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Fiscal Stress Faced by Local Governments

Local governments—including counties, cities, towns, school districts, and special districts—play a significant role in people's lives and in the nation's economy.[1] In 2009, the expenditures of local governments equaled 8.7 percent of gross domestic product, and those governments employed just over 9 percent of the labor force.[2] That year, local governments as a group cut their spending in real (inflation-adjusted) terms. This year and in upcoming years, they expect to constrain spending and services—primarily because of reductions in state aid and falling revenues. In particular, revenues from property taxes are poised to decline to reflect lower property values. To the extent that local governments address budget gaps by reducing spending or raising taxes, such changes will partially counteract the federal government's fiscal support for the economy.

In light of those developments, this Congressional Budget Office (CBO) issue brief describes the economic conditions and budgeting practices that can lead to significant budgetary challenges—often termed fiscal stress—at the local level. The brief also reviews the options available to local governments, state governments, and the federal government for addressing such financial difficulty. Last, the brief examines two options that local governments very rarely use: defaulting on their debt or filing for bankruptcy.

1. Special districts include entities such as water, electric, sewer, hospital, housing, and economic development districts.

2. Data on expenditures by local governments in 2009—the most recent year for which such information is available—are from Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, Table 3.21, 2009. Data on employment are from Department of Commerce, Census Bureau, Annual Survey of State and Local Government Employment and Payroll, Public Employment Data, Local Governments, 2009. Unless otherwise indicated, years referred to are calendar years.

The Functions of Local Governments and the Composition of Their Budgets

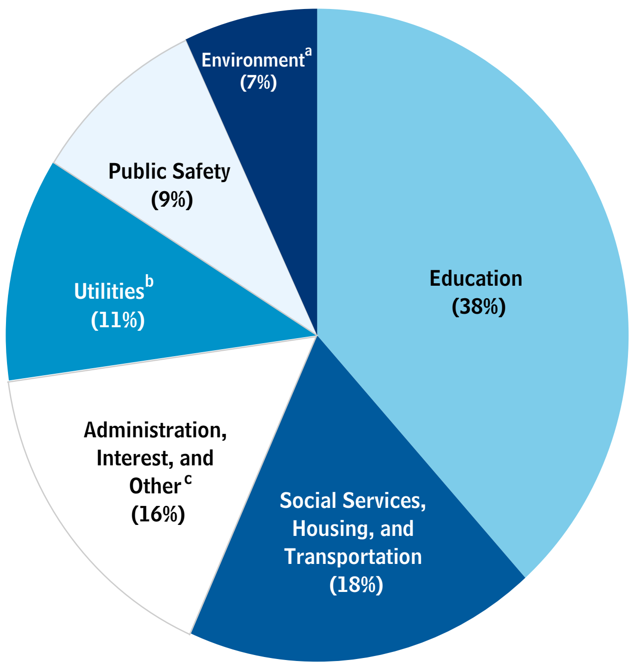
Local governments vary considerably in size, purpose, spending, and revenue sources. Currently, there are about 3,000 counties, 36,000 municipalities (cities, towns, villages, and boroughs), 37,400 special districts, and 14,600 public school systems in the United States. County and city governments are generally the largest, both in the number of people they employ and in the amounts they spend. They provide services such as police protection, transportation, welfare payments, and job training, among others. Special districts are generally the smallest governmental entities and have a singular purpose, such as providing water or treating waste. Collectively, local governments spend more on education than on any other category, followed by spending on social services, housing, and transportation; administration and interest on their debt; utilities; public safety; and the environment (see Figure 1).[3]

The sources of local revenues vary significantly depending on the type of local government. Although counties and cities rely heavily on property and sales taxes, water and sewer districts are funded mostly by utility fees and, consequently, have experienced less fiscal stress than counties and cities during the recent economic downturn. Collectively, local governments derive nearly one-third of their revenues from state aid, about one-quarter from property taxes, one-tenth from sales and other taxes, and most of the remainder from fees and miscellaneous revenues; only 4 percent represents direct aid from the federal government (see Figure 2).

3. The environment category includes parks and recreation, sewerage, solid waste management, and natural resources.

Figure 1.

Types of Spending by Local Governments, 2008



Source: Congressional Budget Office based on data from the Department of Commerce, Census Bureau.

Notes: The most recent data on local governments' spending by type are for 2008.

Shares do not add to 100 percent because of rounding.

a. Includes spending on parks and recreation, sewerage, solid waste management, and natural resources.

b. Includes spending on water, gas, and electric utilities.

c. "Other" includes spending on diverse categories such as unemployment compensation, employee retirement, and the operation of liquor stores.

Causes of Fiscal Stress for Local Governments

Fiscal stress—a gap between projected revenues and expenditures—can be short term, in the case of transitory economic shocks, or long term, in the case of structural budget imbalance. Such structural imbalance may arise from persistent economic shocks or from other factors.

Transitory Economic Shocks

Weak economic conditions lead to fiscal stress for local governments by reducing their tax revenues, lessening the state aid they receive, increasing the demand for some services, and triggering investment losses. Primarily because of their reliance on property taxes—a relatively stable source of funds that makes up just over a quarter of revenues—local governments have experienced less fiscal stress during the recent economic downturn than have state governments. That relative stability may change, however. Nationally, house prices fell by 27 percent from the year ending in June 2006 to the year ending in June 2010 (see Figure 3).[4] Although property tax collections increased 31 percent over that same period, the decline in house prices implies that collections will probably fall in the coming years as local governments gradually update property tax assessments to reflect lower market values. On average, collections of property tax revenues lag behind changes in house prices by three years.[5] Even small declines in collections could cause fiscal stress when the cost of providing public services is growing.

State governments provided 30 percent of revenues for local governments in 2008. However, state revenues—primarily from income and sales taxes—have plummeted during the weak economic conditions of the past two years (see Figure 4 on page 5). States have consequently reduced spending, in part by cutting the amounts provided to local governments. Because periods of local and state fiscal stress tend to occur concurrently, aid to local governments often falls when it is needed most. Following the 2001 recession, total transfers to cities declined by 9 percent from 2002 to 2004.[6] Although data on changes in local aid during the recent recession and slow recovery are not yet available, a recent survey indicates that 22 states reduced aid to local governments in fiscal year 2010, and 20 states have proposed additional cuts in 2011.[7] According to another survey, almost 40 states cut spending for K–12 education in fiscal year 2010, and 31 governors proposed to cut such funding

4. Standard & Poor's, S&P/Case-Shiller Home Price Indices, U.S. National Index, 2nd quarter, 2010.

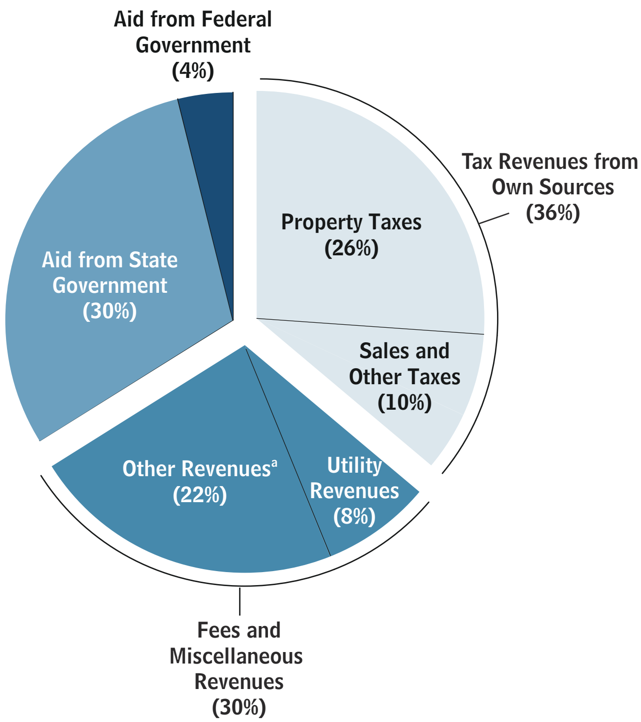
5. Byron Lutz, "The Connection Between House Price Appreciation and Property Tax Revenues," *National Tax Journal*, vol. 61, no. 3 (September 2008), pp. 555–572.

6. Christopher W. Hoene and Michael A. Pagano, "Fend-for-Yourself Federalism: The Effect of Federal and State Deficits on America's Cities," *Government Finance Review* (October 2003).

7. National Governors Association and the National Association of State Budget Officers, *The Fiscal Survey of States* (Washington, D.C.: NASBO, June 2010).

Figure 2.

Sources of Revenues for Local Governments, 2008



Source: Congressional Budget Office based on data from the Department of Commerce, Census Bureau.

Note: The most recent data on local governments' revenues by source are for 2008.

a. Examples of other sources of revenues include hospital, sewerage, and tuition fees.

in their budgets for 2011.[8] (States have different options available to them when responding to fiscal stress. For a brief description of those options, see Box 1 on page 6.)

Economic contractions also often result in increased demand for a host of public services. The unemployed or those facing a reduced work schedule may lose access to health insurance, increasing demands on public hospitals or clinics. Crime generally increases during economic downturns, increasing the need for police protection.[9] People who lose income often opt for less-expensive modes of transportation, such as public transit. As the number of people unemployed increases, so does the demand for job training programs and services provided by public libraries or social welfare offices.

Local governments also may experience fiscal difficulties that result from investment losses; when large, such losses can be extremely disruptive (see Box 2 on page 7).

Structural Budget Imbalance

Long-term imbalances in local budgets arise from a variety of sources that can be difficult to disentangle. Political dynamics frequently play an important role. When a council or other legislative body and the executive fail to agree on a budget—often when the two bodies are dominated by different political parties—deficits may occur. Arrangements with local groups such as public-employee unions may also be a factor. For example, according to a bankruptcy filing of Vallejo, California, the inability of the council and the mayor to control labor costs was the main reason for the filing.

In addition, demographic shifts, particularly occasions when high- or moderate-income households move out of a local jurisdiction, may contribute to long-term budget imbalance. Such shifts are often closely related to the relocation of businesses out of the inner cities and into the surrounding suburbs.[10] As businesses move away, the jurisdiction's tax collections drop. Over time, the need for public services also increases as personal incomes fall and unemployment increases.

Budget imbalance also may result or be exacerbated when a locality lacks adequate budgetary or financial controls. For example, questionable accounting procedures and loose fiscal management allowed New York City officials to mask growing deficits over a period of several years, eventually resulting in deficits so large that the financial markets would no longer finance them.[11] Budgetary controls—including balanced budget requirements, debt limits, and tax and expenditure limits—restrict elected

8. National Conference of State Legislatures, *State Measures to Balance FY 2010 Budgets* (May 2010) and *State Measures to Balance FY 2011 Budgets* (September 2010).

9. Eric D. Gould, Bruce A. Weinberg, and David B. Mustard, "Crime Rates and Local Labor Market Opportunities in the United States: 1979–1997," *Review of Economics and Statistics,* vol. 84, no. 1 (February 2002), pp. 45–61.

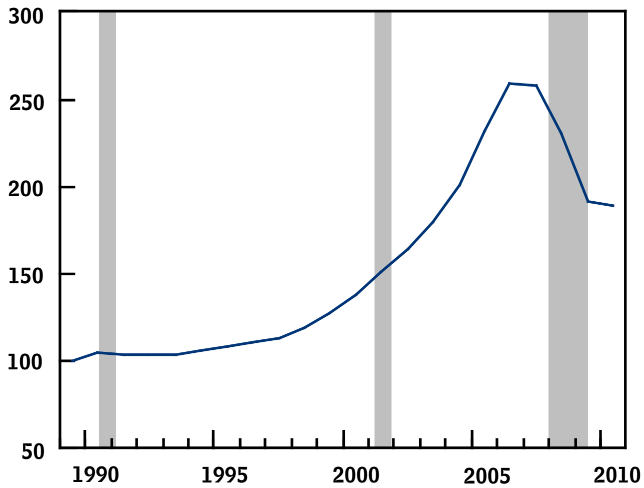
10. Congressional Budget Office, *New York City's Fiscal Problem: Its Origins, Potential Repercussions, and Some Alternative Policy Responses,* Background Paper (October 1975).

11. Ibid.

Figure 3.

Prices for Single-Family Homes, July 1988 to June 2010

(Index, July 1988–June 1989 period = 100)



Source: Congressional Budget Office based on the S&P/Case-Shiller Home Price Index.

Notes: The S&P/Case-Shiller index tracks repeat sales of existing single-family homes financed by all types of mortgages. The data plotted are annual, showing the average value in periods running from July through June.

The shaded vertical bars indicate periods of recession.

officials' ability to spend more on operating expenses than they raise in revenues. The extent to which states require local governments to comply with budgetary controls varies from state to state. Financial controls, including audit practices and financial oversight bodies, help to ensure that resources are allocated to the purposes for which they were intended. Such controls also improve the transparency and accuracy of information that the locality provides to the public about its operations.

Borrowing by local governments may be both a response to and a cause of fiscal stress. If an operating deficit is caused by temporarily poor economic conditions, issuing short-term debt may help to alleviate those pressures. However, local governments that spend more than they collect in revenues for a number of years usually reach a limit on their ability to postpone reconciling that difference, at which point they face even more difficult decisions.

Local Governments' Responses to Fiscal Stress

Local governments can decrease spending and increase taxes and fees in response to fiscal stress, although the extent of those adjustments can be limited by state and federal requirements as well as other factors. Local governments can also shift payments and receipts or borrow funds to bridge a gap between spending and revenues.

Decreasing Spending

Local governments reduced spending in real terms by 0.6 percent in 2008 and by 1.9 percent in 2009. Although comprehensive data on local spending are not yet available for fiscal year 2010, according to the National League of Cities, more than 90 percent of the cities that responded to its annual survey expected to cut expenditures in fiscal year 2010 relative to the amount needed to maintain services at the fiscal year 2009 level.[12] Since 1970, local governments have rarely reduced their workforces, but they did so by 241,000 employees, or 1.7 percent, between December 2007, when the recession began, and November 2010.[13]

Contributions to pension funds or health care funds for retirees are particularly vulnerable to delay during times of fiscal stress. State or federal laws generally do not require local governments to make annual contributions to those funds (unless the state fund covers local employees), and political pressures often lead to delays in those payments as a way of avoiding cuts in services or increases in taxes. Local governments also often postpone capital investments during times of fiscal stress.[14] The effects of postponing those investments are often not immediate, but particularly for single-purpose entities such as water or sewer districts, continually doing so may ultimately

12. Christopher W. Hoene, *City Budget Shortfalls and Responses: Projections for 2010–2012* (Washington, D.C.: National League of Cities, December 2009), p. 2.

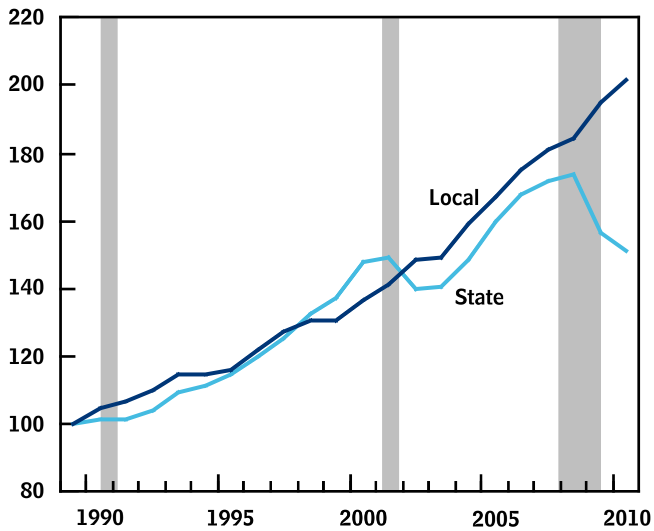
13. CBO's calculation based on Department of Labor, Bureau of Labor Statistics, Current Employment Statistics, Table B-1, October 8, 2010. Since its peak in August 2008, employment by local governments has fallen by 360,000.

14. See Rebecca Hendrick, "The Role of Slack in Local Government Finances," *Public Budgeting and Finance*, vol. 26, no. 1 (2006), pp. 14–46; and David R. Morgan and William J. Pammer Jr., "Coping with Fiscal Stress: Predicting the Use of Financial Management Practices Among U.S. Cities," *Urban Affairs Quarterly*, vol. 24, no. 1 (1988), pp. 69–86.

Figure 4.

State and Local Governments' Tax Collections, July 1988 to June 2010

(Index, July 1988–June 1989 period = 100)



Source: Congressional Budget Office based on data from the Department of Commerce, Bureau of Economic Analysis.

Notes: The data plotted are annual, showing the average value in periods running from July through June.

Values have been adjusted for inflation.

The shaded vertical bars indicate periods of recession.

result in the failure of a system or, alternatively, the need to make a large investment down the line when the funds to do so may not be readily available.

The ability of some local governments to decrease spending is sometimes limited by federal and state requirements, particularly laws that require local governments to pay for a portion of the costs of certain services. For example, more than half of the states require local governments to contribute a share of the costs of the state's Medicaid program. Many states also restrict the way local governments deliver services—regardless of the local government's fiscal situation. For example, many states cover some local employees under their pension plans and restrict the extent to which local governments can reduce their contributions to the plans when revenues fall.

At some point, reducing spending may entail much larger future costs. Deferring maintenance can shorten the service lifetime of equipment or increase future repair costs. Missed pension contributions can lead to large budget shortfalls when benefits come due. Eventually, residents of a locality may decide to move out of the area if service levels are cut (or taxes increased) too much, causing the local government to collect less in revenues than it did before.

Increasing Taxes and Fees

Local governments also can raise taxes and fees in response to fiscal stress. Despite the decline in property values over the past four years, for example, some combination of tax rate increases, lagged updates of the assessed values to which local property tax rates are applied, and expansion of the tax base through new construction has led to increased property tax collections over that period. However, such collections will probably fall in the next few years as the drop in property values is reflected in assessed values; local governments might then decide to increase taxes and fees to make up for the losses. Some states limit the extent to which local governments can increase tax rates or collections in a given year. Those limits most often apply to property tax rates but also extend to sales tax rates, assessments, and fees in some states.

Shifting the Timing of Payments

When spending exceeds revenues, local governments can delay scheduled payments or undertake other temporary measures that balance their budgets in one year by pushing costs into subsequent years. Examples of such measures include selling and leasing back public property, delaying payments to contractors, and shifting pay dates for employees. Local governments that repeatedly use such practices are likely to face higher prices from suppliers, and their payments on leased-back property may exceed the cost of owning those assets. Postponing contributions to pension or health care funds may also represent a short-term shift in payments.

Borrowing

Local governments can borrow to cope with fiscal stress. Like delaying payments, borrowing postpones rather than resolves the need to pay for expenses, and it may increase those expenses because of debt-service costs. The most common forms of borrowing include the use of short-term debt to fund operating deficits and the use of long-term debt to fund capital expenses or contributions to pension or health care funds. Local governments also may borrow against future streams of revenues, such as the payments from settlements of tobacco cases that some are receiving. Short-term borrowing usually must be paid off

Box 1.

States' Options for Addressing Fiscal Stress

States collectively have experienced more fiscal stress during the recent economic downturn than have their local counterparts, in part because of their greater dependence on more-volatile sources of revenues such as income and sales taxes. For local governments, collections of tax revenues grew in real (inflation-adjusted) terms every year for the past 20 years, and grew 9 percent from the year ending June 2008 to the year ending June 2010 (see Figure 4 on page 5).[1] In contrast, collections of tax revenues by state governments fell in real terms during a few years in the past two decades and dropped 13 percent from the year ending June 2008 to the year ending June 2010.

When considering how to adjust their spending and revenues in response to fiscal stress, state governments can face a number of constraints. Eleven states restrict lawmakers' ability to increase taxes by requiring more than a simple majority vote for any legislation that would do so beyond some statutory or constitutional limit.[2] Most states also have laws that require the legislature to pass and/or the governor to enact a balanced budget. States' ability to raise revenues (like local governments') is also constrained by their need to retain and attract residents and by political considerations. In addition, state spending is sometimes required by federal laws that impose mandates and by conditions of federal assistance—such as matching requirements for funding for education and Medicaid.[3]

States can issue short-term debt to fund operating deficits and long-term debt to fund capital investments and contributions to pension or health care funds. However, the amount of debt that can be issued is limited in most states by state law or the state constitution.

States often turn to the federal government for assistance during periods of fiscal stress. In the past, such assistance has included grants, tax credits, loans, and guarantees on debt. From state fiscal year 2008 to state fiscal year 2009, federal aid as a share of total state spending increased from 26 percent to 30 percent.[4] The American Recovery and Reinvestment Act (ARRA) provided assistance to states. In particular, as of September 2010, the federal government had sent $71 billion to states in additional Medicaid grants and $36 billion through the State Fiscal Stabilization Fund, established by ARRA. Excluding the additional assistance provided under ARRA, federal payments to states for Medicaid from early 2009 to September 2010 were $453 billion. Also, in an effort to restart loan purchases by state housing finance authorities (HFAs) that faced high interest costs on their debt because of market turmoil and the failure of several debt insurers, the Treasury provided $24 billion to states in 2010. That support, which consisted of purchases of new debt and credit support to increase the liquidity of outstanding debt, significantly reduced debt-service costs for HFAs, allowing them to purchase new mortgages and to support lending to first-time and low-income home buyers.

If a state was under great fiscal stress, it could default on its debt, but the last state to do so was Arkansas in 1933. The federal government could not take control of a state's fiscal operations, primarily because the U.S. Constitution protects the states from federal infringement on their sovereignty. Furthermore, under federal law, states cannot file for bankruptcy.

1. Many but not all local governments have fiscal years that begin in July and end in June.
2. National Association of State Budget Officers, *Budget Processes in the States* (Washington, D.C.: NASBO, 2008).
3. For a detailed description of federal mandates, see Congressional Budget Office, *Intergovernmental Mandates in Federal Legislation,* Issue Brief (July 2009).
4. National Association of State Budget Officers, *State Expenditure Report* (Washington, D.C.: NASBO, 2009). Many states' fiscal years end in June.

Box 2.

Examples of Investment Losses That Were Disruptive for Local Governments

In the rare instances in which investment losses are extremely large, they can cause severe fiscal distress for local governments. The losses of Alabama's Jefferson County are one example. Beginning in 2003, Jefferson County attempted to lower the cost of its debt for its sewer system by replacing its fixed-rate debt with variable-rate debt. Because interest rates fluctuate, the county simultaneously entered into an agreement with an investment bank whereby the county would provide fixed payments to the bank in exchange for variable-rate payments that the county could use to pay bondholders. That arrangement was flawed, however, because the two variable rates were tied to different indexes. Eventually, those indexes and the payments based on them diverged, causing the county to default in 2008.

Another example is the Orange County Investment Pool's losses in 1994 of $1.7 billion (which were about 22 percent of its assets). The losses of the pool, which was created to manage the revenues of about 200 local governments, occurred primarily because its manager invested heavily in assets whose value would fall if short-term interest rates rose. Beginning in early 1994, the Federal Reserve Board increased short-term rates, causing the value of the pool's investments to drop, triggering withdrawals by local governments and calls by private banks for the collateral held by the pool to back loans.

within a year to 18 months, depending on state law. Some states allow municipalities to refinance short-term debt with new debt, but in most cases, states limit the number of times that such debt may be refinanced. Prevailing interest rates in the market for municipal debt also limit how localities use debt to finance current expenditures.

Municipalities that accumulate a large debt burden and that are perceived as having a significant risk of default tend to pay considerably higher interest rates than those that borrow more conservatively. Those differences in borrowing costs widen during economic downturns. Toward the end of 2008, the spread relative to the yield on Treasury bonds spiked to more than 5.5 percentage points for municipal issuers of 30-year bonds rated BBB but was less than 1 percentage point for issuers of AAA-rated bonds. Since then, rate spreads for all but the safest issuers have narrowed but remain elevated over historical levels, particularly for bonds of longer maturity. Another factor leading to some municipal governments' higher borrowing costs has been a sharp reduction in the availability of municipal bond insurance. A countervailing effect on borrowing costs, however, has been the generally low level of interest rates.

States' Responses to Local Governments' Fiscal Stress

States may assist a local government that faces fiscal stress by providing more aid or by allowing the local government to collect additional tax revenues. If a local government experiences a high level of fiscal stress, the state may increase its oversight or even take over the fiscal operations of the locality.

Increasing State Aid or Allowing Additional Tax Collections

Before decreasing spending or increasing taxes or fees, most local governments seek additional aid from state governments. State aid takes many forms, including increased revenue sharing, additional grants, and the provision of debt guarantees. States can help alleviate changes in revenues caused by local shifts in population by redistributing revenues from one jurisdiction to another. Alternatively, states can adjust taxes that cross jurisdictions, such as commuter or nonresident income taxes, to reduce the incentives for people to move to new areas. States also may expand the types of taxes that a local government can impose in times of fiscal stress—such as allowing a locality to impose a new sales tax—or they may increase the maximum tax rate a locality may impose. For example, Massachusetts, in its fiscal year

2010 budget, allowed localities to impose a tax of 0.75 percent on sales of restaurant meals.[15]

Providing Oversight or Assuming Control

In the event of severe fiscal stress, a state may opt to directly oversee a municipality using a financial control board or other management mechanism. At least 15 states have passed laws establishing a method of detecting and managing fiscal stress at the local level. The laws generally set criteria for determining when a local government is experiencing stress, what must be done to resolve the problem, who has the power to implement a recovery plan, and when the local government no longer is subject to the state oversight procedures.[16] Among those 15 states, 7 can assume fiscal management of a local government using a financial control board or other manager.[17] States other than those 15 have sometimes established oversight authorities for ailing governments on an ad hoc basis, by enacting legislation to address the fiscal problems of a single entity. For example, when New York City neared default in 1975, the state of New York established three oversight bodies whose duties included overseeing the city's accounting practices; managing its borrowing and outstanding debt; approving its budgets; approving contracts with employees; and, when necessary, seizing its bank accounts and directing its operations.[18]

Federal Responses to Local Governments' Fiscal Stress

The federal government assists local governments through grants, loans, debt guarantees, and certain provisions of the tax code. Because local governments derive their authority from states, federal control of local governments would probably violate the U.S. Constitution, which protects the states from federal infringement on their sovereignty. Therefore, the federal government cannot establish an oversight program for a local government or force it to take action to address fiscal stress; it can only encourage the actions it seeks by attaching conditions to the aid it provides.

Federal assistance reaches local governments either directly, when a federal agency provides funds or other assistance to a local government itself, or indirectly, when a state passes federal assistance through to a local entity. Direct federal aid to local governments makes up a small portion of local revenues: only 4 percent in 2008. Data regarding the amount of federal assistance that reaches local governments indirectly are unavailable; Census data track state assistance to local governments, some of which includes funds that pass from the federal government to states and then to local governments.

Federal aid is rarely provided to local governments specifically because they are experiencing fiscal stress, but aid has been provided recently for local governments in areas that were affected by the economic and housing downturns and by natural disasters. For example, in August 2010, the Congress provided $10 billion for aid to the states, almost all of which was required to be conveyed to local school districts to fund jobs in education. The Congress also provided a total of $6 billion in 2008 and 2009 for state and local governments to purchase, rehabilitate, and sell foreclosed properties through the Neighborhood Stabilization Program. That grant program required states to allocate funds to local areas experiencing the greatest percentage of foreclosures. Earlier, the federal government created the Gulf Opportunity Zone Tax Credit and Community Disaster Loans programs, which were targeted to localities in Gulf states affected by Hurricanes Katrina and Rita. Several decades ago, in 1975, the federal government helped New York City by providing up to $2.3 billion in short-term loans to the city.

Local governments also benefit from the federal tax code. The largest amount of support has come from provisions that allow taxpayers to deduct local property taxes and either local income taxes or sales taxes (but not both) from their federal tax liability.[19] Substantial support has also come from a provision that allows taxpayers to

15. Massachusetts Department of Revenue, "Bulletin: Local Option Excises," July 2009; www.mass.gov/Ador/docs/dls/publ/bull/2009/2009_15B.pdf.

16. Anthony G. Cahill and others, "State Government Responses to Fiscal Distress: A Brave New World for State-Local Intergovernmental Relations," *Public Productivity and Management Review*, vol. 17, no. 3 (Spring 1994), p. 255.

17. Charles Coe, "Preventing Local Government Fiscal Crises: Emerging Best Practices, *Public Administration Review*, vol. 68, no. 4 (July/August 2008), p. 762.

18. Martin Shefter, *Political Crisis, Fiscal Crisis: The Collapse and Revival of New York City* (New York: Columbia University Press, 1992), pp. 132–134.

19. The law allowing taxpayers to deduct local income or sales taxes expired at the end of 2009.

exclude from federal income tax the interest earned on municipal bonds.

Local Governments' Default or Bankruptcy

Local governments that experience significant fiscal stress may default on their debt or file for bankruptcy. Default occurs when a municipal government fails to make an interest or principal payment to bondholders or when it violates a term of a bond agreement. Municipal bankruptcy is a process established in federal law that allows a local government to restructure its debt and other obligations under the supervision of a federal court. Both default and bankruptcy are extremely rare.

Default

Of the 18,400 municipal bond issuers rated by Moody's Investors Service from 1970 to 2009, only 54 defaulted during that period. The vast majority of the entities that defaulted were special districts that issued debt to support housing or health care facilities; only six were counties, cities, or towns.[20] In most cases, investors eventually recovered most or all of what they were owed. But defaults on municipal debt have risen in the past few years; this year defaults have exceeded $4 billion.

Municipalities that encounter a large, sudden loss of revenues or an increase in the cost of debt service sometimes default. Both Jefferson County, Alabama, and Orange County, California, defaulted on debt when interest rates moved in an unexpected direction, requiring the municipalities to make large payments (see Box 2 on page 7). A default may also lead a municipality to file for bankruptcy, in part to protect itself from lawsuits or court orders related to the default.

Bankruptcy

In the past 70 years, about 600 governmental entities have declared bankruptcy—with about 170 of those occurring between 1988 and 2005.[21]

As specified in Chapter 9 of the Bankruptcy Code, a governmental entity must meet four main criteria before filing for bankruptcy:

- The entity must be a political subdivision, public agency, or instrumentality of a state (a state itself may not file);
- State law must authorize its governmental entities to use Chapter 9;
- The entity must be insolvent; and
- The entity must negotiate in good faith with its creditors to restructure its debt outside of the bankruptcy, to the extent practical.

Laws in 26 states authorize local governments to file for bankruptcy under Chapter 9. Among those states, 12 impose no restrictions on the ability of municipalities to file, while 14 require local entities to seek approval from a state authority, such as the governor, the attorney general, or a bond commission, before filing. In Georgia, state law prohibits municipalities from filing at all. The other 23 states have not passed laws to address Chapter 9. Local governments in those states would not be allowed to file for bankruptcy unless the state passed a law explicitly permitting them to do so.[22]

To establish insolvency, a judge must determine that the municipality cannot use its reserves, reduce expenditures, raise taxes, borrow, or postpone debt payments to pay its obligations to creditors. In a Chapter 9 case, a bankruptcy court is prohibited from interfering with the municipality's property, revenues, or political or governmental powers. Consequently, the court may not require the municipality to sell property, raise taxes, or remove officials from office. However, a municipality's unreasonable failure to exercise its taxing powers could violate its duty to act in good faith—disqualifying the municipality from bankruptcy protection.[23]

Benefits of Bankruptcy. One key advantage of bankruptcy is the "automatic stay," which is issued by a court and

20. Jennifer Tennant and Kenneth Emery, *U.S. Municipal Bond Defaults and Recoveries, 1970–2009* (New York: Moody's Investors Service, February 2010).

21. Andrew Ward, "GASB Issues Exposure Draft on Bankrupt Municipalities," *The Bond Buyer,* vol. 368, no. 33140 (June 30, 2009), p. 21.

22. Chad Farrington, "Municipal Bankruptcies Imminent? Not So Fast," *Columbia Management Midyear Perspectives* (August 2010), p. 2.

23. See, for example, Sullivan County Refuse Disposal Dist. 165 B.R. 60 (Bankr. D.N.H. 1994).

prevents creditors from taking action against the municipality and its officials without approval from the court. Outside of bankruptcy, a local government may incur legal costs and spend time addressing legal claims as they arise, making the task of forming and implementing a solution to its fiscal problems difficult. In addition, paying claims as they arise may cause a government's problems to snowball by diverting funds from municipal services or debt service. The stay prevents such a scenario. Moreover, while a stay is in place, bondholders cannot force municipal officials to raise taxes in order to make debt-service payments.

Another important advantage of bankruptcy is that courts can implement a restructuring plan without the consent of every creditor. To gain the approval of the court, the plan must have the approval of two-thirds of each class of creditors whose interests would be impaired by the plan. Outside of bankruptcy, creditors that did not agree to a restructuring would maintain the rights provided to them in law and in their bond covenants. For example, Orange County's restructuring agreement gave participants in the investment pool 77 cents on the dollar, an amount some creditors would have been unlikely to accept outside of bankruptcy.

The bankruptcy process may also allow a municipal government to reduce its labor costs by facilitating the consent of employee unions to changes in labor contracts. For example, Vallejo, California—which filed for bankruptcy in May 2008—restructured its labor agreements with three out of four unions, reducing its health care obligations to retirees by 75 percent, from $135 million to $34 million.[24] The city also was able to cut its personnel costs for police protection by 18 percent from the level specified in the contract in place before the bankruptcy, saving a total of about $6 million in fiscal years 2009 and 2010.[25]

Limitations of Bankruptcy. Because a restructuring plan requires the consent of two-thirds of each class of creditors whose interests would be impaired by the plan, a municipality may emerge from bankruptcy in an only slightly better fiscal position than it had when it entered bankruptcy. If new debt is part of the plan to alleviate a municipal government's cash flow problems, the government's obligations may be stretched out over time rather than eliminated. Consequently, the restructuring may constrain government operations for years after the restructuring plan is approved by the court. Orange County, for example, is still paying debt service on a portion of the $1.2 billion of bonds it issued in 1995 and 1996 to exit bankruptcy; the need to pay debt service limits the county's ability to cut taxes, cover increased costs of existing services, and pay for new services. In all cases, some of the fiscal gains from restructuring will be offset by the legal costs the municipality incurs during the process.

In addition, bankruptcy does not necessarily eliminate the political dynamics and state laws that may make recovery difficult. For example, in an attempt to emerge from bankruptcy, Orange County put an increase in its sales tax on the ballot, but the measure was rejected by the voters. State laws that, for example, limit property tax rates or require local governments to contribute a certain percentage of their employees' pension costs each year also continue to limit the ability of municipalities to address their fiscal problems.

This brief was prepared by Elizabeth Cove Delisle. It and other CBO publications are available at the agency's Web site (www.cbo.gov).

Douglas W. Elmendorf

Douglas W. Elmendorf
Director

24. Nicholas Gelinas, "Beware the Muni-Bond Bubble; Where State and Local Finances Are Untenable, Investors Should Stop Throwing Good Money After Bad," *Wall Street Journal*, May 22, 2010.

25. City of Vallejo, "City of Vallejo and Police Officers Association Reach Agreement on Labor Contract" (press release, Vallejo, California, January 27, 2009).