

Chicago Fed Letter

Local governments on the brink

by Richard H. Mattoon, senior economist and economic advisor

This article examines the likelihood of local governments defaulting on their debt or filing for bankruptcy. Despite the challenging fiscal environment today, the vast majority of local governments are not likely to do either, if history serves as a guide for the future.

The fiscal resources of local governments are deeper than commonly believed.

Local governments¹ of all sizes are facing many challenges in 2011, partly because of their overwhelming dependence on property tax revenues to fund their operating budgets. The housing and commercial real estate busts are translating into declining taxable property values; simultaneously, cash-strapped state governments are looking to reduce their aid to local governments so that they can shore up their own budgets. As if this were not bad enough, many local governments also have to deal with underfunded public pensions, which demand larger and larger annual contributions to return to stability.

Given such challenges, many news stories have suggested that a wave of local government bankruptcies and credit defaults may occur in 2011.² Local government bankruptcy filings have been infrequent in U.S. history (e.g., only 600 municipal bankruptcy petitions have been filed since the first federal legislation permitting such bankruptcies was enacted in 1934). Still, some suggest that the problems confronting local governments are different this time around, making bankruptcies more likely. Adding fuel to this speculation has been the poor performance of the municipal debt market³ at the end of 2010 and into 2011; over the past few months, many investors have exited the municipal bond market, and several communities have found it difficult to issue debt.⁴

In this article, I discuss local governments' fiscal conditions, which suggest that

concerns about bankruptcy and default may be overblown. For one, the fiscal resources of local governments are deeper than commonly believed. Also, local governments often can take intermediate corrective budgetary action (usually at the insistence of the state) to avoid bankruptcy. Finally, in most cases this corrective action is preferable to the stigma that bankruptcy creates, particularly with regard to the issuance and performance of municipal bonds.

So how bad is it?

Tax revenues from the workhorse of local governments' tax systems—the local property tax—have not yet fallen as dramatically in recent years as some might think. While there have been declines in property values, administrative features of property tax systems have muted the effects of these declines into actual tax collections. In some cases, time lags in the property value reassessment cycle prevent home values from reflecting the current market conditions. In other instances, revenue collections are authorized for a set dollar value, and they do not change along with property values.⁵ According to the U.S. Census Bureau, property tax revenues made up 72% of all local tax revenues in 2007–08.⁶ Thus, the relatively stable performance of this tax should be welcome news to local governments.

That said, the revenue performances of some other sources have tended to be less robust. During the real estate

1. Experience of selected local governments facing fiscal stress

| | Cause of fiscal stress | Resolution strategy |
|--|--|--|
| Did not file for Chapter 9 | | |
| New York City (pop. 7.9 million), 1975 | A history of questionable accounting practices led to a lack of funds to meet short-term debt obligations. | New York City avoided bankruptcy through a federal loan and debt restructuring. The State of New York created the Municipal Assistance Corporation to act as a virtual receiver to restructure the city's finances. This led to several accounting reforms and the creation of new oversight authorities to prevent future insolvencies. |
| Harrisburg, PA (pop. 47,000), 2010 | The city accumulated a debt of \$282 million for an incinerator retrofit and expansion project (started in 2003). There has been a long-term decline in the underlying fiscal base. | The State of Pennsylvania offered Harrisburg protection and fiscal restructuring, short of bankruptcy, under the state's Act 47. |
| Detroit (pop. 910,000), 2010 | There is no immediate threat of bankruptcy, but long-term economic decline has seen city general fund tax revenues increase by only 1% from 1999 to 2009. | Detroit is required to file a deficit elimination plan designed to produce a \$1.75 million general fund surplus by June 30, 2012. The city has a bond rating of BB from Standard & Poor's. The State of Michigan requires any municipality that has a budget deficit to file a deficit elimination plan, and the state has the explicit power to approve, reject, or change the plan. If necessary, the state can appoint a financial manager whose authority includes approving and amending budgets, renegotiating labor contracts, and monitoring debt levels. The financial manager can also lead the municipality through a Chapter 9 bankruptcy, although this has not been pursued. |
| Filed for Chapter 9 | | |
| Vallejo, CA (pop. 120,000), 2008 | Prior labor contracts created pension and wage obligations that could not be supported by town revenues. For fiscal year 2008–09, labor costs were estimated at \$79.4 million, while general revenues were estimated at \$77.9 million. | Vallejo has filed a five-year fiscal plan with a bankruptcy judge, awaiting resolution. The plan would eliminate \$195 million in unfunded pension liabilities, delay payments to bondholders, cut employee benefits, and create a rainy day fund. Vallejo has paid \$5 million in bankruptcy-related legal costs. |

NOTE: For more on Chapter 9 bankruptcy, see www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx.

SOURCES: M. Miller, 2011, "Harrisburg shouldn't consider bankruptcy, Dauphin County commissioner says," *Patriot-News*, March 3, available at www.pennlive.com/midstate/index.ssf/2011/03/harrisburg_shouldnt_consider_b.html; and A. Vekshin and M. Z. Braun, 2010, "Vallejo's bankruptcy 'failure' scares cities into cutting costs," *Bloomberg Businessweek*, December 14, available at www.businessweek.com/news/2010-12-14/vallejo-s-bankruptcy-failure-scares-cities-into-cutting-costs.html.

boom, local governments feasted on development fees and real estate transfer taxes. Since then, these sources of revenues have largely evaporated. For example, in Chicago, revenues from real estate transfer fees peaked at nearly \$250 million in 2006, before falling to less than \$70 million in 2009.⁷

One great unknown is whether state governments will significantly cut (or at a minimum freeze increases in) aid to local governments in the upcoming budget year (which starts for most states on June 30). Cuts in local aid (or freezes in raising aid) are quite possible because state governments will soon be struggling to make up for budget gaps due to the winding down of the federal stimulus funds. For example, the new revenues produced by the recent hikes in personal and corporate income taxes in Illinois will only go to the state government. The amount of revenues shared with Illinois municipalities will be largely unchanged.

On a positive note, municipalities appear to have reserves that can be tapped in the short run. According to a survey by the National League of Cities, municipalities'

ending balances for general funds, which are like "rainy day funds," peaked at 25.2% of general fund expenditures in 2007. Ending balances still amounted to 21.4% of general fund expenditures in 2009—a healthy share by historical standards. Projected ending balances for 2010 are at 19.9%, which would still be higher than any share of ending balances recorded over the period 1985–2000.⁸

Municipal debt levels

There is clear statistical evidence that since 1999, local governments, in aggregate, have been increasing their debt.⁹ However, it is hard to make the case that this debt is reaching an unmanageable level. For instance, the ratio of municipal debt to gross domestic product (GDP) was around 14% in 2009—roughly at the same level it had been during much of the 1985–94 period.¹⁰ Also, municipalities tend to issue debt for infrastructure projects, and evidence suggests that they tend to match the term of the debt to the life of the project. An examination of the maturity distribution of municipal debt shows a fairly uniform distribution, with between 2.5% and 5.5% of the

debt expiring each year over a 20-year period.¹¹ Little of the debt appears to be short-term debt, which would require immediate payoffs.

However, there is a component of municipal debt that is less readily seen and more worrisome.¹² Underfunded public pensions (and retiree health plans) continue to demand increasing shares of many local government budgets. These pension (and health plan) obligations do not show up in reported debt figures (unless the government has issued debt like pension bonds to help fund them). Still, the necessity of funding these obligations represents a form of debt that places a claim on local revenues.

Should creditors be worried?

History suggests that municipal debt defaults are rare, even in the worst of times. Following the passage of federal bankruptcy legislation in 1934 permitting local governments to file for bankruptcy, there was an expectation that 1935 would see a rash of filings as the Great Depression raged on. Instead, only 1.8% of all local governments defaulted in 1935, and by 1937 most defaults had

been resolved, with the average recovery rate for creditors equaling 97%.¹³ In relatively more recent times, credit rating agency Moody's reports that over the period 1970–2009 the cumulative default rate for local governments was 0.09%; in comparison, the default rate for corporate bonds over the same period was 11.06%.¹⁴

What if bankruptcy is necessary?

During the Great Depression, as tax revenues declined dramatically, some legal process needed to be established to allow local governments to restructure their financial obligations. Before the federal bankruptcy legislation of 1934 had been passed, state-based remedies usually compelled local governments to raise taxes to pay creditors. Such remedies were often counterproductive, since they forced communities to raise taxes during a recession. In addition, these remedies compelled creditors to file separate lawsuits to receive full payment for their claims rather than accept a negotiated settlement to all claims.

Federal bankruptcy law now allows a local government to file for protection under Chapter 9 of the federal bankruptcy statute. However, not all states (including the Seventh Federal Reserve District¹⁵ states of Illinois, Indiana, and Wisconsin) permit Chapter 9 filings.¹⁶ In states where Chapter 9 filings are prohibited, there is often some mechanism for state intervention that allows for a new financial plan to be put in place short of bankruptcy. In Chapter 9 filings (or state interventions), the federal courts (or financial intermediaries) provide protection from creditors so that a fiscally distressed local government can adjust its debts while continuing to provide essential public services.¹⁷

Pros and cons of bankruptcy

The primary advantage of bankruptcy is that a bankruptcy petition invokes an automatic stay of any action taken against the local government, with this protection extending to all local government officers and inhabitants of the community. This injunction gives the local government breathing space to develop a new fiscal plan with the assistance of a bankruptcy judge, who is usually an expert arbiter in the field. Through this

process, existing obligations can be restructured and a sustainable fiscal plan can be implemented.

The primary disadvantage of bankruptcy is its negative repercussions for a local government in the credit market. The credit rating for a local government that has filed for bankruptcy will be either downgraded or suspended, making debt issuance very difficult. However, if a credible fiscal plan can emerge from the bankruptcy process, the local government's credit standing can be restored, as evidenced by the results of the Orange County, CA, filing in 1994.¹⁸ The other disadvantages for a community are the administrative costs and distractions of the bankruptcy process, as well as the stigma associated with it.

Local government authorities contemplate filing for bankruptcy or actually file for bankruptcy for a number of reasons (which are sometimes related). These can range from unrealistic cost assumptions for large infrastructure projects to overly generous employee wage and benefit structures to long-term economic decline. Figure 1 provides a small sampling of fiscally distressed local governments whose authorities had contemplated filing for Chapter 9.

Municipal bond market woes

If the rate of municipal credit defaults has been low in recent years and local governments are not likely to file for bankruptcy, then why did the municipal bond market experience such trouble in late 2010 and early 2011? In December 2010, the municipal bond market took a sudden turn for the worse after nearly two years of strong returns. A sudden net outflow of investor money from municipal bond funds, which led to a spike in bond issuing costs, created a stir about the future health of municipal bonds. However, factors other than a change in the underlying creditworthiness of municipal bond issuers might explain municipal bonds' poor performance late last year and early this year. For one, local governments may have simply glutted the market with their new bond products. In particular, they rushed to issue taxable, federally subsidized Build America Bonds (BABs) before the BABs program expired at the

end of 2010.¹⁹ While BABs appeal to a different type of investor than traditional tax-exempt municipal bonds, the sheer size of the BABs offerings may have satiated investors' appetite for all municipal bonds late last year and into this year. In addition, the Bush tax cuts were extended in December 2010, making the tax advantages of municipal bonds less important for wealthy investors.

Conclusion

There is little disagreement that 2011 will be a tough year in local government finance. Minimal growth or outright declines in property tax revenues, reduced assistance from state governments, and requirements to make larger payments to underfunded public pension funds will loom large for many local governments. However, if history is any guide, few local governments will either default on their debt or end up in bankruptcy. The aftermaths of actual local government bankruptcies—such as that of Vallejo, CA, in 2008—suggest that governments are hurt badly when they emerge from bankruptcy, particularly in their ability to issue debt. And so, in all but the most dire cases, local governments under stress are likely to take alternative steps to shore up their fiscal positions.

Charles L. Evans, *President*; Daniel G. Sullivan, *Executive Vice President and Director of Research*; Spencer Krane, *Senior Vice President and Economic Advisor*; David Marshall, *Senior Vice President, financial markets group*; Daniel Aaronson, *Vice President, microeconomic policy research*; Jonas D. M. Fisher, *Vice President, macroeconomic policy research*; Richard Heckinger, *Assistant Vice President, markets team*; Anna Paulson, *Vice President, finance team*; William A. Testa, *Vice President, regional programs, and Economics Editor*; Helen O'D. Koshy and Han Y. Choi, *Editors*; Rita Molloy and Julia Baker, *Production Editors*; Sheila A. Mangler, *Editorial Assistant*.

Chicago Fed Letter is published by the Economic Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.

© 2011 Federal Reserve Bank of Chicago
Chicago Fed Letter articles may be reproduced in whole or in part, provided the articles are not reproduced or distributed for commercial gain and provided the source is appropriately credited. Prior written permission must be obtained for any other reproduction, distribution, republication, or creation of derivative works of *Chicago Fed Letter* articles. To request permission, please contact Helen Koshy, senior editor, at 312-322-5830 or email Helen.Koshy@chi.frb.org. *Chicago Fed Letter* and other Bank publications are available at www.chicagofed.org.

ISSN 0895-0164

- ¹ In this article, local governments refer to municipal governments and other substate governmental units, such as special districts (e.g., school districts, park and recreation districts, and public utility districts).
- ² See, e.g., D. Byrne, 2010, "Thinking the unthinkable: Bankruptcy in Chicago," *Chicago Tribune*, December 20, available at http://articles.chicagotribune.com/2010-12-20/news/ct-oped-1221-byrne-20101220_1_state-comptroller-chapter-local-units.
- ³ The municipal debt market, or municipal bond market, refers to the market for debt issued (and reported) by all local governments (not just municipalities).
- ⁴ J. Neuman, 2011, "Munis got upended in 2010, and the outlook is mixed," *Wall Street Journal*, January 3, available at <http://online.wsj.com/article/SB10001424052970203731004576045981061735112.html>; and Agnes Crane and Jeffrey Goldfarb, 2010, "Dire headlines unsettle muni bond investors," *New York Times*, December 9, available at www.nytimes.com/2010/12/10/business/10views.html.
- ⁵ However, the most recent National League of Cities fiscal conditions survey for 2010 finds that lower assessments are beginning to catch up with revenues. The survey found that while property tax revenues increased 4.2% in 2009, projected collections are anticipated to drop by 1.8% in 2010. See C. W. Hoene and M. A. Pagano, 2010, "City fiscal conditions in 2010," Research Brief on America's Cities, National League of Cities, October, p. 3, available at www.nlc.org/ASSETS/AE26793318A645C795C9CD11DAB3B39B/RB_CityFiscalConditions2010.pdf.
- ⁶ I calculated this value by dividing total U.S. local property tax revenues by total U.S. local tax revenues in <http://www2.census.gov/govs/estimate/08slsstab1a.xls>.
- ⁷ City of Chicago, Office of Management and Budget, 2010, *Budget 2011: Overview and Revenue Estimates*, report, chart 17, p. 47, available at www.cityofchicago.org/content/dam/city/depts/obm/supp_info/2011_Overview_and_Revenue_Estimates.pdf.
- ⁸ Hoene and Pagano (2010), figure 9, p. 6.
- ⁹ The U.S. Census Bureau reports that total state and local debt was about \$2.5 trillion in 2007–08 (\$1.0 trillion for state and \$1.5 trillion for local); see the debt outstanding row in <http://www2.census.gov/govs/estimate/08slsstab1a.xls>. By comparison, in 1997–98 total state and local debt was about \$1.3 trillion (\$500 billion for state and \$800 billion for local); see the debt outstanding row in <http://www2.census.gov/govs/estimate/98stlss1.xls>.
- ¹⁰ AllianceBernstein LP, 2010, "Municipal market update: State and local governments face difficult decisions," report, New York, October, display 7, p. 6, available at https://www.alliancebernstein.com/abcom/Perspectives_Web/Current/PrivateClient/MuniMarketUpdate_June2010/MuniMarketUpdates_2010i.pdf.
- ¹¹ *Ibid.*, display 10, p. 7.
- ¹² One study suggests that as of June 2009, gaps in U.S. city and county pension funds will equal \$574 billion based on a sample of 77 plans sponsored by 50 major cities and counties; see R. Novy-Marx and J. Rauh, 2010, "The crisis in local government pensions in the United States," Northwestern University, working paper, October, available at www.kellogg.northwestern.edu/faculty/rauh/research/NMRLocal20101011.pdf.
- ¹³ AllianceBernstein LP (2010), p. 5.
- ¹⁴ Moody's Investors Service, 2010, "U.S. municipal bond defaults and recoveries, 1970–2009," special comment, New York, February, exhibit 10, p. 10, available at http://v2.moodys.com/cust/content/Content.ashx?source=StaticContent/Free%20Pages/Regulatory%20Affairs/Documents/us_municipal_bond_defaults_and_recoveries_02_10.pdf.
- ¹⁵ The Seventh Federal Reserve District comprises all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.
- ¹⁶ C. Whatley, 2011, "Facts you should know: State and local bankruptcy, municipal bonds, state and local pensions," The Council of State Governments, fact sheet, February 16, available at <http://knowledgecenter.csg.org/kc/comment/reply/964>.
- ¹⁷ University of California Hastings School of Law, Public Law Research Institute, n.d., ca. 2004, "Municipal bankruptcy: State authorization under the federal bankruptcy code," report, San Francisco, available at <http://w3.uchastings.edu/plri/fal95tex/muniban.html>.
- ¹⁸ F. Norris, 1994, "Orange County's bankruptcy: The overview," *New York Times*, December 8, available at www.nytimes.com/1994/12/08/business/orange-county-s-bankruptcy-the-overview-orange-county-crisis-jolts-bond-market.html.
- ¹⁹ Normally, local governments can only issue tax-exempt bonds, whose interest rates are much lower than those of BABs. For more on BABs, see http://money.cnn.com/2010/12/22/news/economy/build_america_bonds/.