

## **Detroit: The Case of Bankruptcy of a City Government**

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**Case Summary:** *Detroit (USA) was considered to be a city that epitomised the 'American Dream' of industrial development as the driver of economic growth and city development. In fact, it had been touted as the modern and rapidly growing industrial city of the USA and counted amongst the likes of Philadelphia, Pittsburgh and Cleveland. Although, Detroit achieved great success at a time when the automobile industry was booming in the US, the lack of comprehensive city development vision and the neglect of its finance have subsequently brought the city on the brink of bankruptcy and rapid decline. Detroit's experience demonstrates the many challenges that the cities face in a modern world and the preparedness they need to have in order to survive. This case discusses the positioning of Detroit as an industrial city, the short sightedness of city managers, the factors that led to the bankruptcy of the city – particularly the mis-management of the city finances of and the governance of civic services.*

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### **I. Introduction**

On July 18, 2013, Dave Bing, the Mayor of Detroit city in the USA, had announced that the city government was filing for bankruptcy in the US Federal Court, as no solution was found to the serious financial problems faced by it. The shocking announcement became to be known as one of the largest municipal bankruptcies ever in the US history. Although financial bankruptcy of large business houses under Chapter 9 of Federal law has been well recorded in history (and is well known to the citizens of the USA), the bankruptcy of city government is rare; therefore, it formed major news that shook the nation for several days. Budgetary deficits are common in several cities across the globe; however, Detroit chose to go for public declaration of bankruptcy, hitherto not seen. What went wrong with the city once renowned as an automobile base of America? What mistakes led to the collapse of city finance? How serious should the city managements look at their city's development and finance? These are some of the questions that emerge from the financial bankruptcy of Detroit city government.

### **II. Fiscal Distress Of Detroit**

Detroit is the 18<sup>th</sup> largest metropolitan city in the USA and also the largest in the State of Michigan in the USA. The city was experiencing problems in management of its finances for a very long time, which have cumulated into fiscal stress that led to the bankruptcy condition of city government. The fiscal distress of Detroit's finances is on account of several factors that can be discussed under the following areas:

- a) Loss of industry and unemployment
- b) Population decline and revenue loss
- c) Fiscal imbalances
- d) Fiscal mis-management
- e) Fiscal governance
- f) Asset-liability mis-matches
- g) Debt burden
- h) Long-term liabilities.

#### **(a) Loss of industry and Unemployment**

Detroit was considered to be a strong base for automobile manufacturing in the USA. All major auto-giants like Ford, General Motors and Chrysler had set up production units in Detroit by taking advantages of low prices of hinterland and low cost of labour. The city of Detroit also grew on the foundations of automobile industry until

1950s. The domestic auto industry in the USA headed towards difficult times after

1960s, with the competition from cheap imported cars from Japan shook it. All major auto-giants like Ford, General Motors and Chrysler were forced to cut down on the costs by moving to low-cost locations and by sourcing cheaper labour. This had led to the flight of automobile industry from the existing manufacturing locations like Detroit, Pittsburgh and Philadelphia. Figure 1 shows the decline of domestic automobile manufacturing industry based in Detroit.

Although the loss of automobile industry base is primarily attributable to external/ global competitive pressures, the loss of auto manufacturing strength of Detroit led to massive job losses and severe unemployment. Unemployment rates in Detroit are high when compared to other parts of the USA. Figure 2 shows that the unemployment rate has been on constant rise over a period of time to reach the levels of about 20%. Therefore, as a matter of fact, the financial difficulty of Detroit city government originated from the massive losses suffered after 1960 by the automobile industry in the USA, which was the major employer of Detroit population.

#### **(b) Population decline and Revenue loss**

As an industrial city, much of the population of Detroit was engaged in automobile industry as direct or indirect employed workforce. A large amount of (black) population from the South migrated to Detroit due to the availability of manufacturing jobs and formed the majority of it. Until 1950, when the population was at a peak of

1.8 million, Detroit city was growing in terms of both economy and population. The city was, however, over-dependent upon one industry for its economic growth and employment; it did not diversify economic base to other sectors including services.

As a consequence, the loss of automobile industry led to a steady flight of people employed in it and allied industries, which resulted in a steady decline of population in Detroit for several decades. Table 1 shows the statistics of population decline in Detroit city. The average decadal population decline during the period of 1950-2010 was about 189,300 (or, 18,930 people every year) at a decline rate of about 14% per decade (or, 1.4% per annum). The population decline in Detroit city posed challenges to its city administration in terms of providing civic services<sup>2</sup> to a large metropolitan jurisdiction with a low and declining population base.

#### **(c) Fiscal imbalances**

Post-1980, Detroit faced a different kind of challenge in the wake of rapidly declining city population and stagnant economic conditions. Poor economic conditions and the flight of population led to a decline in demand for housing and abandonment of homes/estates, which led to a reduction in the values of land, real estate and property (Alexander 2013). Besides, the residential neighbourhoods of Detroit were disturbed and community living was lost; even the businesses were moving away. There was a sharp reduction in tax revenue (from property and other taxes) and other business income (licenses, sales tax and user charge income). While the revenue income of the city was on decline, the revenue expenditures incurred to provide civic services to the citizens remained the same, as either they were contracted services or they were critically linked to community living. This resulted in revenue account deficit of city government that remained there for a very long time.

Figure 3 shows the rising fiscal imbalance situation in Detroit city government with the net revenue deficit running to several millions of dollars. The net revenue deficit, which appears to have improved after 2008, is due to the raising of debt three times but not due to any rise in revenue income (see also Figure 4). With no improvement on the revenue account, the fiscal health of the city government was deteriorating over a period of time. But, the city managers continued to focus on short term.

<sup>2</sup> The civic services provided by a city include but not limited to water supply, sewerage, roads, drainage/flood protection, streetlights, transport, parks, libraries, policing, fire fighting, ambulatory services, education, healthcare and other such public services as defined by the municipal law measures like resorting to borrowing rather than taking tough measures to improve or even reverse the fiscal situation.

#### **(d) Fiscal Mis-Management**

Analysts opine that the main problem of Detroit's finance was due to its fiscal mis- management. The city had been used to spending more than what it had been earning for several years as it had a large service domain (both geographical area and civic functions) that necessitated large amount of spending (Sherwell 2012). Although the city had a large geographical area and wider range of services to provide, the civic staff was large and inefficient. There was a lack of realignment of staffing structure and service organisation in Detroit city.

As internal sources began to decline, the city was forced to be on a constant look out for external sources of finance such as borrowings from government/ public. Financing government expenditure from borrowings is regarded as a very short term measure but not a sustainable measure over a long period. Sustained dependence on such sources of finance further deepened the fiscal crisis in Detroit as the downfall of revenues could not be arrested i.e., debt service burden grew with revenue decline. Figure 4 shows fiscal imbalance and the role of debt in Detroit.

#### **(e) Fiscal governance**

Fiscal imbalances in Detroit are also rooted in poor fiscal governance, which is evident from the oversight, collusion and lopsided expenditure structure. It is held that the city management (comprising the council members headed by Mayor) was also responsible for creeping fiscal burden by giving approvals to budget proposals that included short term debt/borrowings. This was done while postponing long term payments like bond repayments, pensions and healthcare benefits. It was also alleged that, in the past, a couple of Mayors had colluded with contractors and awarded service contracts by taking bribes (one of them also went to jail on the charges of corruption, rigging and racketing) without any concern for the usefulness of the services and the implications to city finances (Yaccino and Davey 2013).

The spending of city government on its services was not effective and some of the services of the city were notoriously inefficient e.g., police, health and ambulance. The city was already spending almost half of its budgetary expenditure on public safety (Figure 5), which is not a productive expenditure. Although cutting down the expenditure on some services had begun, it would have also negatively impacted on the liveability conditions of the Detroit's communities, rendering its neighbourhoods unattractive. This in turn has resulted in a negative spiral of outflow of people reducing tax revenue and other income to the city government, which further reduced its capacity to spend on providing civic services.

#### **(f) Asset-liability mis-matches**

As mentioned earlier, revenue account deficit in Detroit had led to fiscal imbalances. The accumulation of fiscal imbalances in revenue account would have led to asset- liability mis-matches in Detroit city. The level of net assets of the city government was also on continuous decline over a period of time to become negative by the year 2012<sup>3</sup>. Figure 6 shows the declining trend of net government assets in Detroit.

There was an asset-liability mismatch (deficit) to the tune of \$ 372 million as on June 30, 2012, which is a net of \$ 680 million deficit in core government and \$ 308 million surplus in its services (Bing 2012). While the decline of financial assets is on account of decline in revenues (as shown earlier), the rise of liabilities is on the account of deferred payment of (a) financial borrowings from public bonds (explained below) and (b) worker payment obligations (which is discussed subsequently).

#### **(g) Debt burden**

Fiscal management was the most difficult challenge that Detroit city faced for a long time, but the seriousness of it was brought to the fore by a review team appointed by the Governor of Michigan. The revenue account deficit in Detroit required balancing from the surplus on capital account, which was achieved through raising debt. The city resorted to short and long term debt in the form of issuance of General Obligation (GO) and revenue bonds. The city then deferred the interest payments in short-term in order to fill income-expenditure mis-match. Raising debt through the issuance of bonds by city authorities is permitted and even encouraged in the USA, but there are statutory limits on such borrowing.

The Detroit city had borrowed \$ 1 billion through GO bonds, which was precariously close to the city's legal debt limit of \$ 1.4 billion. The City also issued revenue bonds of about \$ 5 billion, which were backed by the business revenues of the city. However, the falling revenues were not sufficient even to meet the government expenses and, therefore, not enough to make repayment of debts. For a long time, the city did not make contributions to General Fund, from which the interest payment is made on GO bonds.

Excessive dependence on long-term borrowing in the wake of falling revenues added to the fiscal stress and deteriorated the fiscal health of Detroit city government. The result was the loss of confidence among bond investors and consequent down-grading of the ratings of city bonds. The city was fast losing its ability to raise resources by floating public/ general obligation bonds.

<sup>3</sup> In fact, the assets would have declined in value due to the decline in land and estate values in Detroit, which was explained earlier.

#### **(h) Long-term liabilities**

The short-term (gap-filling) approach to the management of fiscal imbalances by the Detroit city government overlooked the rise of long term liabilities. The constant rise in long term liabilities threatened the very existence of Detroit city government. It was estimated by the city government that long term liabilities were about \$3.15 billion as of June 30, 2012, of which pension obligations stood at \$1.18 billion, workers benefits were \$0.8 billion and bond obligations stood at \$1 billion (Bing 2012).

However, the Kevyn Orr Report (2013) found a large oversight in the estimation of such liabilities arising from workmen obligations<sup>4</sup> (benefits, deferred wages, pensions, healthcare obligations etc) and defaults on making contributions to the General Fund for bond and other debt repayments (both interest and redemption payments). The report estimated that the cumulative long-term liabilities could be as high as \$ 18.5 billion of which \$ 9.5 billion were towards workmen obligations. A large amount of pension fund and worker benefit obligation was due to (Sherwell 2013):

- a) a large number of employees, who were hired in good number when the city services were largely staffed, became retirees (it was estimated that there were 2 retirees for every current employee)
- b) a short term approach to financial management which avoided immediate payment of increase in current wage by promising to add it to the benefits receivable led to a sudden surge in retirement benefit obligations
- c) an oversight of the implications of pension-benefit obligations, which were contracted to pension funds (for pension) and insurance firms (for healthcare payments), with an inflation-protection clause that compounds the payments

### **III. Chronology Of Detroit's Fiscal Issues**

Detroit city government has been facing the fiscal problems for a very long time, which began to assume the proportion of a crisis, because of the lack of corrective measures by the city managers for a long period of time and also a lack of appropriate fiscal governance. The serious status of city finances and fiscal crisis were unfolded by a review team organised under a Financial Emergency Manager, who was appointed by the Michigan State government. Accordingly, the constitutional provisions of the Michigan State for filing bankruptcy were invoked by the Financial Emergency Manager. Exhibit 1 shows some key stages of the evolution of fiscal crisis in Detroit.

<sup>4</sup> Partly, the workmen obligations have raised due to the agreements between city government and worker unions towards postponement of the wages and benefits.

#### **4. The Collapse of Civic Services**

With the financial crisis assuming serious proportions and the city on the brink of bankruptcy, the civic services of Detroit city came under severe pressure and began to crumble. The citizens reported that there were unscheduled power and water cuts, poor collection of garbage, erratic and unreliable police, fire fighting and ambulatory services. Adding to this, the neighbourhoods also became unattractive and unsafe due to an increasing crime rate (rapid rise in burglaries, attempts to steal and violent attacks), further leading to the downward spiral leading to the exodus of people from Detroit. Moreover, it also raised the unit cost of service i.e., service cost per capita, to unsustainably high levels, as there was no corresponding cut on service staff and there were historical fixed/sunk costs. The city was in a very difficult situation – high service costs were a cause of fiscal imbalance and a cut back of these could have affected the revenue base of the city.

The collapse of civic services due to high cost of service also poses questions to the organisation of community and community services in the city. The segregation of communities on racial lines began to

emerge; even racist attacks began to surface (with black people looking for opportunities to attack white people and settlements). The collapse of community living further threatened any scope for the revival of fortunes of the city through rebuilding/ redevelopment. The revival of communities/ community living and the sustainable provision of services became increasingly dismal. The City finally drew a City Charter in 2011, which emphasized upon (a) community planning (b) business development and attraction (c) international trade and emerging opportunities (d) recycling (e) green initiatives and technologies (Bing

2012). The Charter was to be implemented from 2012 but it was too late and mattered little in the wake of bankruptcy condition of Detroit.

#### **IV. Conclusions**

Detroit was touted as an epitome of successful model for city development based on industrial development in the USA. The city, however, was not able to adjust to the cyclical fortunes of industrial development. In the event of down-turn of the key automobile industry, the city also lost out both employment and population base. Timely restructuring of finances, proper fiscal management and service delivery improvement appear to have been overlooked. The cumulation of fiscal stress led to bankruptcy conditions for Detroit city government. The result of such city government bankruptcy poses bigger questions to the provision of civic services and the revival of city economy. Detroit case clearly shows that the fortunes of a city and its ability to surge ahead into the future depend upon its ability to adjust to the changes in macro-environment vis-à-vis fragile financial conditions.

#### **References**

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#### **Exhibit 1: The Unfolding of Fiscal Crisis in Detroit**

**Dec 2, 2011:** The State of Michigan launched a preliminary review of Detroit's finances, citing the looming cash crunch. The review brought to the fore the mounting debt problem with a mismatch of long term liabilities (at about \$ 12 billion) and annual revenue (of about \$ 3.1 billion).

**March 26, 2012:** The review team concluded that Detroit was in financial crisis in but did not recommend emergency manager

**Aug 2- Nov 6, 2012:** The repeal of 2011 emergency manager law was mooted and put up for referendum, which the voters support

**Nov 20-Dec 11, 2012:** The city council rejects a contract with law firm Miller Cannfield, which is tied to \$ 10 million in proceeds and risks cash out-flow of \$ 10 million by the end of 2012. It then reverses the decision and approves the contract to gain \$ 10 million bond from Michigan State.

**Jan 3-Feb 19, 2013:** Audit reports indicate steep jump in cumulative deficit from \$196.6 million in 20011 to \$ 326.6 million in 2012. The review team concludes that Detroit faces a fiscal emergency.

**March 1, 2013:** Michigan Governor Rick Snyder clears the way for a State takeover of Detroit's finances by accepting the fiscal emergency situation

**March 14, 2013:** Rick Snyder appoints Lawyer Kevyn Orr as emergency financial manager and media discusses the implications

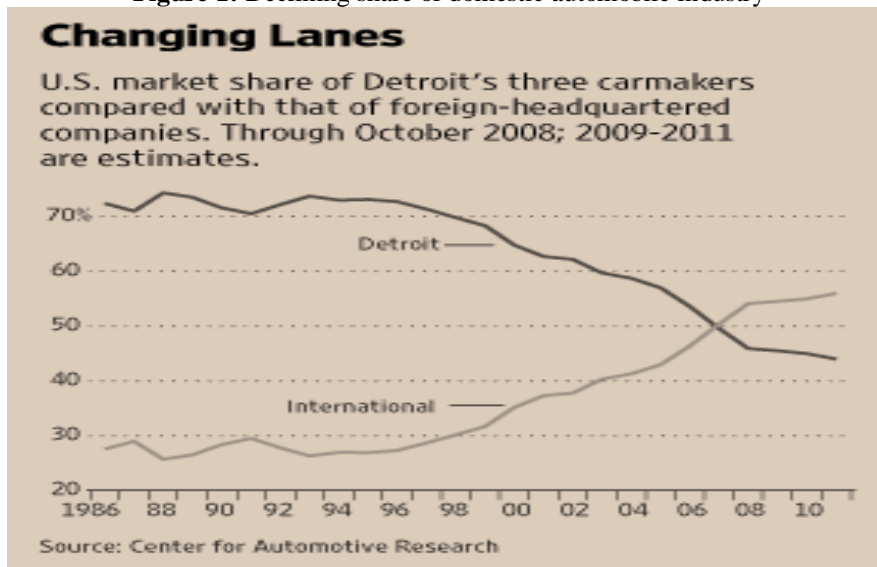
**June 14 – July 18, 2013:** Kevyn Orr declares stopping of all payments and Detroit city files for bankruptcy  
 Source: Michigan State Government (2013)

**Table 1 Decline of Population in Detroit**

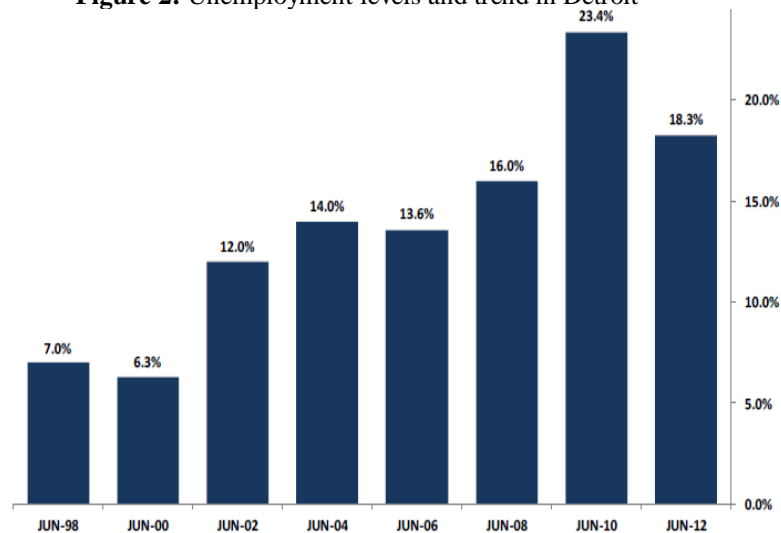
Year	City Population	Population Decline	Per cent decline (%)
1950	1,849,569	-	-
1960	1,670,144	179,425	9.7
1970	1,511,482	158,662	9.5
1980	1,203,339	308,143	20.4
1990	1,027,974	175,365	14.6
2000	951,270	76,704	7.5
2010	713,777	237,493	25

Source: Calculations based on Michigan State Government (2013)

**Figure 1: Declining share of domestic automobile industry**

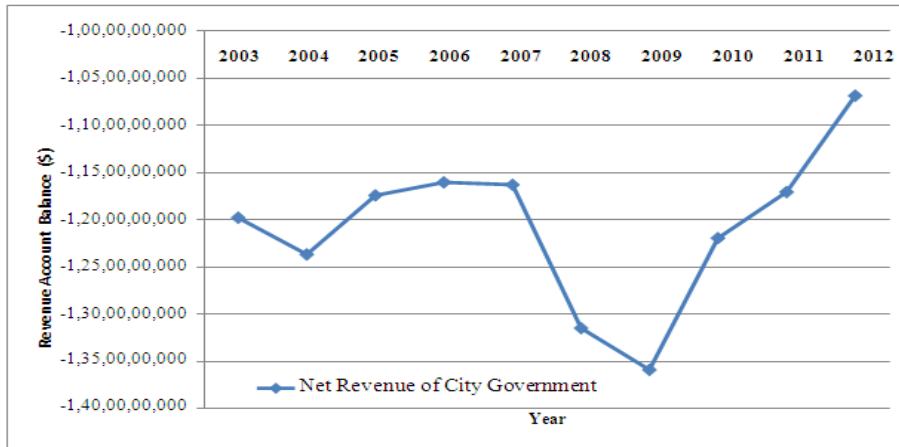


**Figure 2: Unemployment levels and trend in Detroit**

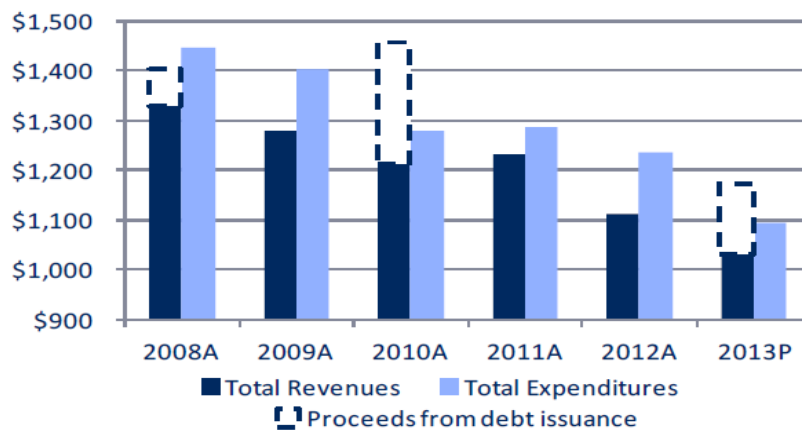


Source: Keyn Orr (2013)

**Figure 3: Revenue Account Balance of Detroit over Time.**

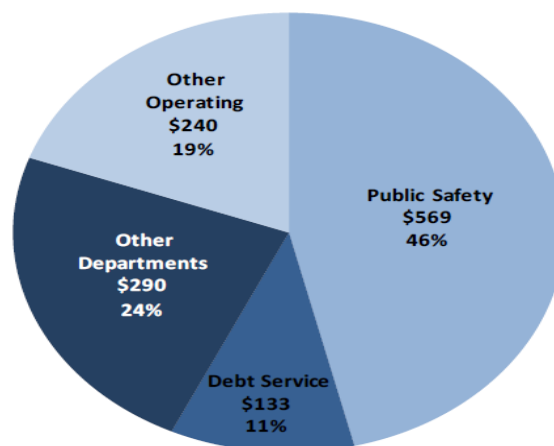


**Figure 4: Revenue Gap filling through Debt Revenues/Expenditures**



N.B. Figures in Millions A: Actual P: Provisional  
 Source: Kevyn Orr (2012)

**Figure 5: Expenditure Structure of Detroit Government  
 FY 2012 Actual Expenses (General Fund)**  
 (\$ in millions)



Source: Kevyn Orr (2013)

**Figure 6:** Declining Trend of Net Assets of City Government

