

Fiscal Sustainability: A Framework and the Detroit Example



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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.

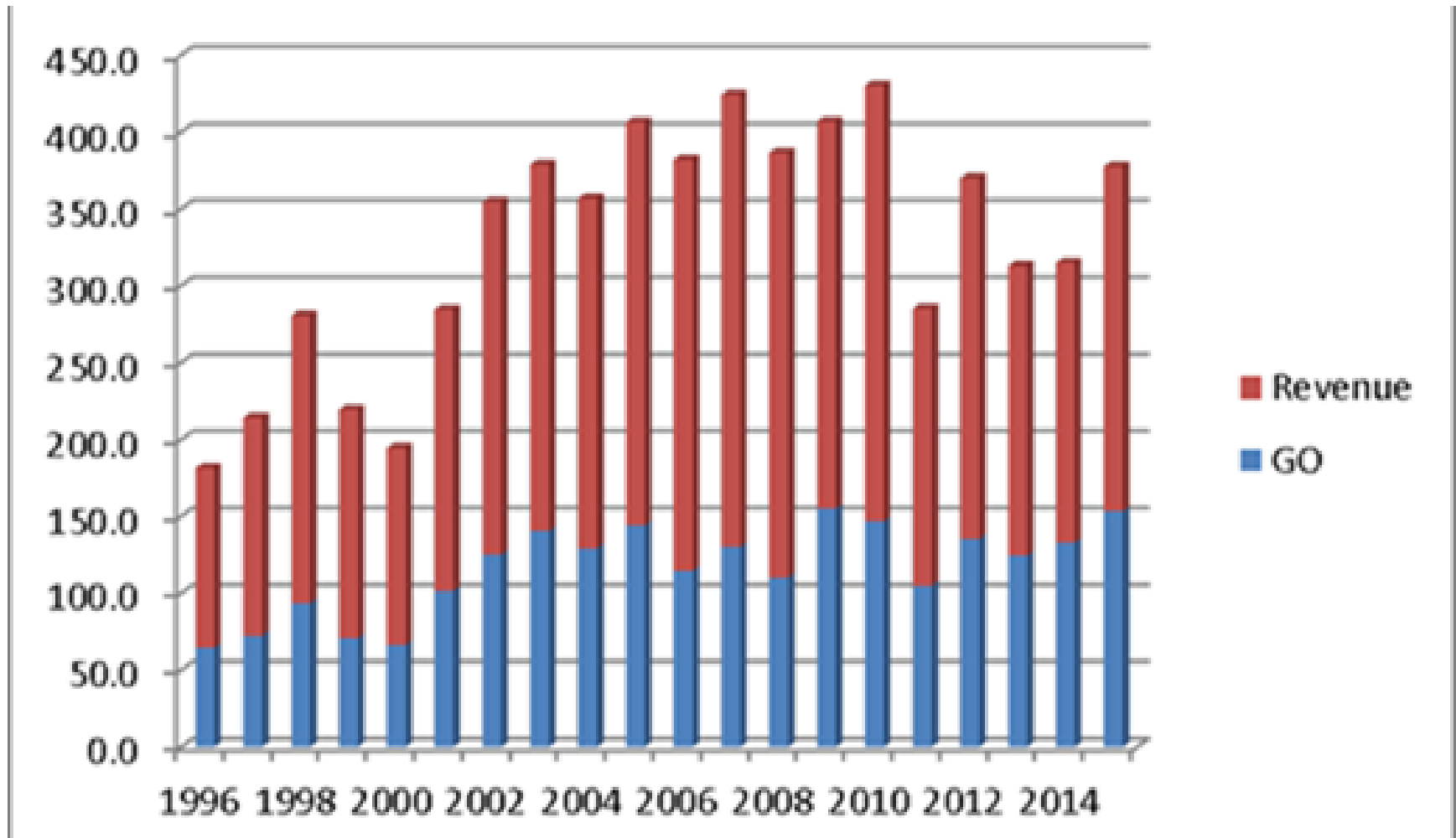
Net creditor status

- 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

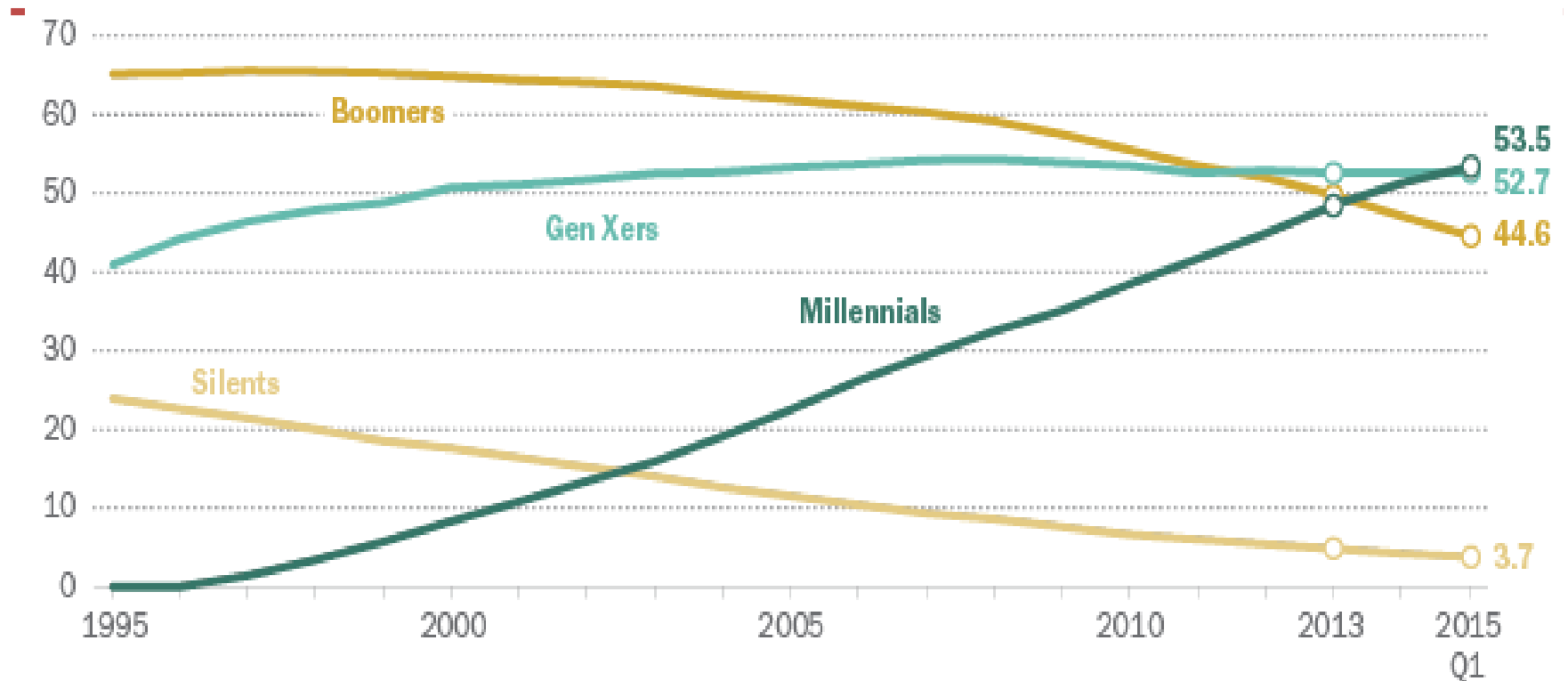
- State and local net financial wealth fell by 8.5% of GDP
- Mostly due to decline in assets values rather than accumulation of new debt

Municipal debt issuance



U.S. Labor Force by Generation, 1995-2015

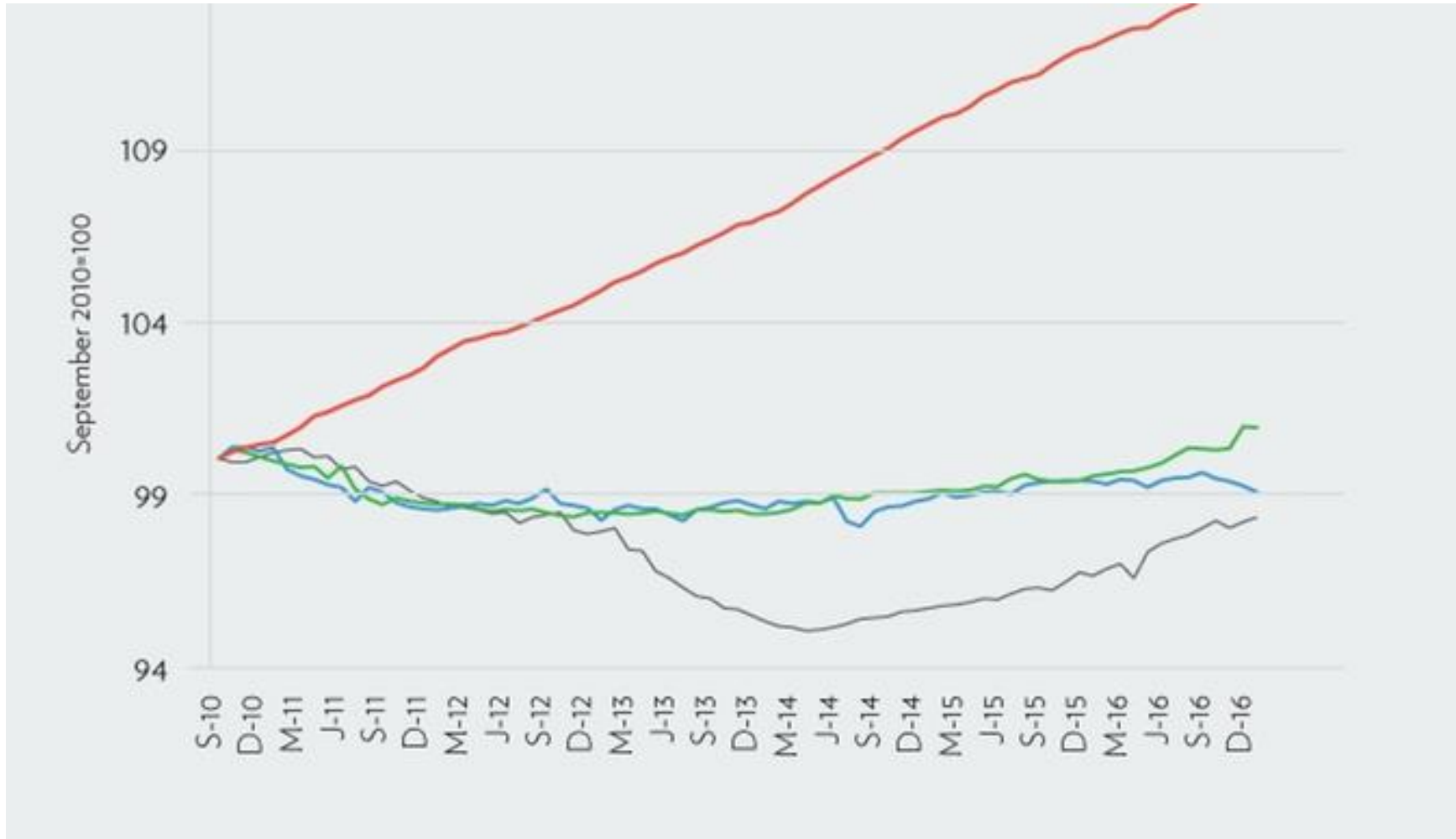
In millions



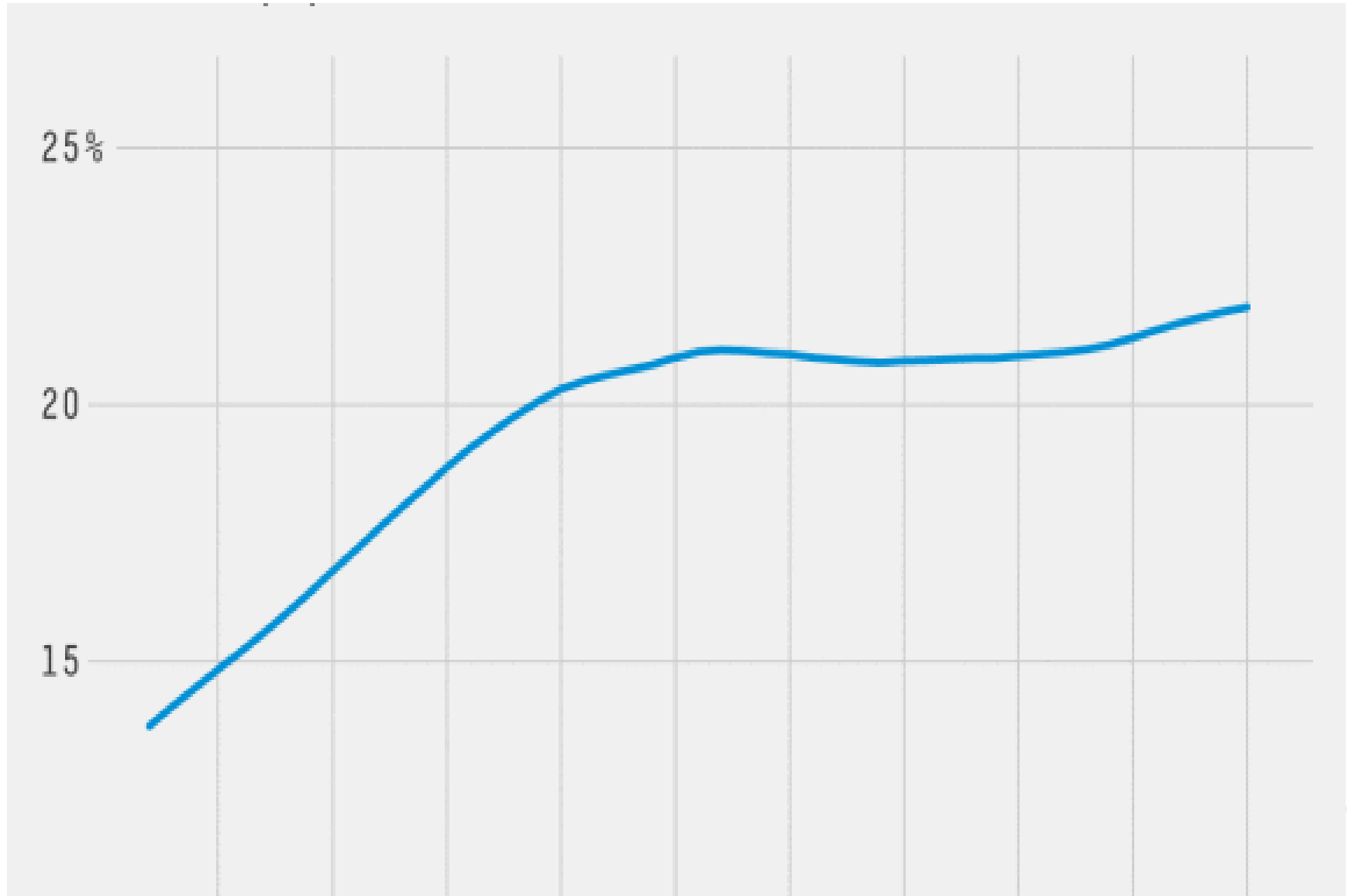
Note: Annual averages plotted 1995-2014. For 2015 the first quarter average of 2015 is shown. Due to data limitations, Silent generation is overestimated from 2008-2015.

Source: Pew Research Center tabulations of monthly 1995-2015 Current Population Surveys, Integrated Public Use Microdata Series (IPUMS)

PEW RESEARCH CENTER



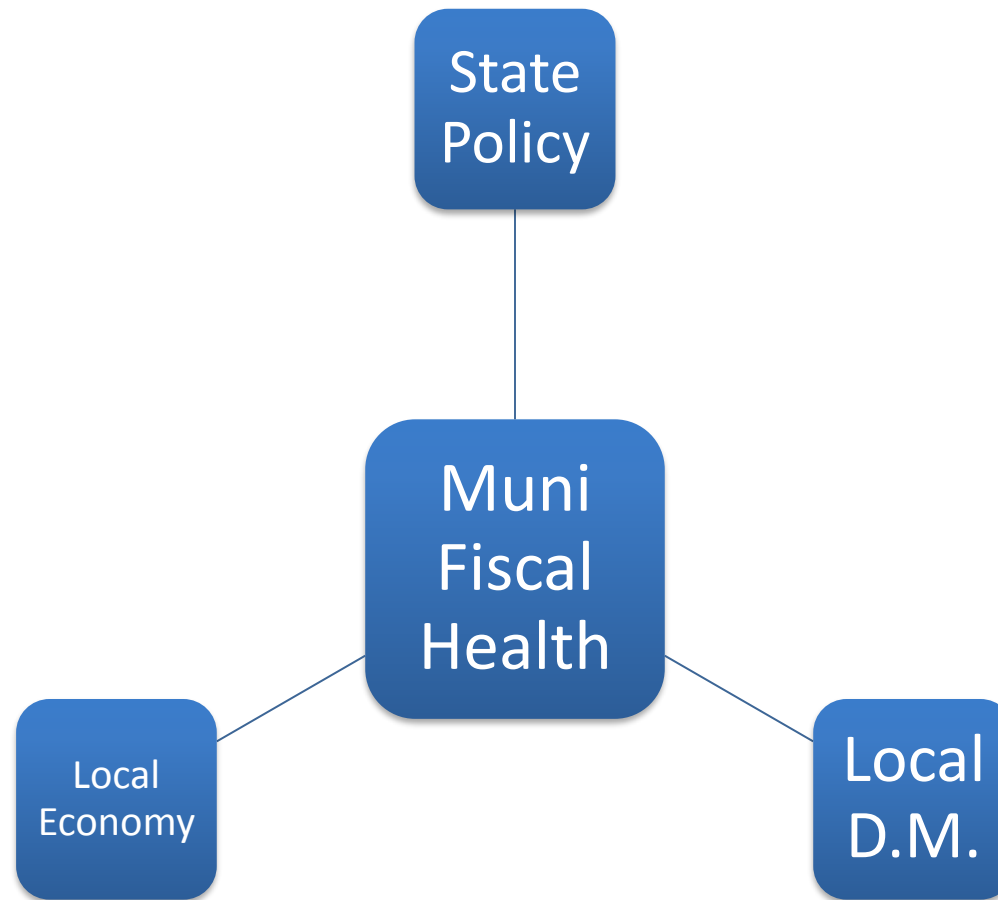
Retiring Americans



Municipal Fiscal Sustainability



A Municipal Fiscal Health Framework



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 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

	Strong External Conditions	Weak External Conditions
Strong Management	New York City, NY (2017)	Detroit, MI (2015-17) St. Louis, MO
Weak Management	Orange County, CA (1988)	Detroit, MI (2012-13)

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

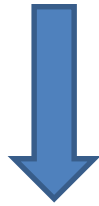
Strong/Weak local Economy Example

- 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

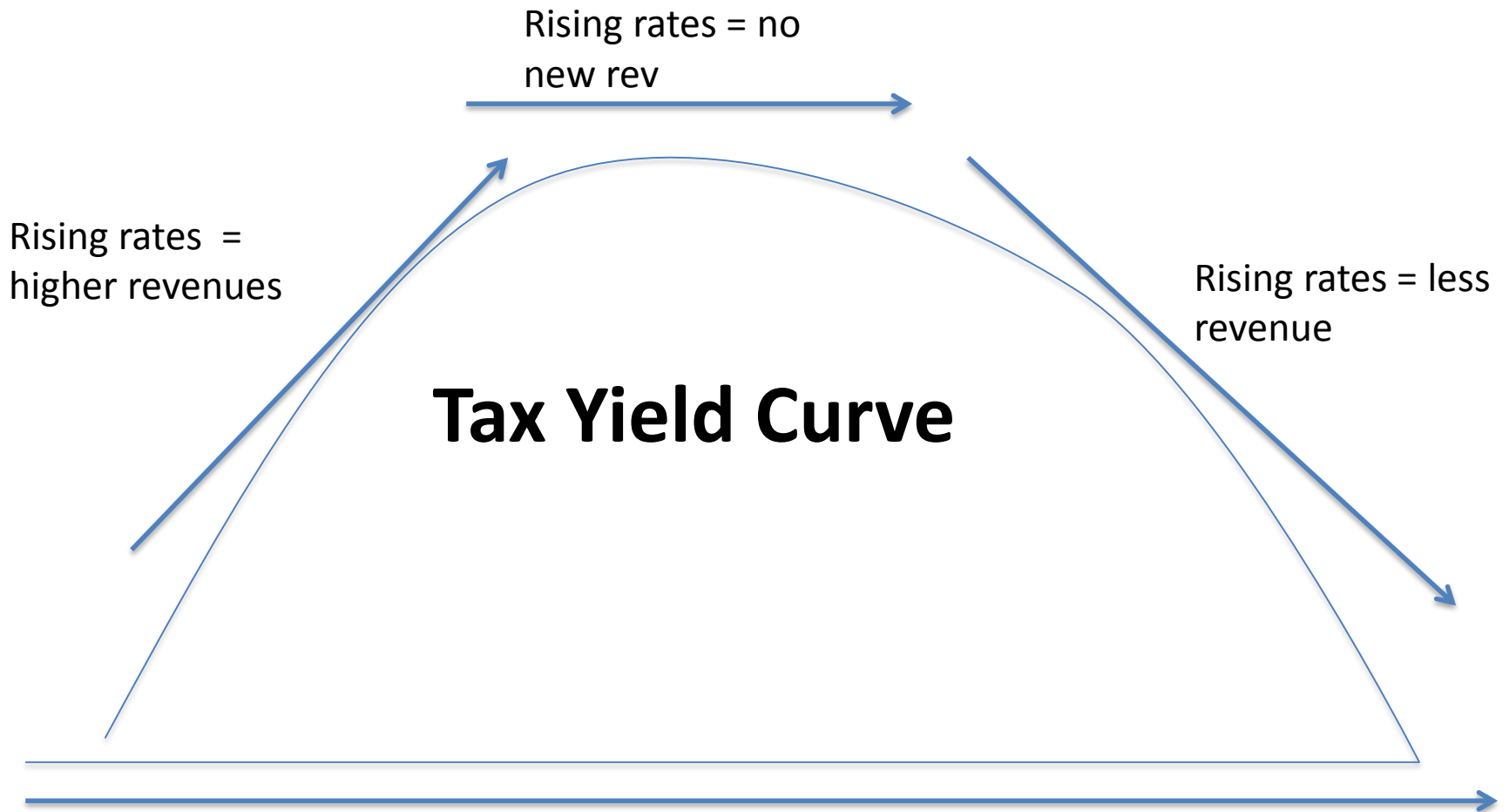
Inman Model (1995 AER paper)

$T(\max) B(T\max) < C - AID - FEES$ **fiscal crisis**

$Rev (Max) < Rev (needs)$ **fiscal crisis**

- C = contractual costs
- AID = state and federal revenue sharing
- $FEES$ = user fees
- T = tax rate and B = tax base

Relationship between taxes and tax rates

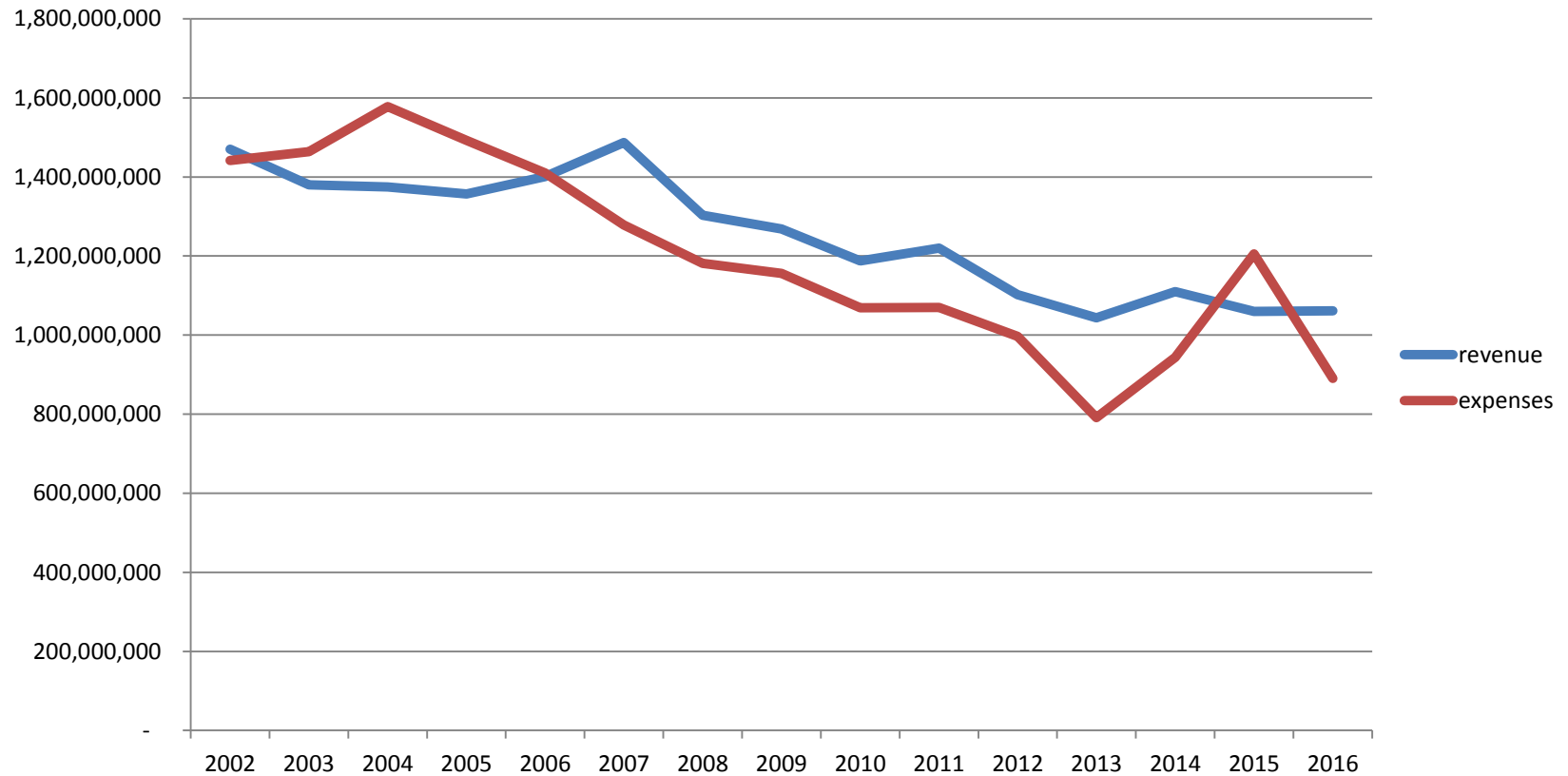


The Motor City Story and Fiscal Sustainability

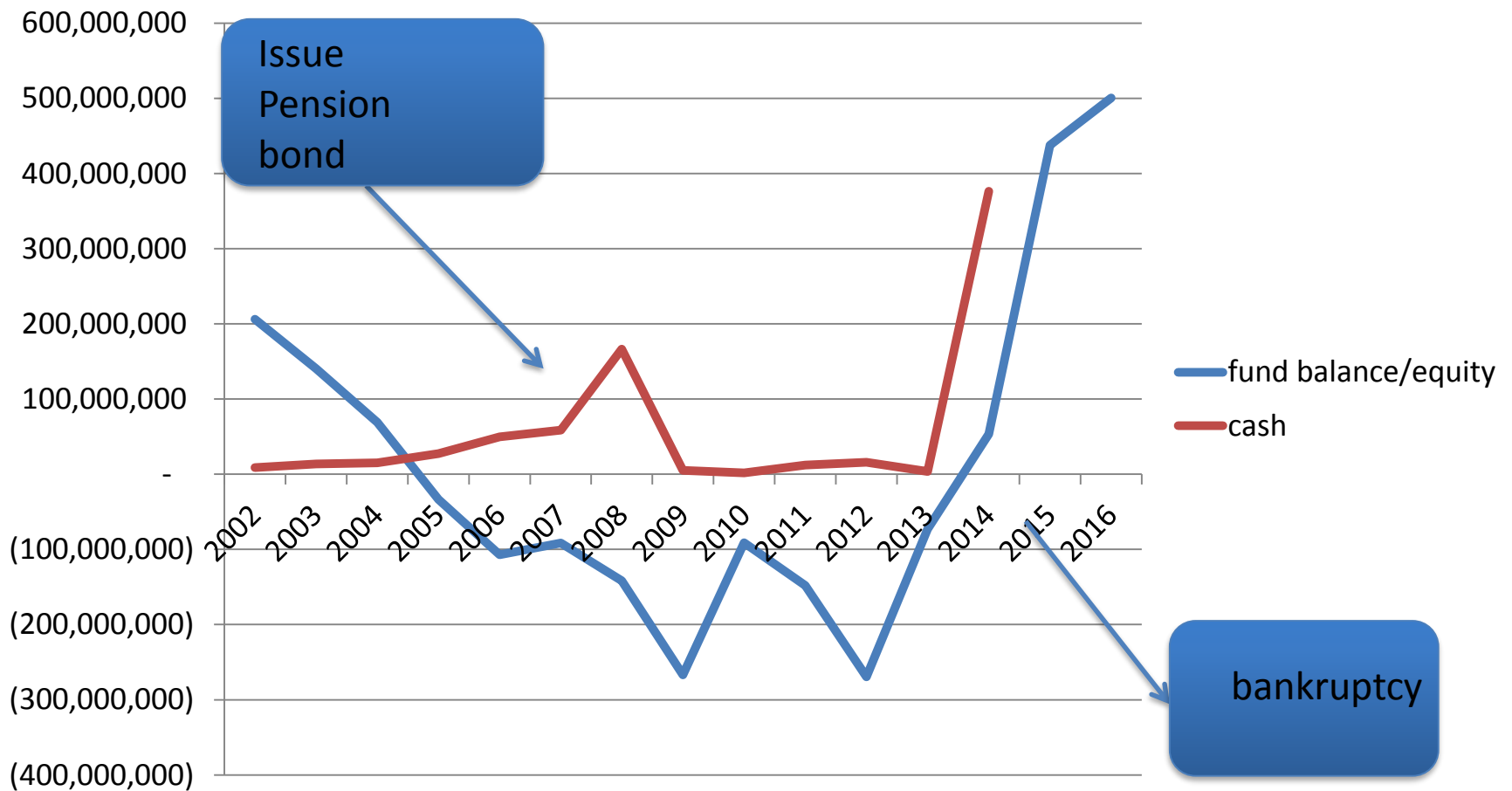




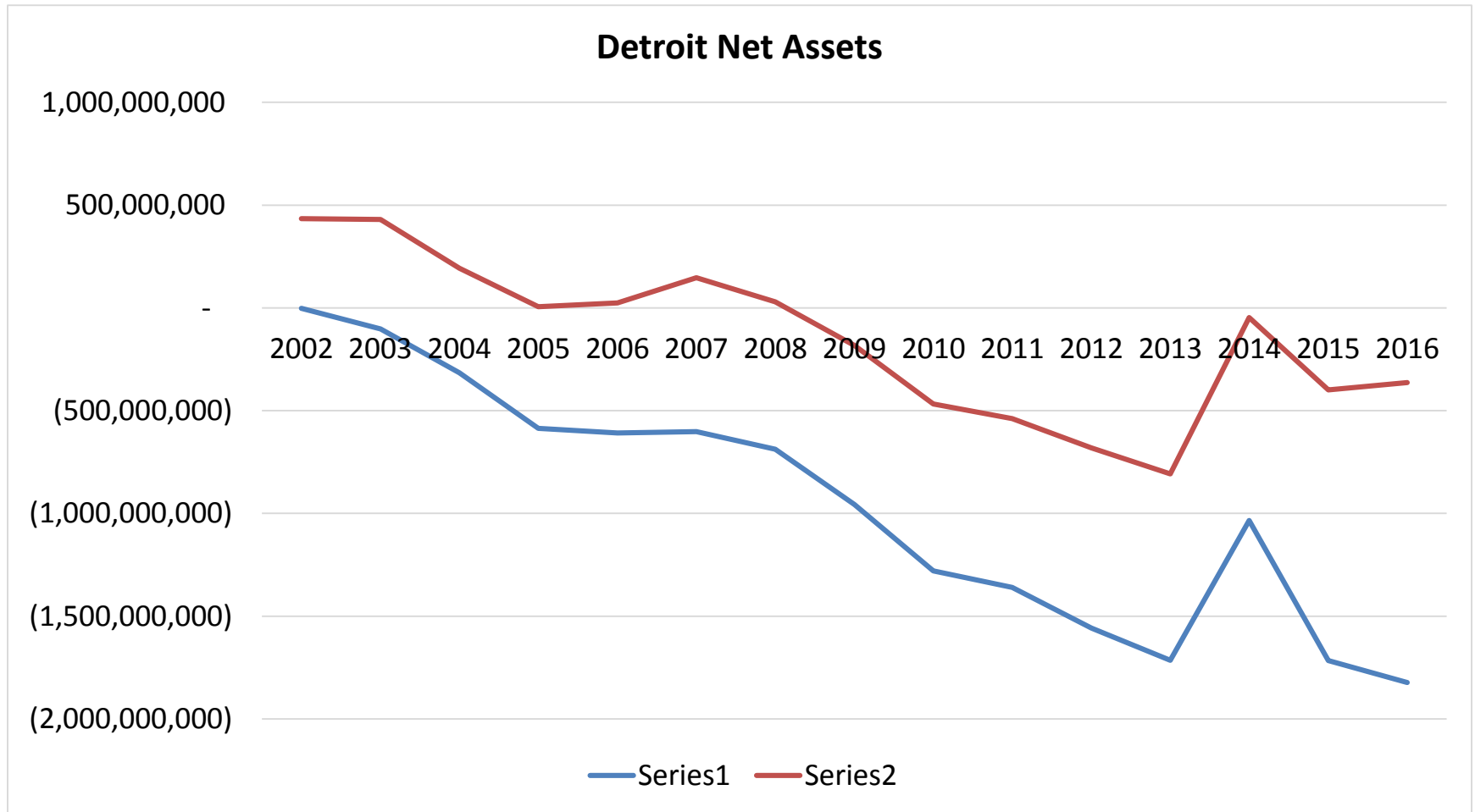
Detroit GF Revenue, Expenses (2002-2016)



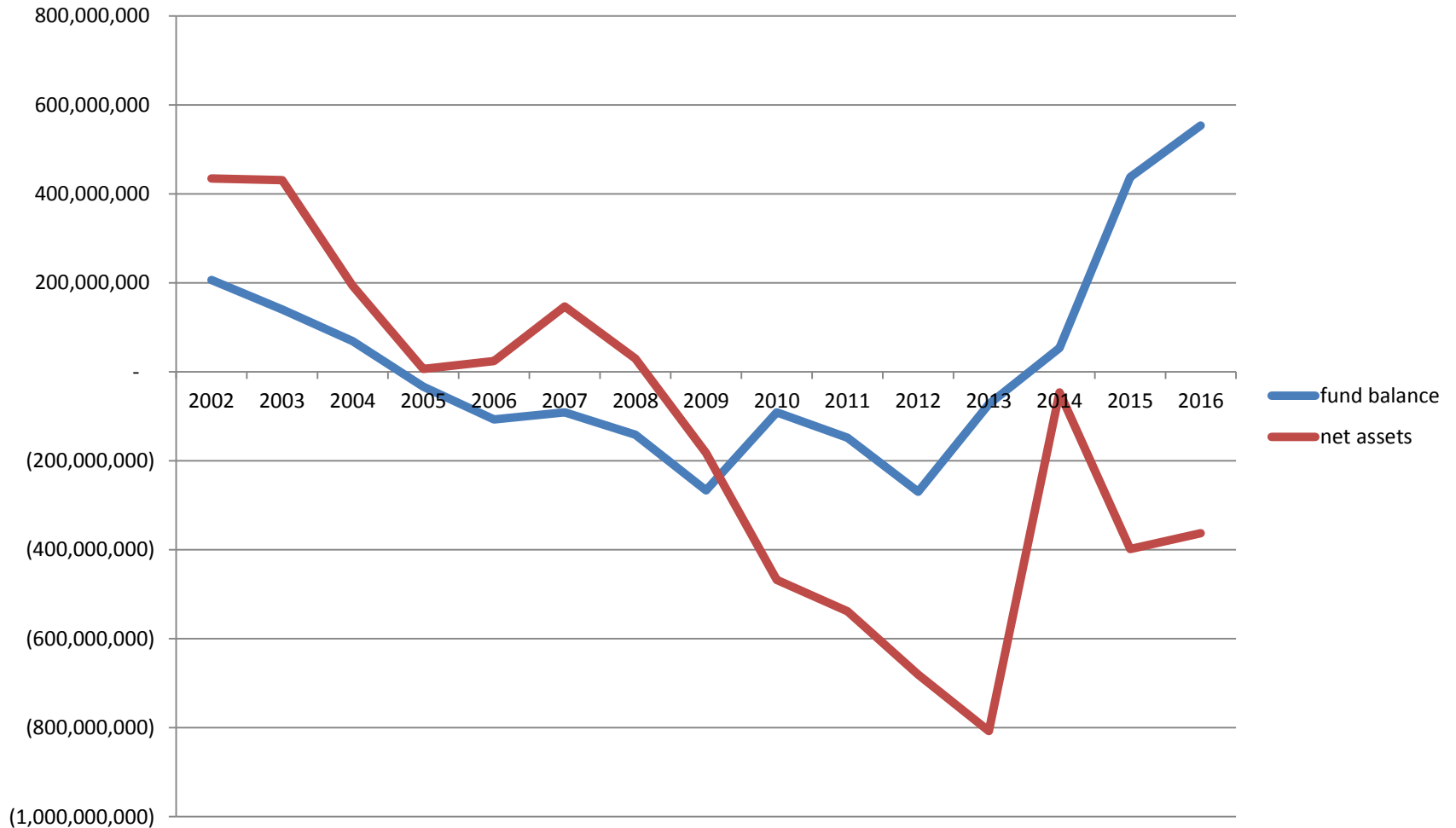
Detroit GF Equity vs. Cash



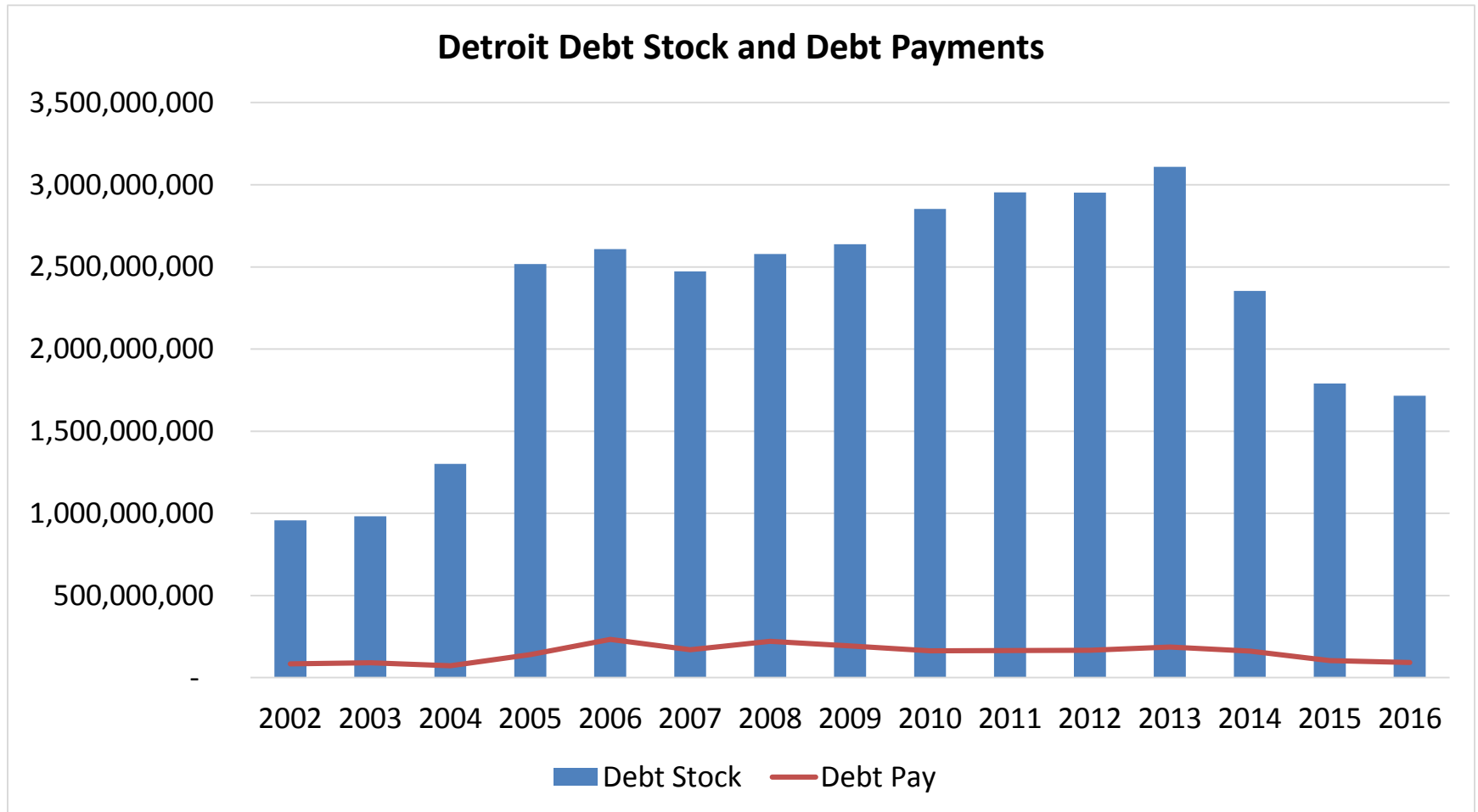
Detroit Net Assets



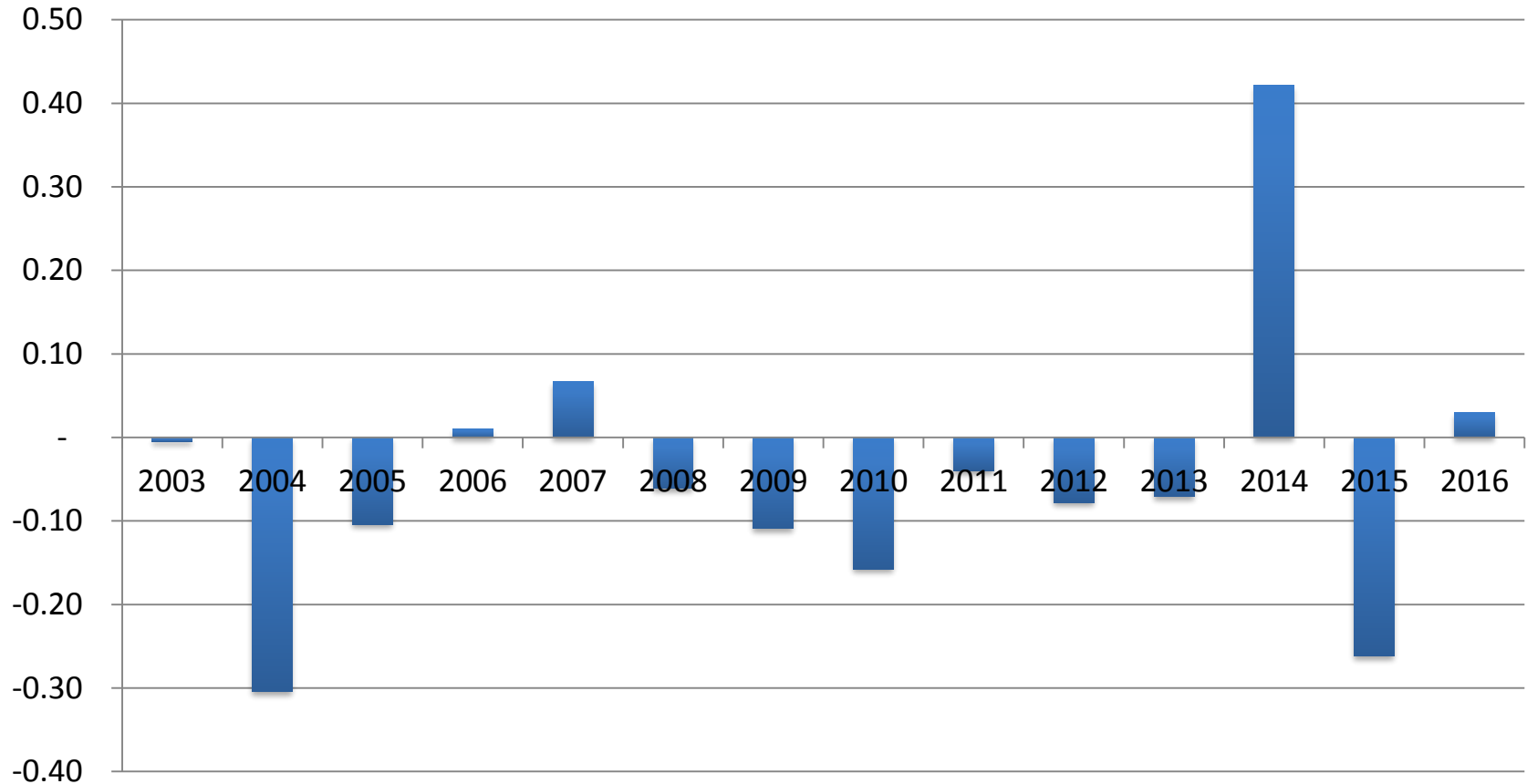
Detroit GF Fund Balance vs. Net Assets (2002-2016)



Detroit Debt Stock and Payments



Detroit Return on Net Assets



Multiple Causes in Detroit

Detroit pop.
Loss of 55%
and state aid
cuts

Detroit
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

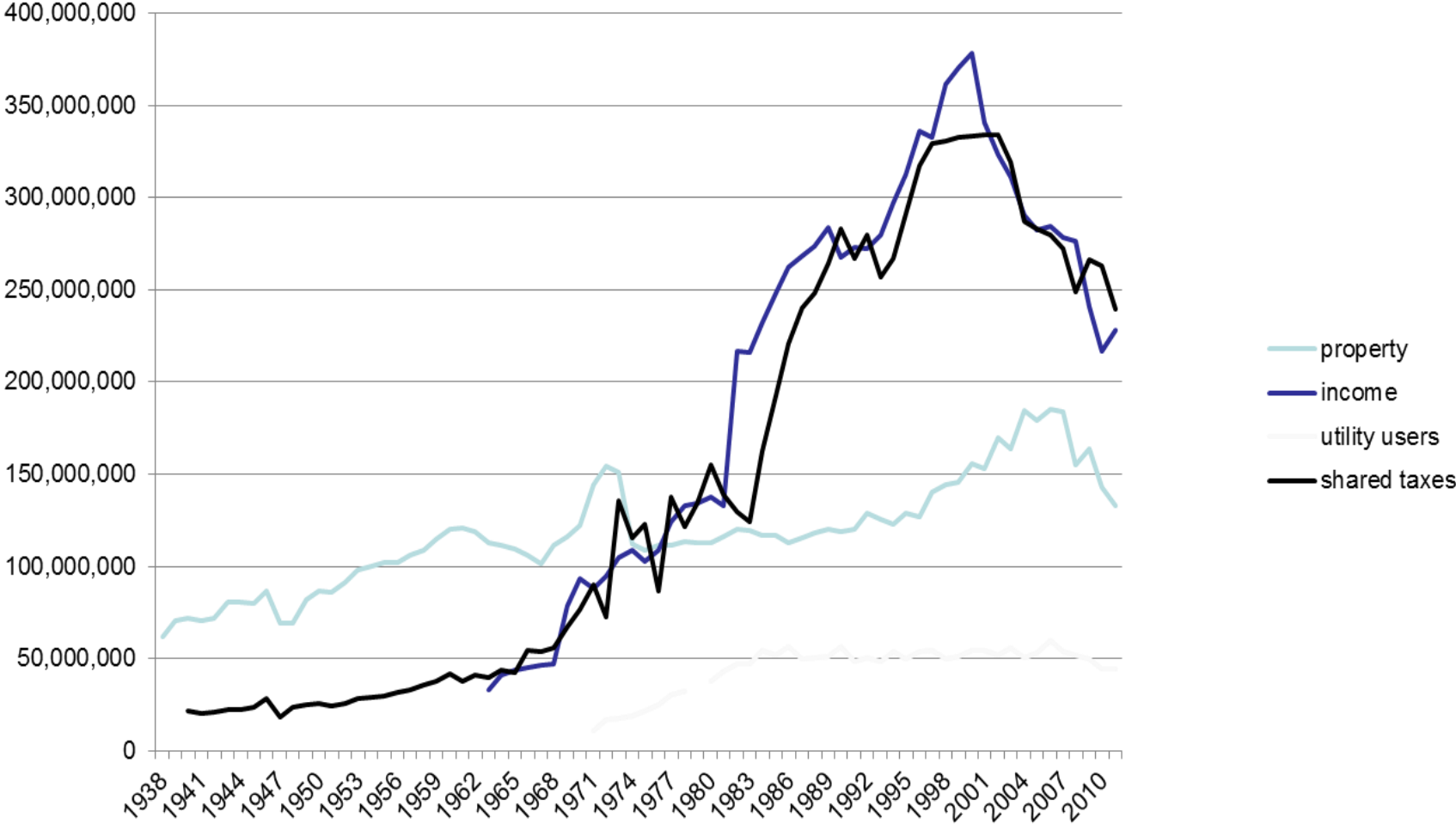
Falling Property Tax Base (tax base per capita)



Detroit Budget and Revenue Trends by Decade

	City Budget	State Aid	Total City Revenues	Govt. Inflation
2000's	3.0%	-2.2%	1.5%	3.87%
1990's	1.6%	1.6%	1.4%	2.9%
1980's	3.3%	5.5%	4.1%	5.6%
1970's	6.2%	6.2%	5.4%	7.7%
1960's	4.0%	4.9%	4.0%	4.2%
1950's	5.0%	5.6%	5.5%	4.1%
1940's	3.6%	1.4%	3.1%	6.5%
Overall Average	3.6%	3.3%	3.6%	4.9%

Detroit Tax Collection Trends (Real, 1938-2011)

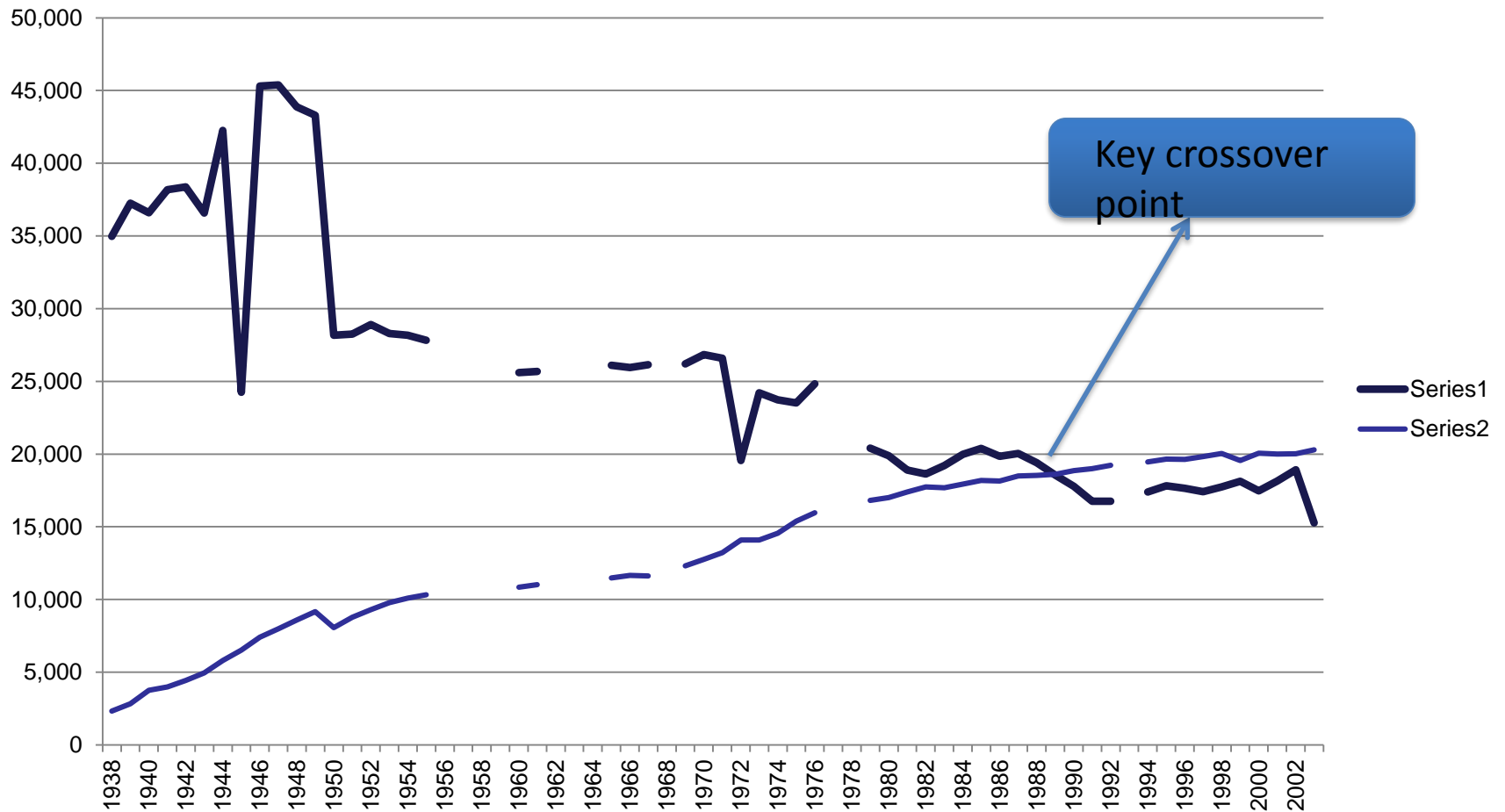


Three key points in Detroit's fiscal history (post WW II)

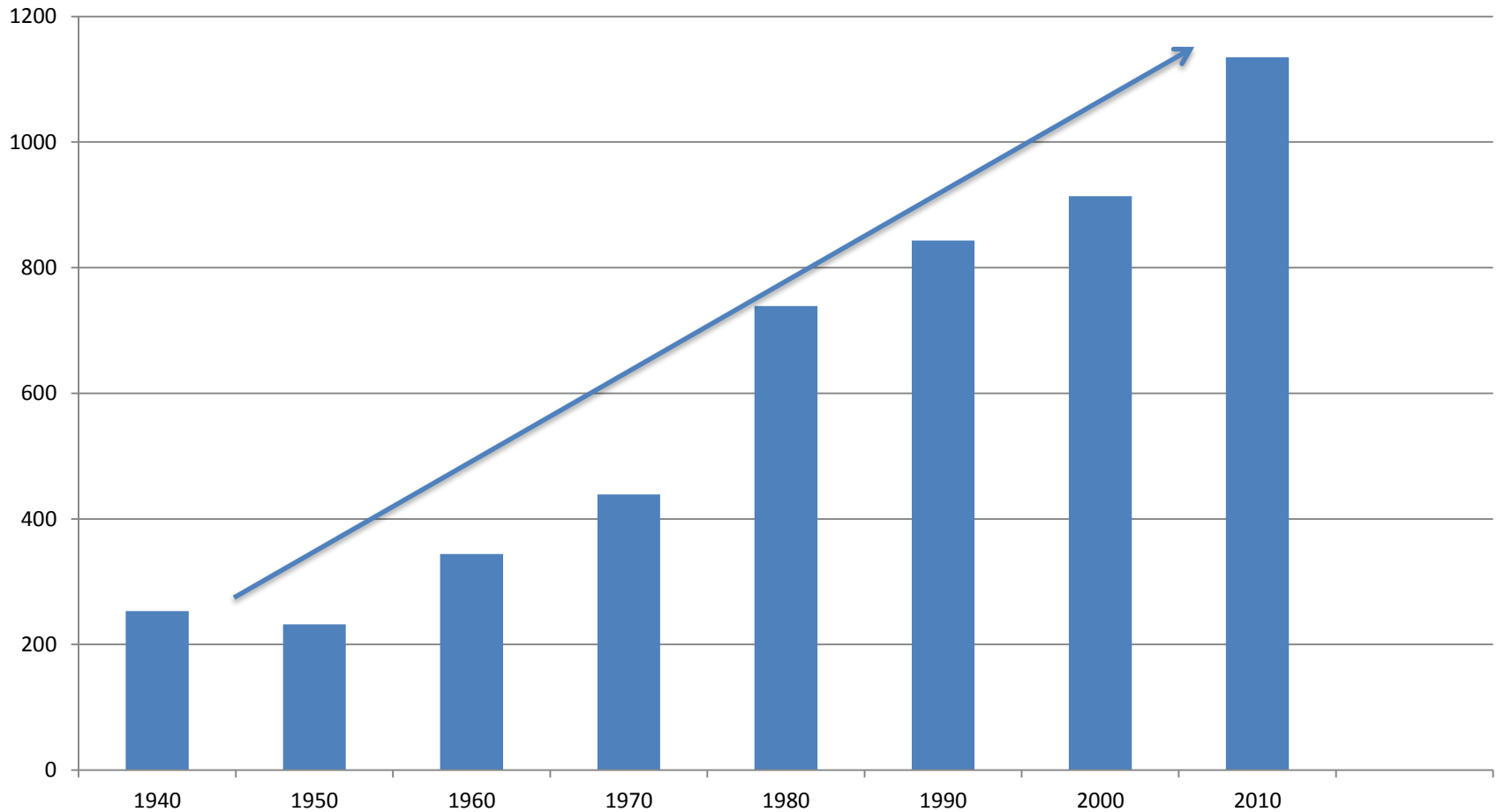
- Pension crisis and income tax adoption (late 1950's-early 1960's)
- Crisis of early 1980's
- Crisis of 2000's

Decision made at each of these critical junctures compounded later problems

Employees vs. Pensioners



Cost Pressures: Street Lights per 10,000 residents





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 revitalization
- Getting the basics of running government right

Thank You....

Questions?

