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Detroit Borrowed $100 Million in July, and Has the Capacity to Borrow More

In a Nutshell

- The City of Detroit's debt burden is low relative to when it filed for bankruptcy in 2013.
- Detroit has had easy access to the municipal bond market despite the mar on its reputation from when it shorted bondholders in bankruptcy.
- Detroit issued $100 million in bonds in July and has the capacity to issue more debt.

Last month marked the tenth anniversary of the City of Detroit's exit from bankruptcy. The Detroit Free Press, The Detroit News, and other publications ran analyses to offer to their readers perspectives on economic development, crime, and that persistent annual deficits have turned to surpluses. Omitted from those analyses is what landed Detroit in bankruptcy court: its debts.

When Detroit filed for bankruptcy in 2013, it had $18 billion in total liabilities. Some of those liabilities represented contractual promises to provide retiree benefits, unpaid bills to vendors, and what was owed to bondholders. Debt—exclusively those liabilities that involved a borrower, the city, and lenders—comprised $651 million. (For this discussion, debt includes those directly incurred by Detroit and payable from tax revenues rather than those debts incurred by the water and sewer department and special districts or authorities.) In the end, Detroit shorted bondholders; that is the purpose of bankruptcy after all, a debtor cannot pay what it owes, so it enters bankruptcy court to settle with creditors. Detroit paid bondholders approximately 64 cents on the dollar.

In addition to the anniversary of the city's descent into insolvency, last month the city issued $100 million in bonds. It was the latest of five oddly easy post-bankruptcy forays into the municipal bond market that were, in part, a testament to the financial turnaround that has occurred. All of this—the anniversary, the new debt issuance—offers an opportunity to analyze the city's indebtedness, to ask:

- How do today's debts compare to yesterday's?
- How much debt is too much?
- Can the city borrow more?

Today's debts compared to yesterday's

The first question—how do the city's current debts compare to those incurred pre-bankruptcy?—requires that we spend a moment on another question. Why do cities borrow money? Debt finance typically pays for the acquisition and construction (and sometimes the demolition as we will note) of fixed assets. Jails, schoolhouses, roads, water and sewer mains, etc.—are fixed assets that are often financed with borrowed money. Why? Because the cost of capital projects often far exceeds what may be paid from annual revenues alone.

Notably, some of the debt incurred by the city in the decade that preceded bankruptcy was non-investment or non-productive debt issued for short-term cash needs, payroll, or to pay other liabilities. For example, in Fiscal Year (FY)2004, the city issued $61 million in so-called "fiscal stabilization bonds" to resupply General Fund cash on hand. Bond proceeds were subsequently spent to support current operations and afterward the city had little to show for it. In contrast to the non-investment debt incurred pre-bankruptcy, debt incurred post-bankruptcy has been used for capital projects.

However, a wrinkle in the evaluation of this new indebtedness is that some of the debt has been incurred to destroy fixed assets rather than for acquisition or construction. The short of it all is that the 1.1 million people who left Detroit between 1950 and 2010 did not take their homes with them and the city has been blotted by abandoned structures since. At the time of its bankruptcy, it was estimated that the city contained 78,000 abandoned structures. The Duggan administration has prioritized remediation, primarily via demolition. Demolition was initially paid for with federally awarded "Hardest Hit" monies, and after that allotment ran out, the city made transfers to the project from its General Fund and borrowed.

To be sure, demolition is a capital project. But typically, debts incurred for the construction of fixed assets have a payback period connected, if only loosely, to the useful life of the fixed asset. For example, a city issues debt repaid over 20 years to finance the construction of roads that will remain safe to drive on for 20 years. In the case of Proposal N, the referendum that authorized additional debt issuance, there are no fixed assets that will be left after the bond proceeds have been spent on demolition.

To date, Proposal N bond proceeds have paid for the completed or scheduled demolition of nearly 6,000 derelict properties. Of the $100 million debt issued last month, $75 million will be used, in part, for the demolition of another 2,500 derelict properties. Given the size and scope of the city's problem with abandoned properties, it can reasonably be said that those monies represent quality-of-life investment. But local elected officials, public administrators, and citizens should be conscious of how added debt will affect the city's financial future.

How much debt is too much?

Indebtedness may be measured in many ways. For this analysis, we settle on three ratios: debt-to-revenue, debt service-to-revenue, and the ten-year payout.

Why are three different ratios required to answer one question that, on its face, is simple? Because debt and debt service costs encumber current resources and future assets, and that temporal difference must be captured and understood. Debt "structure" is also important. There is a difference between a repayment schedule that is level versus those that include balloon payments. Each of the three ratios chosen is intended to assess those aspects of indebtedness.

In FY2013, the city's debt-to-revenue ratio was 1.71. For every dollar the city raised in revenue, it had $1.71 in debt. The metric captures how much debt the city had relative to the size of its operation.

On the other hand, the draw on then-current resources is measured by the debt service-to-revenue ratio. The debt service-to-revenue ratio was 0.17 in FY2013. Or for every dollar in revenue earned, 17 cents were used to repay debt. To some extent, this is why the city went bankrupt. City revenues were used to simply stay current with old debts rather than maintain services or make quality-of-life investments. Moreover, these debts did not include payments toward retiree benefits, another set of costs attributable to the past that did not benefit current or future residents.

As of the FY2022 audited financial statements, Detroit had $927.8 million in bonded debt, or $102.1 million more than what was tallied up in bankruptcy court (adjusted for inflation). So, Detroit has more debt than it did pre-bankruptcy, yet those debts are by the two stated metrics, affordable. Based on the FY2022 debt schedule and income statement, the debt-to-revenue ratio was 0.68 (68 cents) and the debt service-to-revenue ratio was 0.08 (8 cents).

Equally important to the amount of debt, are the terms, i.e., how, and when it must be repaid. In FY2013, the ten-year payout ratio was 0.45. In ten years, Detroit would have paid back less than half of the total principal owed on borrowed money. As of the FY2022 audited financial statements, the ten-year payout ratio is 0.68, a marked improvement.

Even with the debt added in July, (loosely calculated yet reasonable) estimates show that the city's debts remain affordable. With the latest debt issuance included, the debt-to-revenue ratio is estimated to be 0.75 (75 cents), the debt service-to-revenue ratio is an estimated 0.08 (8 cents), and the ten-year payout ratio an estimated 0.64. If the city has been able to access the municipal bond market (its reputation far less harmed from bankruptcy than what was predicted), and its debts are (by the three metrics shown here) affordable, the question that follows is whether the city can borrow more.

Detroit can afford more debt

Whether the city should borrow more is a question of financial and administrative ability. On financial ability first, the city's debt burden remains affordable by the metrics shown above, and a recent victory in federal court means the city's anticipated pension cost will fall by $12 million. Based on loosely made estimates, the city could borrow another $90 million over 10 years or another $140 million over 20 years without need for additional resources. (Debt assumed to be issued at 5.25 percent interest, which mirrors the interest rate on the most recent debt issuance). Each option would include annual debt service costs of $11 million to $12 million, equivalent to what was saved on pension cost. The added debt would not put the debt and revenue-related ratios out of whack, in part owed to the substantial forecasted increases in city revenues.

While additional debt issuance may be financially feasible, added debt may overly burden the city's administrative or functional capacities. Bond proceeds must be spent on the specific activities for which money was borrowed; and the city must have accountants and attorneys ensure that happens. Additionally, if the bond proceeds are incurred for capital projects there must be the internal staff and private sector partners available to carry out the needed work.

Similar to the cash influx provided by debt issuance, Detroit has received $826.7 million in federally awarded monies from the American Rescue Plan Act. The first tranche of $424.6 million came in FY2021, and the second tranche of $402.1 million came in FY2022. Per federal law, that award must be appropriated and contracted by the end of 2024. Detroit has yet to spend it all, and as of the most recently enacted operating budget, some monies that had been allocated to specific projects had to be reallocated because it was doubted that the money could be expended in time. This is not a conundrum particular to Detroit. Many states and cities still have money to spend. However, the city's administrative capacities are likely below most other states and cities, both before the COVID-19 pandemic and likely afterward.

Can the city afford more debt? Yes. Can the city expeditiously spend additional monies? Maybe. The quicker the city can address its problems, the better. The more time provided for problems to fester, the more people likely become exasperated and leave. Yet, Detroit should borrow responsibly, not only in terms of what it can pay back but what it can spend quickly.

Conclusion

Bankruptcy provided Detroit a "fresh start." But for those on watch for a potential return to fiscal misbehavior by the city's elected officials, the question is not simply how much debt the city currently has on its balance sheet, but rather what it has borrowed for, which type of debt was issued, and whether that debt can be responsibly repaid. So far, Detroit has responsibly borrowed for capital projects. The city's debt burden and debt service costs are, relative to revenue, lower than in the pre-bankruptcy period. Lastly, the debt has been reasonably structured. This all indicates that there is no fiscal time bomb for the next mayor to defuse.

ABOUT THE AUTHOR

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James L. Tatum III is the Researcher for the Detroit Bureau of the Citizens Research Council. Previously, he served as an analyst in the City of Detroit's Office of the Chief Financial Officer (OCFO) where he prepared cost-benefit analyses of City projects, asset sales and labor contracts, forecasted city revenues and expenditures, and conducted scenario analyses for the City's pension plans. In addition to his practical experience, he is an accomplished academic. His research on debt, pensions, insolvency, Chapter 9 bankruptcy, and dissolution has been published in trade, law, and academic journals.

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