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Memorandum

To: Ric Brown, Virginia Secretary of Finance
From: David Eichenthal and Randall Bauer, PFM
Re: State Approaches and Recommendations for Virginia Distressed Cities

As the City of Petersburg, Virginia continues to struggle to pay its bills and balance its budget, the Commonwealth is considering policy, programmatic and legislative responses that would allow it to more effectively intervene to prevent additional cities from facing similar challenges. Petersburg's fiscal distress is symptomatic of how the combination of economic challenge and poor fiscal management can create severe fiscal distress.

This is not a problem unique to Virginia. Hundreds of cities across the nation face similar challenges. And while economic decline does not necessarily lead to fiscal distress, it often places pressure on local government finances, which may lead to a loss of tax base and increased demand for service. Other states – and the federal government – have taken steps to address this issue. Our understanding is that Virginia seeks to do the same.

As a firm, Public Financial Management Group Solutions (PFM) has worked with distressed local governments for the last twenty years – both as a direct service provider to local governments and when appointed or hired by state governments to assist these distressed governments. In addition, PFM helps to lead a federally funded, White House initiative designed to enhance the fiscal health and economic competitiveness of economically challenged cities. Based on our experience and subject matter expertise, PFM provides the following review of how states approach the issue of local government fiscal distress as well as recommendations tailored to the Commonwealth's unique relationship with its local governments.

In this analysis, we:

1. Identify and explain existing state approaches and programs that provide assistance and support to distressed local governments.
2. Identify and explain existing indicators that are used in other states and/or might be used in the Commonwealth to identify distressed local governments and/or trigger additional levels of scrutiny or assistance.



3. Recommend approaches for the Commonwealth to consider in assisting distressed local governments.

Overview of the State–Local Government Relationship

State-local government relationships vary greatly from state to state. Generally though, cities and other local governments function as political subdivisions of the state. To varying degrees nationally, local governments rely on state government for funding support and their daily operations and financing are subject to state law and regulation.

There are generally two approaches to the state and local government relationship: Dillon's Rule and Home Rule.

Dillon's Rule is based on two court decisions issued by Iowa Judge John Dillon in 1868. This narrow interpretation of a local government's authority provides that the state must specifically sanction local government activities. Dillon's Rule was upheld by the U.S. Supreme Court in 1903 and again in 1923.

State constitutions and statutes vary in the level of power they grant to local governments. In the cases where there is doubt as to local government powers, Dillon's Rule requires specific authority for those powers to exist. As a result, Dillon's Rule allows state control over local government structure, methods of financing its activities, its procedures and the authority to undertake functions. Currently, 39 states, including Virginia, generally follow Dillon's Rule.

Dillon's Rule often results in local officials spending considerable time and effort lobbying the state legislature to approve bills granting local authority and disapprove bills imposing restrictions. The inflexibility of this system is one reason that many states began to adopt "Home Rule" provisions in the early 1900s, which provided greater authority to their local governments. Home Rule is a delegation of power from the state to its local governments. While generally limited to specific areas, Home Rule reduces direct state control over local government and governance. There are currently 10 states that employ home rule (although some others grant home rule status to certain local governments). The one remaining state, Florida, is aligned with the other Home Rule states except for revenue issues, which are reserved to the State.¹

Fiscal Distress and the State-Local Government Relationship

Local governments are uniformly dependent on state authority when it comes to the most extreme response to severe fiscal distress -- bankruptcy. Under Chapter 9 of the Federal Bankruptcy Code, local governments can declare bankruptcy only with state legal authorization to do so.

¹ A general discussion of the state-local government relationship is found on the National League of Cities website at <http://www.nlc.org/build-skills-and-networks/resources/cities-101/city-powers/local-government-authority>



Yet, there is significant state-to-state variation even in this area. Twelve states specifically authorize Chapter 9 filings for local governments and 12 states conditionally authorize them. In the remaining 26 states (which includes the Commonwealth of Virginia), there is either no specific authorization or it is expressly prohibited.²

Even before fiscal distress reaches the point where a local government is considering bankruptcy, different states take varying approaches to fiscal distress. In fact, most states don't actually have a clear approach. Just 22 states have some formal process for monitoring the financial health of their municipalities by actively and regularly reviewing financial information and only 15 states have statutes that define local fiscal distress.³

Existing State Approaches and Programs

There are four approaches that states take to address local government fiscal distress:

- Reporting and Monitoring
- Assistance
- Oversight
- Control

Reporting and Monitoring

The most basic approach to monitoring is for local governments to report budget or other financial information to the state and for the state to review that information. Often, reporting and monitoring can be the first step in a state's response that ultimately leads to assistance, oversight and/or control.

In **Georgia**, the Department of Community Affairs (DCA) reviews local government budgets and other financial management decisions on an annual basis. Local governments that have financial statements that do not comply with generally accepted accounting principles are required by DCA to submit audited financial reports to the State Auditor. State agencies are prohibited from transmitting grant funds to a local government that fails to submit an audit within the previous five year period. The State prohibits municipalities from filing for Chapter 9 bankruptcy and does not provide financial assistance to distressed municipalities. If a local jurisdiction faces insurmountable financial problems, the law directs that the municipality be dissolved and its assets and related liabilities will be transferred to the County.⁴

In 2013, the State of **Louisiana's** Legislative Auditor (LLA) developed an early warning system, composed of ten key financial ratios and other indicators, to flag local governments headed toward

² Governing Magazine has identified state-by-state bankruptcy laws for local governments, which were taken from multiple sources. Accessed electronically at <http://www.governing.com/gov-data/state-municipal-bankruptcy-laws-policies-map.html>

³ The Pew Charitable Trusts. *State Strategies to Detect Local Fiscal Distress* (September 2016).

⁴ Georgia Code, Chapter 36-80-1.



fiscal distress.⁵ This tool, known as the Local Government Reporting System, uses information found in a municipality's Government-wide Financial Statements of the Primary Government, Governmental Fund Financial Statements of the General Fund, and Notes to the Financial Statements of the Primary Government to detect signs of possible financial distress.⁶

In **North Carolina**, the Local Government Commission reviews city audits with a focus on what are determined to be key fiscal indicators. In particular, the Commission monitors the level of fund balance and establishes threshold levels on a city-by-city basis. Should a city not meet the threshold, it is subject to an increased level of scrutiny (which goes beyond mere reporting and can include a required improvement plan and monitoring of its progress in meeting that plan).

In **Ohio**, the State Auditor's Office monitors local governments by providing them with ratio indicators to benchmark financial performance and identify fiscal distress. The State Auditor collects financial data on local governments through the state's Uniform Accounting Network (UAN). The UAN is a very low cost accounting software program provided to local governments. If a municipality decides to use the program, it must agree to allow the State Auditor to access and analyze its information. More than 70 percent of Ohio's local governments use the system. The State Auditor uses the financial data to monitor their fiscal condition and may recommend that a municipality enter one of the following three programs, based on the severity of financial distress:⁷

- **Fiscal caution:** control stays in the hands of the local officials. The city is given 60 days to develop and submit to the Auditor's office a plan to eliminate the conditions that prompted the fiscal caution declaration.
- **Fiscal watch:** the Auditor may provide technical assistance and support services. Costs for the support are borne by the State.
- **Fiscal emergency:** municipalities come under the oversight of a financial planning and supervision committee. The Auditor serves as the "financial supervisor" to the committee. The committee approves a financial recovery plan containing actions to essentially eliminate fiscal emergency conditions, balance the budget, avoid future deficits and market long-term obligations. Specific conditions must be met in order to terminate fiscal emergency.

In **Connecticut**, the State's Municipal Finance Advisory Commission was created to advise financially struggling local governments. The statutory, eight member body appointed by the Governor is responsible for reviewing proposed regulations regarding the standards for municipal audit reports and working with any municipality, referred to it by the State Office of Policy and Management, to improve the fiscal condition of that municipality. Though local governments are not required to

⁵ The Pew Charitable Trusts. *State Strategies to Detect Local Fiscal Distress* (September 2016).

⁶ Louisiana Legislative Auditor, *Local Government Reporting System User Guide* (November 2014).
<https://app.la.state.la.us/ewdataentry.nsf/Instructions%20for%20using%20Local%20Government%20Reporting%20System.pdf>

⁷ Ohio Auditor, Local Governments and Fiscal Distress. Accessed January 6, 2017.
<https://ohioauditor.gov/fiscal/local.html>



report distress to the Commission or implement the commission's recommendations, this approach offers cities an intermediate step to avoid more serious state courses of action (discussed in greater detail later in this report).

Assistance

There are several states that provide some form of assistance to distressed local governments. This can include targeted state appropriations, particularly if they reduce local expenditure burdens (and if state prohibitions against preferential treatment do not apply). It can also include assistance or resources that will improve local operations or the ability to respond to specific management or other concerns.

A leading example of an assistance approach is provided by the Commonwealth of **Pennsylvania** Early Intervention Program (EIP). The EIP seeks to address fiscal problems before they become severe. Local governments must apply for grant assistance under the program. If approved, they may hire an independent financial and management consultant to quantify the multi-year financial situation, suggest short-term corrective actions and prepare a three to five-year plan with longer-term corrective actions. For the qualifying local governments, the Commonwealth provides grants of up to \$200,000 for 50 percent of the total project cost.⁸

New York operates a Financial Restructuring Board for Local Governments, a ten-member panel created to offer assistance to eligible municipalities. Any county, city, town or village deemed a Fiscally Eligible Municipality by the Board can request a comprehensive financial review. Based on this review, the Board makes recommendations to improve financial stability, management and the delivery of public services. In addition, the Board can offer grants and/or loans of up to \$5 million through the Local Government Performance and Efficiency Program for implementing the Board's recommendations.⁹

As explained in the previous section, the State of **Louisiana's** Legislative Auditor (LLA) has developed an early warning system to flag local governments headed toward fiscal distress. The LLA also provides technical assistance, trend analysis and voluntary corrective action strategies; the LLA may help municipalities estimate how much additional revenue they would need in order to eliminate deficits and explore potential cost-cutting measures.¹⁰

Nevada has an expansive monitoring and technical assistance program, which was created as a result of North Las Vegas' fiscal crisis following the Great Recession. Under the program, if the State

⁸ See Early Intervention Program Guidelines, Governor's Center for Local Government Services, Department of Community and Economic Development, January 2009, p. 1, http://www.newpa.com/sites/default/files/uploads/early-intervention-program_guidelines-jan09.pdf (December 8, 2014). A general description of the Pennsylvania assistance for municipal governments can be accessed electronically at <http://dced.pa.gov/programs/municipal-assistance-program-map/#.WHUM2lMrKM8>.

⁹ New York State Financial Restructuring Board for Local Governments. Accessed January 6, 2017. <https://frb.ny.gov/>

¹⁰ The Pew Charitable Trusts. *State Strategies to Detect Local Fiscal Distress* (September 2016).



identifies a serious issue, the city is put on fiscal watch, and the Committee on Local Government Finance provides technical assistance on budgets, contracts, spending, and debt management in order to avoid more serious state intervention.¹¹

New Jersey offers transitional aid to assist cash-strapped cities. In order to be eligible, the municipality must:¹²

- Demonstrate reductions or limited increases in salary and wage costs
- Introduce a levy containing a tax increase of no less than the maximum permitted by the levy cap or 6 percent, whichever is less
- Demonstrate severe fiscal distress that will result in a constrained ability to raise sufficient revenues to meet budgetary requirements
- Show in its budget spending restraint from the previous fiscal year

Oversight

State oversight often includes some level of prohibition on operational spending and may also include the ability to modify existing arrangements, such as collective bargaining agreements. It may also include a state intercept of revenues to be dedicated to state oversight functions.

In **Florida**, the Local Government Financial Emergency Act provided for the creation of a Financial Emergency Oversight Board. The Board is triggered when a local government fails to meet any of the following conditions: pay debts, transfer taxes withheld on the income of employees, make payroll or address operating deficits. The Governor appoints all members of the Board. Once constituted, the Board has broad authority over municipal fiscal affairs including budgetary and debt approval, and the power to review operations and management. In addition, the Board can limit the financial impact of collective bargaining agreements (similar to Pennsylvania's Act 47). As a last resort, and with Board approval, the local government may file for Chapter 9 bankruptcy.¹³

Florida law also enables a municipality to declare "financial urgency" and reopen existing labor contracts and modify the agreement. Upon declaring a financial urgency, the executive of the local government and the collective bargaining unit will meet to renegotiate a labor agreement. The two parties have 14 days to reach an agreement. If none is reached, the parties proceed to mediation and follow the contract's provisions for impasse resolution.

Rhode Island requires that local governments file annual independently audited financial statements and report budget information quarterly to the State Office of Municipal Affairs. If a local government incurs ongoing deficits that result in a negative fund balance, it must implement a recovery

¹¹ Nevada Department of Taxation. "Committee on Local Government Finance."

https://tax.nv.gov/Boards/Committee_on_Local_Govt_Finance/Committee_on_Local_Government_Finance/

¹² New Jersey Department of Community Affairs, Division of Local Government Services. "Local Finance Notice." February 9, 2016. <http://www.nj.gov/dca/divisions/dlgs/lfns/16/2016-04.pdf>

¹³ Florida Statutes Chapter 218, Section 5.



plan. The state has an intervention plan that includes additional reporting requirements. This can, if it advances to another stage, include the appointment of a receiver.¹⁴

Michigan requires local governments to file audited financial statements within 180 days of the end of the fiscal year and follow uniform procedures in adopting and monitoring their budgets. Michigan law also requires local governments that end the year in a 'deficit condition' to develop a deficit elimination plan, which is filed with the State and must be approved by the local government. The approved plan may lead to the State providing emergency funding, although this is also accompanied by the appointment of an outside financial manager.¹⁵

When **Tennessee** municipalities encounter fiscal distress, the Comptroller of the Treasury can direct local officials to come up with corrective action plans, issue funding bonds, appropriate money to pay their debts, reduce expenditures, or even raise taxes. In some cases, Tennessee requires that local officials obtain state approval before writing a check.¹⁶

Control

State control of local government finance usually occurs after efforts at monitoring, assistance and oversight have not succeeded. In most instances, states will only assume control of local government functions when other alternatives have not been sufficient to restore fiscal stability for a local government.

In **Pennsylvania**, Act 47 is a blend of an assistance and oversight approach, which does not provide for a state takeover of the local government. A determination of municipal fiscal distress is triggered when the local government meets any of the following criteria: operating deficit over a three year period, default in debt payments, missed payroll for 30 days, failure to forward taxes withheld on income of employees or transfer employer contributions for Social Security, failure to make its minimum obligation pension payment, or reached the legal limit in levying real estate tax due to deteriorating economic conditions. The law gives certain public interest groups standing to request a determination of fiscal distress, but in most cases the request is in the form of a petition to the Department of Community and Economic Development (DCED) from the local government itself.

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If DCED reviews the petition and determines that a municipality is financially distressed, a Coordinator is appointed by DCED. The Act 47 Plan Coordinator develops a multi-year financial and management plan for the local government, which is subject to approval by the municipality's governing body. If the plan is rejected by the governing body, the local government must create its own plan, also subject to DCED review. If the plan is accepted by the governing body, the Coordinator will implement the plan but does not have the power to order financial or operational change. If a municipality fails to adopt or implement a recovery plan it may lose access to state grants and loans, and if a recovery plan is adopted and implemented the municipality may receive priority

¹⁴ Moody's Investors Service. *Stat Oversight of Distressed Local Governments Varies Widely* (February 10, 2011).

¹⁵ Ibid.

¹⁶ The Pew Charitable Trusts. *State Strategies to Detect Local Fiscal Distress* (September 2016).



standing for state grants and loans. In addition, the Coordinator's plan may set the parameters for future collective bargaining labor agreements.¹⁷

For the larger Cities of Philadelphia and Pittsburgh, oversight boards known as Intergovernmental Authorities have been established, but they have relatively limited authority compared to the boards used in other states. For Philadelphia, the Philadelphia Intergovernmental Cooperation Authority (PICA) is composed of seven members, five voting and two non-voting. The Governor appoints one member and the State House and Senate each get two appointees. The other two members are the Commonwealth's Budget Secretary and Director of Finance for the City of Philadelphia. At its inception in 1991, PICA was authorized to issue bonds and provide the proceeds to the City upon approval of the City's five year financial plan, which is updated every year. While this debt issuance power has lapsed, PICA must continue to approve annual five year plans until all of the debt is repaid. PICA does not have the authority to nullify a non-compliant labor agreement. The Pittsburgh Intergovernmental Cooperation Authority (ICA) is similar to PICA. The composition of the board and how it is appointed is the same as for the PICA. The ICA approves the City's annual budget and five year financial plan, any issuance of debt, and may make recommendations to the City and the State on issues related to the City's fiscal affairs. The ICA does not have the authority to nullify a non-compliant labor agreement.

New York does not have a law that applies to all fiscally-distressed local governments, because the State has preferred to develop an individual solution for each distressed municipality or county. Typically, the legislature will pass a special act that grants unique powers to a borrowing authority to alleviate the fiscal distress, coupled with an oversight control board mechanism. The board generally has the power to approve or disapprove budgets and financial plans, issue debt, and impose a wage and hiring freeze. The implementation of these powers is typically left to the board's discretion and has varied widely in different cases.

Connecticut, similar to New York, requires the state legislature to pass special legislation to deal with local government fiscal distress on a case by case basis. Generally, the legislature will install a Financial Review Board with the power to approve annual municipal budgets, alter taxes and fees to pay off deficits, and approve debt issuance. The Board may also issue debt on behalf of a municipality. The power to affect collective bargaining agreements has varied. In some cases, the Board has been given extensive power and served as the arbitration panel that specifies the terms of a collective bargaining agreement. In other cases, the Board has more limited authority to review agreements to ensure compliance with the financial plan.

In **Michigan**, Act 4 of 2011 created a new system for State oversight of municipal finances. The process begins with a preliminary review that may be requested by the municipality, a creditor that has not been paid in over six months, a petition by five percent of the electors, or the employee pension

¹⁷ The Pennsylvania Department of Community and Economic Development maintains information on all Act 47 cities and the statute itself, which may be accessed at <http://dc.ed.pa.gov/download/municipalfinancialrecoveryact-pdf/?wpdmdl=58034>.



fund. The State Treasurer will convene a team to conduct the preliminary review. If a finding of “probable financial stress” is made, the Governor will appoint a review team. The review team will have the power to audit a municipality’s financial records and sign a “consent agreement” with a local government that “provides for remedial measures considered necessary to address the local financial problem.” If a finding is made that the local government is severely financially distressed, then the State Treasurer may require a multiyear operational and financial recovery plan, and the hiring of a consultant to assist the local government with implementing the plan. The Governor may declare “financial emergency” for a municipality if the local government does not adopt the consent agreement and recovery plan, materially breaches the agreement or the municipality’s financial condition is so severe that such action is warranted. A declaration of financial emergency places the local government under the receivership of the State. Under receivership, an Emergency Manager (EM) is appointed by the Governor who has broad powers to rectify the local government’s financial emergency.¹⁸

In summary, the powers granted to the EM include the authority to amend, revise, approve or disapprove the municipal budget; reject, modify or terminate collective bargaining agreements; assume and exercise the authority of the local pension board; authorize borrowing; sell assets; recommend consolidation with a neighboring government or disincorporation; and exercise the full authority of the local government.

In **Louisiana**, once a municipality is found to be not fiscally stable, the Fiscal Review Committee determines if a court should appoint a financial administrator to oversee the finances of that locality. If the Committee decides that the government meets the criteria for the appointment of a fiscal administrator, it will authorize the Attorney General to petition the court to appoint one. Once appointed by a court, the administrator has control over all fiscal operations of the local government.¹⁹

Massachusetts provides general oversight of local governments. Certain events can trigger additional oversight, including low or negative free cash, deficits in enterprise or internal service funds, late financial reporting or operating deficits. This generally involves appointment of an overseer or control board to assume local government financial powers until the city’s financial condition has stabilized. The State may also delay the issuance of tax bills or perform an evaluation of financial operations and procedures.²⁰

¹⁸ Michigan Comp. Laws 141.1412-1519.

¹⁹ The Pew Charitable Trusts. *State Strategies to Detect Local Fiscal Distress* (September 2016).

²⁰ Moody’s Investors Services *State Oversight of Distressed Local Governments Varies Widely* (February 10, 2011)



Federal Response: Strong Cities, Strong Communities and the National Resource Network

One of the notable features in this description of current state programs is that there is more focus on reaction to local government distress than proactive measures that assist local governments before there is a need for oversight or greater control of their finances and operations.

The federal Strong Cities, Strong Communities Initiative (SC2) is designed to assist cities that were hardest hit by the Great Recession. Launched in July 2011, the program works to coordinate federal programs and investments to spark economic growth in distressed areas and create stronger cooperation between community organizations, local leadership, and the federal government. The National Resource Network is a component of SC2, and is a \$10 million technical assistance program funded by HUD. The Network is being implemented by a group of private and public sector entities, including PFM, Enterprise Community Partners, HR&A Advisors, New York University's Robert F. Wagner Graduate School of Public Service and the International City/County Management Association (ICMA).

The Network deploys teams of private and public sector experts to work with cities on-the-ground to implement locally identified projects and initiatives that will deliver economic benefits in the near term. Network teams also work to build local capacity and leadership for the future. Cities can apply for direct assistance based on the Network's evaluation of their needs and readiness to move forward on economic turnaround.

Eligibility for the Network is limited to cities with population of 40,000 or more that meet one of criteria – detailed in the next section – based on poverty, unemployment and population decline. Approximately 300 cities are eligible based on these criteria. Other cities can apply based on indicia of fiscal distress and eligibility is reviewed on a case by case basis.

Since launching direct assistance in 2014, the Network has worked with more than 50 economically challenged cities nationally. National Resource Network projects have focused on a range of major challenges facing cities with high poverty, high unemployment or population decline including workforce development, downtown revitalization, community development and housing, education, public safety, municipal budgeting and operations.

In designing direct assistance projects, the Network's first consideration is whether cities have sufficient operational and fiscal capacity to take on economic development, community development, or other quality of life initiatives. Where such capacity is lacking, the Network focuses on these core capacity needs.

- In Providence, Rhode Island, the Network team worked with City leadership to develop a 10-year financial plan to balance budgets and provide for key investments in education, neighborhoods and infrastructure. To build broad support for the plan's continued implementation, the Network worked with the City to bring community stakeholders into the process, including colleges and universities, business organizations, nonprofits, and foundations. The City is now moving forward with implementation of the plan. In November 2016, Fitch upgraded its rating of City debt based on "improved budget practices."



- Richmond, California, is one of the most economically challenged cities in the state. Without a multi-year approach to budgeting, the City risked continued credit downgrades and was unable to address other pressing needs such as affordable housing. City leadership partnered with the Network to craft a five-year financial plan to enable this Bay Area city to better leverage its economic and geographic strengths. Richmond Mayor Tom Butt credits the Network's activities and counsel with helping the City avoid junk bond status.

Where cities have adequate capacity and have avoided severe fiscal distress, the Network focuses its support on larger economic competitiveness opportunities designed to ensure long term economic and fiscal recovery. For example, in Danville, Virginia, the Network has partnered with the City and a local foundation to create a community development corporation to begin to address blight, public safety, health and education issues in a comprehensive manner.

Massachusetts has created a pilot state-funded version of the National Resource Network to provide similar resources for cities within the Commonwealth. The Massachusetts network is a partnership that will provide up to seven cities facing economic challenges with comprehensive and cross-cutting technical assistance designed to increase their economic competitiveness.

In Massachusetts, the State Resource Network will be supported by up to \$1.2 million in federal, state and local funds – including \$375,000 from MassDevelopment, making Massachusetts the first state to provide direct funding to the effort.

Six Massachusetts cities – Brockton, Everett, Fitchburg, New Bedford, Pittsfield and Worcester – have applied for assistance from the State Resource Network and are in an assessment process that will lead to direct assistance projects by April 2017.

Indicators of Fiscal Distress

As discussed in the prior section, states use a variety of indicators to determine if/when a local government has reached a condition of fiscal distress that requires some form of state intervention. Generally, these conditions fall into two categories related to government operations:

- **Internal factors:** those areas that direct local government decision making may impact. These may include issues related to fund balance or debt ratios.
- **External factors:** those areas where issues outside the direct control of local government may have a significant impact. These may include: levels of employment, unemployment, poverty rates, percentage of students qualifying for free and reduced priced lunch, etc.

In general, it is our experience that both internal and external factors should be considered in identifying possible fiscal distress, determining qualification for and constructing appropriate local government assistance programs.



This balanced approach is captured by ICMA's Financial Trends Monitoring System (FTMS). The framework distinguishes among three types of factors that influence fiscal health:²¹

- **Environmental factors:** community conditions that capture local economic indicators, external economy, intergovernmental constraints, community socioeconomic characteristics, disaster risk and political culture.
- **Organizational factors:** those involving government practices and policies.
- **Financial factors:** the outcomes of organizational decisions with regard to available environmental resources and opportunities. Financial factors manifest as measures of revenues, expenditures, operating position, long-term liabilities, and asset maintenance.

These four factors, in turn, help to define four different types of solvency:²²

- **Cash solvency:** A government has enough liquidity to meet its short-term obligations.
- **Budgetary solvency:** A government can draw on sufficient revenues to cover its expenses on an annual basis and maintain a balance between its revenues and expenditures.
- **Long-term solvency:** A government is able to successfully meet its obligations over the long term.
- **Service-level solvency:** A government can provide the level and quality of services desired by the local community.

States monitor a variety of fiscal and other measures for local governments. Indicators used frequently to determine a municipality's fiscal health, commonly found in audits and annual reports, include:²³

- Timely submission of audits
- Deficit or minimum fund balance
- Debt service payments relative to operating revenue
- Sufficient cash for services
- Total revenue and/or expenditures per capita
- Unrestricted fund balance
- Cash to liabilities ratio
- Interfund transfers to supplement the General Fund
- General obligation debt/revenue or total debt per capital
- Whether the local government filed a municipal debt readjustment plan pursuant to Chapter 9 of the bankruptcy code
- Pension plan funding ratios

²¹ Gorina, Evgenia and Craig Maher. *Measuring and Modeling Determinants of Fiscal Stress in US Municipalities*. Mercatus Center at George Mason University. November 2016.

²² Arnett, Sarah. *State Fiscal Condition: Ranking the 50 States*. Mercatus Center at George Mason University. January 2014.

²³ The Pew Charitable Trusts. *State Strategies to Detect Local Fiscal Distress* (September 2016).



In determining whether and how to intervene in cases of fiscal distress, different states review different indicators.

New York primarily relies on two factors, which can automatically qualify a municipality for additional state assistance and services. These are:²⁴

1. An average full value property tax rate greater than the average full value property tax rate of 75 percent of the other municipalities in the State (which would suggest a property-poor municipality, a municipality with a high property tax burden, and/or one with little capacity to further increase revenue through property tax rate increases).
2. An average fund balance percentage below five percent.

Municipalities that do not automatically qualify based on these measures of fiscal distress may make a request to the Financial Restructuring Board for Local Governments. The Board may find additional municipalities to be fiscally eligible for Board services and assistance if it determines that they would benefit from its services and assistance. This determination is done on a case by case basis.²⁵

Ohio relies on five criteria that may allow the State Auditor to place a local government in the 'fiscal caution' category if it meets any one of the five. They are:²⁶

1. When the Auditor declares that a local government's financial records are not auditable, and has issued a letter to the local government indicating the timeframe under which those records must be restored to an auditable condition, and the local government has failed to do so within the timeframe specified in the letter.
2. When the Auditor identifies significant deficiencies or material weaknesses over accounting and financial reporting functions, direct and material noncompliance with applicable laws and regulations, or management letter comments which, in the opinion of the Auditor, the aggregate effect of such reported issues has a significant effect on the financial condition of the municipal corporation, county, or township.
3. When a deficit fund balance exists at year-end in the General Fund that is greater than two percent, and/or when a deficit fund balance exists at year-end in any other fund that is greater than two percent, and there are not sufficient resources in the General Fund that may be transferred to eliminate the deficit or in any other fund that may lawfully transfer resources to eliminate the deficit.
4. When a low year-end carryover balance exists in the General Fund such that the balance is equal to or less than an amount representing one month of expenditures (based on one-twelfth of prior year expenditures), and/or when a low year-end carryover balance exists in any other fund such that the balance is equal to or less than an amount representing one month of

²⁴ New York State Statute, Local Finance Law §160.05 (3).

²⁵ A discussion of these services may be found at <https://frb.ny.gov/ftbrequest/FRBrequestReview.do>

²⁶ Chapter 118 of the Ohio Revised Code.



expenditures (based on one-twelfth of prior year expenditures), and there are not sufficient resources in the General Fund that may be transferred or in any other fund that may lawfully transfer resources to subsidize the fund.

5. When a local government has not reconciled its accounting journals and ledgers with the treasury/bank for more than three months and is unable to reconcile the records within one month of written notification by the State Auditor.

Under the **Pennsylvania** Act 47 program, the enabling legislation identifies 11 criteria, and if at least one of these is present, the State Department of Community and Economic Development may exercise specific powers and duties related to those local governments. The criteria are:²⁷

1. The municipality has maintained a deficit over a three-year period, with a deficit of 1 percent or more in each of the previous fiscal years.
2. The municipality's expenditures have exceeded revenues for a period of three years or more.
3. The municipality has defaulted in payment of principal or interest on any of its bonds or notes or in payment of rentals due any authority.
4. The municipality has missed payroll for 30 days.
5. The municipality has failed to make required payments to judgment creditors for 30 days beyond the date of the recording of the judgment.
6. The municipality, for a period of at least 30 days beyond the due date, has failed to forward taxes withheld on the income of employees or has failed to transfer employer or employee contributions for Social Security.
7. The municipality has accumulated and has operated for each of two successive years a deficit equal to 5 percent or more of its revenues.
8. The municipality has failed to make the budgeted payment of its minimum municipal obligation related to pension funding.
9. A municipality has sought to negotiate resolution or adjustment of a claim in excess of 30 percent against a fund or budget and has failed to reach an agreement with creditors.
10. A municipality has filed a municipal debt readjustment plan pursuant to Chapter 9 of the Federal Bankruptcy Code.
11. The municipality has experienced a decrease in a quantified level of municipal service from the preceding fiscal year which has resulted from the municipality reaching its legal limit in levying real estate tax for general services.

Eligibility for the services provided to distressed cities under the National Resource Network are based on the following criteria:²⁸

²⁷ The Statute and other information for Pennsylvania's Act 47 program may be accessed on the Department of Community and Economic Development's website at <http://dced.pa.gov/local-government/act-47-financial-distress/#.WHUVhVMrKM9>

²⁸ Information on eligibility for the National Resource Network may be accessed electronically at <http://www.nationalresourcenetwork.org/en/solutions/rfafaq#FAQ1>



- Cities with over 40,000 residents may be eligible for Network assistance if they meet at least one of the following criteria:
 - A 2013 annual average unemployment rate of 9 percent or more, as measured by the Bureau of Labor Statistics
 - A population decline of 5 percent or more between 2000 and 2010, as measured by the U.S. Decennial Census
 - A poverty rate of 20 percent or more (excluding students enrolled in undergraduate, graduate or professional school), as measured by the 2010-2012 American Community Survey
- Cities with over 40,000 residents may still qualify for direct assistance projects if they can demonstrate significant government capacity challenges as evidenced by one of the following factors:
 - A bond rating downgrade or change in outlook
 - Failure to balance local government budget for two or more years in a row since 2008
 - A reduction of 10 percent or more of local government workforce in the last three years
- In addition, cities that do not meet eligibility criteria may be included in a regional application for direct assistance. The Network strongly encourages joint applications, where multiple cities in the same geographic region seek to work together to address a common set of problems. The lead city applicant must meet the eligibility criteria and/or demonstrate the government capacity.

Recommended Approaches for the Commonwealth of Virginia

Those states that have an approach to local government fiscal distress tailor a program that fits their unique issues and needs. Both for states and for distressed local governments, there is no good “one size fits all” approach. Given some of the existing facts and circumstances related to the state-local government relationship in Virginia and an interest in being able to put something in place in the near future, the following considerations may assist in these efforts:

- **Ease of Administration.** If possible, using existing mechanisms for reporting and oversight should both reduce the burden on local governments and the time necessary to put a program in place. This may also assist in putting a program in place while acknowledging the fiscal constraints of the current state budget.
- **Tailored Response.** During the past year, PFM has assisted both the cities of Danville (through its association with SC2) and Petersburg (through a direct contract for services with the City) in dealing with issues related to fiscal distress. Despite facing similar economic challenges, the particular needs of these cities were not the same and a program with the flexibility to provide resources and assistance focused on specific local government needs is more likely to be valued and useful for the governments in need of assistance.



- **Prevention First.** From our perspective, programs that identify potential distress and work with communities in the early stages are more cost effective than programs that mostly focus on oversight and control when local governments have passed the early stages of distress.

Based on these considerations, we would recommend that the Commonwealth pursue an approach that focuses on early reporting, monitoring and targeted intervention.

In looking at existing reporting requirements within the Commonwealth, the Auditor of Public Accounts already has the responsibility to prepare the annual Comparative Report of Local Government Revenues and Expenditures and to oversee local government audits. All Virginia counties, cities, towns with a population of 3,500 or more, and towns operating a separate school division are required to submit data to the Auditor of Public Accounts annually. The data presented represents the local government operations for the general government and enterprise activities. The Auditor's website provides a useful source of local government information, as local government audits may be downloaded there.²⁹

Given that there are already established processes in place for local governments to report financial and other information to the Auditor of Public Accounts, it makes sense to use this as a reporting vehicle to identify possible cities in (or likely to face) fiscal distress. This will reduce the need for additional reporting processes and also be a vehicle that local governments are already familiar with, in terms of reporting timeframes and methods.

Any new, additional reporting requirements would entail time and effort for both the reporting entity and those who will administer and review them. We suggest starting with some of the accepted metrics used in other states, and keeping the actual number to a manageable amount for all involved in the process. As a starting point, these should include:

- Fund balance levels below a stated minimum or declining for a period of three years or more
- Expenditures have exceeded revenues for a period of two years or more
- Failure to make timely payments due to any regional or state authority

Of course, these can (and should) be revisited to determine if they are effective in identifying local governments in need of assistance, and additional criteria may be added if warranted.

The Commonwealth should also consider non-fiscal data in identifying local governments that need assistance in addressing or preventing fiscal distress -- such as the economic and demographic criteria used for Network eligibility. While cities that meet these criteria may not need immediate fiscal support or assistance, any one of these economic factors can signal potential or actual loss in tax base that may affect long term fiscal sustainability.

²⁹ http://www.apa.virginia.gov/APA_Reports/localgov_cafrs.aspx



In addition to reporting and monitoring, economically challenged and fiscally distressed cities need easy access to pre-qualified expert advice across a range of policy areas – including financial planning, budget and operations and other expertise designed to enhance local economic competitiveness. Both the New York and Pennsylvania programs provide state funding for technical assistance for fiscally distressed cities to develop financial plans to address immediate fiscal challenges. The National Resource Network model – and the Massachusetts State Resource Network – offers federal and state funding for cities to access a more robust set of tools to both address fiscal distress and prevent it. The Network model is also being considered in several other states, including Rhode Island and California.

The advantage of an ongoing program of assistance is that it provides a readily available vehicle for procuring needed services. In other words, the Commonwealth and local governments need a “doctor on call” rather than having to structure a process and procurement every time that assistance is needed. Moreover, cities that have benefitted from NRN support – especially smaller and mid-size cities -- have regularly noted that they were able to access a level of expertise that they probably could not have procured on their own.

Cost can also be an obstacle for distressed local governments in obtaining the assistance that they need. The local governments most in need of assistance generally are least able to afford to pay for it. On the other hand, even distressed local governments have some financial resources and the likelihood of successful intervention is greatly enhanced when the local government has actual financial buy in to the process.

Under the Network model, most of the cost of assistance is provided by the federal government (for NRN) or state government (for the Massachusetts State Resource Network). In both cases, however, the local government is responsible for some of the cost of technical assistance. In some situations, the local contribution can come from local government. In other cases, all or part of the local contribution may come from the business community or local philanthropy. This has the added benefit of building relationships between local government and outside partners that can be beneficial beyond the technical assistance project.

In other instances, state governments may fully fund technical assistance and support. In still other cases, states assess local governments an amount that is then pooled and may be accessed as needed by eligible local governments. This generally requires up-front effort to establish the payment and collection mechanism, the amount of the assessment, and the rules and regulations related to accessing funding. It does, however, get around the concern that local governments in need are not able to obtain needed services.

Different approaches can be combined and/or mixed and matched to meet specific facts and circumstances. It will be important, however, to identify how a program will function and be funded at its outset.



Summary

Local government fiscal distress is an issue that is likely to continue to present itself – in Virginia and across the country. While the responses vary from state to state, recent events suggest that the Commonwealth would be advised to devise some methods for identifying local governments facing (or likely to face) fiscal distress. Some options have been identified.

Given the Commonwealth's lack of significant involvement in the oversight (or control) of local governments, we believe that an approach focused on reporting, monitoring and, where needed, some provision of technical assistance will be more likely to be implementable and successful.

The Commonwealth needs a program that allows it to quickly identify distress and provide a tailored approach for addressing underlying problems. Moreover, it needs to ensure that the program is as focused on prevention of distress – early intervention – as it is on imminent insolvency and creates a vehicle for providing services to local governments in need that makes sense.

While this memorandum has been general in nature, the project team is prepared to assist the Commonwealth with further analysis and discussion on specific areas of interest as needed.