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Detroit: At the Fiscal Crossroads

In Brief

Two successive City of Detroit General Fund surpluses in FY95 and FY96 have been brought about largely by a buoyant economy and constraints on City employee compensation. The City also funded the pre-existing deficit through a Risk Management Fund in which City self-insurance requirements were capitalized.

Much of the projected surplus for FY96 is composed of better-than-expected performance in property and income taxes. A contribution of $5.5 million to the Budget Stabilization Reserve Fund is contemplated bringing the Fund to its highest level since FY92. At only about one percent of the GF budget, however, the Fund would offer little help in the event of an economic downturn. In FY97 the Mayor's budget is projecting growth of 4.4 percent in the base of the property tax, the largest percentage increase in over 25 years.

Despite the relative strength of the current Detroit fiscal position, it is faced with a potential reduction in its second largest source of revenue, state revenue sharing. To cope with such external eventualities as well as any future economic downturns, the City must address its high per capita expenditures and both the base and structure of City taxes.

Detroit, as much as any large city in the United States, exemplifies the problems of older industrial cities. A slowly growing, or stagnant, tax base, a decaying infrastructure, and high levels of demand for city services are all evident in Detroit. Predictably, the budget of the City reflects these conditions. Since the 1950s, the "normal" condition of the City General Fund has been to operate in the red. For Fiscal Years 1990 through 1994, the City General Fund ran a series of sizable deficits, despite declining expenditures.

For FY95, however, the General Fund produced a $20.0 million surplus, and for FY96 the City is projecting another $11.1 million surplus. These two consecutive surpluses may or may not indicate a longer-term return to fiscal stability. But it does suggest that when economic conditions are fairly robust, Detroit can achieve a fiscal equilibrium. This report examines the current financial condition of the City, some of the challenges it faces, and its prospects for developing sustainable financial stability.

Recent Financial Results

The Mayor has presented his budget proposal for FY97 including a projection of a second consecutive surplus in FY96 of $11.1 million. This will represent only the fifteenth surplus in the last 45 years. (See Table 1 for the operating results of the last 20 years.)

Factors in the Budget Turnaround.

The current "turnaround" condition of the City budget is partly the result of economic conditions and partly of decisions made by the City. Following certain recommendations offered by the Mayor's Committee for the Twenty-First Century in 1992, the City has eliminated the $100-million-plus annual deficits and is now on the threshold of its second straight surplus.

Among the many factors contributing to the turn-around were the following:

1. A robust national, state and local economy.
2. A two-year civilian employee wage reduction of 10 percent, plus a third year of frozen wage levels.

   A three-year freeze on uniformed employee wages, as ordered by compulsory arbitration.
3. Some abatement of the soaring increases in health care costs for employees and retirees.
4. Pension plan revisions in 1992 that have reduced City contributions by over $35 million annually.

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Funding the Existing Deficit.

Another important element was the capitalization of the accumulated deficit. In August 1992, the City marketed a bond issue to finance the $106 million cumulative deficit. This allowed the City a "breathing space" of five years to amortize that deficit. In 1994, when the deficit condition persisted, the new administration presented a plan which would have rolled over the last three years of outstanding principal from the 1992 bond issue, as well as finance the new accumulation of deficit. The plan called for a new $125 million bond issue with a 5 to 10 year life, but targeted in the budget at 7 years.

Risk Management Fund (RMF). However, prior to its implementation, that plan was replaced by a new $100 million bond issue which has been used to capitalize the City's self-insurance requirements. The bond proceeds were used to establish a $100 million Risk Management Fund (RMF). This plan permits the City to begin paying its liability claims out of the RMF, rather than directly from annual appropriations. Essentially, this plan permitted the use of FY95 appropriations provided for self-insurance in the budget to cover the operating deficit, rather than fund it directly from a new "deficit funding" bond issue. Payouts from the RMF will be replenished with appropriations in future General Fund budgets. Thus, there is a built-in delay in the necessity to reimburse claims payments with General Fund dollars.

The RMF Bonds were marketed in June 1995 with a two-part issuance. The debt will not be fully retired until the year 2005. The RMF Bond plan will probably require higher interest payments than the original deficit funding plan, although this may be offset, at least partially, by investment earnings in subsequent years from any unexpended balances in the RMF. Another claimed advantage of the plan is that RMF bonds are exempt by statute from being included in municipal bonding limitations. Also, it avoids the specter of Detroit being forced to directly bond its deficit for the third time in the 15-year period between 1981 and 1995.

Table 1

City of Detroit General Fund Surplus/(Deficit)
Fiscal Years 1975-76 to 1994-95
(in millions)

Fiscal Year	Total Expenditures	Final Operating Results Surplus	or Deficit	Surplus/(Deficit) As a Percent of Total Expenditures
1975-76	$ 519.7		$ 36.9	(7.10%)
1976-77	557.0	$ 11.6		2.08%
1977-78	676.7		8.5	(1.26%)
1978-79	700.6		19.9	(2.84%)
1979-80	777.0		80.9	(10.41%)
1980-81	756.2		115.7	(15.30%)
1981-82	790.2	3.2		0.40%
1982-83	794.9		45.7	(5.75%)
1983-84	819.1		27.3	(3.34%)
1984-85	834.7	47.9		5.74%
1985-86	937.3	58.3		6.22%
1986-87	1,050.4	14.6		1.39%
1987-88	1,088.9	24.4		2.24%
1988-89	1,118.5	6.8		0.61%
1989-90	1,275.8		46.5	(3.65%)
1990-91	1,187.7		105.9	(8.92%)
1991-92	1,151.6		106.1	(9.21%)
1992-93	1,064.8		26.2	(2.46%)
1993-94	1,431.2		53.4	(3.73%)
1994-95	1,140.8	20.0		1.75%

Note: Each year's result is cumulative for all prior years.

Source: Detroit Budget Department.

The Current Condition

After realizing the first surplus in six years in FY95, Detroit adopted a FY96 budget that increased the budgeted number of employees by 627, or 3.5 percent, the first significant increase in a decade. However, the total General Fund dollar increase was a relatively modest 2.6 percent, and, having completed the first three quarters of the fiscal year, the Administration is projecting a year-end surplus of $11.1 million.

Components of the Projected FY96 Surplus.

The net surplus is made up of variances, both plus and minus, from the original budget, as follows:

- State Revenue Sharing is expected to generate a surplus of $14.6 million on an original budget of $303.1 million (+4.8 percent).

- City Income Tax will show a small surplus of $550,000 on an original budget of $327.5 million (+0.17 percent).

- State Equity Grant Funding will show a deficit of $7.5 million on an original budget of $20.16 million (-37 percent). The State's funding formula was substantially revised by the Governor and Legislature during 1995.

- The General Fund subsidy for the mass transit function (D-DOT) will show a deficit of $6.9 million on an original budget of $43.4 million (-15.9 percent). There was a $4.2 million overestimation of farebox revenue, and the Federal operating subsidy has been reduced by 25 percent, causing an additional $2.3 million shortfall.

- Fringe Benefits funding will generate a surplus of $2.1 million on an original budget of approximately $150 million (+1.4 percent).

- A $5.964 million appropriation to pay debt service on a Section 108 loan for the GM "Poletown" project can go to surplus because the City was able to meet that obligation with an accumulation of surplus funds in the GM-TIFA account.

- A $3.0 million appropriation surplus is projected for the Public Lighting Department from the funds budgeted for purchased power from Detroit Edison (+18 percent). About one-third of that amount results from lower unit costs than assumed in the budget. The remaining two-thirds of the savings is due to lower-than-budgeted power usage requirements.

- All other items in the City's $1.2 billion General Fund budget will generate a net $700,000 deficit. It can be concluded that numerous vacant budgeted positions have been offset with higher-than-budgeted amounts of overtime.

An $11.1 million surplus is less than one percent of total General Fund expenditures. In the context of the City's recent financial history, however, back-to-back surpluses are notable. The two revenues most responsive to economic conditions, the Municipal Income Tax and State Revenue Sharing, are showing a combined surplus of $15.2 million indicating that the current condition is less a product of expenditure control than of increased economic activity.

The Proposed Budget for Fiscal Year 1996-97

In the budget proposal for FY97, the Mayor is recommending an overall increase of 10.5 percent in spending, but with a General Fund increase of 4.6 percent. The number of budgeted employee positions is to increase by 136, or 0.7 percent.

Table 2 presents a comparison of the new budget proposal with the last two City budgets.

The Mayor's FY97 budget plan appears capable of achievement if there is no economic downturn. New spending programs are relatively modest, and most are aimed at technology investments which should improve future operating efficiency. Major revenue projections appear to be in line with current economic forecasts.

Significant FY97 Budget Items.

Some of the budget highlights are as follows:

- State Revenue Sharing and the Municipal Income Tax are expected to increase 4.6 percent and 2.5 percent, respectively, over the amounts projected for FY96.

- A proposed $195 million revenue bond issue for Water and

Table 2
City Of Detroit
3-Year Budget Comparison
(in millions)

Appropriations:	1994-95 Budget	1995-96 Budget	Yr. To Yr. Percentage Change	Proposed 1996-97 Budget	Yr. To Yr. Percentage Change	2-Year Percentage Change
Police and Fire Departments	$ 435.4	$ 436.4	0.2%	$ 443.1	1.5%	1.8%
Dept. of Public Works	149.4	180.1	20.5%	183.8	2.1%	23.0%
Public Lighting Department	55.6	57.7	3.8%	57.1	-1.0%	2.7%
Recreation Department	38.5	41.7	8.3%	41.8	0.2%	8.6%
Public Health Department	32.4	30.8	-4.9%	29.7	-3.6%	-8.3%
Transportation Department Subsidy	38.0	43.4	14.2%	57.3	32.0%	50.8%
Finance, Budget, Law, Human Resources, Data and Communications Services Departments	76.3	86.9	13.9%	102.7	18.2%	34.6%
Arts, Civic Center, Historical and Zoological Departments	39.6	40.1	1.3%	40.8	1.7%	3.0%
Mayor's Office	6.1	7.3	19.7%	8.1	11.0%	32.8%
Legislative Branch Agencies	18.2	18.8	3.3%	20.9	11.2%	14.8%
36th District Court	29.9	31.0	3.7%	33.7	8.7%	12.7%
Prior Year's Deficit	63.3	-		-		
Retirement of 1992 Deficit Bonds	82.1	30.6	-62.7%	31.0	1.3%	-62.2%
All Other Operating Departments	25.1	29.5	17.5%	39.7	34.6%	58.2%
Resource Recovery Plant Mortgage Fees	-	49.5	-	47.6	-3.8%	-
Liability Claims & Insurance Premiums	27.5	52.7	91.6%	51.0	-3.2%	85.5%
All Other	54.8	65.6	19.7%	69.3	5.6%	26.5%
TOTAL GENERAL FUND	**$1,172.2**	**$1,202.1**	**2.6%**	**$1,257.6**	**4.6%**	**7.3%**
GENERAL GRANT FUNDS	115.5	145.0	25.5%	139.4	-3.9%	20.7%
EMPLOYMENT & TRAINING FUNDS	31.6	47.9	51.6%	41.0	-14.4%	29.7%
GENERAL CAPITAL FUNDS	34.8	32.7	-6.0%	29.1	-11.0%	-16.4%
ENTERPRISE FUNDS	747.7	622.5	-16.7%	825.6	32.6%	10.4%
DEBT SERVICE FUND	46.7	48.9	4.7%	49.4	1.0%	5.8%
OTHER FUNDS	76.7	82.7	7.8%	69.0	-16.6%	-10.0%
GRAND TOTAL	**$2,225.2**	**$2,181.8**	**-2.0%**	**$2,411.1**	**10.5%**	**8.4%**
BUDGETED EMPLOYEE POSITIONS	**17,797**	**18,424**	**3.5%**	**18,560**	**0.7%**	**4.3%**
Revenues:						
Property Tax - General Fund	$ 120.6	$ 120.5	-0.1%	$ 125.8	4.4%	4.3%
- Debt Service	41.1	44.6	8.5%	45.3	1.6%	10.2%
- Library	13.2	13.1	-0.8%	13.5	3.1%	2.3%
SUB-TOTAL - Property Taxes	$ 174.9	$ 178.2	1.9%	$ 184.6	3.6%	5.5%
City Income Tax	296.3	327.8	10.6%	336.6	2.7%	13.6%
Utility User's tax	52.5	56.3	7.2%	54.7	-2.8%	4.2%
State Revenue Sharing	280.1	303.1	8.2%	332.3	9.6%	18.6%
Sale of Electricity and Steam	48.2	49.7	3.1%	47.4	-4.6%	-1.7%
Parking & Ordinance Fines	17.6	13.4	-23.9%	14.6	9.0%	-17.0%
State Equity Package	20.2	20.2	-	12.6	-37.6%	-37.6%
Enterprise Funds:						
Operating Revenues	415.1	424.5	2.3%	430.5	1.4%	3.7%
Revenue Bond Proceeds	165.0	-	-	185.0	-	12.1%
General Fund Subsidies	38.1	44.7	17.3%	58.8	31.5%	54.3%
Federal Public Housing Grants	73.8	87.6	18.7%	72.7	-17.0%	-1.5%
Mass Transit Grants - State	43.3	45.0	3.9%	46.1	2.4%	6.5%
- Federal	13.9	9.2	-33.8%	5.2	-43.5%	-62.6%
Resource Recovery Plant - Mortgage Reimbursement	-	49.4	-	47.6	-3.6%	-
Community Development Block Grant	59.4	56.6	-4.7%	53.8	-4.9%	-9.4%
Federal Employment & Training Grants	30.0	45.8	52.7%	37.1	-19.0%	23.7%
All Other Federal Funds	79.5	115.6	45.4%	104.4	-9.7%	31.3%
All Other State Funds	73.1	80.3	9.8%	82.9	3.2%	13.4%
Deficit Funding Bond Proceeds	125.0	-	-	-	-	-
Risk Management Fund Reimbursements	-	20.7	-	19.0	-8.2%	-
Prior Year's Surplus	-	9.2	-	5.5	-40.2%	-
All Other Revenue	219.2	244.5	11.5%	279.7	14.4%	27.6%
GRAND TOTAL	$2,225.2	$2,181.8	-2.0%	$2,411.1	10.5%	8.4%

Source: Detroit Budget Department.

- Sewerage is included. This non-repeat item distorts the magnitude of the year-to-year increase in the total budget.
- Funding from the State Equity Grant reflects the $7.5 million (-37 percent) reduction that Detroit experienced in FY96.
- The Mayor is proposing a $3 entry fee for Belle Isle Park to partially offset the revenue loss from State Equity funding cuts. This item has a net revenue value of $3 million. In 1994, this same proposal did not survive City Council's final budget plan.
- The Mayor is proposing a 32 percent increase in the General Fund subsidy to D-DOT. This would represent a 51 percent increase over the last two years. The proposed subsidy of $57.3 million is the equivalent of a 10.5 mill property tax allocation, compared to the 0.33 mills being levied for mass transit throughout much of the balance of the metropolitan area.
- The budget includes a property tax rate decrease of 0.223 mills. This is caused by a $260 million increase in State Equalized Value (SEV). The SEV increase of 4.4 percent is the largest increase in the last 25 years and brings Detroit's total SEV to an all-time high of $6.15 billion. The City's total tax levy will increase by $6.4 million (3.6 percent).
- The budget includes a $10 million new bonding proposal, plus an allocation of $4,495,000 in bond fund interest earnings, to help complete the new Museum of African-American History. Along with earlier appropriations of approximately $23.5 million, the total to date for that project is increased to $38.5 million.
- Total funding for employee pensions is increased in the budget by $11.5 million (+11.9 percent). The Mayor attributes $6 million of the increase to poor investment results by the Pension Boards of Trustees.
- The budget includes a $2.3 million (+3.45 percent) increase in the fee the City pays to dispose of rubbish at the Greater Detroit Resource Recovery Authority (GDRRA) facility. While that increase is significant, it would have been $9.5 million (+14.3 percent) had it not been for savings available to the City from a recent re-financing of the GDRRA plant. The refinancing will save the City an estimated $184 million over the next 13 years.
- The budget proposal makes no provision for any change in the financing of courts. There are current proposals in the State Legislature that would force the cost of Recorder's Court, about $21 million annually, onto Detroit if it is to remain separate from the Wayne County Circuit Court.

Turning to the Future

In many respects, the City of Detroit is at a financial "crossroads" because of the confluence of significant pattern changes, all of which have occurred within the last two years.

First, there has been a change in administrations for the first time in 20 years, heralding the adoption of new policies.

Second, the City has achieved budgetary surplus, which, though small, provides a window of opportunity to develop a more stable, viable, position from which city services can be delivered.

Third, leadership changes in the U.S. Congress and in Michigan state government have spawned numerous efforts to reassess all that governments do, why and how they do it, and to propose new courses for the future.

Of all of the political challenges presented by the changes in Washington, D.C. and in Lansing, one carries with it the greatest significance because of its sheer magnitude. State Revenue Sharing supports over 25 percent of Detroit's General Fund budget. Various proposals to change that program are being actively debated.

State Revenue Sharing

In 1971, Michigan adopted the State Revenue Sharing Act. Its purpose was to create a better distribution of state revenue than the "straight population" formula used up to that time. What was being sought was a measurement of "need." Cities suffering economic decline such as Detroit, Highland Park, Hamtramck, Benton Harbor, and Flint, had reacted to such decline by raising local taxes in order to maintain service levels. It was felt that local tax increases simply aggravated the core problem and induced additional out-migration.

The State's "relative tax effort" (RTE) formula for distributing single business tax and state income tax funds was designed to stem the cycle of decline/tax increase/further decline. The Act provided that cities which taxed themselves the most, relative to their wealth, as measured by state equalized value (SEV), would receive a proportionally greater share of the funding. The base of the RTE calculation includes the local property tax, resident (but not non-resident) local income tax, and utility users' tax, divided by SEV.

State Revenue Sharing has become the second largest item of Detroit General Fund revenue (after the city income tax), at $303.1 million in FY96 because Detroit levies local taxes at a rate more than seven times greater than the average Michigan community. In FY95, Detroit's non-school, RTE millage was 92.15 mills,

Rainy Day Fund

In 1979, following the passage of enabling State legislation, Detroit created the Budget Stabilization Reserve Fund, commonly referred to as the "Rainy Day Fund".

The purpose of the fund is to provide a reserve of resources to support more stable service levels during an economic downturn, when City revenues decline, or do not match increases in costs. The Fund receives one-half of any year-end operating surplus. More than one-half of a surplus, up to the entire amount of the surplus, can be deposited in the Fund, with a two-thirds vote of City Council. In Detroit, there has never been an instance in which more than half of a surplus has been reserved. State law forbids including an appropriation in the regular operating budget of a locality for increasing such a reserve fund, on the belief that such a provision could provide an opportunity to levy higher taxes than are necessary.

Detroit's Rainy Day Fund permits withdrawals from the Fund for any of three specific purposes:

1. To cover a General Fund deficit.
2. To cover expenses arising because of a natural disaster.
3. To restore a reduction in the number of employees, when in a subsequent year's budget preparation, revenues are insufficient to retain all positions that have been included in the last three annual budgets. (A maximum of 25 percent of the Fund's balance can be used in this instance.)

There is a $1 million minimum for any withdrawal.

At the end of FY90, Detroit achieved its historic high mark for its Rainy Day Fund balance, at $76 million. This represented about 6 percent of the General Fund spending level at that time. Five consecutive surpluses had created the $76 million balance. It was exhausted in the two succeeding fiscal years.

Today, after two successive surpluses, there will be a $15.5 million balance in the Rainy Day Fund, assuming the FY96 final audit verifies the $11.1 million projected surplus. That is approximately 1.25 percent of the $1.25 billion General Fund expenditures projected in the FY97 budget proposal. City statutes limit the Rainy Day Fund balance to a maximum of 15 percent of the General Fund budget. Such a level does not appear excessive, given the rapid dissipation of this Fund's 6 percent balance in the 1991-92 economic downturn. Currently, the State of Michigan has a balance of about $1 billion in its Rainy Day Fund. This represents about 12 percent of the State's General Fund/General Purpose annual outlay.

The true purpose of a Rainy Day Fund is to permit a government to adjust to a downturn in revenues in an orderly fashion. Spending, however, should not be allowed to continue at pre-downturn levels. Any plan to use Rainy Day Fund reserves should come only after the adoption of expenditure containment measures.

compared with the statewide average of 12.78 mills, giving Detroit an RTE of 7.21049.

If the RTE formula is scrapped in favor of a return to "straight population" sharing, Detroit would lose about $160 million in annual revenue. To make up that deficiency in local taxes would require the equivalent of over 30.5 mills in additional property tax, an amount that is one and one-half times larger than Detroit's entire General Fund, 20 mill, levy. Of course, such a rate is illegal, but it demonstrates the difficulty that would be faced by the City in accommodating to a revenue loss of that magnitude.

Maintaining Future Fiscal Stability

At least two areas of concern for Detroit's fiscal future are paramount, and should be addressed:

A - Controlling City Costs.

Achieving sustainable fiscal balance will require attention to the level of city expenditures, which remains high relative to other large cities. The following should be examined to determine their potential for containing city costs:

1. Modified Service Delivery - Privatization of some services should be explored. Until now the City has treated such a possibility as "taboo". New labor contracts the City has entered into, and are binding through June 30, 1998, continue to include language which makes privatization almost impossible. The successful experience of many other jurisdictions with privatization should not be ignored.
2. Serious study should also be given to the "spread" of City services. In many instances, Detroit is trying to operate as many service locations, sometimes even more, than when the City's population and the City workforce were 40 percent larger than they are today.
3. Detroit is unique among America's large cities in supporting mass transit from its General Fund. Elimination of this burden ($57.3 million, or the equivalent of 10.5 mills of property tax in FY97) could translate into additional budgetary stability, or a reduction in Detroit's inordinate tax burden, which would, in turn, stimulate longer-term economic growth.
4. Detroit must continue to target much of its "technology investment" on revenue collection efficiency. Delinquent property taxes typically represent over 10 percent of the Detroit property tax levy. All such revenue, if collected, would help eliminate budgetary problems.
5. The Mayor has proposed the adoption of a defined contribution pension plan for city employees. Such a plan would, over the long-run, make retirement costs more stable and predictable. For many years into the future, however, the existing defined benefit plans will continue to determine the level of funding for retirement benefits. The Detroit Charter Revision Commission has sent to the Governor for approval a proposed charter that would end the practice of using so-called "excess earnings" (earnings exceeding actuarially assumed amounts) to increase compensation to active employees and to provide additional benefits to retirees. Actuarial losses, however, are absorbed by the taxpayers. If adopted, such a provision would help the City to meet future financial demands. (It is anticipated that the proposed charter will appear on the August 6, 1996, ballot.)

B - Improving the Local Tax Base.

1. The erosion of Detroit's economic and tax base over the last forty years may have come to a halt, but the tax base, adjusted for inflation, is still far smaller than it was in the 1950s. Past policies for economic development, while they may have scored some successes with individual projects, failed to stem the overall decline in the City's tax base. The challenge now facing the City is to develop a comprehensive set of development policies that will address all elements of the economic infrastructure, large and small, and will

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endure over the long haul.

2. Local Tax Restructuring - This must be a prime element of any long-range development strategy. Detroit's taxes are higher than other jurisdictions in the state and region and are higher than most large cities in the United States. The tax structure in Detroit needs to be examined in terms of both its level and its composition with an eye toward improving the competitiveness of the city.

Conclusion

Detroit is at a crossroads. It has a new mayor with new approaches. It may be emerging, albeit marginally, from a long period of successive annual deficits. It is faced with a new political scenario in both Lansing and Washington.

The City can do relatively little about changing priorities in Lansing or Washington. It can, however, move to reduce spending, which, despite the weak tax base, remains high on a per capita basis. A thorough review of City priorities, services, and methods of delivering those services would be a first step toward bringing the provision of services in line with the ability of the City to reasonably finance those services.

Should this effort be successful, an assessment of the level of revenues required to support those services can be made with an eye toward developing governmental structures and policies that will not impede economic development.

This analysis was prepared for the Citizens Research Council of Michigan by Edward G. Rago, former budget director, City of Detroit. CRC accepts responsibility for the material contained in this *Memorandum*.