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DETROIT: A MICROCOSM OF MUNICIPAL FINANCE, BANKRUPTCY, AND RECOVERY[1]

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The 2019 keynote address offers an important opportunity for economic historians and policy makers to better understand the nuances associated with Detroit's recent financial problems, ultimate bankruptcy, and its broader implications for state and local governments in general. This episode is not unprecedented in US economic history, nor is it in all likelihood the last instance of large-scale municipal bankruptcy that will occur. However, the Detroit story offers both a cautionary tale and a tale of hope centered on a path toward rebounding after financial hardship. This same story can be said of the history of US municipal bankruptcy. A major episode in particular came in the wake of the Panic of 1873 and culminated in default or repudiation of nearly 20 percent of all municipal debt (Albert Hillhouse 1936). While the problems that emerged through the nineteenth century were marked by overinvestment in public works, and especially railroad construction (Hillhouse 1936), today's issues stem much more from unfunded liabilities that have accrued to state and local public pension systems. These unfunded liabilities have been estimated to range between $1 and $4 trillion depending on the underlying assumptions employed (Urban Institute 2018).

This issue came into starkest contrast in the wake of the 2008 financial crisis, which led many commentators to speculate about the potential for episodes of large-scale municipal bankruptcy resulting from an inability to meet pension and other obligations. This very issue was at the center of Detroit's financial woes as the city worked its way through bankruptcy. Detroit's story is one that built up through decades of financial

[1] The editors invited Editorial Board member and Trustee John Dove, much of whose research has addressed US municipal and state debt, to comment on the article in this issue based on John Naglick's keynote address at the Society's 2019 conference in Detroit.

mismanagement, fiscal irresponsibility, and outright corruption. While some saw Detroit's crisis as the potential powder keg that might ignite a rash of municipal bankruptcies, the ultimate conclusion of the event saw a reemergence and revitalization of the city, with very little in the way of contagion.

While Detroit became the highest profile bankruptcy in the aftermath of the financial crisis, there were several other major Chapter 9 proceedings including Jefferson County, Alabama (which was the largest municipal bankruptcy in US history prior to Detroit (Jayden Sangha 2019)); Stockton, California; and San Bernardino, California among others (Pew 2015). In most of these instances the issues pitted creditors (who clearly hoped to be repaid in full), pensioners and current public employees (who wanted to receive their promised benefits), and taxpayers (who wanted to continue to receive current services and generally disfavored increased tax burdens) all against one another. Clearly not all parties could walk away with what they hoped, which should provide important and sobering lessons for all municipal governments moving forward.

Importantly, the history of municipal default and bankruptcy in the US shows that such episodes are not unprecedented, and in many cases the lead up to such events share many similarities. Two of the most prominent events center on the Panic of 1873 and the Great Depression. As noted, through overinvestment, speculation, and at times outright corruption, the former episode resulted in some 20 percent of all municipal debt winding up in a state of default, with large swaths of this outright repudiated. The aftermath led many states to impose a number of fiscal and constitutional constraints meant to limit these events from occurring again (John Dove 2014, 2016).

The second wave of municipal difficulty came during the Great Depression. To combat these growing problems, Congress passed the Municipal Bankruptcy Act in 1934 (Douglas Watson, Donna Handley, and Wendy Hassett 2005). This legislation provided the process by which a municipal government could specifically file for bankruptcy protection under federal law. Since that time, over 500 municipalities have done so. However, the ability to pursue such actions lies squarely with such a municipality's state government. While Detroit wound up its affairs through Chapter 9, for many municipalities this would require significant coordination with their respective state governments.

The story of Detroit also adds to the growing literature on public finance broadly, and in particular the interrelationships with public pensions, migration, corruption, and other demographic and industrial shifts. This literature has especially seen a resurgence since the financial crisis. Municipal defaults and bankruptcies can have significant effects across jurisdictions, which Detroit provides as a cautionary tale, as other municipal governments, private firms, and a parent state may face higher borrowing costs or outright exclusion from credit markets, thus creating a sort of contagion effect across jurisdictions (John Halstead, Shantaram Hegde, and Linda Schmid-Klein, 2004; MarketWatch 2013).

Such a situation has resulted in a more proactive role by state governments when their municipalities do begin to face financial trouble, especially through the employment of emergency managers. Though not unique to the Detroit experience, such managers have been applied in numerous instances, many times quite controversially, with those opposed noting the anti-democratic nature of these individuals (given that the authority generally granted to these managers emasculates city councils, mayors, and thus the ability of citizens to effectively elect their own representation) (Jamie Peck 2014).

Another strand of the literature tied directly to the issues of municipal insolvency centers on constitutionally- or statutorily-imposed fiscal constraints which came largely in response to the municipal debt episodes following the Panic of 1873, and were meant to stem the pursuit of time-inconsistent policy. The most important constraints that emerged through this period include limitations on general obligation debt, and tax and expenditure limits (TELs). While these measures were meant to limit public expenditures, revenue generation, debt burdens, and instill greater fiscal responsibility, many of them came with several potentially negative secondary effects. All these issues have been studied extensively within the literature and provide important implications for both pre- and post-crisis management.

Here, the evidence generally indicates that TELs have only a limited and mostly negative impact on local government finances. For instance, TELs do not seem to actually limit public-sector revenue generation, but rather force local governments to simply shift where sources of revenue are derived from, generally taking the form of increased income taxes, sales taxes, and user charges (Judith Stallmann 2007; Rui Sun 2014). While such limitations may not have directly impacted Detroit, the evidence is clear that the city was forced to raise tax rates in the face of a falling tax base, which only exacerbated the problems of out-migration. Compounding this, the above-noted revenue sources are highly cyclical, meaning that in times of economic distress, those municipalities that rely more heavily upon such sources are faced with potentially even greater fiscal burdens, which decreases the ability of such a government to effectively provide public services when they may be most needed.

Crucially, the ability of a TEL to limit unsustainable government growth is tied to the *de facto* restrictiveness of such a limit (Lindsay Amiel, Steven Deller, Stallmann, and Craig Maher 2014). Additionally, TELs have been found to be negatively correlated with bond ratings and positively with borrowing costs (Sharon Kioko 2010). Especially in times of economic crisis, this can create a downward spiral in which the inability to meet debt obligations through additional sources of revenue increases the risk of default or bankruptcy, which in turn leads to higher borrowing costs and lower bond ratings, with the cycle continuing. Tied to this, evidence also indicates that TELs are associated with an increased likelihood of municipal distress and default (Dove 2014, 2016, 2019).

Further, the evidence also suggests that TELs simply lead local governments to create and rely more heavily upon special assessment districts (Stallman 2007; Jered Carr and Jayce Farmer 2011). While such districts better meet the benefits principle of taxation, wherein only the direct recipients of public services are those who pay, such districts also rely much more heavily on revenue bonds rather than general obligation bonds, the former of which generally face relatively higher borrowing costs. This is a result of the inherent volatility association with public-sector revenue generation. These arrangements also increase the likelihood of widespread default or bankruptcy in times of economic downturn and crisis.

On the other hand, debt limits appear to improve state and local finances, especially relative to tax limits. Specifically, anti-deficit measures reduce overall levels of debt, deficits, and thus debt burdens

(Alberto Alesina and Tamim Bayoumi 1996; Henning Bohn and Robert Inman 1996; Barry Eichengreen 1992; Eichengreen and Bayoumi 1994; Roderick Kiewiet and Kristin Szakaly 1996). These constraints have also been analyzed for their effect on state and local borrowing costs (Bayoumi, Morris Goldstein and Geoffrey Woglom 1995; Dove 2012, 2014, 2016; Eichengreen 1992; Goldstein and Woglom 1992; Craig Johnson and Kenneth Kriz 2005; Robert Lowry 2001; James Poterba and Kim Rueben 1999). This research generally finds that outright prohibitions on issuing debt above certain limits tend to lower borrowing costs, while procedural safeguards on issuing debt have little to no effect.

Though these fiscal constraints were not directly tied to Detroit's financial woes, they do present important implications for policymakers and may play a larger role in the event that widespread municipal distress ever comes to fruition at some point in the future. This would suggest a reevaluation and reconsideration of these constraints by state officials and citizens to incentivize the pursuit of more time-consistent public policy by local officials and help reduce the likelihood of fiscal crisis moving forward. Detroit offers just that cautionary tale when political incentives do not align with economic realities and culminates in severe financial and personal hardship. Thus, taking the initiative to avoid this outcome should be a top priority.

However, as the keynote address also showed, in the event that other municipalities do face a similar hardship, Detroit offers a glimmer of hope in how to address such a crisis head on and how circumstances can be improved relatively rapidly. This requires leadership and cooperation at and between state and local governments, possibly stronger oversight by state governments over municipal finances, and building strong relationships with, and providing opportunities for the reemergence of, a robust and diverse private sector to help revitalize those distressed municipalities and communities.

It was such strategic partnerships with private entities in particular that have helped Detroit reemerge, with Dan Gilbert of Quicken Loans leading the way. This partnership has brought thousands of jobs and a significant revitalization of the downtown area–and with it much needed tax revenue–at an extremely important time in the city's recovery. This along with a commitment by the city to maintain a balanced budget and adequately fund its public pensions moving forward has generated the stability the city had long neglected. This has allowed Detroit to again be able to issue bonds under its own name, rather than through state- or insurer-backed guarantees. Though this may not persist forever, Detroit's recent financial history, as this keynote address suggests, is hopefully sobering enough to have pushed at least some state and local governments to reassess and realign public-sector incentives and hopefully avoid similar events in the future.

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