federal revenue sharing
- \( \text{FEES} = \) user fees
- \( T = \) tax rate and \( B = \) tax base
Relationship between taxes and tax rates

Rising rates = no new rev

Rising rates = higher revenues

Rising rates = less revenue

Tax Yield Curve
The Motor City Story and Fiscal Sustainability
Detroit GF Revenue, Expenses (2002-2016)
Detroit GF Equity vs. Cash

- Issue
- Pension
- bond

fund balance/equity

cash

bankruptcy
Detroit Net Assets

Detroit Net Assets

Series1

Series2

Detroit Debt Stock and Payments

Detroit Debt Stock and Debt Payments

Debt Stock  Debt Pay
Detroit Return on Net Assets

-0.40 -0.30 -0.20 -0.10 0.10 0.20 0.30 0.40

Multiple Causes in Detroit

- Detroit pop. Loss of 55% and state aid cuts
- Mayor Kilpatrick convicted for corruption
- City property values fall by 60% and has 90,000 abandoned homes
- Detroit borrows $1.2 bil. to shore up pension system
Falling Property Tax Base (tax base per capita)
Detroit Budget and Revenue Trends by Decade

<table>
<thead>
<tr>
<th>Decade</th>
<th>City Budget</th>
<th>State Aid</th>
<th>Total City Revenues</th>
<th>Govt. Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000's</td>
<td>3.0%</td>
<td>-2.2%</td>
<td>1.5%</td>
<td>3.87%</td>
</tr>
<tr>
<td>1990's</td>
<td>1.6%</td>
<td>1.6%</td>
<td>1.4%</td>
<td>2.9%</td>
</tr>
<tr>
<td>1980's</td>
<td>3.3%</td>
<td>5.5%</td>
<td>4.1%</td>
<td>5.6%</td>
</tr>
<tr>
<td>1970's</td>
<td>6.2%</td>
<td>6.2%</td>
<td>5.4%</td>
<td>7.7%</td>
</tr>
<tr>
<td>1960's</td>
<td>4.0%</td>
<td>4.9%</td>
<td>4.0%</td>
<td>4.2%</td>
</tr>
<tr>
<td>1950's</td>
<td>5.0%</td>
<td>5.6%</td>
<td>5.5%</td>
<td>4.1%</td>
</tr>
<tr>
<td>1940's</td>
<td>3.6%</td>
<td>1.4%</td>
<td>3.1%</td>
<td>6.5%</td>
</tr>
<tr>
<td>Overall Average</td>
<td>3.6%</td>
<td>3.3%</td>
<td>3.6%</td>
<td>4.9%</td>
</tr>
</tbody>
</table>
Three key points in Detroit's fiscal history (post WW II)

• Pension crisis and income tax adoption (late 1950’s-early 1960’s)

• Crisis of early 1980’s

• Crisis of 2000’s

Decision made at each of these critical junctures compounded later problems
Employees vs. Pensioners

Key crossover point
Cost Pressures: Street Lights per 10,000 residents

The graph shows the increase in the number of street lights per 10,000 residents from 1940 to 2010. The number of street lights has significantly increased over the years, with a sharp rise in the 1990s and 2000s.
Policy Choices Debate in Fiscal Distress
Yesterday and Today

- Municipal problems caused by high bonded debt
- 1830’s-1970’s
- Bondholders vs. citizens

- Municipal problems caused by high legacy costs
- 2000’s
- Employees & retirees vs. citizens (and bondholders too)
Policy Choices

• Do nothing
• Allow for individual Creditor remedies
  – Impose tax hikes or seize assets
• State control of municipality
  – Various forms and processes (17 states)
• Bankruptcy
  – State controlled or municipal driven
• Dissolve municipality
Bankruptcy vs. State Control

- Bankruptcy
  - Political control remains with city (state)
  - Provides power to override contractual obligations

- State Control
  - Political control transfers partially (totally) to state
  - May provide some additional fiscal tools
Detroit FRC members

• State treasurer
• Director of state Dept. of Management, Budget and Technology
• Three gubernatorial appointments with business or finance expertise (one has to be a resident)
• Mayor / local legislative leader
• One gubernatorial appointee nominated by senate majority leader and House leader
FRC Requirements and Powers

• Ensure compliance state budget and debt laws
• Approving 4 year city financial plan
  – Failure will allow FRC to impose a 4 year plan on city
• Compliance with plan of adjustment
• Contract approval over $750,000
• Provisions for managerial accountability, streamlining of services, improved collection of revenues
• Approve all collective bargaining agreements
• Review and revise revenue estimates
FRC Additional Powers.....

• Require CFO to attend all meetings of FRC and provide information to FRC
  – May require removal of CFO
• Review and approve issuance of debt
• Approve appointment of CFO
Current Status

• City of Detroit government is on track to enter FRC dormancy in early 2018

• Detroit Public schools is just entering process but first audit has some improvements
  – Balanced budget and surplus available
FRC dormancy is based on:

- City or school district adopt three consecutive years of deficit free budgets
- Ability to sell all necessary debt in capital markets
- Projects a balanced four years into the future
- No violation of plan of adjustment
- Transparency of contracts approved
- City or school is in compliance with local budgeting law
Detroit Pension Challenges, Post-Bankruptcy

- Two tiered management system in place
  - General employee pension board & Police & fire pension board
  - Investment boards

- Post-bankruptcy, Detroit was to forego pension payments until 2024
  - Soon realized that due to computational errors, pension problems were larger than expected
Future Detroit Pension Management

- A ramp-up system was developed to address pension problems

- Detroit would begin funding a new pension trust now for increased payments in 2024
Key Lessons from Detroit

• State oversight works in combination with a comprehensive (and flexible) long term plan
  – Detroit Future City as example
  – Capital plan, operations plan economic plan

• Strong financial leadership

• Commitment from private and not for profit sector to economic revitilization

• Getting the basics of running government right
Thank You….

Questions?