

BY JOEL COHEN

## Municipal Debt Crisis in the U.S.

### Challenges, Chapter 9 and Pathways to Fiscal Sustainability

As the national discourse fixates on America's towering federal debt, a related issue is looming at the local level: State and municipal debt in the U.S. has climbed to an alarming \$3.4 trillion,<sup>1</sup> mirroring the national struggle with financial sustainability. Given the potential pullback of federal support, one could argue that the trickle-down effect of funds from the constriction at the top level could exacerbate these local fiscal challenges. According to a 2023 report by the National League of Cities, nearly 50 percent of cities reported that they were less able to balance their 2024 budgets, up from 11 percent and 31 percent in 2022 and 2023, respectively. This downward trend is expected to continue, particularly as the current administration prioritizes efficiency in federal spending, which is likely to reduce the flow of federal aid to local governments.<sup>2</sup>

Federal aid significantly drives value, with cities noting that such aid had a 16 percent positive effect on their local budgets.<sup>3</sup> Measured against the backdrop of shrinking revenues and increasing service demands, this fact underscores a critical need for governmental efficiency not just in Washington but in city halls across the nation. Chapter 9 offers municipalities a pathway to address fiscal distress by restructuring their debt and regaining financial stability.

### Current State of Municipal Financial Health

The current financial health of U.S. municipalities is under significant strain, driven by three primary interdependent factors: (1) escalating municipal debt; (2) expanding unfunded liabilities; and (3) persistent budget deficits.

### Growing Debt Burden

Over the past 20 years, municipal debt has risen dramatically. In 2003, total debt stood at approximately \$1.6 trillion. By 2024, this figure has soared

to \$3.4 trillion.<sup>4</sup> The growth is fueled by infrastructure demands, including aging public utilities, and by reliance on borrowing to bridge fiscal gaps.

However, many municipalities lack the financial resources to address these needs, leading to a vicious cycle of deferred maintenance and increasing costs. While municipal bonds have long been a cornerstone of public finance, rising interest rates have increased debt-servicing costs, further straining budgets.

### Unfunded Liabilities Crisis

Unfunded liabilities present an even graver concern. Pension obligations, which were underfunded by \$439 billion<sup>5</sup> in 2001, exceed \$1.2 trillion in fiscal year 2022, according to Pew Charitable Trusts.<sup>6</sup> Retiree health care liabilities (OPEBs) have added another \$789 billion to the financial burden, as of fiscal year 2022.<sup>7</sup> The growing obligations stem from demographic trends, overly optimistic investment assumptions and insufficient funding, creating a significant drag on municipal resources. (The exhibit illustrates the dramatic growth in unfunded pension and OPEB liabilities among U.S. municipalities from 2000-23.)

### Persistent Budget Deficits

Municipal budget deficits complete the picture of financial distress. The COVID-19 pandemic revealed the vulnerabilities of local revenue streams, with municipalities reporting nearly \$134 billion in revenue losses in 2020 alone.<sup>8</sup> Federal aid, such as the American Rescue Plan, temporarily mitigated these deficits but discouraged long-term reforms. The U.S. Department of the Treasury reported that the American Rescue Plan allocated \$350 billion to state and local governments to address revenue shortfalls and pandemic-related expenses,<sup>9</sup> which



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1 Federal Reserve Economic Data, Fed. Reserve Bank of St. Louis, [fred.stlouisfed.org/series/SLGSDODNS](https://fred.stlouisfed.org/series/SLGSDODNS) (unless otherwise specified, all links in this article were last visited on Sept. 22, 2025).

2 Asma Khalid, Franco Ordoñez, Deirdre Walsh, Barbara Sprunt & Ashley Lopez, "Judge Pauses Trump's Federal Funding Freeze as Confusion and Frustration Spread," Nat'l Public Radio (Jan. 28, 2025), [npr.org/2025/01/28/nx-st-5277029/trump-memo-halt-funding](https://www.npr.org/2025/01/28/nx-st-5277029/trump-memo-halt-funding). On Jan. 27, 2025, the Office of Management and Budget issued a memo pausing all federal grants and loans — potentially \$3 trillion annually — pending review for alignment with the current administration's priorities. A federal judge blocked it on Jan. 28, 2025, but the executive intent is clear.

3 "City Fiscal Conditions 2023," Nat'l League of Cities, [nlc.org/resource/city-fiscal-conditions-2023](https://nlc.org/resource/city-fiscal-conditions-2023).

4 Federal Reserve Economic Data, *supra* n.1.

5 Keith Sliwa, David Draine & Eli Gullett, "As Pension Funding Levels Fell in 2022, Higher Contributions Helped States Manage Debt," Pew Charitable Trusts (Sept. 10, 2024), [pew.org/en/research-and-analysis/articles/2024/09/10/as-pension-funding-levels-fell-in-2022-higher-contributions-helped-states-manage-debt](https://www.pew.org/en/research-and-analysis/articles/2024/09/10/as-pension-funding-levels-fell-in-2022-higher-contributions-helped-states-manage-debt).

6 David Draine, Keith Sliwa, Joanna Biernacka-Lievestro & Riley Judd, "An Increase in Pension Obligations Adds to States' Unfunded Liabilities," Pew Charitable Trusts (July 30, 2022), [pew.org/en/research-and-analysis/articles/2025/07/30/an-increase-in-pension-obligations-adds-to-states-unfunded-liabilities](https://www.pew.org/en/research-and-analysis/articles/2025/07/30/an-increase-in-pension-obligations-adds-to-states-unfunded-liabilities).

7 "Reinventing Healthcare for Public Sector Retirees," WTW (Aug. 8, 2025), [wtwco.com/en-us/insights/2025/08/reinventing-healthcare-for-public-sector-retirees](https://www.wtwco.com/en-us/insights/2025/08/reinventing-healthcare-for-public-sector-retirees).

8 "City Fiscal Conditions 2023," Nat'l League of Cities, [covid19.nlc.org/wp-content/uploads/2020/11/Cities-Are-Essential-Revenue-Loss\\_One-Pager.pdf](https://www.nlc.org/wp-content/uploads/2020/11/Cities-Are-Essential-Revenue-Loss_One-Pager.pdf).

9 "State and Local Fiscal Recovery Funds," U.S. Dep't of the Treasury, [home.treasury.gov/policy-issues/coronavirus/assistance-for-state-local-and-tribal-governments/state-and-local-fiscal-recovery-funds](https://www.home.treasury.gov/policy-issues/coronavirus/assistance-for-state-local-and-tribal-governments/state-and-local-fiscal-recovery-funds).

created reliance on such measures and diverted focus from systemic issues, including pension underfunding and narrow revenue bases.

Federal aid programs introduced during and after the COVID-19 pandemic provided temporary fiscal relief and reduced immediate insolvency pressures. These factors collectively suppressed chapter 9 filings despite worsening fiscal conditions.

Amidst the current state of fiscal instability, there are several solutions that could be taken to restore municipalities' health. Municipalities can look to improve efficiency, restructure their debt and look to long-term solutions to many of their current fiscal issues. A critical option to help aid with current struggles is chapter 9 bankruptcy, which provides municipalities a framework to restructure and aid in insolvency. While chapter 9 provides a crucial pathway to restructuring, it is important to also understand its limitations, as chapter 9 is a much more constrictive process than other forms of bankruptcy and is often limited by the Constitution, state legislation and federal funding.

## Considerations and Hurdles While Filing Chapter 9

Compounded by state-level barriers to bankruptcy filings and uncertainties around federal funding, municipalities face significant challenges in addressing financial instability proactively.

### Lack of Credit Spreads at Local Government Level

Municipalities often lack the transparency and market mechanisms that are available to corporate entities, such as credit spreads, which are critical indicators of financial

health. Credit spreads reflect the risk premium that investors demand to hold a municipality's debt over risk-free securities.

However, the municipal bond market is characterized by a lack of standardized credit-risk metrics, making it difficult to assess the financial distress of local governments. Unlike corporate bonds, municipal bonds are often held by retail investors who rely on credit ratings rather than market-driven indicators like spreads. This lack of accessible market signals can delay the recognition of financial distress, potentially leading to more severe outcomes when bankruptcy is finally considered.

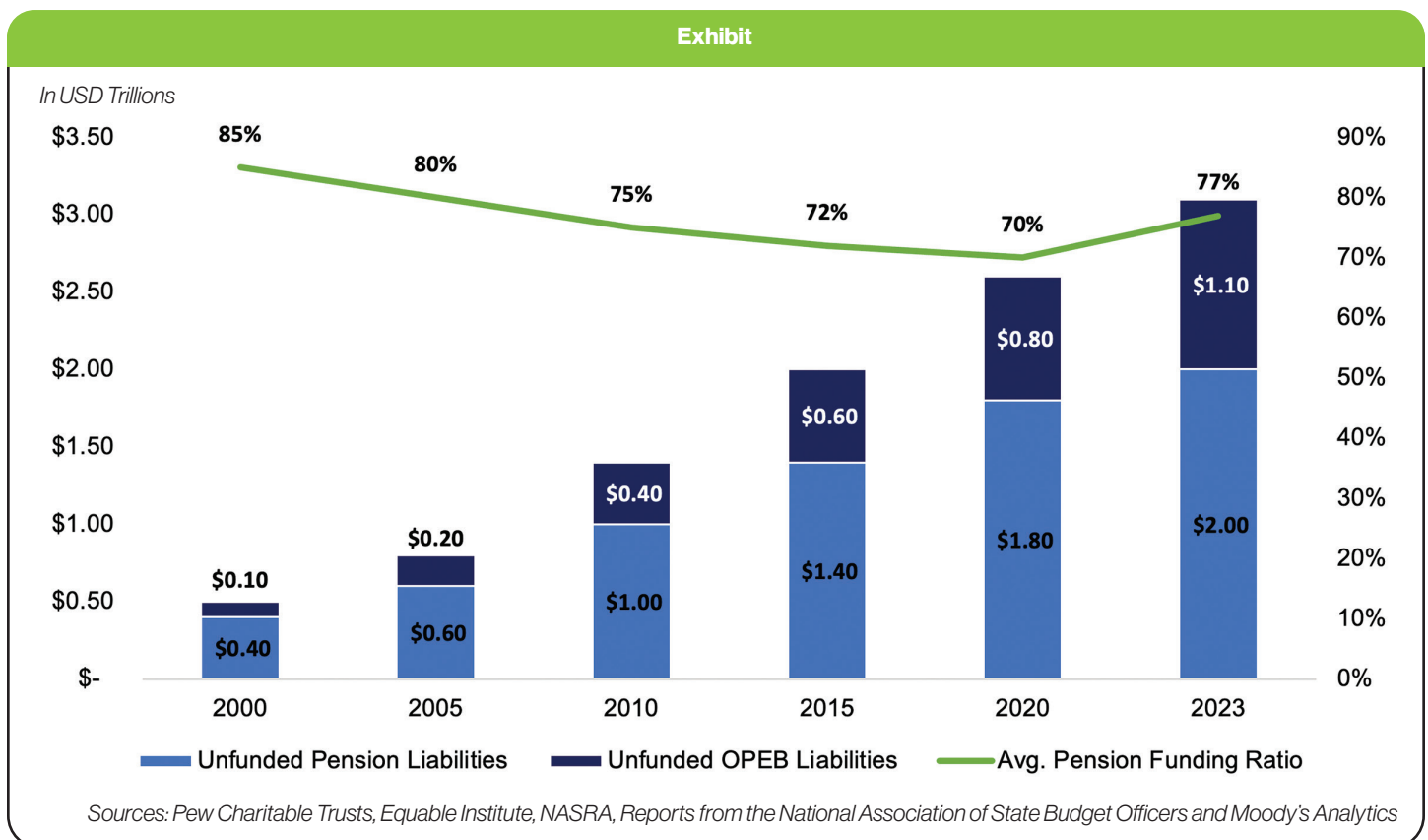
For example, during the Detroit bankruptcy, the city's financial distress was not fully apparent to investors until it was too late. The lack of credit spreads and reliance on outdated financial disclosures contributed to the sudden realization of Detroit's insolvency. This case highlights the need for better financial transparency and market mechanisms to identify distress early, as identified in a study conducted by the Federal Reserve Bank of Boston.<sup>10</sup>

### Voluntary Filing Option Not Available

Municipalities cannot unilaterally decide to file for chapter 9; they must receive authorization from their state government. This creates a significant barrier to early intervention, as states might delay or deny permission due to political or economic concerns. In the case of City of Stockton, Calif., the city had to negotiate with its creditors and demonstrate insolvency before the state allowed it to file for chapter 9.

<sup>10</sup> Nikolay Gospodinov, Brian Robertson & Paula Tkac, "Do Municipal Bonds Pose a Systemic Risk? Evidence from the Detroit Bankruptcy," Fed. Reserve Bank of Boston (December 2014), [bostonfed.org/-/media/Documents/conference/PDF/tkac.pdf](https://bostonfed.org/-/media/Documents/conference/PDF/tkac.pdf).

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This state-authorization process can be both time-consuming and politicized, potentially delaying necessary restructuring efforts until the financial situation becomes critical.

## Federal Funding Uncertainty

With the 2025 Executive Order to pause infrastructure funding, cities and states face uncertainties regarding the continuation of federally supported projects and their impact on municipal budgets.<sup>11</sup> This also underscores the need for proactive monitoring of structural issues in the absence of federal funding.

## Limited Court Oversight

Constitutional and legal constraints limit the authority of bankruptcy courts in municipal cases, which can lead to unaddressed structural issues.

**Constitutional Limitations:** The U.S. Constitution's Tenth Amendment restricts federal courts from interfering with a state's internal governance. This limitation restricts the ability of bankruptcy courts to oversee municipal operations, unlike in chapter 11 cases, where courts have broad authority to intervene in corporate management. This also limits courts' ability to enforce fiscal discipline or operational changes directly, relying instead on the municipality's voluntary compliance with court-approved plans. For example, in *In re City of Vallejo, California*,<sup>12</sup> the court explicitly addressed its restricted role under 11 U.S.C. § 903, which states that chapter 9 "does not limit or impair the power of a State to control, by legislation or otherwise, a municipality ... in the exercise of the political or governmental powers of such municipality."

**No Removal of Elected Officials:** Unlike chapter 11, where a trustee or examiner can replace management if mismanagement is proven, chapter 9 does not allow for the removal or replacement of elected officials. Chapter 9's purpose is to adjust municipal debts, not to overhaul governance. This limitation can be problematic in cases where poor governance has contributed to financial distress, and it can hinder effective governance reform, as elected officials who may have contributed to the financial distress continue to make decisions during the bankruptcy process.

**Deference to Municipal Judgment:** Courts generally defer to a municipality's judgment in proposing a debt-adjustment plan, as long as it meets basic requirements. Creditors often face an uphill battle in challenging these plans. For example, in *In re City of Detroit, Michigan*,<sup>13</sup> the court deferred to the city's judgment in proposing an adjustment plan and approved a plan that imposed significant losses on bondholders while preserving pension benefits, despite objections from creditors.

## Pension and Labor Obligations

State constitutional protections for public-employee pensions often shield these benefits from reduction, even in bankruptcy, thus creating significant challenges for municipalities seeking financial relief.

**Constitutional Protections:** In many states, public-employee pensions are protected by state constitutions, laws or court rulings. For example, the Illinois state constitution explicitly prohibits the diminishment or impairment of pension benefits. This protection makes it extremely difficult to renegotiate pension terms, even in bankruptcy. The strength of these protections can vary widely by state, with some states offering more leeway in pension adjustments than others.

**Pensions vs. Other Creditors:** Pension obligations are often given priority over other unsecured debts, leaving bondholders and vendors to absorb larger losses. For example, in *City of Detroit*, pensioners received a higher recovery rate compared to bondholders, who faced significant haircuts. This prioritization can lead to contentious legal battles, such as in *Detroit*, where the city's adjustment plan was challenged on grounds of fairness to creditors.<sup>14</sup>

## Recent Legal Disruptions to Bondholder Rights

In recent years, certain judgments have disrupted the established standards pertaining to the rights of bondholders. For example, special revenue bonds, secured by specific revenue streams (e.g., utility fees or tolls), are generally considered safer than general obligation bonds. Under the Bankruptcy Code, § 928(a)<sup>15</sup> provides that holders of special revenue bonds retain their liens on pledged revenues — even if a municipality files for chapter 9. Section 922(d) further allows municipalities to continue paying debt service on special revenue bonds during bankruptcy proceedings without requiring court approval.<sup>16</sup>

For decades, this framework was understood to mean that municipalities "should" continue paying special revenue bondholders during chapter 9 bankruptcy. This interpretation reassured investors and maintained the integrity of the municipal bond market. However, the First Circuit's 2019 ruling in *Fin. Oversight & Mgmt. Bd. for Puerto Rico v. Andalusian Global Designated Activity Co.* disrupted this perception.<sup>17</sup> The court ruled that municipalities in chapter 9 are not required to continue paying debt service on special revenue bonds, even though bondholders retain liens on pledged revenues.

14 See *Detroit*, 524 B.R. 147 (Bankr. E.D. Mich. 2014) (confirming plan despite objections from Syncora and FGIC, which challenged fairness of 75-85 percent bondholder losses vs. 85-90 percent pension retention, ECF Nos. 6989, 7002).

15 11 U.S.C. § 928(a).

16 11 U.S.C. § 922(d).

17 *Fin. Oversight & Mgmt. Bd. for Puerto Rico v. Andalusian Global Designated Activity Co.* (In re *Fin. Oversight & Mgmt. Bd. for Puerto Rico*), 916 F.3d 98 (1st Cir. 2019).

11 Dan Zukowski, "What Trump's Infrastructure Funding Pause Means for Cities," *Smart Cities Dive* (Jan. 24, 2025), smartcitiesdive.com/news/trump-infrastructure-funding-pause-impact-cities-states/738206.

12 *In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Cal. 2009); *aff'd sub nom., In re City of Vallejo, Calif.*, 432 B.R. 262 (E.D. Cal. 2010).

13 *In re City of Detroit*, 524 B.R. 147 (Bankr. E.D. Mich. 2014).

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In January 2020, the U.S. Supreme Court declined to review the First Circuit's ruling, leaving it as binding precedent only within the First Circuit's jurisdiction.<sup>18</sup> This includes the Commonwealth of Puerto Rico and such states as Maine, Massachusetts, New Hampshire and Rhode Island. By denying *certiorari*, the Supreme Court left open the broader question of whether § 922(d) mandates continued payments on special revenue bonds during chapter 9 bankruptcies. Outside of the First Circuit, courts remain free to adopt differing interpretations, further fragmenting the legal landscape.

## Efficiency Measures for Local Governments and Their Integration into Chapter 9

Local governments can increase efficiency by taking measures already underway at the federal level, including streamlining operations, improving financial transparency and leveraging technology. These measures can be particularly effective when integrated into the chapter 9 framework and a confirmed plan, as they address both the root causes of municipal distress and the challenges of restructuring. Below are some recommendations and how they can be better implemented within an improved chapter 9 adjustment plan.

### Streamlining Operations

**Consolidation of Services:** Local governments can consolidate redundant services, such as merging fire departments or public works divisions across neighboring municipalities. This reduces overhead costs and improves service delivery. For example, the Northeast Ohio Regional Sewer District consolidated wastewater treatment across multiple municipalities, generating millions in annual savings through economies of scale while improving environmental compliance.<sup>19</sup> Furthermore, neighboring municipalities can establish formal agreements to share specialized services, equipment or staff to reduce overhead costs across several local governments.

**Outsourcing Noncore Functions:** Functions like waste management, information-technology services and payroll processing can be outsourced to private contractors, often at a lower cost than maintaining in-house operations. This is a key area that the federal government is focused on, and state and local governments can leverage similar efficiency measures. A streamlined and transparent request-for-proposal process, with discounted government pricing, can add considerable cost savings and help cut budget deficits. For example, the city of Sandy Springs, Ga., has adopted a hybrid model outsourcing a significant portion of its municipal services, which resulted in significant cost

savings and improved efficiency, indicating the potential and possibility of such measures.<sup>20</sup> Municipalities can also join purchasing cooperatives to secure volume discounts on everything from vehicles to office supplies, like how the U.S. Communities Government Purchasing Alliance has helped thousands of public agencies reduce procurement costs through aggregated purchasing power and negotiated government rates.<sup>21</sup>

### Improving Financial Transparency

**Real-Time Financial Reporting:** Implementing modern financial-management systems that provide real-time data on revenues, expenditures and liabilities can help local governments make informed decisions and avoid fiscal mismanagement. New York City's Financial Management System provides real-time budget tracking and has been instrumental in maintaining fiscal discipline.

**Independent Audits:** Regular audits by independent firms can identify inefficiencies and ensure compliance with financial best practices. Philadelphia is moving toward outcome-based budgeting, aligning resources with strategic outcomes and results, and it has implemented participatory budgeting to allow residents to have a direct say in how public funds are spent.<sup>22</sup>

### Leveraging Technology

**Digital Transformation:** Adopting digital tools for citizen services (*e.g.*, online permit applications and property tax payments) can reduce administrative costs and improve accessibility. Investing in IoT sensors and smart infrastructure can reduce long-term maintenance costs.

**Data Analytics:** Using data analytics to optimize resource allocation, such as predicting peak demand for public services, can enhance efficiency. Los Angeles implemented a data-driven approach to reduce traffic congestion and improve public transportation efficiency.<sup>23</sup>

### Pension and Labor Reforms

**Switching to Defined Contribution Plans:** Moving from defined benefit pensions to defined contribution plans can reduce long-term liabilities. Michigan's 2017 public school employee pension reform created a hybrid system that reduced future unfunded liabilities while providing competitive retirement benefits.<sup>24</sup>

**Negotiating Labor Contracts:** Renegotiating labor contracts to align wages and benefits with fiscal realities can help control costs. Rhode Island's 2011 pension reform, which

20 "A Failure of Privatization — or a Sound Adaptation to the Market? The Sandy Springs Story," Opportunity Now (March 25, 2025), [opportunitynowsv.org/blog/-a-failure-of-privatization-or-a-sound-adaptation-to-the-market-the-sandy-springs-story-24](https://opportunitynowsv.org/blog/-a-failure-of-privatization-or-a-sound-adaptation-to-the-market-the-sandy-springs-story-24).

21 "U.S. Communities Keeps Public Agencies Nimble," Nat'l Ass'n of Counties (Feb. 20, 2018), [naco.org/articles/us-communities-keeps-public-agencies-nimble](https://naco.org/articles/us-communities-keeps-public-agencies-nimble).

22 "Participatory Budgeting," City of Philadelphia, [phila.gov/programs/participatory-budgeting](https://phila.gov/programs/participatory-budgeting).

23 Jason Shueh, "How Los Angeles Is Using Big Data to Improve Traffic," StateScoop (Dec. 4, 2017), [statescoop.com/how-los-angeles-is-using-big-data-to-improve-traffic](https://statescoop.com/how-los-angeles-is-using-big-data-to-improve-traffic).

24 Leonard Gilroy, Anthony Randazzo & Daniel Takash, "Michigan Adopts Most Innovative Teacher Pension Reform in the Nation," Reason Found. (June 16, 2017), [reason.org/commentary/michigan-adopts-most-innovative-teacher-pension-reform-in-the-nation](https://reason.org/commentary/michigan-adopts-most-innovative-teacher-pension-reform-in-the-nation).

18 *Andalusian Global Designated Activity Co. v. Fin. Oversight & Mgmt. Bd. for Puerto Rico*, cert. denied, 141 S. Ct. 1059 (2020).

19 Emily Simonson, "Leading on Regional One Water Partnerships," U.S. Water Alliance (Aug. 28, 2024), [uswateralliance.org/leading-on-regional-one-water-partnerships](https://uswateralliance.org/leading-on-regional-one-water-partnerships).

included suspending cost-of-living adjustments and raising retirement ages, significantly reduced the state's unfunded pension liabilities.<sup>25</sup>

## Integrating Efficiency Measures into Chapter 9

A chapter 9 framework that integrates efficiency measures in the plan of adjustment of debt can enhance municipal efficiency by mandating cost-saving measures as part of bankruptcy plans, ensuring long-term fiscal sustainabil-

ity. Courts could appoint independent financial monitors to oversee implementation, improving accountability. Creditors might support efficiency measures if offered higher recoveries tied to cost-saving targets. Essential services like public safety could be protected while restructuring other obligations. Streamlined negotiation processes, including mediation, could resolve disputes faster.

By embedding efficiency measures within chapter 9, municipalities gain a legal framework for enforcement, creditor confidence and long-term stability, thus reducing the likelihood of future distress. This approach ensures that operational reforms are prioritized during restructuring, benefiting both municipalities and creditors. **abi**

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25 Anthony Randazzo, "Pension Reform Case Study: Rhode Island," Reason Found. (Jan. 15, 2014), [reason.org/policy-brief/pension-reform-rhode-island](https://reason.org/policy-brief/pension-reform-rhode-island).