Acute Shocks and Chronic Structural Distress: Paths Toward Municipal Bankruptcy

In Brief

In recent years, the frequency of municipalities filing for bankruptcy has increased. In this article, we identified two types of pathways to municipal bankruptcy - acute one-time shocks, and chronic structural distress. To illustrate these paths, we reviewed three cases of municipal bankruptcy, in Orange County, California, Harrisburg, Pennsylvania, and Vallejo, California. In all of these cases, mismanagement by the municipalities' leadership is a common thread.

Introduction

While municipal bankruptcies are a rare occurrence, the chances of municipalities becoming insolvent have increased due to the combination of a high levels of municipal debt, and large amounts of unfunded liabilities those associated with retired public employee pensions and non-pension benefits have increased the chances of municipalities becoming insolvent. To provide greater perspective on municipal bankruptcy, this article describes some of the paths to insolvency. We identify two types of pathways to bankruptcy: "acute" paths that involve forceful one-time shocks, and "chronic" paths that involve long-term structural declines. To illustrate these paths, we review three cases of municipal bankruptcy, in Orange County, California, Harrisburg, Pennsylvania, and Vallejo, California. In each case, despite taking somewhat different fiscal paths municipal leaders exhibited risky and costly fiscal mismanagement that nonetheless ultimately resulted in each filing for bankruptcy.

Background: Municipal Insolvency and Bankruptcy

Municipalities are cities, towns, and counties that govern and provide services to residents. Municipal services range from safety provisions, such as fire, police, and emergency medical services, to infrastructure provisions, such as water, sewer, road, and transportation systems. To pay for these services, municipalities must generate sufficient **revenue**. Most citizens are familiar with tax revenue, fines, and fees. Municipalities also raise revenue through investment portfolios. When a municipality's revenues are inadequate to meet its expenses, it may reduce expenses on services, generate debt by borrowing money. In serious cases, where expenses exceed revenues substantially or routinely, it may become **insolvent**, meaning it cannot pay its bills when due. When an insolvent municipality cannot find a way to pay down its debts, its leaders may opt to file for bankruptcy and restructure its debt through a federal bankruptcy judge.

Two Paths to Bankruptcy: One-Time Shocks and Chronic Structural Stress

Municipalities can become financially insolvent, and therefore more likely to file for bankruptcy, due to acute one-time shocks or chronic structural financial problems. These two distinct pathways to bankruptcy constitute a high-level framework for articulating different ways governments may find themselves on the brink of insolvency.

An acute shock can take multiple forms. For example, in 2011 in Boise County, Idaho, a large adverse civil judgment stressed the municipality's budget almost to the point of insolvency. In the same year in Jefferson County, Alabama, fraudulent behavior caused immediate financial stress when it was uncovered. One-time shocks can lead otherwise stable municipalities to bankruptcy, as happened in Orange County in 1994. Alternatively, they may reveal underlying weaknesses in a government's fiscal condition, as in Harrisburg. Insolvency can also result from chronic budgetary imbalances arising from multiple factors. These factors can include reductions in revenue, caused, by changes such as a shrinking population base, reduced economic activity, or declining property values. Factors that increase costs can also lead to insolvency. Unfunded public pension liabilities are one such common cost stressor, as are infrastructure projects, cost overruns, and unfunded increases in service provision. Vallejo is a case in which long-term fiscal instability led the city to bankruptcy.

Orange County, California: A One-Time Shock with Financially Sound Prior Conditions

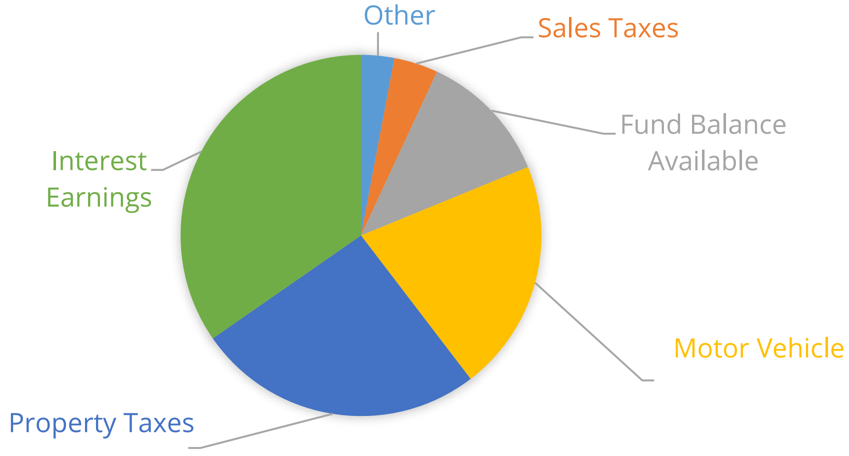
Orange County declared bankruptcy in 1994, surprising its creditors, county leadership, and 2.5 million residents at the time. Home to the "Gold Coast" of million-dollar homes, Orange County was known for its affluence. County Treasurer Robert Citron's high-risk investment strategy catalyzed the municipality's pathway to bankruptcy.

Citron was a longtime municipal employee who had served in the county's tax offices since the 1960s and was elected Orange County tax collector in 1970. Three years later, the county consolidated the offices of tax collector and treasurer, and Citron thereby assumed responsibility for the Treasury. Never having invested before, Citron took charge of an investment pool composed of contributions from the county, local school districts, cities, and special districts. From 1973 to 1991, the investment pool grew at an average rate of 9.4% per year.

However, Orange County localities increasingly struggled to maintain adequate revenue streams after 1978's state Proposition 13 limited property tax levels. Feeling pressure to find additional revenue streams quickly, Citron came to depend on the advice of financial salesmen, who pitched him on investments with higher risks and higher potential returns. In 1991, these salesmen introduced Citron to securities that paid progressively more even as interest rates fell. Because the U.S. economy was in a recession at the time, interest rates were low, and Citron was convinced that they would continue to fall.

From 1991 to 1994, Citron shifted the county's investment portfolio toward higher-risk investments. Specifically, he reduced the county's low-risk investments in U.S. Treasury securities and repurchase agreements and increased the county's share of high-risk investments from 0% to 32% of its total portfolio. Additionally, Citron borrowed money to invest in derivatives and long-term bonds that paid high yields. He promised that interest earnings would account for 35% of the county's general revenues in its budget for fiscal year 1995, despite government accounting standards that say interest should not comprise more than 5% of general revenue (Figure 1).

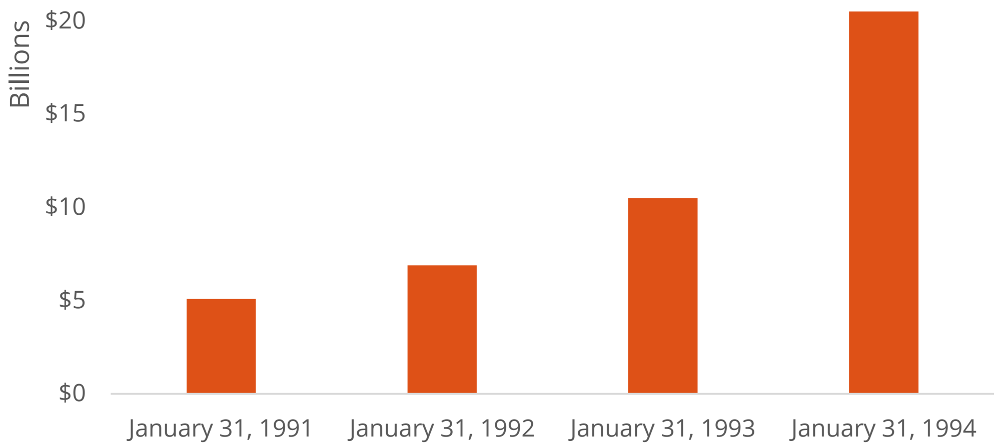
Figure 1. Citron's Promised Revenue Sources for OC County's FY1995 Budget



Source: Public Policy Institute of California

Citron continued his investment strategy and made more investments with borrowed money. The county's investment pool increased from $5.1 billion in 1991 to $20.6 billion in 1994 (Figure 2).

Figure 2. Orange County Investment Portfolio: Amount Invested



Source: California State Auditor

Although the Federal Reserve Board decided to raise interest rates in 1994, Citron thought rates would soon decline and his investments would continue to pay off. Instead, interest rates rose, Citron's investments fell sharply due to the increased cost of borrowing, and by November of 1994, auditors found that Citron had lost $1.6 billion of the $7.5 billion in assets contributors had deposited. This amounted to an approximately 21% loss as interest rates rose from 3% to 5.7%.

Citron's investment strategy constituted financial mismanagement because it was overly risky. However, the county's pathway also demonstrated a breakdown of and failure to provide transparency and accountability. For years, officials failed to scrutinize Citron's work and were, instead, impressed by the revenue growth he generated. As then-Orange County Supervisor Thomas Riley said before the loss was discovered, "Citron has gotten us millions of dollars. I don't know how in the hell he does it, but he makes us all look good." After auditors informed county officials that Citron had lost $1.6 billion, however, supervisors realized the county would be unable to repay its debt to lenders and local government pool depositors. Soon thereafter in 1994, the county declared bankruptcy.

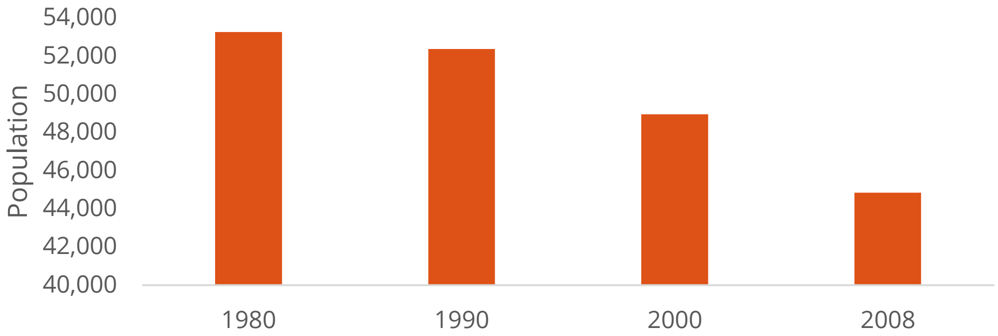
Harrisburg, Pennsylvania: Long-Term Instability Incinerated

Pennsylvania's capital city, Harrisburg, filed for bankruptcy in October 2011 with over $300 million in debt. But its petition was rejected because it was against the state law. Before filing, Harrisburg had structural deficits for several years — the result of declining tax and fee receipts. But what ultimately drove the city to file for bankruptcy was the debt it took on to finance improvements to its trash incinerator plant.

Harrisburg had a structural deficit due to ongoing budget strains that resulted mainly from weakening tax and fee receipts. The city has experienced a gradual decline in population over the previous three decades

(Figure 3). That population loss, coupled with a high poverty rate of 28%, negatively impacted the city's tax base. Moreover, real estate taxes had been one of the city's primary general fund revenue sources. Harrisburg's high number of tax-exempt properties, however, hindered its ability to generate revenue. Currently, 48% of properties in Harrisburg are tax-exempt.

Figure 3. Harrisburg's Population

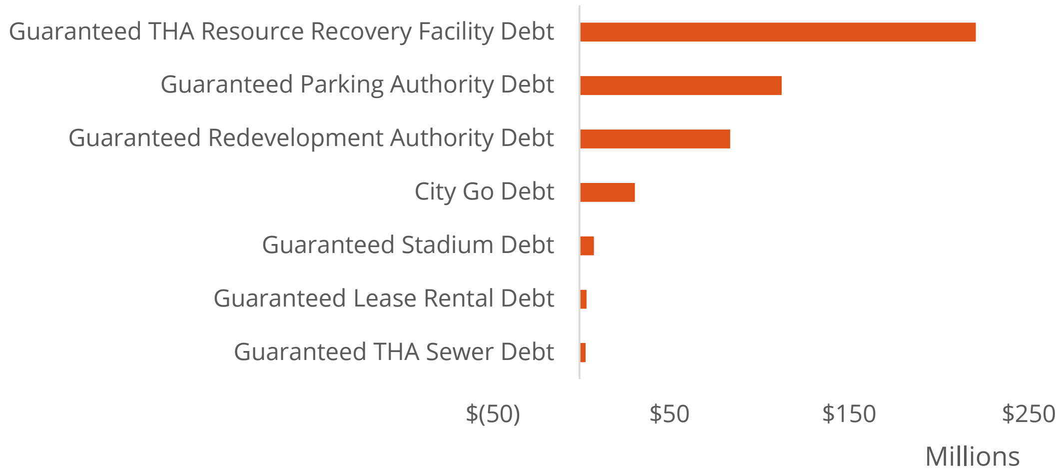


Source: Municipal Financial Recovery Act, Recovery Plan, City of Harrisburg

While Harrisburg had an unstable fiscal foundation, a series of obligations arising from its guarantee of improvements to a trash incinerator plant catalyzed its municipal bankruptcy filing. The city sold the incinerator to The Harrisburg Authority (THA) in 1993. In 2003, the federal Environmental Protection Agency found that the plant violated air pollution regulations and ordered its closure. Instead of cutting its losses of approximately $104 million on the incinerator at the time and closing the plant, city officials committed to rebuilding it. City leaders accepted a $77 million bid from Barlow Projects, a startup incinerator technology company, and issued $125 million in bonds to fund the project. One year later, Barlow requested additional funds to offset a spike in steel prices and city leadership obliged to funding the cost overrun.

These financial commitments were virtually uninsured. Due to its weak financial condition, Barlow was unable to obtain a performance bond for the project, as contractors often do. A performance bond would have ensured that Harrisburg was reimbursed if Barlow failed to complete the project as contractually stipulated. This left the city particularly vulnerable. By the end of 2005, the city's bond payments were coming due, and repaying the debt depended on the plant's generation of its projected revenues. However, with some parts unfinished and others faulty, the plant was still not ready to incinerate trash, propelling Harrisburg further into debt. The City of Harrisburg not only guaranteed all the outstanding incinerator debt, but also the debt issued by other component units – organizations that are fiscally dependent on the primary government but legally separate – of the city. The debt that THA issued for the incinerator made up the largest portion of the component unit debt that the city guaranteed (Figure 4). In 2009, the city was required to pay $264 million when THA failed to pay that incinerator-related debt. As a result, the city experienced a decline in its total net asset, with liabilities exceeding assets by approximately $227 million (Figure 5). Since 2007, Covanta, a private operator, has operated the plant.

Figure 4. Principal Amounts Outstanding as of January 1st, 2011



Source: [Municipal Financial Recovery Act, Recovery Plan, City of Harrisburg]

Figure 5. Total Net Assets
(Excluding Component Units) (Dollars)

Source: [Harrisburg City Controller, Comprehensive Annual Financial Reports]
Note: If we add the total net asset of all the component units to this graph, the total net asset for year 2011 would amount to approximately $496 million.

Under pressure due to the plant-related debts, city leaders reduced government staff, increased property taxes, and increased waste management fees. Nonetheless, in 2010 alone, Harrisburg accumulated $68 million in debt for the incinerator project, more than the city's annual general fund revenues, which typically ranged from $55 million to $65 million. Coupled with Harrisburg's already high debt burden, cuts in services and tax hikes were not sufficient to fill the financial hole, and the city filed for bankruptcy in 2011.

Vallejo, California: Excessive Salaries Left City Vulnerable to Recession

The city of Vallejo, California declared bankruptcy in May 2008 following years of falling tax revenues and rising pension costs. These structural shortfalls left the city especially vulnerable to the 2007-09 recession's impacts. Local leaders recognized warning signs of fiscal decline as early as 1992 when the city convened a citizen task force to examine government revenues and spending and to draft recommendations for improving its budgeting practices. The task force concluded that the city's pensions, salaries, and healthcare costs were unsustainable. Further, the task force concluded that unless Vallejo changed course, it would have to file for bankruptcy protection by 2010.

In 1996, just two years after the task force's expressed concerns, the Navy closed its Mare Island base in Vallejo, leaving the remaining (approximately 1,500) employees of the base in flux. The city's housing values declined by 60% from 2006 to 2012, during the 2007-09 recession, leaving property tax coffers bare (Figure 6). From fiscal year 2007-08 to fiscal year 2011-12, the city's general fund revenues fell 17% (Figure 7). Despite its declining tax base, however, Vallejo did not reduce its expenditures.

Figure 6. Median Home Value (Dollars)

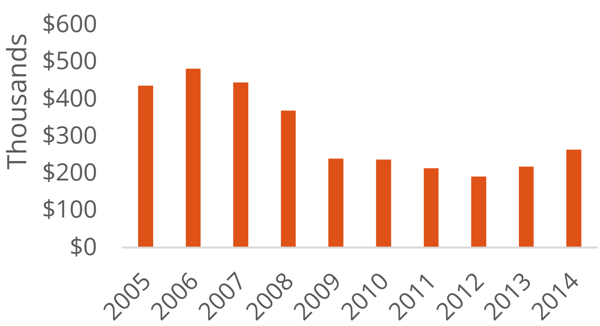
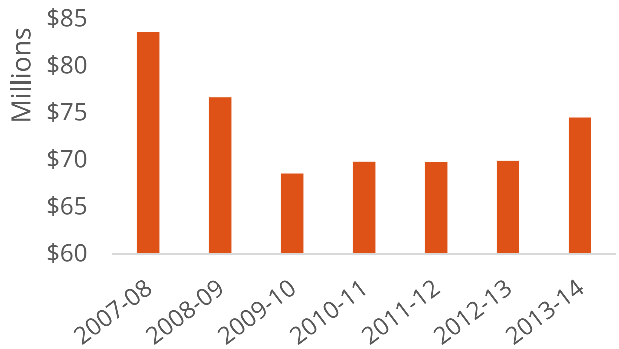


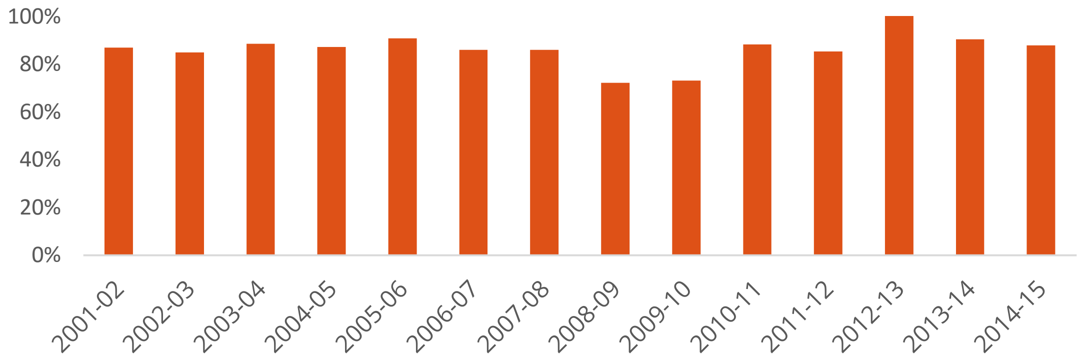
Figure 7. Total General Fund Revenue, Fiscal Years 2007-08 to 2013-14



Sources: U.S. Census Bureau, American Factfinder; City of Vallejo Budgets

Unusually high employee salary and retirement costs, rising debt, and diminishing tax revenues exacerbated Vallejo's financial distress. By the time the city filed for bankruptcy in 2008, approximately 86% of its general fund expenditure was on salaries and benefits (Figure 8). This relatively large portion was in part a result of police and firefighter contracts, which saw substantial growth when negotiated in a high-profile strike in the 1970s. Alone, police and firefighter pensions and overtime pay accounted for 74% of Vallejo's $80 million general fund budget, more than the California statewide average of 60%. In addition to these high salary and benefit costs, Vallejo's debts were large. Its general fund-supported debt was $53 million, its debt obligations backed by non-general fund revenues (special revenues) were $123 million, and its unfunded pension liability amounted to $128 million.

Figure 8. Percent of General Fund Expenditures Dedicated to Salaries and Benefits



Sources: City of Vallejo Budgets

Long-term debt, unsustainable salary and benefit expenditures, and a shrinking revenue base left the city vulnerable to recessionary shock. In 2008, with few positive prospects and mounting long-term debt, the city faced a $16.6 million annual budget shortfall. Vallejo's leadership saw bankruptcy as the best path forward.

Conclusion

We reviewed two distinct paths to insolvency. We showed that both acute shocks (as in the case of Orange County) and chronic long-term imbalances (Vallejo) can disrupt services, leave municipalities insolvent, and in the worst cases, lead to municipal bankruptcy. The case of Harrisburg illustrates that, in many and perhaps most cases, a combination of acute and chronic problems can be at work.

Mismanagement by the municipalities' leadership is a common thread in all three cases and a lack of effective oversight played particularly clear roles in the Orange County and Harrisburg cases. In Orange County, risky investments and a lack of oversight left an affluent county in the red. In Harrisburg, a delayed incinerator project provided the shock that drove the city toward insolvency, but leaders made a number of poor decisions over multiple years that saddled the city with uninsured debt. The case of Vallejo is somewhat different insofar as a series of long-term forces and the absence of action by leaders created a fiscal crisis. In all three cases, there were at least several opportunities to prevent or reduce the scale of the problem, which emphasizes the integral role effective management plays in securing a community's fiscal health.

Works Cited

Bellante, Don, David Denholm, and Ivan Osorio. Cato Institute. "Vallejo Con Dios: Why Public Sector Unionism Is a Bad Deal for Taxpayers and Representative Government." Policy Analysis No. 645. September 28, 2009. http://object.cato.org/sites/cato.org/files/pubs/pdf/pa645.pdf

Bergstresser, Daniel and Cohen, Randolph. Harvard Business School. "Why Fears About Municipal Credit Are Overblown." June 2011. http://www.hbs.edu/faculty/Publication%20Files/11-129.pdf

Bond Girl and Self-Evident. Business Insider. "The Money Pit: The Real Reason Harrisburg Pennsylvania Went Bankrupt." October 16, 2011. http://www.businessinsider.com/the-money-pit-the-real-reason-harrisburg-pennsylvania-went-bankrupt-2011-10

California Military Department, California Military Museum System, Naval History. "Mare Island: A Ship Yard is Born." 2011. http://militarymuseum.org/Mare%20Island.html

California State Auditor. "Report 94026.3 Summary." March 1995. https://www.bsa.ca.gov/reports/summary/94026.3

City of Vallejo California, Finance Document Library. "Budget Documents." http://www.ci.vallejo.ca.us/cms/One.aspx?portalId=13506&pageId=26970&objectId.2700=29230&contextId.2700=26974&parentId.2700=26975

Deal, Keren, Judith Kamnikar, and Edward Kamnikar. Journal of Public Budgeting, Accounting & Financial Management. "A Descriptive Case Study of the Greene County, Alabama Bankruptcy." Fall 2009. http://pracademics.com/attachments/article/776/Ar_1_Deal_Kamnikar_Kamnikar.pdf

Deitch, Michael J. Fordham Law Review. "Time for an Update: A New Framework for Evaluating Chapter 9 Bankruptcies." 83 FordhamL. Rev. 2705, 2015. http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=5101&context=flr

Eucalitto, Cory, Kristen De Pena, and Shannon Younger. State Budget Solutions. "Municipal Bankruptcy: An Overview for Local Officials." February 26, 2013. http://www.statebudgetsolutions.org/publications/detail/municipal-bankruptcy-an-overview-for-local-officials

Fletcher, Michael A. The Washington Post. "Harrisburg, Pennsylvania's capital, files for bankruptcy." October 12, 2011. https://www.washingtonpost.com/business/economy/harrisburg-pennsylvanias-capital-files-for-bankruptcy/2011/10/12/gIQAeQ6HgL_story.html

Governmental Accounting Standards Board (GASB). Technical Issues. "Summary of Statement No. 14 The Financial Entity." http://www.gasb.org/st/summary/gstsm14.html

Harrisburg City Council Report. "Evaluation of Alternatives Available to the City of Harrisburg to Address Its Current Financial Situation." March 31, 2011. https://todaysthedayhbg.files.wordpress.com/2011/03/embargoed-copy-cravath-harrisburg-city-council-report.pdf

La Ganga, Maria L. Los Angeles Times. "City of Dreams and Struggles." August 12, 2012. http://articles.latimes.com/2012/aug/12/local/la-me-vallejo-post-bankruptcy-20120812

Luhby, Tami. CNN Money. "Troubled Harrisburg now state's problem." November 23, 2011. http://money.cnn.com/2011/11/23/news/economy/harrisburg_bankruptcy/

MacDonald, Scott B., and Hughes, Jane E. (2015). Empires Undone: Samuel Insull, the Emperor of Utilities. Separating Fools from Their Money: A History of American Financial Scandals (Second Edition). New Brunswick, New Jersey: Transaction Publishers.

Park, Keeok. Journal of Public Budgeting, Accounting & Financial Management. "To File or Not to File: The Causes of Municipal Bankruptcy in the United States." Summer 2004. http://pracademics.com/attachments/article/631/BeckettSympAr3%20Park.pdf

Petek, Gabriel J., Jeffrey J. Previdi, Steve J. Murphy, and Bill Montrone. Standard & Poor's Ratings Services. "Case Study: The Vallejo, Calif. Bankruptcy." October 4, 2012. http://ibvallejo.com/docs/s_p_vallejo_2012.pdf

Public Policy Institute of California. "When Government Fails: The Orange County Bankruptcy – A Policy Summary." March 18, 1998. http://www.ppic.org/content/pubs/op/OP_398OP.pdf

Schleicher, Douglas F., David M. Duffus, Glenn A. Weiner, and James T. O'Brien. "The Harrisburg Authority Resource Recovery Facility Forensic Investigation Report." January 12, 2012. http://harrisburgcitycontroller.com/wp-content/uploads/Harrisburg-Report.pdf

Sforza, Teri. The Orange County Register. "Robert Citron was a hard-to-hate villain in O.C.'s bankruptcy." January 17, 2013. http://www.ocregister.com/articles/citron-383795-county-money.html

The Wall Street Journal. "Important Bankruptcy Events." June 9, 1996. http://www.wsj.com/articles/SB834350594173976500

Veronesi, Pietro. (November 18, 2009). The Bankruptcy of Orange County. Fixed Income Securities: Valuation, Risk, and Risk Management. Wiley.
Winegarden, Wayne H. Pacific Research Institute. "Going Broke One City at a Time: Municipal Bankruptcies in America." January 2014. http://www.pacificresearch.org/fileadmin/documents/Studies/PDFs/2013-2015/MunicipalBankruptcy2014_F.pdf