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Detroit's Bankruptcy Could Hold Unforeseen Dangers

The announcement of Detroit's bankruptcy filing was not unexpected. After all, the city has been running huge deficits for years, has built up almost $20 billion in unfunded pension liabilities and debt, has abysmally poor public services including inadequate policing, has been hemorrhaging population and has high crime rates. In financial terms the city has been bankrupt for years. And it has benefitted from major federal assistance in the form of a bailout of GM that preserved jobs, pensions and health benefits for union employees.

Normally, when a deeply financially stressed private entity goes through bankruptcy it can be positive if it results in a restructuring that preserves the entity, saves jobs, etc. Of course in really bad cases, the only option could be liquidation and the end of the organization. For large municipalities, liquidation is not an option, so any restructuring must be effective if bankruptcy is to accomplish meaningful financial improvements.

Indeed, if the bankruptcy judge makes good rulings, a municipality could be given a new lease on its financial life. To do that the rulings must firmly address the underlying causes of the problem. That means dealing with extravagant and excessively generous legacy labor costs. It means forcing the municipality to shed programs it cannot afford, to outsource where private vendors can perform the function cheaper. And the rulings must ensure that taxpayers and businesses are not burdened to the point they are driven to abandon the community.

But it is also true that government bankruptcy presents potential outcomes that vary widely from the typical private sector bankruptcy.

Assuming the Federal courts proceed with the Detroit bankruptcy there will be some real pain dealt to creditors. If it proceeds is a necessary qualification at this point because a Michigan state appellate judge has ruled the bankruptcy is unconstitutional under Michigan's constitution. In all likelihood, Federal bankruptcy laws will supersede the state constitution and the Detroit bankruptcy will proceed as municipal bankruptcies have done in other states. When it does, there will be major hits for bond holders and other creditors, unpaid vendors and so forth.

Beyond the effects on Detroit, some analysts have expressed concerns that the Detroit filing could be a harbinger of other municipal bankruptcies. Some have mentioned the possibility that municipal bond rates will rise as lenders demand higher yields in the face of greater risks. That will bear watching as the terms of a settlement unfold.

Besides the likelihood of more bankruptcy filings by municipalities across the country, there are two possible great dangers surrounding the Detroit bankruptcy and its resolution. First, is the danger that massively unfunded pensions are not seriously addressed leaving the city heavily burdened going forward after the settlement. And if pension funding is not addressed, other creditors could be forced to take even harsher cuts in payouts than would otherwise have been the case. Then too, if pensions are not addressed, there is a strong likelihood taxpayers will see tax hikes or citizens and businesses will see further reductions in service. This is an all too real possibility in light of the settlements in California that did not deal with pension problems.

The second big danger is that the federal government will step in with financial assistance. Bear in mind that with the federal government's huge deficits, $17 trillion in debt along with tens of trillions in unfunded liabilities, vast and growing numbers of people on public assistance and a precarious economy that could succumb to the effects of Obamacare or some international shock, the ability of the federal government to fund municipal governments is severely constrained. But even worse than the Fed's lack of financial wherewithal to undertake more spending is the damage that will result if the federal government decides to start aiding municipalities.

There are a large number of cities and towns across the country in serious financial straits. A few in California have already opted to declare bankruptcy. And Pennsylvania has its share of cities under state financial oversight, including Philadelphia, Pittsburgh and Harrisburg. Once the precedent is set for the federal government to bail out bankrupt municipalities or those threatening to file bankruptcy papers, there will be a flood of aid seekers. And how can they be turned away?

The federal government's ubiquitous reach into almost every nook and cranny of U.S. society would finally have the leverage it needs to effectively vacate the vestiges of federalism still remaining. If the government in Detroit can turn to Uncle Sam for the money they need to continue their profligate kowtowing to the unions, why would they care about what Lansing thinks? If the federal government provides funds, those funds will come with strings as to how the money is spent, what taxes can be levied and what rates to set, social services that must be provided, educational policies that must be adopted, environmental regulations that must be followed, ad nausea.

Is this too pessimistic? A casual review of the ever expanding reach and role the federal government has arrogated to itself argues it is not unreasonable. Take education for example. The constitution makes no provision for the Congress to pass laws or the president to issue directives concerning education. Yet we have a massive department doing just that. Health care? The commerce clause says people cannot be forced to buy a product, but a wayward, contorted ruling by a Chief Justice keeps the takeover of U.S.

health care in place. The federal government does not enforce immigration laws or protect the borders but when a state tries to protect its citizens, the Court denies the state any such right.

The long run effect of the federal government bailing out bankrupt cities such as Detroit and the flood that will inevitably follow is to put local governments completely in the hands of the public sector unions forever along with the elected officials who will be handpicked and elected by them. The very same public unions and their friendly elected officials who have given them all the expensive and now unaffordable compensation, and favorable work rules, etc., have been the major driving force behind the financial calamity many municipalities have become. But for those looking for an ever expanding federal government, this is an opportunity not to be missed.

Any effort by the federal government to prevent the consequences of Detroit's bad behavior from falling on the city will simply ensure more and worse behavior in the future. Experience should be a teacher here and Congress should never agree to allow municipal bankruptcy bailouts.

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