



# After Municipal Bankruptcy

Lessons from Detroit and other local governments

# The Pew Charitable Trusts

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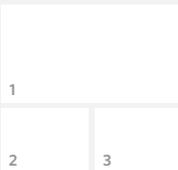
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### Cover photos:

1. Downtown Detroit seen through brick window frames. Photo: iStock
2. An aerial view of the Detroit River. Photo: Jim Hunt/Getty Images
3. A Detroit street with the Michigan Central Depot in the background. Photo: Jon Shireman/Getty Images

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## Overview

The recent high-profile bankruptcy filings by Detroit and a handful of other local governments around the country have renewed state and local policymaker interest in strategies to prevent future financial crises as well as in the choices states face about whether to intervene to help distressed cities and counties.

Starting with Vallejo, California, in 2008, a string of municipal Chapter 9 bankruptcies shook Prichard, Alabama; Central Falls, Rhode Island; Jefferson County, Alabama; Detroit; and Stockton and San Bernardino, California. Detroit was the largest municipal bankruptcy in U.S. history, and Jefferson was the largest county bankruptcy.<sup>1</sup> In the wake of this wave, policymakers have an opportunity, similar to the one that followed New York City's near-default in 1975, to update and expand laws and policies clarifying states' role in monitoring and intervening in financial crises of local governments.

Understanding what happened in Detroit and other recent Chapter 9 filings is critical to preventing future bankruptcies and the years of pain that can accompany them: service reductions, employee layoffs, cuts to public pensions, bond investment losses, property tax increases, millions of dollars in legal fees, infrastructure decay, and loss of population. As federal Judge Steven Rhodes said when he approved Detroit's bankruptcy plan in 2014, the necessary adjustments "will cause real hardship. In some cases, it is severe."<sup>2</sup>

The difficulties are one reason some analysts predict that there will not be a rash of filings in the coming years, even though many troubled cities are still struggling to balance revenue and spending following the last recession. A few cities—North Las Vegas, Nevada; Desert Hot Springs, California; and Atlantic City, New Jersey—are on the precipice, but no city has filed for bankruptcy since Detroit did so in July 2013. Detroit ended its bankruptcy in December 2014, leaving San Bernardino as the only city with an unresolved Chapter 9 filing.<sup>3</sup>

Until now, lawyers and financial analysts have conducted most post-bankruptcy analyses, focusing on the effect on investors who buy and insure municipal bonds. But state and municipal leaders need to weigh broader impacts on residents and workers. This report offers important lessons from Detroit and other municipalities to help policymakers avoid future financial meltdowns and manage fiscal crises when they do occur. Among the lessons learned:

- Early state intervention in local governments' financial emergencies can help avert a crisis or possible insolvency.
- When local governments have no options other than filing for Chapter 9 protection, a broad outreach plan that includes all stakeholders throughout the process can help resolve conflicts.
- Once a local government exits Chapter 9, a long-term recovery plan that outlines immediate financial fixes and long-term strategies, such as investing in economic growth, is critical to addressing underlying fiscal problems and preventing future crises.
- By taking active steps to budget over the long term—matching expenses and revenue over several years—local officials can promote fiscal health and increase their city's capacity to weather the ups and downs of the business cycle.
- Regular monitoring of local government finances can help state officials detect early signs of distress.
- State policymakers can prevent Chapter 9 filings by developing alternatives, such as naming a monitor or temporary manager to restore a city's finances.

## **Municipal bankruptcies are rare**

Cities cannot file Chapter 9 without state permission, which is rarely given. Only 12 states authorize cities to file without conditions, and another 12 permit filing with certain stipulations.<sup>4</sup> In the past 60 years, only 63 cities, towns, or counties have sought Chapter 9 protection.<sup>5</sup> Although municipal bankruptcies probably will continue to be rare, local governments across the country are facing significant fiscal challenges—from ongoing revenue pressures as the effects of the housing crisis linger in many areas to serious problems with managing long-term obligations, such as public employee retirement and health care costs.

When cities have sought bankruptcy, each case has included a unique set of issues that state lawmakers and federal judges must contend with as they seek to improve a city's long-term finances and restore control to local officials. The Great Recession worsened municipal finances, but it was not the main reason the cities and counties declared bankruptcy or defaulted. Nearly every recent financial emergency can be traced to a one-time blow that pushed a community with long-standing structural problems over the edge.

Jefferson County in Alabama and Harrisburg, Pennsylvania, mismanaged large infrastructure projects. Vallejo and Central Falls could not keep up with their rising payroll and public pension costs. Mammoth Lakes, California, and Westfall Township, Pennsylvania, could not pay for multimillion-dollar legal judgments against them. Wenatchee, Washington, promised to backstop bonds for a regional hockey and concert arena but came up short of the revenue needed to honor its guarantee. Bell, California, defaulted on part of its bonds after a corruption scandal in which eight city officials were charged with misusing taxpayer funds. Stockton and San Bernardino sold millions of dollars of pension obligation bonds before the recession to help pay for their employee retirement benefits, but the interest costs exceeded the anticipated rate of return, which contributed to their bankruptcies.

Because municipal bankruptcies are so infrequent, Detroit and the other distressed cities had few legal precedents to draw on to guide their restructuring. This lack of direction gave substantial discretion to federal bankruptcy judges, governors, and legislatures to set the boundaries, including how much creditors would be paid back, where that money would come from, how pensioners would be treated compared with bondholders, and how the city would attempt to balance its spending and revenue in the future.

As a result of the distinctive causes of and resolutions to bankruptcy, Pew found that approaches to resolving local financial emergencies varied widely with respect to the amount of time required, the losses stakeholders were obliged to accept, and whether additional oversight of local government finances would continue. Each of the recent bankruptcies has been different, making it hard to generalize about the best ways to handle municipal bankruptcies or to come up with a one-size-fits-all set of guidelines that state and local governments can adopt. Despite the contrasts, however, Detroit and other bankrupt cities do share some lessons that state and local officials and other policymakers should consider as they manage their finances.

## **Act quickly before a crisis occurs**

Only 19 state legislatures permit their governments to intervene in local finances, and they differ in how aggressive those efforts can be. But the recent spate of municipal bankruptcies demonstrated the importance of stepping in quickly, a fact that should not be lost on states considering authorizing or expanding intervention measures.

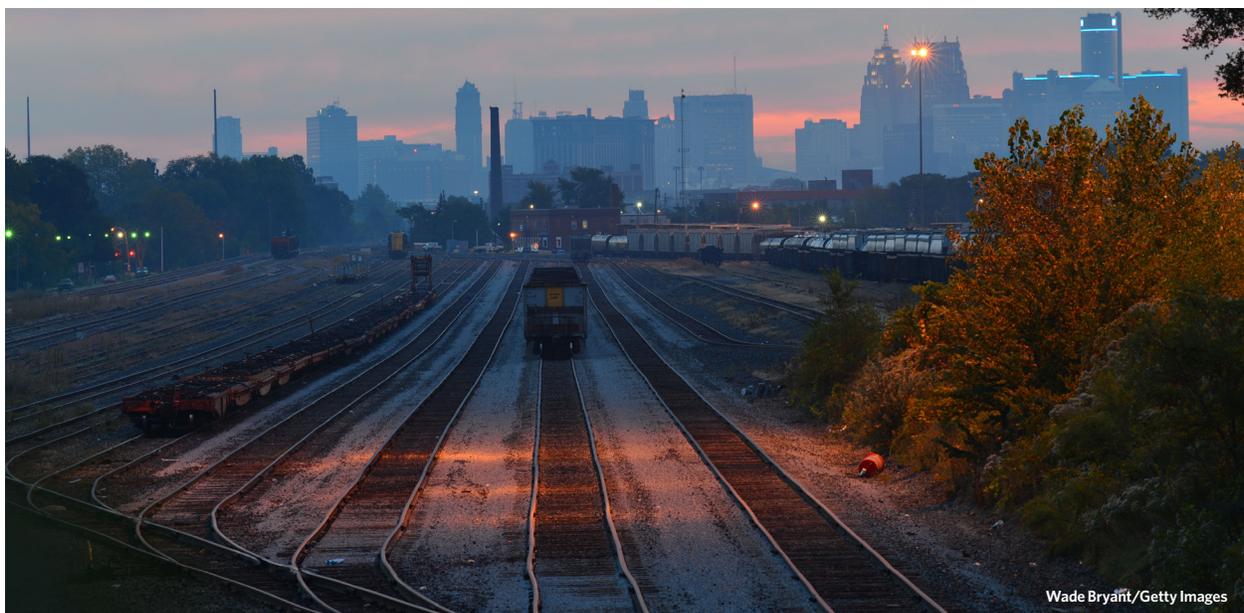
There were precedents for state intervention before Detroit's bankruptcy filing. New York City (1975), Cleveland (1978), and Philadelphia (1991) avoided bankruptcy because their state governments interceded with direct aid,

loans, and oversight structures. New Jersey has not had a municipal bankruptcy since the 1930s in part because of active, hands-on oversight by the state government as evidenced by the recent interventions in financially troubled Newark, Camden, and Atlantic City.

Michigan became one of the first states to set up a formal intervention program in 1990 and has seen mixed results in the cities and school districts where emergency managers took over. Detroit's experience shows that the longer state officials wait to intervene, the harder it is to escape bankruptcy. "For 50 years, Detroit's economy, its physical infrastructure, and its social structure had been on a steady decline. And the political system did nothing whatsoever about it," says Richard Ravitch, former lieutenant governor of New York, who helped New York City avoid bankruptcy in 1975 and has been advising Detroit officials.<sup>6</sup>

Detroit officials had failed in their repeated attempts to save the city from insolvency. The unending loss of people and jobs over decades drained tax revenue, making it impossible for the city to pay its bills or even get a clear picture of its finances. Instead of helping, Michigan contributed to the revenue losses by cutting state aid 48 percent between 2002 and 2012 when the state was going through its own budget crisis.<sup>7</sup> In addition, city officials agreed to a risky plan to sell pension bonds to shore up the retirement system. City leaders assumed that they could reinvest the bond proceeds to earn a higher return, thereby covering their borrowing costs and paying down existing pension obligations. They were mistaken, however, and these investments underperformed expectations. Adding to the fiscal crisis was a breakdown in political leadership: The city's mayor, Kwame Kilpatrick, was removed from office in 2008 following a series of scandals.

By the time the state got involved in 2011, it was too late. The police chief described the situation as not only a financial crisis but also a "service delivery insolvency," characterized by high crime rates, broken streetlights, thousands of abandoned and blighted structures and lots, and closed parks, among other problems.<sup>8</sup> The state appointed an emergency manager in March 2013 to attempt a fix, but the scale of the challenge—the city had piled up \$18 billion in debt—forced Detroit to seek bankruptcy protection in July 2013. "The delays in addressing the financial crisis in Detroit have made it much more difficult to address," says John Hill, chief financial officer to the emergency manager.<sup>9</sup>



The Detroit rail yard.

## Chapter 9 Is Expensive and Painful

The recent succession of municipal bankruptcies shows that a city's residents and workers often suffer significantly during and following a Chapter 9 bankruptcy. In Jefferson County, sewer system customers will pay some of the highest rates in the nation over the next 40 years as part of the debt restructuring.<sup>\*</sup> In Central Falls, residents' property tax bills are increasing 4 percent in each of the next five years.<sup>†</sup> Retired city workers of Central Falls and Detroit will receive lower pension or cost-of-living benefits than they were promised. "It was a very difficult conversation," former Central Falls receiver Robert Flanders recalls of negotiations with pensioners. "I had to say, 'Look, we're going to have to cut your pensions by half.'"<sup>‡</sup>

Bankruptcy also is costly to arbitrate. States and cities have to pay the receivers and emergency managers. The Detroit emergency manager's \$275,000-a-year salary was \$116,000 more than the Michigan governor's.<sup>§</sup> Rhode Island paid the Central Falls receiver \$30,000 a month,<sup>\*\*</sup> which is \$2,000 more than the city's annual median household income.<sup>††</sup> Then there are the fees each city must pay to its outside bankruptcy attorneys. Attorneys' fees are nearing \$170 million in Detroit.<sup>‡‡</sup> Stockton will pay nearly \$14 million in attorney fees, and Jefferson County will pay over \$25 million.<sup>§§</sup> "It seems to me that it's impossible to do Chapter 9 cases without an eight-digit figure," says the Stockton judge, Christopher Klein.<sup>\*\*\*</sup>

Beyond the direct financial costs, a price cannot be put on the damage that bankruptcy does to a city's reputation. Unlike most San Francisco Bay Area cities, Vallejo lost population during the 2000s, which reduced the tax base and hurt economic growth. "Bankruptcy makes you believe you have failed," says Mayor Osby Davis.<sup>†††</sup> Like Vallejo, Detroit's image suffered from the bankruptcy, and its future is uncertain. The harm should serve as a lesson to any city's policymakers to adopt a long-term perspective, understand imbalances between revenue and spending needs, and implement plans to address them. "There's nothing to celebrate about bankruptcy," says former Stockton city manager Bob Deis.<sup>‡‡‡</sup>

\* Moody's Investors Service, "Jefferson County, Alabama, Sewer Ratepayers' Appeal Proceeds, a Credit Negative for Sewer Warrant Holders," sector comment (Oct. 6, 2014).

† The Pew Charitable Trusts, "The State Role in Local Government Financial Distress" (July 2013), 41, [http://www.pewtrusts.org/-/media/Assets/2013/07/23/Pew\\_State\\_Role\\_in\\_Local\\_Government\\_Financial\\_Distress.pdf](http://www.pewtrusts.org/-/media/Assets/2013/07/23/Pew_State_Role_in_Local_Government_Financial_Distress.pdf).

‡ Robert Flanders, remarks at panel presentation, National League of Cities Congress of Cities, Austin, Texas (Nov. 21, 2014), <http://www.nlccongressofcities.org/friday-november-21>.

§ Michigan Governor Rick Snyder, letter to Kevyn Orr, March 26, 2013, [https://www.michigan.gov/documents/treasury/KevynOrr\\_Contract\\_414570\\_7.pdf](https://www.michigan.gov/documents/treasury/KevynOrr_Contract_414570_7.pdf).

\*\* The Associated Press, "New Central Falls Receiver Has 3-Month Contract," *The Boston Globe*, June 5, 2012, [http://www.boston.com/news/local/rhode\\_island/articles/2012/06/05/new\\_central\\_falls\\_receiver\\_has\\_3\\_month\\_contract](http://www.boston.com/news/local/rhode_island/articles/2012/06/05/new_central_falls_receiver_has_3_month_contract).

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- <sup>††</sup> “QuickFacts, Central Falls, Rhode Island,” U.S. Census Bureau, <http://quickfacts.census.gov/qfd/states/44/4414140.html>.
- <sup>‡‡</sup> “City of Detroit’s Disclosure of Fees and Expenses,” U.S. Bankruptcy Court, Eastern District of Michigan, Chapter 9 case No. 13-53846, Dec. 30, 2014. [http://media.mlive.com/news/detroit\\_impact/other/fees.pdf](http://media.mlive.com/news/detroit_impact/other/fees.pdf).
- <sup>§§</sup> Kent Faulk, “Judge Says Jefferson County Can Exit Historic \$4.23 Billion Bankruptcy,” *AL.com*, Nov. 21, 2103, [http://blog.al.com/spotnews/2013/11/judge\\_says\\_jefferson\\_county\\_ca.html#incart\\_river](http://blog.al.com/spotnews/2013/11/judge_says_jefferson_county_ca.html#incart_river).
- <sup>\*\*\*</sup> Michael Bathon, Alison Vekshin, and Steven Church, “Stockton’s Pension-Protecting Bankruptcy Plan Approved,” *Bloomberg*, Oct. 30, 2014. <http://origin-www.bloomberg.com/apps/news?pid=conewsstory&tkr=3654MF:US&sid=ayhoPfsT.A71>.
- <sup>†††</sup> Michael P. McConnell, “The Growing Shadow of Municipal Bankruptcy,” *Advisor & Source Newspapers*, July 30, 2012, <http://www.sourcenewspapers.com/articles/2012/07/30/news/doc5016d7996ecfd947239230.txt?viewmode=default>.
- <sup>‡‡‡</sup> Bob Deis, remarks at panel presentation, National League of Cities Congress of Cities, Austin, Texas (Nov. 21, 2014), <http://www.nlccongressofcities.org/friday-november-21>.



Our state has rallied around its largest and iconic city. It is no longer Detroit vs. Michigan but the embracing of Detroit, Michigan.”

Michigan Governor Rick Snyder

## Reach out to stakeholders

Once Michigan did get involved in Detroit’s finances, the governor and Legislature demonstrated, through their actions and dollars, that the state would take the lead in saving Detroit. “Our state has rallied around its largest and iconic city,” Governor Rick Snyder said after the bankruptcy plan was approved. “It is no longer Detroit vs. Michigan but the embracing of Detroit, Michigan.”<sup>10</sup>

One way the governor demonstrated this support was with his handpicked Detroit management team. He appointed Kevyn Orr, a strong emergency manager experienced in bankruptcy restructurings, who in turn named Hill as chief financial officer. Hill had previously led the financial control board that Congress created in 1995 to rescue the nation’s capital from insolvency.

The governor and emergency manager set a clear goal of persuading the federal judge, Steven Rhodes, to approve the bankruptcy adjustment plan by November 2014, less than a year after his ruling that the bankruptcy could proceed.<sup>11</sup> By contrast, the Vallejo bankruptcy took about three years to resolve, and Central Falls needed 13 months.

To achieve the 2014 exit target, Gov. Snyder and the emergency manager had to convince the stakeholders—unions, bondholders, pensioners, city employees, nonprofit foundations, business leaders, state and local lawmakers of both political parties, and the 690,000 residents—that everyone would have to accept cuts, contribute money, or both if the city was going to reduce its debt and stabilize its services.

Working with a court-appointed mediator, the stakeholders agreed to a “Grand Bargain,” a collection of settlements that emphasized the policy of cooperation and shared sacrifice: Bondholders accepted losses, and pensioners approved benefit cuts. City officials committed to set aside \$1.7 billion over 10 years to fix broken services.<sup>12</sup> In addition, state taxpayers, foundations, and other private donors chipped in \$816 million to protect the Detroit Institute of Arts’ renowned collection from being sold and to prevent deeper pension cuts. Michigan taxpayers contributed about \$200 million of those funds.<sup>13</sup> “At some point, people had buy-in and realized we were sincere,” Orr says.<sup>14</sup>

The shared sacrifices made Rhodes’ job easier. To achieve the compromises, he named the mediator, Chief Judge Gerald Rosen of the U.S. District Court for the Eastern District of Michigan, whose eight-member team sorted out the creditors’ claims and resolved them relatively quickly. “Never before have bankruptcy mediators proactively sought to marshal the community’s financial resources to solve a community problem,” Rhodes said in his decision approving the exit plan. “Most importantly, they knew that their work was not simply about resolving a bankruptcy case. It was about fixing a broken city. Where would this case be without them?”<sup>15</sup>

## Adopt a post-bankruptcy recovery plan

The intent of filing for municipal bankruptcy is to restructure and reduce a city’s debts—a temporary fix that gives the government a fresh start but is not a long-term solution. At a news conference celebrating the end of Detroit’s bankruptcy, Gov. Snyder was careful to stress that much work remained to be done. “Detroit’s journey is far from over,” he said.<sup>16</sup> The arguably harder work is addressing the underlying structural issues that contributed to the bankruptcy in the first place. In Detroit’s case, these were population and job losses, creeping blight, lack of investment in infrastructure, broken services, poorly performing schools, and declining tax revenue. Producing a multiyear recovery plan for a city emerging from bankruptcy and its government is crucial to keeping and attracting residents, businesses, and investors to grow revenue. “Chapter 9 provide[s] the breathing room, [but] the recovery plan provides the resolution,” says James Spiotto, a Chicago municipal bankruptcy attorney.<sup>17</sup>

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Another high-profile restructuring occurred in the District of Columbia. Although the District never entered federal bankruptcy protection, the five-member financial control board that ran the city between 1995 and 2001 was central to its subsequent population and business growth. The board overhauled Washington’s bloated bureaucracy, financial systems and controls, unfunded pension debt, and deteriorating services. Working with Congress, the board created a sustainable fiscal structure, which so far has succeeded in preventing a repeat of the crisis.

Key elements of that structure were the hiring of an independent chief financial officer to manage the city’s \$10 billion financial operations and requirements that the District maintain a balanced budget and receive a clean audit for at least four straight years or risk reactivating the control board. The city has met those obligations, and the resulting fiscal stability, which has persisted, contributed to an investment boom in commercial, residential, cultural, retail, and restaurant development that has fueled budget surpluses, population growth—especially of millennials—and job creation.<sup>18</sup>

Hill, who ran the District's control board and later was the Detroit chief financial officer during the bankruptcy, says "the post-bankruptcy structure is absolutely critical" to sustaining Detroit's long-term recovery. "No one wants to get out of bankruptcy and get back in there," he says.<sup>19</sup>

Similarly, the state of Michigan compelled Detroit to create a financial review commission to oversee the post-bankruptcy plan, and the governor appointed an emergency manager to revive the city's troubled school system.<sup>20</sup> The nine-member panel, which includes the Detroit mayor and City Council president, does not have as many of the broad powers of Washington's control board, but it can approve contracts and borrowing. Rhodes, who questioned whether the mayor and council president could serve as independent watchdogs over city spending, reiterated the critical nature of the commission when he said in his bankruptcy decision, "It cannot be emphasized enough that the long-term feasibility of the plan of adjustment will depend on the effectiveness of the Financial Review Commission. This is a matter of extraordinary weight and responsibility."<sup>21</sup>

By comparison, failure to confront core financial problems could haunt post-bankruptcy Vallejo. Generous police and firefighter salaries and retirement benefits were at the heart of that city's insolvency when the housing crisis hit in 2008 and tax revenue plummeted. City officials did cut personnel, retiree health care, and other costs during and after its bankruptcy. However, the California Public Employees' Retirement System, the state's public pension entity, has been asking for higher contributions from local governments each year, and Vallejo's most recent annual financial report indicates increasing distress, largely because of these growing payments, which could exceed 60 percent of the city's payroll costs by fiscal year 2016.<sup>22</sup> Stockton and San Bernardino are part of the same state retirement system and are facing similar projected rises in contributions. These California cities may ultimately serve as a cautionary tale about why labor costs must be part of a post-bankruptcy recovery strategy.

Contrast Vallejo with Central Falls. In March 2014, less than two years after Central Falls emerged from bankruptcy, city officials reported a budget surplus for fiscal 2013.<sup>23</sup> To carry out the city's six-year recovery plan, Rhode Island returned control of daily operations to elected municipal officials while retaining oversight of city finances. The bankruptcy court maintains the authority to intervene to enforce or change the recovery plan if the judge believes that the city is mismanaging its finances.



Left: A bird's-eye view of Detroit. Right: Children jumping on a trampoline in Detroit.

## Bondholders and Pensioners Can Be Treated Differently in a Chapter 9

How much of a bankrupt local government's debt should be paid to public employees who receive taxpayer-financed pensions and how much should go to investors who buy municipal bonds has been a central question in the recent series of Chapter 9 filings.

City retirees argue that their benefits are part of the compensation packages from their working years. On the other hand, encouraging investment in bonds that pay for capital projects is crucial to a local government's financial health.

In every recent bankruptcy, courts have allowed cuts in promised pension benefits, saying that costly past promises are unsustainable over the long run. But in most of the cities, municipal bond investors have also had to accept losses.

In Detroit, the federal bankruptcy judge approved a debt-restructuring plan that called for bondholders to absorb greater losses than pensioners. Rhodes said the city has a stronger interest in the welfare of its 32,000 public employees, who provide essential services, than in its bondholders. Before the restructuring plan, Rhodes said, the average annual pension benefit for Detroit's non-public-safety workers was \$18,000; for public-safety workers, who are ineligible for Social Security, it was \$30,000 a year.

Both groups of creditors initially objected to proposed losses. Current and future retirees said the Michigan Constitution shielded them from "impairments" to their benefits, but Rhodes said the constitutional protection did not apply in a federal bankruptcy case. Current city workers were put into a new, less generous retirement plan, police and fire retirees accepted a cut in their cost-of-living increases, and other retired city workers agreed to reduced pension benefits and elimination of the cost-of-living increase. Bondholders and their insurers contended that they had the first lien on Detroit's property tax revenue and should be paid in full. But city officials said Detroit lacked sufficient revenue to honor their repayment pledge on the bonds, and investors grudgingly agreed to receive cents on the dollar.

The Central Falls bankruptcy differed in its treatment of pensioners and bondholders. When that city was teetering toward insolvency in 2010, state lawmakers approved legislation that, among other things, gave priority for repayment to investors who buy tax-free municipal bonds over public pension recipients and other creditors, meaning that the city paid its debt to bondholders in full but cut workers' pensions and raised their health care premiums. The law spelled out the order of repayment to creditors not only for Central Falls but for any future Rhode Island municipal bankruptcy in order to ensure that cities in the state continued to have access to the credit markets.

In Stockton's Chapter 9, local officials argued that the city had already cut pension benefits before the filing and that the municipal bond industry knows it is selling a product that carries

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risk and should not be treated differently from other creditors. The federal bankruptcy judge agreed, and bondholders absorbed losses.

Since the Detroit bankruptcy was filed in 2013, California, Michigan, Nebraska, and Illinois lawmakers have considered legislation that would spell out the order of payment in certain instances, with preferential treatment given to bondholders.<sup>†</sup> Lawmakers in California and Michigan enacted versions of this policy. Pew does not have a recommendation regarding which group of creditors should receive priority but has observed that having explicit policies can reduce the confusion and disputes that accompany municipal bankruptcy proceedings.

\* The Pew Charitable Trusts, “The State Role in Local Government Financial Distress” (July 2013), 40, [http://www.pewtrusts.org/-/media/Assets/2013/07/23/Pew\\_State\\_Role\\_in\\_Local\\_Government\\_Financial\\_Distress.pdf](http://www.pewtrusts.org/-/media/Assets/2013/07/23/Pew_State_Role_in_Local_Government_Financial_Distress.pdf).

<sup>†</sup> Kyle Glazier, “New California Law Would Secure Local GO Holders in Bankruptcies,” *The Bond Buyer*, July 17, 2015; and Act No. 17, Public Acts of 2015 Approved by the Governor, State of Michigan, 98th Legislature, Senate Bill 160, April 22, 2015.

## Think long term

In nearly all of the recent municipal bankruptcies, the local governments—sometimes constrained by a lack of state help—failed repeatedly to balance revenue and spending over many years leading up to insolvency. Especially during the current period of increasingly volatile tax revenue, it is important that policymakers plan for economic ups and downs by establishing a long-term, sustainable budget.

When the economy and revenue are growing, elected officials may raise spending on education, health services, and other programs or increase pay and benefits for public employees, as happened during the 1990s, when many local governments piled up significant surpluses. But local leaders do not always plan for leaner times when tax collections fall: When revenue dropped in the 2000s, those added costs did not stop growing, especially in the case of public-sector retirement benefits. So to balance tight budgets, many cities skipped or cut back on their annually required contributions to pension funds.

Soaring retiree benefit costs—as a result of lower-than-expected investment performance and policymakers deferring or short-changing annual payments and increasing retiree benefits—were key factors in Detroit’s slide into insolvency. The city’s unfunded pension and retiree health care liabilities made up nearly \$11 billion of its \$18 billion debt.<sup>24</sup> In Stockton, where city and union officials had agreed over the years to some of the nation’s most generous compensation and retirement packages, revenue did not keep up with increases in the city’s required annual contribution to the California public pension system.<sup>25</sup> Prichard was the most extreme example of what can transpire when a dwindling tax base and population, skipped pension payments, and corruption hit a city: The Alabama town stopped making payments into the fund and, when it was depleted in 2009, discontinued sending pension checks to retirees until resuming partial payments in 2011.<sup>26</sup>

As these examples show, prudent long-term budget planning must include an examination of long-term liabilities, such as public retiree benefits. Although today’s policymakers are reluctant to rescind the promises made to

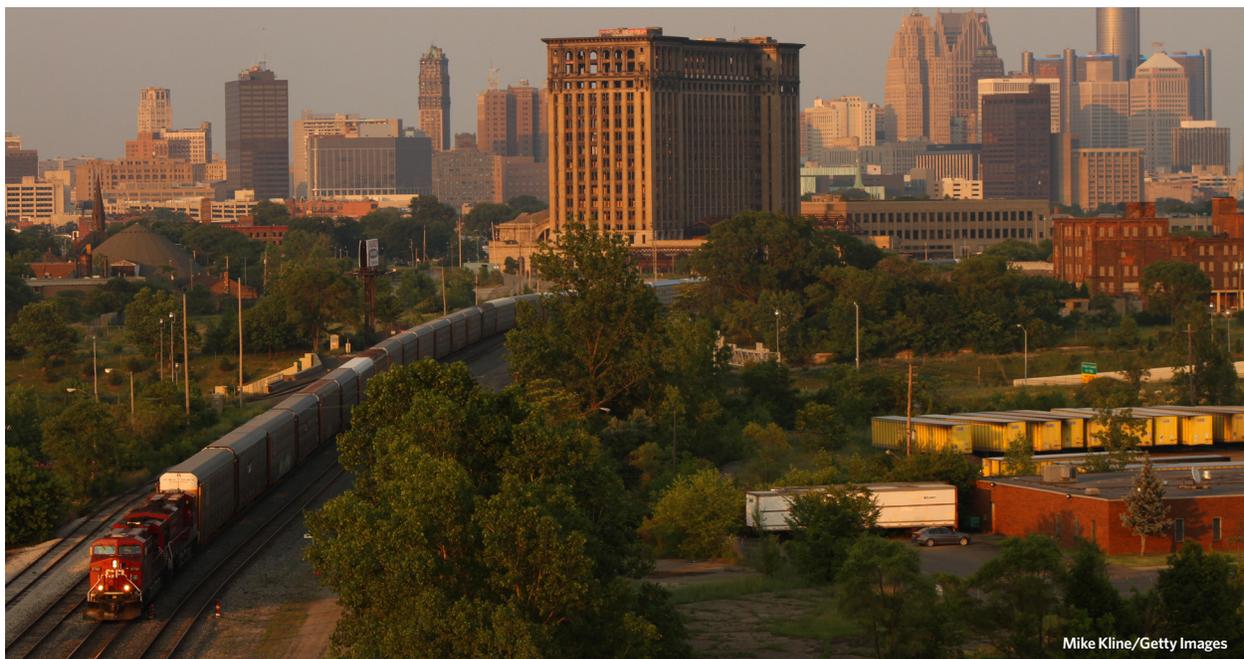
employees by their predecessors, they can learn from those mistakes and determine the level of retirement benefits—given the revenue situation—that the city or county can afford going forward, especially for newly hired municipal workers. Many cities are making tough choices, including asking employees to contribute more money for their retirement benefits, freezing or reducing cost-of-living increases, trimming or eliminating retiree health benefits, and changing pension plans, often by reducing benefits for new workers or adding 401(k)-style elements.<sup>27</sup>

## Monitor to detect distress

Although states have different political traditions and policies regarding assisting fiscally distressed municipalities, they all could take one proactive step to prevent financial emergencies: regular monitoring of local government finances. Such oversight, which involves local officials sending key financial data to the state for review, can provide an early warning when cities are having trouble balancing revenue and spending. State policymakers can then make an informed decision about whether to intervene. In addition, monitoring statewide trends in municipal finances allows for comparisons across cities and regions to help guide decisions about policies that affect local financial health, including whether to provide temporary aid or allow local governments to raise taxes.

Nearly 20 states have financial monitoring systems in place.<sup>28</sup> Although the number of fiscal indicators they track varies, they all include basic financial reporting, such as assets and liabilities, fund balances, revenue and spending comparisons, debt amounts and types, economic conditions, service demands, legal challenges, and actions taken to correct problems.

The biggest differences among states that monitor local government finances are in what they do with the data after they are reported. Some only observe. Washington state posts each city's financial profile on a website but has no formal program to intervene if the fiscal indicators demonstrate distress. Illinois requires local governments to submit annual financial reports for analysis but leaves it up to local officials to ask for assistance.<sup>29</sup>



A freight train in Detroit with the Renaissance Center and Central Depot in the background.

Other states are more hands-on. New York’s comptroller assigns stress scores to all local governments, based on their submitted data, and offers technical assistance to those with high scores.<sup>30</sup> New Jersey requires that municipalities send their budgets to the state for review once every three years, but the most distressed localities, as well as those that apply for state aid, must obtain prior state approval before adopting their budgets.<sup>31</sup> A similar system in North Carolina allows the state to approve and sell bonds on behalf of local governments, monitor municipal budgets closely, and step in to manage a city’s finances in the worst cases.<sup>32</sup> In 2012, North Carolina officials noticed that Scotland County’s data indicated that a fund balance had fallen below the 8 percent minimum the state requires, so the North Carolina Local Government Commission warned the county to remedy the shortfall or face a state takeover.<sup>33</sup> The county took a number of actions, including raising property taxes, cutting jobs, and slashing elected officials’ salaries.<sup>34</sup>

Along with the monitoring, some states also have a formal intervention program to address signs of distress. But of the 19 states that allow intervention, only a handful have active, ongoing programs.

## **Alternatives to bankruptcy**

Several states have constructed policies and programs over the past few decades to proactively help municipalities avoid insolvency and the pain that comes with a bankruptcy filing. These strategies include a wide range of approaches and have had mixed results.

Since 2011, lawmakers in Michigan, Pennsylvania, Rhode Island, and New Jersey have reformed their programs, responding in different ways to their distressed cities. The common thread in each is that policymakers believe the state has an interest in ensuring the stability of local government finances. For example, Pennsylvania has been assisting financially troubled local governments to avoid insolvency under Act 47 since 1987. But state intervention was often without end: Of the 27 local governments that have entered the program, only seven met the conditions to leave it. In 2014, the state’s Legislature set an eight-year limit for a city to be subject to Act 47 oversight and allowed local governments to raise a payroll tax to generate additional revenue.<sup>35</sup>

In 2012, Michigan changed its 22-year-old intervention program to allow cities to choose a mediator or bankruptcy filing in addition to the options of having an emergency manager or consent agreement.<sup>36</sup>

Rhode Island retooled its intervention model in 2010, enacting an incremental process—beginning with a state-appointed manager, then a budget commission, and finally a receiver—for distressed municipalities.<sup>37</sup> Local governments generally must complete all three steps before the state will consider permitting a bankruptcy filing, although in emergencies such as Central Falls the state can appoint a receiver from the start.

In New Jersey, which has a long tradition of assisting local governments with money and technical assistance, Governor Chris Christie appointed an emergency manager in January 2015 to stabilize Atlantic City, which has been plagued by a shrinking tax base as casinos close because of competition from neighboring states.<sup>38</sup>

Indiana and California have taken more modest steps. In 2012, Indiana, which does not allow local governments to file for bankruptcy, authorized the appointment of emergency managers to run distressed cities.<sup>39</sup> In the wake of Vallejo’s Chapter 9 experience, historically hands-off California established a 60-day process of mediation between a distressed city and its creditors intended to avoid bankruptcy.<sup>40</sup> But the impact of this effort remains to be seen: In Stockton, creditors declined to negotiate with the mediator, and San Bernardino bypassed the system altogether and filed for bankruptcy without engaging in any mediation.

## Conclusion

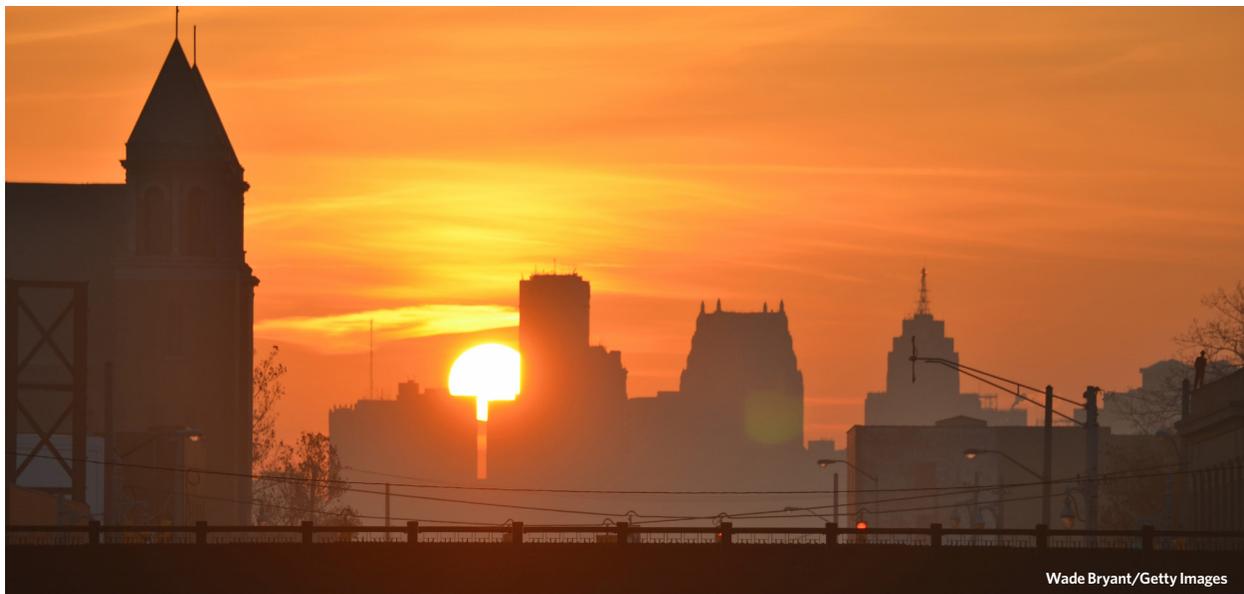
Municipal bankruptcies do not wipe away a distressed local government's problems. Policymakers are still left with agonizing decisions: whether to raise taxes to pay for key services or to cut them, how to keep existing residents and businesses from fleeing, and how to improve economic conditions in the long run. "Probably one of the most beneficial outcomes from the Detroit filing has been that other municipalities who are suffering financial distress have seen the time, expense, uncertainty, and political or social unrest that the Chapter 9 process has caused in Detroit," says James Spiotto, a municipal bankruptcy lawyer in Chicago.<sup>41</sup>

Whether and by what means governments can avoid financial crises will vary from state to state. No magic formula exists to address every situation. Still, there are lessons to be learned from the recent municipal bankruptcies.

To avoid tumbling into distress, or worse, local policymakers should first balance revenue against the spending pressures of public safety, infrastructure, education, and public-sector retiree-benefit obligations. When revenue exceeds expectations, it is important to resist the urge to enact unsustainable spending increases for programs, services, and retirement benefits.

Beyond that, policymakers can consider other steps to mitigate fiscal risk while remaining true to the distinctive traditions and philosophies of their states and cities. Statewide monitoring programs that keep an eye on local finances have proved effective in several states. And formal intervention programs, in which states supervise and assist distressed cities, are worthy of consideration, especially if they enable states to get involved early in emerging crises.

Chapter 9 bankruptcy filings are rare, but when they happen, the person or board managing the process must bring together all the stakeholders. A transparent, objective review of the city's finances can help persuade all affected parties to share in the sacrifices that are needed to win judicial approval for a restructuring plan. And once the plan is approved, policymakers need to develop a long-term strategy with specific benchmarks that can allow the city to chart a better financial future for the coming years.

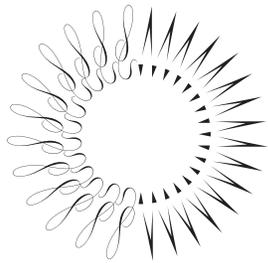


The Detroit skyline at sunrise.

## Endnotes

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