Infomail

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A Tale of Two Cities

"If you don't know where you are going, you'll end up somewhere else."
NY Yankee Great Yogi Berra

In 1997, the USA passed the Community Reinvestment Act (CRA), with the intention to prohibit interstate banking of those banks that were not making credit available in local communities. The law didn't make much of an impact and had little oversight. Until the Clinton administration took over.

Every President likes to point to greater home ownership as a sign of success.

In 1995, Bill Clinton began toying with the CRA by revamping the process and revving up intimidation. When the Department of Housing and Urban Development (HUD) directed Fannie Mae and Freddie Mac to buy loans riskier than their original charters intended, the bubble began to inflate. By 2001 the industry came up with creative ways to monetize these loans that saw down payments drift to as low as 3%, and eventually, zero money down, to even "money back" programs.

The housing run from 2001 to 2007 was amazing. Home prices swelled and soon everyone was not just owning a home but actually "flipping" them to make money. It was a wonderful time in real estate. It would never have been possible without the Federal government forcing banks to make high risk loans.

There is plenty of evidence that traces the housing bubble to the CRA, and the Clinton administration which made it high octane, reenergized it, and then enjoyed by George Bush who watched home ownership reach all-time levels.

The ultimate "Frankenstein" mortgage monster allowed Fannie Mae and Freddy Mac to make subprime loans 50% of their purchases, even though their failure rate was significantly higher than other loans.

The average new home size in the USA reflected this as well:

1973 – 1660 sq. feet
1980 – 1740 sq. feet
1985 – 1785 sq. feet

1990 – 2100 sq. feet
1995 – 2266 sq. feet
2000 – 2434 sq. feet
2005 – 2521 sq. feet
2010 – 2392 sq. feet
2013 – 2150 sq. feet
(Source: The Gartman Report Feb 27, 2013)

Two cities which are poster children for the boom and bust are Detroit and Buffalo.

Last week, David Bing, former NBA star, and a successful businessman after his basketball career, announced he is not seeking a second term as the Mayor of Detroit. It points to what has become, in the eyes of many, a hopeless situation. The state of Michigan has taken over the city, and at this point seems like some form of bankruptcy is in the offing.

The story of Detroit should be followed closely because of the economic and moral implications. The city is still spending money it doesn't have and now must also find ways to pay its massive deficit.

As of June 30, 2013 (Projected)

$326.6 million unrestricted deficit
<u>$60.0 million added between now and June 30th</u>
$386.6 million

It is estimated $247 million in property taxes and fees went uncollected in 2012 from more than 150,000 homeowners (47%), mostly out of defiance. Why pay taxes for services that stopped a long time ago? Parts of Detroit are now in ruin.

Detroit was the manufacturing marvel of the world for quite a long time. In what was a very productive city, complacency and green set in, as power shifted towards unions in industry which constantly fought with management on how to divide up the spoils. At the same time, in a scenario which played out in scores of formerly prosperous cities, the shift from balanced government to Democrats in complete control. Don't believe me? The last Republican mayor of Detroit was Louis Miriani, from 1957 to 1962.

Detroit peaked in 1964.

Since then:

- The population has gone from 1.7 million in 1960 to 800,000 and falling
- 40% of the street lights don't work
- 47% of the citizens are functionally illiterate, the drop out rate is 20%
- Detroit is #2 in the USA for violent crime (2012)
- A mistress of former mayor still owes the city $85,000

(Source: Wall Street Strategies Dec 7, 2012)

The growing belief of entitlement that simply being born in America should replace working hard, achieving and making sacrifices will fail if people taking out of the pot seem to think those actually putting into the pot actually owe them.

In my modest opinion, Detroit is a disaster, a man made disaster, but it's not the only one.

Growing up in Niagara in the late 1960's and 1970's I can recall countless trips over the "Peace Bridge" to Buffalo. The closest "big City" to us, all lit up, a quintessential manufacturing city which was bustling, and whose most famous citizen was OJ Simpson, then more known for being a great running back.

Yes Buffalo was bustling, until is busted.

What broke Buffalo? High and constantly rising taxes and projects the market didn't want nor need. They spent over $500 million on a 6.2 mile light rail transportation system downtown (That's roughly $80+ million per mile). Buffalo has always been one of the highest taxed municipalities in the USA. According to the Cato Institute, the average resident of Buffalo pays 25% more in income taxes than the average US resident in America's largest metro areas.

Buffalo's problems are made worse by the fact it is in New York state, another Democratic stronghold, and one of the worst states in the nation to start or run a business.

So what is the solution if these cities are to have any chance of surviving and turning around?

They could follow New Zealand's lead where twenty years ago, the IMF recommended it cut spending and raise taxes. Instead New Zealand chose to CUT taxes aggressively and cut them again, and then again…each time taking in more tax revenue than the year before, eventually turning the economy, and balancing the budget, in a relatively short span of time.

Detroit is one of the homes of progressivism in America which believes raising wages forever will improves lives, when in reality it eventually becomes so non-competitive, it begins to push business out of the city. High taxes and tough unions made competition so difficult, the city began to die.

In the meantime, a certain lifestyle became the norm for citizens and government alike. Money was overspent, promises which could never be kept were made, and the seeds of the current malaise were sown.

Despite what the Obama administration preaches that people's earnings are part of the public domain, better jobs and better opportunities for our youth will only happen if the private sector thrives.

Government run or dominated economies have always failed, and always will, no matter how appealing the rhetoric. In Detroit, eight of the top 10 employers are government, education and healthcare. Private business only accounts for 10% of employers, and there is no way Detroit can ever get back on its feet with a model that relies on high taxes to create jobs as job creators flee the city. Those leaving are brilliant and innovative. Those staying are needy and have been coddled with so many programs that their ability to get by without a government program has vanished.

The city would do better to lower taxes than raise them, which by the way is what soon to be former Mayor Bing wanted to do. The cure for Detroit, Buffalo and many other cities is a combination of things, almost all of which are painful.

Like Europe is learning right now, tough austerity will only work if articulated with a plan the citizens buy into. A plan that somehow gets people to pay their taxes because they understand and believe change will take all of time, money and sacrifice. Detroit and Buffalo are glaring examples of how the “progressive” agenda can destroy industry. Promoting the idea that wages which exceed free market boundaries being promoted as “fair” is to be frank, nothing but a lie.

Stay tuned,

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