Federation of Business Discipline Journal
Volume 10, 2020 p 11 - 23

MUNICIPALITY STRESS: AN INVESTIGATION OF BANKRUPTCY, FINANCIAL ISSUES AND CONSEQUENCES

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ABSTRACT

Cities and other municipalities falling on hard financial times are common due to population shifts as well as economic and other changes. Recently, however, municipalities have filed bankruptcy as a means to resolve their financial difficulties. This study reviews municipalities that filed for bankruptcy, with negative net positions (technical bankruptcy), and analyzes the differences. The discussion addresses both the positive and negative effects of municipal bankruptcies and financial stress on the communities and their stakeholders together with concerns for the future.

INTRODUCTION

Within the past two decades, several notable municipalities have filed bankruptcy proceedings. Five of the municipalities are located in California. The first, Orange County, CA, was caught with inappropriate investment decisions resulting in insufficient resources to pay ongoing operating costs. A decade later as the nation coped with an economic downturn, municipalities sought bankruptcy protection as relief from a mixture of issues including litigation, declining tax revenues, escalating benefit obligations, and failing contracts. In June 2012, Stockton, CA's high crime rate, chronic unemployment and dysfunctional local government culminated in its filing for bankruptcy, at the time the largest city in the U.S. to ever seek protection status (Badenhausen 2013; Christie, 2012). In 2013, Detroit, MI became the largest municipality to declare bankruptcy (Fletcher, 2013).

Stockton's path from burgeoning economic growth and prosperity to dysfunction and failure is one it shares with numerous other municipalities across the nation, from San Bernardino, CA to Central Falls, RI and Detroit, MI. This study outlines the dynamics and events that contributed to their failures, commonalities, and the effects of bankruptcy on the community and stakeholders. The municipalities' comprehensive annual financial reports (CAFR) are examined to identify financial issues, if any, that contribute to their financial issues. With numerous municipalities across the nation teetering on insolvency, issues that could spark a widespread crisis are identified and discussed.

DEFINITION

Accounting insolvency for municipalities occurs when total liabilities exceed the net assets, i.e., financial insolvency or negative net worth. Technical insolvency occurs when a municipality is unable to meet its financial obligations. If a municipality does not meet an obligation, it is in default. Thus, technical insolvency is not a synonym for bankruptcy because bankruptcy is a determination of insolvency made by a court of law whose deliberations attempt to resolve the obligation. Municipalities must meet explicit criteria to declare bankruptcy as those who hold the municipality's debt cannot seize the municipality's assets as payment of the debt. Provisions within the United States Bankruptcy Code employ certain rights within the Code to protect the municipality from creditors and to balance respective interests of the creditors.

Chapter 9 of the Bankruptcy Code provides for the reorganization of municipalities including cities, villages, towns, counties, and school districts. The first legislation involving municipal bankruptcies was enacted in 1934 in the wake of the Great Depression. The purpose of Chapter 9 is similar to that for individuals and private institutions in that it seeks to provide financially distressed municipalities protection from their creditors while they negotiate a plan for resolving their obligations (United States Courts, 2020).

Municipalities are creations of state laws, and therefore, a prerequisite to any bankruptcy filing requires an evaluation of potential applicable state laws preventing or governing bankruptcies. The following five criteria that must be met for a municipality to file for bankruptcy:

1. The municipality must have specific authority to file for Chapter 9 bankruptcy from the stae;
2. The municipality must be insolvent;
3. The municipality must prove its desire to adopt a plan to adjust its debt;
4. The municipality must satisfy at least one of four specified conditions to demonstrate that it has obtained or tried to obtain an agreement with its creditors, that it is not feasible to negotiate with its creditors holding at least the majority of the claims in each class that the entity intends to impair under its debt adjustment plan, or that it has reason to believe its creditors might attempt to obtain preferential payment or transfer of the entity's assets, and;
5. The municipality must show that it has filed for bankruptcy in good faith.

Appendix 1 displays the 50 U.S. states' authorization for municipal bankruptcy filing. The states authorize or conditionally authorize municipal bankruptcy, grant limited authorization, prohibit municipalities from filing, or provide no specific authorization regarding municipal bankruptcy. In states lacking authorization, municipalities are not eligible to file (Eucalitto, Younger & Pena, 2013; Murphy, 2018; Morbidelli, 2019).

Oftentimes, Chapter 9 results in a direct conflict with the Tenth Amendment to the Constitution and the sovereignty of states in governing their internal affairs. The Constitution

prevents the federal government from liquidating the assets of the municipality and distributing them to creditors. As a result, the federal government is far more limited in its ability to manage municipal bankruptcies than it is in private industries (United States Courts, 2020).

Empirical research on bankruptcy authorizations is still in the nascent stage (Yang, 2019). Gao, Lee and Murphy (2019) and Moldogaziev, Kioko and Hildreth (2017) examine the impact on local, not state, borrowing cost that show bonds issued in unconditional states have higher interest rates that signals the end of implicit state guarantee for the local municipalities borrowing.

Despite numerous instances of fiscal mismanagement, municipal bankruptcies are still quite small as less than 700 instances have occurred since Congress first instituted a system for protection (Reid, 2012). Of those, the majority occur in only a handful of states. California, Texas, and Alabama, have all witnessed bankruptcy filings, but it is Nebraska that holds the dubious distinction of the state with the most Chapter 9 bankruptcies. Nebraska contains unique taxing authorities named Sanitary and Improvement Districts (SIDs). Quirks in the state law allow them unobstructed access to bankruptcy courts (Chapman , 2020). The resulting SID filings have made Nebraska home to almost one-fifth of the 220 municipal bankruptcy filings occurring in the U.S. since 1981 (Chapman, 2020; Eucalitto et al., 2013, 11).

MUNICIPAL BANKRUPTICIES

While the frequency of municipal bankruptcies is still rather small compared to the corporate world, the rate appears to be growing. When municipalities do file for protection the amounts can be staggering. The largest municipal bankruptcies in history have all occurred within the past decade, each possessing multi-million-dollar deficits and liabilities.

Table 1												
Financial Issues												
Municipalities That Filed for Bankruptcy												
Municipalities filing for bankruptcy	Date Filed	End Date	Union Contracts	Pensions	Infrastructure	Low Reserves	Population Shift and Property Value	Decrease in State Aid	High Debt per Capita	Low Days of Cask on Hand	Low Taxable Real Estate per Capita	Other Issue
Orange CO CA	1994	2017										Investment Scheme
Vallejo, CA	2009	2012	X	X			X		X		Salary	benefits
Prichard, AL*	2009	2010		X								Pension contract
Central Falls, RI	2011	2012	X	X								Benefit contract
Boise Ca, ID*	2011	2011			X							Litigation
Jefferson Co. AL	2011	2013			X							Sewer

Harrisburg, PA*	2011	2012			X	X			X			Incinerator
Mammoth Lakes, CA*.	2012	2012			X							Development contract
Stockton, CA	2012	2015	X	X	X		X	X	X	X	X	Waterfront development
San Bernardino, CA	2012	2017	X	X			X	X		X		Benefits & pop change
Detroit, MI	2013	2014	X	X		X	X		X		X	Contracts /I.: pop change
Hillview, KY*.	2015	2016										Property dispute
Fairfield, Al	2020						X		X			Out of control spending

*Filing denied or dismissed
** Case settled
Source:
Euealitto et al. 2013; Merritt Research Service 2013; Pew Charitable Trust, 2017

Table 1 displays the financial issues confronting municipalities that filed for bankruptcy in the past two decades. The notable commonalities among the issues facing the municipalities are union and pension contracts, shifts in the population, high debt per capita, and ambitious infrastructure projects. All municipalities have emerged from bankruptcy filing with the exception of Fairfield, AL that filed in May 2020.

Fairfield has struggled to maintain its debt obligations since a steel mill closed part of its facility in 2015 and Walmart closed a Supercenter in 2016. After these closures, the transit authority stopped bus service, the municipality faced the shut-off of water service for lack of payment and the county assumed responsibility for police protection. Due to tax revenue reduction and increased costs, Fairfield filed for bankruptcy as a means to extend the terms of its debt, reduce the amount of debt principal and interest or refinancing its debt (Chapman, 2020).

COMMONALITIES AMONG MUNICIPALITIES FILING BANKRUPTCY

The question is, what do municipalities that declared bankruptcy have in common from a financial perspective? Table 2 displays the available 2018 balance sheet for those municipalities that have filed for bankruptcy. Information for Prichard, Al, Hillview, KY, and Fairfield, AL is excluded because the information was not posted on their web pages. These municipalities have very small populations of less than 20,000 and a minimal governance organization. Not finding a

Table 2
2018 Government-wide Statement of Net Position

		Orange County	Vallejo	Central Falls	Boise County	Harrisburg	Mommoth Lakes	Stockton	San Bernardino	Detroit
		Calif	**Calif**	**RI**	**ID**	**PA**	**Calif**	**Calif**	**Calif**	**MI**
Assets:										
Current	$	3,562,470,000	131,618,665	7,890,805	15,330,333	100,822,577	45,760,780	564,282,282	116,439,223	1,345,349,257
Long-term		3,147,060,000	397,778,178	20,875,561	13,093,963	94,201,157	64,487,081	760,120,022	393,340,124	1,430,620,502
Total Assets		**6,709,530,000**	**529,396,843**	**28,766,366**	**28,424,296**	**195,023,734**	**110,247,861**	**1,324,402,304**	**509,779,347**	**2,775,969,759**
Deferred Outflow		**1,051,004,000**	**54,783,382**	**4,618,042**	**371,205**	**28,030,303**	**5,640,649**	**124,202,654**	**74,412,365**	**145,377,491**
Liabilities:										
Current		998,626,000	54,523,485	4,954,327	1,147,906	22,166,425	2,658,723	58,613,383	23,920,823	386,617,187
Long-term		4,790,298,000	321,787,821	40,030,339	1,658,850	220459343	56,484,813	625,100,429	425,981,576	2,860,270,106
Total liabilities		**5,788,924,000**	**376,311,306**	**44,984,666**	**2,806,756**	**242,625,768**	**59,143,536**	**683,713,812**	**449,902,399**	**3,246,887,293**
Deferred Inflow		**818,737,000**	**8,721,029**	**4,240,204**	**327,387**	**55,251,500**	**702,125**	**27,679,965**	**9,660,800**	**16,367,727**
Net Position										
Invested in capital assets net of related debt		3,031,574,000	316,622,007	11,730,561	12,676,432	48,253,700	64,487,081	328,283,709	291,168,979	1,131,353,263
Restricted		1,433,605,000	69,927,367	2,874,449	8,774,662	34,180,924	5,762,155	170,506,765	114,629,131	282,679,621
Unrestricted		(3,312,306,000)	(187,401,484)	(30,445,472)	4,210,264	(157,257,855)	(14,206,387)	238,420,707	(281,169,597)	(1,755,940,654)
Total Net Position	**$**	**1,152,873,000**	**199,147,890**	**(15,840,462)**	**25,661,358**	**(74,823,231)**	**56,042,849**	**737,211,181**	**124,628,513**	**(341,907,770)**
Source: 2018 CAFR										

posted 2018 annual financial report was not unexpected. It is interesting to note that only two municipalities, Boise County , ID and Stockton, CA, have a positive Unrestricted Net Position balance. Given the negative total net position balances only Central Falls, RI, Harrisburg, PA and Detroit, MI have a negative aggregate total net position. That is, these municipalities are accounting insolvent as their liabilities exceed their assets. The confounding variables are the deferred outflow i.e. long-term prepaid expenses and deferred inflows i.e., prepaid long-term revenues.

With the exception of Boise County, ID and Stockton ,CA the one thing the municipalities that have filed bankruptcy have in common in 2018 is a negative unrestricted net position. The negative unrestricted balance indicates these municipalities have no available reserve resources that can be deployed for future operations, program enhancements, or unanticipated costs.

According to Eucalitto et al. (2013) and Merritt Research Services (2013), several municipalities are in fiscal trouble but have not yet filed for bankruptcy protection (Table 3).

Table 3
Financial Issues of
Municipalities That Have Not Filed for Bankruptcy (yet)

Municipalities Fiscal Issues NOT Filing for Bankruptcy	Union Contracts	Pensions	Infrastruc ture	Low Reserves	Population Shift and Property Value Decline	Decrease in State Aid	High Debt per Capita	Low Days of Cash on Hand	Low Taxable Real Estate per Capita
Allentown, PA		X	X	X	X			X	X
Bridgeport, CT	X			X	X		X	X	X
Buffalo, NY					X	X			X
Chicago, IL	X	X			X		X	X	X
New Haven, CT		X		X	X	X	X		X
New Orleans, LA				X	X			X	
New York, NY	X	X		X		X	X		
Philadelphia, PA	X			X	X	X			X
Providence, RI		X		X		X	X		
Rochester, NY		X			X	X			X
San Jose, CA	X	X				X			
Springfield, IL		X			X				X
Source: Eucalitto et al. 2013; Merritt Research Service									

Municipalities displayed in Table 3 exhibit comparable reasons for their financial stress as those municipalities filing bankruptcy (see Table 1). Major among the financial distress is population shift, i.e. decline, resulting in property value decline that produces low taxable real estate. It also appears that personnel union contracts and benefit obligations as well as high debt per capita exacerbate the municipalities' financial stress (Neumann, 2013

OTHER MUNICIPALITIES REPORTING FINANCIAL ISSUES

To determine whether other municipalities have financial issues, a random sample of 2018 Comprehensive Annual Financial Reports (CAFR) was retrieved for analysis. Using the Excel

random number generator function, the 687 municipalities reporting a minimum revenue of $100 million from the 2012 U.S. Census of Governments file were sorted by state and then by the random number assigned. Only financial reports prepared in accordance with GAAP are included in the analysis. The first randomly selected municipality in each state that meets the criteria is included in the 50 CAFR sample. All of the municipalities' CAFRs in the sample received an audit opinion in which the auditors concluded the financial statements fairly represent the financial position of the municipality. None of the 2018 CAFRs in the sample included a going concern note disclosure.

Forty-four of the 50 CAFRs (88 %) report a negative unrestricted net position indicating financial distress. Analysis finds the primary reason for the negative balance results from reporting pension obligations and post-retirement benefits as liabilities in accordance with GAAP (GASB, 2012; 2015). Seventeen (34%) municipalities in the analysis report a negative total net position i.e., accounting insolvency. Several Management Discussion and Analysis (MD&A) for the 17 municipalities with financial issues that have not declared bankruptcy did include an explanation of the accumulated negative unrestricted net position and the negative net position balance.

Table 4 displays selected data for these technical insolvent municipalities

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Table 4									
Municipalities with Negative Total Net Position (Technically Bankrupt)									
Municipality	**Current Ratio**	**Net Invested in Capital Assets**	**Restricted Net Position**	**Unrestricted Net Position**	**Total Net Position**	**Change in Net Position**	**Population**	**Tax Revenue**	**Long-term Liabilities**
Wilmington, DE	2.38	85,923,514	8,771,679	(120,687,342)	(25,992,149)	12,638,629	71,106	117,012,053	291,217,162
Jacksonville, FL	1.49	730,505	195,272	(2,122,995)	(1,197,218)	(80,627)	952,861	626,382,000	5,280,413,000
Alanta, GA	4.76	156,421,000	785,519,000	(2,025,541,000)	(1,083,601,000)	(1,607,000)	498,044	353,811,000	3,087,130,000
Honolulu, HI	7.97	308,600,000	492,800,000	(3,211,900,000)	(2,410,500,000)	(124,300,000)	979,858	1,187,800,000	6,997,200,000
Chicago, IL	2.77	(332,200,000)	2,509,100,000	(32,304,600,000)	(30,127,700,000)	(854,200,000)	2,695,598	1,405,400,000	39,518,900,000
Indianapolis, IN	5.87	706,470,000	164,849,000	(998,291,000)	(126,972,000)	60,284,000	867,125	315,230,000	2,346,805,000
New Orleans, LA	1.71	1,269,531,000	162,247,000	(1,420,011,000)	11,767,000	298,799,000	391,006	277,047,000	2,187,435,000
Detroit, MI	4.81	1,131,353,000	28,268,000	(1,755,941,000)	(341,908,000)	9,655,000	672,662	159,149,000	2,967,404,000
Boston, MA	2.79	685,036,000	75,098,000	(2,501,770,000)	(1,741,636,000)	134,989,000	694,583	2,543,645,000	5,414,072,000
Jackson, MS	8.74	229,661,000	4,348,800	(277,805,000)	(4,656,000)	21,480,000	173,514	78,079,000	397,521,000
New York, NY	1.82	(13,501,564,000)	2,942,744,000	(187,208,884,000)	(197,767,704,000)	(3,331,463,000)	8,399,000	58,477,389,000	257,587,422,000
Philadelphia. PA	1.62	645,200,000	793,200,000	(8,709,900,000)	(7,271,500,000)	243,900,000	1,580,863	2,052,900,000	4,676,900,000
Providencs, RI	3.68	238,126,000	18,809,000	(2,241,691,000)	(1,984,756,000)	(6,497,000)	178,042	3,981,613,000	2,709,966,000
Memphis, TN	1.29	340,474,000	358,736,000	(1,031,458,000)	(332,248,000)	104,110,000	650,618	607,148,000	1,526,478,000
Houston, TX	1.63	4,865,000,000	187,000,000	(5,967,000,000)	(915,000,000)	(435,000,000)	2,312,717	1,172,000,000	9,796,818,000
Charleston, WV	6.16	50,490,892	60,228,650	(563,091,161)	(452,371,619)	(9,344,089)	51,400	14,899,309	725,103,000
Milwaukee, WI	3.53	812,090,000	202,334,000	(1,884,385,000)	(869,961,000)	(115,520,000)	595,555	316,655,000	2,586,087,000
Source: 2018 CAFR									

Five of the accounting insolvent municipalities reported in Table 3 that identified fiscally distressed some eight years ago include Chicago, IL, New Orleans, LA, New York, NY, Philadelphia, PA and Providence, RI. Detroit, MI declared bankruptcy in 2012 and emerged in 2013. All of these municipalities report both a negative unrestricted and net position in 2018 (Davey, 2014). Detroit did, however, report a $9.6 million excess revenue over expenses.

Note that eight of the 17 accounting insolvent municipalities (Table 4) report current ratios great than 3.5 indicating a robust current asset to current liability relationship. Although all the municipalities in the survey had annual revenue of $100 million in 2012, due to population reduction both Jackson, MS and Charleston, WV aggregate revenue has diminished. The unusual negative net invested in capital assets reported by Chicago, Il and New York, NY result from capital asset debt exceeding the net capitalized capital assets. Neither of these municipalities include a note disclosure in their CAFR to explain the unusual balances.

Judgements and legal claims also were frequently mentioned as a financial issue. The two largest negative total net position balances, New York, and Chicago, were attributed to tax incentive financing (TIF).

With the exception of Arizona, every state and the District of Columbia has established legislation for TIF. Although TIF has been discontinued in California, thousands of TIF districts still operate nationwide. TIF is used by local municipalities to publicly finance structural improvements and boost infrastructure. The costs of the improvements are eventually repaid by the future tax revenues associated with economic development. In a typical model, public-sector bonds are used to raise the funds needed to finance the improvements desired at the beginning of the project. The tax revenue generated by the TIF district is then used to repay the bonds. Prior to the bonds being paid in full, the municipality reports the long-term debt obligation with a debit to unrestricted net position. When the bonds are paid in full, the tax base is displayed at its gross value (Johnson & Man, 2001).

As noted by Williams and Fadairo (2013), municipal fiscal stress can be a function of poor management such as corruption, derivative-laden bond financing, runaway spending, frivolous projects , unsustainable benefit packets and so on. Unfortunately, these variables are not easily available for analysis. Also unavailable are financial stress inducers not controlled by management such as real estate demand, economic downturns, and state support.

MUNICIPAL FISCAL DISTRESS BY-PRODUCTS

Crime

For the constituents served by a municipality, bankruptcy brings deterioration in the quality of daily life. A little more than 12 months before San Bernardino filed for bankruptcy, the city had served as an inspiration for its reduction in crime (Lovett, 2013). Due in part to an aggressive stance on gang activity, the city had reduced its homicide rate by almost half from its high in 2005. However, with over 73% percent of their general fund benefit going toward public safety costs (Reid, 2012), San Bernardino was forced to reduce its police force by approximately 25%. The result was disastrous. In less than a year, the homicide rate exploded by more than 50 percent. Emergency response times are up, and nonemergency calls get no response (Lovett, 2013).

Further compounding the issues was the simultaneous placement of over 4,000 criminals under the authority of San Bernardino County who normally would have been sent to state prison. The decision was an effort by the state to reduce prison populations and costs, but with limited

resources, the county was forced to release some of those criminals, adding yet another dangerous element to a bad situation (Lovett, 2013).

San Bernardino is no exception as numerous other cities with budgetary issues are left with few alternatives other than to cut their public safety forces. Stockton witnessed its homicide rate grow while the city of Vallejo became a center for prostitution (Lovett, 2013). Detroit, already notorious for its crime, holds the distinction as the highest rate of violent crime of all the nation's metropolitan areas (Fletcher, 2013). With few options, those communities were relegated to organizing neighborhood watch groups and other measures in an attempt to fight crime.

Municipal Services

Cuts in public safety personnel are not the only places where local governments are being forced to save money. Not surprisingly, when local governments are forced to make budget cuts, nonessential services such as their Parks and Recreation Departments or city maintenance bear much of the brunt. For San Bernardino, reductions in Parks and Recreation began as far back as 2009 with the department being understaffed ever since. More than half of Detroit's parks have closed since 2008 and approximately 40% of its streetlights did not work when it filed for bankruptcy (Davey & Walsh, 2013).

Other cities have attempted to remedy some of their fiscal issues by selling assets or privatizing some of their services. To help stave off bankruptcy, Harrisburg, PA moved toward selling assets such as its trash incinerator and public parking system (Shade, 2012). Jefferson County, AL has been forced to end in-patient treatment at the county hospital and fired hundreds of county employees (Newkirk, 2013). However, while these measures help, they pale in comparison to the real issue affecting budget constraints.

Employee Benefits Past Promises

As indicated earlier, a widespread cause of many municipalities' financial stress is the rising cost of healthcare benefits and pension contributions. During the economic boom, many local governments granted higher benefit contracts to public employees, obligating themselves to long-term, expensive benefit obligations. In Stockton's case, officials spent recklessly, reaching the point where employees and their spouses could be eligible for retiree healthcare for life, even if they only worked one month for the city. The result was predictable and unsustainable, with many employees retiring early and the city's long-term health liabilities growing to over $400 million (Motlagh, 2012).

Rising pension costs are another factor contributing to many municipalities' financial concerns. In San Jose, CA, another city with dire budgetary issues, payments to pension recipients increased from $73 million in 2001 to over $245 million in 2012. These pension payments represent 27% of the government's general fund budget.

For San Jose and other financially distressed cities, options such as raising taxes or reducing services provide a means to partially eliminate deficits but restructuring their benefit obligations would be the real key and remains extremely difficult (Farmer, 2013).

In Detroit, tense negotiations between city officials and retirees have taken place for years. The city's emergency manager during the bankruptcy encountered fierce opposition to his plan to significantly cut vested pensions for public-sector workers which he claimed were underfunded by approximately $3.5 billion (Guillen, 2013).

In the case of San Bernardino, the police union eventually signed a new contract requiring them to pay for their own pension costs, amounting to a salary decrease of nearly 14 percent for

its officers (Hagen, 2013). Under Stockton's bankruptcy plan, health benefits for all employees and retirees were reduced while benefits for employees with less than 10 years of service were eliminated altogether. Beginning in 2013, medical benefits for all of Stockton's retirees ceased, resulting in uncertainty for the families being affected (Associated Press, 2012). Perhaps California's health insurance exchange under Obama Care can be employed to offset the Stockton retirees' loss.

Unemployment

While high unemployment levels are frequently a contributing factor in a municipality's bankruptcy, the austerity measures imposed on a local government's budget both before and after bankruptcy compound the problem as public jobs and payrolls are slashed. Local governments are often one of the largest employers in a community, so layoffs have a multiplier effect which ripples through the economy. Stockton and Detroit have both attempted to deal with multimillion-dollar deficits through drastic cuts in their personnel. Their overall unemployment rates now hover above 16% (Fletcher, 2013; Motlagh, 2012). San Bernardino reduced its workforce by over 20% and negotiated labor reductions of about $10 million per year. Those efforts are an attempt to offset the city's high cost of labor due to stipulations in its charter requiring compensation levels to be based on cities of similar size, even though other cities may be able to afford it (Church, et.al., 2012).

Financing Issues

When looking at the pain and distress reductions in a local government's services or retirement packages have on their constituents, it is easy to believe that the best solution would be to simply default on debt obligations. However, a default or renegotiation of a municipality's bonds would have ramifications on not only the distressed government, but other governments across the country.

Municipalities have long been beneficiaries of their tax-free status from the federal government. Municipalities have also benefitted from their reputations as being extraordinarily low risk investments. The default rate on municipal debt currently stands at less than 1% of the entire $3.7 trillion municipal bond market. Subsequently, municipal bonds have on average historically carried yields of approximately 85% of U.S. Treasuries thereby resulting in significant cost savings to state and local governments (Krantz, 2013). As the market foresees the likelihood of a municipality's default increasing, investors will demand a higher yield to compensate for the additional risk. A prime example is Detroit which, even before filing bankruptcy, was having to pay approximately 2.5 percentage points (nearly 50 percent) higher than comparable bonds from other cities (Krantz, 2013). That added interest cost diverts funds that could otherwise go toward increasing services or improving infrastructure.

To date, the market has taken most of the municipal bankruptcies in stride. However, when, or if, municipal default rates start rising or bondholders are forced to accept pennies on the dollar for their investments in bankruptcy proceedings, borrowing costs will rise across the board for all municipalities. Detroit's bankruptcy exit plan lumped approximately $640 million in general obligation bonds in with unsecured creditors (Woodall, et al., 2013). Bondholders expressed great concern for any scenario where their terms are reduced, since general obligation bonds carry with them the full faith and credit of a municipality's tax revenues. Ambac, one of the insurers of Detroit's bonds, will be required to make the city's debt service payments in the event Detroit defaults on the bonds. The company has warned that any violation of the city's

unconditional pledge to repay the bonds will seriously hinder Detroit's ability to obtain cost-effective financing in the future (Reuters, 2013). The Detroit bankruptcy prompted some investors to move into higher-rated segments of the municipal bond market (Nolan & Cherney, 2013) or sell all of their Michigan general-obligation bonds (Maxey, 2013).

Positive Impacts

Municipal bankruptcy provides a stop for all collection actions against the debtor and its property upon filing the petition. This legal "time-out" provides an opportunity for municipal officials to examine finances and make more rational decisions regarding whether to cut spending, increase taxes, and/or renegotiate the terms of contracts spiraling out of fiscal control (particularly those relating to government employees' healthcare, salaries, and benefits). Current collective bargaining agreements may be rejected and renegotiated to more sustainable provisions.

THE HORIZON

While cautious signs of recovery are soothing fears in the national economy, years of unchecked spending and swelling retirement benefits by municipalities have created a deep undercurrent of instability still sweeping beneath the surface of the general public's awareness. Furthermore, as the municipal crisis originally predicted by many experts when the 2008 economic downturn began has so far failed to materialize, many people have mistakenly assumed that the issues plaguing local governments are being corrected.

Interest Rates

An issue looming on the horizon for municipalities is the probability that interest rates will begin moving upward as the overall economy recovers from the present healthcare pandemic and the Federal Reserve begins reversing its current monetary policy. The Federal Reserve in the past couple of years purchased approximately $85 billion in bonds every month in an effort to spur economic growth, subsequently dampening yields on everything from mortgage rates to U.S. Treasury debt. Since municipal bond rates tend to follow yields on U.S. Treasuries, any pullback by the Federal Reserve on its bond buying program result in increased borrowing costs for all municipalities (Cherney & Glazer, 2013).

Currently, the U.S. budget deficit has ballooned to nearly $3 trillion and is expected to keep growing (Rappeport and Tankersley, 2020). The federal government is supporting initiatives to fund unemployment benefits, small business loans and direct financial support to families. These efforts are related to the 2020 economy's collapse resulting from the pandemic and Congress's efforts to save people and businesses from financial ruin. Indicators suggest that any rebound will result in enhanced interest and tax rates.

Increase in Bankruptcy Filings

One factor currently preventing a greater frequency of municipal bankruptcies is state laws or litigation that restrict local governments from filing. Pennsylvania's capital city, Harrisburg, first attempted to file bankruptcy in October of 2011 but has so far been prevented from doing so due to state law. Like other cities, Harrisburg was driven to financial ruin by falling property tax revenues, climbing healthcare and retirement costs, and costly spending on civic projects such as a multimillion-dollar trash incinerator (Shade, 2012). The legacy of its careless spending is a city debt now totaling over $300 million. With the state legislature's ban on the bankruptcy scheduled to expire, Harrisburg will once again be faced with the option of filing Chapter 9.

Struggling with Recovery

Despite the relatively low rate of municipal bankruptcies to date, given the significant impact that new accounting requirements or increased borrowing costs would have on local governments' operations, there are legitimate concerns about the probability of a larger crisis looming on the horizon. There is concern among bondholders that recoveries may decrease from the historical norm. Additionally, there is concern that Detroit's bankruptcy could set a standard or legal precedence regarding how distressed municipalities treat their long-term debt. Treating general obligations as unsecured liabilities in bankruptcy would significantly weaken their claims relative to secured liabilities. From 1970 to 2010 Moody's reports only seven rated defaults. However, there were four general obligation bonds and lease defaults in 2012 and 2013 (Moody's, 2013). Although this is a very small number when compared to the 7,500 rated local governments, it could be the beginning of a trend. However, that has not occurred.

Recent Bankruptcy Decelerations

In 2015, a small Kentucky municipality filed bankruptcy due to a land purchase disagreement. Within the year, an agreement to restructure the contract resulted in the Hillview, KY bankruptcy filing being dismissed by the court (Maciag, 2014; Stech, 2016). In 2020, another small Alabama municipality filed bankruptcy in an effort to restructure its debt (Chapman, 2020). At this time, the deceleration under analysis in the municipality court.

CONCLUSION

The economic downturn of the past decade had an impact on local governments across the nation. Plummeting tax bases coupled with rising employment benefits and runaway spending created scores of municipalities with bleak financial situations. A local municipality may be left with its only option being bankruptcy protection if the state allows for municipality bankruptcy.

As municipalities struggle to bring their operating budgets in line, steep cuts in the public payrolls produce a wide range of effects. Reductions in police and public safety officials have created skyrocketing crime rates in some communities. Many local governments are being forced to renegotiate their labor contracts, cut pension contributions, and eliminate healthcare benefits for employees and retirees. Further compounding the issue of high unemployment in those communities, municipalities are laying off sections of their workforce causing a ripple effect that flows through the local economy.

Many more municipalities may topple as the accounting standards are implemented requiring local governments to recognize the full extent of their pension and OPEB obligations. The standards also require governments to use realistic estimates for the rates of return on their investments amplifying the degree to which they are currently underfunding their pension and OPEB plans. Rising interest rates coupled with cutbacks in state funding will put an even greater strain on municipalities.

State laws and political resistance have created other municipalities whose financial issues warrant bankruptcy consideration but the municipalities have been unable to file. In Harrisburg, PA, state officials have taken steps to prevent the bankruptcy of the city. However, with no optimistic signs of change for the local economy, Harrisburg and other municipalities may soon face the same fate as Stockton, San Bernardino, and Detroit.

This study finds municipalities that declare bankruptcy differ little, if any, from those municipalities with financial issues or those technically insolvent. The study did find a single common reported financial element, a negative total unrestrictive net position. Future research is

needed to ascertain what other commonalities, if any, exist among municipalities with financial stress.

Despite the relatively low rate of municipalities seeking protection, the inability of many governments to rectify their issues coupled with the effects from accounting and reporting changes and increasing borrowing costs could result in a widespread municipal crisis. However, the 2020 healthcare pandemic may well be a far more disruptive event that impacts municipal fiscal health. With few other options, bankruptcy and the passage of time may be a municipality's best hope for a brighter future.

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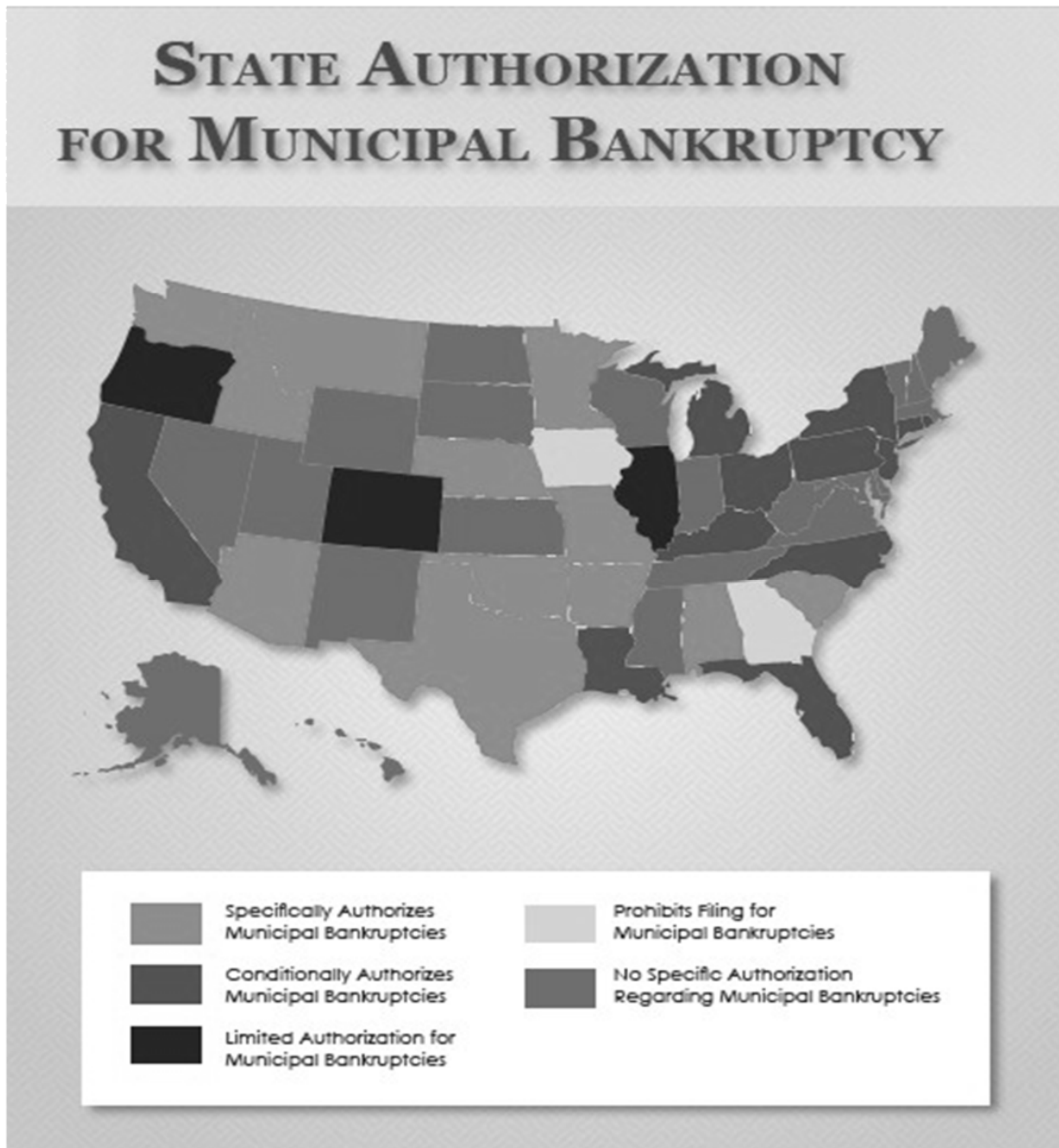
APPENDIX



Source: Eucalitto, et al., (2013, 7) from Prinmer on Municipal Debt Adjustmane, Chapter 9: The Last Resort for Financially Distressed Municipalities, Chapman and Cutler, LLP First Edition, 2012 http://www.afgi.org/resources/Bankruptcy_Primer,pdf , Murphy 2018.