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REVIEW OF THE FINANCIAL SITUATION OF THE CITY OF DETROIT, MICHIGAN

by

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INTRODUCTION

The fiscal future of Michigan's largest city, Detroit, is a critical harbinger for other local governments in the State as well as State government itself. The City of Detroit, in one of its recent bond filings, warned of the possibility or risk of municipal bankruptcy. Since that time, the Honorable Mayor David Bing and other Detroit officials have made similar comments in public. The financial difficulties facing Detroit were further highlighted by a recent report issued by the Citizens Research Council of Michigan. This Senate Fiscal Agency issue paper examines the current state of affairs based on available data and information regarding Detroit's finances.

A City of Detroit bankruptcy or some manifestation of a severe fiscal or cash crisis could have serious ramifications for the entire State of Michigan. There are several potential problems the State may face in such a situation. To perhaps a lesser degree, any major municipal or school district bankruptcy or even bond default could lead to significant problems as well. The biggest financial problem would be the potential impact on the State's and other political subdivisions' cost of borrowing and access to credit. This financial problem is known as "contagion", where one government borrower defaults or has a near default that has a negative spillover effect on other government borrowers.

This contagion scenario has been tested in several other states. A number of studies were conducted following the New York City fiscal crisis and near default in 1975. These studies found that there was evidence that the New York City fiscal stress did lead to problems for other northern industrial cities. These problems manifested themselves as increased borrowing costs for other municipalities (Kidwell and Trzcinka, 1983; Gramlich, 1976; Forbes and Peterson, 1975). Another example was the Orange County 1994 municipal bankruptcy filing. There is strong evidence that this bankruptcy had a significant and negative effect on many other municipal bond issuers, again in the form of higher borrowing costs. These two cases provide evidence that a City of Detroit default, near default, or bankruptcy filing could have potentially severe negative consequences on borrowing costs and credit availability for other Michigan municipalities and even the State government.

This issue paper is based on information from Detroit's fiscal year (FY) 2007-08 and 2008-09 audits as well as Detroit's FY 2009-10 and FY 2010-11 budgets. The objective of this report is to trace the City of Detroit's fiscal situation over the past few years and assess the current projections to address the ongoing and accumulated deficit as well as address projected future deficits and long-term liability and legacy cost challenges.

The paper is organized as follows. First, Detroit's most recent financial audits (FY 2007-08 and FY 2008-09) are briefly reviewed to assess the most recent final numbers on the status of the situation. However, while these are the most recent numbers, in fact, Detroit's financial situation has been created over the years and thus it is useful to review historical information as well. Second, the paper reviews Detroit's 2009 deficit elimination plan as well as the related information from the FY 2007-08 financial audit. At the time the deficit elimination plan was created, the FY 2008-09 financial audit was not completed. Finally, the paper reviews the current status of the budget negotiations concerning FY 2010-11 and the projections for the accumulated deficit reduction strategies.

FY 2007-08 Financial Audit Review

Fiscal Year 2007-08 provides a good perspective on how Detroit's finances have evolved over time. As of June 30, 2008, Detroit ended the fiscal year with a general fund accumulated deficit of $141.7 million. Looking at this deficit in a historical perspective, Detroit went from a positive $69.6 million general fund unreserved, undesignated fund balance in FY 2000-01 to a negative $141.7 million balance in FY 2007-08.

Fund balance is considered a critical proxy of fiscal health for a state or local government entity. It represents the available cash resources for the government to ensure proper cash flow and to address any emergencies. Several factors contributed to Detroit's large FY 2007-08 deficit. The general fund had to write off $24.0 million in receivables from the transportation fund. Further, due to the City's failure to timely submit a financial audit, the State of Michigan withheld $23.0 million in revenue sharing, which was projected to be recognized in FY 2008-09. Finally, Detroit had to recognize a much higher property tax charge-back of $49.4 million from Wayne County due to uncollectible tax delinquencies. Some of these items may be viewed as one-time in nature and not as contributions to a structural deficit.

While the above items contributed to the deficit problem, other perhaps more long-term or structural factors were at play as well. A closer examination of these factors reveals some important information about Detroit's budgetary position (Table 1). General fund transfers to other governmental funds totaled $264.0 million, which included $34.0 million to the police and fire retirement system, $25.0 million to the general retirement system, $97.0 million to the transportation fund, and $103.0 million to other nonmajor governmental funds. These transfers resulted in a continual degradation in Detroit's financial position as measured by the general fund balance. The FY 2007-08 for Detroit ended with a general fund deficit due in large part to significant interfund transfers.

Table 1

FY 2007-08 CITY OF DETROIT AUDIT REVIEW
(Thousands of Dollars)

	General Fund	Police and Fire Retirement	General Retirement	Other Funds	Total (Governmental Funds)
Beginning Fund Balance	**$(91,406)**	**$315**	**$24,612**	**$223,979**	**$157,500**
Revenue	1,303,429	N/A	1,324	468,746	$1,773,499
Expenditures	1,181,358	34,418	26,516	665,469	1,907,761
Operating Surplus/Deficit	122,071	(34,418)	(25,192)	(196,723)	(134,262)
Transfers In	91,825	34,112	25,144	346,104	497,185
Transfers Out	(264,177)	N/A	N/A	(119,751)	(383,928)
Total Other Uses or Sources	(172,352)	34,112	25,144	226,353	113,257
Fund Balance	**$(141,687)**	**$9**	**$24,564**	**$253,609**	**$136,495**

Note: Slight differences between this table and the Comprehensive Annual Financial Report due to rounding.

Source: City of Detroit Financial Audit 2007-2008

FY 2008-09 Financial Audit Review

The FY 2008-09 financial audit is the most recent and fully comprehensive view of Detroit's finances as of June 30, 2009 (Table 2). Compared with the FY 2007-08 audit, this most recent financial snapshot reveals some of the same negative trends in fund balance and overall fiscal sustainability.

The audit does provide a good perspective on the nature of Detroit's spending and revenue patterns. In the arena of governmental activities, Detroit spends nearly $1.8 billion. The governmental activities area consists of the general fund ($1.15 billion), general retirement system fund, police and fire retirement system fund, and other governmental funds. The general fund, the largest discretionary account, is dominated by public safety activities ($619.0 million or nearly two-thirds). The other major general fund categories include health services ($80.0 million), recreation and culture ($21.0 million), physical environment ($89.0 million), and development and management ($305.0 million).

In the other governmental funds category, Detroit spends nearly $600.0 million annually. These funds include the solid waste management fund ($69.0 million), street funds ($75.0 million), targeted business development ($7.0 million), debt service ($180.0 million), community development block grant ($36.0

million), construction code ($25.0 million), workforce development ($75.0 million), human services ($73.0 million), and some other smaller funds. In total, these funds ended the fiscal year with an $11.0 million operating deficit and after transfers a negative $21.0 million. Thus, the fund balance for these funds dropped from $83.0 million in the prior year to $61.0 million in FY 2008-09.

Table 2

CITY OF DETROIT FY 2008-09 AUDIT REVIEW
(Thousands of Dollars)

	General Fund	Police and Fire Retirement	General Retirement	Other Funds	Total (Governmental Funds)
Beginning Fund Balance	**$(141,000)**	**$24,564**	**$10**	**$253,618**	**$137,192**
Revenue	1,268,000	1,445	0	478,072	1,747,517
Expenditures	1,155,000	29,125	38,974	619,009	1,842,108
Operating Surplus/Deficit	113,000	(27,680)	(38,974)	(140,937)	(94,591)
Transfers In	12,000	27,759	38,974	137,000	215,733
Transfers Out	(248,000)	0	0	(35,080)	(283,080)
Total other Uses or Sources	(236,000)	27,759	38,974	101,920	(67,347)
Fund Balance	**$(264,000)**	**$24,643**	**$10**	**$214,601**	**$(27,746)**

Note: Slight differences between this table and the Comprehensive Annual Financial Report due to rounding.

Source: City of Detroit FY 2008-09 Financial Audit

Similar to FY 2007-08, Detroit actually ended the fiscal year with an operating surplus of $112.0 million in the general fund. However, once interfund transfers ($248.0 million) are accounted for, the fund balance ended up being a negative $124.0 million. These interfund transfers are a critical part of the City of Detroit budget picture.

In FY 2008-09, Detroit's general fund transferred nearly $250.0 million to other funds. These transfers included over $60.0 million to the retirement systems, $108.0 million to other governmental funds, and $73.0 million to the transportation fund. A major portion ($103.0 million) of the other governmental funds transfer was to the debt service fund. These transfers and other uses of funds not related to direct City expenditures resulted in a negative $236.0 million to the General Fund.

Overall, this current-year deficit came on top on an accumulated deficit from previous fiscal years of $141.7 million. Thus, Detroit ended FY 2008-09 with an accumulated deficit of $266.0 million. However, due to restricted money within the fund balance ($65.0 million), the total unreserved, undesignated fund balance ended up being $331.0 million. By State law, a municipality that ends a fiscal year with a deficit in any fund is required to file a deficit elimination plan with the Michigan Department of Treasury (discussed in the next section). Other governmental funds ended the year with a total surplus of $212.0 million. Governmental activities do not include enterprise funds such as the water, transportation, automobile parking, and sewer system, which are accounted for separately.

FY 2009-10 Executive and Adopted Budget

The Mayor's proposed budget for FY 2009-10 included a revenue forecast for the general fund of $1.6 billion and a spending plan that was balanced with $1.6 billion in expenditures[1]. In the revenue or source of funds plan, there was to be an increase in "other revenue" from $37.0 million in FY 2008-09 to $289.0 million in FY 2009-10. In this budget plan, the estimate was that FY 2008-09 would end the year with a $280.0 million accumulated deficit, including a $124.0 million shortfall in FY 2008-09. This accumulated and ongoing deficit would be addressed through the "other revenue" category.

[1] The Mayor's FY 2009-10 budget was released prior to completion of FY 2008-09 financial audit.

Initially, the accumulated budget deficit of $280.0 million from FY 2008-09 would have been addressed in FY 2009-10 through a combination of asset sales and the securitization of assets (other revenue category). One item was the securitization of the Detroit-Windsor Tunnel. Detroit expected to garner $100.0 million from the sale of the rights to the fees of the Detroit Windsor tunnel system. Another $100.0 million was expected to be produced through the securitization of the parking system and $75.0 million was expected from the securitization of the public lighting system. Thus, $275.0 million in other revenue was expected to be collected in this manner to address the accumulated deficit in FY 2009-10. This number was not realized in FY 2009-10 and in fact has been removed from the FY 2010-11 budget proposal by Mayor Bing.

The Detroit City Council adopted a budget that had $1.6 billion in general fund revenue and $670.0 million in other government fund revenue. On the spending side, the adopted budget had $1.6 billion in general fund appropriations and $670.0 million in other governmental fund spending. A critical part of the budget plan is contained in the nondepartmental category for appropriations, which includes the interfund transfers.

In this adopted general fund budget, support for the Detroit transportation fund was budgeted at $80.0 million compared with the $73.0 million spent in FY 2008-09. The prior year's deficit of $280.0 million also was included in the nondepartmental category. At the time the FY 2009-10 budget was adopted, the FY 2008-09 audit had not been published. The final accumulated unreserved deficit ended up being $331.0 million rather than the $280.0 million budgeted. Transfers also included $10.0 million for the parking system, $89.0 million for pension bond payment of principal and interest and Swap termination fees, and other items. This nondepartmental category also includes general revenue and certain special one-time revenue. In this case, the proposed and adopted budget was balanced using securitization of assets as discussed above. The final comparison of the budget to actual revenue and expenditures and the final outcome related to the accumulated deficit remain to be seen. The FY 2009-10 audit is expected to be released by the end of 2010.

FY 2009-10 Deficit Elimination Plan

In late 2009, during the FY 2009-10 budget year, the City of Detroit was required to issue a deficit elimination plan to the Michigan Department of Treasury. In that plan, the Detroit Administration stated that the accumulated government deficit had grown to $325.0 million (though it ended up being $331.0 million) in the beginning of FY 2009-10 and could end up as high as $400.0 million as of June 30, 2010, without major restructuring efforts. This accumulated deficit was a sign of major fiscal stress facing the Detroit City government.

In the City of Detroit's deficit elimination plan, several scenarios for FY 2009-10, 2010-11, and 2011-12 were presented. For FY 2009-10, the plan recognized a revenue shortfall of $49.0 million to $84.0 million with a middle ground scenario of $69.0 million (Table 3). On the expense side, the plan foresaw several opportunities to rein in spending. The low-risk options included layoffs, furloughs, and some restructuring that amounted to $82.0 million in savings. In the medium-risk category, the plan identified another $83.0 million of cost savings, including Greektown Casino repayments and restructuring items. Finally, in a high-risk category, the plan identified almost another $100.0 million in savings. Having recognized various low-, medium-, and high-opportunity scenarios, the deficit elimination plan went forward using the medium-risk and -opportunity scenarios. These are the numbers shown in Table 3.

For FY 2009-10, using the medium-risk and -opportunity scenario figures, these numbers would result in a net decrease in the accumulated deficit to $47.0 million (Table 3). This was due to the fact that fiscal stabilization bonds of $230.0 million were projected to be sold and expenditure reductions of $82.0 million were projected. The medium-risk scenario of a $69.0 million revenue shortfall in property and income taxes was also built into these figures.

Table 3

CITY OF DETROIT DEFICIT ELIMINATION PLAN FY 2009-10 through FY 2011-12 (Millions of Dollars)						
Fiscal Year	**Beginning of Year Accumulated Deficit**	**Sources of Funds**	**Revenue Shortfall**	**Expenditure Changes**	**Change in Deficit**	**End of Year Accumulated Deficit**
FY 2009-10	$220.0	$230.0	$(69.0)	$82.0	$13.0	$(47.0)
FY 2010-11	(47.0)	N/A	N/A	38.8	38.8	(8.3)
FY 2011-12	(8.3)	N/A	N/A	10.0	10.0	1.8

Source: City of Detroit FY 2009-10 Deficit Elimination Plan

For FY 2010-11, the same type of process was followed. The plan identified a risk of a $20.0 million increase in expenses due to increased debt service from the fiscal stabilization bonds. In terms of cost-saving opportunities, the plan identified nearly $20.0 million in savings from restructuring and furloughs, over $100.0 million in the medium-opportunity category for restructuring items, and $240.0 million from longer-term and more difficult restructuring of City operations and facilities in the high- opportunity category. No revenue shortfalls or risk scenarios were identified in the plan for FY 2010-11. Again, using the medium-opportunity category, the operating budget position would be improved by $38.8 million and the accumulated deficit would be reduced to $8.3 million.

The accumulated City deficit would finally be closed in FY 2011-12 through further restructuring and furloughs. These figures amounted to a $10.0 million increase in operating budget position and the final elimination of the accumulated deficit. These figures did recognize the $20.0 million increase in debt service to fiscal stabilization bonds. Thus, in FY 2011-12, the accumulated deficit would be resolved according to the deficit elimination plan.

FY 2010-11 Executive Proposed Budget

The sale of the fiscal stabilization bonds is an important backdrop to the Mayor's proposed FY 2010-11 budget as outlined in the deficit elimination plan. In the winter of 2010, the City of Detroit was able to sell these bonds, $250.0 million in total. These bonds were viewed favorably in the marketplace, despite Detroit's junk bond rating status, due to being secured by State aid payments. By selling these bonds, Detroit was able to reduce the reported accumulated deficit in the general fund by this amount. It should be recognized that there is an accumulated deficit, which as of June 30, 2009, was $266.0 million (up to $330.0 million in unrestricted funds), and then the ongoing deficit was built up in the current fiscal year. Thus, Detroit has addressed its accumulated deficit, but at a long-term higher cost of debt repayment.

In understanding the FY 2010-11 budget, it is useful to reassess the FY 2009-10 budget and prior years' budgets as highlighted in the previous sections. Under Michigan law, a municipal government must balance its budget, which includes any carry-over deficit from previous years. Detroit has carried a general fund deficit forward for several years before this period. According to the released FY 2007-08 audit, Detroit faced a total unrestricted general fund deficit of $219.0 million. This budget deficit then was carried forward, as required by law, to FY 2008-09. The FY 2008-09 budget experienced significant revenue and spending challenges and the ongoing unrestricted general fund deficit grew from $219.0 million to nearly $331.0 million, according to the most recent information available. At this level, it would represent a budget gap of nearly 28.0%. This deficit was carried forward into the FY 2009-10 adopted budget. Table 4 documents the history of the general fund deficit since FY 2003-04.

Table 4

HISTORY OF CITY OF DETROIT GENERAL FUND BUDGET DEFICITS (Millions of Dollars)								
	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11
Budget Deficit	$(95.0)	$(155.4)	$(173.7)	$(155.6)	$(220.0)	$(330.2)	$(85.3)	N/A

Source: FY 2003-04 through FY 2008-09 Financial Audits and FY 2008-09 and FY 2010-11 Mayoral Executive Budgets

Table 5 depicts the Mayor's proposed FY 2010-11 budget. The other financing sources of $373.1 million in FY 2009-10 include the sale of the Fiscal Stabilization Bond. In this manner, Detroit has been able to reduce the accumulated deficit to $85.3 million in the FY 2010-11 budget.

Table 5

MAYOR'S PROPOSED FY 2010-11 BUDGET (Thousands of Dollars)		
	FY 2010-11[a)]	FY 2009-10[b)]
Accumulated Deficit	$(85.3)	$(330.0)
Revenue	1,178.6	1,170.0
Other Financing Sources	127.3	373.1
Total Resources	**$1,220.6**	**$1,213.1**
Expenditures	$1,047.6	$1,087.2
Other Financing Uses	172.8	211.2
Total Uses	**$1,220.4**	**$1,298.4**
Excess/Deficiency		**$(85.3)**

[a)] Proposed; [b)] estimated.

Source: FY 2010-11 Mayoral Executive Budget

FY 2010-11 Mayoral Budget Revenue Projections

The FY 2010-11 budget, as presented by the Mayor, foresees a 0.7% increase in total general fund revenue (Table 6). This is less than the revenue reductions in FY 2008-09 (-6.9%) and in FY 2009-10 (-6.7%). In looking at the details of this FY 2010-11 revenue forecast there are several items of note. The Mayor’s budget envisions no change in State revenue sharing, a small increase of 1.0% in casino wagering tax revenue, a small reduction of 1.0% in city income tax revenue, and an 8.5% reduction in property tax revenue.

Table 6

GENERAL FUND REVENUE PROJECTIONS FOR FY 2010-11 (Thousands of Dollars)			
	FY 2010-11	FY 2009-10	% Change
Income Tax	$215.0	$217.5	(1.2)%
Property Tax	147.9	160.9	(8.1)
Licenses and Permits	10.2	10.2	0.0
Use of Assets	8.8	34.1	(74.2)
State Revenue Sharing	233.4	233.3	0.0
Charges for Services	192.0	212.2	(9.5)
Subtotal	**$807.3**	**$868.2**	**(7.0)%**
Other Revenue	370.7	301.8	22.8
Total Revenue	**$1,178.0**	**$1,170.0**	**0.7%**

Source: FY 2010-11 Mayoral Executive Budget

A longer historical perspective on the City of Detroit's revenue streams may provide additional context in understanding the current fiscal crisis. Historically, Detroit has relied on income taxes, property taxes, and State-shared revenue for the majority of general fund financing. In addition, the casino wagering tax has become ever more important and now ranks as one of Detroit's leading sources of income. Table 7 depicts the 10-year history of Detroit's major revenue sources.

Table 7

10-YEAR HISTORY FOR CITY OF DETROIT MAJOR GENERAL FUND REVENUE SOURCES (Millions of Dollars)

Fiscal Year	Property Tax	Income Tax	State Shared Revenue	Casino	Total	Percent Change
1999-2000	$155.6	$378.3	$332.6	$53.4	$919.9	---
2000-01	152.8	341.0	333.3	85.8	912.9	(0.8)%
2001-02	169.6	323.5	332.0	106.5	931.6	2.0
2002-03	166.3	310.9	319.7	111.3	908.2	(2.5)
2003-04	184.7	290.6	286.5	116.1	877.9	(3.3)
2004-05	178.9	282.5	282.9	137.9	882.2	0.5
2005-06	185.3	284.1	279.5	156.6	905.5	2.6
2006-07	183.7	278.3	271.1	179.7	912.8	0.8
2007-08	177.8	277.1	272.7	179.9	907.5	(0.6)
2008-09	163.7	240.8	266.0	173.0	843.5	(7.1)
2009-10[a)]	160.9	217.5	233.3	171.6	783.3	(7.1)
2010-11[b)]	147.3	215	233.4	173.4	769.1	(1.8)

[a)] Estimated revenue; [b)] projected revenue.

Source: FY 2010-11 Mayoral Executive Budget

Property Taxes

In more closely examining Detroit's major general fund revenue, several trends are noteworthy. Property tax revenue continued to climb through the first half of the decade until about 2006, going from $155.0 million in FY 1999-2000 to $185.0 million in FY 2005-06. From that point forward, property tax revenue has declined from $185.0 million to an estimated $147.0 million in FY 2010-11, a decline of 20.5%. This change only partly corresponds to changes in Detroit's State Equalized Valuation (SEV) and taxable value over the same period. A major part of this reduction is due to the elimination of a solid waste management tax levy in FY 2006-07.

In fact, the City of Detroit's property value trends have been a lagging indicator relative to other economic indicators such as unemployment. Only in 2008 did the total SEV of Detroit decline (Table 8). Taxable value did not begin declining until 2009. This was because it took some time for the gap between taxable value (TV) and SEV to close. As SEV begins to fall below taxable value, property taxes begin to fall.

At a finer level of detail, homestead taxable value began to fall sooner than overall taxable value. This was partly because the sub-prime mortgage crisis first hit the residential housing market. Detroit saw continuing development in its commercial and nonresidential property values until later in the 2008-09 recession. In fact, the City of Detroit's homestead taxable value had already fallen by over 20.0% from 2007 through 2009. More recently, it has become evident that the commercial real estate sector is also under pressure. It is likely that Detroit will continue to experience further declines over the next few years.

Table 8

STATE EQUALIZED VALUATION, TAXABLE VALUE, AND HOMESTEAD TAXABLE VALUE (Millions of Dollars)			
Fiscal Year	**SEV**	**TV**	**Homestead TV**
1999-2000	9,824.0	7,204.0	2,645.0
2001-02	10,972.0	7,639.0	2,872.0
2002-03	12,048.0	7,976.0	3,089.0
2003-04	12,060.0	7,844.0	3,186.0
2004-05	12,840.0	8,446.0	3,103.0
2005-06	13,412.0	8,872.0	3,103.0
2006-07	13,455.0	9,298.0	3,300.0
2007-08	14,113.0	9,896.0	3,365.0
2008-09	13,945.0	10,031.0	3,211.0
2009-10	12,497.0	9,725.0	2,883.0

Source: FY 2010-11 Mayoral Executive Budget

Income Tax Revenue

Detroit's most important revenue source is the municipal income tax as authorized by Public Act 284 of 1964 and modified by subsequent legislation. City income tax peaked at $378.0 million in FY 1999-2000, and then fell during the following decade. For FY 2010-11, it is estimated to generate $215.0 million in revenue. This represents a revenue reduction of 43.1% over the decade. This decline mirrors Detroit's job losses and increases in unemployment. Public Act 500 of 1998 provided for incremental reductions in the Detroit income tax rate, which at the time was 3.0% on residents and 1.5% on nonresidents. In FY 2002-03, the rate was reduced to 2.5% on residents and 1.25% on nonresidents. Further income tax rate reductions were scheduled to occur but were suspended in 2003 due to the poor economy. Thus, a combination of rate reductions and economic stress has reduced income tax revenue.

State Revenue Sharing

Another critical revenue source is State revenue sharing. In FY 1999-2000, State revenue sharing for Detroit was $332.6 million. Over the decade, State revenue was reduced multiple times, resulting in an estimated figure of $233.4 million in FY 2010-11. This nearly $100.0 million reduction represents a 30.0% revenue reduction.

When viewed across these three traditional major revenue sources, property taxes, income taxes, and State revenue sharing, collections were substantially reduced over the last decade.

Casino Wagering Tax

One important offsetting revenue factor has been the casino wagering tax. In FY 1999-2000, the casino tax resulted in collections of $53.0 million. For FY 2010-11, the collection figure has been estimated at $173.0 million. This increase of $120.0 million has assisted in providing a cushion for the revenue reductions from the three major traditional revenue sources. However, it should be noted that the casino tax revenue is sequestered before it is given to Detroit by a trustee and some of the revenue is transferred to UBS bank. This transfer is due to a settlement regarding an interest rate swap deal.

FY 2010-11 Mayoral Budget Proposed Expenditures

The expenditure side of the proposed FY 2010-11 budget also plays a critical role in addressing the deficit challenge for Detroit. On the spending side, the Mayor's general fund budget reflects a reduction of 782 positions. This includes a nearly 5.0% general fund-related reduction in uniformed police officers from 4,680 to 4,395 (Table 9). There are other staff reductions across all departments. Finally, the Department of Transportation realizes a staff reduction of 183 positions due to the reduction in the general fund subsidy to the transportation fund. These staff reductions, along with cuts to contractual services and operating supplies, represent a total proposed expenditure reduction of 3.6% or $40.0 million in FY 2010-11.

Looking beyond expenditures on departmental or legislative line items, there are several significant fund transfers that affect the financial status of the general fund. Even before FY 2010-11, Detroit's general fund has consistently provided a large transfer of dollars to other governmental funds such as transportation and solid waste. The Department of Transportation operations have been consistently subsidized by the general fund. The fees generated by the transportation system do not cover the cost of operating the system. For the past few years, this subsidy has been running at around $80.0 million to $90.0 million. The FY 2010-11 budget proposal is to reduce this subsidy from $80.0 million to $50.0 million (Table 9). Other transfers appear to be consistent with previous fiscal years.

Table 9

FY 2010-11 MAYOR PROPOSED GENERAL FUND EXPENDITURES (Millions of Dollars)

	FY 2010-11[a]	FY 2009-10[b]	% Change
Public Protection	$633.8	$665.2	(4.7)%
Health, Recreation & Culture	43.6	41.7	4.6
Housing Supply	6.1	5.3	15.1
Physical Environment	58.7	73.8	(20.5)
Development & Management	305.2	300.8	1.5
Subtotal Spending	**$1,047.4**	**$1,087.8**	**(3.7)%**
Transportation Fund	$55.1	$80.0	(31.1)%
Debt Service	95.0	100.7	(5.7)
Other financing	22.7	30.6	(25.8)
Subtotal Financing	**$172.8**	**$211.3**	**(18.2)%**
Total	**$1,220.2**	**$1,298.8**	**(6.1)%**

[a] Projected; [b] estimated.

Source: FY 2010-11 Mayoral Executive Budget

City Council Fiscal Analysis Division: Review of Mayor's Proposed FY 2010-11 Budget

The Detroit City Council's Fiscal Analysis Division is charged with reviewing the Mayor's proposed budget. The Division's analysis indicated several points of difference on the size of Detroit's deficit and the projected revenue that Detroit is expected to generate in FY 2010-11. The City Council Fiscal Analysis Division did not agree with all of the analysis and supporting documentation regarding the FY 2010-11 Mayoral budget.

Based on its own modeling, the Fiscal Analysis Division stated that the Mayor's revenue projections were overstated by $7.0 million. Breaking this down, the Fiscal Analysis Division stated that revenue estimates should be lowered as follows: $2.8 million, income tax;, $1.0 million, utility user's tax; $3.8 million, casino wagering tax; and $4.4 million, other revenue; and property tax collections should be raised by $4.7 million.

On the revenue side to address the accumulated deficit, the Mayor's proposed budget has some one-time revenue sources. This revenue category includes $5.7 million for delinquent receivables, $8.0 million related to the Greektown Casino settlement, $20.0 million DTE escrow, $23.0 million revenue sharing posting, $15.0 million in Detroit Public School bad debt, and $13.0 million in Detroit Department of Transportation grant funding. These items, which will not recur in future fiscal years, total $84.7 million. In terms of cost savings, the Administration had identified $84.2 million of this amount; $50.2 million did not contain adequate detail or documentation. The undocumented items included: 1) $6.0 million reduction in collection of delinquent receivables, 2) $12.0 million in employee cost reductions via a hospital audit, 3) $14.9 million in required furloughs, 4) $7.1 million in contractual service reductions, 5) $2.9 in reduced operating supplies, and 6) $5.0 million in reduced inventory supplies and risk management changes. Without more detail, the fiscal analysis did not recommend that the City Council accept these reductions.

In the category of spending reductions, there are $102.0 million identified by the Fiscal Analysis Division. This includes 1,152 position reductions, layoffs, furloughs, contractual service reductions, elimination of support to the Cobo Center and City Airport, and inventory reductions. The Fiscal Analysis Division also felt that the Administration did not fully document the projected expenditure reductions, thus leading to some ambiguity as to the nature of those reductions. Of the $102.0 million in proposed general fund reductions, the Fiscal Analysis Division stated that some of these changes were temporary, such as furloughs ($4.2 million), and some changes amounting to $38.0 million did not have reasonable detail as to how they would be implemented.

The final estimate is related to the accumulated deficit. The City Council Fiscal Analysis Division estimated that as of June 30, 2010, Detroit will have ended the year with a $39.5 million operating deficit and a total accumulated deficit of $124.5 million. After accounting for $50.9 million in one time revenue to help close part of the accumulated past deficit, the Fiscal Analysis Division found that the Mayor's estimated $85.4 million end-of-fiscal year deficit was off by $39.5 million due to the fact that the Mayor's budget did not recognize the FY 2009-10 operating deficit.

Based on this analysis and other information, the Detroit City Council passed a budget that resulted in an additional $31.0 million in expenditure reductions. Thus, the Council's total spending reductions amounted to $132.0 million. The additional $31.0 million in spending reductions were targeted on an "across the board" spectrum. The Fiscal Analysis Division also proposed across-the-board general fund budget reductions equal to one quarter of the accumulated deficit for the next four years to eliminate the deficit entirely. The Mayor vetoed these additional budget cuts but the veto was overridden by the Detroit City Council.

<u>City of Detroit Debt and Debt Service</u>

In terms of any potential municipal bankruptcy filing (as discussed above), the most relevant issue is the degree of debt and other liabilities currently being held by Detroit. From 2007 through 2009, Detroit relied on short-term financing to address the ongoing deficit and cash- flow issues. Using short-term financing was potentially risky for Detroit as access to credit could be eliminated at any time and interest rate spikes could greatly increase the cost of borrowing. The reliance on short-term financing was part of the impetus for the failure of several investment banks, such as Bear Sterns and Lehman Brothers, during the 2008 financial crisis.

This information is based on the FY 2007-08 audit, according to data as of June 30, 2008, and a report issued by the Municipal Advisory Council of Michigan. In FY 2007-08, Detroit had $943.0 million of general obligation unlimited and limited tax fund bonds. In FY 2009-10, this amount had increased to $1.4 billion. A major part of that increase was the $250.0 million fiscal stabilization bonds. According to the Mayor's most recent budget proposal, the general fund will be required to pay out approximately

$100.0 million in debt service payments. This figure represents about 8.0% of total general fund expenditures. As of spring 2010, Detroit had approximately $6.6 billion in outstanding municipal bonds (Table 10). The revenue bonds of $5.1 billion are secured mostly by sewer and water revenue, and are less risky than general obligation bonds.

Table 10

CITY OF DETROIT MUNICIPAL BONDS OUTSTANDING
(Millions of Dollars)

Bond Types	Amount
General Obligation – Unlimited Tax	$1,079.3
General Obligation – Limited Tax.................................	363.5
Revenue Bonds..	5,111.9
Total...	**$6,556.3**

Source: FY 2008-09 City of Detroit Financial Audit and Municipal Advisory Council of Michigan

Much of the debt issued by the City of Detroit is actually considered high quality. The revenue bonds, which are typically secured by water or sewer revenue, are highly rated by the rating agencies. On the other hand, the general obligation is considered "junk" level status and this is of greater concern.

The general obligation debt does require a substantial amount of resource use. The resources used to repay debt are not available for basic city services. In the FY 2010-11 budget, general obligation amounted to nearly $75.0 million.

Long-Term Financial Sustainability Issues

Beyond these immediate financial obligations, Detroit faces some significant long-term challenges. Two important long-run obligations are the pension system and health care retiree obligations. As stated previously, Detroit maintains a police and fire retirement system and a general retirement system for other personnel.

The annual required contribution is $60.0 million for Detroit's police and fire retirement system and $21.0 million for the general employee retirement system, which falls under governmental activities. Due to adjustments to the annual contribution required by an actual analysis, the total adjustment to the annual required contribution in FY 2010-11 amounted to $20.7 million for the police and fire system and $10.0 million for the general employee system.

In the pension systems, Detroit has a policy to fund normal costs and the amortization of prior service costs. Based on this policy, Detroit was required to fund 9.96% of annual payroll for the general system and 26.71% for the police and fire retirement system. These percentages amounted to a City contribution of $41.0 million in FY 2008-09 for general retirement and $36.0 million for the police and fire system. Employees in the general system contributed $21.0 million in FY 2008-09 and police and fire employees contributed $10.0 million.

Certainly, there are significant pension contributions required to be provided out of the governmental funds of Detroit. The promising aspect of Detroit's pension system is that the funded ratio is 100% in both systems. Therefore, Detroit is not underfunding the pension and building up a long-term unfunded liability. At the same time, this pension requires a significant discharge of money from the general fund and other funds that is not available for current services.

The retiree health care situation is a more significant problem going forward. Detroit covers 100% of retiree health care expenses for general system employees hired before 1984. For employees hired during or after 1984, Detroit covers 90% of retiree health care. Detroit covers 90% of all retiree health care costs for police and fire employees. Health care and dental coverage also is provided for spouses.

From an actuarial required perspective, the annual required contribution for the health and life insurance retiree coverage is $250.0 million. Of this amount, Detroit appropriated $133.0 million on a pay-as-you-go basis. This appropriation left a Net Open Obligation on an annual basis that increased from $114.0 million in FY 2007-08 to $236.0 million in FY 2008-09. Looking at the retiree health care challenge over the long-run, Detroit faces a very significant problem. The actuarial accrued liability for all City employees was $4.8 billion. Detroit has prefunded 0% of this accrued liability. This liability will weigh heavily on Detroit over the long term.

CONCLUSION

Given the attention paid to the City of Detroit and Detroit public schools, it is critical to point out that many if not most political subdivisions of the State are facing financial difficulties. Financial emergencies and even municipal bankruptcy could be a potential threat to any number of cities, villages, townships, counties, or special districts in the State. The size and scale of the City of Detroit make it important in its own right, but at the same time Detroit has access to revenue sources such as major asset sales, casino wagering revenue, and other sources that are not available to other municipalities.

The City of Detroit has managed to reduce its ongoing and accumulated deficit through the use of fiscal stabilization bonds and spending reductions. The downside is that Detroit has been forced to take on more long-term debt and debt payments as a result. Detroit now has over $1.4 billion in outstanding municipal bonds. Bond payments will continue to be a long-term drain on City coffers.

Real spending reductions, including layoffs and service reductions, have occurred in Detroit. However, interfund transfers or departmental spending must still be tracked and, as stated by the Fiscal Analysis Division, it is likely that another $125.0 million of ongoing expenditures still must be wrought from the budget without major tax changes.

Beyond the bond payments and ongoing expenditure reductions, pensions and retiree health care also are consuming an ever-growing portion of the governmental and enterprise funds of Detroit. These payments are unavailable to meet ongoing service needs. In particular, the retiree health care liability will be an ever-growing burden on Detroit that will require a significant percentage of ongoing revenue.

One critical, but difficult-to-answer question, is the level of sustainable ongoing revenue for the City of Detroit. It is likely that property and income taxes will continue to fall over the next year and after that may begin to stabilize. The casino wagering tax has played a significant role in keeping Detroit's finances stable given the downturn in the traditional revenue streams. The answer to this question, which may be uncertain for at least the next year, is important in identifying a sustainable level of ongoing service provision for Detroit.

A long-term economic recovery plan will be vital to ensure that debt payments can be made in a timely fashion, in order to ensure long-term fiscal sustainability. It is likely that it will take several years if not longer for Detroit's economy to regain some traction. In the meantime, Detroit faces difficult short- and long-run challenges in balancing the current and near-term budgets.

APPENDIX: CITY OF DETROIT AND MICHIGAN DEPARTMENT OF TREASURY FISCAL SCORES

See Senate Fiscal Agency Issue Paper entitled, "An Assessment of Michigan's Local Government Fiscal Indicator System", September 2010, by Tina Plerhoples and Eric Scorsone for an explanation of the Michigan Fiscal Indicator System.

The City of Detroit, like other Michigan municipalities, has been ranked on the Michigan Department of Treasury's fiscal indicator system. This system has ranked Detroit for 2006 and 2007. The 2008 and 2009 scores have not been released due to delayed audits. In 2006, the City of Detroit scored a total of eight points. It did not score 10 points due to scores of zero into categories. Between 2004 and 2006, Detroit did experience growth in real taxable value as was the case with most of Michigan. Detroit also did not incur any points due to a large change in real taxable value. This indicator is used to determine when a jurisdiction experiences the shock of the loss of major employer. Given the overall size of the City of Detroit, it would be difficult for Detroit to experience a shock large enough to trigger this indicator, compared with a much smaller jurisdiction where it is more likely to occur.

In 2007, Detroit scored only six points, down two points from 2006. This was partly because Detroit did experience growth in real taxable value between 2005 and 2006, which was not uncommon across the State. Further, Detroit did not experience any large real taxable value declines due to loss of a major employer for example. Finally, Detroit did not experience an operating deficit in that general fund revenue exceeded general fund expenditures. However, this last indicator is misleading because in fact Detroit did end the year with a deficit in overall fund balance. Because interfund transfers were not included, Detroit appears to be in balance when in fact it is not.