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The Risks States Take for Their Distressed Cities.

Wall Street can be hard on a state that moves to keep its local governments solvent or help them through bankruptcy. But it's a chance that some states have decided is worth taking.

Two years ago, Wells Fargo declared state and local governments' efforts to deal with critical fiscal issues to be "light years ahead" of the federal government's. It's hard to argue with that assessment. But beyond the Beltway, the interplay between states and local governments in the wake of the Great Recession has raised unprecedented challenges. It has displayed stark differences in the roles states choose to play in dealing with their distressed localities. And it has highlighted the question of how much credit risk those states are willing to take on to help get their local governments' houses in order.

In looking at the municipal bankruptcies (or near-bankruptcies) in Alabama, California, Michigan, Pennsylvania and Rhode Island, the roles of the respective states ranged from adverse (Alabama) to seemingly irrelevant (California) to positive (Maryland, Michigan, Pennsylvania and Rhode Island). The Great Recession demarcated states into those with oversight programs that either protected against municipal insolvency or offered good support for troubled communities; those that accepted risks and reacted by changing their laws; and those that appeared to contribute to the distress and avoid the acceptance of any risk. The hard issue for state leaders was — and is — a fear of credit-risk contagion.

State involvement in local fiscal distress carries risks both fiscal and political. Nowhere is that playing out more starkly than in Detroit's bankruptcy with the truly extraordinary and bipartisan involvement by Michigan Gov. Rick Snyder and the state's legislative leaders.

When Standard and Poor's recently revised its outlook on Michigan's credit downward from positive to stable, it cited several economic and fiscal factors, including softening revenue. But the rating agency noted another factor: Michigan's recent decision to dip into its rainy-day fund to contribute $195 million to Detroit's city-government retirees as a critical part of the so-called "grand bargain" for the Motor City's exit from bankruptcy. S&P wrote that the state's action "raises questions as to potential future state contributions to other distressed localities and school districts."

S&P's action wasn't a big surprise in Lansing. In a statement to the Bond Buyer, a spokesperson for the governor's office wrote: "We knew the Detroit settlement package and [budget stabilization fund] was a concern with the rating agencies, which is why the Governor felt it was important to address head on and show why the package was a financially responsible, smart way for the state to address Detroit," adding that the contribution was unlikely to set a precedent for other distressed local governments in the state. Subsequently, Fitch Ratings affirmed its AA rating and stable outlook on the state's general-obligation bonds, and Moody's affirmed its Aa2 rating with a positive outlook.

Needless to say, S&P did not analyze what its rating might have been had the governor and bipartisan state legislative leadership not stepped up to the plate; as far as Michigan's leaders were concerned, the far greater potential credit risk was not to act. Indeed, the question for states is how to balance the credit risk of non-involvement versus involvement. In some states — especially smaller ones such as Rhode Island or Maryland, where a default by Providence or Baltimore would have led to significant repercussions to the states' economies and credit ratings — whether the state needed to establish a proactive role could not really be in question. In a similar sense, state leaders in Albany and Lansing have clearly recognized the critical role of New York City and Detroit to their states' economies.

Cities' and counties' fiscal distress or bankruptcy cannot be isolated from their states' economies, as much as legislators in Springfield, Ill., or Montgomery, Ala. might wish they could. Thus, statutory "emergency rooms" of some sort — or "pre-emergency rooms," such as long-established programs in New Jersey and North Carolina that have worked to prevent any municipal bankruptcy filings — have demonstrated efficient means to provide state oversight without debt adjustment. Many states require municipalities to regularly submit audit reports and budgets to a state division of local government, and other oversight programs allow intervention when budgets are out of balance. Some states may also offer temporary assistance through loans or emergency grants.

The focus of such state oversight programs is to maintain or improve local governments' fiscal and managerial functionality. State policy-makers recognize that when that functionality disappears in the calamity of a bankruptcy, it will be the state's taxpayers and its credit rating that will be at risk.

Programs like these, of course, present their own risks to states, such as setting a precedent that would trigger comparable assistance to other distressed communities; forgoing investments in infrastructure or education in order to prop up a city or county's pensions; or creating an impression that a state will weigh in against its investors in favor of its poorly managed municipalities.

But in accepting risks like these, a state is betting that its constructive role will not just cure a cancer and prevent its spread, but, more importantly, lay the foundation for accruing economic benefits to the region and state that outweigh any capital-markets costs. And the state is aiming to lay the foundation for a more constructive state-local relationship for the future.

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