



Overview of Municipal Financial Crises and State Responses

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Overview

- Fiscal Challenges and Potential Action of Municipalities and States in General
- Select State Situations, Options and Responses
- Specific Case Studies: Harrisburg, PA; Detroit, MI; Washington, DC

* Most information contained in this presentation is from Pew Research Study: *“The State Role in Local Government Financial Distress”* and Governing Magazine unless otherwise noted.

Fiscal Challenges Facing States and Localities

- State intervention into the affairs of a local government are not uncommon (e.g. natural disasters, failing school systems, etc.)
- As manufacturing facilities have closed in the United States, many jobs that used to exist and provided for thriving communities in the Northeast, Midwest and Southeast are no longer available
- The effects of the Recession of 2007-2009 are still felt in many former manufacturing regions of the country and contribute to municipal fiscal stress:
 - According to Pew, local governments were the last to emerge from this most recent economic downturn because of the “lag time” between the ***decline in home values and the drop in property tax revenue***. In addition to the decline in real estate tax revenue, states have cut aid to local governments
 - These 2 sources, which together account for ***more than half of local revenue, dropped simultaneously*** for the first time since 1980
- Fiscal mismanagement, especially of major projects, corruption, and ill-advised revenue systems can contribute to municipal fiscal stress
- Finally, when employment opportunities drop significantly in a region, inevitably the ***population will depart in search of jobs*** causing substantial declines in large population centers and symbiotic smaller, local communities

One Last Consideration – Loss of Federal Funds

Many of the municipalities that experience fiscal distress and crisis are dependent upon State and Federal government funds to meet the needs of their citizens. ***There is great risk that these funds may be misused, discontinued or clawed back as a result of increased municipal mismanagement of a fiscal crisis.*** According to a recent GAO report:

1. The diminished capacity of municipalities in distress hindered their ability to manage their federal grants in several ways:

- Reductions in the number of city employees may greatly reduce the ability of some cities to carry out grant compliance and oversight responsibilities
- Loss of human capital capacity may also lead to loss of institutional grant management skills,
- Decreased financial capacity may reduce some municipalities' ability to obtain federal grants due to a sudden loss of requisite matching funds, and
- Outdated information technology (IT) systems may hamper municipalities' ability to oversee and report on federal grants

2. ***We know our localities continue to be awarded federal funds despite fiscal stress***

- Can we be assured they won't misuse or redirect these funds for other purposes?
- Can we be assured they have not fired the people with the institutional knowledge to manage these grant programs, or that the localities continue to have the staff to manage the number of grants they have received?
- Do they still have the ability to provide matching funds to qualify for much need federal funds to serve the needs of Virginia's citizens?

Three Stages of Municipalities in Danger

States that have a well-defined system to routinely monitor the fiscal health of local governments have the opportunity to address any problems before they become institutional and unmanageable

Some states define the conditions that trigger different levels of state response for localities heading into trouble, such as: budget deficit, late payments to vendors, inability to meet payroll or pay bondholders, losses from bad investments, and failure to keep up with pension payments

1. **Distress** – One or more of these indicators in one or more consecutive years may serve as a trigger mechanism requiring a detailed review of local finances
2. **Crisis** – For localities that are unable to rectify the difficulties identified as problematic, a more firm response may be required by the state in order to head off further fiscal decline, including appointing an emergency manager or financial control board.
3. **Bankruptcy** – Locality is forced to file Chapter 9 bankruptcy in federal court. That takes the solution to the problems out of the hands of the elected officials, which may have a positive or negative impact upon those affected by municipal fiscal mismanagement.

States and Municipal Bankruptcy

According to the Pew Research Study:

- 12 states specifically authorize bankruptcy filings by localities
- Another 12 states have conditional authorization
- 3 states have limited authorization and 2 states generally prohibit localities from filing for bankruptcy
- The remaining 21 states provide NO authorization or prohibition for a municipal bankruptcy filing
- *Virginia is not one of the states that permits localities to file for bankruptcy*
- Federal judges decide municipal bankruptcy cases, but judges cannot liquidate localities
- Municipal bankruptcies are rare (55k municipal governments in US that sell bonds; only 276 have filed since 1980)
- Almost every recent emergency can be traced to a one-time blow or a structural problem that worsened over time
- It is possible that legal fees paid by a locality during the process may offset bankruptcy savings & subsequent surpluses could be realized through restructuring

States and Intervention: Some Common Denominators

- Some states are reluctant to involve themselves in local, financial affairs unless given no alternative due to the rapid deterioration of government structures and inability to perform basic functions
- Pew Research conducted this study and examined the range of state involvement in local government finances. Their findings illustrate the following, in brief:
 1. *Fewer than half* the states have laws allowing them to intervene in municipal finances; some states are Home rule, some are Dillon rule; some are a hybrid
 2. *Intervention practices vary* among the 20 states that have such programs
 3. *State behavior*, for the most part, *is reactionary* and not preventative
 4. *States intervene to protect their own financial standing*, that of other municipalities, as well as to maintain public safety and health
 5. Some *state interventions can be aggressive*, and
 6. *Local officials often resent state officials* for infringing upon their right to govern their own affairs

Intervention: Different Approaches & Responses

- States have enacted intervention laws to provide *an alternative to a municipal bankruptcy* or prevent a municipality from filing for bankruptcy
- **Intervention practices** vary among states but include some of the following:
 - Order an assessment; designate a receiver, emergency manager or financial control board
 - Provide power and authority to restructure debt or labor contracts; raise taxes & fees; offer state-backed loans or grants; provide technical advice or even dissolve local government
- Some states, like MI, NC, PA and RI, have extensive resources made available for local financial crises that provide for a more aggressive & flexible response
 - Others, such as CA and AL have almost no support system, or, as in the case of New York, found ways to provide assistance without providing direct aid
 - *States that have some kind of plan for intervention, or closely monitor the financial health of localities, are viewed positively by Moody's Corporation, Standard & Poor's and Fitch credit rating organizations*
- Local governments that become dysfunctional and suffer from severe political inability to resolve their fiscal problems will themselves unify in opposition to remedies that appear to be forced upon them due to *resentment over interference in their affairs*

Intervention Practices - Tools in the Toolbox

- **Debt** – 15 of 20 states allow for the receiver, state agency or control board to approve bond sales or renegotiate the terms of existing bonds. New York state established third party corporations to sell bonds to help specific localities raise money and balance their budgets
- **Emergency Financing** – 14 states provide no-interest or low-interest loan, grants or credit guarantees – transitional financing – but in practice few offer these options due to dwindling state revenues and a reluctance to build dependency and expectation among other localities
- **Technical Assistance** – All states with intervention programs, except New Hampshire, offer technical advice to fiscally stressed localities. These services include, but are not limited to, the following: auditing records, creating a financial plan, putting together a balanced budget, negotiating and approving labor and other contracts, and approving spending
- **Taxes, fees & credits** – 11 states give intervenors authority to raise existing taxes and fees or implement new ones, as well as reduce city services, if warranted
- **Dissolving or consolidating local government involuntarily** – MI, NV and TN allow the intervenor to dis-incorporate and dissolve a city and consolidate it with other nearby jurisdictions
- **Labor** – 7 states permit intervenors to renegotiate existing labor contracts, including multi-year agreements that call for increases in salaries, benefits or other compensation. In some instances, recommendations may be made for the termination of current public employees by the local government authority, as well as consent for any new hires

Some States and Some Details

North Carolina – According to Pew, the Tarheel State has one of the strongest local government oversight systems in the country

1. Established a **Local Government Commission (LGC)**

- Professional staff and a nine-member board
- This state agency approves all local bond projects
- Monitors all government financial reports; issues warnings and recommendations
- Can step in and act as a financial control board to run a locality's day-to-day operations while the local government fixes the underlying problems

2. North Carolina has a **single, consolidated public sector pension system**

3. **LGC** relies on fund balances to determine fiscal health of locality (minimum 8% difference between assets & liabilities)

- Many NC localities require over 8% minimum
- Local Government Commission will not approve any bond projects if the fund balance is below the minimum

The three large credit rating agencies that evaluate municipal bonds have rewarded NC communicates with bond ratings higher than those in most of the United States, as a result of the LGC's work

Some States and Some Details

Rhode Island – When Central Falls, RI went into a receivership in 2010, the State acted quickly to protect the credit rating of other RI localities by replacing the current, limited intervention program with one that enabled Rhode Island to get involved with distressed cities earlier

- **Central Falls had multi-million dollar budget deficits; cash divided in 54 separate accounts; unpaid bills stuffed in a drawer; and, \$80m shortfall in pension/benefits owed versus what was set aside**
- Up until then, state law called for a budget commission to take over a city's finances only after it defaulted on its debt or if its bond rating dropped to junk grade

The revised program included, but was not limited to, the Director of the state Department of Revenue supervising a graduated, 3-step process for financially shaky cities:

1. State appoints an overseer to advise officials on city's ability to balance budget
2. Director could then appoint a budget commission, which supplants the city's elected officials; Commission consists of the Mayor, chief local legislative official, and 3 state appointees
3. If the Commission can't balance the budget then a the State appoints a receiver, whose powers include declaring the city bankrupt

By the end of 2010 three more cities joined the list of RI's distressed cities, followed soon after by the capitol, Providence

Some States and Some Details – Rhode Island (cont')

- **Central Falls, RI** was in such dire shape that it was put directly into receivership and eventually declared bankruptcy. The most noteworthy action taken by the State in 2011 in its rehabilitation of the fiscal system in Central Falls was that *bondholders would be given preferential treatment for reimbursement over all other creditors*
 - This decision was based upon Rhode Island's desire to protect the future borrowing interests of its localities and the State
 - Bondholders were to be paid in full and could place liens on city revenues
- This concern seems to be widespread as various States address municipal fiscal stress and crises
 - The ability to rehabilitate and reform the fiscal management systems of a locality are one important part of any intervention plan
 - A locality must be able to secure future debt on its own if it is to stand on its own and determine its own future
- There are alternatives but this provides for less state intervention, as opposed to increased state support in the form of issuing bonds on behalf of the locality or other potentially more complex options

Some States and Some Details

Alabama – Has no intervention laws and has a history of apathy toward non-disaster-related fiscal stress in its localities. No monitoring

- Recently, its largest county, Jefferson County, filed for bankruptcy due to corruption and mismanagement surrounding a rebuild of its sewer system; loss of 25% of its GF revenue; and rising costs of a new public hospital
- The Dillon rule state will not give the County permission to raise revenue, nor will it provide a subsidy for the hospital or take on the debt for the sewer system
- In the past, many of Alabama’s problems have had to be resolved by the federal government and courts (e.g. crowded prisons, inadequate mental health care, civil rights protections, etc.)

California – Has intervention laws specific to the school districts which it has had a long-term and direct relationship that was strengthened in 1991. No municipal monitoring

- Since then, the State has required county offices of education to monitor school district revenue, enrollment, spending, cash flow, debt and other costs
- If the county identifies problems and cannot solve them on its own, the State can intervene in a number of ways: providing a loan from GF revenue; State can issue bonds to help county repay the loan; and, appoint an administrator to run the district until it is solvent once again
- In 2011 California passed a **60-day “mediation period”** for municipal crises that permit all interested parties to come to an accommodation. Still permits bankruptcy filings but is designed to encourage cooperation

Case Study: Harrisburg, PA



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Harrisburg, PA – The primary driver of Harrisburg's fiscal crisis was a mismanaged infrastructure project that ended up costing more than 3x what is started out

1. In 1982 the new mayor came into office in charge of a city faced with bankruptcy. Rather than file, Mayor Reed decided to turn things around and was successful for 20 years
 - In 2004 Harrisburg decided to retrofit an old waste-to-energy incinerator, and expand its capability by 1/3. The City created an Authority and agreed to issue debt in conjunction with the surrounding county (Dauphin)
 - Contractor was selected (lowest bid), and after allegedly conducting due diligence work began with an estimated price of \$77m (1/3 less than competitors' bids)
2. The City did not follow standards for securing project cost or debt in case it went awry
 - Did not hire a project manager; Company was its own PM
 - Penalties were part of contract for delays or cost overruns, but Company not financially able to pay fines
 - Authority released the retainage fee (\$7m) in 2005 to keep project alive after it ran into trouble, thus no reserve or leverage
 - ***Lastly, no performance bond was secured***, as the Company did not qualify to be bonded. An ad hoc array of less impressive guarantees was cobbled together and approved by the City's legal counsel

Case Study: Harrisburg, PA (cont.)

3. Company is fired and a replacement company is brought in 2006
 - Incinerator site is a disaster; the new 3rd boiler has been cannibalized to restore the original two
 - Now, instead of making enough revenue to pay the debt, the facility is expected to lose \$1million/month
 - ***Project management failure is now turned into a political debacle and leadership failure***
4. Mayor and Council cannot agree on a plan to get recover and sue each other over power to make appointments to the Authority
 - Mayor is ousted in election 2009
5. Council rejects new mayor's solutions (e.g. higher taxes & fees, lease property, etc.)
 - Hired a consultant to sort out the problem but did not act on recommendations
 - Council refused to accept \$850k offer from an outraged Governor Rendell to pay for a consultant to fix the problem; ***also refuses to pay bondholders 1st as part of any recovery plan***
6. The original average estimate for this project was \$120m and now costs approximately \$288m and rates charged by facility are \$200/ton, far in excess of average cost or projection
 - ***Dauphin County sued Harrisburg for not making its payments forcing County to cover debt***
 - Harrisburg at one time owed \$34m in payments due (12/14/2010)
7. Bankruptcy judge denies City application (2011); ***SEC charges Harrisburg, currently in receivership under (Pennsylvania's ACT-47), with securities fraud for providing misleading statements about its financial status (2013)***

Case Study: Detroit, MI



Detroit Blight Authority photos

Case Study: Detroit, MI

According to the Pew report, *Michigan's unemployment increased from 3% to 14%* - well above the national average of 10% - *from 2000 to 2010*. The Great Recession made this problem worse

- As a result of increasing municipal strain, the *State strengthened its pre-existing emergency managers law in 2011*, in particular allowing them to break union contracts to control rising labor costs. It also gave the State authority to intervene earlier if it was determined necessary after a financial review

Detroit – Deindustrialization, decaying schools, increasing crime, and the foreclosure crisis brought on by the Great Recession all contributed to the decline of this iconic city. Since 2000 Detroit lost 25% of population, severely impacting revenue stream

1. A political crisis driven by corruption in city hall accompanied this rapid urban decline and ended with the removal of the Mayor, but the City was distracted from attending to its problems

2. After an April 2012 financial review, Governor Snyder appointed an emergency manager (EM) with the power to remake Detroit's budget and services 2013, but it could not be repaired in time to avoid bankruptcy

3. *There were approximately 70k vacant lots; tens of thousands (no one really knows exact figure) of abandoned houses; massive unemployment*

- The number of city government employees decreased from 29k (1951) to 10.5k (2013)
- Decrease in property taxes (residential & commercial); drop in income taxes and payees into a city retirement system

Case Study: Detroit, MI (cont.)

4. Budget deficit in 2012 was \$327m; it rose throughout 2013 to \$380m with a total city, long-term obligations of \$15b by 2012
 - No money for salaries for public safety or schools leads to increased layoffs, which translates to *one-hour average wait times for a 911 response* and class sizes so large that *teachers walked out, shutting down 64 or 97 schools*
5. In July 2013, the EM for Detroit sought and received permission from the Governor to file for bankruptcy, which triggered a 1-3 month review to determine eligibility
 - EM met with labor leaders, pension holders and other creditors but was unable to reconcile differences. *Total debt and unfunded liabilities at time = \$18b*
 - State constitution provides for pension protections, so unions and retiree groups felt they did not need to negotiate
6. By December-2013, 40% of Detroit residents were living in poverty; federal bankruptcy judge finally agreed to permit the City to proceed into Chapter 9 protection
 - One aspect of Judge Steve Rhodes' 140-page, unprecedented opinion was his decision making it clear that the entitlements could be subject to cuts in municipalities under Chapter 9 protections. *He concluded that the City's pension debt was similar to other creditor debt, and that any State constitutional protections for pensions did not apply in federal bankruptcy court*
7. Detroit exited bankruptcy November-2014, after 18 months of being run by an EM; will have a Financial Review Commission oversee finances for decade and "investment committee" to oversee pension decisions

Case Study: Washington, DC



Case Study: Washington, DC

Washington, DC – After considering numerous options, including bailout, bankruptcy & reversion, in April-1995, the 104th Congress passed H.R. 13451 (Public Law 104-8) also known as the *District of Columbia Financial Responsibility and Management Assistance Act of 1995* (the ‘Act’)

1. The Congress made a series of observations abutted financial condition and management of the District of Columbia (DC or ‘the District’) before committing to this strategy

- In 1991, the Rivlin Commission recommended a financial strategy to restore the budget and long-term finances of the District. This plan contained an additional \$1 billion dollars from Congress and included some form of general obligation bond issuance
- GAO issued a report in Summer-1994 concluding the District was faced with both unresolved long-term financial issues and continual short-term fiscal crises
- *In Fall-1994, Congress warned the new Mayor and Council about the situation and mandated \$140m in reductions to expenditures for DC’s FY1995 appropriations, capping the number of city government employees, and increasing financial reporting requirements*
- Mayor Barry, in his revised FY 1995 budget asked for \$267m additional revenue and lifting the spending cap. Moreover, for his FY1996 budget, Mayor Barry called for less than 3% cuts in spending and 200 additional employees

2. While the District finances appeared to be nearly balanced, in actuality the city government was deferring pension payments each year from 1991 through 1994

3. In addition, DC’s budgeting process annually overestimated revenues & underestimated expenses since 1991; Mayor playing shell game with number of employees & Medicaid data

Case Study: Washington, DC (cont')

1. **The Intention of the Act was four-fold:**

- Create a 5-member financial control Authority appointed by President in consultation with Congress
- Heighten the responsibilities of the District of Columbia Inspector General to conform with the Federal Inspector General regulations/criteria
- Create the position of **Chief Financial Officer (CFO) of the District** to be appointed by the Mayor with the advice of the Council and confirmation by the Authority
- Create a detailed and extensive 5-year financial plan for the District

2. **Powers of the financial control Authority**

- Can hire professional staff, experts, consultants, etc
- May obtain information from Federal and District agencies; District must comply
- Authority has civil enforcement and subpoena power; it must comply with Sunshine Act and FOIA
- Authority has 30-day period to review Mayor's 5-year financial plan & budget, approve or reject
 - After two tries at reconciling Council and Mayor's plan and budget, documents forwarded to President and Congress with Authority's recommendations
- Mayor must submit 4 quarterly reports to Authority to ensure balanced budget

Case Study: Washington, DC (cont')

2. Powers of Authority (cont')

- Has right to review all contracts for compliance with financial plan; must review all labor contracts for compliance and may recommend revisions to financial plan to bring it into compliance with budgetary guidelines
- *District MAY NOT borrow funds without approval of the Authority; Treasury funds are deposited with the Authority, as are borrowed funds*
- City must notify the Authority if it does not adopt any specific recommendation along with reasons for that action
 - *Authority may implement rejected recommendations after consultation w/ Congress*
- If the Authority goes into a “non-control” period it can be re-initiated

3. Home Rule Act is amended to provide for the position of a CFO

- The CFO is appointed by the Mayor during a control period with approval of the Council and the Authority
- During control periods if the CFO is dismissed it must be with the approval of the Authority; *the CFO supervises and performs all the financial responsibilities of the Mayor, as well as all the duties normally assigned to that position*

4. New standards for the existing District Inspector General (IG) are also included in Act

- The IG budget cannot be reduced or altered by the Mayor or the Council; appointed for a 6-year term