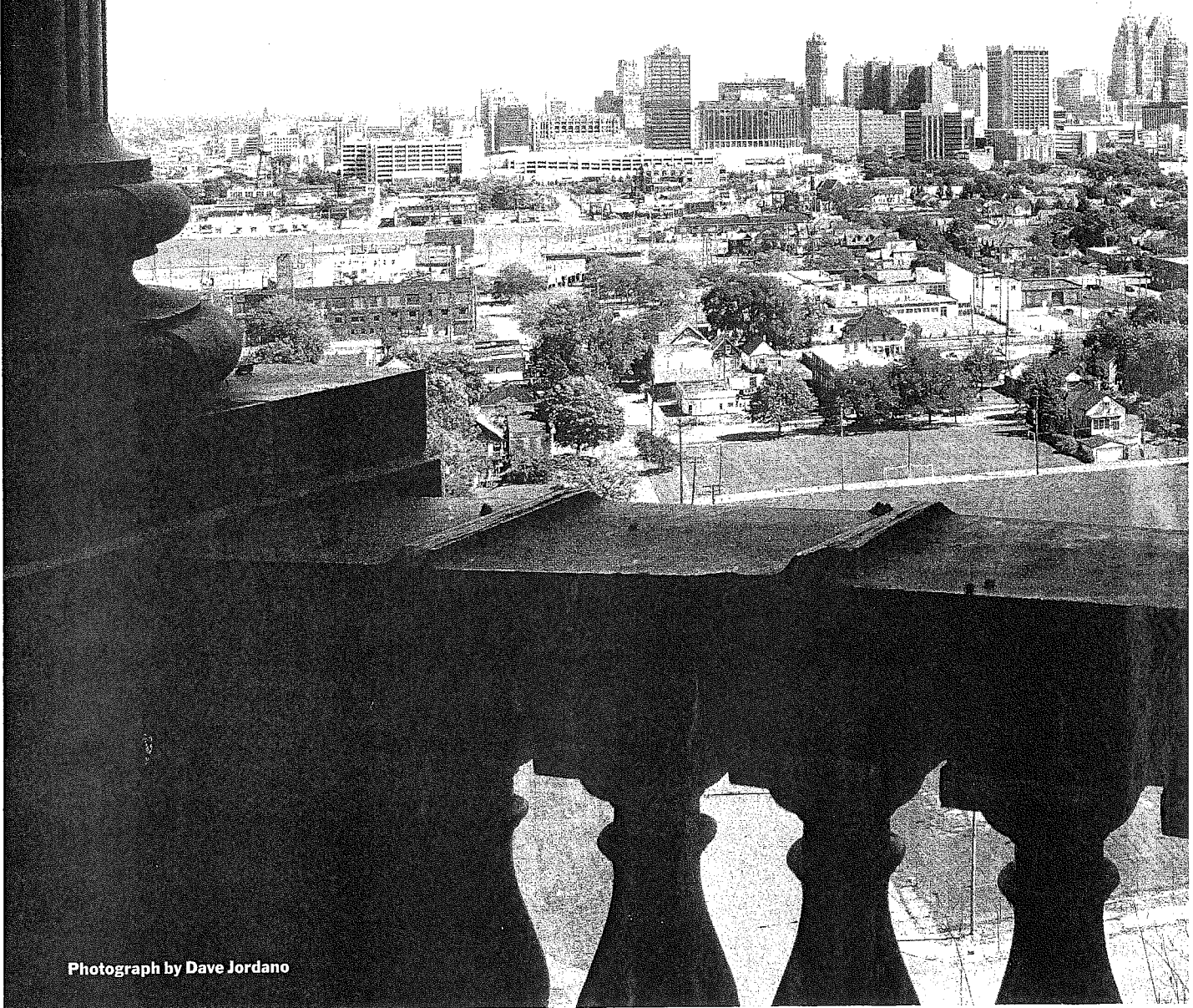


ECONOMY

# BROKEN

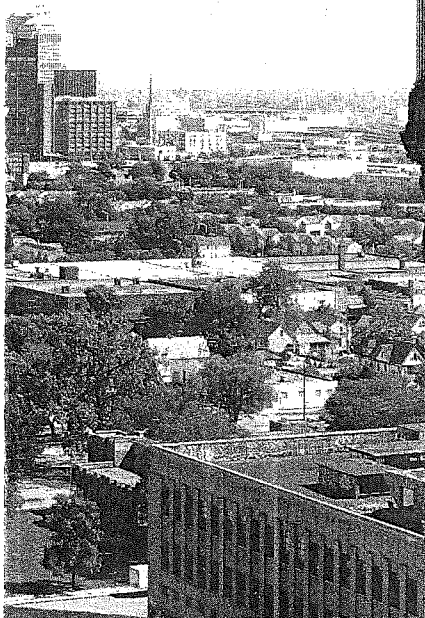
HOW DETROIT'S EPIC  
BANKRUPTCY COULD HELP THE  
REST OF THE COUNTRY

BY RANA FOROOHAR



Photograph by Dave Jordano

# CITY



► The Detroit skyline  
from the top floor of the  
abandoned Michigan  
Central Station train depot



► Firefighters take a break after putting out a blaze on Detroit's east side. Home to more than 80,000 abandoned buildings, the city averages 14 arsons a day. Fire-department budgets have been slashed and wages cut, and a third of the city's fire companies were shut down in the past year. With the bankruptcy filing, firefighters worry that their pensions will go up in smoke too

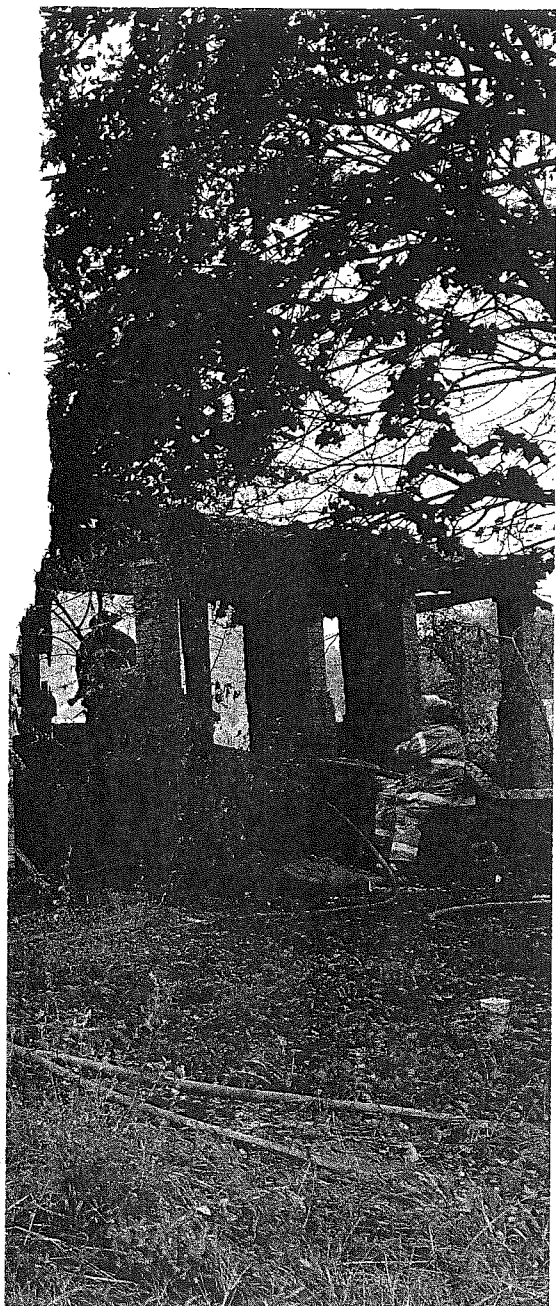


**T**HE LIGHTS HAVE GONE OUT IN DETROIT, literally. Forty percent of the streetlights don't work, since there isn't enough money to keep them on, or up, in a city that some 60 years ago was the richest in the country and perhaps the world. But that was another time, when the city's manufacturing might powered the Arsenal of Democracy and its factories turned out the cars that shaped the map of modern America. That was before the riots, the white flight, the corruption and the decay that has left entire neighborhoods looking like ruins. That was before the auto industry fell on hard

times, came back, then fell on hard times again, and then came back again. The 2009 bailouts may have revived the carmakers, but they haven't saved the city.

So now Detroit has acquired bragging rights that make it the envy of no one. By declaring bankruptcy on July 18, it became the largest ever municipal failure in the U.S. As Kevyn Orr, the bankruptcy lawyer who was brought in by Michigan Governor Rick Snyder to handle the default and its aftermath, put it, the Motor City is "clearly insolvent." Detroit faces a \$162 million budget shortfall this year alone. Creditors—including big-name investors and

DAVE JORDANO



pension funds—are already knocking at the door, waiting to see who will get paid first, or at all. Public workers are bracing for pension cuts that may leave their retirement plans in ruins. Residents can look for taxes to go up even as services continue to decline. There's talk of auctioning off prize works from the Detroit Institute of Arts to pay for more ambulances. Downtown businesses are being asked to pay for their own security patrols since so many police have been laid off.

But there is a bright side to all this, unbelievable as that might sound. Detroit's pain is unavoidable if the city is to save itself—and it may ultimately

help save other cities too. That's because America's cities desperately need a wake-up call to fix their finances. Though nearly everyone agrees that Detroit is in particularly bad shape, many of its underlying issues—crushing debt and unfunded and unsustainable retiree benefits—are not unique. Since 2011, areas including Jefferson County, Alabama, and such California cities as Stockton and San Bernardino have been forced to declare bankruptcy.

Those legacy costs are at the heart of what many experts believe is a coming municipal-finance crisis in the U.S. A worst-case scenario comes from banking analyst Meredith Whitney, who famously predicted the financial crisis in 2007: a chain reaction of dozens of big cities going bust. It's not a crisis of the Lehman Brothers sort—the \$2.9 trillion municipal-bond market is half the size of the corporate market and one-sixth that of the U.S. equity market. But while few will go as far as Whitney in forecasting an epidemic of defaults, most believe that further credit downgrades are likely—which will raise borrowing costs for cities and dig them deeper into the debt hole. Chicago was just downgraded, and the big ratings agency Fitch is considering a broader re-evaluation of local-government debt on the basis of the situation in Detroit.

But city finances are not the same thing as city economies. In much of the country, unemployment is ticking down, tax receipts are up, and the property market, a huge generator of local income, is starting to recover. Detroit is going bankrupt at a time when it actually has a viable plan for growth, under the leadership of Mayor Dave Bing, with businesses relocating downtown, riverfront areas being redeveloped and medical facilities expanding. Chicago is at the forefront of some of the country's most innovative experiments in education reform, private-public partnerships and alternative-energy investment. Meanwhile, other cities are thinking and working outside the box, from Providence, R.I. (crafting compromises with public employees to reduce long-term liabilities), to Miami (funding infrastructure projects with private consortiums instead of public debt). "Cities are starting to take control of their economic future," says Bruce Katz, director of the Brookings Institution's Metropolitan Policy Program and author of the recent book *The Metropolitan Revolution*, which looks at a coming shift in regional growth models. "They aren't waiting for Washington."

It may not be much consolation to the people of Detroit or the other cities that must get their finances in order. Battles are already under way to decide if bankruptcy will allow Detroit to escape its pension commitments and turn away creditors. Promises, it must be said, will be broken; the questions now are which ones and how badly. And everyone is watching: "If Detroit manages to wiggle out of its pension liabilities, then other cities may start to think bankruptcy isn't a bad idea," says Paul Dales, senior U.S. economist at Capital Economics. On the other hand, if Detroit's bankruptcy results

## MOTOR CITY MELTDOWN

SINCE 1950,  
DETROIT'S  
POPULATION HAS  
FALLEN 63%,  
WHILE ITS PUBLIC  
WORKFORCE  
HAS FALLEN 40%,  
INCREASING  
PRESSURE ON  
PUBLIC FINANCES

40%

PERCENTAGE OF  
STREETLIGHTS THAT  
DON'T WORK; LESS  
THAN TWO-THIRDS  
OF THE BUSES RUN  
ON TIME

78,000  
STRUCTURES AND  
6,000 LOTS  
ARE ABANDONED

**\$25,193**

MEDIAN HOUSEHOLD  
INCOME IN 2011,  
THE LOWEST AMONG  
THE 30 LARGEST  
U.S. CITIES

SOURCES: PEW CENTER ON  
THE STATES; BLACKROCK;  
TRANSPORTATION RIDERS UNITED

## CITY LIMITS



GOVERNMENT CONTRIBUTIONS TO STATE AND LOCAL PENSION PLANS MORE THAN DOUBLED IN THE PAST TWO DECADES, UP TO \$96 BILLION IN 2011

IN 2010, STATE AID AND PROPERTY TAXES—WHICH ACCOUNT FOR OVER HALF OF LOCAL REVENUE IN THE U.S.—SHRANK TOGETHER FOR THE FIRST TIME SINCE 1980

# 500,000

JOB'S ELIMINATED BY LOCAL GOVERNMENTS FROM 2008 TO 2011

SOURCES: PEW CENTER ON THE STATES; U.S. CENSUS BUREAU

in years of court battles without clear winners, other cities may find settlement and compromise a more appealing prospect than default.

Either way, Detroit is making it impossible to ignore the financial issues holding cities back, and that can help everyone. "You don't have a Sputnik moment without some sort of very visible catalyst," says Mohamed El-Erian, CEO of Pimco, the world's largest bond-investment company. "Detroit could be it for America's cities."

### Extreme Failure

IT MUST BE SAID THAT DETROIT IS SINGULAR AMONG large U.S. cities in terms of its extreme combination of continual, precipitous decline, civic mismanagement, corruption and systemic labor issues. Most big cities have those issues, but few have had so many for so long. They have contributed to a massive population exodus (Detroit went from 1.85 million residents in 1950 to an estimated 701,475 today), making it nearly impossible for the Motor City to jump-start growth. Half the city's property owners don't pay taxes, according to the *Detroit News*, some because they've simply abandoned their still underwater homes. Too few can afford to buy, even at rock-bottom prices, since unemployment has tripled since 2000.

For many residents, safety is a more pressing concern than housing. The homicide rate is the highest it's been in nearly 40 years. The police officers who are still on the payroll take an average of 58 minutes to answer calls, compared with 11 minutes nationally. Only a third of the city's ambulances still function. It's hard to feel secure when your house is surrounded by vacant lots.

Now comes the bankruptcy. Generally speaking, bankruptcy is a way for an individual, company or even government entity to solve the problem of having fallen so far into debt that it looks impossible to get out or even to continue paying everyone who is owed money. In bankruptcy proceedings, some of those creditors may get most or all of what they're owed, others may get some and still others may get nothing.

Municipal bankruptcies are an especially tricky business because they involve federal, state and local laws, some of which conflict. For starters, federal law states that in such defaults, secured creditors (typically big-name investors who hold general-obligation bonds) get paid first. Pensioners typically get whatever is left, and possibly zero. But Detroit is hoping to use bankruptcy to treat its general-obligation creditors as unsecured—meaning investors who thought they were guaranteed money might not get to collect as much as they expected. While that may or may not be legal, a lot of people feel it's fair to spread the pain around. "Public employees didn't cause these problems. Politicians making unfunded promises did," says David Crane, a onetime economic adviser to former California governor Arnold Schwarzenegger and now a lecturer at Stanford. "Yet employees are often the ones who suffer."

### FRESNO

BUDGET SHORTFALL \$4.2 MILLION

The city was hit hard by the housing downturn and the recession. General-fund revenue declined 16% from 2008 to 2010, led by double-digit drops in property and sales taxes, the city's two largest revenue sources. It still suffers from high unemployment.

78%

PENSION FUNDING LEVEL

+16%

POPULATION CHANGE 2000-11

12%

UNEMPLOYMENT RATE

### NORTH LAS VEGAS

BUDGET DEFICIT \$18.8 MILLION

Real estate and tourism suffered during the housing and financial crises. The city, Las Vegas' poorer cousin, is now in its second year of a state of emergency, reflected in its recent credit-rating downgrade. Among its challenges are a sharp drop in revenue and an inability to renegotiate costly contracts with its four labor unions.

64%

PENSION FUNDING LEVEL

+86%

POPULATION CHANGE 2000-11

11%

UNEMPLOYMENT RATE

That's just what Susan Hyter is afraid of. Hyter, 65, drives street sweepers and salt trucks for Detroit's department of public works. "It's devastating to work and think you're going to have a pension and be told you're not going to have one, or maybe three-quarters of one," she says. She worries that damage to her pension is inevitable—as is the disruption of her retirement plans. "I'd rather use my retired life to volunteer and help people, but right now I'm thinking about getting a job at McDonald's."

But while it's painful—and sometimes tragic—for workers to contemplate benefit cuts, it is far from clear that labor unions serve their members best by

## DETROIT

DEBT OBLIGATIONS \$18.5 BILLION

The largest city ever to file for bankruptcy, the Motor City faces problems stemming from \$3.5 billion in pension liabilities for municipal retirees, who far outnumber the city's current workforce. Detroit's dwindling tax base offers little relief; its population is less than half of what it was in 1970.

83%

PENSION  
FUNDING  
LEVEL

-25%

POPULATION  
CHANGE,  
2000-11

18%

UNEMPLOYMENT  
RATE

## PHILADELPHIA

DEBT OBLIGATIONS \$9 BILLION

For several years Philadelphia has battled a lingering pension problem. With a high rate of property-tax delinquencies, among other revenue challenges, the city is left with a hefty \$9.8 billion tab in future retirement liabilities that are seriously underfunded.

46%

PENSION  
FUNDING  
LEVEL

+1%

POPULATION  
CHANGE,  
2000-11

11%

UNEMPLOYMENT  
RATE

## BIRMINGHAM

BUDGET DEFICIT \$30 MILLION

Jefferson County (home to Birmingham) declared the then biggest municipal bankruptcy in 2011 after failing to settle a \$3.14 billion sewer-system debt with creditors—a project that sent 17 people to prison. In June the county announced a plan to sell \$1.89 billion of debt.

81%

PENSION  
FUNDING  
LEVEL

+12%

POPULATION  
CHANGE,  
2000-11

6%

UNEMPLOYMENT  
RATE

## NEW ORLEANS

DEBT OBLIGATIONS \$1.9 BILLION

Though New Orleans' debt is investment-grade, the city has suffered from infrastructure and pension issues since Katrina. After the 2005 hurricane, New Orleans fired nearly half its workforce. By 2010, it had \$855 million in unfunded pensions. Today, just 2,300 city employees remain on the payroll.

61%

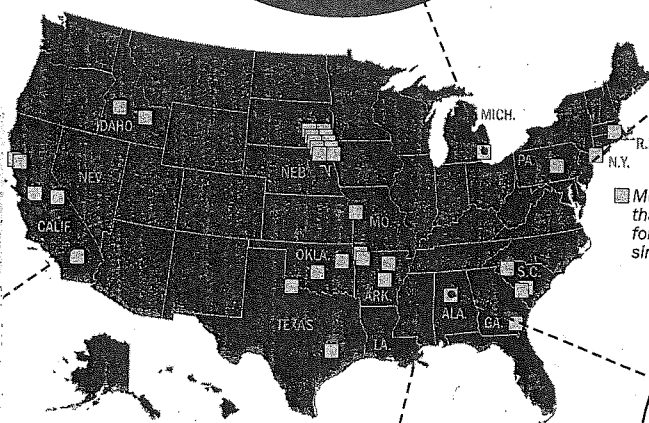
PENSION  
FUNDING  
LEVEL

-25%

POPULATION  
CHANGE,  
2000-11

7%

UNEMPLOYMENT  
RATE



Municipalities  
that have filed  
for bankruptcy  
since 2010

## TOUGH SPOTS

Despite an improving economy, many cities are hampered by shrinking tax revenue, expensive pension commitments to retirees and excessive debt. And though few big names are considered in danger of defaulting, that doesn't minimize the financial challenges. Here's a look at how some cities are faring.

# 36

NUMBER OF  
MUNICIPAL  
BANKRUPTCY  
FILINGS SINCE 2010;  
THESE INCLUDE  
CITIES, TOWNS,  
COUNTIES AND  
UTILITY AUTHORITIES

SOURCES: PEW CENTER  
ON THE STATES; U.S.  
CENSUS BUREAU;  
BUREAU OF LABOR  
STATISTICS

taking a hard line. Pension funds in Detroit have launched lawsuits to try to prevent the city from declaring bankruptcy and restructuring \$3.5 billion worth of unfunded pension contracts, written in far flusher times and assuming returns that were never all that realistic to begin with (8%). It's true that Michigan's constitution has provisions protecting public-worker pensions, but all the magical thinking in the world won't change the fact that barring a federal bailout, making Detroit's budget work without restructuring entitlements is a losing battle—and a dying city is in no position to pay anyone. Detroit, said Governor Snyder in a July 18

statement, must lay the foundation for future growth and make a "fresh start" without "burdens of debt it cannot hope to repay."

### Better Economies, Bad Finances

IN MANY WAYS, WHAT'S HAPPENING IN DETROIT AND other beleaguered American cities is a microcosm of our national situation. Just as the dysfunction in Washington doesn't characterize the entire U.S. economy, broken city governments and pension systems don't necessarily define the economic fortunes of cities themselves. At a national level, if you stripped government out of the economy,

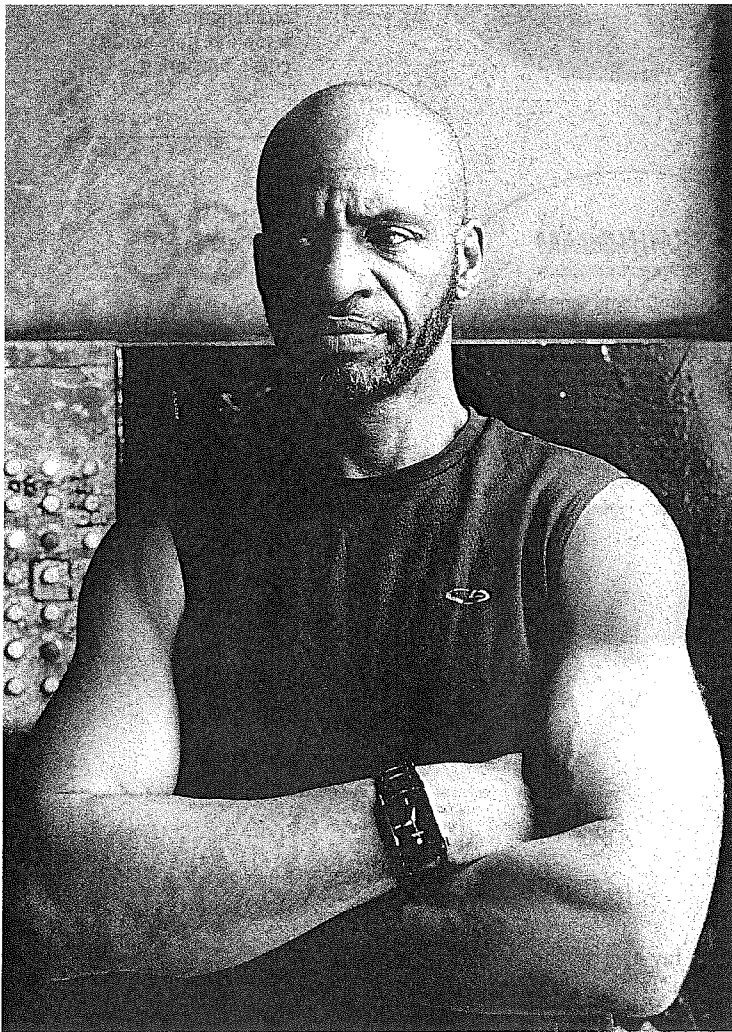


we'd already be at 3% growth rather than 2%. The private sector is in an increasingly robust recovery, and while second-quarter GDP figures are likely to be somewhat weak, many analysts are predicting a good rest of the year for areas like housing, construction, manufacturing and some parts of the retail sector. Meanwhile, government at all levels is still shrinking and cutting, creating a headwind for the overall economy.

Likewise, the federal-deficit conversation has always been flawed: the U.S. doesn't have a debt problem so much as it has a long-term entitlement problem. The same is true for many cities; Detroit,

Chicago, Philadelphia and Portland, Ore., may have unsustainable public finances, but they also have interesting strategies for growth. "City governments don't equal city economies," says Brookings' Katz. "It's possible to have unsustainable city budgets and dysfunctional politics and very exciting regional growth prospects and all of those trends happening at once."

Perhaps no city illustrates that better than Chicago. Its pension liabilities are actually far higher than Detroit's, while its economy is nearly three times as large and unemployment a third lower. But unions have made it difficult even to craft a



## DETROIT'S PUBLIC WORKERS

### ► THE TRADESMAN

An 18-year veteran of the water-and-sewerage department, Alvin Coleman, 50, says he's "reasonably optimistic" that most of his already-earned pension will be there when he retires. But he fears for residents who are unskilled. "If somehow I lose my job, I can still grab my tools and get paid somewhere," he says. "I'm not worried."



### ► THE OFFICE ASSISTANT

As Detroit inched closer to bankruptcy, Anita Lopp, 53, says stress over her job at the Detroit police department triggered anxiety attacks and insomnia. Lopp's income has dropped 30% since 2011. "My pension is threatened, and I might lose my job," she says. "I thought I could work for the city forever."

plan for pension reform, let alone come up with a deal. Chicago had its credit downgraded the day before Detroit declared bankruptcy, an event that "was an alarm bell to everyone in the state, and should be to everyone around the country," says Illinois Governor Pat Quinn, who is trying to force the Illinois legislature to enact pension reform by refusing to take his own salary and refusing to pay theirs until they come up with a solution.

To ward off any damage to the city's reputation, Chicago Mayor Rahm Emanuel, who has waged his own wars for pension reform, quickly went into marketing mode. He hosted a tour for

investors just days after the downgrade to assure them of Chicago's growth prospects. Emanuel's handlers sent out lists of the major companies that have relocated to the city during his term—an impressive club that includes the likes of Motorola, Google, Nokia, ThyssenKrupp and other blue chips—and recited the mayor's many growth-spurring successes, from launching a new raft of six-year high school–community-college schools in conjunction with IBM to revamping energy policy to luring private investors to fund things like a \$500 million port project that is expecting to create 1,000 jobs. Yet everything that



#### ► THE BUS REPAIRMAN

After 19 years with the department of transportation, Dwayne Robinson says the city's public employees have minimal career opportunities if they lose their jobs. "For us Detroiters, there's not enough options," he says. "I'm 54 years old. My clock-punching days are over. I'd have to go in business for myself, if anything."



#### ► THE PARK-MAINTENANCE ASSISTANT

Yolanda Wyche has worked for the city for seven years and thinks her job will be eliminated before she earns a pension. She says her pay is down 20% in recent years. "At this point, I don't even know if the department will be around," Wyche says. She's considering leaving Detroit for better opportunities.



## DIRE STATES

74.1%

THE AVERAGE FUNDING PERCENTAGE FOR PUBLIC RETIREMENT PLANS ACROSS THE U.S. IN 2012, BASED ON A SAMPLING OF 126 MAJOR STATE AND LOCAL PLANS. THAT'S A PER-CITIZEN UNFUNDED LIABILITY OF \$2,882.

THE RATIO OF CURRENT CONTRIBUTORS TO BENEFICIARIES OF STATE-ADMINISTERED PUBLIC PENSION SYSTEMS HAS NEARLY HALVED.

1970-1980



2000-2010

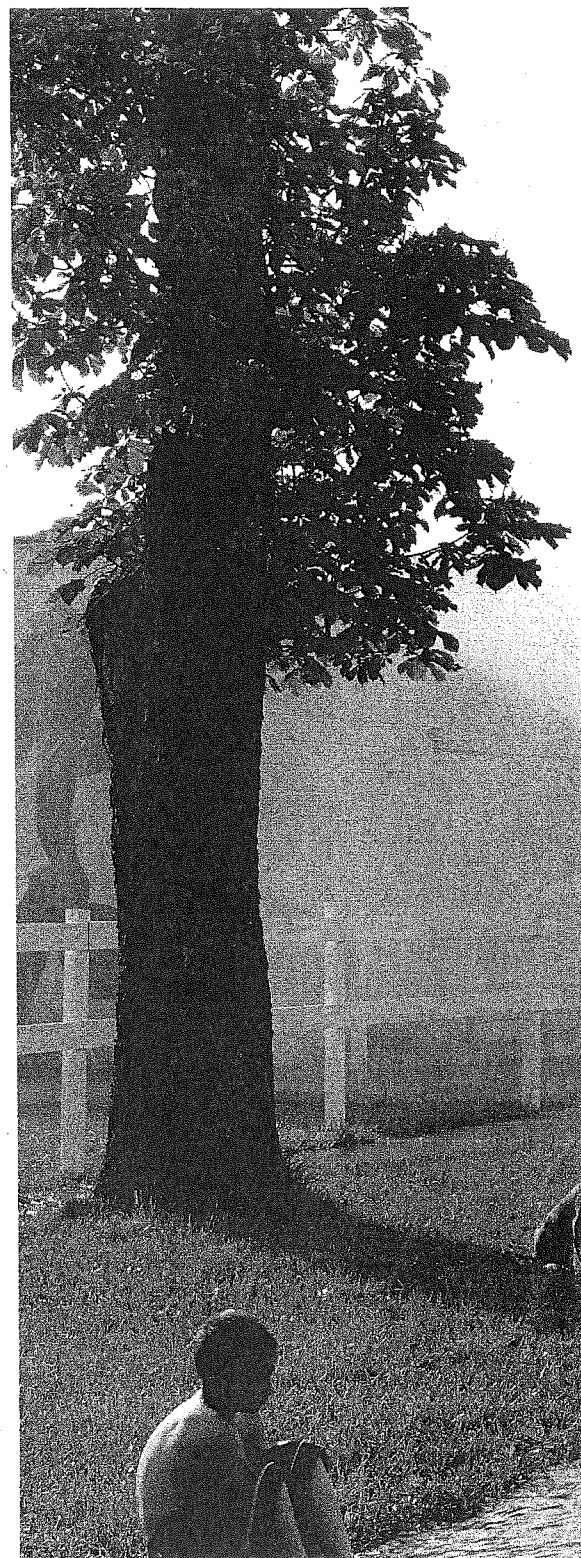


the city has done to try to reboot growth and diversify its economy for a new era “will go out the window,” as the mayor once put it, if Chicago can’t fix its pension crisis. On the current trajectory, even with stronger growth, pension payments would represent 22% of the city’s budget in four years—an amount equal to the entire salary of the police force, 10 new high schools or the resurfacing of 32,000 blocks. “Our taxpayers and residents should not be asked to choose between pension payments and public safety... or pension payments and public health,” said Emanuel in a speech last year.

### Trade-Off City

BUT THOSE ARE THE CHOICES THAT CITIZENS ALL over the country are being asked to make and will continue to have to make before the municipal crisis is over. You can bet that some of the battles are going to get ugly. Two years on from its bankruptcy declaration, Stockton, Calif., is still fighting with creditors to get them to accept lower payments, creating a toxic political environment that makes it hard to focus on new growth ideas. Pension battles also rage on in San Jose, Calif., which is trying to avoid bankruptcy. Internationally, there are even more-extreme case studies, like Argentina, which is fighting bondholders 12 years on from a sovereign-debt default that has saddled the country with permanently higher borrowing costs. And don’t forget Europe, where Cypriots took to the streets to overturn debt restructurings that would have penalized taxpayers over banks and where Greeks continue to rage over German-imposed austerity measures that are a cost of their own debt forgiveness.

It’s unlikely to get that bad anywhere in the U.S., even in Detroit. But the fall of this iconic city will bring many changes in the way local governments function and cities grow. While the broader rerating of municipal debt that’s very likely to happen down the pike would increase borrowing costs and reduce the amount of money all cities can raise through bond issuance, it might also prompt many to shift their growth models, rein in unsustainable labor costs and partner in more innovative ways with the private sector (which still has \$2 trillion in cash on its balance sheets) in areas like education and infrastructure at a time when federal help is less forthcoming. In the short term, the uncertainty factor is huge. As one judge in Detroit described the unknowns in a bankruptcy of unprecedented scale, “It’s like a stream you’re trying to cross. Each step will have to be taken very carefully, like putting your feet on stones, one at a time.” But it’s worth it to get to the other side. At the very least, Detroit’s bankruptcy should lead to an era in which a once great American city can put the lights back on and see its way to a new kind of future. —WITH REPORTING BY MARY M. CHAPMAN AND DORON P. LEVIN/DETROIT AND ELIANA DOCKTERMAN AND CLAIRE MANIBOG/NEW YORK



SOURCES: STATE BUDGET CRISIS TASK FORCE; U.S. CENSUS BUREAU

### Broken City Discussion Questions

1. What city in the United States was the richest 60 years ago?
2. How has the car industry impacted Detroit's current financial situation?
3. On July 18, 2013, which American city declared bankruptcy?
4. Who does Detroit owe money to?
5. Banking analyst Meredith Whitney predicted a coming crisis in 2007. What was her prediction?
6. Why are city finances different than city economies?
7. Why is it said that bankruptcy is related to promises?
8. Why is Detroit a case of extreme failure?
9. How does bankruptcy impact residences of a city?
10. Why are municipal bankruptcies an especially tricky business?
11. Why are Fresno and North Las Vegas in such financial turmoil?
12. Why is Philadelphia facing economic turmoil?

13. Why are pensions in Detroit so difficult to pay?
14. Why do some say that the USA doesn't have a debt problem but rather a long term entitlement problem?
15. What kind of financial future is Chicago facing? How has Chicago planned for facing its future?
16. Stockton, California tried to fix its finances but is still having trouble. Why?