Going Broke One City at a Time:
Municipal Bankruptcies in America

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Executive Summary

Municipalities have rarely defaulted on their debt. As a consequence, municipal debt is regarded as having an extremely low risk for investors. There are disconcerting trends developing that may change this historical view. The combination of the weak U.S. economy, high municipal debt levels, and large under-funded pension liabilities coupled with unfunded retiree health benefits raises the likelihood that more municipalities will become insolvent going forward.

Declaring bankruptcy (officially Chapter 9 bankruptcy) is an option available to a financially troubled municipality—more precisely to state leaders who must consent to a municipality's bankruptcy filing—if they meet the eligibility conditions. A municipality can only declare bankruptcy if it is insolvent and only after the municipality has conducted good faith negotiations with its creditors to resolve its financial obligations.

To provide greater perspective on this subject, this study overviews the purpose of Chapter 9 bankruptcy and then reviews the bankruptcy (or near-bankruptcy) of several prominent cases including:

- Vallejo, California;
- Detroit, Michigan;
- Stockton, California;
- San Bernardino, California;
- San Jose, California;
- Jefferson County, Alabama;
- Harrisburg, Pennsylvania;
- Scranton, Pennsylvania; and,
- New York City, New York.

There are important similarities across these high-profile municipal bankruptcies and near bankruptcies that provide valuable lessons regarding how financial insolvency arises and the value and limits of bankruptcy protection.

The Roots of Financial Insolvency

Municipal financial distress is rarely caused by a single, unlucky, event. Typically, a municipality's financial distress is caused by a combination of a poor economic environment (often caused by anti-growth state and local policies) coupled with gross financial mismanagement or negligence on the part of the municipality that are manifested in the municipality issuing too much debt.

Typically, fiscal insolvency is a problem that emerges following many years of financial mismanagement and many years of slow economic decline. Once the financial and economic problems have festered for many years, the solvency of the municipality is lost. Ultimately, because the municipality is in such a weak financial position, an unexpected economic or financial shock reveals the underlying financial insolvency of the municipality.

> If used appropriately, bankruptcy can be an important tool that helps an insolvent municipality restructure its finances and restore its long-term fiscal solvency.

In reality, most municipal financial insolvencies are built up over many years. And, because the insolvency builds up over many years, it is unreasonable to assume that these problems can be addressed quickly. As the New York City case study reviewed in the full study vividly demonstrates, regaining long-term fiscal solvency can take many years.

THE VALUE AND LIMITS OF CHAPTER 9 BANKRUPTCY

If used appropriately, bankruptcy can be an important tool that helps an insolvent municipality restructure its finances and restore its long-term fiscal solvency.

This positive outcome can occur only if the underlying structural problems that caused the municipality's insolvency have been fully addressed. It should always be remembered that declaring bankruptcy is not a solution to a municipality's financial troubles by itself. Addressing the core problems that caused the financial insolvency, generally fiscal mismanagement and/or economic stagnation, is the solution. Chapter 9 bankruptcy should be viewed as a tool that may have value toward addressing the core problems.

When addressing the fiscal insolvency problems, several key principles must be adhered to. First, granting debt relief to a municipality will not resolve the problem if a culture of financial mismanagement continues. To the extent that a municipality lacked the proper financial controls or systems that would have prevented the financially unsound decisions, these financial controls need to be implemented.

Next, declaring bankruptcy provides breathing room for a municipality. The insolvent municipality should take advantage of that breathing room by comprehensively addressing *all* of its problems with creditors—no creditor or future obligation should be excluded. Future pension obligations deserve particular emphasis due to their severe underfunding; their central role in many current, and possibly future, municipal insolvencies; and, the unwillingness/inability for several municipalities to address this problem during bankruptcy. Municipalities with structurally unsound pension systems cannot hope to regain fiscal solvency if they ignore their future pension obligations when establishing a financial solvency plan. Doing so ensures that a municipality's insolvency problem will not be fixed—instead the insolvency is simply pushed down the road forcing future municipal leaders to address it at a later date.

Last, fiscal insolvency typically arises in tandem with economic stagnation. Ideally, when addressing the fiscal insolvency problems, the municipality would also implement policies that pro-actively encourage regional economic growth; or, implement policies that remove a policy obstacle that is currently discouraging regional economic growth. At a minimum, municipal leaders should account for the impact of the proposed solvency reforms on the regional economy.

The costs of declaring bankruptcy for municipalities are also important. These direct and indirect costs must be factored into the municipality's decision process when thinking about filing for bankruptcy. One major cost from declaring bankruptcy is higher borrowing costs. For instance, as part of its plan to emerge from bankruptcy Jefferson County, Alabama has issued $1.8 billion in sewer debt in November 2013. Due to Jefferson County's lower perceived credit quality, the interest rate costs on the debt was significantly above the costs paid by top rated municipalities.

Other costs include the significant amount of money it generally costs just to declare bankruptcy, and the negative signal a bankruptcy filing sends to employers and citizens, both prospective and current. The negative signal, while hard to quantify, could be particularly damaging by discouraging new economic activity. The lower incentive to conduct business in a municipality that has declared bankruptcy weakens the regional economic environment and further erodes the future tax revenue base.

Ultimately, the most important goal for an insolvent municipality is to create a plan that is achievable, establishes the right financial management tools, returns the municipality to solvency, and respects the rights of current debt holders and pensioners (to the largest extent possible) while financially empowering the municipality to provide the key services that current and future citizens require. When declaring bankruptcy enhances this process, then municipal bankruptcy is a valuable option. Otherwise, Chapter 9 bankruptcy is a distraction that does not provide the municipality with the necessary benefits to justify its costs.

Introduction

Municipalities face unprecedented fiscal challenges today and for the foreseeable future. Effectively managing that fiscal stress is arguably the most important task facing state and local leaders. One option for a financially stressed municipality, with the approval of state leaders, is for the municipality to declare bankruptcy—officially Chapter 9 bankruptcy.

While a legal option, municipal bankruptcies are rare. According to Governing.com only 37 municipal bankruptcy filings have been made since 2010, and most of these (29) were filed by smaller special districts such as utility authorities.[1] According to the U.S. District Court, "In the more than 60 years since Congress established a federal mechanism for the resolution of municipal debts, there have been fewer than 500 municipal bankruptcy petitions filed."[2]

The typical municipal bankruptcy case involves a great deal of debt, however, amplifying its impact. Again quoting the U.S. District Court, "Although Chapter 9 cases are rare, a filing by a large municipality can—like the 1994 filing by Orange County, California—involve many millions of dollars in municipal debt."[3]

Despite the historical rarity of municipal bankruptcy, high profile municipal bankruptcies have been making headlines as of late—including the bankruptcy filing of Detroit, Michigan— the largest municipal bankruptcy in our nation's history—and the pending bankruptcy of Scranton Pennsylvania. The combination of weak current and future municipal finances raises important questions regarding the value of Chapter 9 bankruptcy for struggling municipalities.

Historically, has declaring bankruptcy helped struggling municipalities regain their financial footing? Or, has bankruptcy only provided temporary respite delaying the reforms necessary for the municipality to regain its financial solvency? Additionally, are there any similarities between the financial stresses and broader environments of those municipalities that declared bankruptcy compared to those municipalities that faced extreme financial stress, but did not declare bankruptcy?

After describing the purpose and theory behind Chapter 9 bankruptcy, this paper reviews the experiences of several prominent municipal bankruptcies and "near bankruptcies". Based on this review there are several attributes that most municipalities that declared bankruptcy had in common. Additionally, it is clear that, like personal bankruptcy, municipal bankruptcy only provides relief if the underlying fiscal problems are addressed. Without solving the fiscal problems that led to the financial insolvency, declaring bankruptcy provides no value to a municipality or its citizens.

THE PURPOSE OF CHAPTER 9 BANKRUPTCY

Chapter 9 was created to provide municipalities the ability to negotiate a repayment plan with creditors. Typical renegotiations include reducing the municipality's debt, the interest rates charged on its debt, or extending the term of the loan. Chapter 9 bankruptcies are a tool that is available to financially strapped municipalities—or more precisely to the states which must give the municipality permission to file for bankruptcy protection.

Just like with a personal bankruptcy or a corporate bankruptcy, simply declaring bankruptcy does not solve a municipality's underlying financial problem. A bankruptcy filing only creates value for the municipality when the state and municipality obtains a comprehensive understanding of its core financial problems, and uses the bankruptcy filing as one of many tools to correct the current financial stress affecting the municipality. Toward

this end, the state will often appoint a financial manager to oversee the finances and discover the sources of the municipality's financial stress.

Discovering the source of the financial stress includes assessing whether the problem is due to a one-time shock, such as a one-time revenue loss (e.g. Orange County's investment loss), or, is the problem due to a long-run mismatch between revenues and expenditures—the more common source. Regardless of the cause, it is important to understand upfront that declaring bankruptcy is not the end of the process for a financially stressed municipality. It is the beginning.

In short, declaring bankruptcy creates breathing room. The intention of creating breathing room is to create an opportunity to establish a financial plan that is fair to the municipality's creditors and provides sufficient relief to the municipality such that the municipality's budget is once again financially sustainable. According to the U.S. Courts,

> *The purpose of Chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts.*[4]

Ultimately, the Chapter 9 bankruptcy provides a municipality the opportunity to file a plan of adjustment, and receive a court approved confirmation of this plan. The plan may (or may not) include repayment of all of its debts in full. Chapter 9 was originally meant to exclusively address payments on municipal bonds, not other obligations. Following reforms implemented in 1976, the coverage was expanded to include all debts and financial obligations.

CHAPTER 9 BANKRUPTCY'S REQUIREMENTS AND BENEFITS

A municipality must meet certain requirements in order to be eligible for Chapter 9 bankruptcy protection. Municipalities must be insolvent. Chapter 9 is designed to be a tool that is used as a last resort—not a convenient way to alter debts and financial obligations a municipality has the capacity to meet. The insolvency requirement that must be met before a municipality can file for bankruptcy has been viewed as restrictive in many circumstances due to a municipality's ability to levy taxes. This view limits the opportunity for many municipalities to file for Chapter 9 bankruptcy even if local leaders want to file.

Regardless of the cause, it is important to understand upfront that declaring bankruptcy is not the end of the process for a financially stressed municipality. It is the beginning.

The municipality must have made a good-faith attempt to negotiate a settlement with its creditors before filing for Chapter 9, including a documented demonstration that it has obtained or tried to obtain an agreement with its creditors to resolve the issues. The municipality must further demonstrate that it is not feasible to continue negotiations with its creditors who are holding at least the majority of the claims. Furthermore, if the municipality has reason to believe its creditors might attempt to obtain preferential payment this can be considered cause for filing for Chapter 9.

A municipality must also obtain specific authority to file for Chapter 9 from the state—in practice it is the state that has the authority to allow a Chapter 9 bankruptcy filing, not the municipality. When the municipality enters bankruptcy, it must be willing to devise a plan to resolve its debts and show that it has filed for bankruptcy in good faith.

Municipalities will create their own debt restructuring plans. The role of the bankruptcy courts is to approve the plan, or reject the plan, with input from other stakeholders. This highlights several important differences between a Chapter 9 bankruptcy compared to bankruptcy filings by individuals and corporations.

Unlike personal or corporate bankruptcies, courts have no authority to make spending or other policy decisions on behalf of a municipality. This rule ensures that even after a municipality files for Chapter 9 bankruptcy protection basic government functions will continue throughout the bankruptcy process. Such guarantees do not exist for corporate bankruptcies, for example, which sometimes become non-viable entities during the bankruptcy process.

Additionally, unlike personal or corporate bankruptcies there are no provisions under Chapter 9 bankruptcy that require a municipality to liquidate any assets in order to satisfy its creditors. As Eide (2013) noted, the justification is simple: "No matter how insolvent and dysfunctional a city may be, if people still live there, basic services must continue to be provided."[5] Consequently, municipalities have greater control over their reorganization plan and the amount and manner their debt payments will be reduced compared to corporate or individual bankruptcies.

The major benefits from filing for Chapter 9 bankruptcy protection is time. Once a municipality has filed for bankruptcy, lawsuits and other pending financial obligations are temporarily halted. This provides policymakers breathing room and creates a judicial structure to help facilitate a deal to restructure their debts. If this breathing room is used to correctly re-structure their obligations, then filing for Chapter 9 protection can help a municipality stabilize its financials.

THE RISKS AND PROBLEMS OF A BANKRUPTCY FILING

Time and breathing room come with costs, as it is widely accepted that filing for Chapter 9 bankruptcy protection comes with significant risks and problems. Knox and Levinson (2009) exemplify this view stating that "filing for bankruptcy protection under Chapter 9 should be considered a last resort, to be effected only after every effort has been made to avoid it".[6] The justification is simple. Filing for Chapter 9 bankruptcy protection creates many new costs and problems for a municipality including:

- Raising the likelihood of lower credit rating and higher future borrowing costs for the government;
- Damaging the municipality's image which could result in an exodus of residents or less business investment;
- An exodus of residents and businesses can reduce government tax collections and, if severe enough, hurt the municipality's financial sustainability; and,
- The bankruptcy filing could result in higher taxes, fewer municipal services, and/or deferred maintenance on infrastructure.

Common Financial Stresses Across Distressed Municipalities

A common theme across distressed municipalities emerges over and over again. Financially-stressed municipalities, whether they ultimately declare Chapter 9 bankruptcy or not, typically face:

- Escalating operating expenses;
- Plummeting operating revenues; and,
- High fixed costs that are driven by:
    - Previous debts—particularly for capital projects that were either ill-considered or were negatively impacted by unexpected shocks; and/or,
    - Collective-bargaining agreements that are very costly and create financial rigidity that restricts a municipality's ability to implement programs that could potentially save money or balance the books—particularly employment agreements that create long-term funding obligations relating to defined benefit pension plans and other post-employment benefits (OPEB).

Often, the impetus for the financial stress is a precipitous decline in revenues that was caused by an external economic shock—such as a national economic slowdown. The short-term economic shock exposes the fundamental financial weakness of the municipality; a weakness that can no longer be addressed through temporary fixes, short-sighted policies, or ignored through the use of budgetary gimmicks.

When economic stress reveals a municipality's insolvency, the municipality must now address its structural financial imbalances and turnaround its financial state of affairs. Ultimately, the success of the turnaround is dependent upon whether the financial imbalance is sustainably addressed—the insolvent entity is made, once again, solvent. Typically, those municipalities that are pushed into insolvency by an economic shock have been stagnating economically for a long time (e.g., Detroit, Michigan; Jefferson County, Alabama; and Stockton, California). Therefore, implementing policies that will help reinvigorate local economic growth should be an important component as the policies that are implemented to regain fiscal solvency.

The value of Chapter 9 bankruptcy is completely dependent upon whether the bankruptcy filing improves the municipality's ability to regain its solvency. In those cases where the bankruptcy filing can enable the necessary reforms more efficiently, or can enable the necessary reforms that would not have been possible without the filing, then Chapter 9 can be a valuable tool for a municipality.

The value of actually declaring the Chapter 9 option should be clearly understood. Bankruptcy should be only exercised in those relatively rare cases when declaring bankruptcy makes it possible for a municipality to create a sustainable financial path for itself, when it would be otherwise impossible.

The following case studies provide a brief overview of several prominent municipal bankruptcy (or near-bankruptcy) filings. It should never be forgotten that it is the process of rearranging a municipality's financials to create a sustainable path that, ultimately, restores the vibrancy and solvency of a municipality. When filing for Chapter 9 enhances that process, it is beneficial. When it does not, Chapter 9 is a distraction from the municipality's actual problems.

This point is particularly useful given that unfunded and unaffordable pension and retiree health benefits are a prominent cause of several of the most recent municipal bankruptcies. These unsustainable pension and retiree expenses are also looming over many municipalities across the country. As the Vallejo bankruptcy case study illustrates below, declaring bankruptcy will not solve a municipality's financial problems if these pension and health care expenses are not addressed.

Bankruptcy Case Studies

VALLEJO, CALIFORNIA

Important lessons should be drawn from the Vallejo, California bankruptcy experience, making Vallejo a good opening case study. Vallejo filed for bankruptcy in 2008 and completed the bankruptcy process in 2011. In what is typical for municipalities that declare bankruptcy, Vallejo, California was a municipality with fundamentally weak financials that was pushed over the edge by an external economic event. In the case of Vallejo, the external economic event was the great recession of 2008.

While the great recession pushed Vallejo over the edge, the city's poor financial management over many years all but ensured that a day of reckoning would come. It was simply a matter of what event would push Vallejo into bankruptcy.

Vallejo's problems were fairly straightforward. As Greenhut (2010) noted, Vallejo was "faced with falling tax revenues, rising pension costs, and unmovable public-employee unions".[7] George Will summarized Vallejo's problems succinctly in a 2008 editorial describing why the city went bankrupt:

> *Mayor Osby Davis, who has lived in this waterfront city across San Pablo Bay from San Francisco for 60 of his 62 years, says: "If you have a can that's leaking two ounces a minute and you put an ounce a minute in it, it's going to get empty." He is describing his city's coffers.*
>
> *Joseph Tanner, who became city manager after this municipality of 120,000 souls was mismanaged to the brink of bankruptcy, stands at a whiteboard to explain the simple arithmetic that has pushed Vallejo over the brink. Its crisis -- a cash flow insufficient to cover contractual obligations -- came about because (to use fiscal 2007 figures) each of the 100 firefighters paid $230 a month in union dues and each of the 140 police officers paid $254 a month, giving their unions enormous sums to purchase a compliant city council.*
>
> *So a police captain receives $306,000 a year in pay and benefits, a lieutenant receives $247,644, and the average for firefighters -- 21 of them earn more than $200,000, including overtime -- is $171,000. Police and firefighters can store up unused vacation and leave time over their careers and walk away, as one of the more than 20 who recently retired did, with a $370,000 check. Last year, 292 city employees made more than $100,000. And after just five years, all police and firefighters are guaranteed lifetime health benefits.*[8]

These salaries were so excessive that "police and firefighter salaries, pensions, and overtime accounted for 74 percent of Vallejo's $80-million general budget, significantly higher than the state average of 60 percent."[9]

DESPITE THE DECLINING TAX BASE, VALLEJO DID NOT REDUCE ITS EXPENDITURES COMMENSURATELY, AND THE CITY SIMPLY HAD TOO-MANY EXPENDITURES RELATIVE TO THEIR REVENUES.

Vallejo was also facing diminished economic prospects as the Naval Base that was a key economic anchor closed in 1996 and was never replaced. Despite the declining tax base, Vallejo did not reduce its expenditures commensurately, and the city simply had too-many expenditures relative to their revenues. The economic and tax revenue implications of the housing crisis of 2008 simply pushed the financially insolvent city into bankruptcy, which the City of Vallejo declared on May 23, 2008 facing a $16.6 million budget shortfall.[10]

In bankruptcy, "the city slashed costs, including police and firefighter numbers, retiree health benefits, payments to bondholders and other city services."[11] According to Greenhut (2010)

> *Vallejo…slashed spending where it could, mostly by cutting personnel and services. As a recent* San Francisco Chronicle *editorial pointed out, the city cut its police force to about 100 officers from nearly 160 and warned residents to use the 911 system judiciously, even while it experienced crime rates higher than other comparable cities in California. The city has also cut funding for a senior center, youth groups, and arts organizations and has done little to restore an increasingly decrepit downtown, develop waterfront properties, or attract new businesses.*
>
> *To permanently bring its spending in line with its tax base, however, at some point Vallejo will have to do something about its pensions.* [12]

The city never adequately addressed its pension problem because during its bankruptcy negotiations the city did not alter the payments it was required to make to the California Public Employees Retirement System (CALPERS).[13] By failing to address the pension payments, the city ignored one of the primary drivers of its future deficits. And, that decision is now coming back to haunt the city:

> *"Any municipal bankruptcy that doesn't restructure pension obligations is going to be a failure because pension obligations are the largest debt a city has," said Karol Denniston, a municipal bankruptcy attorney in San Francisco.*
>
> *"A city like Vallejo can be reasonably managed but it is still going to be flooded out because it cannot be expected to keep up with its pension obligations."*[14]

These pension costs are now growing at an unsustainable rate and are threatening to destabilize the city's finances once again. This inability to adequately address all of the causes of the city's fiscal problems eliminated the potential benefits to the city from filing for bankruptcy. Two years out of bankruptcy, Vallejo is still financially unstable and the future prospects for the city remain dim.

The Vallejo case study supports the notion that Chapter 9 bankruptcy is only a tool; and the value of filing for bankruptcy is dependent upon how the municipal leaders use that tool. Chapter 9 bankruptcy will fail to create a permanent solution for municipalities, like Vallejo, that do not fully address the root causes of the municipality's financial problems. And, in these instances the municipality could end up in an even worse financial position having to bear the costs of the bankruptcy without enjoying the long-term benefits of a fresh start. The lesson of Vallejo is that when municipalities file for Chapter 9 bankruptcy it is essential that all of the problems driving the municipality's insolvency are fully addressed—including unaffordable pension obligations.

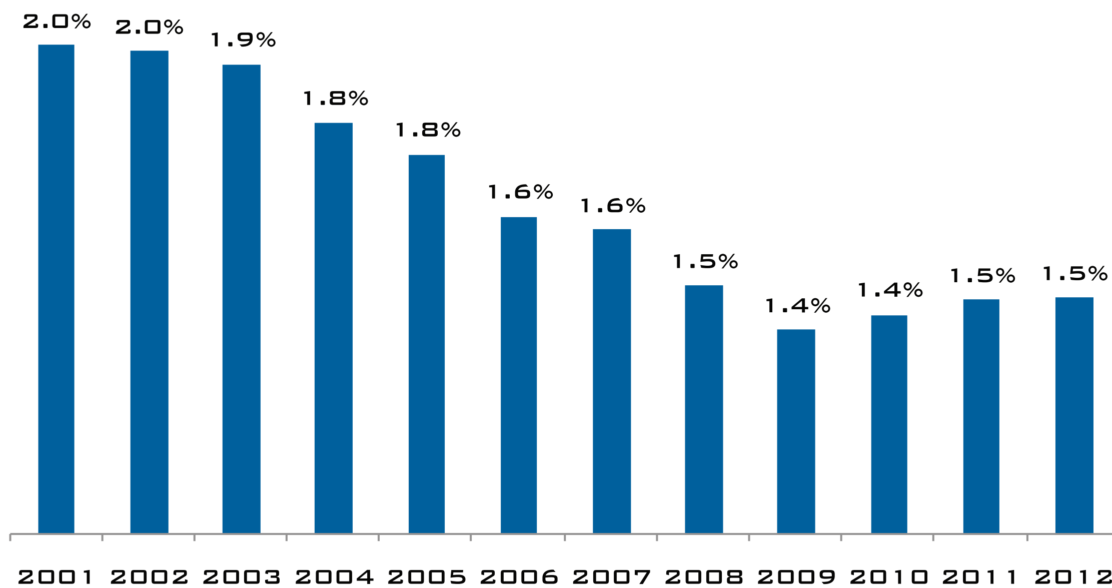
DETROIT, MICHIGAN

The largest municipal bankruptcy in the nation's history is just beginning. Nevertheless, even at this early date the primary causes of Detroit's July 18, 2013 Chapter 9 bankruptcy filing are clear. Detroit is insolvent due to long-term problems that have been festering for decades: a combination of long-term economic decline, years of financial mismanagement, and the simply unaffordable massive unfunded pension liabilities ($3.5 billion) and unfunded retiree healthcare promises (nearly $6 billion).[15]

Due to Detroit's long-term financial mismanagement and the unfunded retiree benefits, Detroit's total debt and long-term obligations are estimated to be at least $18 billion,[16] which is more than seven times larger than Detroit's total municipal budget of approximately $2.5 billion.[17]

Arguably, Detroit's well documented long-term economic decline is the core problem because the economic decline has exacerbated every other problem. Figure 1 provides a quick snapshot of Detroit's decline by relating the total economic output of the Detroit metropolitan area compared to all U.S. metropolitan areas.[18] As Figure 1 illustrates, Detroit's share of the national economy, while having recovered from the depths of the post-2008 recession, continues to shrink—and there are no signs that this long-term decline will change anytime soon.

FIGURE 1
TOTAL GROSS DOMESTIC PRODUCT DETROIT MSA RELATIVE TO TOTAL U.S. METROPOLITAN AREAS



Legend / Footnotes:
Note - NAICS Industry detail is based on the 2002 North American Industry Classification System (NAICS).
Note - Per capita real GDP statistics for 2001-2012 reflect Census Bureau mid-year population estimates available as of March 2013.

Source: U.S. Bureau of Economic Analysis

A declining economic base creates all sorts of long-term problems for a municipality, and Detroit is no exception. Paramount among these problems from a financial sustainability perspective is that a declining economic base guts a municipality's tax base. According to the *Detroit Free Press*:

> *The total assessed value of Detroit property—a good gauge of the city's tax base and its ability to pay bills—fell a staggering 77 percent over the past 50 years in today's dollars.*[19]

As an illustration of this decline, there are:

> *An estimated 78,000 homes [that] are unoccupied in the city, and in 2011 half of the occupiers of the city's 305,000 properties did not pay any tax.*[20]

The decline in the property tax base was mirrored by the decline in Detroit's population, which fell from a highpoint of 1.8 million to around 700,000 people currently.[21] The erosion of the property tax base coupled with the exodus of people has gutted the tax base for Detroit.

The ideal tax code levies the lowest possible tax rate on the broadest possible tax base in a manner that minimizes the compliance costs and complexity of the tax code. Detroit has been moving in the opposite direction of the ideal tax code—raising tax rates on an ever-narrowing tax base. According to the Citizens Research Council of Michigan:

> *Detroit's revenues from taxes and state shared revenues are much higher than those of any other large Michigan city on a per capita basis. In FY2010, Detroit raised $1,289 per capita from its property tax, income tax, utility users' tax, casino wagering tax, and state shared revenues. This ranked first among the largest cities in Michigan, and was 50 percent higher than Dearborn, which ranked second…*[22]

Making matters worse, until the most recent crisis, Detroit's expenditures did not decline in proportion to the declining population and tax base. The Citizens Research Council of Michigan summarized these problems well:

> *Detroit receives nearly 60 percent of the state's statutory shared revenues as well as hundreds of millions of dollars in other state and federal grants ($452.3 million of the FY2013 total budgeted revenues of $2.6 billion are expected to come from state and federal sources). Nonetheless, since FY2003 General Fund expenditures have exceeded revenues every year, even though municipal service levels are far below adequate. As the city's tax base shrinks, obligations for legacy costs including pensions, certificates of participation, and retiree health care; negotiated wages and employee benefits; limited tax debt service; and vendor payments become harder to meet. Deficits are now so large that the city has repeatedly warned it will exhaust its cash.* [23]

And, the economic decline and fiscal insolvency of Detroit has social impacts as well including unemployment rates, poverty rates, crime rates, and illiteracy rates all at crisis levels.[24] As Herbert Stein noted, "that which can't continue won't". In the case of Detroit, the bankruptcy filing was the inevitable result of trends that simply could not continue.

Detroit filed for bankruptcy after the emergency manager's (Kevyn Orr) recommendation to file for bankruptcy was heeded based on the belief that the creditors (especially the unsecured creditors) were not willing or able to make the types of concessions necessary.[25]

While there are some benefits to Detroit's bankruptcy filing, the filing does not address the core problems facing the city. As Eide (2013) noted:

> *Bankruptcy will cut Detroit's debt, thereby freeing up revenue to devote to services. It won't address the city's high poverty and crime rates, its cratered tax base (property values aren't expected to start growing until 2021), and 16 percent unemployment rate. Bankruptcy can't eradicate corruption or a union-friendly political culture. Two years after emerging from bankruptcy, Vallejo's budget remains unbalanced, services are still diminished and the city has yet to regain access to credit.*
>
> *And let's not forget that debt reduction comes at a cost: Detroit's legal and professional-services fees have already run into the millions and, in the distant post-bankruptcy future, the city will likely face a steep borrowing premium when it re-enters the bond market.*

> *… Detroit's troubles are many and deeply rooted. Municipal bankruptcy can't remedy a lack of political will.*[26]

The continued declines in Detroit's property tax base, income tax base, and population continues to weaken the city's financial position due to Detroit's past financial commitments. And, there is the question of the unaffordable pension and health care obligations. Like Stockton, California and San Bernardino California (discussed next), even if all of Detroit's other problems were addressed (a big if) the current pension and retiree health care obligations raise serious concerns regarding the city's financial sustainability.

Detroit's bankruptcy filing will only be successful if the breathing room and debt relief created by the filing begins a long and arduous process of fiscal and economic reform. Without such reforms, Detroit (like Vallejo) will only be partially addressing some of its problems. On a positive note, on December 3 Judge Steven Rhodes ruled that Detroit's bankruptcy could proceed, and that the city's public pension obligations were not sacrosanct. Empowering Detroit to address all of its debts and liabilities creates an opportunity for Detroit to regain its financial health.

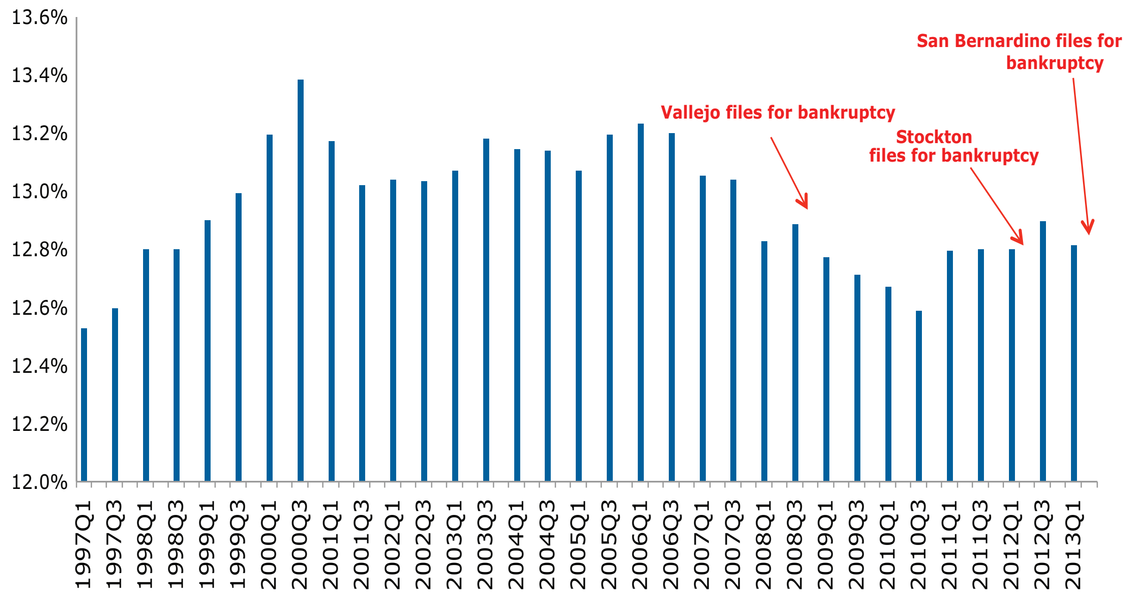
Creating a precedent that public pension obligations are not inviolable is also beneficial for many other municipalities that are facing unfunded, and unaffordable, pension liabilities. It has been unclear whether the Chapter 9 negotiation process includes pension obligations in addition to municipalities' other debts and liabilities. Judge Rhodes decision begins a process that will hopefully clarify the issue.

Should the logic of Judge Rhodes decision stand, and bankrupt municipalities are empowered to renegotiate with the holders of pension obligations in the same manner as any other creditor, then the ability to effectively address the financial problems facing municipalities across the country will have been significantly improved.

STOCKTON & SAN BERNARDINO, CALIFORNIA

The previous case studies have exemplified how a weak macroeconomic environment is a common shock that pushes a fiscally unsound municipality into Chapter 9 bankruptcy. And, this was true for Stockton, California and San Bernardino, California as well. Figure 2 illustrates California's growing share of U.S. personal income up through the middle of 2000; and the general decline in the state's share of U.S. personal income since (with periods of boom and bust in between). Figure 2 also shows that Vallejo, Stockton, and San Bernardino all declared bankruptcy during a time when the state's share of the national economy was doing poorly—a relative weakening of California's economic environment preceded each of California's recent municipality bankruptcy filings.

FIGURE 2
CALIFORNIA'S SHARE OF NATIONAL PERSONAL INCOME



Source: U.S. Bureau of Economic Analysis

Both Stockton's and San Bernardino's unsustainable fiscal position was stretched to the breaking point due to the 2008 recession. The combination of the housing bust (and resulting decline in property tax revenues), weak economic activity, and declining state revenues effectively pushed both cities into insolvency. San Bernardino, for instance, filed for bankruptcy protection facing a $46 million budget deficit and no resources to fall back on.[27] Stockton faced a 2012 budget deficit of $26 million prior to its bankruptcy filing.[28]

Regardless of the extreme fiscal distress caused by the recession, however, Stockton and San Bernardino were already on fiscally unsustainable paths. And, the largest contributor to each city's insolvent fiscal position was unaffordable and unfunded pension and other retirement obligations.

San Bernardino filed for bankruptcy with an "unfunded pension liability of about $143 million and…$50.4 million in bonds it issued in 2005 to help cover pension obligations …"[29] According to California Public Employees' Retirement System (CALPERS), just since San Bernardino filed for bankruptcy, the amount of money the city owed to CALPERS increased further by "…$17 million, plus growing interest, late fees and penalty payments" (San Bernardino stopped funding its pension obligations after it declared bankruptcy through July 2013).[30]

Similarly, Stockton owed CALPERS $147.5 million in unfunded pension costs; in addition Stockton owed investors who held $124.3 million of pension obligation bonds, $40.4 million of the variable rate demand obligations, $35.1 million of public facilities fees bonds and $31.6 million of the city's parking garage debt.[31]

The success of Chapter 9 bankruptcy for both of these cities is dependent upon how the huge unfunded pension obligations are addressed. If, like Vallejo, the pension obligations are not addressed, then the bankruptcy filing will not succeed in creating a sustainable fiscal position for either municipality.

Stockton, which as of this writing is finalizing its exit plan from bankruptcy, does not appear to be fully addressing the pension problem. Stockton's plan includes an increase in the local sales tax, which was just approved by residents, imposes a 50-percent cut to the city's bondholders and eliminates some of the retirees' health insurance benefits; but it does not appear that the pension liabilities are going to be reduced.[32]

San Bernardino is at the beginning stages of its bankruptcy process. While it is unknown whether San Bernardino will reduce its pension liabilities as part of its bankruptcy proceeding, the fact that CALPERS is opposing the city's filings, and that San Bernardino stopped making payments to CALPERS for over a year, provides an indication that adjusting the city's required pension obligations may be under consideration. And, doing so would set an important precedent for other municipalities as well:

> *The San Bernardino case is taking a much different course than that of Stockton, another California city that filed for bankruptcy last year. San Bernardino stopped paying CALPERS, while Stockton has kept current on all payments to the fund.*
>
> *In its draft bankruptcy plan, Stockton is seeking to lower payments to some bondholders, while maintaining all obligations to CALPERS. The fund has supported the city's bankruptcy.*
>
> *In San Bernardino, the pension fund has fought the city's quest for bankruptcy protection at every turn.*
>
> *On Tuesday, the judge refused a request by CALPERS to appeal her August decision to grant San Bernardino bankruptcy protection directly to the federal Circuit Court of Appeals. But she invited CALPERS to appeal the so-called eligibility ruling to the federal District Court.*
>
> *"I fully understand the importance of this case goes far beyond the city of San Bernardino," Jury said.*
>
> *Jury said she and other bankruptcy judges were "floundering around" when it came to their eligibility rulings, and she said some clarification of the municipal bankruptcy law – for which there is little precedent – would be welcome.*
>
> *"It would be useful for the state, and the whole country, if the issue of eligibility goes to an appellate court," Jury said.*[33]

If implemented, San Bernardino's approach to address all of the causes of its fiscal insolvency will be a more effective use of the Chapter 9 bankruptcy than Stockton, which appears to be making the same mistake as Vallejo.

SAN JOSE, CALIFORNIA

Unaffordable pension obligations have even impacted the "capital of Silicon Valley". San Jose, California exemplifies how unaffordable pension and retiree health care benefits can push almost any municipality toward insolvency. San Jose, "now spends one-fifth of its $1.1 billion general fund on pensions and retiree health care, and the amount keeps rising. To free up the money, services have been cut, libraries and community centers closed, the number of city workers trimmed, salaries reduced, and new facilities left unused for lack of staff. From potholes to home burglaries, the city's problems are growing."[34]

If left unchecked, or if San Jose turned to budgetary tricks to try and pay for both more services and higher pension problems, these are the type of fiscal pressures that often begin a municipality's slide toward insolvency. Instead of following this path, however, Mayor Chuck Reed devised a pension reform plan to alter the city's fiscal path. The plan, which was approved by 70 percent of the residents reflected that some "voters grew re-

sentful of the benefits given government workers—police officers and firefighters in San Jose could retire after 30 years with pensions worth 90 percent of their salaries—while private-sector pensions were growing rarer."[35]

The reform is currently being challenged in court, but if the city prevails then:

> *The measure gives city workers an option: They can keep their current pension, as long as they agree to contribute more of their salaries—up to 16 percent—to the pension fund, or they can enter a less generous pension plan with a higher retirement age, benefits that accrue more slowly and smaller cost-of-living adjustments. Future hires would be put into a plan that costs even less, and would be required to contribute up to half of its cost.*
>
> *Mayor Chuck Reed of San Jose, a Democrat, said the pension cuts were needed to restore police positions that were eliminated and to reopen firehouses that were closed on certain days, and so the city could afford to open the four closed libraries. He added that the changes were needed to make sure there would be enough money to pay retirees their benefits, so they did not end up like the retirees of Central Falls, R.I., whose benefits were cut when the city went bankrupt.* [36]

San Jose's reform plan is being watched carefully across the country. Should the plan be upheld in court, then San Jose provides a positive example for other municipalities to follow. San Jose's reform proposes to address a potential future financial crisis before it occurs and rights the city's financial course before more drastic measures are necessary. San Jose also exemplifies that the future financial health of municipalities cannot be separated from the problem of overly-generous municipal pensions and retiree benefits.

JEFFERSON COUNTY, ALABAMA

On November 9, 2011, Jefferson County filed for bankruptcy. Jefferson County's bankruptcy filing was the most expensive municipal bankruptcy ever in the US at its date of filing—Detroit's bankruptcy is now the most expensive. At the time of its bankruptcy filing, which followed the breakdown of negotiations between municipal leaders and its creditors, Jefferson County had amassed debts of $3.14 billion relating to sewer work, $814 million in school construction debt, and $305 million in general obligation debt for a total of $4.2 billion in total debt.[37]

Unlike the previous case studies, Jefferson County's largest problem was not unfunded pension obligations. Jefferson County's problems were a combination of the *one-time* large financial burden—the need to issue bonds to finance federally-mandated repairs to the municipal sewer system—coupled with fundamentally unsound financial management and a town that has been experiencing economic stagnation as evidenced by its persistent lower than average median household income—$42,053 in Jefferson County compared to $50,502 in the U.S. overall.[38] The 2008 financial crisis and its ensuing recession raised the costs on the debt that pushed the county into bankruptcy.

If the ill-fated sewer bonds are the key symptom of the Jefferson County's financial failure, then the disease was poor financial management. The problem with the sewer bonds began in 1996 when, in response to a lawsuit alleging the county's sewer system was violating the federal Clean Water Act, the County issued $3.14 billion in revenue bonds.[39] The revenue bonds were not general obligation bonds—directly backed by the state government. Instead, the bonds were backed by the public utility through the rates charged to customers.

Making matters worse from the get-go, the sewer bonds were a complicated financial instrument that created high financial transaction costs for the county—and these problems were worsened during subsequent refinancing activities that were futile attempts by the county to regain some semblance of financial sustainability for the

project.[40] The financing terms were never fixed however, and imposed significant, and unnecessary, costs on the county.

Just as damaging was the financial and operational mismanagement of the sewer reconstruction projects. This mismanagement led to 21 people being "…convicted or plead[ing] guilty to corruption-related charges in connection with the sewer construction and financing, including three…onetime commissioners."[41] Due to the operational mismanagement, the necessary sewer work still has not been completed; nor are there any indications that this work will be completed anytime soon.

Despite the unnecessary costs, and despite the inability to create the necessary public infrastructure which was the original justification of the debt, municipal sewer rates increased significantly—by some estimates, as of 2011, the costs of sewage and water rates "increased by 329 percent over the past 15 years, making it among the highest in America…."[42]

The tipping point for Jefferson County was the 2008 financial crisis. Due to the structure of the bonds, the financial crisis increased the municipality's financing costs on the sewer bonds.[43] These additional costs, when coupled with the county's constrained revenues, effectively made the county insolvent and eligible for Chapter 9 bankruptcy. On November 9, 2011, the county officially filed for bankruptcy protection.

In response to the bankruptcy filing, as of May 2012, Jefferson County had slashed expenses and reduced employment of county government workers by more than 700 people, with 155 more layoffs either planned or in process.[44] Government expenditures have been reduced as well including the elimination of litter patrols; the closing of satellite court houses; and, despite problems of over-crowding in the county jail, Jefferson County has not used an $11 million refurbished county jail due to the inability to pay for the guards.[45]

The County is in the process of emerging from bankruptcy, as creditors have agreed to a refinancing plan that will cut the costs of the sewer debt approximately in half.[46] In a highly unusual move, in mid-November 2013, Jefferson County challenged the notion that municipalities that declare bankruptcy cannot issue bonds by selling "…$1.8 billion in sewer debt as part of the cash-strapped county's plan to exit from one of the largest municipal bankruptcies in the U.S."[47] Tellingly, the costs on the debt were much higher than top-rated municipalities.

> *Jefferson County offered institutional investors a 40-year bond with a yield of 6.85 percent, according to investors following the deal. That is 0.10 percentage point more than it had discussed with investors earlier in the day and 0.35 percentage point more than what was previously offered to individual investors…*
>
> *The insured bonds still yield about 1.56 percentage points more than a generic 30-year top-rated municipal bond, according to one measure from Thomson Reuters Municipal Market Data.*[48]

Nevertheless, the ability for Jefferson County to be able to return to the debt markets so quickly reduces a potential cost (i.e. the inability to issue debt at all) on municipalities that file for Chapter 9 bankruptcy protection.

Addressing the unaffordable burden of the sewer bonds only cures a symptom of the problem, however. A return to financial health for Jefferson County requires the leaders to address the poor financial management that (1) caused the problems with the sewer capital projects, and (2) has weakened the County's overall financial position.

If these core problems are addressed, then the bankruptcy process will be seen as a valuable tool for Jefferson County that provided the time and breathing room necessary to regain its financial footing. If these core prob-

lems have not been addressed, then the bankruptcy process would have been wasted. Furthermore, the costs the county has faced, including the higher borrowing costs, would not have been worth it.

Harrisburg, Pennsylvania

The capital of Pennsylvania has fallen upon hard times. Harrisburg's 2011 bankruptcy filing by the City Council was dismissed by the federal bankruptcy court because the state did not give Harrisburg (nor did the Mayor) the authority to file for bankruptcy—a key prerequisite for declaring bankruptcy. The rejection of its bankruptcy filing did not solve its financial problems.

Harrisburg's financial troubles follow the familiar script with a one-time shock (in this case, fiscally irresponsible decisions regarding a trash incinerator plant) stressing a precarious financial position due to long-term fiscal mismanagement. According to the state mandated recovery plan:

> *Public confidence in the City's ability to conduct its affairs is extremely low. The community and elected officials are coming to terms with unwise decisions made by elected officials over the past several decades that have led to a structural deficit, staggering debt, and deteriorating infrastructure throughout the City. The contentious relationship and lawsuits among the City's own elected officials frustrate a citizenry who want their local government to be responsible, refrain from placing blame and start taking affirmative action to restore fiscal stability and long-term viability of the City.*[49]

While the city was facing a structural deficit, it was the inability to pay the debt on a trash incinerator plant due to the financially irresponsible construction of the plant that was the spark to the crisis. As summarized by the *Washington Post* (2010):

> *Harrisburg's crisis has been precipitated by a malfunctioning municipal incinerator, whose ill-fated expansion was promoted as a potential moneymaker. But after seven years of cost overruns, construction delays, design problems, financings, refinancings, and more refinancings, the city is on the hook. The $68 million bill is part of $288 million in outstanding debt related to the project.*[50]

The ill-fated plant has never earned the anticipated revenue stream to finance the huge increase in debt. The incinerator debt added to Harrisburg's already high debt burden (a total of approximately $362.5 million or seven times the size of the general fund[51]), and coupled with the revenue squeeze associated with the 2008-09 economic recession, pushed Harrisburg toward insolvency.

> Harrisburg did not officially file for bankruptcy again, and has implemented solutions to address its fiscal insolvency problem.

Harrisburg did not officially file for bankruptcy again, and has implemented solutions to address its fiscal insolvency problem. Under the proposed solution, Harrisburg will sell its waste-to-energy plant and lease its parking system, raising $210 million. Harrisburg has also negotiated concessions from municipal workers, which include the establishment of a fund to pay for retiree health care benefits.[52] If approved, and if the management reforms suggested by state mandated recovery plan are implemented,[53] then these measures appear to be sufficient to address the debt burdens that caused Harrisburg's insolvency without officially entering Chapter 9 bankruptcy.

SCRANTON, PENNSYLVANIA

Scranton has not declared bankruptcy yet, but it likely will. Scranton faced a $21 million budget deficit for 2013 or "about half the amount that the city currently collects in taxes or one and a half times its property tax collections. And it's not clear how much more the city can collect—already, 13 percent of billed property taxes go uncollected."[54] And, these deficits are expected to be of a similar magnitude—around $20 million—in 2014.[55]

Making Scranton's situation more dire, the city has been relying on one-off fixes for years while never addressing the long-run financial imbalance. Barro (2012) summarized the financial games that Scranton has been playing well:

> *For years, Scranton has been addressing its budget gaps with a combination of borrowing, asset sales, and one-time funding sources. In May, Senator Bob Casey (a Scranton native) helped secure a $5 million grant from FEMA to help the city re-hire firefighters it had laid off. That is helping for now, but the grant only runs for two years. Scranton also sold its future parking meter revenue and applied the proceeds ($6 million) to the current budget—producing one-time money but depriving the city of future revenue.*
>
> *The city is running out of assets to sell. Mayor Doherty is having to revise his proposed recovery plan because one of his proposed revenue items, selling the city's storm sewers, hit a snag: The city doesn't actually own the sewers.* [56]

Scranton has also resorted to gimmicks to balance its books as well; such as, paying all municipal workers (including the Mayor) the minimum wage. But, the time where financial gimmicks can actually buy Scranton some time may be ending. For example,

> *Scranton's police and fire unions have received a judgment against the city for the overdue $21 million that the city owes the unions from a landmark arbitration ruling.*
>
> *The money was due July 2, but the city has not yet paid and is still seeking borrowing or selling an asset to honor the bill, Mayor Chris Doherty said.*
>
> *But the judgment means the unions now can seize city assets and sell them to collect what is owed, said city solicitor Paul Kelly and the unions' attorney, Thomas Jennings…*
>
> *The judgment is the latest event in the epic labor saga between the mayor and unions that was fought against the backdrop of the city's longtime designation as financially distressed under state Act 47. Years of legal fights came to a head in October 2011, when the state Supreme Court issued its landmark ruling in favor of the unions. The city initially estimated the back-pay arbitration awards at $17 million, but an audit completed a few months ago pegged the figure at $20.9 million.*[57]

Scranton's current situation exemplifies the types of ongoing financial mismanagement and fundamental insolvency facing municipalities prior to when they will file for Chapter 9 bankruptcy protection. And, the ongoing budget deficits and dwindling financial options is leaving Scranton with few other options than declaring bankruptcy and starting the negotiation process with its creditors and employees.

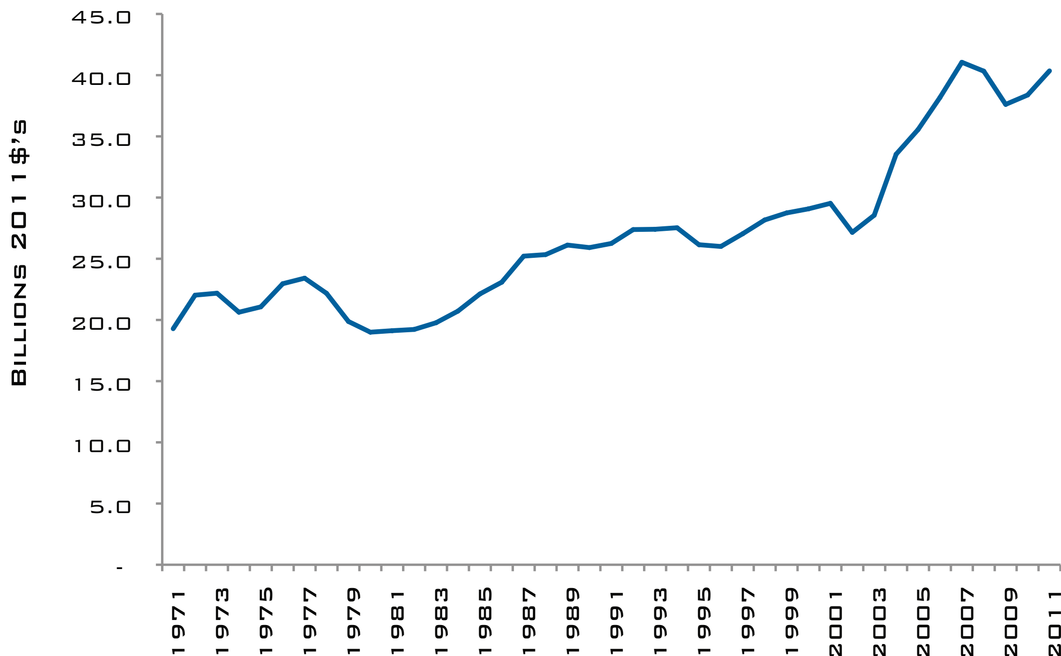
NEW YORK CITY, NEW YORK

New York City's response to its fiscal crisis, and its ability to regain fiscal solvency, has garnered a great deal of attention. Unlike Detroit, Stockton, Vallejo, and San Bernardino, New York City never actually declared bankruptcy. New York's fiscal calamity, which culminated in 1975, was just as problematic however. As summarized by the California Research Bureau, New York City "…had literally run out of money and could not pay for normal operating expenses."[58] This perilous financial position was the result of years of financial mismanagement that was exacerbated by weak economic performance—a familiar theme across the case studies discussed above. At the time of the fiscal crisis,

> *…New York City and its subdivisions had $14 billion of debt outstanding of which almost $6 billion was short-term. The city admitted to an operating deficit of at least $600 million, although honest accounting techniques put it at more like $2.2 billion and the city found itself shut out from credit markets.*[59]

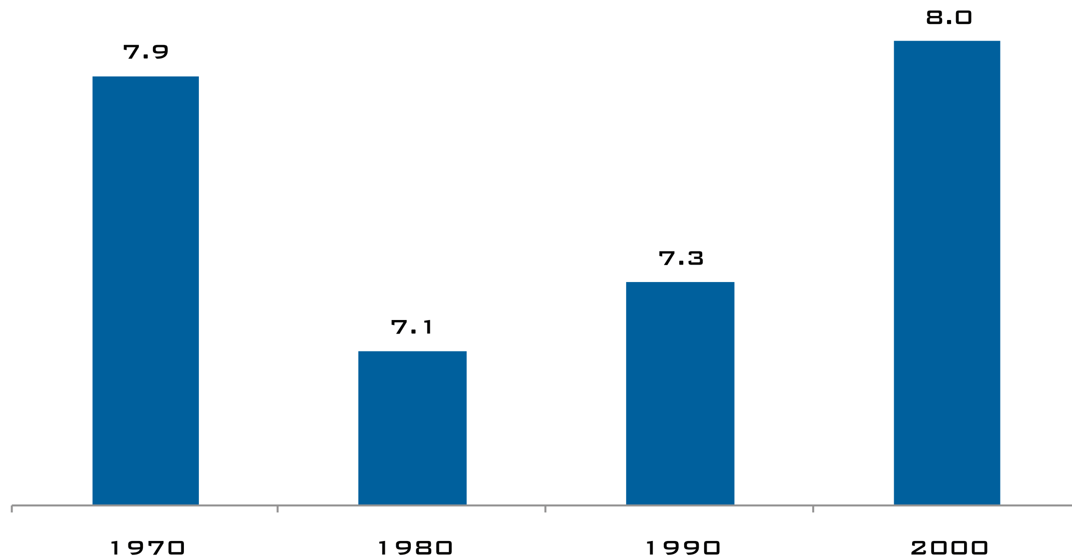
The difference between New York City's official operating deficit ($600 million) and the "honest accounting" deficit ($2.2 billion) goes a long way to explaining New York City's problems. During the difficult economy of the 1970s, real revenue growth of New York City was weak, see Figure 3. New York City's economic troubles were compounded by the unprecedented drop in population that occurred between 1970 and 1980 (see Figure 4)—the drop in population being caused by the worsening fiscal and economic environment.

FIGURE 3
TOTAL NEW YORK CITY TAX REVENUE DATA
1971 - 2011
(IN 2011 $S)[60]



Source: New York City Office of Management & Budget

FIGURE 4
TOTAL NEW YORK CITY POPULATION
1970, 1980, 1990 & 2000[61]



Source: Office of the New York State Comptroller

Despite the weak real revenue growth, expenditures continued to grow, leading to New York City's fiscal crisis. New York City was able to emerge from its fiscal crisis only with the help of New York State and the federal government. New York State intervened several times, including establishing the Municipal Assistance Corporation to sell bonds on behalf of the city and putting New York City into receivership; however, these reforms only met with limited success.[62] New York City's return to solvency, which was a long drawn out affair, ultimately contained

> *…three major breakthroughs that helped refinance the Big Apple. First, municipal unions, as well as conceding pay cuts, used their pension funds to invest in the city. Then big Wall Street banks, which owned a lot of New York municipal debt and therefore had strong incentives to cooperate on restructuring, agreed to defer loan repayment and underwrote new securities on the cheap. And despite President Gerald Ford's famous message to New York, pressure from Congress—and even from foreign governments fearing a default—led to federal guarantees on the city's debt.*[63]

The federal government initially extended up to $2.3 billion in short-term loans for New York City in 1975—additional loans were needed again in 1978.[64] The federal support, along with the ability of the municipal unions to use their pension funds as a means to purchase New York City's assets were, arguably, unique tools available to New York City at the time but not available to distressed municipalities today. Nevertheless, these sources of revenues were effective at addressing the short-term financing needs of New York City.

In return for these loans, the city was forced (by the federal government) to raise fees for services (such as the subway) and raised taxes by $200 million.[65] The reductions, in municipal employment were also draconian. Overall, municipal employment was reduced by 20 percent as was wages of those employees who kept their jobs.

Longer-term, New York City's return to solvency was not achieved until the early 1980s—the first balanced budget in years occurred in 1981. This long-term solvency was bolstered by the economic renaissance that began during the 1980s and, was accelerated in the 1990s in New York City. The 1990s coupled strong economic growth with a return of sound financial management and effective municipal policies that increased the desirability of New York City as a place to live and work. These positive trends are reflected in Figures 3 and 4 where revenue growth and population growth clearly accelerated for the city. New York City's positive financial and economic trends could become jeopardized should newly elected Mayor Bill de Blasio fulfill his campaign promises to raise taxes, increase municipal pay, and expand municipal pension promises.

A central takeaway from the New York City case study, however, is that the return of vibrant economic growth to New York City played an important role in New York City's return to fiscal solvency. The lesson for troubled municipalities today from New York City is that long-term fiscal solvency and long-term economic vibrancy are inter-twined. The New York City experience emphasizes that the problems of economic growth facing the municipalities in California; or Jefferson County, Alabama; or Detroit, Michigan must also be addressed before these municipalities can be considered solvent for the long-term.

THE VALUE OF CHAPTER 9 BANKRUPTCY

The municipalities that can benefit from Chapter 9 bankruptcy are a small sub-set of fiscally insolvent localities. For instance,

> *The localities that stand to benefit most from bankruptcy are those that have been overwhelmed by some unforeseen catastrophe, such as a big, one-time tort settlement, as was the case in Bay St. Louis, Mississippi, in 1977 and South Tucson, Arizona, in 1983. [In these cases the] government abruptly finds itself saddled with a claim it can't pay, but the source of the debt is isolated and doesn't impugn the locality's basic ability to function.*
>
> *The 1994 bankruptcy of Orange County, California, while not wholly unforeseen, was rooted in an overleveraged investment plan run by the county treasurer. When, contrary to his expectations, interest rates rose, lenders threatened to seize collateral, and bankruptcy became the only option. But Orange County's basic ability to function was never in question, and, after restructuring its debt in bankruptcy, it returned to credit markets relatively rapidly.* [66]

Such one-time shocks to the system are not the root cause behind the financial problems for most municipalities, however. The case studies reviewed above emphasized that fundamental structural problems and financial mismanagement play the central role in most municipal insolvencies. With respect to these municipalities, several key themes re-emerged over again that provides important lessons for other financially unsound municipalities.

First, fiscal insolvency is a problem that emerges over many years. Therefore, it is unreasonable to assume the problems will be solved quickly. As the New York City case study vividly demonstrates, it can take years to effectively resolve all of the underlying problems.

Next, a common problem facing most municipalities today is under-funded pension promises. Vallejo, California, which is teetering back toward insolvency, illustrates the dangers to municipalities that do not address the adverse financial consequences that promised retiree pension and health benefits will create.

The specific solution for each municipality will vary depending upon the specific circumstance; but, one principle is generally applicable. Defined Benefit (DB) pension plans are unwise, unsustainable, and should be

replaced with Defined Contribution (DC) plans. DB plans are unwise and unsustainable because the incentives are all wrong. Politicians have an incentive to offer overly-generous pension benefits today because they can gain a near-term benefit (employee compensation) without imposing a cost on their constituents today—as exemplified by the under-funded state and local pension plans across the country.

Additionally, minor adjustments to the expected rate of return on the pension plan's assets can have major impacts on the amount of expenditures that need to be allocated away from taxpayer services (e.g. road maintenance) and toward funding DB pension funds. As a consequence, the unfunded pension programs are exacerbated "…by the fact that in many instances the regulators controlling pension funds have overestimated the value of future investments and the rate of return they can expect from the investments held by the pension fund."[67]

The most effective way to eliminate these problems with a DB pension plan is to replace DB plans with a DC retirement system, which are the retirement plans offered to most workers in the private sector.

Third, fiscal insolvency typically arises in tandem with economic stagnation. Effectively addressing the problem of fiscal insolvency should also address the causes of a municipality's economic problems.

Lastly, whether a municipality declares bankruptcy is not as important as how the municipality addresses the two key problems of fiscal mismanagement and economic stagnation. Implementing policies that sustainably address these core problems for the long term should be the goal of municipal leaders, and Chapter 9 bankruptcy should be viewed as a tool that may have value toward achieving that goal.

The sustainability of programs designed to address a municipality's core problems is enhanced when citizen buy-in is obtained, where applicable, through a local initiative or referendum (I&R). I&Rs can be over-used tools. However, with respect to the long-term commitments necessary to improve a municipality's fiscal solvency, obtaining citizen buy-in through an initiative or referendum enhances the durability and stability of the financial reform program. This confidence boosting measure boosts the confidence of the municipality's creditors that the municipality will uphold its end of any negotiated agreement.

In the end, if declaring bankruptcy can help move the municipality toward a more sustainable financial and economic position, then the municipality should consider doing so. If declaring bankruptcy will not help achieve these goals, then there will be no long-term value from declaring bankruptcy.

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