November 27, 2023

Community Finance Brief

Economics, Politics, Race & Local Government Insolvency

MATT POSNER | COURT STREET GROUP LLC

Municipal bonds issued by local governments in the United States do not default often. Since the turn of the century, the number of times this has happened is below twenty. This is an anomaly for debt markets around the world. To compare, single-A rated global corporates for a 10-year tenor have a default rate of 1.96% compared to 0.10% for the single-A muni sector in the same tenor from 1970 to 2022. Speculative grade corporates sit at 28.92% versus 6.94% for municipalities that are below investment-grade (Fidelity).

This is in part because the structure of the market is unique as sub-sovereigns in the U.S. (IE- states and locals) have much more autonomy from their sovereigns compared to other countries. This component of the U.S. muni market is essentially the buying and selling of faith in local governments. These are entities that cannot pull up stakes and leave like a company can and represent communities that in many cases stretch back generations. There is really no other marketplace in the world wherein finances and community mesh day-in and day-out. Even with confidence in the U.S. government's debt declining in the last 15-years, municipal interest rates generally reflect confidence in the full faith and credit (and other security types) of U.S. state and local governments.

When defaults happen, or there are downgrade trends, in various sectors, it belies valuable information that tells us something bigger about a topic. The first sentence of *this brief* specified 'local government' defaults because there are pseudo-private sector entities that issue municipal bonds for a public purpose. These default with slightly more frequency and tell us about the economic health of sectors in general such as senior living, or higher education, for example.

Earlier this year, the culmination of a long series of events in

Quick Takes

From 1970 to 2022, there have been 13 city or county government bond defaults while the so-called "housing" sector (public and private) have seen the largest amount in this time frame at 46
– *Moody's Investors Service*

Private sector, or pseudo-public bonds such as senior living, student housing, industrial development, account for 77% of all defaults compared to fully publicly-backed taxpayer revenues or indirectly through full-faith general obligation credits from 1958 through 2011
– *Federal Reserve Bank of New York*

Single-A muni bonds 10-year default risk from 2005 through 2015 sits at 0.09% compared to 2.07% for corporates and 4.28% to 15.96% in the BB category from munis to corporates
– *Standard & Poor's*

Milwaukee, Wisconsin led to a small movement by certain community members to support a local default on the city's debt. This is somewhat rare and merits a thoughtful discussion about the limited local government default arena in the country.

They tend to be written off as 'one-off's by many market participants because in general, it is bad business to talk about default and history does not treat those who yell fire (**see quote, right**) very well. Some of these defaults have made national headlines like Detroit, Michigan or the territory of Puerto Rico while others have largely floated under the radar, like Central Falls, Rhode Island or Chester, Pennsylvania.

In all of these cases, there are some interesting parallels that are helpful for policy makers, community members and investors to think about the future. For the purposes of this discussion, we omit Puerto Rico as it is a territory of the country and from a statutory viewpoint, is really not comparable to U.S. local governments and from a taxation point of view, is another polygon altogether.

Since the 2008 financial crisis there have been a number of local governments that have declared Chapter 9 bankruptcy and had some process of default on their bonds. In *this brief*, we look at the broad parallels of communities in the **table, page 3**, which comprise many of the local government defaults in this time period. These bankruptcies were caused by a variety of factors, including economic downturns that were exacerbated by dependency on a certain industry in the local economy, the mismanagement of funds (from either specific projects or structured government benefits), as well as the role that the state government, race and politics played in the fate of the community's finances.

Detroit, Michigan

The state of Michigan imposed a number of unfunded mandates on Detroit, including requirements to provide certain services to residents of other cities in the county including statutory revenue sharing on its income taxes, Public Act 4 (2011) that required payments to the state pension system, Public Act 143 (2011) that require the city to provide certain services to the county for non-residents and Public Act 94 (2013) that required payments to the state health care trust fund. These mandates contributed to the city's financial problems by increasing its expenses. In 2009, the state legislature passed a law that allowed the governor to appoint an emergency financial manager about 3-years before it did.

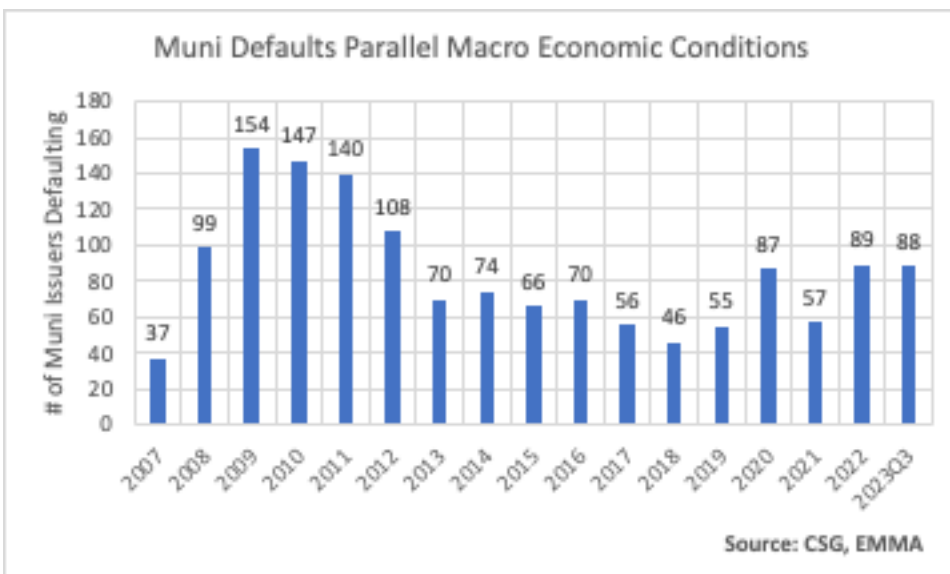
"There's not a doubt in my mind that you will see a spate of municipal bond defaults," said investor **Meredith Whitney** on *CBS 60 Minutes* in 2011. "You could see 50 sizable default, 50 to 100 disable defaults, more. This will amount of hundreds of billions of dollars worth of defaults. It's been building for decades. Municipalities have been engaging in a lot of financial engineering, a lot of practices that have allowed them to appear solvent when they were not. They've been using a lot of accounting tricks, they've been using a lot of off-balance-sheet debt. And they've been doing this to fund their operating budges to fund their pension obligations and to fund their capital spending."

Bankruptcy Year	Jurisdiction	Local Government Type	Population (2020 Census)
2008	Jefferson County, Alabama	County	673,611
2009	Vallejo, California	City	115,242
2010	San Bernardino, California	City	211,568
2011	Harrisburg, Pennsylvania	City	50,069
2011	Central Falls, Rhode Island	City	18,999
2012	Stockton, California	City	309,008
2013	Detroit, Michigan	City	638,176
2015	Hillview, Kentucky	City	7,877
2022	Chester, Pennsylvania	City	32,689
			Source: U.S Census Bureau

It's The Economy, Silly

The ability to payback loans has to do with the broader economic conditions of a community. Fundamentals and the macro conditions need to be considered when looking at this topic and it is no surprise to see the uptick in defaults in the wake of the 2008 financial crisis as well as during the pandemic period (**see chart, page 3** on total universe of muni defaults). The drop in 2021 is attributed to stimulus by many. As we head into a crossroads as far as the central bank landing comes to reality, these statistics are relevant.

If one were to look at defaults in the last 15-years there are consistencies in that these local governments became particularly dependent on one industry and were less diversified as a local economy. While Detroit is the poster child for this (Motor City is apt), we would also point to places like Harrisburg, and Chester, Pennsylvania, which were never able to fully recover from its dependence on the steel industry. These so-called rust belt cities went from over half of their workforce in this industry in the 1980s to less than 5% by the financial crisis, which was halved in the 2008 to 2010 time frame for all three of these cities. The decline of the steel industry had a ripple effect throughout the economies of these governments and the cities tax



Jefferson County, Alabama

The state of Alabama imposed a number of unfunded mandates on Jefferson County, including a requirement to fund the state's pension system for county employees, to self-insure its workers' compensation plan, pay for the incarceration of state inmates in the country jail, enforce child support orders and provide mental health searches to county residents. These mandates contributed to the county's financial problems by diverting resources away from other essential services.

revenues declined as a result. A somewhat vicious cycle ensued as cities struggled to attract and retain new business and workers.

Central Falls, Rhode Island, prior to it's bankruptcy filing in 2011, had for 50-years been a major manufacturing area of the country with a focus on textiles and jewelry. During the 20th century, the town was a thriving industrial center with numerous mills employing over half of the city's workforce. The decline of said manufacturing industry in the latter half of the century had a devastating impact on the city's tax base.

Stockton, California was the largest city in the U.S. at the time to declare chapter 9 in 2012 and its economic troubles stemmed from its over-reliance on the housing market and related industries. During the housing boom of the early 2000s, Stockton experienced rapid growth and expansion (nearly doubling in population from 1990 to 2010). The 2008 housing bust had an unreal impact on the city's finances within months amid the second highest foreclosure rate of all U.S. metropolitan areas in 2011(source: RealtyTrac, LLC).

Vallejo's economy was heavily reliant on the shipbuilding industry, which had been a major employer in the city since the early 20th century. The Mare Island Naval Shipyard, in particular, was a major source of jobs and economic activity for Vallejo. However, the decline of the shipbuilding industry in the late 20th century had a devastating impact on the city. As the shipyard downsized and eventually closed in 1996, Vallejo lost a significant portion of its workforce and tax base.

San Bernardino, California

The state of California imposed a number of unfunded mandates on San Bernardino, including a requirement to provide certain health benefits to county employees (CalPERS), required the city to provide up to 12 weeks of unpaid leave (per CDRA), pay pubic projects workers prevailing wages and asses environmental impact of public projects via CEQA. These mandates contributed to the county's financial problems by increasing its expenses and while not specific to San Bernardino, the growth of public projects leading up to the 2008 financial crisis compounded its expense.

When reading about all these community's lack of diversification in their tax base, each review turns to financial mismanagement by the government as the touch point for an eventual bankruptcy. And while 'mismanagement' can mean a lot of things, there are similarities in the cases where each local government went to the final step in declaring chapter 9.

Government Mismanagement and/or 'One Bad Investment'

Pensions and other post-employment benefits is a common denominator for all local bankruptcies in the United States this century. Underfunded pension systems for years had these local governments facing unfunded liabilities that at a certain point became untenable. In some cases, pension obligation bonds were (POB) a financial tool used to pass forward costs of public pensions and in every single use of this financial instrument, POB issuance is a red flag. Yet, the public pension problem is a nationwide one at the state and local level. Each state's constitution has different protections and obligations for these liabilities but this is not the only precursor to default.

"I don't see how you can govern a diverse city like Stockton and not be equity-minded and equity-focused," says Stockton's first black mayor, **Michael Tubbs**, elected in 2016. "For the city of Stockton to thrive, we're going to have to invest in everybody, but particular this who haven't been invested in historically - and that's the majority of our population."

Instead, in these instances one generally sees a specific investment, usually in part financed by municipal bonds, that just doesn't pan out (to put it mildly). In Harrisburg it was a famous trash incinerator and a parking garage, Hillview had a land dispute with Truck America Training, Chester had a riverfront redevelopment project, Central Falls had a private prison, while Stockton and Vallejo had public-private partnerships in each downtown's real estate that did not become profitable.

Detroit and Jefferson County are much larger to generally identify a single project (although Jefferson County's decision to allow citizens to remove themselves from the public waste system was a major factor). These communities were too large to have a single item force the issue of bankruptcy but instead a lack of government oversight and poor budgeting as a result of various poor decisions would be the precursors that live in this portion of analysis.

Vallejo, California

The state of California imposed a number of restrictions on Vallejo's ability to raise revenue, including a limit on property taxes. Proposition 13 (1978) limited property taxes, proposition 8 (1994) requiring a two-third majority voter approval of any increases beyond the state-manned inflation adjustment and proposition 26 (1994), which also required a two-thirds majority voter approval on sales taxes were all restrictions that limited the city's ability to generate the funds it needed to meet its obligations.

Of the general themes under the 'government mismanagement' paradigm, **CSG** sees the following:

- Underfunding pension obligations;
- Overspending and excessing borrowing as it relates to relationships between revenue expectations and future growth;
- Lack of proper financial oversight and management overall financial transparency;
- Reliance on private support for public utilities; and
- Reliance on private development for an economy that is over reliant on a single sector.

Chester, Pennsylvania

The state of Pennsylvania imposed a number of restrictions on Chester's ability to raise revenue, which includes Act 442 (noted on Harrisburg) that impacted the EIT proceeds but it was mores the State Redevelopment Law that restricted the use of tax increment financing in Pennsylvania that hurt the city, which had used TIF financing as a source of funding economic development. These restrictions limited the city's ability to generate the funds it needed to meet its obligations.

"A large number of you told me that you were angry that your City was being taken away from you and put into bankruptcy," **Judge Steven Rhodes**' verbal opinion in approving Detroit plan to exit Chapter 9. "…'Democracy is not a spectator sport.' And so I ask you, for the good of the city's fresh start, move past your anger. Move past it and join I the work that is necessary to fix this city. Help your City leaders do that. It is your City."

These are broad strokes, but a review of these five areas are important for policy makers in cities where one or more of these is very apparent. In many cases, it will be the pension issue, because of standardized accounting practices in this country, that is easier to identify. It is usually politics that then will play a role in how a government addresses these issues. That will then directly turn to the oversight and transparency concepts, of which there are less easy objective ways to assess (more on this shortly). When budget shortfalls grow, we inevitably see a community turn to a private-sector development concept as an economy boost.

As for the economic considerations at play, since the 2008 crisis, the body of work on progressive taxes, appropriate fines and fees , budget stress testing, and diversification mechanisms for communities has grown significantly. The use of equitable concepts in local governance in these mechanisms has also risen to prominence and changed viewpoints on what systemic growth looks like for a community. This has inadvertently (or intentionally) supported more diverse economies from which towns, cities and counties can draw from in times of need. The proof may be in the pudding as the current economic downturn has not seen the same types of bankruptcies that were noted in the aftermath of the 2008 financial crisis.

Still, there are some remaining stones unturned when it comes to understanding why some local governments default and others do not and that lies in the relationships between local and state governments.

State Governments Matter

While local governments bear primary responsibility for managing their finances, state governments play a crucial role in shaping their financial landscape and influencing their decisions regarding insolvency proceedings. In the path to insolvency, state governments can inadvertently contribute to the financial distress of local governments through various means.

One key factor is the imposition of unfunded mandates, which are requirements imposed by state governments on local governments without providing the necessary financial resources to fulfill them. These mandates can strain local budgets, diverting resources from essential services and increasing the risk of financial instability. State governments may also exert control over local revenue streams, limiting local governments' ability to generate their own revenue and raise funds to address financial challenges.

> **Harrisburg, Pennsylvania**
>
> The state of Pennsylvania imposed a number of restrictions on Harrisburg's ability to raise revenue, including a limit on the city's income tax from a 1974 law that placed a limit on the amount of income tax that Pennsylvania municipalities could collect and Act 442 of 2007 that further restricted the city's ability to raise revenue by requiring a voter referendum for any increase in the city's earned income tax. These restrictions limited the city's ability to generate the funds it needed to meet its obligations.

Throughout *this brief* **are grey inserts** that illustrate examples of these actions for all of the local governments tracked in this brief.

Given that state governments and legislatures can play an important role leading up to, and in the negotiations of, bankruptcy, the question remains whether there are any parallels in the relationship between the state and the local governments. In all of these instances, there is a state legislature essentially forcing the hands of community policy makers in a variety of ways. In prying into the 'why' this was the case, **CSG** provides some statistical information for the state-to-local relationship that is valuable.

The **two tables, page 8,** lay out some interesting items to consider. In each table, the year 2010 is used as it is a focal point as this is the census year (with the exception of Milwaukee and Chester) wherein the bankruptcies are the closest, and happens to be a year that the 2008 financial crisis was fully felt and settled into statistics. All data is taken from the U.S. Census Bureau, the National Council of State Legislators and state-level election bureaus.

In every single community:

1) The population of self-identified "white, non-hispanic" had been declining more than the national average for the previous two decades.
2) The state legislatures where each local government resides were all majority self-identified "white, non-hispanic."

> **Central Falls, Rhode Island**
>
> The state of Rhode Island imposed a number of unfunded mandates on Central Falls, including a requirement to fund the state's pension system for municipal employees. These mandates contributed to the city's financial problems by diverting resources away from other essential services. Additionally, the state placed Central Falls under state receivership in 2010, giving the state control over the city's finances. This restricted the city's ability to make its own financial decisions and contributed to its eventual bankruptcy in 2011.

Further, a look at political party affiliation between the local government and the state legislature yields a similar theme. In all but three cases, the local government has less (and in most cases significantly less) percent of registered Republicans in the community compared to the breakdown of the state legislature. In the three outliers, each jurisdiction saw Republican party affiliation decline from 2010 to 2020.

Jurisdiction	Change in White Population from 1990-2010*	Percent of State Legislators That Are White in 2010*
Jefferson County, Alabama	-14%	62%
Vallejo, California	-24%	54.70%
San Bernardino, California	-17%	54.70%
Harrisburg, Pennsylvania	-29%	83.70%
Central Falls, Rhode Island	-49%	89.40%
Stockton, California	-28%	54.70%
Detroit, Michigan	-14%	86.10%
Hillview, Kentucky	-11%	93.50%
Chester, Pennsylvania*	-69%	90.00%
Entire U.S.	-12%	92.80%
Milwaukee*	-33%	87.00%
Asterisk means data from 2020 for these jurisdictions instead of 2010		

In every single instance you have a racial and political trend of the community headed in one direction and the state-level legislatures not reflective of those trends, or moving in the opposite direction. There is room here for a sociological discussion but this is not a field of expertise. Instead, these statistics generally paint a picture wherein the local government is an enclave of different viewpoints and shared racial background where one could see a state government body less willing to be supportive of the local government's policies.

State-level decisions have a clear impact on each situation of local default. It is informative to understand the make-up of the governing bodies wherein many cases, the sovereign body did not reflect that of the sub-sovereign. This becomes especially important as one considers the political angles of many of these bankruptcies. Medicaid, public pensions, organized labor etc...all have racial and political elements to them and play a role in decision-making leading to eventual bankruptcy.

Jurisdiction	Jurisdiction Registered Republicans in 2010	State Legislature Percent Republican in 2010*
Jefferson County, Alabama	60.90%	59.50%
Vallejo, California	36.30%	43.70%
San Bernardino, California	48.30%	43.70%
Harrisburg, Pennsylvania	56.20%	62%
Central Falls, Rhode Island	18.80%	55.30%
Stockton, California	39.70%	43.70%
Detroit, Michigan	38.40%	56.70%
Hillview, Kentucky	79.60%	73.80%
Chester, Pennsylvania*	34.60%	55.00%
Milwaukee*	34%	61.70%
Asterisk means data from 2020 for these jurisdictions		

Role of the State Legislature

Political factors play a role in the relationship between state governments and local governments in bankruptcy proceedings. State-level political dynamics can influence the willingness of state governments to provide support or intervene in local bankruptcy cases.

The role of state governments in local government bankruptcies varies considerably from state to state. Some states have adopted proactive measures to support local governments in financial distress, providing assistance with financial planning, debt management, and access to emergency loans. Other states have taken a more hands-off approach, leaving local governments to navigate their financial challenges largely on their own.

As summarized in various examples throughout *this brief*, state legislatures can force difficult fiscal dynamics for local governments that in these instances played an important role in eventual insolvency. There are three consistent themes in every case reviewed:

Milwaukee, Wisconsin

The state of Wisconsin has made it increasingly difficult for local governments to raise revenue through property taxes. In 2011, the state passed Act 10, which limited the ability of public sector unions to collectively bargain for wages and benefits. This led to a decline in property tax revenue for Milwaukee, as property tax assessments are based on the value of homes and businesses, which are often lower when public sector workers are paid less. Additionally, the state has imposed a number of restrictions on local governments' ability to raise other types of revenue, such as fees and sales taxes. These restrictions have made it more difficult for Milwaukee to generate the funds it needs to meet its obligations.

- The state legislature cut funding or forced funding mandates for the local government for several years prior to bankruptcy, which made it difficult for the city to provide essential services. Usually, political rhetoric played a role in these decisions;
- The state legislature passed laws that give bond holders priority over pensioners in the bankruptcy process, which is essentially a way to subvert union power in local politics; and
- The state legislature appoints an iteration of a state emergency manager to oversee the local governments' finances (for the majority of cases reviewed). This arm has broad powers to to make cuts to city services, lay-off city employees without the democratic process that is afforded the position.

Given these contexts, the tables above on the political and racial vectors at play come full circle.

The City of Milwaukee faces nearly all of the dynamics mentioned in this brief and a discussion on that city's situation will ensue.