The Heritage Foundation
LEADERSHIP FOR AMERICA

ISSUE BRIEF

No. 4004 | AUGUST 2, 2013

Detroit's Bankruptcy Marks the Tip of the Iceberg

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Detroit's recent filing for Chapter 9 bankruptcy protection would protect the city from its creditors while allowing it to restructure its debts. The proceedings that follow will, in many respects, set precedents for the swell of municipal bankruptcies that are likely to follow. Some of these precedents will be set through the courts, but federal policymakers have the power to set the most important precedent of all: that bailouts are not an option.

Contrary to popular belief, recent and looming municipal bankruptcy filings were not caused by the recent "great recession." Rather, they represent the inevitable demise of big-government, liberal policies promoted by self-interested politicians and the coercive public employee unions that support them. A federal bailout of Detroit would reward the very actions that led to the city's demise and simply enable future fiscal mismanagement. Moreover, bailouts would also encourage other fiscally troubled state and local governments to continue their reckless ways.[1]

Detroit's Decline. Since the 1960s, Detroit's population has declined by 60 percent, with 25 percent of that decline occurring over the past decade alone. As Detroit's population has fled the city, so too has its tax base. The average income of Detroit residents is only $15,261.[2]

Detroit serves as a poster child for economic decline. Its policies and politics over the past half-century should serve as a "do not" guide for policymakers across the country. America's manufacturing decline hit Detroit particularly hard, but rather than respond by trying to diversify the city's output and attract new businesses, the city enacted policies that drove out businesses and residents.

Rather than reduce the size of government as its population shrank, Detroit sought higher levels of government spending. City leaders, following in the footsteps of the automakers, acquiesced to the unions by increasing employee benefits, especially future pensions and retiree health care. Leaders also ceded control and flexibility over employees to unions in their labor contracts, making it much more difficult to cut costs or restructure the workforce when and as needed.[3]

To attempt to pay for it all, Detroit continually increased taxes and engaged in prolific borrowing when the tax increases did not close the gap. And yet, despite the growth in government taxes and debt, Detroit's citizens experienced ever-declining city services, the most troublesome result of which has arguably been the steep rise in crime.[4]

The Burden of Public Employee Pensions and Other Retirement Benefits. One thing former Detroit businesses and residents that fled the city did not take with them was the city's accumulated legacy costs. Today, those legacy costs (which include public employee pension and other post-employment

This paper, in its entirety, can be found at
http://report.heritage.org/ib4004

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

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benefits, as well as payments on debt) consume 43 percent of the city's entire tax revenues.[5] It is estimated that four years from now, that figure will reach 65 percent of tax revenues, leaving just 35 percent to pay current employees and run the city. This is simply unsustainable.

Although Detroit's pension funds are not among the worst in the nation, the unfunded liabilities they have accumulated weigh heavily on the city's finances. Of Detroit's $18.3 billion in debt, more than half is unfunded retirement benefits for public employees: $3.5 billion in pension liabilities and $5.7 billion in other post-employment benefits.[6] The problem with these unfunded liabilities has as much to do with the city's failure to make the necessary contributions to pay future benefits as it does with the benefits that were promised to employees.

In evaluating the finances of public employee pensions, Detroit and other local and state governments have relied on accounting methods that allow overly optimistic rates of return on what are supposed to be riskless pension benefits to be assumed. Such rates are risky in the long run because they can show a pension plan to be adequately funded when it is not. They also allow the employer—in this case the city of Detroit—to make smaller annual contributions than it should. Ironically, by assuming a risky rate of return, Detroit and other government entities across the nation have transformed what were supposed to be guaranteed benefits into risky ones.

Detroit reports an unfunded pension liability of only $644 million, but appropriate accounting methods and Detroit's emergency manager assess the city's unfunded pension liability at more than five times that level—$3.5 billion—when more realistic assumptions are used.[7]

But Detroit's unfunded pension shortfall is just a drop in the bucket. Across the nation, appropriate accounting assumptions peg total state and local unfunded pension liabilities in the range of $3 trillion to $4 trillion—the equivalent of 1,000 Detroits.[8] And this does not even include unfunded liabilities for post-employment benefits such as health care, which can be far more costly. These benefits are often nearly 100 percent unfunded, meaning that no money has been set aside to pay these often constitutionally protected benefits.[9]

It Is in Workers' and Unions' Best Interests to Accept Reforms. Across the nation, unfunded pension and other retiree benefits are crowding out state and local finances. Unable to renegotiate unsustainable and underfunded liabilities, lawmakers' hands are often tied. If they follow the Detroit model, raising taxes and allowing unions to restrict lawmakers' ability to cut costs and provide efficient services, they will drive out businesses, residents, and their tax base.

But if unions and workers instead agree to reasonable reforms, they will increase their governments' chances of successful financial recovery and, therefore, their own chances of receiving higher portions of promised pay and benefits, let alone continued employment.

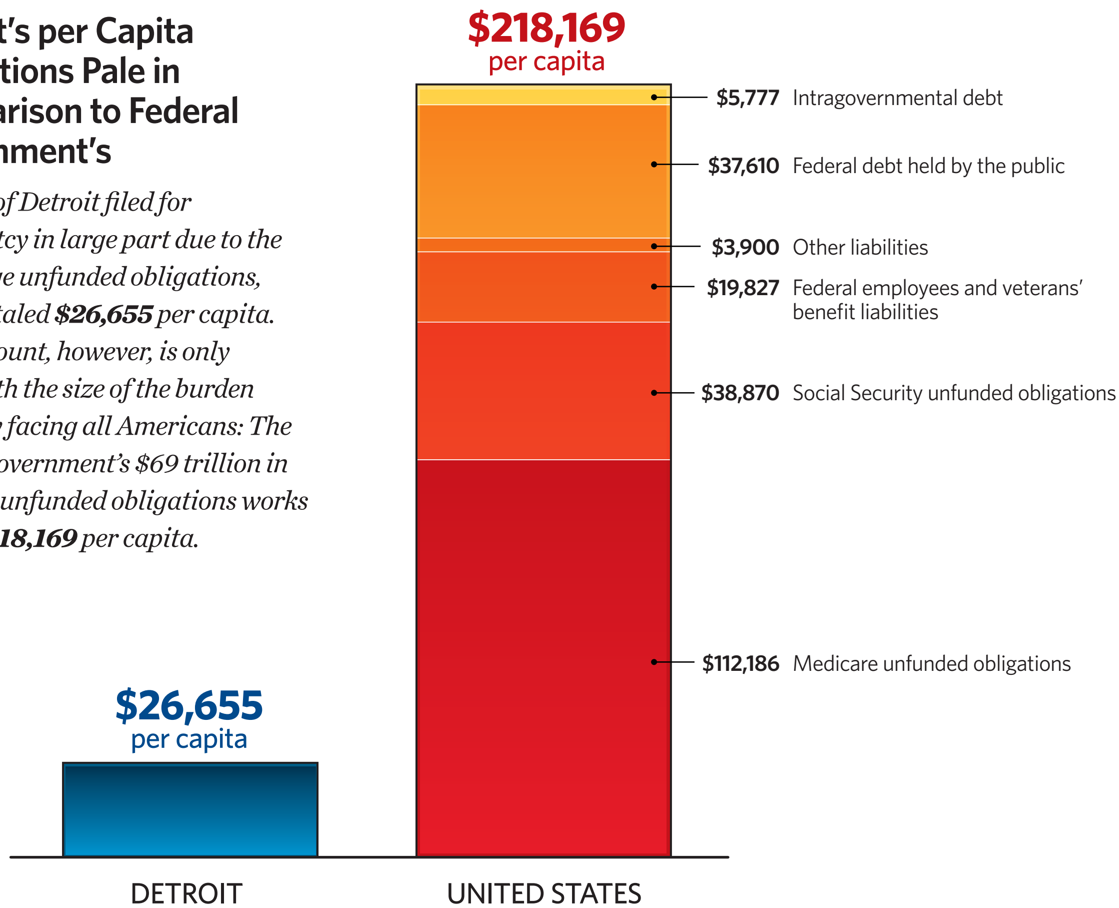
Bailouts Are Not the Answer. With rumors that Detroit's pensioners may take significant hits and bondholders may receive mere pennies on the

1. See Alison Acosta Fraser and Rachel Greszler, "Detroit Bankruptcy Is No Time for Federal Bailouts," The Heritage Foundation, The Foundry, July 19, 2013, http://blog.heritage.org/2013/07/19/detroit-bankruptcy-is-no-time-for-federal-bailouts/.
2. Kevyn Orr, *City of Detroit Proposal for Creditors*, June 14, 2013, p. 5, http://s3.documentcloud.org/documents/713693/detroit-emergency-manager-kevyn-orrs-report-to.pdf (accessed July 30, 2013).
3. Bill Nojay, "Lessons from a Front Row Seat for Detroit's Dysfunction," *The Wall Street Journal*, July 29, 2013, http://online.wsj.com/article/SB10001424127887323829104578623422748612116.html (accessed July 31, 2013).
4. For example, Detroit's average response time for a priority one emergency is 58 minutes, the city reports one crime per every five people, and on average, only 8.7 percent of those crimes are solved. See Orr, *City of Detroit Proposal for Creditors*, pp. 9–14.
5. Ibid., p. 34.
6. This figure does not include $1.43 billion in pension-related Certificate of Participation liabilities. Ibid., p. 23.
7. Ibid., pp. 31, 98, 109.
8. Robert Novy-Marx and Joshua D. Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?," December 18, 2009, http://econ.as.nyu.edu/docs/IO/14310/Rauh_20100310.pdf (accessed July 30, 2013); Andrew G. Biggs, "Public Sector Pensions: How Well Funded Are They, Really?," State Budget Solutions, July 2012, http://www.statebudgetsolutions.org/doclib/20120716_PensionFinancingUpdate.pdf (accessed July 30, 2013).
9. Pew Charitable Trusts, "A Widening Gap in Cities, Shortfalls in Funding for Pensions and Retiree Health Care," January 16, 2013, http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_city_pensions_report.pdf (accessed July 30, 2013).

CHART 1

Detroit's per Capita Obligations Pale in Comparison to Federal Government's

*The city of Detroit filed for bankruptcy in large part due to the city's huge unfunded obligations, which totaled **$26,655** per capita. That amount, however, is only one-eighth the size of the burden currently facing all Americans: The federal government's $69 trillion in debt and unfunded obligations works out to **$218,169** per capita.*



Note: Figures shown are based on $2.8 trillion in the Social Security trust fund and $227 billion in the HI and SMI Medicare trust funds being included in the long-term Social Security and Medicare obligations and are excluded from intragovernmental debt.
Source: Authors' calculations based on data from U.S. Department of the Treasury, Government Accountability Office, Social Security and Medicare trustees' reports, Centers for Medicare and Medicaid Services, U.S. Census Bureau, and Kevyn Orr, "City of Detroit Proposal for Creditors," June 14, 2013, http://s3.documentcloud.org/documents/713693/detroit-emergency-manager-kevyn-orrs-report-to.pdf (accessed July 30, 2013).

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dollar, there will certainly be cries of "unfairness," but a federal bailout of Detroit is not the answer.

If Congress were to step in to protect any of Detroit's creditors—be they pensioners or bondholders—it would create an untenable moral hazard. Believing that the federal government would step in to help them, troubled state and local governments across the nation would have no incentive to enact reforms, and unions and workers would have no incentive to accept them.

Moreover, a federal bailout of Detroit or any state or local government would impose the costs of one city's fiscal recklessness on the taxpayers of other, more responsible states and localities.

Perhaps most important, though, the federal government is in no fiscal position to be providing bailouts.

Detroit's Debt Pales in Comparison to the National Debt. As significant as Detroit's debt is, the federal government is in far worse shape. Detroit's $18.3 billion in debt amounts to about $27,000 per capita. Today, the U.S. debt held by the public is nearly $12 trillion, or $38,000 per capita. But including massive unfunded entitlement and other obligations—$12.3 trillion from Social Security, $35.5 trillion from Medicare, $1.8 trillion in intragovernmental debt, $6.3 trillion from federal employee and military retiree benefits, and

$1.2 trillion in other liabilities—brings the total U.S. federal debt exposure to $69 trillion. At a per capita level of over $218,000 per person, the federal government's exposure is more than eight times that of bankrupt Detroit.

Learn from Detroit's Mistakes. Detroit's spiraling decline is certainly a tragedy. But bankruptcy would force the city's leaders to work with an estimated 100,000 creditors to restructure its debt and lead the city to a brighter future. Lawmakers in Washington should learn from Detroit's mistakes and rein in entitlements before there is a debt crisis instead of bailing out this long-troubled city and opening the floodgates for many more.

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