

The Finances of American Cities:
Lessons from Vallejo, Stockton, and San Bernardino

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Introduction*

The California municipalities of Vallejo, Stockton, and San Bernardino have each declared Chapter 9 bankruptcy due to their inability to address their mounting fiscal challenges – fiscal challenges that many municipalities across the country may soon face.

This study briefly reviews the experiences of these three California municipalities to identify important lessons for other U.S. municipalities. In this review, the Vallejo case study receives greater attention because Vallejo is the only municipality that both entered into, and emerged from, bankruptcy as of this writing.

Vallejo, Stockton, and San Bernardino all faced similar fiscal challenges including:

- Weakening economic fundamentals
- Escalating operating expenses;
- Plummeting operating revenues; and,
- High fixed costs that were driven by:
 - Previous debts – either for capital projects that were ill-considered or were negatively impacted by unexpected shocks; and/or,
 - Collective-bargaining agreements that are very costly and create financial rigidity that restricts their ability to implement programs that could potentially save money / balance the books.

The impetus for the bankruptcy filing in each case was a short-term economic shock. The short-term economic shock exposed the fundamental financial weakness of these municipalities; a weakness that could 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.

Regaining fiscal solvency requires a municipality to accurately diagnose the underlying fiscal problems, and then effectively address all of the problems – allowing any fiscal cost (particularly long-term pension costs) to remain unaddressed lessens a municipality’s prospects for regaining fiscal solvency. Specifically, the lessons from these California municipalities are:

- Chapter 9 bankruptcy is a tool, not a solution, and the Chapter 9 tool should be used sparingly;
- Until the value from all future obligations/expenditures are addressed, the fiscal crisis will not be sustainably resolved; and,
- Incenting future economic growth in the municipality is as important as establishing a long-term sustainable budget.

All three municipalities used Chapter 9 bankruptcy as a tool to regain fiscal solvency; consequently, before the three municipalities are reviewed a quick review of the purpose and value of Chapter 9 is presented.

A Chapter 9 Bankruptcy Primer

Historically, municipal bankruptcies have been rare. According to Governing.com only 38 municipal bankruptcy filings have been made since 2010, and most of these (29) were filed by smaller special districts such as utility authorities. 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.”

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.” Detroit’s \$18 billion bankruptcy is the largest city to ever file for Chapter 9 bankruptcy as of October 2014.

Chapter 9 bankruptcy 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 loan terms. Pragmatically speaking, negotiations for many municipalities (Vallejo, Stockton, and San Bernardino included) will also need to include pension and retiree health care obligations.

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 when the municipality obtains a comprehensive understanding of its core financial problems, and leverages the bankruptcy filing to correct the current financial stress affecting the municipality.

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 source for all three California municipalities examined here.

The purpose of Chapter 9 bankruptcy is 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.

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.

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.

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 file for Chapter 9 bankruptcy, 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 of 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 requires 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.” 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 and breathing room. 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.

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”. 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.

Despite the historical rarity of municipal bankruptcy, Vallejo, Stockton and San Bernardino have all declared Chapter 9 bankruptcy. This raises an important question regarding the value of Chapter 9 bankruptcy for municipalities with weak current and future municipal finances.

The case studies of Vallejo, Stockton and San Bernardino illustrate that the costs from filing for bankruptcy are real and not worth bearing unless the municipality is prepared to implement a

comprehensive and effective plan to restore fiscal solvency.

Vallejo, California

Vallejo filed for bankruptcy in 2008 and completed the bankruptcy process in 2011 – the only municipality of the three that has exited Chapter 9 bankruptcy. 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. However, the growth in Vallejo's local economy had been lagging the U.S. average even prior to declaring bankruptcy. Between 2004 and 2008 the average annual personal income growth in Vallejo, California was 0.67 percentage points below the national average over that time period, see Figure 1. Additionally, Vallejo's population growth had stagnated – during the 2004 to 2008 period the city's population actually declined slightly (0.03% annual decline).

Figure 1
Vallejo, California's Average Annual Percent Change in Population and
The Difference between Vallejo's Average Annual Personal Income Growth
And U.S. Average Annual Personal Income Growth
2004-08

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". 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.

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.”

Vallejo was also facing diminished economic prospects (see Figure 1). Additionally, the Naval Base, a key economic anchor, was closed in 1996 and 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. Figure 2 illustrates the city’s fiscal shortfalls.

Figure 2
Vallejo, California’s State Budget Total Revenues and Total Expenditures
2004 to 2013

As Figure 2 illustrates, the declining economic opportunities in Vallejo were also being manifested through declining resources available to the state government. Ultimately, as became evident in 2007, the city’s declining revenues coupled with growing expenditure pressures were simply incompatible. This incompatibility was not a one-time shock, but due to a long-term fiscal mis-match leading Vallejo to declare bankruptcy.

In bankruptcy, “the city slashed costs, including police and firefighter numbers, retiree health benefits, payments to bondholders and other city services.” 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.

While expenditures and services were cut, the city never adequately addressed its pension problem – during its bankruptcy negotiations the city did not alter the payments it was required to make to the California Public Employees Retirement System (CALPERS). 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.”

Based on the projections from the Vallejo FY2014-2015 budget, expenditures on pensions will vastly outpace all other General Fund expenditures, as well as General Fund revenues. If these projections are realized, then pension expenditures will increase from 13.6 percent of General Fund revenues in the FY12-13 budget up to 21.3 percent of General Fund revenues in the FY19-20 budget.

Figure 3
Projected Annual Percentage Growth Vallejo, California’s State Budget Expenditures
FY12-13 Budget Compared to Projected FY19-20 Budget

Vallejo’s pension costs are still 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.

In fact, Vallejo is now experiencing most of the costs associated with Chapter 9 bankruptcy. “Standard & Poor’s Gabriel Petek led a cost benefit analysis on Vallejo’s bankruptcy and determined:

We think that evaluating the city’s bankruptcy solely on its fiscal merits, therefore, renders an equivocal verdict. When indirect and long-term costs are added to the equation, based on our estimate, it becomes even less likely that the benefits of bankruptcy will come near the costs.

“S&P explicitly identifies labor costs as a problem that was not adequately addressed within the bankruptcy process:

Probably the most substantial adjustment Vallejo obtained in bankruptcy was the ability to reject its labor contracts. But even here, aside from some short-term savings, it’s not clear to us that the bankruptcy will prove to have netted a benefit to the city’s fiscal position when considering the longer-term costs to the city and its economic effects. Furthermore, even after filing its bankruptcy petition, the city and its labor unions struggled to renegotiate contracts for 10 months before the bankruptcy judge, siding with the city, compelled a renegotiation.

Norcross (2013) summed up Vallejo’s position well”

Chapter 9 gave the city the opportunity to reject its costly collective-bargaining agreements. To deal with rising costs, city officials cut health-care benefits, laid off public-safety workers, and reduced services and payments to bondholders. But left untouched was the source of Vallejo’s budgetary morass: \$128 million in unfunded pension obligations. Two years after the city emerged from a bankruptcy, its labor costs are eating up more of the general fund than they did before the filing.

Vallejo’s economy continues to under-perform as well. For instance, the exodus from Vallejo has accelerated since filing for Chapter 9 bankruptcy, see Figure 4. Vallejo’s under-performance in personal income growth compared to the national average has also accelerated since the bankruptcy filing. Both consequences are potential costs from filing for Chapter 9 bankruptcy protection. When coupled with the unresolved fiscal problems, these results confirm Standard & Poor’s assessment that the costs Vallejo

endured due to the bankruptcy filing has exceeded the benefits.

Figure 4
Vallejo, California's Average Annual Percent Change in Population and
The Difference between Vallejo's Average Annual Personal Income Growth
And U.S. Average Annual Personal Income Growth
2008-13

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. 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.

Stockton, California

Vallejo illustrated that a weak macroeconomic environment can be the shock that pushes a fiscally unsound municipality into Chapter 9 bankruptcy. And, this was true for Stockton, California as well. Both before the latest recession, and following the latest recession, Stockton's economy has been underperforming the average for municipalities in the U.S., see Figure 5.

Figure 5 illustrates that in the years prior to the Great Recession, the municipality's economy was lagging the national average. Following the recession, Stockton continued to lag the slower national growth benchmark leading up to its 2012 bankruptcy filing, continuing through 2013. Stockton's unsustainable fiscal position was then stretched to the breaking point due to the weak overall economic environment that was exacerbated by the 2008 recession.

Figure 5
Stockton, California's Average Annual Change in GDP
Compared to U.S. Average Annual Change in GDP
2003-2008 & 2008-13

As Figure 6 illustrates, Stockton's fiscal position looks very similar to Vallejo's prior to and following its bankruptcy filing – stagnating revenues and growing expenditures created unsustainable deficits causing the municipality to become insolvent.

Figure 6
Stockton, California's State Budget Total Revenues and Total Expenditures
2004 to 2013

The combination of the housing bust (and resulting decline in property tax revenues), weak economic activity, and declining state revenues effectively made Stockton insolvent. Stockton faced a 2012 budget deficit of \$26 million prior to its bankruptcy filing.

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

- \$147.5 million in unfunded pension costs owed to CALPERS;
- \$124.3 million in pension obligation bonds;
- \$40.4 million of variable rate demand obligations;
- \$35.1 million of public facilities fees bonds; and,
- \$31.6 million of the city's parking garage debt.

Buried under these obligations, Stockton declared bankruptcy in June 2012. Ultimately, the success of Chapter 9 bankruptcy for Stockton depends upon how the huge unfunded pension obligations are addressed. Toward that end,

The federal judge overseeing the bankruptcy of Stockton, Calif., ruled that the city has the power to cut its pension obligations, a landmark decision that has implications for workers, investors and troubled municipalities across the country.

U.S. Bankruptcy Judge Christopher Klein ruled Wednesday bankruptcy laws give Stockton the power to cut ties with California Public Employees' Retirement System, or Calpers, which controls city workers' retirement money as the country's largest public pension fund. Judge Klein said that the section of the U.S. Bankruptcy Code that allows distressed cities and companies to break contracts is one of bankruptcy law's core powers.

"Pensions could be adjusted," Judge Klein said from his Sacramento courtroom.

Payments into pension funds are usually considered sacrosanct, but Judge Klein is the second judge to rule recently that they may be cut. In December, the judge overseeing Detroit's bankruptcy case ruled that such obligations aren't entitled to "extraordinary protection" despite state constitutional safeguards against benefit cuts.

Stockton, as of this writing, is finalizing its exit plan from bankruptcy. Stockton's plan includes an increase in the local sales tax, imposes a 50-percent (or more) cut to the city's bondholders, and eliminates some of the retirees' health insurance benefits. Based on Vallejo's experience, a bankruptcy plan that fails to create a fiscally solvent plan that can effectively address the problem of unaffordable pension costs will fail to restore the fiscal solvency of a municipality. Despite Judge Klein's ruling, Stockton does not appear to be fully addressing the pension problem.

If, like Vallejo, the unsustainability of the pension obligations are not addressed, then the bankruptcy filing will not establish a viable fiscal plan for the municipality. Instead, Stockton risks falling into the

same fiscal and economic trap as Vallejo over next several years.

San Bernardino, California

Like Vallejo and Stockton, the timing of San Bernardino's fiscal crisis also was due to an economic shock – the existence of the crisis was due to fundamentally unsound budgeting practices. San Bernardino filed for bankruptcy protection facing a \$46 million budget deficit and, for all intent and purposes, no resources in reserve.

San Bernardino's revenues and expenditures resembled Vallejo's and Stockton's – stagnating revenues that were the result of a stagnating local economy coupled with expenditure growth that was outpacing the capacity of the city to fund those costs, see Figures 7 & 8.

Figure 7
City of San Bernardino, California's State Budget Total Revenues and Total Expenditures
2004 to 2013

Figure 8 illustrates that while San Bernardino was experiencing faster growth prior to the recession, since the recession the city has been facing similar economic headwinds.

Figure 8
City of San Bernardino, California's Average Annual Change in GDP
Compared to U.S. Average Annual Change in GDP
2003-2008 & 2008-13

However, unfunded pensions are an overwhelming debt afflicting the city. 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 ...”

A major difference between San Bernardino compared to Vallejo and Stockton is that San Bernardino is considering restructuring its pension obligations as part of the Chapter 9 process. According to California Public Employees' Retirement System (CALPERS), right after San Bernardino filed for bankruptcy, the amount of money the city owed to CALPERS increased 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). And, this was very different than the approach Stockton, California has taken:

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.

In June 2014, an interim deal between CALPERS and city leaders was reached, although the timing and

amount are under a gag order. There are still many other unknowns regarding the resolution of San Bernardino's bankruptcy, such as how the city will improve its processes to more effectively manage its finances is still unknown. Similarly, how (or if) San Bernardino will reduce its pension liabilities as part of its bankruptcy proceeding is also unknown. The recent court ruling in favor of Stockton, California, however, is favorable for San Bernardino should the city want to substantially change its pension obligations. Adjusting its pension obligations is a crucial precedent for other municipalities as well.

If effective pension liability reforms are 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.

Lessons Learned

The leadership of Vallejo, Stockton and San Bernardino all decided that filing for Chapter 9 Bankruptcy, with the approval of state leaders, was necessary in order to regain fiscal solvency. Generally speaking, a Chapter 9 bankruptcy filing is valuable only if it enables the necessary reforms more efficiently; or, can enable the necessary reforms that would not have been possible without the filing.

It should never be forgotten that it is the process of rearranging all of a municipality's financials to create a sustainable path that, ultimately, restores the vibrancy and solvency of a municipality. This point is particularly useful given that unfunded and unaffordable pension and retiree health benefits are a prominent cause of the financial distress facing each of these municipalities. Unsustainable pension expenses are also looming over many municipalities across the country.

As the Vallejo bankruptcy case study illustrates, declaring bankruptcy will not solve a municipality's financial problems if the pension and health care expenses are not addressed. Vallejo, California is teetering back toward insolvency because it did not address its unfunded pension liability problem. Consequently, it does not appear that the benefits from declaring bankruptcy – gaining additional time and breathing room to renegotiate its financial obligations – were worth the many new costs and problems from declaring bankruptcy including:

- Raising the likelihood of lower credit rating and higher future borrowing costs for the Vallejo government;
- Damaging the municipality's image which may be encouraging the exodus of residents and sub-par economic performance; and,
- The bankruptcy filing could result in higher taxes, fewer municipal services, and/or deferred maintenance on Vallejo's infrastructure.

A key lesson from Vallejo for other financially unsound municipalities is that the long-term pension funding insufficiencies must be addressed. The cities of Stockton and San Bernardino are still in process, but at this stage confirm the lessons from Vallejo.

The need to address the fiscally unsustainable pension systems raises the important question of how. A principle that should guide the reform process for municipalities is that 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."

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

Switching to a DC system still leaves the obligations built up under the current DB system. One way to reduce these obligations is to provide current employees (or former employees who have not yet retired) a cash-out option. Under the cash out option, workers and retirees (if they chose) would receive their share of the currently funded portion of their pension obligation in a personal 401k-type account. The payout would eliminate all future obligations of the pension fund – both the asset and liability are zeroed out at the current funding level. The actual cash-out figure would need to be determined by the specific municipality, but would likely be based upon their specific length of service, employee class, and salary history.

Additionally, 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.

Implementing policies that sustainably address all core problems (especially the long term cost of pension obligations) for the long term should be the goal of municipal leaders. 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.

Endnotes