MUNICIPAL DISTRESS: REFLECTIONS OF A RECEIVER

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I. INTRODUCTION

When I served as the state-appointed receiver for the City of Harrisburg, from December 2011 through March 2012, I spoke with a broad spectrum of groups and individuals about the city's fiscal distress. One of the more memorable discussions was with the Occupy Harrisburg group that was camped out on the steps of Pennsylvania's Capitol Building. A member of the group lit into me about how undemocratic it was for the state to put an unelected receiver over the elected officials of the city, and he wondered how I could in good conscience agree to serve in such an abhorrently undemocratic position.

I acknowledged to him that it was undemocratic, but the state believed, and I believed, that things had gotten so bad for the city that it needed an independent receiver to help it deal with its problems and get back to a stable fiscal position. I said that I hoped the receivership would not last long, but I was determined to use the office to do what was best for the city.

The receivership did work out well for Harrisburg. I reached out to the people of the city and other interested parties and

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developed a preliminary plan that took into account the true fiscal problems faced by the city. The plan was approved by the Commonwealth Court of Pennsylvania.[1] After I resigned, Governor Tom Corbett nominated Major General William Lynch to be receiver, and he served from May 2012 to March 2014. General Lynch did a terrific job negotiating with the city officials and the creditors, and the resulting *Harrisburg Strong Plan*[2] has put Harrisburg back in a stable financial position. The city still has fiscal challenges which are common to all cities in Pennsylvania, but it was able, as a result of the receivership process, to pare back the albatross of debt which was sinking it; and all of this was done while avoiding the risky, complex, lengthy, stigmatic and expensive process of municipal bankruptcy.

In the years since I served as receiver, I have given a lot of thought to the causes of and solutions for municipal distress. The more I study the problem, the more convinced I am that municipal distress is not an isolated issue but rather is at the crossroads of many of the most fundamental issues confronting American society and government. In this article, I will try, in plain language, to identify these issues and how they manifest themselves in municipal distress. You may or may not agree with my opinions, but I hope they give you some food for thought.

II. THE PUBLIC SECTOR AS A CLASS WITH INTERESTS SEPARATE FROM THE CITIZENS' INTERESTS

The taxpayers pay the salaries and benefits of public sector employees, but the taxpayers do not directly determine those salaries and benefits. They are set by other public sector employees, either through decision-making by managers (including the elected officials) or through labor negotiations between managers and union workers. The only influence taxpayers have in this process is through the ballot box.

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[1] Walker v. City of Harrisburg, No. 569 M.D. 2011 (Pa. Commw. Ct. Mar. 9, 2012).

[2] HARRISBURG STRONG PLAN (Aug. 26, 2013), *available at* http://www.newpa.com/sites/default/files/uploads/Local_Gov/Act47/harrisburg-receiver/Harrisburg-Strong-Plan-8_26.pdf.

A large portion of the expenses in a municipal budget is for the cost of labor, including salaries, benefits, pensions and other post-employment benefits (OPEB) such as healthcare for retirees. This is because the services provided by municipal governments, such as police and fire, are very labor intensive. In almost all municipal distress situations, one of the great drivers of the distress is that revenues are insufficient to pay the agreed-upon labor costs.

Many people like to characterize high labor costs in the public sector as a "union problem." There is certainly a union component to the problem. In Pennsylvania, under Act 111 of 1968, arbitrators who make arbitration awards with respect to fire and police contracts do not have to take into account the ability of the municipality to pay the award[3]—as a result, many municipalities end up with contracts they simply cannot afford.[4]

But the unions are not the only actors in the process. The laws that establish the level of pension and OPEB benefits for state workers are adopted by the legislature and approved by the executive branch. The laws that define the negotiation and arbitration process for contracts with municipal unions are adopted by the legislature and approved by the executive branch. All of these laws are interpreted by the judicial branch. All of these actors in the process are public employees with an interest in public sector salaries, pensions and other benefits. To the extent municipal governments are unable to control their labor costs, it is a result of the actions of all of these actors.

When I was the Harrisburg receiver, I received a call one day from the chief of police. He wanted to have me meet with him and three of the police captains. I assumed the meeting was about a recent crime wave in the capital. But when I got to the meeting, the chief and captains wanted to talk about where my negotiations stood with the police union and how it would affect their salaries and benefits; and they wanted to know whether they should resign

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[3] 43 P.S. § 217.7 (enacted 1968).

[4] Recent events in Scranton provide one example. *See* Jim Lockwood, *Scranton's Police, Fire, DPW Unions File Lawsuit Against Salary Cuts*, THE SCRANTON TIMES-TRIBUNE (July 3, 2012), *available at* http://thetimes-tribune.com/news/scranton-s-police-fire-dpw-unions-file-lawsuit-against-salary-cuts-1.1338006 (highlighting the Mayor's efforts to slash the contractual salaries of all public employees to minimum wage).

now before the city might file for bankruptcy. Decisions about benefits drive much of what is done or not done by state and local governments and by the elected officials, judges and public workers.

The difference between the way a private business runs and the way a government runs is that the government will often delay addressing problems for much longer than a business would. It is easier and politically safer for an elected official, whether at the state or municipal level, to promise public employees benefits that do not have to be paid for years, or to ignore current pension funding requirements, in order to avoid raising taxes. In the short run, such decision making may help the official get reelected, but in the long run it creates a huge and ever-increasing liability for the government. Such is the case at the state level in Kentucky, Illinois and Pennsylvania, and at the local level in Chicago and Philadelphia, and in many other places too. As a result of the Great Recession, many of these poor practices have come home to roost.

This problem of labor costs has nothing to do with the quality of the work being done. The vast majority of public employees are dedicated and hardworking, and for their efforts, they deserve to be paid salaries and benefits that are fair. But to promise salaries and benefits now that the government cannot afford to pay in the long run is a prescription for fiscal disaster. Municipal governments are often in the position of being unable under existing law to control their labor costs.

III. THE FINANCE INDUSTRY AS CONTRIBUTOR TO MUNICIPAL FISCAL DISTRESS

The finance industry caused the Great Recession through a combination of highly risky products, including in particular the securitization of subprime loans and credit default swaps. The public finance subset of the finance industry at the same time was recommending its own set of risky products.

One example is auction rate bonds. Both municipal issuers and investors were sold on a structure that would give short term rates to the municipal issuer on a long term bond, without the expense or bother of obtaining a liquidity facility. The bonds bore interest at a low rate because the investors assumed that they could get out of their bonds at any time on short notice. The investors assumed this because a handful of large financial institutions implicitly represented that they would maintain a market in the bonds through an auction mechanism, thereby giving the investors the comfort of liquidity. The municipal issuers were attracted to the product because the issuer could borrow at a low, short-term interest rate without having to pay a bank to provide back-up liquidity for the bonds.

The auction rate bonds, and other bond structures, could be wrapped by another product—interest rate swaps. For example, a variable rate issue would be transformed into a fixed rate transaction if the municipal issuer entered into a separate contract swapping interest rate obligations with a large financial institution (the counterparty), often an affiliate of the investment banker who was marketing the municipal issuer's bonds. The counterparty would pay the municipal issuer a variable rate which was intended to cover the municipal issuer's variable rate obligation on the bonds, and the municipal issuer would pay the counterparty an agreed upon fixed rate. The result: a synthetic fixed rate obligation has been created out of a variable rate obligation.

Other debt products included "scoop and toss" refundings and synthetic advance refundings using swaptions. These and other public finance products generated significant fees for the large financial institutions and the rating agencies (just like in the subprime mortgage securitization business), as well as for all the local financial institutions, financial advisors and lawyers involved in these transactions.

When the Great Recession hit, thanks to the subprime mortgage transactions and credit default swaps, it had a devastating effect on many of the particular products marketed by the public finance industry to municipalities. The auction rate bonds almost immediately went into cardiac arrest. Municipal issuers were stuck with bonds that shot up to a double digit "maximum rate" when the auctions failed.

Municipal issuers who wanted to refund out of complex bond structures were finding it very difficult. If the municipal issuers also wrapped those bonds with swaps, they had to pay very high termination fees to get out of the swaps.

The point of all this is that municipalities were not treated well by the public finance industry's supposedly sophisticated products. The municipalities were sold products that shifted long-term risks to the municipal issuers, in exchange for short term financial benefits to those issuers.

Federal taxpayers ended up bailing out many large financial institutions which had been promoting these products. But when the particular public finance products went bad, there was no bailout of the affected municipalities by the federal government. The local taxpayers again have had to step to the plate to pay the losses generated by these debt and swap obligations. There are municipal issuers even today, six years after the fact, who are still struggling with the repercussions of these products.

In many municipal distress situations, including Harrisburg, Detroit and Puerto Rico, problems with bonds and swaps have been a major contributor to the distress.

IV. FAILURE TO COMPROMISE LEAVES MUNICIPALITIES HOLDING THE BAG

Municipal government is literally where the rubber meets the road. If a sink hole opens in a road, or if street lights are out, or if the garbage is not picked up on time, municipal officials hear about it directly from their citizens. Municipal government is all about practical management.

Higher levels of government, particularly state legislatures and the U.S. Congress, can have theoretical debates about taxes and unions and other political issues. But when these issues filter down to the local level, it is all about what can work. Municipal officials cannot afford the luxury of taking uncompromising positions on these issues.

A good example is the arbitration process for uniformed employees under Act 111 of 1968 in Pennsylvania. When the process results in unaffordable contracts for municipalities, you have the anomalous result of Democratic mayors lobbying the state legislature to cut back the provisions of the act which disproportionately favor the unions. These mayors are not taking this position because they are anti-union; they are taking the position because their municipalities simply cannot afford the contracts which result from Act 111.[5]

And yet these Democratic mayors find it almost impossible to find any Democratic state legislators who will support legislation to make the arbitration process fairer for municipalities. It is even very difficult to get many Republican legislators to take a position that might be adverse to police or fire unions. Several Republican senators have introduced Senate Bill 1111 (2013–2014 Session) to make Act 111 fairer.[6] The bottom line on this issue is that most distressed municipalities in Pennsylvania will not be able to get out of distress until Act 111 is fixed.

The failure of state and Federal legislators to compromise and come up with practical solutions to real problems faced by municipalities and their citizens is a major contributing factor to municipal distress.

V. FEDERAL GOVERNMENT'S POLICIES UNDERMINE THE MIDDLE CLASS AND MUNICIPALITIES

The thing that has made our country so strong from its very inception has been our middle class. I grew up in Pittsburgh in the '50s, '60s and early '70s. The parents of most of the students in my high school had solid middle class jobs, many of them with manufacturing companies like U.S. Steel or Westinghouse, or with smaller companies that served as specialty manufacturers or suppliers to the big manufacturers. Someone with a high school diploma who was willing to work hard could get a good manufacturing job and could buy a house and raise a family on the earnings from that job.

Manufacturing was the key to our economy. Americans made things for a living. The rich were not too rich, and there was not a dramatic difference in earnings between a company executive and the worker on the line.

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[5] *See id*. (responding to the backlash from public employees, Democratic Mayor Doherty responded, "What am I going to pay them with? We don't have the money.").

[6] S.B. 1111, Reg. Sess. 2013-2014 (Printer's No. 1539) (referred to Senate Committee on Local Government on Nov. 8, 2013).

Things have changed dramatically over the last 40 years. Our economists and political leaders have adopted the mantra of "free trade": let other countries do most of the manufacturing; we will focus on specialized services like finance and electronic technology.

The loss of manufacturing has eroded our middle class. To get a middle class job now usually requires a college degree, and often times that is not enough. Where are all the well-paying middle class jobs that free trade was supposed to create? Our best and brightest from our top colleges have gone into finance where they make nothing except complicated financial products like securitized mortgage pools and credit default swaps. The rich get fabulously richer, and when their financial schemes backfire, the middle class American taxpayers bail them out.

One area in which middle class jobs, with good wages and benefits, have grown over the last 25 years is government employment, at the local, state and federal levels. At the same time that middle class workers in the private sector have had to settle for lower and lower paying jobs and have had to pay for more and more of their own benefits, workers in the public sector, until recently, have had steadily increasing pay, defined benefit pension plans and retirement medical coverage.

The political class fostered both of these trends. They pandered to schemes of the financial industry and international free trade on the one hand (in exchange for political contributions or for high paying jobs in the revolving door between the public sector and the private sector), and they increased the salaries and benefits of public employees on the other (of which they were an integral part and co-beneficiaries). The middle class has been caught in "the middle" of these two trends. It is the taxes of the American middle class that have financed both, while both of these developments have continuously eroded the strength of the middle class.

The typical distressed municipality is caught between unaffordable labor costs and insufficient revenues from middle class taxpayers who are stretched to the limit. The solution for a distressed municipality which is lucky enough to have some valuable assets is predictable: sell or lease the assets; apply the proceeds of the sale or lease to take care of the burdensome legacy liabilities; downsize the government through privatization and lower labor costs; and operate a smaller, cheaper government going forward.

These budgetary pressures are not just a problem for the most obvious distressed municipalities like Detroit. I speak to a lot of municipal officials from all sizes and types of municipalities. They are all feeling the pressures of high labor costs and insufficient revenues, even the municipalities in fairly wealthy areas. As our middle class continues to erode, the finances of all local governments are going to continue to erode.

Municipalities and the middle class are victims of a total lack of vision for two generations by our national leaders. I remember pumping gas for a summer job in 1974 when cars were lined up out into the highway waiting for "even and odd" rationed gas. Why, 40 years and seven presidents later, do we still have no rational policy for energy self-sufficiency? Why do we have no rational policy for the promotion of American manufacturing? Why do we reward companies that send our manufacturing jobs throughout the world? Why do we reward companies that shelter income offshore to avoid paying American taxes? Why do we care so little about the effect of these actions on our middle class?

It is unfortunate that our public sector workers are going to earn less with fewer benefits. But that is merely a reflection of what has been going on for middle class workers in the private sector for years. Time has run out for many municipalities in local areas which have been hit hardest by the evisceration of the American middle class. The day of reckoning is coming for more wealthy municipalities and for our country as a whole unless we act now to get our act together.

VI. CONCLUSION

We need to get beyond all the simplistic, special interest slogans. We can no longer protect the rich, or the unions. We need practical solutions. Not just municipal government, but all levels of government need to approach public policy issues with an open mind and with the goal of achieving practical solutions for the benefit of all the citizens. We need to figure out how to grow our manufacturing base and live within our means. Without a strong middle class, the American dream will come to an end. If we focus on policies that first and foremost strengthen our middle class, we can rise again.