The Benefits of Helping Struggling Cities.

For financially distressed municipalities, it's good to be in a state that intervenes, according to a new study.

Earlier this month, New Jersey stopped Atlantic City from defaulting on its debt with a $74 million bridge loan. While there was plenty of bluster and several hollow threats from legislators that they would not step in to help the financially beleaguered gambling town, it didn't surprise anyone when they finally did.

That's because New Jersey has a reputation in the credit market for going to any lengths to prevent one of its municipalities from entering Chapter 9 bankruptcy. In fact, no New Jersey municipality has defaulted on debt since the Great Depression. This extra layer of protection is not only comforting to local officials in struggling cities like Camden or Trenton, it's viewed as a big plus by those who invest in New Jersey municipal debt.

Now, preliminary research affirms the benefits of being a municipality in a more proactive state. Scholars at the University of Notre Dame and University of Illinois at Chicago have found that creditors tend to give municipalities in these states a slightly lower borrowing rate than they do municipalities in states without any kind of bankruptcy intervention program.

All other things being equal, the research found that municipalities in proactive states tend to get an initial interest rate on their bonds that is 1.4 basis points or 0.014 percentage points lower than those in states that don't have restrictions on entering bankruptcy. It may not seem like much but the difference in borrowing rates amounts to real cash. According to the researchers, it means that total local borrowing costs in an unrestrictive state were at least $105 million higher over the 12 years studied than in a proactive state.

The findings provide new information in an ongoing debate about the appropriate role of a state in its distressed localities. "I think what this answers is that getting a second set of eyes and additional input can help when you compare that against the municipalities who are authorized to file for Chapter 9 without conditions," said James Spiotto, an attorney and municipal restructuring expert.

Only about half of U.S. states even allow their municipalities to file for bankruptcy. Of those, the authors identified Maine, Michigan, Nevada, New Jersey, New York, North Carolina, Ohio and Pennsylvania as states with proactive policies designed to intervene before bankruptcy. These interventions are characterized by programs that allow the state to restructure a distressed locality's finances and often feature emergency loans and revenue transfers.

It's worth noting of course that proactive states do not always succeed in keeping a municipality from default or bankruptcy. One of the primary factors in whether an intervention is successful is the economy. After all, economic conditions are generally out of a state's control. A 2013 Pew Charitable Trusts study found this to be the case in Michigan, where Detroit filed for bankruptcy and five other cities were under emergency managers, and Pennsylvania, where Harrisburg was at the time was run by a receiver. The effects of the Great Recession in these cities continue to make it harder to rebound.

The Pew study recommended that states consider establishing an early warning system for localities and designing a program that includes all stakeholders when possible.

The research from Notre Dame and the University of Illinois offers an additional insight: an active intervention program comes at a cost. Proactive states tend to have a slightly higher interest rate on their general obligation bonds than states with unrestrictive policies.

Still, noted Spiotto, all states pay a price when a municipality — particularly a major one — defaults on debt. “It’s the perception of risk,” he said. “If a major municipality is having a problem, investors assume the state has a problem. Rightfully or wrongfully, it reflects poorly on the state.”

States that allow bankruptcy but generally don’t step in to try and avoid municipal Chapter 9 filings include Alabama, Arkansas, Arizona, California, Idaho, Minnesota, Missouri, Montana, Nebraska, Oklahoma, South Carolina, Texas, and Washington.

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