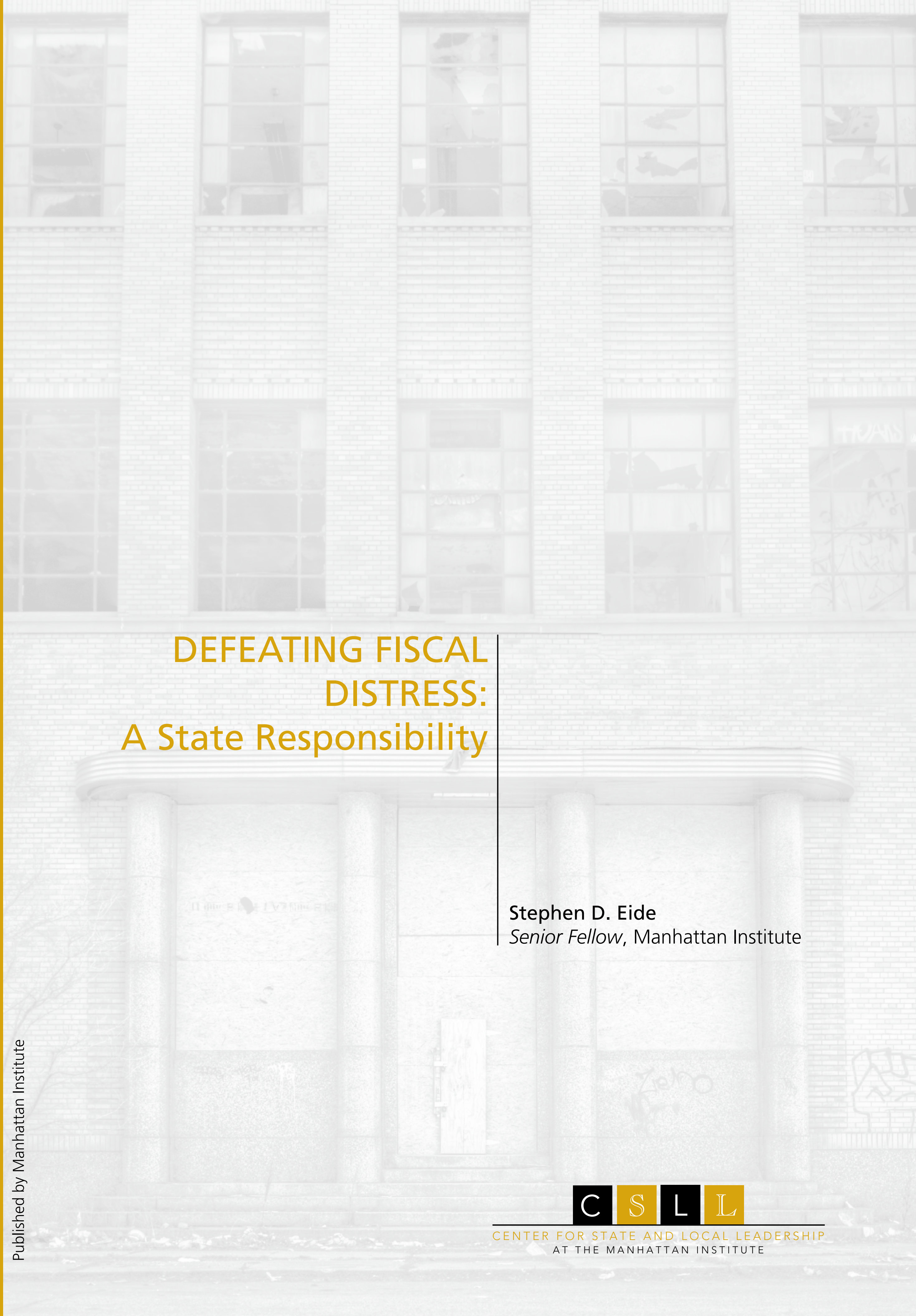
Civic Report
No. 78 July 2013



DEFEATING FISCAL DISTRESS: A State Responsibility

Stephen D. Eide
Senior Fellow, Manhattan Institute

Published by Manhattan Institute

CSLL
CENTER FOR STATE AND LOCAL LEADERSHIP
AT THE MANHATTAN INSTITUTE

Executive Summary

Across the nation, municipal budgets are tight, as annual cost increases in many spending categories continue to exceed revenue growth. Default will likely remain rare among the 90,000 local governments in America, but states should expect it to become more common than it has been in the past. Though the causes of distress can be difficult to isolate, it always commands significant public attention, even in the case of small communities. States cannot stand idly by. New policy solutions at the state level will be necessary to anticipate, prevent, and manage distress. While some mandate relief is important, in general the solution is neither more local autonomy nor municipal bankruptcy. States should develop new oversight, intervention, and takeover policies.

State and local governments cannot count on economic growth to alleviate distress, nor would it be wise for them to try to engineer growth by adopting more aggressive economic policies. Better fiscal policymaking is what cities need, particularly with regard to personnel spending, since salaries and benefits dominate cities' budgets.

There are four possible approaches to prevent and manage fiscal distress: mandate relief, oversight, intervention, and bankruptcy. Intervention and oversight should take the lead, while also allotting a role to mandate relief and bankruptcy. State governments should coordinate the four into a structured approach to preventing and managing fiscal distress.

1. State governments, particularly those in states with strong public-sector unions, should grant mandate relief to local governments in matters of personnel spending.

2. States should strengthen existing oversight policies toward local finances.

3. States should develop strong and general intervention policies before cases of fiscal distress arise.

4. States should allow local governments to file for Chapter 9 municipal bankruptcy only as a last resort. Additionally, a state-appointed authority should guide localities through bankruptcy.

About the Author

Stephen D. Eide is a senior fellow at the Manhattan Institute's Center for State and Local Leadership. He edits PublicSectorInc.org (@PubSectorInc), a project of the Manhattan Institute, and is also a contributor to the site. His work focuses on public administration, public finance, political theory, and urban policy. His writings have been published in the *Worcester Telegram and Gazette*, *Orange County Register*, the *New York Post*, *Interpretation: A Journal of Political Philosophy*, and *City Journal*.

He was previously a senior research associate at the Worcester Regional Research Bureau, and holds a bachelor's degree from St. John's College in Santa Fe, N.M., and a Ph.D. in political philosophy from Boston College.

CONTENTS

"How did you go bankrupt?" Bill asked. "Two ways," Mike said.
"Gradually and then suddenly."
—Ernest Hemingway, *The Sun Also Rises*

Defeating Fiscal Distress: A State Responsibility

Stephen D. Eide

INTRODUCTION

Despite an improvement in economic conditions since their low point in 2008–09, the fiscal outlook for state and local government remains weak. A few cities find themselves actually insolvent; all face a long-term gap between recurring revenues and expenditures. In some of the severest cases, localities, with the permission of their state governments, have resorted to Chapter 9 municipal bankruptcy.

An alternative approach was taken in March 2013 in Detroit, a city even worse off than some that entered bankruptcy. Despite Detroit's massive debt and deficits, Michigan governor Rick Snyder appointed an emergency financial manager to take over city operations. Snyder's decision reflected his doubts about the wisdom of municipal bankruptcy and his conviction that state governments, not the federal courts, are in the best position to manage fiscal distress while maintaining essential public services.

This paper will examine the roots of municipal distress and weigh possible responses. It will argue that the best policy is neither bankruptcy nor more local autonomy (although both may have a role to play) but more oversight and intervention by state governments. To prevent distress, states should more actively monitor the fiscal condition of their cities (which are, after all, legal creations of state government) and prepare themselves to intervene more aggressively.

There are no easy answers. Many cities have problems that stretch back for decades. The most effective forms of intervention are likely to be preemptive; yet perhaps the most counterproductive measure that state governments could take would be to stifle local reform efforts currently under way. Nonetheless, it falls to state government to take the lead role in defeating distress.

MUNICIPAL DISTRESS: A BRIEF HISTORY

During the Great Depression, fiscal distress was rampant. Some 4,800 municipal issuers defaulted on their obligations, affecting almost $6.5 billion in debt (almost $120 billion in 2013 dollars).[1] In the peak default year of 1933, 3.7 percent of issuers and 18.2 percent of all debt were in default.[2] Among all municipal issuers, cities contributed the most to the Depression's default crisis.[3] The proximate cause was global economic collapse, but governments also bore some responsibility. Local governments overborrowed for capital improvements such as paved roads, and state and federal policies encouraged cities' profligacy.

The institution of the federal income tax and provision of an exemption for municipal bond interest caused demand for municipal bonds to surge during the 1920s.[4] The federal government also had limited municipal debt issuance during World War I, to restrict competition with Treasury bonds. When the government lifted the restriction, annual municipal debt issuance more than tripled in six years.[5] According to an analysis by Kroll Bond Ratings, local defaults were concentrated in the states that were especially lax in exercising oversight over local issuers.[6] The Depression-era crisis in municipal finance provoked Congress to pass a law in 1937 that gave municipalities access to federal bankruptcy to adjust their debts.[7]

The Depression was followed by possibly the most tranquil era of public finance in American history.[8] Municipal bankruptcy filings slowed to a trickle.[9] Because of the postwar economic boom—from World War II until the mid-1970s, when New York City effectively defaulted—municipal distress was virtually nonexistent. After Detroit's default in 1933, no major American city failed to honor its debt obligations for another four decades.[10]

But in the 1970s, the effects of deindustrialization and urban decline, which had been under way since before World War II, finally caught up with city budgets. In the mid-seventies—as they have more recently—American newspapers began running a steady stream of stories about the fiscal woes of New York, Cleveland, and other old industrial cities.[11] Such cities' problems with depopulation, crime, poverty, and erosion of the tax base persisted into the 1990s and beyond. Philadelphia was taken over by Pennsylvania in 1991; Washington, D.C., was taken over by the federal government in 1995.

The present era of municipal distress began around 2000, when cities began to experience rapid increases in the costs of employee health and pension benefits. This new fiscal problem compounded existing economic problems in cities such as Central Falls, Rhode Island, and Detroit, which were associated with deindustrialization. Since 2008, three sizable cities in California (Stockton, Vallejo, and San Bernardino) have filed for bankruptcy because they could not meet their overwhelming pension and health-care obligations in the face of nation-leading declines in housing prices. Stockton and San Bernardino, as well as Jefferson County, Alabama, are now seeking to use the bankruptcy process to obtain a reduction in the principal on their debt, something that hasn't been achieved since the Great Depression.[12]

But throughout the twentieth and twenty-first centuries, in both good times and bad, it has been a very good bet to invest in state and local governments because of their extremely low default rate.[13] Only 54 issuers rated by Moody's defaulted between 1970 and 2009.[14] Even during the Great Depression, holders of general obligation bonds in default eventually recovered 99 percent of the principal, on average.[15] Municipal borrowing costs did briefly spike in the wake of the 2008 fiscal crisis and again in late 2010, and some predicted that default rates would soon rise to Great Depression levels. But predictions of catastrophe have not panned out. In 2012, total municipal defaults were $1.8 billion, down from $6.5 billion in 2011, and a small fraction of the total $3 trillion in outstanding municipal credit market debt.[16] The vast majority of defaults have been concentrated in small special issuers unrated by the credit rating agencies, as has traditionally been the case with "municipal" defaults.

If one were to define "distress" solely as "default," one could come to the conclusion that municipal distress is not a problem. But there are at least two reasons to think that governments should view distress as a major problem worthy of a serious policy response, and thus should not rest content with the status quo.

WHY DISTRESS IS A PROBLEM

First, as many experts have noted, state and local governments face a long-term gap between revenues and expenditures.[17] In the near term, this may not lead to pervasive fiscal collapse, assuming that the economy continues to grow at a normal pace. For most governments, the main effect of this structural deficit will be a "crowd-out" effect on budgets, as a greater share is devoted to health and retirement benefits, leaving less available for basic public services.[18] But because budgets are so tight, it stands to reason that distress, even if still rare, will be more common than in the past.[19] Distress and the crowd-out effect are quantitatively different, not qualitatively different.

Second, statistics about default rates, borrowing costs, or any other macro-level benchmark can be misleading because even when a small city falls into distress, it typically requires a major policy response on the part of state government. The crisis in Central Falls (population 20,000) prompted Rhode Island's state government to enact major fiscal restructuring legislation.[20] There are thousands of local government units in Michigan and Pennsylvania, the vast majority of which do not face imminent fiscal collapse. But would anyone say that this means that distress is not a serious issue in Michigan and Pennsylvania?[21] Historically, what has prompted states to intervene in a fiscally distressed municipality has been concern for the effect on other municipalities' access to credit. This effect is known as "contagion," defined by New York University Law School professor Clayton Gillette as "the possibility that local distress is indicative of more general fiscal difficulties or that unresolved local distress will cause disruption in other markets, because the risks of one are interconnected with risks elsewhere."[22] In short, credit markets may not allow local distress to be isolated.

IS DISTRESS A FISCAL OR AN ECONOMIC CONDITION?

Local governments may become insolvent for several reasons, such as a tort settlement (Bay St. Louis, Mississippi; or South Tucson, Arizona)[23] or an ill-advised capital investment (an incinerator for Harrisburg, Pennsylvania, and nuclear power plants for the Washington Public Power System in the 1980s). Naturally, mismanagement and corruption (which has been found in Washington, D.C.; Jefferson County, Alabama; Detroit; and Central Falls) are ever-present dangers in political life. Cities almost never go into default for only a single reason, fiscal or economic, which partially explains why local officials often have so much trouble agreeing about the nature of the problem and how to solve it.

If state governments, working in cooperation with troubled localities, are to prevent and manage distress, they must concentrate on the most common and tractable causes. Distress's fiscal causes are more manageable than its economic causes. Of course, economic development matters. Probably, Detroit would not be insolvent had the U.S. auto industry not lost market share. More than any other factor, Wall Street's three-decade boom restored New York City's finances after its near-collapse in the mid-1970s. The ranks of distressed cities always swell during national recessions. Between 1946 and 1964, outstanding municipal debt increased by 600 percent, a greater increase than in the years leading up to the Great Depression; but no massive spike in defaults resulted (as it did in the Depression) because GDP grew so strongly.[24]

But to which area should policymakers direct their attention? Even in the case of non-distressed areas, urban economists "probably understand which policies cause failure better than [they] understand which cause success."[25] The few urban development policies that can be said to have broad applicability, such as gentrification, have small economic effects.[26] Accordingly, public officials have far less influence over the kinds of broad economic policies and trends that can transform a city's prospects than they do over fiscal policy, including the allocation of existing resources.

Reining in personnel spending is the most important fiscal step that officials can take. Salaries and health and retirement benefits constitute the largest portion of city budgets. And, at the local level, these expenditures are growing at a faster rate than revenues.[27] Pension and retiree health benefits are also the source of state and local governments' greatest debt burdens. Nationwide, state and local governments' obligations for pensions and retiree health care ($4 trillion) exceed the amount of capital that they have been able to raise in the debt markets ($3 trillion).

MANDATE RELIEF

State mandates increase the difficulty of scaling back personnel spending. During the post–World War II era, as the memory of the Great Depression receded, many cities and states passed laws allowing government workers to engage in collective bargaining.[28] These same states—blue and blue-leaning states historically dominated by organized labor—have harbored most of the severest cases of distress in recent years.

Thus, the first step in preventing distress must be relieving cities of burdensome pro-labor mandates at the state level. Texas, Virginia, and several other red states have formally banned collective bargaining in the public sector, thereby dramatically improving local governments' flexibility in managing personnel costs. If such a step is not politically feasible, states can modify labor laws to increase local governments' leverage. In 2011, for example, Massachusetts passed a law removing co-pays and deductibles from the collective bargaining process. While it was a seemingly minor change, allowing local governments to shift costs to beneficiaries reduced health-care costs by $178 million for Massachusetts's cities and towns in its first year of implementation.[29]

Binding-arbitration laws are another state mandate that helps precipitate distress.[30] Originally intended to provide resolution of contract negotiations in the public sector, where in some places strikes are banned, the binding-arbitration process has become biased toward labor and often imposes expensive settlements on cities that can ill afford them.

Where you stand depends on where you sit. Distressed cities often blame state policies for their problems, particularly when faced with the possibility of takeover. Arguments against state mandates have some credence when cities are subjected to policies that favor unions over local government in negotiations over benefits and pay. But broad relief from state mandates, on its own, is not the solution to fiscal distress. Cities' problems are often of their own making. San Bernardino chose to insert into its city charter a clause that links its public-safety personnel's compensation to that of workers in nearby, wealthier communities.[31] It was gross mismanagement by Detroit officials that finally caused Michigan's state government to appoint an emergency financial manager.[32]

The influence of unions is not confined to the collective bargaining processes. In New York and Massachusetts, for example, state law specifies pension levels and terms. Change can occur, therefore, only through the legislative process, in which unions are also active. Thus, the unlikelihood in most states of a ban on collective bargaining, plus the limited relief that fewer, less onerous, state-imposed mandates would provide, would still not bring distressed cities back from the precipice. In states with strong unions and political support for them, greater local autonomy is not the answer. A further restructuring of the state-local relationship, entailing more oversight by state governments, will be necessary.

BANKRUPTCY—AND ITS LIMITATIONS

Some cities have succeeded in reducing personnel spending in bankruptcy court—most notably, Central Falls, Rhode Island. In August 2011, after failing to reach an agreement with unions to reduce pension payments, Central Falls filed for bankruptcy, permitting it to cut retiree pensions by over 50 percent. *Governing* magazine claims that Central Falls's example has led to "a growing sense among some leaders that municipal bankruptcy—unthinkable just a few years ago—may be a valuable tool in a city's financial toolbox."[33] Though understandable, this line of thinking ignores crucial flaws in the Chapter 9 process.

Many local governments throughout American history have found themselves in default, but none were legally "bankrupt" until the passage of Chapter 9, in 1937. Chapter 9 grants municipal corporations access to federal court for the purpose of sorting through conflicting claims among their various creditors. (States still may not declare bankruptcy.) Chapter 9's passage provided cities with a way to address the so-called holdout problem, which results when a debtor is unable to effect a comprehensive debt restructuring on account of the resistance of a minority of its creditors.[34]

Municipal bankruptcy occurs far less often than corporate bankruptcy, especially in the case of bankruptcy by cities. Since the Great Depression, there have been only 641 municipal bankruptcies, or fewer than ten per year on average, whereas thousands of American corporations file for Chapter 11 bankruptcy every year.[35] Among general-purpose local governments, only about 40 filed for Chapter 9 between 1976 and 2009.[36] The rarity of Chapter 9's invocation may be explained by its design, which differs in several important respects from corporate bankruptcy. To begin, under no circumstances may municipal creditors initiate the process, no matter how derelict the indebted city may be.[37] Even when it is the municipality that is seeking bankruptcy protection, its petition faces impediments that voluntary filers under Chapter 11 do not face. The city must formally demonstrate that it is insolvent, it must have been granted explicit permission to file by its state government,[38] and it must have made "good faith" efforts to work out its difficulties with creditors prior to filing.[39] These various restrictions may have disallowed opportunistic bankruptcy filings by governments; but they have also undermined municipal bankruptcy's value.

Further, under Chapter 9, judges have no authority to assert control over the debtor.[40] Local officials remain in charge of day-to-day operations for as long as their municipality is protected in bankruptcy from creditors. Judges do have the power to rule on Chapter 9 eligibility and decide whether the debt-adjustment plan that the city proposes in bankruptcy is fair to creditors. But Chapter 9 judges cannot design and impose a debt-adjustment plan of their own.[41]

Chapter 9 is purely a debt-adjustment process. In its present form, it can be of most assistance when a municipality's fiscal woes have a single source, such as an overwhelming tort settlement. In such cases, a municipality has just one major creditor, and its problems do not reflect more general difficulties within the community or beyond. Such communities face a liquidity problem, not a structural problem,[42] so states might as well allow them to seek bankruptcy protection.

But when distress is rooted in shared factors that indicate a need for fundamental reform of municipalities throughout the state, state government is the better reform agent.[43] States have a responsibility to eliminate the threat of contagion—that is, the impairment of other cities' access to credit as a result of assumed structural similarities between the distressed city and other cities in the same area.[44] Because only states *can* assume control of city governments, they are in the best position to enact fundamental reforms that promise to eliminate or reduce the potential for fiscal recidivism.[45] State appointees can liquidate assets, whereas a federal judge cannot.[46] Most local governments become insolvent from a lack of political will. But that problem does not disappear in bankruptcy because the existing city government remains in control of operations and is responsible for the debt restructuring plan. Only state government is in a position to supplement a local lack of political will.

State takeovers are arguably more in accord with constitutional and democratic principles than federal bankruptcy, which, originally, was deemed unconstitutional. Though state takeovers are always unpopular, particularly with the local officials they displace, elected state officials are much more accountable to voters than federal judges are.

INTERVENTION AND BANKRUPTCY: A COORDINATED APPROACH

Chapter 9's advocates point to the speed and effectiveness with which bankruptcy addressed Central Falls's problems. The city had been under the control of a state-appointed receiver, who proved unable, before the city entered bankruptcy, to negotiate labor costs to manageable levels. But Central Falls is a special case. Prior to the city's bankruptcy, Rhode Island passed a law granting bondholders a first claim on the city's revenues, ahead of the police, the fire department, and retirees, which drastically simplified the bankruptcy judge's task.[47] Such a policy may have been effective, in a limited sense, but it is of questionable fairness since it amounts to a bailout of investors in risky bonds. A more useful lesson to draw from Central Falls is that a state appointee should guide the locality through the bankruptcy process. Opting for bankruptcy is a tough decision, but tougher decisions lie ahead when negotiating the debt adjustment plan with creditors. The political will possessed by a state appointee, along with bankruptcy court's authority over debt, makes for a powerful combination that, in the most desperate cases, may be required to resolve distress.

California, by contrast, grants relatively free and general access to Chapter 9. Vallejo, San Bernardino, and Stockton became insolvent for fiscal as well as economic reasons, but they went bankrupt because of California state government's traditional disinclination to call for or pursue intervention.[48] The results are not encouraging.[49] Vallejo filed for bankruptcy in May 2008 to obtain relief from its personnel costs, which constituted 80 percent of its budget. Before exiting Chapter 9 in November 2011, Vallejo did manage to restructure some aspects of employee compensation, producing, most notably, a $100 million cut in retiree health-care benefits. In the view of many financial analysts, however, the $10 million that the city spent on legal fees did not produce reductions of a corresponding extent.[50] In fact, Vallejo's payments to pensioners actually increased after the city emerged from bankruptcy.[51]

Chapter 9's ability to reduce debt cannot be ignored. Debt may not be the only problem that a distressed city faces, and when weighed against the considerable legal fees, cutting debt service through bankruptcy may not be worth it.[52] Clearly, in many instances of distress, excessive debt hinders solvency, and, while possible to negotiate debt outside Chapter 9, it is much easier to do so in Chapter 9. After having taken every measure to restore solvency outside bankruptcy, state government may still need the additional power of federal courts in certain cases.

The model is Michigan, where Governor Rick Snyder has attempted to coordinate state intervention and bankruptcy. It is the decided but not final view of his administration that "what can be done in a Chapter 9 can be done outside of a Chapter 9, so why would you go there if you didn't have to?"[53] When Snyder came into office, Michigan had an interventionist policy in place, Public Act 72, passed in 1990. It was ineffective because it failed to give emergency managers the power to restructure union contracts.[54] In 2011, Snyder persuaded the legislature to pass Public Act 4, which granted this power. After Public Act 4 was overturned in a November 2012 referendum, Snyder and the legislature came back with Public Act 436, the Local Financial Stability and Choice Act, which passed shortly after Christmas 2012. Though milder than Public Act 4, granting localities more say in the state intervention process, the new law retained the previous law's authority over contracts.

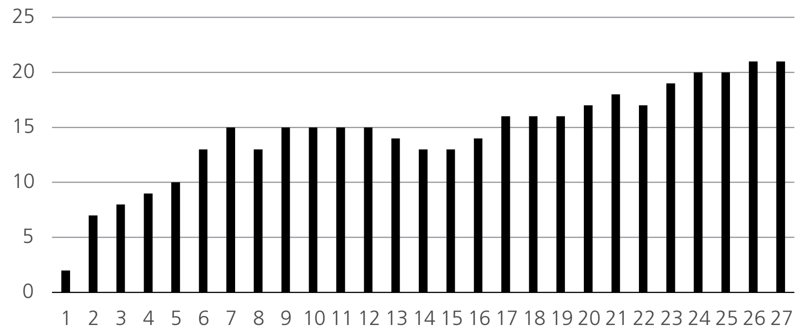
Although Snyder has emphasized state-appointed emergency managers as the best solution to distress, Detroit may yet file for bankruptcy.[55] The emergency financial manager whom Snyder appointed is a corporate-bankruptcy expert, and Public Act 436 explicitly empowers the emergency manager to petition federal court for bankruptcy protection, should a

Pennsylvania's Act 47: Are New Revenues and Technical Expertise Enough?

Passed in 1987, Pennsylvania's Financially Distressed Municipalities Act, or Act 47, remains the state's principal tool for managing local distress. The state's Department of Community and Economic Development administers the program and has authority to declare a local government "fiscally distressed" on the basis of any one of 11 official criteria, such as whether the city has defaulted on its obligations or whether its budget has been out of balance for three years. Upon invoking Act 47, the state hires a private firm to serve as a "recovery coordinator." The coordinator develops a multiyear recovery plan. When the plan is approved by local authorities, the community becomes eligible to apply for state grants and loans and to raise local income and property taxes above their normal statutory limits.

The program is meant to be temporary, but few Act 47 communities have ever left the program, and their ranks have steadily grown.

Chart: Act 47 Communities, 1987-present



Source: Prennsylvania Department of Community and Economic Development

Act 47 has two important flaws that explain its ineffectiveness. First, it overemphasizes the benefit of new revenues. The only special power that the program confers on distressed communities relates to taxation. In general, Act 47 communities must manage collective bargaining, their debt loads, and all other cost-related challenges just as an ordinary, non-distressed community would. The new revenues may reduce communities' incentive to rein in spending, and they usually induce dependence. Many local officials feel that they cannot leave the program because they have no realistic prospect of replacing the tax revenues to which participation in Act 47 gives them access. In a 2007 report, the Brookings Institution recommended that Pennsylvania grant new taxing authority only after a local government emerges from distress.

Second, Act 47 overemphasizes the benefit of technical expertise. The position of recovery coordinator is too weak to be effective because local officials have the right to review and approve any recovery plan. It is rare for a local government to reject a plan, but coordinators—fearing that it will do so—often refrain from recommending tough but necessary measures. Moreover, some observers have claimed that the private firms hired to be recovery coordinators have a conflict of interest, since they benefit from protracted distress. For these reasons and perhaps others, recovery coordinators are a far less forceful and effective presence than the financial control boards or emergency managers that other states have employed to direct fiscal recoveries.

Fiscal distress may result from inadequate revenues, excessive expenditures, poor management, or some combination of the three. Act 47 demonstrates the ineffectiveness of an approach to distress resolution that fails to address spending.

state takeover fail to restore solvency, as happened in Central Falls.[56] The *Detroit Free Press* has argued that Detroit's emergency financial manager should use the threat of bankruptcy to impose needed reforms.[57] If Detroit's emergency manager does eventually take the city into bankruptcy, it will have the same advantage that Central Falls did when its bankruptcy was directed by a state-appointed receiver. But states' primary focus should be on avoiding bankruptcy through effective state intervention policies.

FISCAL OVERSIGHT

Intervention by itself is not enough to meet the challenge of distress. States should also develop oversight policies to identify distress early on, prevent it with technical assistance, and generally encourage best practices in local financial management.

At the local level, basic long-range planning is not the norm. Most local governments do not project revenues or costs beyond one or two years. Baltimore recently made headlines by commissioning a ten-year financial forecast, a move that *The Bond Buyer* described as "unprecedented" among large American cities.[58] According to the Empire Center for New York State Policy, only five of New York State's 80 largest governments project revenues and expenditures more than one year into the future, and of those five, all but one are subject to oversight by a state control board.[59]

Many fiscal-management best practices would reduce the threat of distress, were states to require them of local governments, such as setting benchmarks for fund balances and maintaining modest debt loads and pension costs. But long-range planning is the most critical because only a plan that projects revenues and expenditures four or five years out can anticipate distress and motivate governments to prevent it.

State oversight policies vary widely in their rigor,[60] but there is precedent for tight oversight of local budgets. North Carolina's highly regarded Local Government Commission reviews, approves, and even sells all general obligation bonds issued by local governments in the state.[61] Doing so does not keep local debt in check directly; rather, the state uses the threat of denying credit access as leverage for instituting sound fiscal policy. The commission will not approve a debt issuance if a local government has inadequate reserves. It analyzes local governments' financial reports and places any governments found wanting on a watch list. State government has the authority to seize control of cities' fiscal and administrative affairs, up to the point of increasing taxes; however, it has almost never come to that. The Local Government Commission boasts a strong record of impelling local officials to work out problems on their own.

SUMMARY PROPOSAL

The sequester and other efforts to reduce the federal deficit have raised awareness of the interrelationship between the federal and state and local governments. State and local officials have been among the most vocal in opposing federal cuts because of the prospect of harm to state and local budgets. Local governments, in particular, have only very recently shown signs of recovery. Thus, the concern among some is that reduced federal aid will hinder a yet-fragile return to strength.

But local governments are much more dependent on state aid than federal aid. Local governments are the legal creations of state government, and, inevitably, their problems become states' problems. For the age of austerity—which is certainly real—it is more important to reassess the state and local relationship than the federal and state relationship.

There are four possible approaches to preventing and managing distress: mandate relief, oversight, intervention, and bankruptcy. State governments should coordinate the four into a structured approach to defeating fiscal distress.

Recommendations:

1. ***State governments, particularly in states with strong public-sector unions, should grant mandate relief to local governments in matters of***

personnel spending. States should strengthen local management's bargaining position by weakening pro-labor mandates such as binding arbitration. States should also enact carve-outs from their collective bargaining laws, which would enable cities to determine at least some aspects of compensation unilaterally.

2. ***States should strengthen existing oversight policies toward local finances.*** The point of mandate relief is to give local governments more leverage at the bargaining table. However, all may not use this leverage, so states must adopt toward local finances an attitude of "trust, but verify." States should institute benchmarks for fund balances and adopt statutory debt limits for pensions and retiree health-care liabilities—particularly the latter, which are usually not subject to any state regulation. Although pensions are a more complicated case, since state regulations often determine local pensions' structure and funding, it would still be a useful exercise for governments to settle on an appropriate level of pension debt, as they have for capital debt. States should start requiring local governments to produce fiscal plans extending at least four years into the future. To enforce this requirement, states could either make local aid distributions contingent on such planning, or reserve the right to disapprove local debt issuances in the absence of such planning, as the North Carolina Local Government Commission does.

3. ***States should develop strong and general intervention policies before cases of distress arise.*** Many states, such as New York, have traditionally dealt with distress by means of legislation designed on a case-by-case basis. But such an approach is not always practical, since, when cities become insolvent, events can move rapidly, leaving little time for legislative deliberation.[62] Some questions should be settled in advance. The existence of a clearly articulated intervention policy can give states the leverage to force local officials to address insolvency themselves. The state may play the bad cop to city government's good cop, providing cover for those local officials who want to address the problem but fear the political consequences. States nearly always prefer that cities solve their own problems. But in a fiscal emergency, state government will need to assume control over local government, either through intervention by a state control board, as in the case of the New York City fiscal crisis, or an emergency manager or receiver. In either case, state government should possess ultimate authority over multiyear planning, debt management, and personnel spending.

4. ***States should allow local governments to file for Chapter 9 municipal bankruptcy but only as a last resort and for the specific purpose of debt adjustment.*** Additionally, a state-appointed authority, such as an emergency manager, should guide the locality through bankruptcy.

ENDNOTES

[1] Kroll Bond Ratings, "An Analysis of Historical Municipal Bond Defaults," November 14, 2011, 7.

[2] Ibid., 14.

[3] Ibid., 17.

[4] Ibid., 8, 12

[5] Ibid., 13.

[6] Ibid., 8, 14–16, 21–27.

[7] Technically, the first municipal bankruptcy law was passed in 1934, but the Supreme Court struck it down. The 1937 law withstood constitutional challenge.

[8] Advisory Commission on Intergovernmental Relations, "Bankruptcies, Defaults, and Other Local Government Financial Emergencies," March 1985, 2–3.

[9] Idem, "City Financial Emergencies: The Intergovernmental Dimension," July 1973, 82.

[10] "Actions Taken by Five Cities to Restore Their Financial Health," House of Representatives, Subcommittee on the District of Columbia, Committee on Government Reform and Oversight, March 2, 1995, 62.

[11] "Since early 1975, seldom has a day gone by without the financial plight of America's largest cities receiving prominent mention in the news media": Thomas E. Harvey, "Municipal Debt Adjustment," *The Business Lawyer* 33, no. 1 (November 1977): 221. "An incredible and seemingly insoluble array of financial difficulties confront urban governments in America today": Advisory Commission on Intergovernmental Relations, "City Financial Emergencies," 3.

[12] Steven Church and Jared Goyette, "Stockton Creditors Dispute City's Insolvency at Trial," Bloomberg, March 25, 2013.

[13] See, generally, George Hempel, *The Postwar Quality of State and Local Debt*, National Bureau of Economic Research, 1971.

[14] Moody's Investors Service, "U.S. Municipal Bond Defaults and Recoveries, 1970–2009," February 2010.

[15] Kroll Bond Ratings, "An Analysis of Historical Municipal Bond Defaults," 19.

[16] Brian Chappatta, "Biggest Exodus Since Whitney Ignores May Win Streak," Bloomberg, May 5, 2013.

[17] Moody's outlook on the entire U.S. local government sector has been negative since 2009, and was recently reaffirmed: Moody's Investors Service, "Moody's: Outlook for US Local Governments Remains Negative in 2013," February 21, 2013; United States Government Accountability Office, "State and Local Governments' Fiscal Outlook," April 2012; and "State Budget Crisis Task Force Report," July 2012, 53–56.

[18] Pew Charitable Trusts, "The Local Squeeze," June 2012; and Daniel DiSalvo, "Government Crowded Out," Manhattan Institute Civic Report No. 77, April 2013.

[19] Lisa Lambert, "California Cities to Remain 'Fiscally Challenged'—Moody's," Thomson Reuters News & Insight, May 14, 2013. In the first quarter of 2013, Moody's enacted 207 rating changes, of which 83 percent were downgrades; Jennifer DePaul, "Moody's: High Pace of Downgrades Continues," *Bond Buyer*, April 29, 2013.

[20] Rhode Island Public Expenditure Council, "Fiscal Stress and Municipal Bankruptcy: History and Implications for Rhode Island," April 2012.

[21] Ted Roelofs, "Not Just Detroit: New Report Finds Fiscal Troubles for Dozens of City Halls Across Michigan," MLive.com / *Bridge* magazine, May 16, 2013.

[22] Clayton P. Gillette, "Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy," *The University of Chicago Law Review* 79, no. 1 (winter 2012): 302–8. "A financial emergency occurring in even one unit of local government can cause serious damage to the credit of governments throughout the State": Advisory Commission on Intergovernmental Relations, "City Financial Emergencies," 7.

[23] Michael W. McConnell and Randal C. Picker, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy," *The University of Chicago Law Review* 60, no. 2, (spring 1993): 470–71.

[24] Kroll Bond Ratings, "An Analysis of Historical Municipal Bond Defaults," 13.

[25] Mario Polèse, "Five Principles of Urban Economics," *City Journal* 23, no. 1 (winter 2013).

[26] Aaron Renn, "Why Gentrification?," newgeography.com, May 14, 2013.

[27] U.S. Government Accountability Office, "State and Local Governments' Fiscal Outlook"; "State Budget Crisis Task Force Report," 53–56; and "Moody's: Outlook for US Local Governments Remains Negative in 2013."

[28] Daniel DiSalvo, "The Trouble with Public Sector Unions," *National Affairs* (fall 2010).

[29] "One Year Later, Municipal Health Insurance Law a Smashing Success," press release, Metropolitan Area Planning Council and the Boston Foundation, July 11, 2012.

[30] Steven Malanga, "Death by Arbitration," *City Journal* 22, no. 4 (autumn 2012); and E. J. McMahon and Michael Wright, "Police and Fire Pay Keep Rising, Benefits Sticky Under Arbitration," Empire Center for New York State Policy, May 2013.

[31] Tim Reid, "Bankrupt San Bernardino Approves over $1 Million in Pay Hikes," Reuters, March 19, 2013.

[32] "Supplemental Documentation of the Detroit Financial Review Team," February 19, 2013; and James Hohman, "Detroit's Emergency Manager Must Enforce Rules City Officials Ignored," *The Detroit News*, March 19, 2013.

[33] Liz Farmer, "The 'B' Word: Is Municipal Bankruptcy's Stigma Fading?," *Governing* (March 2013).

[34] McConnell and Picker, "When Cities Go Broke," 454; and Advisory Commission on Intergovernmental Relations, "City Financial Emergencies," 75–76.

[35] Alison Vekshin, "California's Municipal Bankruptcies Sign of Stigma Waning," *Bloomberg*, July 12, 2012.

[36] Omer Kimhi, "Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem," *Yale Journal on Regulation* 27:2 (2010): 369.

[37] McConnell and Picker, "When Cities Go Broke," 455, 463.

[38] Twelve states specifically authorize municipalities to file for bankruptcy, another 12 grant conditional filings, three grant limited authorization, two prohibit filings, and 21 provide no authorization; James E. Spiotto, Ann E. Acker, and Laura E. Appleby, *Municipalities in Distress?: How States and Investors Deal with Local Government Financial Emergencies*, Chapman & Cutler LLP, 2012, chap. 7, p. 5.

[39] McConnell and Picker, "When Cities Go Broke," 460. "The Bankruptcy Code thus erects serious obstacles to municipal filing beyond those faces by private debtors," (461).

[40] Kimhi, "Chapter 9 of the Bankruptcy Code," 357.

[41] "In a typical bankruptcy case, the debtor has a limited period of time during which it has the exclusive right to file and obtain approval of a plan of reorganization or liquidation, after which creditors or other parties in interest may propose their own plan(s). By contrast, in a chapter 9 case, only the municipality may propose a plan of adjustment." Peter Benvenutti et al., "United States: An Overview of Chapter 9 of the Bankruptcy Code: Municipal Debt Adjustments," mondaq.com, August 23, 2010.

[42] Kimhi, "Chapter 9 of the Bankruptcy Code," 360-1, 384.

[43] Ibid.

[44] "Patterson: Detroit Bankruptcy Would Hurt Oakland's Bond Rating," *The Detroit News*, March 21, 2013.

[45] "[U]nlike Chapter 9, state intervention offers a genuine rehabilitation process, and not simply a temporary solution to liquidity problems": Kimhi, "Chapter 9 of the Bankruptcy Code," 51.

[46] Ibid., 27. "[T]he bankruptcy court is not able to take certain actions in a chapter 9 case that it can take in other bankruptcy cases. For example, a bankruptcy court cannot appoint a trustee to operate the municipality or allow a secured creditor to force the sale of assets to satisfy the secured creditor's lien. In this regard, municipalities in bankruptcy enjoy a level of protection over their operations and property that other debtors do not have." Benvenutti et al., "United States: An Overview of Chapter 9 of the Bankruptcy Code."

[47] Michael Corkery, "Pensions Chopped by Investors Paid," *The Wall Street Journal*, December 20, 2011; Rhode Island Public Expenditure Council, "Fiscal Stress and Municipal Bankruptcy: History and Implications for Rhode Island," April 2012; and Cate Long, "Bondholders Have Cut in Line," Reuters, August 3, 2011.

[48] "California has long held that its cities should manage themselves": Stephen C. Fehr, "New York, California Seek Ways to Help Fiscally Fragile Cities," *Stateline*, December 17, 2012.

[49] Alison Vekshin and Martin Z. Braun, "Vallejo's Bankruptcy 'Failure' Scares Cities into Cutting Costs," Bloomberg, December 14, 2010.

[50] Jefferson County, which filed for bankruptcy in November 2011, had legal fees of about $1 million per month as of April 2013; "The Municipal Fiscal Crisis: Comptroller DiNapoli's Keynote Address at the Public Policy Forum, Nelson A. Rockefeller Institute of Government," April 8, 2013.

[51] "Vallejo Exits Bankruptcy Paying More for Pensions," Calpensions, August 8, 2011. According to a report issued by Bank of America: "The city paid roughly $10 million in legal fees and wound up with no changes to its labor costs, which was the impetus for filing." While in bankruptcy, Vallejo negotiated a contract with police that gave them a 7 percent raise. Cate Long, "Despite Neighborhood Watch Efforts, Bankrupt Vallejo Is Still Running Deficits," Reuters, May 21, 2013; and Ron French, "In Post-Bankruptcy Vallejo, Services Few, Times Hard," *Detroit Free Press / Bridge* magazine, May 21, 2013. For a careful cost-benefit analysis of Vallejo's experience in bankruptcy, see Gabriel Petek et al., "Case Study: The Vallejo, Calif. Bankruptcy," Standard & Poor's, October 4, 2012; and Jessica York, "Vallejo Looks to Labor Concessions to Plug $5.2 Million Deficit," *Times Herald*, May 18, 2013.

[52] "Bankruptcy is not a viable option because primarily we have very little debt," Flint emergency manager Ed Kurtz said, adding that "it's a four to eight year process that would cost between $10 and 18 million": Dominic Adams, "Bankruptcy Not an Option for Flint, Says Emergency Manager Ed Kurtz," MLive.com, May 20, 2013. "Bankruptcies restructure debt, but they don't address gross mismanagement, [Louis Schimmel, Pontiac, Michigan's emergency financial manager] says. During his 18-month tenure, Schimmel has struck new labor agreements, consolidated city resources, cut spending and sold off assets to bring Pontiac into a balanced budget. Bankruptcy, he says, doesn't stop a city from making poor financial choices in the future": Farmer, "The 'B' Word."

[53] Brian Chappatta, "Detroit Better Off with Manager than Bankruptcy, Dillon Says," Bloomberg, February 25, 2013.

[54] As one Michigan emergency manager put it, to task a manager with reforming a distressed city without squarely addressing personnel spending, particularly in a blue state, is tantamount to saying, "I want you to fix this problem, but you can't touch 80 percent of what's under the hood": Holeywell, "Emergency Financial Managers."

[55] Matt Helms and Joe Guillen, "Detroit's Emergency Financial Manager Won't Rule Out Bankruptcy for the City," *Detroit Free Press*, March 17, 2013.

[56] Technically, Detroit's emergency manager was appointed under Public Act 72, but he was to be invested with Public 436's enhanced powers when the latter went into effect in late March. "Snyder Confirms Financial Emergency in Detroit, Turnaround Expert Kevyn Orr Appointed EFM," press release, office of Governor Rick Snyder, March 14, 2013.

[57] "Six Keys to Making an Emergency Manager Work in Detroit," editorial, *Detroit Free Press*, March 3, 2013.

[58] Kyle Glazier, "Baltimore's 10-Year Forecast Sets Precedent," *The Bond Buyer*, February 7, 2013.

[59] "Taking a Longer View on Our Local Budgets," Empire Center for New York State Policy, January 16, 2013.

[60] Spiotto, Acker, and Appleby, *Municipalities in Distress?*, chaps. 4, 7.

[61] Throughout the years, North Carolina's Local Government Commission has attracted a considerable degree of admiration: "State Administrative Supervision of Local Government Debt: The North Carolina Model," *Duke Law Journal 21,* issue 5, 487-510; Kimhi, "Chapter 9 of the Bankruptcy Code," 392-5; Stephen C. Fehr, "North Carolina Agency Is Local Government Lifeline," *Stateline*, June 6, 2012; Charles Coe, "Preventing Local Government Fiscal Crises: The North Carolina Approach," *Public Budgeting & Finance* 27, no. 3 (fall 2007), 39–49; and Advisory Commission on Intergovernmental Relations, "City Financial Emergencies," 79.

[62] Advisory Commission on Intergovernmental Relations, "City Financial Emergencies," 8.

The Manhattan Institute's **Center for State and Local Leadership (CSLL)** promotes promising new approaches to reform of state and local government. CSLL works on a broad range of issues, including public sector reform (specifically of pensions and health benefits), education reform, prisoner reentry, policing, public housing, infrastructure, immigration, and public service delivery. By spotlighting new ideas, and providing the research and proposals to inform creative new policies, the CSLL hopes to lay the groundwork for an environment in which commerce, employment, and a rich civic life can flourish.

The CSLL operates across the country, working in states such as California, Illinois, and Rhode Island, and cities such as Newark, New Jersey and Detroit, Michigan. The CSLL's tools include regular writing and research reports by affiliated Manhattan Institute scholars and senior fellows, along with public events and media appearances. The CSLL operates www.PublicSectorInc.org, a website devoted to analysis of the implications—financial and political—of the power wielded by public sector unions and allied elected officials. The CSLL also annually selects and showcases the Manhattan Institute's Urban Innovator Award, which recognizes a state or local leader whose combination of policy creativity and skill at implementation has led to groundbreaking improvements in public service, and the Manhattan Institute's Social Entrepreneurship Awards, which recognize those who identify social needs and take it upon themselves to address them privately.

www.manhattan-institute.org/csll

The Manhattan Institute is a 501(C)(3) nonprofit organization. Contributions are tax-deductible to the fullest extent of the law. EIN #13-2912529