CITIZENS RESEARCH COUNCIL OF MICHIGAN

"The right to criticize government is also an obligation to know what you're talking about."
Lent Upson,
First Director of the Citizens Research Council

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Bankruptcy Will Not Solve Highland Park's Financial Problems

In a Nutshell

- All appeals have been exhausted and the courts have ruled that the City of Highland Park owes the Great Lakes Water Authority an estimated $24 million for unpaid sewerage services.
- Contrary to the city's desire for bankruptcy to absolve the city from this debt, it is neither equitable nor in the interest of the Southeast Michigan region for the debt to be written off.
- The issue raises a new spotlight on Michigan's small cities that lack the critical capacity and, often, the tax base to provide a full menu of municipal services. Highland Park has lost so many people and so much tax base that its sustainability has to be called into question.

Once again, the City of Highland Park is having financial troubles. This time, a long-running lawsuit with the Great Lakes Water Authority has run its course and the court has ruled that the city owes the water authority an estimated $24 million for unpaid services.

Conflicts between Highland Park and the water authority, including its predecessor the Detroit Water and Sewerage Department (DWSD), have gone on for decades. Highland Park chronically underpaid DWSD for its charges for sewage treatment services. Those problems continued after the Great Lakes Water Authority (GLWA) was created to take on water and sewerage services for most communities in Southeast Michigan. With the transition to the regional authority, it became more acutely apparent that the other communities participating in the GLWA were bearing a higher burden because of Highland Park's past failures to collect and remit the proper sewerage charges.

An August 2022 Michigan Court of Appeals ruling determined that Highland Park had to pay an estimated $24 million. The Michigan Supreme Court denied the city's appeal, thus ending litigation on the merits of the city's arguments. The case was sent back to the Wayne County Circuit Court to work with the city and authority to determine how Highland Park will begin to pay the amount owed.

One consequence of the case dragging on for many years has been that the amount due has amassed to more than Highland Park can handle. The estimated $24 million ruling against the city is more than twice what the city collects annually in property and income tax revenues and more than four times the city's annual Water and Sewer Fund revenues.

The City of Highland Park must find a way to pay the settlement amount. To absolve the city of the debt does not short a third-party interest that speculated on the city providing a return on an investment. It shorts the GLWA and all of its participating municipalities and deprives Southeast Michigan, including Highland Park itself, or much-needed resources to invest in water and sewer infrastructure.

Highland Park Seeks Bankruptcy

Michigan law allows local governments facing financial distress to proceed under federal bankruptcy laws only with the approval of the governor. On April 10, 2023, the Highland Park City Council adopted a resolution asking the state to initiate a review of the city's finances pursuant to Public Act 436 of 2012, the state's emergency manager law. If a review finds the city to be in fiscal distress, it has four options: seek mediation, negotiate a consent decree with the state to initiate corrective actions, request the appointment of an emergency manager, or file for Chapter 9 bankruptcy. A week after the Act 436 request, the city council adopted a new resolution seeking to skip the process established in PA 436 and jump straight to filing for municipal bankruptcy.

With a front-row seat to Detroit's historic bankruptcy a decade ago, perhaps Highland Park's city officials think bankruptcy is a model fitted for their current troubles. Highland Park leaders and residents can clearly see that Detroit's financial condition and service delivery abilities have improved in the years since bankruptcy. If they want to model things after Detroit's debt reconciliation, they would be well served by taking a closer look. There are significant differences.

Detroit's fiscal decay and years of poor policy choices led to unbalanced budgets, impeded its cash flow, caused it to run up years of operating deficits, and created long-term debts the city was unable to manage. By 2012, bankruptcy was the only answer. Highland Park's financial condition is much better than Detroit's pre-bankruptcy condition. Since exiting its most recent stint under an emergency manager in 2018, the city has maintained balanced budgets, stashed more than a third of its operating expenditures in cash reserves, and worked to pay down its long-term debt.

It Matters to Whom the Money is Owed

Instead of looking at the City of Detroit's 2013 bankruptcy as a way forward, Highland Park officials might consider the state actions in 2016 that addressed the long-standing financial problems that faced Detroit Public Schools (DPS). That is because Highland Park's unpaid debt to the GLWA more closely resembles the types of debts that the struggling school district amassed under years of state financial oversight. In particular, at the time of the district's restructuring, it owed over $1.7 billion of multi-year notes and loans that were backed by the State of Michigan and other school districts.

Different government debts have different types of creditors. Some governments borrow from private entities – usually in the form of bonds or loans. Funding from investors and financial institutions comes with the government's promise to repay the borrowed amounts with interest. The financial history and creditworthiness of the government dictate the interest rates charged for borrowing. Thus, on the one hand, financially healthy governments offer a safe haven for investors, investments with financially troubled governments offer higher rates of return.

Local governments also borrow from the state or regional governments. This can come in the form of financial backing on bond sales, cash-flow borrowing, and leniency on payments to state or regionally operated programs. In these cases, it is the other governments participating in the programs, and ultimately state taxpayers, who bear the risk and absorb the cost if payments are not made.

This is significant as policymakers consider the implications of who bears the burden if financial promises are broken. Depending on the debt, the financial burden of a broken promise will fall upon private individuals or other taxpayers.

Detroit filed for bankruptcy with most of its debt owed to investors and pensioners. While retirees, many of whom still reside in the city, were forced to accept reductions to their pension and health care benefits as part of the city's financial restructuring, much of Detroit's debt relief came from shorting investors. Holders of revenue bonds, general obligation bonds, and pension certificates of participation invested their money in Detroit with the understanding that it had experienced decades of decline and was a financial risk. They expected to receive attractive returns on their investments.

The Detroit Public Schools had experienced for decades the same socio-economic declines and financial struggles and by 2016 was saddled with more than $3.5 billion in debt. More than half of that amount was owed for delinquent payments for pension and retiree health care, the cost of early retirement incentives, and the repayment of cash flow borrowing. Because Michigan operates a state-run teacher pension system and provided funding for the cash flow borrowing, it was the state, other school districts, and state taxpayers on the hook for most of DPS's debts. Payments on these debts consumed 40 percent of the district's per-pupil operating funding, depleting the resources available to teach students.

The different nature of the debt dictated an approach different from Detroit's bankruptcy.

The adopted state-funded debt relief plan uses the Detroit Public Schools property tax levy solely to repay the debt but created a new legal entity, the Detroit Public Schools Community District (DPSCD), to educate the students. Whereas other school districts receive operating funds from a mix of a local property tax and state foundation grants, DPSCD receives state foundation grants for the full amount of its operating costs. Because state taxpayers fund the state School Aid Fund that provides the funding for the school foundation grants, DPS' debts are indirectly being paid by other school districts.

An analysis of who is on the hook for Highland Park's debt makes clear that its current financial challenge involving unpaid sewerage billings is more akin to DPS's problems than the City of Detroit's. All other cities, villages, and townships that contracted with the DWSD and then became members of the GLWA have floated the money while Highland Park wrangled with DWSD and GLWA. GLWA had fewer resources to invest in infrastructure improvements because Highland Park was delinquent in its payments. Debt relief that does not make the GLWA whole will push Highland Park's troubles onto its neighbors.

Repaying Highland Park's Debts

If bankruptcy to absolve Highland Park of its water and sewer debt is not a good response, what are the alternatives?

Highland Park operates on a General Fund budget of almost $20 million. It finished the 2021-22 fiscal year with $4 million in cash reserves. It does not have the cash on hand to pay back this debt. Repurposing existing revenues for this purpose would draw from general government, public safety, public works, and other services that arguably already are under-resourced.

The Wayne County Circuit Court could Detroit impose a judgment levy to repay the debt. This would be a new burden levied solely to repay GLWA. However, this is a poor option. Highland Park property -taxpayers already pay 25.8 mills of judgment levies to finance other past debts (a mill is a tax term meaning $1 of tax for every $1,000 of taxable value). This would be in addition to the 22.5 mills taxpayers pay for general operating and rubbish taxes and for loan repayment taxes. Highland Park's total tax burden (including school, county, and special authorities) is already the eighth highest in the state. While there is an element of fairness to this option – those that incurred the debt must pay for it – adding to the already high tax burden could further lessen any incentives to locate in Highland Park.

Issuing a bond to finance the debt would spread the cost over several years, with the effect of shifting the burden from past generations to future generations. Highland Park does not have an unusually large amount of bonded debt, but it does have fiscal stabilization bonds and emergency loans that have borrowed against the future to pay current operating costs. To take on more debt for operating costs would further burden future generations with the high cost of being in Highland Park for services provided in earlier years.

A third option is to have the state government foot the bill. Surplus funding from the previous fiscal year and federal funding, from pandemic relief and new infrastructure funding, is being doled out by the legislature as they enact supplemental appropriations bills and craft a budget for the next fiscal year. This has taxpayers throughout the state foot the bill for Highland Park's debt.

The governor has proposed that GLWA repurpose a 2022 state grant to make the payment on Highland Park's behalf. The state provided a $25 million clean water grant from federal funding to the GLWA. The funding came from the federal American Rescue Plan Act and Infrastructure Investment and Jobs Act, therefore, all U.S. taxpayers would be absorbing the cost of this option. Use of this option would amount to an opportunity cost, as it would make Highland Park whole but result in less funding to invest in improvements to the region's water and sewerage infrastructure. The dispute would be settled on paper, but in the end, all other local governments participating in the GLWA would share the burden of using the grant in this way.

Each of these options comes with different tradeoffs with respect to who ultimately bears the cost of repaying the debt and the ability to pay. Regardless of the policy adopted to address Highland Park's water and sewerage debt, the city's court case and Act 436 filing bring to light some larger issues facing the small, aging, and shrinking urban city.

Bigger Issues

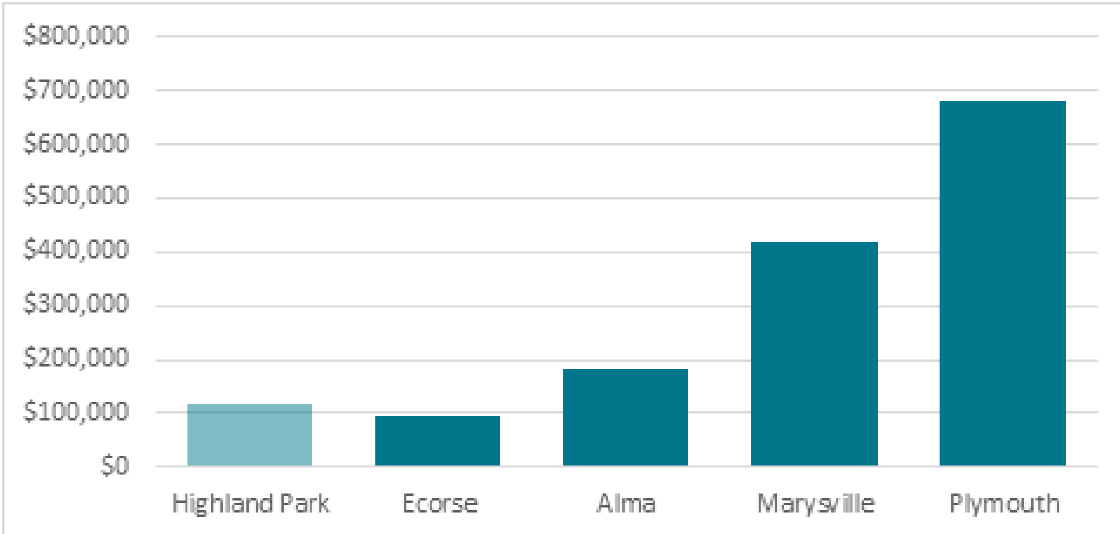
The fact that Highland Park has again applied for assistance through Act 436 raises questions about the long-term sustainability of the city. The Citizens Research Council first worked with the city in an effort to better manage its deteriorating finances 41 years ago. Since that time, the city has been in and out of the state's emergency manager process several times.

The goal of Act 436 is to restore financial management to the local governments and put them on a path of financial sustainability. Indeed, Highland Park appears to be on such a path but for this significant debt. However, addressing the underlying issues of local governments such as Highland Park is beyond the goals of Act 436. Highland Park remains a city in precarious financial condition.

With a current population of 8,703 people, the three-square-mile city has lost nearly 84 percent of its population since peaking at 52,959 people in the 1930 census. Vacant lots, abandoned buildings, and blighted places are common in Highland Park. The city has lost much of its tax base, highlighted by the Chrysler Corporation's departure in 1996.

The city taxes its residents and businesses at high rates to yield the same revenues communities with richer tax bases can garner at lower rates. The chart below shows that one mill levied on Highland Park's tax base yields about one-sixth of what a mill yields in Plymouth and about a quarter of what a mill yields in Marysville, two comparably sized cities.

Revenues Yielded by a One-Mill Property Tax in Cities with Populations Similar to Highland Park, 2022



Whether a solution to the current financial crisis is adopted through the courts, the emergency manager process, or facilitated by state officials, it is likely that the solution will slap another band-aid on the city's finances and prop it up for a few more years. Ultimately, state and local government officials must choose between dissolving the city to make it part of Detroit or adopting an urban agenda to help places like Highland Park prosper again.

Michigan has a plethora of cities and villages that are three square miles or smaller in urban and rural settings. While this relatively small size once made sense, today it institutionalizes economic inefficiencies. It is beneficial for residents to be close to their elected officials, but that benefit comes with higher costs and challenges to providing quality services. As some of these cities empty out, it becomes increasingly difficult to cope with those inefficiencies.

Being a three-square-mile enclave of Detroit creates extra troubles for Highland Park. State economic development efforts to support Detroit often leave Highland Park and Hamtramck as afterthoughts. The city cannot afford the same economic development apparatus as Detroit, so it continues to struggle to attract businesses that will provide jobs and a tax base for the city.

The bigger issue is that the state's tax policy and economic development efforts allow urban sprawl further and further from Michigan's urban cores. Property tax policy rewards local governments experiencing new development more than those that are built out. With sprawl, state programs facilitate the extension of roads, water and sewerage, electricity, and other services to serve the needs of these growing populations on the urban fringe. This practice strains scarce resources and comes at the expense of older cities such as Highland Park.

Highland Park and Southeast Michigan will get past this latest financial trouble. The city's debt to GLWA will get paid and life will go on. It is unlikely that the solution to repay the city's debt will address many of the long-term sustainability issues. Highland Park will go on as a struggling city that is bleeding people and tax base. Michigan, and Southeast Michigan in particular, will struggle to address the water and sewerage infrastructure needs of the region.

ABOUT THE AUTHOR

Eric Lupher - President

Eric has been President of the Citizens Research Council since September of 2014. He has been with the Citizens Research Council since 1987, the first two years as a Lent Upson-Loren Miller Fellow, and since then as a Research Associate and, later, as Director of Local Affairs. Eric has researched such issues as state taxes, state revenue sharing, highway funding, unemployment insurance, economic development incentives, and stadium funding. His recent work focused on local government matters, including intergovernmental cooperation, governance issues, and municipal finance. Eric is a past president of the Governmental Research Association and also served as vice-chairman of the Governmental Accounting Standards Advisory Council (GASAC), an advisory body for the Governmental Accounting Standards Board (GASB), representing the user community on behalf of the Governmental Research Association.

Founded in 1916, the Citizens Research Council of Michigan works to improve government in Michigan. The organization provides factual, unbiased, independent information concerning significant issues of state and local government organization, policy, and finance. By delivery of this information to policymakers and citizens, the Citizens Research Council aims to ensure sound and rational public policy formation in Michigan. For more information, visit www.crcmich.org.

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