Avoiding Local Government Financial Crisis: The Role of State Oversight

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AVOIDING LOCAL GOVERNMENT FINANCIAL CRISIS: THE ROLE OF STATE OVERSIGHT

I. Introduction

Over the years, Michigan has had a handful of local governmental units that, from time to time, have experienced serious fiscal distress. Consisting of 10 to 15 units out of about 2,800 local units (not including charter schools) of all types in Michigan, this handful has hardly constituted a crisis of local government finance. But the attention demanded to address the problems of these units makes this a subject of state and local government relations worthy of policy consideration.

Attempts to give this subject attention are complicated by the need to find the right balance between the powers of the state over local governments and the local discretion afforded local governments through their home rule powers. Local governments are created by, and derive their authority from, the state, creating an implied supervisory relationship between the state and its subdivisions. That is, the state is, in a general way, interested in what its subdivisions do. This interest derives from the state's need to protect its own credit and the credit of its subdivisions, to assure the performance of contractual obligations by local units, and to assure the continuation of necessary public services. These necessary services include providing for the health and safety of residents not only in that community but in neighboring communities, property assessment and taxation, and conducting and certifying elections.

Set against this interest is local home rule, which implies wide latitude for local governments to set their own courses. Various sections of Article VII of the 1963 Michigan Constitution specify the rights of citizens in cities, villages, and counties to adopt charters that define their preferred form of local government. The state's critical interest in the financial condition of local units of government must be balanced with the powers inherent in the concept of home rule.

Over the years, the state has developed a number of policies to deal with local fiscal matters, including:

- Constitutional provisions for the removal or suspension of local government officers;
- Authority for local units to file for bankruptcy under the Federal Bankruptcy Act;
- The Fire and/or Police Department Pension and Retirement Act, which provides for separate police and fire pension systems and funding;
- The Uniform Budgeting and Accounting Act, which defines budgeting and accounting standards;
- State revenue sharing, which provides state financial assistance to general-purpose local units;
- The Municipal Finance Act, which allows local units to borrow against future revenues;
- The Emergency Municipal Loan Act, which provides for loans to units in fiscal emergencies;
- The Fiscal Stabilization Act of 1981, which allows local units of government to issue general obligation bonds to fund operating deficits;
- The Municipal Employees' Retirement Act of 1984, which provides for a municipal employees' retirement system to administer pension systems; and finally,
- The Local Government Fiscal Responsibility Act of 1990, which serves as a means to intervene in the affairs of local units of government which incur a fiscal emergency.

While each of these policies was at least partially intended to prevent or alleviate fiscal emergencies, these policies individually or collectively, have not been effective in preventing all fiscal problems. Several Michigan local units of government have encountered fiscal distress in recent times despite these existing policies, including the cities of Benton Harbor, Detroit, Ecorse, River Rouge, and Highland Park, Royal Oak Township, the Kalkaska school district, and Wayne County.

This paper considers the causes of local government fiscal distress and the state interest in addressing those problems. It considers the range of state responses available and how current Michigan laws fit into that range. It considers the proper state response relative to current Michigan laws and relative to the experience of other states. Finally, it makes a number of recommendations for how the state could redirect its efforts to positively affect the finances of Michigan local governments and strive to prevent the occurrence of fiscal distress.

II. Origins of Local Government Fiscal Distress

Local government fiscal distress can be categorized as either structural or managerial. Structural distress results from an inequality of revenues and expenditures from: (1) failures in the supply of resources, e.g., slowing of economic growth; (2) higher than expected public expenditures, whether the demands for those expenditures are generated by the public or within the political system itself; or (3) a combination of expanded expenditures at a time when restricted resources can least support it. Managerial distress results from inadequate, poor, or corrupt management practices, whether those practices are a result of intentional or unintentional actions.

A. Erosion of Economic Base

Erosion of the economic base can occur when there is a net loss of taxpaying property owners and tax generating activity from an entity. High taxes, crime, poor school systems, and deteriorated infrastructure have dissuaded people and businesses from moving into some central cities. As a result, several cities have experienced an eroded economic base, which translates into an eroded tax base – either in absolute terms or relative to the growth rate of expenditures.

At its extreme, a ghost town is an example of a former community whose economic base has eroded to the point that the economic basis for existence has become questionable. Less extreme are mining towns in the Upper Peninsula, communities built up around military bases, or manufacturing towns from which the major employer has departed. The circumstances of these communities make self-sufficiency a problem. With little prospect for long-term employment, many of the youth have left these communities for job opportunities elsewhere. The role of the state and any long-term prospects for continuance as a municipality must be analyzed differently for these communities than it should for others that have suffered from poor decisions or a series of unforeseen circumstances.

Erosion of the economic base need not be, in and of itself, a cause of fiscal distress. If expenditures are kept in balance with declining revenues, the result is a smaller government; smaller in terms of the number and level of services offered, but smaller at a level that is supportable with incoming revenues.

The problem for many entities with eroding economic bases is that opportunities to reduce expenditures are not always apparent. Urban sprawl leaves the entities with fewer people, but the geographic sizes of the communities are not reduced. They may not have fewer properties to serve in terms of garbage pickup or police patrols. They do not have fewer roads and bridges to maintain.

Usually, those leaving the distressed community are those with the greatest financial resources. In some cases, not all, those remaining in the community are low-income residents, persons that have the greatest demand for government services due to higher crime rates, greater social service needs, and more health care needs. Thus, government officials in the urban core are faced with fewer tax dollars from negative or stagnant growth in the economic base and an unchanged or increased demand for government services.

Events such as the sudden loss of a major taxpayer can put a unit of government into fiscal distress. As an example, the Chrysler Corporation ended operations in the City of Highland Park and moved to the City of Auburn Hills in 1995. With a Fortune 500 company headquarters in a city of three square miles, a large part of Highland Park's revenues centered on having the company in the city. Its departure meant lost revenues for the city. On the other hand, the departure of the company did not reduce the demand for services in other parts of the city. The same number of houses required garbage collection. The police and fire departments had to protect the same number of residents. The recreation department had to provide parks and recreation opportunities for the same number of people. Highland Park was faced with basically the same demand for services, with a tax base almost one-third the size it was with Chrysler still in the city. While Chrysler provided a $30 million contribution to the city to ease the transition, the long-term need to fund the same level of services without a major taxpayer remained unchanged.

B. Artifact of Incorporations

Michigan has had a few instances where a large proportion of a township was incorporated as a city or cities. The original 36 square miles of Royal Oak Township were divided into nine separate cities, with two isolated fragments of unincorporated territory totaling less than one square mile constituting what is now the Charter Township of Royal Oak. Similarly, the majority of Dearborn Township was included as part of the City of Dearborn. Residents of the unincorporated territory attempted on two different occasions during the 1950s to annex to Dearborn, only to be turned down by city voters who did not want to spread their relatively high tax base over a larger area. The remaining U-shaped territory that wrapped around the west end of Dearborn incorporated individually as the City of Dearborn Heights. In both examples, the most significant properties in the tax base of the community were included in the new city(s), and the remaining territory was left with little tax base to support the services expected of it. Whether the artifacts of incorporation become cities or remain townships, it is a challenge to support local government services from their tax revenues garnered from the local economic base.

C. Management Restrictions

Even when local officials recognize that expenditures must decrease to meet revenues, they often are constrained by the earmarked taxes, organizational structure, charter requirements, building maintenance restrictions, personnel administration restrictions, and labor contract restrictions.

While it is common practice to levy a single millage for general operating purposes, some local units have dedicated millages for public safety, roads, libraries, and other local government functions. While this practice increases citizen understanding of the use of their tax dollars, it restricts the ability of the elected officials to respond to budget demands by shifting funding between functions.

The organizational structure of a local unit of government might not delegate clear decision-making authority to a single position for budgeting purposes. Everyone blames another for the responsibility of a fiscal crisis, with the result that no one is accountable to make the difficult decisions.

Building maintenance problems have occurred when municipalities have simply over-extended themselves or failed to budget for building and infrastructure maintenance. Funds become earmarked for maintenance of ice rinks, libraries, maintenance garages, and the like, even when they can no longer afford to support those functions.

Personnel administration problems occur in dealing with union and civil service restrictions, which may bind the ability to move or eliminate personnel as financing warrants.

Finally, charter requirements have dictated that specific functions be delivered, that "excess" pension earnings be returned to current employees, and have otherwise confined the choices available in making budget decisions.

Each of these restrictions leaves local government policy makers hamstrung to control finances without making politically sensitive changes or offering charter amendments.

D. Unforeseen Events

Fiscal distress can be caused by unforeseen events that severely hamper available tax revenues or place unusually high demands on expenditures. For instance, an unforeseen decision in a law suit not covered by the municipal insurer may hold a unit liable for payment of a large sum of money that would not be anticipated in an annual budget and would restrict the ability of the unit to fund other activities.

In theory, events such as a natural disaster could not only decimate the property tax base, but also could create additional demands for government services until circumstances are returned to normal. Realistically, the Federal Emergency Management Administration (FEMA) has taken such an active role in recent times at providing financial assistance following a natural disaster that local units of government are not left to bear the brunt of the financial burden in handling additional services. This does not take away from the fact that a natural disaster can decimate the properties in a small community, wiping out the municipality's tax base.

E. Mismanagement

Mismanagement involves action or inaction by city officials that run contrary to good management practices. Mismanagement can be borne of negligence, or by officials that simply don't have the background or knowledge base to make the best decisions. Such actions also can be the result of intended decisions that improperly take chances with the tax dollars of the city residents. The experiences of New York City and Orange County illustrate the dangers that can be caused by allowing mismanagement to go unchecked.

New York City. In the mid-1970s, New York City experienced a fiscal crisis in which the banks refused to lend the city any more money. The city had been accumulating vast quantities of floating debt that was financed by rolling over short-term notes. As a result, the city found itself in a fiscal crisis when the banks refused to lend the city any more money. It ultimately became necessary for the state government to become an active participant in solving the city's fiscal problems.

Orange County, California. In 1979, the Orange County, California treasurer championed state legislation that allowed county treasurers to invest with borrowed money, a technique known as leveraging. The expectation for such investments is that the interest rate charged for loans will be lower than the earnings made on the money earned from the investments. The difference is profit.

In 1991, the treasurer began buying derivatives with the county's cash assets. Derivatives are securities whose value depends on the underlying value of another asset, which could be another security, a reference rate, or an index. In essence, the county treasurer was betting on the direction of interest rates. As long as they stayed low, the investments earned a healthy rate of return. When they increased, the county investments lost money. Indications of financial mismanagement appeared as early as 1993, when money began to be diverted to other funds in violation of state law. Finally, on December 6, 1994, it was reported that Orange county lost $1.64 billion on investments when the bond market soured in late 1994.

III. The Implications of Local Government Fiscal Distress

In the private sector, bankruptcy laws are in place to deal with fiscally distressed entities. These laws allow debtors, persons or businesses, to voluntarily or involuntarily be adjudged and obtain relief by reorganization and readjustment. These laws provide the debtors a breathing spell from debt collection efforts to allow the debtors and creditors to work out a repayment plan.[1]

Businesses are launched and fail in the private sector according to the laws of supply and demand and effective management. If a business fails, it is either due to a lack of demand for a good or service, or because a competitor can produce that good or service, or a suitable alternative, at a better price. Those most directly affected by a business facing fiscal distress and going out of business are the employees and investors in that business. Consumers that formerly purchased goods or services from that business usually can find alternatives to purchase that are identical or similar to that produced by the failed business.

Unlike businesses, governments are defined geographically. Rarely is there an alternative source of local government services that residents of a community can turn to should their local government fail and "go out of business." Cities and townships can, and have, transferred individual functions to the county, but the failure of local units of government would create voids where no entities exist to provide local government services. Other types of local governments do not have an overlapping governmental unit that could serve as a suitable alternative service provider. Schools, single purpose authorities, and community college districts are the sole provider of their public service. Should they fail, a neighboring unit would have to expand to assume service delivery to that geographical territory.

Local governments compete for residents and businesses and many residents are able to vote with their feet, moving to communities where there are lower taxes, better services, or both. But not all residents or businesses are able to use this option. There will always be some residents or businesses who cannot, or will not, move away from a distressed community. Actions must be taken to continue the provision of local government services to those persons.

The election of municipal officials remains the strongest weapon for residents to control the policies of their local unit of government if a pattern of mismanagement can be detected. However, the vote can be an ineffective weapon in cases of fiscal distress in the short term. The election of municipal officials takes place no more often than once every two years, more commonly once every four years. Additionally, it is common in cases of fiscal distress that the severity of the fiscal problems is not made clear until it reaches crisis proportions. Choosing to elect different officials would do little to change those circumstances.

Thus, a few local units of government may face fiscal distress from time to time. Because essential services must be provided, the state must determine a policy for preventing or alleviating these fiscal emergencies.

Bankruptcy for Local Governments

In the private sector, one response to fiscal distress is bankruptcy. The fundamental justification for such intervention is the protection of the interests of all creditors. The intervention of law creates a binding procedure providing for an orderly liquidation of the assets of an insolvent corporation that maximizes value and the equitable distribution of the proceeds in a manner that fairly protects the interests of all creditors.[2]

The underlying policy justification for Chapter 9 of the federal Bankruptcy Code: Adjustment of Debts of a Municipality is different than the justification for bankruptcy laws regulating corporations due to the fundamental differences between corporations and municipalities. While a corporation is organized for the purpose of making a profit, a municipality is a governmental unit organized to provide essential public services. While it is sometimes necessary, if not desirable, to liquidate an insolvent corporation, liquidation is not an option for municipalities. They must continue to operate to provide essential services to the public.[3]

Chapter 9 of the Bankruptcy Code is not a bankruptcy in the usual sense. It is most comparable to Chapter 11 of the Bankruptcy Code, which sets forth the bankruptcy law pertaining to the reorganization of corporations. The power to establish laws on the subject of bankruptcy is one of the enumerated powers of the federal government under Article I, Section 8 of the U.S. Constitution, and is consequently the exclusive province of Congress. On the other hand, the Tenth Amendment reserves to the states respectively, or to the people, all powers not delegated to the federal government.

Any municipal bankruptcy laws that are mandatory in nature were felt to threaten the independence of the states. As a result, application for bankruptcy under Chapter 9 is a voluntary step for adjusting the debts of insolvent municipalities. Application must be filed by the municipality itself. It cannot be filed by creditors. Unlike other chapters of the federal Bankruptcy Code, the municipality cannot be forced to sell its assets to meet debts; the municipality is required only to list its creditors. The court may not interfere with general operations of the municipality. In fact, provisions were explicitly included to recognize the power of states to control their municipalities. Chapter 9 of the Bankruptcy Code is an attempt to provide relief for municipalities without overstepping states' powers. The fundamental policy goal underlying municipal bankruptcy law is to provide a legal context for distressed municipalities to be able to address their financial problems in a manner which enables them to continue to provide essential services rather than to collapse into social and financial chaos.[4]

Under Chapter 9, an entity is eligible for relief if it

- is a municipality, meaning a "political subdivision or public agency or instrumentality of a state;"
- is permitted by state law to be a debtor under Chapter 9;
- is insolvent or unable to meet its debts as such debts mature;
- desires to effect a plan to adjust its debts; and
- has met certain requirements with respect to pre-filing negotiations with creditors.

States have tended to intervene before municipalities have felt the need to file for Chapter 9 relief for several reasons. Chief among these is the potential damage to future credit. A second reason may have been the difficulty of filing. Until the Code was amended in 1976 in response to the fiscal crisis in New York City, the law required that 51 percent of all creditors (in dollar amount) accept a plan for adjusting the municipality's debts prior to filing for relief. For a large city to identify and successfully negotiate with its major creditors would have been nearly impossible. Current law requires only that a municipality attempt to negotiate in good faith with its creditors.[5]

IV. State Interest in Local Governments' Fiscal Health

Michigan has a strong tradition of municipal home rule reinforced by numerous constitutional and statutory provisions. Home rule is predicated on the notion that the state will take a hands-off position relative to the structure and operation of that unit as long as certain fundamental processes (conduct of elections, assessment of property, and collection of property taxes) are carried out. The corollary of this notion is that the consequences, bad as well as good, that flow from local decisions will accrue to the residents of that unit and that if problems result, the state will allow the local unit to find its own solutions.

On the other hand, the state has an interest in preventing fiscal problems of a local unit from terminating basic public services in that unit or from creating difficulties for other units. Public health and safety should not be jeopardized in the name of home rule nor should the residents of other communities be expected to absorb the negative results of policies pursued by a unit of government that finds itself in fiscal distress.

With respect to local fiscal problems, the state has six reasons to be interested in the operations of a home rule unit of government. The state might take actions to:

1. Assure a minimal level of services;
2. Protect contractual obligations;
3. Prevent collateral damage to credit rating;
4. Protect the finances of overlapping local units;
5. Assure efficient use of state revenue sharing; and,
6. Assure success of local home rule.

A. Assure a Minimal Level of Services

A unit of local government that finds itself in fiscal distress may attempt to meet the problem by reducing its level of services. This usually begins with reductions in the amounts of "non-essential" services. Depending on the situation, financial problems may simply force the unit to make decisions that it should have made previously. Many units have reduced maintenance, as a low visibility service that is often not seen as essential. At some point, however, reductions in expenditures can begin to compromise the ability of the unit to provide basic services.

The state assumes a certain level of services from different types of local government. Cities and townships are expected to assess property for taxation and collect taxes for all overlapping units of government. They are expected to conduct and certify elections. Likewise, counties are considered an extension of state government, providing many human service functions funded by the state government. Although the county has assumed the role of provider of local services in many instances, its roots are in its role as an arm of state government. Many county functions, including maintaining property records, vital statistics, courts, and law enforcement, began as extensions of state government at the local level. The state continues to have a particular interest in the delivery of those county services that had their origin as the local manifestation of state authority.

Should fiscal distress affect any of these functions, it indirectly would affect all taxpayers and residents of the state. Additionally, the state relies on local governments to provide for the health and safety of its residents. If a municipality cannot finance the provision of public safety, sanitation, or other health and safety services, the state may be required to act to assure that the citizens receive at least basic levels of these services.

Abandonment by those able to flee worsens the financial health of a distressed unit. Not everyone has the financial wherewithal to leave a financially distressed unit – "vote with their feet," so those remaining must be provided local government services. If not the failing unit, then absorption by a neighboring unit remains an option. Allowing the tax base to deteriorate lessens the potential attractiveness of consolidation for any neighboring units, so it is in the state's interest to address fiscal distress before there is an incentive for everyone to leave.

B. Protect Contractual Obligations

It has long been recognized that if the carrying out of contractual obligations could not be relied upon, commerce would cease. Moreover, private enforcement of contracts can result in disorder. For this reason, a strong consensus exists that enforcing contracts is on the short list of functions that government must perform. It would, therefore, be ironic if governments failed to honor their own contractual obligations. Local units of government enter into nu-

merous contracts, including those with suppliers of goods and services and with their own employees. Even though the state may not have directly participated in the creation of the contractual obligations of a local unit, it may be in the interest of the state to assure that those obligations are honored.

C. Prevent Collateral Damage to Credit Rating

As creatures of the state, the financial performance of local units of government reflects not only on those units, but also on the state as a whole. Although failure to meet payrolls, pension payments, or debt service payments by a local government does not necessarily mean that the state or other local units of government thereby constitute a greater credit risk, the financial community may not see it that way. Whether justified or not, financial failure by a local unit of government, especially if it is large, can result in difficulties in marketing bonds and possibly higher borrowing costs for other units, principally the state. With or without home rule, local units of government continue to be perceived as creatures of the state. By ignoring the financial problems of one of its local units of government, the state may be perceived as unwilling to step in to assist any of its local governments. Bond markets may react to such a perception with less favorable interest rates, which could result in higher costs to the state and its local units. Costs incurred by the state in assuring that debt service payments are made may be more than offset by the savings from protecting the state credit rating.

D. Protect the Finances of Overlapping Local Units

Michigan local government is characterized by a large number of units of local government with overlapping geographical boundaries and often overlapping service responsibilities and taxing authority. Counties, local school districts, intermediate school districts, and community college districts and special authorities in some cases, overlap cities, villages, and townships. A resident of one of these types of local government also is a resident of each overlapping type of local government. The financial health of any one unit will affect the overlapping units. If the tax base of a city deteriorates, the tax base of the county, the overlapping school district, the community college district, and any other overlapping local governments may deteriorate also. By choosing not to deal with a single unit of government in fiscal distress, the state could be allowing several overlapping units to deteriorate into fiscal distress.

E. Assure Efficient Use of State Resources

State government in Michigan has assumed a role as a funding source for local government. Nearly 70 percent of state-raised revenues are paid to other units of government that ultimately deliver services. In being accountable for the taxes it collects, the state, therefore, has a strong interest in how local governments perform financially. Whether transfers are made in the form of unrestricted revenue sharing payments, or restricted funding, local governments are spending money raised from state tax sources. General purpose units of government receive unrestricted state revenue sharing payments that can be spent for any legitimate local government purpose. Restricted funding takes the form of School Aid Fund payments to local school districts, Act 51 payments of transportation funding to cities, villages, and counties, or a number of other forms of state assistance programs. The local tax dollars paid to a fiscally distressed unit are at stake, but so are the tax dollars of all state taxpayers.

F. Assure Success of Local Home Rule

Inasmuch as Michigan is committed to a policy of home rule, at least with respect to cities and villages, the delivery of local services depends to a significant extent on the health of that policy. Individual local units may, for any of several reasons, not achieve the kind of fully functioning self-government that is possible under home rule. To the extent that some local units are unable to provide adequate governmental services independently, the state may be forced to take actions designed to assure that those failures do not diminish home rule in the remaining jurisdictions.

V. Nature of State Response

The state, therefore, can cite adequate justification for intervening in the affairs of local governments. The trick is to do so in a fashion that solves the problem that called forth the intervention without at the same time eroding or destroying the capacity for self-government in the affected local unit – or in others.

Current Michigan laws attempt to achieve several goals. They attempt to provide wide latitude to local units consistent with the strong home rule tradition enjoyed by local units in the state. They attempt to treat all units equitably. They have avoided options such as bankruptcy or state bailouts that unfairly penalize state taxpayers through extra taxes and do not encourage the changes needed to avoid future fiscal distress. Providing enhanced taxing authority to distressed communities has been used on occasion, but this has proved to further erode the economic base, rather than providing a long-term solution. The state has attempted to provide a structure within which local units of government must operate financially, it has provided broad financial oversight, and it has attempted to provide a structure for assisting local officials to address problems that have led to fiscal distress.

Despite its efforts, the state has not been able to devise a system that prevents local governments from becoming fiscally distressed. This section will analyze the theoretical range of responses available to a state government, assess the current Michigan laws, and explore the experience of other states in dealing with local government fiscal distress. The following section will make several recommendations suggesting ways in which these laws could be more effectively utilized to provide the needed state oversight to avoid future local government fiscal distress.

A. Choosing the Appropriate Response

State policy regarding units in fiscal distress incorporates a range of responses. Thus, the state response can be commensurate with the circumstances placing the unit in fiscal distress. A disaster or unforeseen loss of a significant part of the tax base does not warrant the same response as evidence of mismanagement. Similarly, fiscal distress that results from artifacts of incorporation are not equivalent to distress resulting from tax base erosion.

1. Home Rule Considerations

Michigan is one of 37 states with constitutions that provide for home rule for cities and villages and one of 23 state constitutions that give home rule powers to counties. A longstanding, perhaps inherent, tension between state control and local self-governance exists under these home rule provisions. The state constitutional and statutory provisions which have sought to reconcile this tension place both legal and practical limitations upon the extent to which state government can effectively intervene in the affairs of local units of government to resolve fiscal difficulties.

The competing views regarding state oversight on the one hand and local self-government on the other were expressed in Michigan by two opposing legal precedents, referred to generally as Dillon's Rule and the Cooley Doctrine. The former, set forth in *Clinton v Cedar Rapids and the Missouri River Railroad,* (24 Iowa 455, ___; 1868), held that "[m]uncipal corporations owe their origin to, and derive their powers and rights wholly from, the legislature. It breathes into them the breath of life, without which they cannot exist. As it creates, so may it destroy. If it may destroy, it may abridge and control." In direct contrast to Dillon's Rule is the Cooley Doctrine, which stands for an inherent right to local governance. That doctrine, as enunciated by Michigan Supreme Court Justice Thomas M. Cooley in *People v Hurlbut,* (24 Mich 44, 95; 1871), held that "[l]ocal government is a matter of absolute right, and the state cannot take it away."

The delegates who drafted the Michigan Constitution addressed the opposing views represented by Dillon's Rule and the Cooley Doctrine in a manner that gave complete ascendancy to neither. Under the constitutional provisions, counties, cities, and villages (but not townships and school districts) are accorded broad home rule powers. However, these provisions are not self-executing; they require statutory implementation. The fact that such implementation requires enactment of *general* law precludes the legislature from directly adopting special legislation aimed at particular home rule local units of government.

2. Significant Constitutional Provisions

The Local Government Article of the Michigan Constitution, Article VII, consists of 34 Sections, of which four are

directly relevant to local home rule.

County Charters. Section 2 provides as follows:

> Any county may frame, adopt, amend or repeal a county charter in a manner and with powers and limitations to be provided by general law, which shall among other things provide for the election of a charter commission. The law may permit the organization of county government in form different from that set forth in this constitution and shall limit the rate of ad valorem property taxation for county purposes, and restrict the powers of charter counties to borrow money and contract debts. Each charter county is hereby granted power to levy other taxes for county purposes subject to limitations and prohibitions set forth in this constitution or law. Subject to law, a county charter may authorize the county through its regularly constituted authority to adopt resolutions and ordinances relating to its concerns.

Cities and Villages; Incorporation, Taxes, Indebtedness. Section 21 provides as follows:

> The legislature shall provide by general laws for the incorporation of cities and villages. Such laws shall limit their rate of ad valorem property taxation for municipal purposes, and restrict the powers of cities and villages to borrow money and contract debts. Each city and village is granted power to levy other taxes for public purposes, subject to limitations and prohibitions provided by this constitution or by law.

Charters, Resolutions, Ordinances; Enumeration of Powers. Section 22 provides as follows:

> Under general laws the electors of each city and village shall have the power and authority to frame, adopt and amend its charter, and to amend an existing charter of the city or village heretofore granted or enacted by the legislature for the government of the city or village. Each such city and village shall have power to adopt resolutions and ordinances relating to its municipal concerns, property and government, subject to the constitution and law. No enumeration of powers granted to cities and villages in this constitution shall limit or restrict the general grant of authority conferred by this section.

Construction of Constitution and Law Concerning Counties, Townships, Cities, Villages. Section 34 provides as follows:

> The provisions of this constitution and law concerning counties, townships, cities and villages shall be liberally construed in their favor. Powers granted to counties and townships by this constitution and by law shall include those fairly implied and not prohibited by this constitution.

Current application of Michigan law puts state government in a position of not responding to local government financial distress until it is a full-fledged emergency. To borrow from a cliché, this last-resort philosophy puts the state in the position of not acting until the horse has left the barn. The local government officials, with guidance from state officials and/or a state appointed review team, are then put into a position of trying to get the horse back into the barn without more damage occurring in the meantime.

This need not be the case. Even though local governments are afforded a high degree of autonomy under local home rule, state government has absolute legal rights to regulate local budgeting and finance:

> State governments supervise the financial activities of their municipalities. States determine where cities get their money, how cities borrow money, how cities spend money, and how cities manage their financial affairs. States have the legal power to regulate municipal finance by virtue of their superior constitutional position.... Because municipalities are legally "creatures of the state," state governments regulate their taxing, borrowing, spending, and financial administration.[6]

B. Range of Responses

The range of options at the disposal of state government for addressing local government fiscal distress fall into five broad themes:

1. a hands-off, nonintervention approach;
2. intervention for the purpose of dissolving such local units of government;
3. intervention for the purpose of restoring such local units of government to some degree of fiscal vitality; and
4. intervention to give local officials the technical or policy skills necessary to alleviate fiscal distress and avoid future distress.

The fifth option, continuous monitoring of local government finances, attempts to keep governments from falling into financial distress, rather than addressing their needs after they enter financial distress.

1. Non-Intervention

The state could choose to do nothing. As long as the cause of the fiscal distress was not a state policy, state interest in the way the unit resolves its problems may be limited. However, consideration of this policy must take into account outstanding obligations that might not be met, the health and safety of citizens, how such a solution would affect other local units of government, and the implications for future responses to fiscal crisis.

a. Home Rule Entails Responsibilities as Well as Rights

The rationale in support of non-intervention flows directly from the concept of home rule. Notwithstanding the axiom that local units of government are creatures of the state, the home rule provisions of the state Constitution, implementing statutes, and case law make clear that home rule local units of government are to enjoy broad latitude with respect to self governance, insofar as that latitude does not contravene the Constitution or general laws of the state.

Home rule may be viewed not only as a set of rights that local units of government enjoy, but also as a set of responsibilities that local units of government accept. While it is generally assumed that the state must "do something" when a unit of local government experiences financial difficulty, the basis for such an assumption is not readily apparent. Assuming that the state did nothing directly or indirectly to contribute to the fiscal plight of the unit of local government, a persuasive argument could be made that the state should have no direct interest in, or involvement with, the way that financial difficulty is resolved. However, such an argument would be subject to two qualifications: (1) it would be necessary to assure that contractual obligations are satisfied; and (2) it might be that a policy of non-intervention could apply only to smaller units.

i. Satisfaction of Contractual Obligations

First, some orderly, in all likelihood statutory, process would have to exist to ensure that any contractual obligations of failing local units of government were satisfied. Such obligations would include pension benefits of former employees and any outstanding full faith and credit bonded indebtedness. The basis of this qualification is that while the state might not have a direct interest in the continued existence of any given unit of local government, it would have an interest in ensuring that contractual obligations not be impaired.

ii. Might Apply Only to Smaller Units

The second qualification has to do with what might be referred to as the "too big to fail" doctrine of the private sector. For example, the Federal Reserve Board has long adhered to the position that a bank which confronts self-inflicted financial collapse should be allowed to fail. However, such a position has been tempered by the unspoken reality that it would be far easier to maintain if, for example, the Bank of Poughkeepsie rather than Chase Manhattan, was on the verge of insolvency. In the same vein, a non-intervention approach on the part of the state might work reasonably well with respect to the Village of Mineral Hills, or another similarly-sized unit of government, but not at all with respect to cities the size of Detroit or Grand Rapids.

b. State Would Permit Unit to Solve its Own Problems or Cease Operation

If a local unit experienced a number of financial crises, citizens presumably would vote to replace the officials that allowed those circumstances to arise or would vote with their feet by moving to communities where such circumstances do not arise. If the problems persisted, state and local policymakers eventually would have to decide whether the local governmental unit was sustainable as an independent unit of government. If not, the state could choose to intervene – either by facilitating a merger with another unit of government or by forcing the entity to revert to township status – or not to intervene, thus allowing the unit to file for bankruptcy.

2. Intervention

The first consideration in providing technical or policy assistance should be the origins of the fiscal problem. The level of assistance or suggested solution should recognize the conditions that resulted in fiscal distress and the actions the local unit has initiated on its own to address the fiscal distress. Just as fiscal distress is not caused by one factor, the state should not take a one-size-fits-all approach to dealing with local government fiscal distress.

A second consideration in providing this assistance should be the long-term prospect of viability for the local unit. As was mentioned above in the discussion of erosion of the economic base, the long-term viability of some local units of government has disappeared with the economic base around which the community was established. Whether as a result of changing markets, military base closure, or closed mines, these bleak economic outlooks have led to the de-

Three Case Studies of State Responses to Local Government Fiscal Distress

Local units of government in Michigan have experienced fiscal distress for a number of reasons, and the state has adopted varied responses to those conditions. The following are descriptions of three local units of government, exploring how they became fiscally distressed, what actions were taken to address that fiscal distress, and how those changes have affected the long-term fiscal condition of the local unit.

Benton Harbor

Benton Harbor, a 4.1 square mile city with a 1990 population of 12,818, provides an example of how direct financial intervention has not solved the root problems causing fiscal distress. During the early 1900s, Benton Harbor established a strong base of manufacturing and metal fabricating plants. By 1920, the city was also a strong tourist destination and distribution center for fruit. In 1930, 54 industries were employing 4,500 city and area residents prompting a 20-year building boom, and by 1950, Benton Harbor was the area's leading center for manufacturing, retail, and wholesale trade. The population had reached an all time high of 18,769.

By 1960, Benton Harbor's economic decline had begun. Commercial businesses began to leave for malls in outlying townships. Relocation activities emptied the city of many retail outlets. Redevelopment projects were quickly started to save some of the city's commercial base, but by that time the city had lost its fruit market and many retail outlets.

The employment base was hurt by an out migration of industry. Manufacturers began leaving in search of cheaper labor and material costs. Technological changes for the manufacturers allowed those businesses to produce more while employing fewer, but more highly skilled, workers. Lost job opportunities, combined with the severe economic cycles of the 1970s and 1980s resulted in a large net out-migration of jobs and population from the city.

Initial government efforts to make the city attractive once again, in the form of urban renewal, cleared many abandoned commercial and marginal residential areas to make room for redevelopment, but new businesses never came, leaving some of those sites vacant today.

Benton Harbor became trapped in a downward spiral. The net out-migration of employers and residential housing left little demand for property in the city, causing severe tax base erosion. The city had fewer tax dollars to provide the same services it had always provided. At the same time, the city was in a position where any programs that might attract new businesses or people required higher levels of services. The only seemingly viable option was to increase property tax rates so the city could provide the same level of service to a dwindling population. Instead of stabilizing the city or its finances, higher tax rates just made the situation worse.

It was in this economic setting that the state opted to go beyond the legislation that was on the books. In 1986, the Michigan Enterprise Zone Authority designated the City of Benton Harbor, in its entirety, an enterprise zone.

As an economic development tool, the Enterprise Zone Act went far beyond other tools available at the time, which only provided for the abatement or capture of local property taxes. Most significantly, it offered exemptions from state taxes, including the following ten-year tax abatements:

1. Exemption from the Single Business Tax.
2. Exemption from the Sales and Use Taxes for purchases of tangible real and personal property.
3. A 60 percent reduction in local property taxes.

The Enterprise Zone Act also provided for additional funding for local government services. The state allowed the city to capture school operating millage paid by qualified firms for its own use. To compensate for this, the state School Aid Fund paid approximately $2 million more than it would have under normal circumstances.

The incentives in this act created a form of financial intervention that was more direct than it seemed. In many ways, the state aid resulting from the Enterprise Zone Act became more significant than it would have been if the state aid provided a bailout or another financial package. However, Benton Harbor remains one of the Michigan municipalities bordering on financial distress, with a taxable value per capita that is less than half that of the next lowest unit in the state. Direct aid to the city government, financial incentives to companies locating or expanding in the city, and hiring incentives all have failed to reverse the declining tax base.

Ecorse

Ecorse provides an example of an outside party forcing severe changes in a municipality's finances to bring expenditures in line with revenues. A small city, with a 1990 population of 12,180, bordering the City of Detroit, Ecorse grew up around the automotive industry and the fate of the steel industry. On December 3, 1986, severe fiscal stress resulted in appointment of a financial receiver to the City of Ecorse by a Wayne County circuit judge.

Ecorse had a history as a once-thriving community that suffered from tax base erosion. A tax base that once supported good schools,

parks, youth sports teams, annual community events such as fireworks displays, became incapable of supporting these amenities. Rather than scaling back to a level of services that could be supported by the declining tax base, the same level of services was continued by incurring deficits and mounting debt.

The City eventually began to collapse upon itself. With the books in a shambles, the City was not sure what assets it held or what liabilities were owed. In 1984, the City failed to pay its Police and Fire Pension Plan contribution, utility bills, and other vendors. These costs were ultimately paid through the issuance of judgment bonds totaling $4 million. In 1986, the City had $6 million in debts with little short-term possibility of repayment. In addition, the City failed to operate under a deficit elimination plan as required by its home rule charter and state law. In connection with this requirement, the Wayne County Circuit Court appointed a receiver to develop and implement a fund-balance deficit reduction program and do whatever else was necessary to improve the City's overall financial condition.

With this backing, the receiver began making the severe changes necessary to reduce the deficit and bring expenditures in line with revenues. Settlements were negotiated to save the City money on numerous lawsuits. Surplus buildings and land were sold, including the public library, and most of the park property. New computers, phones, radios, and copy equipment were purchased to allow remaining staff to perform their duties more efficiently.

While the City did not declare bankruptcy, the financial receivership took on many aspects of a bankruptcy. Assets were liquidated. Non-essential services were terminated. Every effort was made to treat all debtors and remaining employees equitably, so that while they might not have gotten what they originally felt they had coming, they did receive something.

Unnecessary services and appointed positions were eliminated, cutting the City payroll by more than half. The City Police and Fire Pension Fund was frozen with all new employees placed in the Michigan Municipal Employees Retirement System (MMERS). New contracts were negotiated with existing police and fire employees.

The public works department was eliminated and a private firm was contracted to provide the service previously provided by that department. Also privatized were operation of the boat launching facility, animal control services, ambulance billing, and city hall building maintenance.

August 1, 1999, marked the final loan repayments to the state for the borrowing. Since the receiver made the changes, the City has continued to operate with a leaner workforce. The City is paying its bills and remains solvent. Services such as the public library and some youth sports programs have been restored. It appears that the hard lessons have been learned and the City will continue to operate as a much leaner municipality than it once was.

Wayne County

Wayne County, the state's oldest and most urbanized county, provides an example of how it is sometimes necessary to change the operating structure to bring about desired financial reforms.

It had been recognized for several decades that reorganization of Wayne County was necessary, but it was not until the late 1970s that the staggering problems of the county came to a head. The county's records were unauditable; a letter from the deputy state treasurer to the board of auditors cited 22 significant variances from generally accepted accounting practices which prevented the state treasurer's office from auditing county financial operations. The state auditor general asked a prominent CPA firm for suggestions and assistance, but the CPA firm declined, citing an insufficient commitment by the county to make an audit engagement worthwhile.

In addition, county employee costs were extravagant. There were too many elected officials, too much cronyism, and too many semi-autonomous departments. Wayne County was facing ever more critical problems, but no one was in charge. The role of the county commission was too broad, encompassing both legislative and executive functions, and at the same time too narrow, rendering it powerless to prevent excesses in operations headed by elected, or even appointed, officials. The commission structure was recognized as causing some, and inhibiting resolution of other, fiscal and operating problems.

That structure required that the elected board of auditors prepare the proposed county budget and submit that proposal to the county board of commissioners. The board of auditors did not audit and had no control over spending by county departments. The road commission budget was separately prepared and adopted by the road commission itself. The county budget omitted most of the expenditures of the drain commissioner, the road commission, and all grants. Court decisions rendered the budget meaningless: elected officials sued to obtain the resources they felt were necessary to meet their constitutional responsibilities.

In 1976, the Michigan Municipal Finance Commission issued an order to Wayne County directing the county to balance its budget. In spite of that order, the county deficit continued to grow. In 1979, the Michigan Municipal Finance Commission made a Wayne County sale of tax anticipation notes conditional on county submission of a plan to eliminate the deficit; county officials were unable to produce such a plan. Later, in August 1979, Wayne County's request to issue $22 million of tax anticipation notes was denied, and in October 1979, Wayne County was unable to pay its employees, the first county since the great depression to default on a payroll.

It was only after passage of Public Act 7 of 1980, which addressed many of the objections raised by local and state officials against the original charter county enabling legislation, that a Wayne County charter commission was approved by the electors. In November 1981, Wayne County voters adopted a charter "for the purpose of providing more efficient, responsive, and accountable government."

The most important effect of the charter was the restructuring of responsibilities and separation of powers between the legislative and executive branches. Empowered by these charter provisions, the new county executive reorganized all functions not under the domain of independently elected officials under his control.

With a new organizational structure, the county was able to tackle its financial problems. A Ten-Point Fiscal Integrity Plan was drafted to turn around the county's finances and deal with the 1982 budget deficit of $117 million. Nine of those ten points were achieved to varying degrees.

The county's deficit was eliminated over time. A clear understanding of the county's revenues and expenditures has developed, and the county has consistently maintained a balanced budget. Annual audits have improved to the point that the Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the County for its 1998 comprehensive annual financial report, recognizing conformance with the highest standards for preparation of a state and local government financial report.

By addressing the problems presented by an organizational structure that did not provide a clear level of responsibility or accountability, state and county officials were able to create a structure within which fiscal distress could be confronted and future distress avoided.

parture of those able to leave. The state should be equipped with suitable responses to such conditions differently than it might treat a unit suffering from corruption or mismanagement or a unit that has suffered the loss of a few taxpayers that has greater prospects of rebuilding its tax base.

a. Dissolve Local Unit of Government

The state may choose intervention for the express purpose of dissolving a local unit of government as an autonomous entity. The rationale in support of this approach is similar to that mentioned in regard to non-intervention, namely that home rule consists not just of rights, but responsibilities. Indeed, the very notion of home rule presupposes some minimum ability on the part of the residents to govern themselves. However, when a local unit of government reveals by its conduct over an extended period of time that it is incapable of responsible self government, the state would seem justified in concluding that home rule was not appropriate for that particular unit.

i. Presupposes that Chronic Fiscal Problems Reflect Deeper Problems

A recommendation for dissolution presupposes that something about a unit precludes it from operating in a fiscally stable manner. The tax base may be insufficient to generate adequate revenues to provide minimal services. Dissolving the unit under such circumstances takes the decision out of the hands of the residents, placing it in the hands of state policy makers.

A home rule charter could have committed the government to payments that create a structural deficit indefinitely into the future, precluded actions that would allow a deficit situation to be rectified, or maintained a governance structure that does not support a strong decision-making structure. The people of the community should be given the opportunity to rectify the situation themselves with a charter amendment or adoption of a new charter. However, failing such actions, consideration could be given to revoking the home rule charter.

ii. Satisfaction of Contractual Obligations

Any options that would eliminate a unit of government must consider outstanding obligations. Arrangements must be made to fund any outstanding indebtedness and pension benefits of former employees into the future. Options for ensuring the future payments of these obligations could involve their assumption by the local unit of government that becomes the service provider to that community; a dedicated millage, with the tax levied only at that rate needed to pay the obligations; or, these obligations could be assumed by the state. While state assumption of the obligations is not equitable to taxpayers in the state outside that community, the obligations could be considered one-time costs necessary to eliminate an ongoing problem.

iii. Merger/Consolidation

One means of dissolving a local unit of government is to encourage consolidation with one or more of the surrounding, stronger local units of government. This option would address the need to continue service delivery, and create a larger pool of potential residents from which to draw elected

and non-elected officials. In many cases, it would create greater economies of scale to reduce the unit cost of delivering government services.

However, it is worth noting that mergers and consolidations do not take place regularly, even when economic conditions seem to indicate that all involved would benefit from such actions. Mergers threaten the identity communities develop. Most recently, four Upper Peninsula municipalities – Mineral Hills, Caspian, Iron River, and Stambaugh – asked their residents to consider consolidation. Collectively, these municipalities suffered from declining population, loss of economic activity, slow growth in property tax base, high millage rates, and duplication of services. While consolidation would not alleviate all of these problems, it would have eliminated some of the duplication and strengthened the overall tax base. Ultimately, in November of 1998, voters in Caspian voted against consolidation – approval was required in each of the communities individually. Issues identified as concerns leading to defeat included differences in municipal services, cross-subsidization of services among the geographic areas, and worries over creating a new municipal identity. While there were strong economic reasons for consolidation, ultimately the political reasons not to consolidate were stronger. Later, at the November 1999 election, voters of Mineral Hills, Iron River, and Stambaugh voted to proceed with consolidation without the community of Caspian.[7]

With only one of the units considering merger in fiscal distress, merger might be more attractive to residents of the distressed community than it is for residents of the other. In most cases of fiscal distress, the area has been experiencing erosion of its economic base for some time. Flight from these problems has led the most able taxpayers, those with the lowest levels of service demands, to move away. Thus, the healthier unit is faced with absorbing an area with little economic base and fairly high service demands from the residents and businesses that are left.

Under these conditions, the state must attempt to influence decisions that would not otherwise take place. The options are either to force merger or create incentives that make merger attractive. In 1982, the Kellogg Company concluded that the financially depressed City of Battle Creek would be better served by merging with neighboring Battle Creek Township. Kellogg was having trouble attracting executive personnel to a city that was experiencing urban flight and an eroding economic tax base. On the brink of a decision on where to construct a new corporate headquarters, the company looked to other metropolitan areas that had coalesced to achieve major growth – Toronto, Nashville, Jacksonville, Minneapolis-St. Paul, Indianapolis, and Columbus. Kellogg told the city and neighboring township to merge or it was going to find another place to locate its headquarters. The two units merged and Kellogg remained an anchor for the community.

Ultimately, the state cannot force communities to merge, as happened with the City of Battle Creek and Battle Creek Township. Voters in both communities must vote for it to happen. To this end, incentives could be formulated to take away some of the negatives of consolidation or to sweeten the pot. Policy makers must keep in mind the issues that determined the fate of the Upper Peninsula communities when formulating any incentives to promote consolidation. It is not clear that any level of incentives that rewarded the municipal government would have changed the voting pattern of the residents of Caspian. It might be the case that incentives would be more effective if they are targeted to the individuals that reside in the communities considering consolidation.

iv. Elimination of All but Basic Services

Alternatively, the state could dissolve the unit completely. City or village status would be completely ended. In doing so, the unit could revert to township status, with a lesser level of powers, responsibilities, and taxing authority. The unit would be responsible for property assessment, tax collection, elections, and some minimal level of services. Since some services would be eliminated, employees could be laid off. Property not used to provide the reduced level of services could be sold.

If at some point down the road, the community decided that township status was not adequate to meet their governmental needs, the community could go through the process of drafting a charter, gaining approval of the attorney general and the governor, and adopting a new charter through a vote of the people. Such a charter should be flagged coming through the offices of the attorney general and the governor to denote any provisions in the previous charter that contributed to fiscal distress, if any, and the state actions that were necessary as a result. Home rule could remain an option to the residents of this community, but not at the expense of more state assistance and oversight.

b. Financial Intervention

Financial intervention might include direct intervention into the financial affairs of a local unit, increased or decreased state aid, or the use of state aid on the unit's behalf.

i. Direct Intervention

This option would allow the state to intervene directly into the revenue raising and spending affairs of the local unit. If local government officials cannot manage their finances on their own, the state could do it on their behalf. In other states, direct intervention has involved the ability to increase local tax rates and make spending decisions on the units behalf.

However, any state efforts to raise local taxes sufficient to meet needs must consider the Headlee Amendment restrictions on local taxation. At the November 1978 general election, voters ratified a state constitutional amendment that limited state and local government revenues and required voter approval of new taxes. The "Headlee Amendment," added Sections 25 through 33 to Article IX of the state Constitution and amended Section 6 of Article IX. Section 31 of Article IX provides in part as follows:

> Local units of government are hereby prohibited from levying any tax not authorized by law or charter when this section is ratified or from increasing the rate of an existing tax above that rate authorized by law or charter when this section is ratified, without the approval of a majority of the qualified electors of that unit of Local Government voting thereon.

If a local unit of government at its statutory or charter limit got into a financial crisis, the only option available without a vote of the people would be to cut expenditures. This approach effectively defines the powers of the emergency financial manager currently provided for under the Local Government Fiscal Responsibility Act.

ii. Increase or Decrease State Aid

A second level of financial intervention would be to adjust the amount of money distributed to the local unit from the state. The state could attempt to solve the financial problems of a financially distressed unit by providing more money to make revenues equal to expenditures. This approach would offer a carrot – in the form of more money – for some level of changes, assuming the financial problem could, in fact, be solved by making those changes, but it would reward irresponsible behavior and risk having the unit in the same condition a few years down the road.

The state also could use a stick. Money that otherwise would be paid to the local unit in state aid could be withheld unless changes are made. This approach likely would only serve to make the financial situation a little worse. If the local unit budgets for a certain level of state aid, providing less aid would only give that unit fewer resources with which to meet obligations when it did not have enough to begin with.

iii. Use State Aid on the Unit's Behalf

A third level of financial intervention has the state assume some control, but minimizes the level of intrusion into local home rule. State-shared revenues could be used to meet obligations on a municipality's behalf. School districts receive about 70 percent of their funding from state revenue sources. Every city, village, and township in the state receives unrestricted state revenue sharing based on population and a complicated formula that accounts for variation in taxable value, type of government, and tax capacity. State revenues also are shared for restricted purposes, such as highway construction and maintenance and the courts. If a local unit began experiencing pension problems, unpaid employee paydays, revenue shortfalls, or if other situations arose where others stood to suffer because of the financial dealings of a single unit, the state could direct that unit's share of state aid to those purposes.

3. Technical and Policy Intervention

Intervention that provides technical assistance and policy direction to local units of government falls between non-intervention and full intervention. While the state government does not make financial decisions for the local unit of government – such as dictating tax rates or budgetary choices, or managing the books – this type of intervention allows the state to assist in restoring the unit to financial health and keeping it out of financial distress. In 1976, the Committee for Economic Development argued that this is the proper role for state governments to avoid treading on local autonomy:

> … the state governments should play a central role in providing leadership, incentives, and technical assistance for improving the productivity of their local governments and further should work toward removing state-imposed impediments to productivity, which in many states are numerous. This does not imply a diminution of local prerogatives; on the contrary, it suggests a need for state to update their traditional responsibility for providing foundations of local government that will permit cities and counties to manage their affairs more efficiently.[8]

To a great extent, Michigan has adopted this approach with enactment of the laws that currently provide for state oversight of local government finances. That the process provided by Public Act 72 of 1990, the Local Government Fiscal Responsibility Act, was intended to be an intermediate step between non-intervention on the one hand and intervention for the sake of dissolving local units of government on the other, is suggested by Section 2 of the Act which provides in part that

> The legislature hereby determines that the public health and welfare of the citizens of this state would be adversely affected by the insolvency of local units of government, including certain school districts, and that the survival of local units of government is vitally necessary to the interests of the people of this state to provide necessary governmental services. The legislature further determines that it is vitally necessary to protect the credit of the state and its political subdivisions and that it is a valid public purpose for the state to take action and to assist a unit of local government in a fiscal emergency situation to remedy this emergency situation by requiring the prudent fiscal management...

a. Current Michigan Law

The Constitution and statutes provide the state government with authority to monitor and supervise the financial affairs of local governments. Most of the statutory authority to perform this supervision rests with the state treasurer. The statutes attempt to provide a framework within which local governments must operate, and to provide tools for dealing with fiscal distress should it occur.

i. Misconduct or Willful Neglect of Duties

It is the duty of state officials to monitor the actions of local government officials and hold them accountable for neglect of duty or misfeasance in the conduct of their duty. Section 10 of Article V of the state constitution states:

> The governor shall have the power and it shall be his duty to inquire into the condition and administration of any public office and the acts of any public officer, elective or appointive. He may remove or suspend from office for gross neglect of duty or for corrupt conduct in office, or for any other misfeasance or malfeasance therein, any elective or appointive state officer, except legislative or judicial, and shall report the reasons for such removal or suspension to the legislature.

Chapter 15 of the Michigan Election Law provides the governor with authority to remove local officials who are guilty of official misconduct or willful neglect of duty.[9] This option has not been invoked in the most recent cases involving the state and a local unit.

ii. Uniform Budgeting and Accounting Act

The Uniform Budgeting and Accounting Act[10] requires local units to maintain uniform charts of accounts and enables the state treasurer to provide assistance to establish or maintain the uniform chart of accounts for those local units which require assistance. If the local unit fails to establish and maintain a uniform chart of accounts, the law empowers the state treasurer to perform the necessary services to adequately establish or maintain the uniform chart of accounts. Local units are required to make and file with the state treasurer an annual financial report containing summaries of all revenues and expenditures, indebtedness, and fund balances.

All local units of more than 2,000 people, except the City of Detroit, must have an annual audit of their financial records, accounts, and procedures. The audit is required for local units of less than 2,000 population at least once every two years. The law specifies that if the City of Detroit establishes internal auditing procedures for all public monies and submits a copy of the annual internal audit, then an independent audit is required at least once every five years. One copy of every audit and the audit report must be filed with the state treasurer. The state treasurer may examine those audits and conduct investigations and report violations of statutes to the attorney general, who may pursue criminal or civil actions if any audit or investigation discloses statutory violations on the part of any officer, employee, or board of any local unit.

The Uniform Budgeting and Accounting Act also requires that budgets must be balanced and that deviations from the appropriations act may not be made without amending the appropriations act. Local governments may not authorize or participate in the expenditure of funds except as authorized by a general appropriations act. If it appears that actual revenues will be less than anticipated, the chief administrative or fiscal officer must present to the legislative body recommendations that, if adopted, would prevent expenditures from exceeding revenues. Officials and employees of a unit are prohibited from creating debt or incurring obligations on behalf of the unit unless permitted by law, and from incurring expenditures in an account in excess of appropriations.

iii. Uniform System of Accounting Act

The Uniform System of Accounting Act[11] provides for the formulation and establishment of a uniform system of accounting and reporting in state government and county offices. Counties are required to make annual financial reports in the prescribed form, one copy to be filed with the state treasurer and one copy with the governor. The state treasurer is directed to examine county financial reports at least once each year or as often as the public good requires and county officials are required to produce records and truthfully answer questions. The treasurer must make a report of the examination, and if criminal malfeasance, misfeasance, nonfeasance, or gross neglect of duty is discovered, must file a copy with the attorney general who must institute, or direct the county prosecuting attorney to institute, criminal proceedings and civil action for recovery. The governor is authorized to remove county officers for failure to comply with the act.

iv. State Revenue Sharing Act of 1971

The State Revenue Sharing Act[12] provides authority to the state to withhold revenue sharing payments if a local unit fails to provide an adequate financial report or audit. The State Revenue Sharing Act also requires local units that experience a deficit to formulate and file financial recovery plans with the Department of Treasury within 90 days after the beginning of their next fiscal year. The state Department of Treasury may help to develop the plan, and must evaluate the plan and certify that it ensures correction of the deficit. After certification by Treasury, the local unit "shall institute the plan." An amount equal to 25 percent of state revenue sharing payments may be withheld from any unit until requirements of the subsection are met.

v. Municipal Finance Act

The Municipal Finance Act[13] permits local units to issue tax anticipation notes. If the loans anticipate tax collections for the next succeeding year and the borrowing is for the payment of operating expenses, the money can be used only for expenses

- "which could not reasonably have been foreseen and adequately provided for in the tax levy for the then current fiscal year;
- for the payment of an expense in the then current fiscal year which cannot be funded because of a delay in or failure of receipt of budgeted revenue; or
- for the payment of budgeted expenses in the then current fiscal year that precede budgeted revenues."

If a local unit defaults on an outstanding obligation, the state treasurer may investigate the municipality's fiscal affairs, may assist the municipality in developing a financing plan, and may withhold state revenue sharing payments and use those payments to satisfy unpaid or subsequently due amounts. If the governing body of the municipality refuses to implement a financing plan that the state Department of Treasury has found to be fair and equitable, "the department shall be vested with all powers of the municipality, its governing body, and its officers that are necessary to implement the plan." The state treasurer may institute court action to force implementation of the plan, and, when a plan has been put into effect, may require any periodic reports that the department considers necessary, may approve or reject the municipality's general appropriation act or budget and any amendments thereto before adoption. The municipality is required to make any modifications in the budget recommended by the state treasury department.

vi. Emergency Municipal Loan Act

The Emergency Municipal Loan Act[14] establishes the local emergency financial assistance loan board in the department of treasury, consisting of the state treasurer, director of commerce, and director of management and budget. The board is empowered to make and renegotiate loans to municipalities, and to examine the books and records of municipalities that apply for or receive a loan to ascertain whether the municipality is complying with the requirements of the board, state law, and local charter, ordinances, and resolutions. The board may require sworn statements from officers or employees of a municipality and may require a statement of financial condition. The local emergency financial assistance board may issue orders to a recipient municipality and may enforce compliance with its orders, the terms of a loan, state law, or local charter, ordinance, or resolution. In order to be eligible for an emergency loan, a unit must

- have a current year deficit;
- have applied to the municipal finance division within six months for approval to issue tax anticipation notes (TANS) or revenue anticipation notes (RANs);
- have an income tax revenue growth rate of 90 percent or less from year to year, local tax base growth rate of 75 percent or less of the state rate, or have state equalized value (SEV) less than in the preceding year; and
- submit a long-range plan outlining actions to be

taken to balance expenditures with revenues.

In receiving loans, local units of government commit themselves to certain requirements. Units which receive loans

- must employ a full-time professional administrator;
- submit semiannual evaluations of actual performance compared to the long-range plan;
- submit quarterly statements of actual revenues received in the last quarter and in the current fiscal year to date, total estimated current year revenues, actual expenditures and encumbrances in the last quarter and the current year to date, estimated revenues and expenditures for the current year and through the end of the last quarter, and a balance sheet indicating whether total estimated expenditures for the current fiscal year and for the last quarter have exceeded the total estimated revenues for the current fiscal year and the last quarter, respectively;
- submit the general appropriations act and amendments, budget changes before adoption, and proposed budget; and
- certify use of the uniform chart of accounts.

The Emergency Municipal Loan Act states that a local unit may receive an emergency loan of up to $1 million in any one year, and in five years of any ten year period. Interest is due annually one year after the loan is made; principal is due in not less than ten equal annual installments beginning ten years after the loan is issued. If the unit is delinquent in repaying interest or principal, the state treasurer may withhold the delinquent amount from state revenue sharing payments.

vii. Fiscal Stabilization Act of 1981

The Fiscal Stabilization Act[15] allows a local unit to issue general obligation bonds to fund an operating deficit. Three conditions must be met in order for a local unit to obtain the necessary approval from the state administrative board.

1. The unit must have an accumulated operating deficit in the preceding year or a projected current year deficit.
2. The amount of the deficit must exceed the amount available from the emergency municipal loan fund.
3. The amount of the deficit must be more than can be raised by issuing tax anticipation notes.

The unit must also provide a statement outlining how it intends to avoid future deficits. The sale is limited to the lesser of three percent of state equalized value (SEV) or $125 million, and a maximum term of ten years. If voter approval is obtained, the debt service may be met by an unlimited tax; if voters reject or are not offered the opportunity to vote, repayment must be accomplished within general tax limits.

viii. Pensions

Local units are obliged to pay retirants the full amounts owed, and to set aside in pension accounts amounts that are earned by active employees in each fiscal year. Retirants are protected by Section 24 of Article IX, of the state Constitution, which states:

> The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby. Financial benefits arising on account of service rendered in each fiscal year shall be funded during that year and such funding shall not be used for financing accrued liabilities.

One very common indicator of fiscal distress, and one that often precipitates financial crisis, is the failure to fund local pension systems on an actuarially sound basis. Because unfunded accrued liabilities are not part of a local unit's deficit, underfunding pension costs can postpone the necessity of dealing with the local units financial problems. Local units experiencing fiscal distress are tempted to "borrow" from their pension funds with the expectation that they will spread that cost over the longer term. Unfortunately, persistent underfunding compounds operating problems as required pension contributions grow ever larger.

Should there be insufficient assets in the pension fund to pay retired workers, those retirees' payments must be made directly from current accounts. Either retirants or active employees, usually through the pension board, may seek protection through the courts. In Michigan, courts have on occasion used the device of judgment bonds and judgment levies to allow local units to increase property taxes beyond normal limits to meet pension obligations.

ix. Municipal Employees' Retirement Act of 1984

The Municipal Employees' Retirement Act[16] provides for a municipal employees' retirement system to which any Michigan municipality may elect, either by a majority vote of its governing body or an affirmative vote of its electorate, to belong. The system is administered by a board composed

of the state treasurer or his/her designee, three officers of participating municipalities, and three municipal employees who are members of the system; the board appoints an actuary and a medical director. The state treasurer is treasurer of the system, the attorney general is legal advisor, and the director of the bureau of retirement systems, in the Department of Management and Budget, is executive secretary. Local units may select from a range of benefit programs. Participating municipalities are required to annually contribute an amount certified by the board, and may be charged interest and penalties for late payments. "Contribution requirements shall be actuarially determined using experience assumptions and level percent of payroll actuarial cost methods adopted by the retirement board." Membership in the state system guarantees that the pension system will be professionally managed, that assumptions and benefits are reasonable, and that funding is current.

x. Fire and/or Police Department Pension and Retirement Act

The Fire and/or Police Department Pension and Retirement Act[17] provides for the establishment and administration of local pension systems for uniformed police and fire personnel. The statute defines the authority of the retirement board as well as pension benefits, options, and member contributions. The municipality is required to appropriate "an amount sufficient to maintain actuarially determined reserves covering pensions payable or which might be payable on account of service performed and to be performed by active members, and pensions being paid retired members and beneficiaries." Annual appropriations must be sufficient to pay all pensions due and payable that year, and may not be less than ten percent of member payroll unless a lesser percentage contribution is actuarially determined. The amount required for annual pension contributions under the act is outside tax limitations imposed by charter limitations or state law, subject to Section 25 of Article IX of the state Constitution.

b. Local Government Fiscal Responsibility Act

The Local Government Fiscal Responsibility Act[18] provides a statutory mechanism for state intervention into the affairs of local units of government for the purpose of resolving fiscal distress.

i. Origins of the Acts

The Legislature had for some time debated the merits of having a statute that would define expected state actions when a unit became fiscally distressed. It was not until a Wayne County circuit judge appointed a financial receiver to the City of Ecorse that this matter received some resolution. Apparently concluding that judicial fiat was not the preferred method for addressing local fiscal distress, the Legislature adopted Public Act 101 of 1988, the Local Government Fiscal Responsibility Act. Act 101 provided a statutory mechanism for state intervention into the affairs of local units of government, other than school districts, for the purpose of resolving fiscal emergencies. Subsequently, the Legislature adopted Public Act 72 of 1990, which incorporated the provisions of the predecessor act and extended them, with some modifications, to school districts.

ii. Embodied in the Current Process

The Local Government Fiscal Responsibility Act enumerates 14 conditions, the existence of one or more of which within a unit of local government triggers a preliminary review by the state treasurer:

(a) The governing body or the chief administrative officer of a local government requests a preliminary review under this article [of the act]. The request shall be in writing and shall identify the existing financial condition that makes the request necessary.

(b) The state treasurer receives a written request from a creditor with an undisputed claim that is unpaid six months after its due date against the local government that exceeds the greater of $10,000 or one percent of the annual general fund budget of the local government, provided that the creditor notifies the local government in writing at least 30 days before his or her request to the state treasurer of the intention to invoke this provision.

(c) The state treasurer receives a petition containing specific allegations of local government financial distress signed by a number of registered electors residing within the jurisdiction of the local government equal to not less than ten percent of the total vote cast for all candidates for governor within the jurisdiction of the local government at the last preceding election at which a governor was elected. Petitions shall not be filed under this subdivision within 60 days before any election of the local government.

(d) The state treasurer receives written notification from the trustee, actuary, or at least ten percent of the beneficiaries of a local government pension fund alleging that a local government has not timely deposited its minimum obligation payment to the local government pension fund as required by law.

(e) The state treasurer receives written notification that

employees of the local government have not been paid and it has been at least seven days after the scheduled date of payment.

(f) The state treasurer receives written notification from a trustee, paying agent, or bondholder of a default in a bond payment or violation of one or more bond covenants.

(g) The state treasurer receives a resolution from either the senate or the house of representatives requesting a preliminary review under this section.

(h) The local government has violated the conditions of an order issued pursuant to, or of a requirement of, Public Act 202 of 1943, the Municipal Finance Act, or any other law governing the issuance of bonds or notes.

(i) The local government has violated the conditions of an order issued in the effectuation of the purposes of the Emergency Municipal Loan Act by the local emergency financial assistance loan board created by Public Act 243 of 1980.

(j) The local government has violated the requirements of sections 17 to 20 of Public Act 2 of 1968, the Uniform Budgeting and Accounting Act, and the state treasurer has forwarded a report of this violation to the attorney general.

(k) The local government has failed to comply with section 21 of Public Act 140 of 1971, the State Revenue Sharing Act of 1971, for filing or instituting a deficit recovery plan.

(l) The local government fails to provide an annual financial report or audit that conforms with the minimum procedures and standards of the state treasurer and is required under Public Act 2 of 1968, the Uniform Budgeting and Accounting Act.

(m) The local government is delinquent in the distribution of tax revenues, as required by law, that it has collected for another taxing jurisdiction, and that taxing jurisdiction requests a preliminary review.

(n) A court has ordered an additional tax levy without the prior approval of the governing body of the local government.

In an instance when the state treasurer reports to the governor that there exists within the unit of local government one or more of the preceding conditions indicative of a serious financial problem, the governor is required to appoint a review team to conduct a more extensive review of the financial condition of the unit of local government. The statute provides that a review team is to consist of the state treasurer, the state auditor general, a nominee of the Senate majority leader, a nominee of the speaker of the House of Representatives, and, other state officials or individuals with relevant professional experience.

Upon completion of its review, a review team must transmit to the governor a report specifying whether the following conditions indicative of a serious financial problem exist, has occurred, or would be likely to occur if remedial action were not taken:

(a) A default in the payment of principal or interest upon bonded obligations or notes for which no or insufficient funds are on hand and segregated in a special trust fund.

(b) Failure for a period of 30 days or more beyond the due date to transfer one or more of the following to the appropriate agency:
   (i) Taxes withheld on income of employees;
   (ii) Taxes collected by the government as agent for another government unit, school district, or other entity or taxing authority;
   (iii) Any contribution required by a pension, retirement, or benefit plan.

(c) Failure for a period of 30 days or more to pay wages and salaries or other compensation owed to employees or retirees.

(d) The total amount of accounts payable for the current fiscal year, as determined by the state treasurer's uniform chart of accounts, is in excess of ten percent of the total expenditures of the local government in that fiscal year.

(e) Failure to eliminate an existing deficit in any fund of the local government within a two-year period preceding the end of the local government's fiscal year during which the review team report is received.

(f) Projection of a deficit in the general fund of the local government, for the current fiscal year in excess of ten percent of the budgeted revenues for the general fund.

The review team, in its report to the governor, is required to reach one of the following conclusions:

(a) That a serious financial problem does not exist within the unit of local government;

(b) That a serious financial problem does exist within the unit of local government, but that the review team and the unit of local government have entered into a consent agreement containing a plan to resolve the financial problem; or

(c) That a financial emergency exists within the unit of local government because no satisfactory plan could be

entered into to resolve the serious financial problem.

It should be noted that the sections requiring the governor, and then a review team, determine the existence of a serious financial problem tend to be cumbersome. Equally cumbersome is the requirement that the governor, upon receipt of the report by the review team, make a conclusion of serious financial condition. Given the statutory requirement that appointment of a review team be preceded either by the governing body of a unit of local government requesting assistance in meeting the ordinary needs of government, or by the state treasurer determining the existence of one or more statutory conditions indicative of a serious financial problem, it is implausible that a review team subsequently would conclude that no serious financial emergency existed. It is equally implausible that a governor, after having received the written report of a review team, would conclude that no serious financial problem existed.

In an instance in which the governor determines the existence of a financial emergency within a unit of local government, or where the governor is informed by the state treasurer or a review team that a unit of local government which had entered into a consent agreement is not abiding by that agreement, the governor is required to assign responsibility for managing the financial emergency to the local emergency assistance loan board, which, in turn, is required to appoint an emergency financial manager.

iii. Utilization of the Acts

The provisions of Public Act 101 of 1988 were invoked on two occasions: involving the City of River Rouge and the Township of Royal Oak. In both instances, local officials negotiated consent agreements with review teams to avoid appointment of an emergency financial manager. In the case of River Rouge, the review team recommended the appointment of an emergency financial manager after the consent agreement was violated, but no action was taken regarding that recommendation. It is unclear to what extent the consent agreement signed with Royal Oak Township has been observed by the township. Actions initiated under Act 101 continued by operation of law under Act 72.

The provisions of Act 72 have been invoked on two occasions to date, with respect to the Kalkaska School District in the winter of 1993 and the City of Highland Park in the spring of 1996. The Kalkaska School District's financial problems were eventually addressed by the changes in school funding brought about under Proposal A of 1994. Like River Rouge and Royal Oak Township, the City of Highland Park and the review team entered into a consent agreement in August of 1996, under the terms of which the review team would continue to monitor the financial condition of the city until requirements specified in the consent agreement were satisfied. As of this writing, the City of Hamtramck is in the early stages of the Act 72 process, after the mayor of that city requested a preliminary review.

C. Avoiding Fiscal Distress Through Monitoring

State supervision has three components: (a) the establishment of standards of service and the goals to be achieved; (b) the guidance and instruction needed to assist local officials to comply with the standards; and (c) the authority to monitor local units and to improve their work if necessary. Michigan has established the standards and goals in state law. For most units, guidance and instruction are limited to state laws that set out uniform budgeting and accounting standards and define reporting requirements for units wishing to borrow or incur debt. For a small number of units, guidance and instruction has come through the Local Government Fiscal Responsibility Act, through which a review team provides oversight and instructs local officials on techniques for sound financial management to avoid future problems. State efforts to inspect local units have not gone beyond requirements that local units file financial statements with the state at the end of each fiscal year. Little is done with these financial statements.

A proactive approach to monitoring and early intervention could expand the current state role without crossing into state control. A state oversight approach based on monitoring and early intervention could use the tools developed for providing technical and policy intervention to continuously track local government finances. Such a role would not imply state control, where financial responsibility rests primarily with the state and the local units are mere agents. The aim would be to provide the guidance to keep local governments financially healthy and to identify potential problems before they become serious. By identifying indicators of potential future fiscal distress, the state could assist local government officials in making positive changes to avoid imposing the Local Government Fiscal Responsibility Act process or some other means of financial intervention at a later date. State supervision recognizes that the primary responsibility lies with the localities and that the state is responsible for aiding and improving local adminis-

tration, but not for the detailed acts of that administration.

Two issues complicate any state efforts to oversee local government finances: (1) the number of local units of government, and; (2) the measures to monitor as indicators of future fiscal distress.

1. Number of Units.

Michigan has 1,859 general-purpose units of government and 555 local school districts that are covered by the Local Government Fiscal Responsibility Act. Additionally, 57 intermediate school districts, 28 community college districts, and over 250 special districts and authorities require some level of state oversight. Overseeing the finances of all of these units would require much higher levels of staffing than are currently assigned to such tasks.

A "triage" strategy would reduce the number of units requiring active state oversight as a beginning point. As will be explored below, the North Carolina Local Government Commission uses this methodology with some success. Other states also work under this same premise in developing lists of units under "fiscal watch" or some level of higher state oversight.

A "triage" strategy would reduce the number of units requiring active state oversight. A triage strategy for handling this number of local units would begin with an assumption that units do very well in managing their finances. Under this method, the forms of local government are clustered into three groups.

1. Units that are assumed to be financially healthy based on past experience, barring any misdeeds or catastrophic acts. This group should receive minimal attention. They should not be ignored, but staff will not have sufficient time or resources to analyze their finances closely.
2. Units that have consistently experienced fiscal distress. This group should receive the lion's share of the attention in the state oversight efforts.
3. The remaining units should receive a fair amount of attention, but unlike the second group, oversight efforts will begin with the assumption that they are healthy and will remain healthy.

As will be explored below, the North Carolina Local Government Commission uses this methodology with some success. Other states also work under this same premise in developing lists of units under "fiscal watch" or some level of higher state oversight.

2. Indicators of Fiscal Distress.

The state already possesses some means to identify local units which are experiencing fiscal distress. Local units must adopt balanced budgets and file audit reports, file deficit recovery plans that must be approved and certified by the state treasurer, and implement those plans. Local units must obtain approval from the Department of Treasury to sell tax anticipation notes (TANs) or revenue anticipation notes (RANs), from the Local Emergency Financial Assistance Loan Board for emergency loans, and from the State Administrative Board to issue deficit-funding bonds.

The problem for the state is how to make these tools work to achieve a more proactive level of oversight, in order to identify units before it is necessary to take some of these emergency actions. It is difficult with an issue such as local government finance to establish a uniform definition for fiscal distress. Local units of government vary by tax base, service delivery, and demographic measures such as population. Uniformity differences are compounded by such analytical problems as:

- Very few standards against which local government finances can be measured with confidence;
- Fiscal difficulties emerge gradually and incrementally, making potential difficulties less obvious;
- A lack of "useable" and "understandable" dissemination vehicles and formats to assess financial condition.

Some states use a system of fiscal benchmarking to track the financial condition of a number of local units. Benchmarking is, to put it simply, a system of comparing a number of units, (1) relative to themselves at another point in time, (2) to each other at that same point in time, and (3) to a standard measure that is considered critical, to identify strengths and weaknesses in their operations. Benchmarking is a widely accepted means of information gathering and analysis.

Fiscal benchmarking can address the lack of uniformity and the analytical difficulties of local governments. Ideally, fiscal benchmarking would create ratios from information about revenues, expenditures, operating policies, debt structure, the liability structure, condition of the capital plant, demographic data, and management and data-reporting practices.

a The Level of Solvency to be Measured

The range of time, and thus the type of solvency a benchmarking system would hope to insure, must be decided before any indicators can be measured to determine relative fiscal health. Financial condition, the "solvency" of the governmental unit, can mean a number of things, based on the range of time used as a reference. For instance, the International City/County Management Association's *Evaluating Financial Condition: A Handbook for Local Government* describes these varying levels of solvency:

- *Cash solvency* refers to governments' ability to generate enough cash over 30 to 60 days to pay its bills.
- *Budgetary solvency* refers to governments' ability to generate enough revenues over its normal budgetary period to meet its expenditures and not incur deficits.
- *Long-run solvency* refers to governments' ability in the long run to pay all the costs of doing business, including expenditures that normally appear in each annual budget and those that appear in the years in which they must be paid.
- *Service-level solvency* refers to governments' ability to provide services at the level and quality that are required for the health, safety, and welfare of the community and that its citizens desire.

The range of time used as a reference is a significant factor that separates measuring the financial health of private entities from the financial health of public entities. Private enterprise can be measured in a number of ways revolving around the ability of the enterprise to turn a profit, but for the most part, investors in private enterprise are concerned about the long-term financial health of the enterprise, and the return on their investments over the long-run. Performing each task in the production of a final good as efficiently as possible is desirable, if not attainable.

Measuring the fiscal health of public entities is not as straight forward as it is for private entities. The nature of public entities precludes the measurement of financial health based on their ability to turn a profit. Financial health must be measured on their ability to raise sufficient revenues to fund the services provided. Additionally, short-term cash and budgetary solvency tend to be more significant in measuring the fiscal health of public bodies. Finally, in government, fund accounting has been regarded as more important than program cost accounting and the measurement of long-term financial health, although this will change with the new Governmental Accounting Standards Board guidelines (See **Effects of GASB Guidelines Changes**).[19]

b. Data to be Collected

The possibilities for ratios that could be compiled to provide a snapshot of the financial status of a unit of government at a point in time are extensive. A unique system could be created, or one of a number of models available for replication could be adopted. Standard and Poor's has developed "Public Finance Criteria." The International City/County Management Association (ICMA) has developed "Financial Trends Monitoring System" (FTMS). The Governmental Finance Officers Association has developed a "Financial Indicators Database."

Following the methodology laid out by ICMA's Financial Trends Monitoring System, ratios that could be included in a system of fiscal benchmarking might include environmental, organizational, and financial factors.

Environmental factors would include measures of

- *community needs and resources*, such as changes in population or property value, and
- *intergovernmental constraints*, such as tax rates relative to charter or statutory tax rate limitations.

Organizational factors would include measures of

- *management practices and conformance with legislative policies*, such as use of generally accepted accounting principles and the timely filing of required reports.

Financial factors would include measures of

- *revenues*, such as revenues per capita, measures of expenditures, such as fixed costs as a percent of net operating expenditures,
- *operating policies*, such as fund balances or liquidity as a percent of net operating revenues,
- *debt structure*, such as current liabilities as a percent of net operating revenues,
- *unfunded liabilities*, such as unfunded pension liabilities or accumulated employee leave, and
- *capital plant*, such as the maintenance effort or the capital outlay as a percent of net operating expenditures.

Appendix 1 – Potential Ratios for Fiscal Benchmarking box, lists possible ratios and indicates what type of information might be gleaned from each.

Effects of GASB Guidelines Changes

If it is to comply with generally accepted accounting principles, every governmental unit will have to incorporate new guidelines promulgated by the Governmental Accounting Standards Board (GASB) for preparing financial statements over a period of three years, beginning in 2002. Information required under current financial reporting guidelines is too disaggregated to provide a "big picture" overview of government finances, has a narrow short-term focus, and is incomplete, lacking information about capital assets. The changes were promulgated to provide more, easier to understand, information to financial report users about their government. This information will describe how costs are being shifted from current to future generations, if a government's financial condition has improved or deteriorated, and how much is being spent on infrastructure costs.

Better Tools to Judge Financial Health

Annual financial statements will be more accessible and contain comprehensive information that can be used to assess the long-term, total financial condition of a government under this new format.

The Old. Using current fund-based government financial statements it is difficult to understand the "big picture" because fund accounting for general activities – like police protection – focuses on short-term resources such as cash and investments and short-term liabilities. To track these services, governments employ modified accrual accounting, which reports only the revenues received and the cost attributable to services provided in the current year. While this method permits government officials to demonstrate how well they are managing public funds in the short-term, it does not allow users to understand a government's total financial condition in the long-term.

By contrast, governments use full accrual accounting – which recognizes transactions and events as revenues or expenses when they occur, regardless of hte timing of related cash flows – for business-type activities (such as airports) that charge a fee for services and fiduciary activities (such as a pension fund) in which governments act as agents for outside parties. This is the accounting method used in the private sector.

Additionally, current financial statements fail to provide information about the cost of constructing and maintaining infrastructure assets, such as roads, bridges, buildings, and sewers. Private sector firms and nonprofit organizations, in sharp contrast, already include capital assets, and the cost of using them over time, in their financial statements.

The New. The new guidelines will address many of these shortcomings. Annual financial statements will be more accessible and contain comprehensive information that can be used to assess a government's long-term, total financial condition. Governments will continue to provide information for major funds, but they will also provide government-wide statements that are prepared using full accrual accounting.

The government-wide statements will consider government from an economic perspective, which views government as a single economic unit, not just a collection of separate funds. It will use a single basis of accounting – full accrual – so that all revenues and all expenses in a fiscal year are reported. That includes all measurable assets and liabilities, both short-term and long-term, financial and capital, whether they support governmental activities or fee-for service activities. For the first time, financial statements will report information about all capital assets, including infrastructure assets.

Financial managers will have their first opportunity to provide informed insights about their government's finances. Intended to be an objective, easily readable analysis of a government's overall financial condition, such an analysis should allow users to readily determine whether a government's finances have improved or deteriorated since the previous year. In doing so, it will be incumbent upon the financial managers to discuss the reasons for significant changes from the previous year.

More Units May Appear Near Fiscal Crisis

While the adoption of these new guidelines will provide a better long-term perspective on the financial outlook, it is likely that many units judged to be in strong financial condition using the current reporting methods will suddenly appear to be approaching financial distress. The primary cause for this change will be the introduction of infrastructure asset reporting. Governments must calculate the historical or original cost of existing major infrastructure assets that were constructed, purchased, or renovated since the first fiscal year ending after June 30, 1980. At a minimum, the government can assess the historical cost of their infrastructure over a 25-year period and then allocate those costs over the useful lives of the assets by reporting annual depreciation expenses. Governments that can provide documentation that they are maintaining and preserving their infrastructure at an established condition level may report their maintenance and preservation expenses in lieu of depreciation. While depreciation of assets has been common practice in private sector accounting, government accounting has never before included infrastructure depreciation. With infrastructure introduced on one side of the ledger, but nothing to offset that value on the other side of the ledger, the overall financial status of governmental units is likely to change, even though they are doing nothing different.

It is vitally important for these ratios to be meaningful. By grouping local governmental units according to population and the type of government, they facilitate comparisons of units with roughly the same service provisions, demand levels, and operating costs. Because there will never be two units of government that are identical in their organization, the resources available to them, or the services demanded of them, the aim is to overcome these differences for purposes of comparison.

c. Identifying Problems with the Data

The ratios should be organized into reports and made available for public consumption. Besides the state oversight efforts, such information would be useful to elected and financial officials in the local units, citizens concerned with their government's finances, and state officials in understanding local government fiscal trends. By using a database for more than just internal state purposes, those comparing themselves against other units will be able to identify those falling far from the norm and point out any problems with the data.

One of the constituencies most likely to use such a database would be the finance and budget officials in each unit. The ability to benchmark themselves against other units of similar size and service demands can be a tool of considerable value to these officials. Being closest to the data, they also would be among the first to recognize any problems with the data. Thus, the very units that are measured in a database would be the ones auditing and cleaning up the data.

Auditing also becomes a function of use. When the state comes to a unit because a ratio or indicator identifies a potential problem, two possibilities present themselves:

1. that a problem exists that can be addressed with the proper attention; or
2. that the unit is not out of line, but there is a problem with the way the data is aggregated or reported.

In the case of the second possibility, addressing a reporting problem once should alleviate the problem for the following years.

Washington and Montana consulted with local government officials in developing their benchmarking systems. Instead of a top-down system where state officials told the local governments what was to be reported, the state became facilitators for a bottom-up system. The system ultimately was designed to meet both state and local management needs and thereby became fairly sophisticated. The end result was a stronger system that was useful to a wider range of potential users than would have been the case if the states unilaterally developed their own systems.

d. Pros and Cons of Fiscal Benchmarking

Fiscal benchmarking can strengthen the state oversight role, but state officials should understand the pluses and minuses of benchmarking before they adopt it.

i. External Benefits of Fiscal Benchmarking

For the citizens, a database of this sort becomes a tool for monitoring the finances of their unit of government. Simple to understand, meaningful ratios could increase citizen involvement in local government.

Identification of best practices in neighboring communities and of costs that are out of line with the costs other communities are paying for particular functions allows local units of government to identify potential cost savings. Ultimately those savings can be returned to taxpayers in reduced tax rates and/or enhanced service delivery.

Investor confidence is raised by knowing the state is taking an active interest in the financial practices of its local units of government. Rating agencies report upgrading the bond ratings for North Carolina local units of government beyond the ratings they would otherwise receive because the Local Government Commission actively oversees their financial practices and investigates the overall environment in which repayment will take place before bonds are even offered for sale. The end result of this improved investor confidence is reduced cost of municipal borrowing. Increased confidence translates into upgraded bond ratings, which, in turn, translates into lower interest rates. Lower interest rates mean less money has to be paid for interest costs and more money is available to pay the principal on borrowing.

ii. Advantages of Benchmarking

Institutional Knowledge. A benefit of having an on-going system of state monitoring is that state officials develop a knowledge base by working with the local governments. They learn what kind of accounting gimmicks might be employed to mask problems. They develop trust in certain ratios or measures of fiscal health. They learn what local units are doing well and can relay that knowledge to other units in similar circumstances that might benefit from the experience. Similarly, benchmarking allows local government officials to analyze their own finances relative to other

units of similar characteristics. If another unit is substantially outperforming other units in one or more ratios, the local government officials can contact that unit directly to benefit from their innovation.

Collegial v. Adversarial Relationship. A strong state role in local government oversight provides an opportunity for state and local government officials to develop a working relationship during strong financial times. One of the weaknesses of the Act 72 process is the adversarial relationships that have tended to develop between the state and the local government officials. Rather than creating a system of collegiality, the atmosphere has resulted in local government officials attempting to do whatever it takes to get the state out of their business. Relative to the conditions prior to state intervention, when dissension among the local officials could sometimes prevent substantial and meaningful changes, state intervention has tended to cause the local officials to coalesce to end this intervention. While creating a common enemy might prove useful in settling disputes, in most cases of fiscal distress the real problems of the local governmental unit are not dealt with in these efforts.

iii. Problems of Benchmarking

False Readings. A danger in relying too strongly on a system of benchmarking is that false readings are not only frequent, but troublesome. For instance, interfund borrowing might mask a brewing crisis that could come to a head in even greater magnitude a few years down the road if resources are not sufficient to repay the borrowing while maintaining other obligations. Use of one-time, non-recurring funds might keep a unit's finances from appearing negative as they might otherwise appear. The appearance of a deficit would not necessarily relay information on whether the cause was a onetime occurrence or a structural problem.

That said, if ratios are developed to benchmark local government finances, for officials to judge their own performance and for the state to use as one of several tools, this system can be a powerful first step in identifying which units warrant greater scrutiny.

D. Experience of Other States

Three major events stand out as key dates in shaping state oversight of local government finance and responses to local government fiscal distress. (1) A major transformation in the ways in which state governments and their local units of government interacted with one another occurred in the late 19th and early 20th centuries. Before this era, states typically exercised great control over their local units of government: writing their charters, dictating taxation and expenditure levels, and controlling the structure within which local governments interacted with each other. This period resulted in an opening of government to the people with home rule laws that allowed local units of government to create their own charters. At the same time the cities were gaining home rule powers, states were increasing the intensity of monitoring local government finances. Because of the technical restraints and the lack of budgeting sophistication of the time, these were ex post facto efforts at analyzing prior year finances of local governments, typically efforts were directed at ensuring accounts were balanced and supervising assessments.

The systems established by states to monitor the finances of local government during this era laid the groundwork for many of the subsequent supervision and monitoring laws that followed. It was during this period that state governments, with revenues still flowing from property taxes, created boards of equalization, with the powers to change the aggregate valuation of counties so as to equalize the apportionment of state taxes. States also emphasized accountability, a common tenet of Progressive Era reforms, through such measures as reporting requirements and standardization of accounts. Less attention was paid to the aggregate levels of spending or the accounting and budgeting systems employed. As bad as some of the municipal accounting and budgeting systems were, they were often better than those of the states within which the cities were located.

(2) The second major event, the Great Depression, affected the mix of state and local taxation and service responsibilities and left many local units of government in fiscal distress with only federal bankruptcy laws to handle the crises. States reacted to those developments in a number of ways, some of which are reflected in Michigan law. Some states changed their focus from controlling local budgets as a way of controlling property taxes to across-the-board tax and spending limitations. Michigan adopted the 15/50-mill tax limitation in 1932. Some states relieved the property tax burden by increasing state aid. Michigan began a system of sharing revenues raised by the new liquor tax and beer and wine taxes with local governments that grew into the cur-

rent state revenue sharing program. Also at this time, a number of states gave their local governments permission to raise revenues from non-property taxes. A centralization of state supervision and control over local finances also resulted from the Great Depression. This was true for Michigan, but many states went far beyond the levels of centralization implemented in Michigan.

(3) The third major event was the New York City fiscal crisis. While this crisis affected only New York City and the State of New York directly, it served as a wake-up call for every other state. If it could happen in a city, such as New York, that receives a great deal of attention and budget scrutiny, surely it could happen in smaller cities and towns with less budget scrutiny. States began to notice, as a result of this crisis in one of the nation's major cities, that improvements in accounting and integration of the accounting, budgeting, and reporting systems could provide an early warning system to the state governments to prevent fiscal emergencies.[20]

Although all states were influenced by these three events, state oversight of local government finances varies widely from state to state. As of 1977, the last time a study compiled practices of the states, 37 states had a statutory basis for monitoring or supervising local government budgets. Local government budgets are collected in 34 of the 37 states, and many of those states had power to change a budget if it was found to be out of compliance with state laws. Uniform budget standards or guidelines for preparation of local budget documents were devised in 24 states. Eight states (and the county governments in Ohio) approve all or part of the local budgets before the local government can expend any money. Indiana, Massachusetts, Nevada, New Hampshire, New Mexico, Ohio, and West Virginia all require approval of the budget or certification of tax rates before funds can be expended or revenues raised for that fiscal year. Colorado and Missouri require local governments to file their budgets before they can expend money. Louisiana, Michigan, North Carolina, and Tennessee all can assume detailed control of local government budgets under some circumstances.[21]

A major theme running through these periods, one that still rings true in analyzing state oversight systems, is the difference between legislative mandates and administrative supervision. Legislative mandates – as implemented through such tools as state mandates for local spending on specific functions, approval requirements for debt issuance, and tax limitations – are equated with state government's efforts to determine local policies and usurp local priorities. Administrative supervision – as implemented through such tools as balanced budget requirements, uniform budget and accounting standards, and standardization of accounts – is equated with state government's efforts to set up general rules for local units of government to follow and the determination of state governments to enforce those rules. While most states have administrative supervision, Indiana, Massachusetts, New Jersey, New Mexico, North Carolina, Ohio, and Washington are among the states that have fairly strong state oversight powers that include some level of legislative mandates, including some level of centralized control over local budgets.[22]

The following is a brief description of the state oversight process in select states. North Carolina's Local Government Commission (LGC) is the model for other states in the oversight of local government finances. As a result of the proactive monitoring performed by the LGC – strong fiscal and debt management and superior disclosure – local units of government receive above-average debt ratings for local general obligation and revenue bond issue. North Carolina taxpayers ultimately benefit from this oversight with savings that result from lower interest rates. At the end of the 1998 Fiscal Year, the Local Government Commission had played a part in the sale of over $1.09 billion in competitive tax-exempt general obligation bond sales for local government, with rates averaging 47 basis points under the national Bond Buyer's Index. The result was savings in excess of $48.9 million over the life of these bonds.

A number of states have extensive programs for overseeing local government finance and responding to local government fiscal distress. While they do not go as far as North Carolina, these states offer interesting comparisons to the current statutes in Michigan.

1. General Oversight in Michigan

The Bureau of Local Government in the Michigan Department of Treasury is charged with local government financial monitoring for most of the laws effecting the finances of local government (described above in the **Technical and Policy Intervention** section). The responsibilities of the Bureau of Local Government are currently divided as follows:

- Assessor Certification Division is responsible for examining and certifying the abilities of local government assessors and equalization officers.

- Local Audit and Finance Division has three sections, local audits, municipal finance, and special audits.

  Local Audit Section is responsible for conducting audits for counties, is the repository for audits of other local governmental units, and performs audits on expenditure of Public Act 51 transportation funds for county road commissions, cities, and villages.

  Municipal Finance Section is responsible for approving all bonds and notes consistent with Public Act 202, the Municipal Finance Act.

  Special Audit Section is responsible for performing audits when there are allegations of fraud or misdeeds.

- City Income Tax Division is responsible for administering the city income tax for the City of Albion.
- Local Property Services Division is responsible for administering the Homestead tax exemption program and the tax reversion process.
- Property Tax Division acts as staff to the State Tax Commission, is responsible for assessing utility property, and oversees property tax exemption programs (such as the Public Act 198 industrial tax abatements).

  The State Tax Commission is responsible for oversight of the property tax, including assessment and equalization, and hears appeals from aggrieved taxpayers or local units of government.

While the structure is in place to provide financial oversight, Michigan's Bureau of Local Government has not adopted an active policy of oversight. The most active financial oversight is provided for administration of the property tax system. Local units of government are required to file audits, but these receive minimal review – checking that they are prepared in accordance with generally accepted accounting principles and that the funds are not in deficit. Local units receive a greater amount of financial review if they wish to borrow. In order to receive the necessary approval from the Department of Treasury to issue any bonds or notes, local units must complete a form detailing the current financial and debt status of the unit. The Bureau does not actively oversee local government finances, and has on occasion learned of potential fiscal distress from citizen or media questions.

2. General Oversight in Selected States

Reporting Requirements. Reporting requirements generally vary among states only in the frequency of required reports. While not all states require financial reports from their local units of government, those that do generally require only an annual year-end financial report. Some states require that a budget be submitted before the beginning of the fiscal year. **North Carolina** law requires that local governments submit semiannual statements of finance, as well as audited financial statements on an annual basis. Additionally, the Commission has the authority to require additional reports should circumstances warrant. While the powers of the Local Government Commission to exercise financial control over local government matters is substantial, it is the ongoing financial surveillance that prevents fiscal stress from becoming a crisis for local governments.[23]

Oversight generally includes accounting and auditing. States are interested that Generally Accepted Accounting Principals (GAAP) are being adhered to for the budgetary and auditing processes. The general oversight role allows the state overseers to comment on the financial accuracy and legal compliance of the reports.

Debt Reporting Requirements. Some states also require local governments to report to the state on debt issuance. Every planned debt issue – including general obligation bonds and notes, utility/enterprise revenue bonds, and public hospital bonds – must undergo a fiscal review by **North Carolina's** Local Government Commission staff. General obligation and revenue bond issuers are required to submit lengthy applications for bond issue approval, including summary financial and debt information, projected tax rates required, and forecast enterprise operations if the bonds are to be paid from enterprise earnings. Most bond documents must be close to being finalized before submission and approval by the Commission. The state Commission has the authority to disapprove or revise bond issue plans.

Although the local government debt issuers may hire their own financial advisers, **North Carolina's** LGC takes an active role in the negotiation process for hiring these advisers. The state also is actively involved in the actual sale and marketing of securities. The LGC has the authority to mandate tax levies for debt and budgetary requirements, should local officials not take such actions on their own.[24]

Staff. Staff levels are cited as one of the strengths of **North Carolina's** Local Government Commission. With a staff of 35, 16 of whom are dedicated to the continuous fiscal surveillance of local units, **North Carolina** laws for fiscal oversight and responding to fiscal distress are generally written to empower this body rather than dictating when actions must occur. The staff is composed primarily of individuals with masters degrees in business administration and accountants, almost all of whom have Certified Public Accountant credentials. Continuity, specialization in fiscal oversight, and experience from dealing with multiple units has provided the Commission with the expertise needed to recognize potential fiscal distress and make informed decisions on dealing with those situations.[25]

Technical Assistance. Many states provide technical assistance to local government officials in budgeting, accounting practices, auditing, preparation of bond plans, and with most other financial matters for which some assistance can be offered. In **North Carolina** for instance, on-site assistance is offered for accounting systems and proper internal controls, cash and investment management, budget preparation, risk management, capital planning, and changes in law and regulations. Training is extended not only to local government employees, but to auditors, consultants, and anyone else who might benefit. The commission is a contractual party to all auditing contracts.

A positive side benefit resulting from these types of assistance programs is a collegial, congenial relationship that develops between staff of the state oversight bodies and the local government officials and employees. The state does not come into the local governments only when fiscal distress is imminent, but when times are good as well. Should finances become stressed, the staff of the state oversight body is not looked upon as strangers unfamiliar with local circumstances, but familiar faces that the local government officials and employees have worked with on other matters.

Consulting Services. A number of states have begun to extend technical assistance to include consulting services. In **New Jersey**, a state with no property tax limitations, the Local Government Budget Review program was instituted as an effort to bring about property tax relief. It combines the expertise of professionals from the Departments of Treasury, Community Affairs, and Education with team leaders who are experienced local government managers to provide local governments with a management review and consulting service.

To find those "cost drivers" in local government, the teams review all aspects of local government operations, looking for ways to improve efficiency and reduce costs. The teams also document those state regulations or legislative mandates that place an unnecessary burden on local governments, and suggest which ones should be modified or eliminated. Finally, the teams note where local governments are utilizing "best practices" – innovative ideas that deserve recognition and that other municipalities may want to emulate.

The Local Government Budget Review Program reviews the finances of a number of individual municipalities, school districts, and authorities each year. Every aspect of the local governmental unit's finances are reviewed, including not only the service functions, but the basic administrative operations of each unit as well. Based on the expertise of the staff and using benchmarks identified from reviewing other local governmental units, these reviews are able to identify program changes, operational inefficiencies, and other areas that could lead to potential cost savings. The final report for each local unit is an in depth audit that benefits from having other units for operations and costs comparisons. This intensive review and dialogue between local officials and the review team is designed to produce significant insight into what factors are driving the costs of local governments, and provide the necessary tools to bring meaningful property tax relief to the State.

The **Minnesota** Office of State Auditor serves as a resource for cities and counties to obtain, review, and compare financial data to find more efficient and economical ways to spend public funds. The office works with local government officials to provide answers to legal and financial compliance questions and to find ways to implement cost-effective internal controls. One result of these efforts has been the development of a unique software program. The Small City and Towns Accounting System was designed to improve the accounting and reporting of financial data from local governments.

Benchmarking. With the availability of desktop computers, states are developing computerized databases on financial performance of the local governments. States do not rely on the databases for official purposes. Rather, they are used for inter-unit and class comparisons of financial performance measurements. The reports are useful to lawmakers in understanding the fiscal trends of the local governments within the state, to local government officials for comparing their performance with their peers, and to citizens as

a tool for understanding how the finances of their units compare with the finances of other units.

The **Ohio** Office of Auditor of State has received national acclaim for its benchmarking studies. The Government Finance Officers Association of the United States and Canada presented the **Ohio** Office of Auditor of State with a 1998 Award for Excellence in Government Finance for the ongoing series of summary reports detailing benchmark information on local government finances.

These benchmark studies, the State Ratio Analysis Series, employ key ratios to obtain a more comprehensive picture of fiscal situations among the **Ohio** local units of government. These basic indicators illustrate financial practices among governments, and consequently are valuable as financial planning aids. Moreover, they may provide an early warning to entities drifting toward financial crisis. **North Carolina** and **Minnesota** also use such databases.

In the late 1960s and early 1970s, **Washington** introduced the budgeting, accounting, and reporting system (BARS). This new program required a level of local government information that the state did not have. In the state auditor's efforts to institute the BARS program as an aid to state policymaking, local input was incorporated into the development of the system. Rather than unilaterally deciding to gather only information that could be anticipated to assist the state, the system ultimately was designed to meet both state and local management needs and thereby became fairly sophisticated.

Other states have followed this example of incorporating local concerns into any state reporting requirements. When **Montana** developed a budgeting, accounting, and reporting system similar to **Washington's**, it was more in response to local demands than from state initiative. The aim was to assist cities and counties in creating day-to-day financial reports to assist local government managers in financial decision making.[26]

i. State Action Triggers

The decision for the state oversight body to begin actions beyond that of general oversight comes about in four basic ways, including (1) requests by municipal officials, (2) legislatively defined criteria that trigger state actions, (3) providing the latitude to staff to initiate action, and (4) responding to legislative decisions.

Requests by Municipal Officials. Requests by the elected local government officials for assistance is a common mechanism triggering state intervention. As an intermediary step before bankruptcy, allowing the elected officials to come to the state allows them to take actions to control their financial circumstances. Upon being approached by a local government official and reviewing the finances of that unit, the state and city must negotiate an intergovernmental agreement before the state can intervene in the affairs of the city. Michigan's Local Government Fiscal Responsibility Act contains provisions for the state to intervene if requested by a municipal official.

Legislatively Defined Triggers. A number of state legislatures have enacted laws that define criteria that must be met before any state intervention can be initiated by the state. Triggers are generally dependent on whether:

1. Debts are being repaid -- bonded debt, rentals, money owed other governmental units
2. Past and present employees are being paid -- employee payroll, taxes on employee income, pension obligations
3. There is a deficit -- in the general fund, in all accounts
4. There are recurring financial problems -- deficits in consecutive years, short-term borrowing in consecutive years, borrowing against future revenues

Figure 1 identifies indicators of fiscal distress that are commonly used by selected states. The states represented each have a statutory system defining fiscal distress and suggesting when it is proper for the state to intervene in the local government financial affairs. While many of these triggers may be applied by the Local Government Commission, North Carolina does not have a statute defining local government fiscal distress or suggesting when state intervention is necessary. These matters are left to the Local Government Commission to decide based on past experience with each unit and their analyses of how the units are dealing with their financial problems.

Legislative Decision. **Massachusetts** and **Connecticut** both have financial control boards currently in place as a result of special legislation that was a reaction to particular cities financial troubles. The **Massachusetts** law places the City of Chelsea in receivership. **Connecticut's** law involves the Jewett City Borough. In both cases, a receiver is appointed by the governor. The receiver of Jewett has comprehensive

fiscal powers and authority to supervise all personnel and operations. The receiver has power to establish rates for taxes, fees, and charges if the governing body does not act or the power to levy added taxes during the fiscal year if necessary to meet obligations. The receiver of Chelsea is vested with the powers of the city mayor.

Figure 1

Indicators of Fiscal Distress Commonly Used by Selected States

	Michigan	Florida	New Jersey	Ohio	Penna
Default or failure to make payment of principal or interest upon bonded obligations, notes, or rentals due	X	X	X	X	X
Failure to repay short-term loans within the same fiscal year they are due		X			
Failure to transfer taxes withheld on income of employees	X	X		X	X
Failure to transfer taxes collected for another government unit	X				
Failure to transfer contributions required by a pension, retirement, or benefit plan	X	X			X
Failure to pay wages and salaries or other compensation owed to employees or retirees	X	X			X
Spending in excess of revenues					For 3 years or more
Total accounts payable is in excess of 10% of the total expenditures of the local government in that fiscal year	X			X	
Failure to eliminate an existing deficit in any fund	X				
Maintained a deficit		2 successive years		exceeding 4% of the total tax levy for two consecutive years	1% or more in each of 3 previous fiscal years
Projection of a deficit in the general fund for the current fiscal year	In excess of 10% of total spending				
Noncompliance of the local government retirement system with actuarial conditions stipulated by law		X			
Decreased a quantified level of municipal services from the preceeding fiscal year due to tax limitations					X
Filed a debt readjustment plan under the federal bankruptcy code					X

ii. Powers of Control Boards

Most states have powers similar to Michigan's review teams in the Act 72 process, which allow a control board to advise local government officials and set targets for the creation of a recovery strategy. The control boards in some states have limited authority to control finances, requiring state approval to make spending decisions or the ability to set tax rates. Other states, such as **North Carolina**, have the power to assume full financial control over a local government's finances. Finally, some states, including Michigan, bypass the control board approach and appoint a receiver to oversee local government finances.

Advisory. Michigan, like most other states, has provided for the review teams to provide a predominantly advisory role. The Local Government Fiscal Responsibility Act provides for an emergency financial manager with fairly extensive powers to control revenue and spending decisions. However, in three circumstances where a review team was appointed to work with local governments in creating a recovery strategy, the process never proceeded to the point of hiring an emergency financial manager. Advice of the review teams ultimately led to consent agreements in which local government officials agreed to make changes necessary to bring about financial reform.

The **Pennsylvania** Constitution prohibits the legislature from enacting any law regulating the affairs of a municipality, or delegating to any commission the power to intervene in municipal functions. The Financially Distressed Municipalities Act of 1987 provides a mechanism for the state to work with local units of government, but the actions of the state are not binding on those municipalities. The municipality may decide to adopt or reject any plans offered by a Department of Community Affairs' coordinator. If the plan is rejected, the municipality must prepare an alternative plan acceptable to the Department, or risk having the state withhold loans, grants, and entitlements. If the plan is adopted, the coordinator is responsible for implementation.

Recognizing the role of home rule, the **Florida** financial emergency statute does not attempt to remove responsibilities from the municipal government in a financial emergency. Instead, the statute attempts to put the state in a position to insure that local governments take the appropriate steps to eliminate the financial emergency. Upon being approached by a local unit of government and reviewing that unit's finances, it is necessary for the state and city to negotiate an intergovernmental agreement allowing the state to intervene in the affairs of the city. Most recently, the role of the control board working with Miami officials was to provide oversight. However, their powers reached far enough that the City had to have board approval for any major purchases.[27]

New Jersey has had mixed experience with working with local units of government in financial distress. In the late 1980s, a system was instituted to attempt to keep local units from getting into financial trouble. State auditors began working with local governments to identify spending problems. Increased state aid was used as the incentive to work with the state. This program ran for four years, at which time the state ended the auditing practice, but continued state aid.

That system was replaced by the Local Government Budget Review program, which authorizes the state to work with local governmental units and monitor their financial health in an effort to bring about property tax relief. This program had the same intent as the state audits under the previous program, but the voluntary nature of the previous program limited its effectiveness. Under this new program, the state has more power to force changes as suggested by the auditors.

Full Financial Control. If the advisory role of the state in **New Jersey** fails, the state assumes full financial supervision. Local finance boards are appointed by the governor, with advice and consent from the legislature. All spending and revenue raising responsibilities fall under control of the local finance boards. This normally lasts for one year, although it could last longer as circumstances dictate.

The powers granted to the state under such circumstances allow it to bring revenues in line with expenditures. They do not allow the state to make substantive changes in how a city operates. The state can set tax rates and adjust spending levels. However, if structural problems can be identified, it is ultimately up to the municipal officials to address those problems. Thus, there have been instances where the state has had to assume financial control on multiple occasions during a number of years, because state assumption of financial control only addressed problems in the short term.

North Carolina has the most extensive powers to monitor and intervene in the financial affairs of a local unit of government of any state. The Local Government Commission is empowered to perform adequate and frequent financial reviews, it has a broad set of control powers that allow it to

intercede in the financial affairs of local government, and it has been allowed do what was needed to maintain the financial health of its local units of government. The LGC has the authority to remove any officer or employee, and to impound the books and records and assume full control of all its financial affairs if, in the opinion of the LGC, the unit is in jeopardy of default, financial policies and practices of the unit are not improved, or a unit fails to comply with directives of the LGC.

In addition, the law requires the LGC to notify issuers days in advance of all scheduled installments of interest and principal of that issuer's public debt. If a local government fails or refuses to levy taxes sufficient to meet debt installments, the commission's order to levy taxes have the same legal force and effect as if the taxes had been levied by the offending governing board.

While this law allows the state to intervene in the home rule powers of local governments, local governments are given every opportunity to levy the necessary taxes on its own. Wall Street has a great deal of confidence that any bonds, debts, or obligations will be paid. **North Carolina's** Local Government Commission effectively serves as a "credit firewall," performing frequent financial, debt, economic, and management reviews of all local governments that, in many ways mirror the reviews performed by the bond rating agencies. **North Carolina** taxpayers benefit from the strong oversight provided by the state as well. The confidence of being repaid translates to above-average ratings and lower interest rates, which result in lower taxes to finance bond sales.

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State Receivership. While Michigan has experience with a court appointed receiver for the City of Ecorse, it is not clear under what authority the judge was acting in appointing a receiver. The Local Government Fiscal Responsibility Act of 1989 was a reaction to the actions of the judge and created a process to prevent the appointment of receivers in the future.

Connecticut, **Maine**, **Massachusetts**, and **Nevada** have adopted fiscal distress legislation that places a local government in receivership. The powers of the receivers in **Connecticut** and **Massachusetts** are granted under special legislation responding to the inability of two units of government to address their fiscal problems.

In **Nevada**, the law does not provide for a board of control or any other similar distress agent. If the State Tax Commission determines that a municipality is in severe fiscal distress, it must order the State Tax Department to "…take over the management of the local government…."

Increasing Powers Over Time. The several Michigan laws relevant to financial oversight provide the Department of Treasury with authority to conduct oversight at varying levels, ranging from requiring audits and charts of accounts to withholding state revenue sharing if a unit is delinquent in repaying loans. Michigan's Local Government Fiscal Responsibility Act provides a wide level of discretion for a review team in its oversight of local government finances. A review team may choose to negotiate a consent agreement, allowing the unit to solve its own problems to the extent that it can, or it may recommend the appointment of a emergency financial manager, if it judges that the unit will not be able or willing to make the changes necessary to deal with the fiscal crisis.

Ohio has two different levels of state intervention: fiscal watch and fiscal emergency. If a unit is placed in fiscal watch, state advice is offered, but the unit is allowed to develop a recovery strategy without oversight from the Financial Planning and Supervision Commission. The Auditor of State may provide technical and support services, the cost for which is borne by the state.

The state assumes extensive powers over local units of government in **Ohio** that digress from fiscal watch into fiscal emergency. Such an occurrence causes a Financial Planning and Supervision Commission to be created. This commission must approve a financial recovery plan containing actions to eliminate the fiscal emergency conditions, balance the budget, avoid future deficits, and market long-term obligations. The plan must be submitted to the commission within 120 days of its first meeting, at which time, the commission can either accept or reject the plan, listing reasons if rejected. The commission is also responsible for retaining a financial supervisor, which can be either a CPA firm with fiscal emergency experience or the Auditor of State. The commission, or the supervisor when authorized by the commission, has the authority to

- Review all revenue and expenditure estimates to determine whether they result in a balanced budget;
- Require the government by ordinance or resolution to establish monthly levels of expenditures and encumbrances consistent with the financial plan; to approve and monitor these levels;
- Approve the amount and purpose of any debt issues;
- Make and enter into all contracts and agreements necessary to performance of its duties, and
- Make recommendations for cost reductions or revenue increases to carry out the financial plan.

iii. Closure

A recurring issue for each of the review teams that have been assembled to work with local governments through the Local Government Fiscal Responsibility Act has been when to end the active level of oversight provided under the act. In each instance, a consent agreement was negotiated with the local government officials for changes to address the financial problems. The River Rouge consent agreement was violated and the review team recommended the appointment of an emergency financial manager for that city. This occurrence raised the issue of how long active state oversight should continue under the act. Accordingly, when a review team was convened to work with the City of Highland Park, the duration of the review team was left open ended. It was agreed that the review team would not be eliminated until all of the following had occurred:

a. The City's financial statements reported that, on the basis of generally accepted accounting principles, no fund was in a deficit condition.
b. The City had received a qualified or unqualified opinion from independent certified public accountants for that fiscal year.
c. The City had cured the internal control deficiencies as detailed in the independent certified public accountants management letter of June 30, 1995, and any subsequent management letters.
d. No action had been taken or condition was in place that would initiate or allow the initiation of a preliminary review under Section 12(l) of Act 72, Public Acts of 1990.

The consent agreement with Highland Park remained in effect until the end of the 1999 fiscal year.

As an ongoing effort to oversee local government finances, **North Carolina's** Local Government Commission never stops. Oversight efforts can remain just as strong several years after a fiscal crisis as they were immediately after the crisis.

Likewise, **Ohio** illustrates how multiple levels of oversight can provide strong oversight long after the occurrence of a fiscal crisis. **Ohio** statutes provide a clear point at which local units of government change back to fiscal watch from a fiscal emergency. The Financial Planning and Supervision Commission is dissolved when

- An effective financial accounting and reporting system is being implemented, with expected completion within two years;
- All fiscal emergency conditions have been or are in the process of being eliminated, and no new emergency conditions have occurred;
- The financial recovery plan objectives are being met;

The entity has a five-year financial forecast that the Auditor of State determines "nonadverse."

VI. Recommendations

It seems clear from the range of options available that having a state response to fit the circumstances is the intent of current Michigan policy, either intentionally or unintentionally. Erosion of the tax base has been a leading cause of fiscal distress among the Michigan local units. Accordingly, the state has used tools such as the Municipal Finance Act, the Emergency Municipal Loan Act, and the Local Government Fiscal Responsibility Act. Similarly, the state has seemed to recognize structural problems. The fiscal distress experienced by Wayne County in the early 1980s led state policymakers to amend the Home Rule Counties Act to make home rule a more viable option for Wayne County. Most of these policies are structured so that local government officials can work their way out of their own problems, with sanctions available to state officials should the local officials fail to carry out the actions to which they commit themselves. In a worse case scenario, constitutional provisions are available for removal of government officers in cases of misconduct. This should not change.

It also seems clear that implementation of the current array of state oversight tools is of questionable effectiveness for a number of reasons. Staffing of the Local Audit and Finance Division of the Michigan Department of Treasury Bureau of Local Government has been cut to such levels as to render the three staff members remaining incapable of performing meaningful financial reviews. With a bare bones operation, the Division is left in a response mode. The Division often is left to learn about local government financial problems in individual local units from the media or concerned citizens.

Also clear is the view that the implementation of current laws does nothing to alleviate the animosity between state and local government officials that is so prevalent in Michigan. A spirit of distrust of the other level of government has been allowed to ferment to the point that it permeates nearly every aspect of state/local government relations in Michigan. Local government officials fear state government officials are not fully providing the obliged level of funding, they are imposing unfunded mandates on local governments, and they are intervening into affairs that should properly be decided by local government decision makers. State government officials' distrust of local government officials tends to stem from accusations of wasteful spending of the resources provided by the state and a perceived lesser level of sophistication in dealing with governmental matters.

While this spirit of distrust has permeated nearly every aspect of state/local relations, it is never worse than when a unit of local government gets into fiscal distress and an Act 72 review team is assembled to address that unit's finances. Rather than working together to make the budget solvent, local government officials have tended to adopt an "us versus them" mentality that is more confrontational than collegial. This animosity during Act 72 processes has been made further confrontational by racial accusations, since many of the local units that have gotten into fiscal distress have had a large minority population. This confrontational relationship, which make it difficult to get anything constructive accomplished, needs to change.

The following recommendations attempt to address some of these issues by creating a system of oversight and by establishing an educational system for local government officials and employees. The main goal is to promote a collegial working relationship between the state and local government officials. The primary means of accomplishing that goal is to achieve a greater level of familiarity. More frequent contact by state officials will go far toward accomplishing this goal. It is accomplished by making the state a resource to which local officials can turn to for answers to questions, rather than only hearing from these officials when there are problems and state officials are pointing accusatory fingers.

Another goal of these recommendations is to position the state so that it can address fiscal problems before they reach crisis proportions. By increasing staff and giving them the tools to regularly assess local government finances, the state can share best practices of the fiscally healthy units, identify potential problems early enough to make meaningful changes, and attempt to prevent local government finances from deteriorating to the point of fiscal distress. Further, if a unit's finances do deteriorate into a distressed condition, having this working relationship and regular monitoring should allow shortening of the Act 72 process to more immediately address the problems resulting in fiscal distress. If Michigan has experiences similar to other states, the net effect of such efforts should be a saving to taxpayers.

A. Emulate the North Carolina Local Government Commission.

Bond rating agencies and others agree that North Carolina is one of the leading states in state supervision of local gov-

Figure 2

Changes in State/Local Relations in North Carolina and Michigan by Issue

Issue	North Carolina[28]	Michigan
Property Tax	Legislative actions reduced property tax revenues by 43 percent from 1931 to 1934.	A 1932 constitutional amendment created property tax limitation. Property tax revenues reduced 41 percent from 1931 to 1934.
Sales Tax	A 3% sales tax was enacted to pay for the state's increased responsibilities.	A 3% sales tax was enacted as part of a package to pay for the state's increased responsibilities.
Public Schools	The state assumed responsibility for school operating expenses throughout the state, with local governments retaining authority for building and maintaining school buildings. In 1996-97, the state was responsible for 67 percent of total school operating revenues.[28]	State dedication of sales tax through a 1946 constitutional amendment formalized what had been voluntary state grants to schools. Proposal A of 1994 changed funding so that the state currently collects 68 percent of school operating revenues.[29]
Highway Funding	All local taxes for roads repealed as a result of Depression, with State Highway Commission assuming the responsibility for highways outside municipal boundaries.	The McNitt Act of 1931 ended townships' role in maintaining roads by merging township roads into county road systems. State assistance went from 12 percent of total highway expenditures in 1930 to 97 percent in 1939. The Horton Act of 1931 was a precursor to Public Act 51 of 1951 for distribution of state highway-user taxes to local governments for highway care.
State Supervision of Local Government Finances	Local Government Commission created to review all proposed bond and note issues by local governments and supervise local accounting and fiscal practices.	Supervision has been limited to oversight of property tax, Municipal Finance Act, and efforts to provide a uniform budgeting and accounting framework.

ernment finances. By performing frequent and thorough reviews of each unit's finances, the financial oversight performed by the Local Government Commission has been successful at keeping units from getting into fiscal distress. Furthermore, the activities of the Local Government Commission help to keep local government tax rates low and save taxpayers money. Ratings on North Carolina local government bonds are upgraded primarily because of the confidence bond raters have in the Local Government Commission.

Programs that work well in one state sometimes cannot easily be transferred to another state. That does not appear to be the case with Michigan relative to North Carolina's Local Government Commission. Many similarities exist between North Carolina and Michigan in the allocation and financing of government functions. Most of these are a result of how these two states reacted to the circumstances of the Great Depression. In each state, local governments were especially hard hit by erosion of their economic bases – more local governments defaulted in North Carolina than in any other state during the early 1930s.[30] **Figure 2** illustrates some of the similarities in the allocation of responsibility and financing between the two states.

The primary difference between these two states in the assignment of responsibility for delivery and funding of government services is that North Carolina transferred directly to state control several functions, whereas Michigan left them as a local responsibility but provided state revenues to fund their delivery. In Michigan, nearly 70 percent of all state-raised revenues are paid to other governmental units that ultimately deliver services. State tax dollars go to local gov-

ernments for school aid, unrestricted state revenue sharing, transportation, community colleges, and the courts. Several local units of government in Michigan receive more from state aid then they do from their own local tax sources. It can be argued that such an arrangement increases the justification for a strong state oversight above what it should be if the state were overseeing only local expenditure of local tax revenues. It is incumbent upon the state to ensure an economic and efficient use of state aid, not only in how the dollars are distributed to the local units through statutory formulas, but also in the actual expenditure of dollars by the local units.

Increased state supervision of local government finances might be viewed as an infringement on local home rule, but the alternative of state intervention in the affairs of a financially failing local unit almost certainly has greater negative long term consequences for the concept of home rule in Michigan. With several Michigan laws already on the books providing the state power to oversee local government finances, increased state supervision is likely to be incremental. Moreover, fewer than one-third of the 1,800 general purpose local units of government even have home rule powers in Michigan. Besides the Charter County of Wayne, cities and villages are the only units with home rule authority. The other 82 counties, all 1,241 townships, and all school districts, community college districts, and special authorities or districts operate under state laws that determine their governmental structure, function, and revenue raising authority.

North Carolina municipalities are afforded only slightly less home rule power than that enjoyed by Michigan municipalities, yet the state government in North Carolina provides one of the strongest levels of financial supervision. Almost 20 years ago, the U.S. Advisory Commission on Intergovernmental Relations (ACIR) studied the degree of local discretion state constitutions and state laws afford local governments.[31] Michigan cities ranked as the third highest degree of local discretion; North Carolina cities ranked fifth. North Carolina counties ranked third among all of the states in their degree of local discretion. While Michigan ranked fairly low (28th), state law affords Michigan counties local discretion through the Charter County Act that remains largely unused. Local governments in North Carolina have relatively great discretion in governmental structure, function, and personnel, but have somewhat less freedom in financial matters.

Many of the state/local government relations issues are common to both North Carolina and Michigan. In a recent North Carolina legislative session, a bill was introduced to restrict cities' and counties' authority to regulate billboards, guns, and land use. That legislation stalled in the Senate. Legislation was passed that dictated requirements for local school systems. Many of these same issues have been the cause of some recent controversy in Michigan, as recent legislation perceived as intervening in the affairs of local government has led local government officials to propose a constitutional amendment that would attempt to protect against such infringements on home rule powers.

B. Assign Monitoring Responsibility to the Bureau of Local Government.

Responsibility for monitoring the finances of local government should rest with the Local Audit and Finance Division within the Bureau of Local Government in the Michigan Department of Treasury. Strengthening the role of the Bureau will involve many of the same tasks that are currently performed, but at a level that more proactively investigates signs of fiscal distress. The Bureau should have immediate information on local government finances, tax rates, debt, and pension status. Other units that directly relate to local government finance, such as the Local Government Claims Review Board, the State Tax Commission, and the Office of Revenue and Tax Analysis staff responsible for administering state revenue sharing, all should maintain a strong working relationship with that division. The Bureau also should participate in additional tasks associated with investigating and monitoring local government finances. The ensuing recommendations identify those tasks.

C. Create an advisory body to monitor the actions of the Bureau of Local Government.

Increasing the oversight role of the Bureau will mean the exercise of greater discretion in dealing with local governments. As an administrative body without policymaking authority, it is important the Bureau have sufficient discretion to carryout the tasks assigned to it. An advisory body to monitor the actions of the Bureau of Local Government would ensure that it keeps to its charge, and is evenhanded in its dealings with local government, helping to increase the confidence of local units in its actions. Not only would having an advisory body provide the authority to carry out its responsibilities, but it could provide some insight into the oversight activities of the Bureau and the operating actions of the local units. An advisory board for the Bureau of Local Government oversight body could be composed of:

- The state treasurer;

- The director of the Department of Management and Budget;
- The legislative auditor general;
- One appointee of the majority leader of the senate;
- One appointee of the speaker of the house;
- Five appointees of the governor, to represent (1) cities and villages, (2) townships, (3) counties, (4) school districts, (5) special authorities and districts.

In North Carolina, oversight of the Local Government Commission is carried out by a board composed of the secretary of treasury, the secretary of state, the secretary of revenue, the state auditor, three appointees of the governor, an appointee of the president pro tem of the senate, and an appointee of the speaker of the house.

D. Develop an educational program for local government officials and employees at a major Michigan university.

It is not enough to tell local government officials and employees what is expected of them, education must be made available so as to leave no ambiguity in how to perform financial tasks. This should be accomplished by developing a full-time educational program, with a wide range of expertise in all matters of local government.

The North Carolina Local Government Commission does not operate in a vacuum. The Institute of Government (http://ioginfo.iog.unc.edu/) was established at the University of North Carolina at Chapel Hill in 1931 to provide expert opinion on difficult issues and to help local and state officials to hone the skills needed to conduct public business. The Institute of Government is a university-based local government training, consulting, and research organization. Moody's has commended the Institute's "rigorous and highly respected certification programs," calling it "a university for public officials." Similar institutes in Georgia and New York have modeled themselves after the University of North Carolina program, which attracts continuing national and international interest.

Institute faculty teach primarily in two settings: (1) the Master of Public Administration program, and (2) continuing education programs for North Carolina's public officials. For public officials, the Institute's annual offering of more than 200 classes, seminars, schools, and specialized conferences cover topics such as:

- Legal requirements and obligations of public-office holders;
- State-of-the-art management techniques for departments and agencies;
- Ensuring fiscal soundness and preparing useful financial reports;
- Effective land-use planning tools and techniques;
- Review of current law in specialized fields ranging from conservation and environment to taxation, annexation, and gun control;
- Making informed policy decisions.

In a given year, the Institute will host city and county managers, county commissioners, city mayors, registers of deeds, public defenders, state judges, social services employees, city and county attorneys, planners, recreation directors and budget officers, among many other types of officials and community leaders.

Any of several Michigan public universities could create an academic program, or alter an existing program, to educate local government officials. Unlike North Carolina, where local government programs have been concentrated at the University of North Carolina - Chapel Hill campus, Michigan local government programs have taken root at a number of public universities. Michigan State University has the Department of Agricultural Economics, Wayne State University has the Center for Urban Studies, Eastern Michigan University has the Institute for Community and Regional Development, and the University of Michigan has the Gerald R. Ford School of Public Policy, which used to be The Institute for Public Policy Studies. While each of these programs has made a name for itself in different areas of specialty, none have developed the wide variety of offering as has the University of North Carolina's Institute of Government.

E. Provide oversight of local government finances.

State oversight efforts should extend to the economic and management policies, fiscal management practices, and debt management practices of local units, making the state aware of such indicators of fiscal distress as: tax rates, debt levels, and pension obligations. The state should work with local units continuously to create familiarity with local government practices, and to create a comfort level for local officials in contacting the state for assistance.

Monitor economic and management policies. In part, doing more to monitor the economic and management prac-

tices of local governments simply means doing a better job of enforcing the laws that are already on the books: the Uniform Budgeting and Accounting Act and the Uniform System of Accounting Act. Beyond enforcing those laws, the Bureau should ensure that local units are

- Using accounting practices that conform with generally accepted accounting principles;
- Submitting balanced budgets annually;
- Levying taxes sufficient for debt and budgetary requirements; and
- Investing governmental operating and capital funds prudently.

Working more closely with local government finance officials will make Local Audit and Finance Division staff more aware of budget devices that might mask fiscal distress. State oversight efforts should investigate the use of unrealistic economic assumptions for the projection of future revenues; the use of one-time revenues for budget balancing purposes; the use of inter-fund transfers; and inadequately funded pension obligations. Other management practices that have led to fiscal problems, such as the use of short-term borrowing to fund current operations, should raise red flags leading to further investigation. Oversight efforts should allow the Bureau to work with the State Tax Commission to identify authorized tax rates for each type of unit of government, and be prepared to identify tax levies that do not have statutory or constitutional authority. As is the case in North Carolina, the Bureau should also be authorized to set auditing standards, perhaps going so far as accreditation of municipal auditors.

The Local Government Commission in North Carolina is a party to all auditing contracts. While local units are free to contract with a firm of their own choosing, by making the state a contractual party, it is clear that the auditor is answerable to the state as well as the local government officials responsible for the contract. The Local Government Commission reviews auditors' management letters dealing with internal controls and potential weaknesses in financial management systems. Upon their review, the Commission corresponds with the unit to advise of a "clean" review or outlining improvements to operations recommended by the Local Government Commission or the auditors in their management letters, or both.

Monitor fiscal management practices. The strength of North Carolina's oversight efforts stem from the significant powers of the Local Government Commission. However, the absence of North Carolina local governmental units in fiscal distress relates directly to the frequent and thorough reviews of each local unit of government's finances performed by the Local Government Commission. Local governments are required to submit statements of finances semi-annually and audited financial statements annually. The Local Government Commission analyzes these statements for several key factors associated with fiscal distress:

- General Fund deficit/surplus position
- Revenue and expenditure trends
- Performance compared to budget projections
- Inter-fund transfers
- Fund balance as a percentage of spending
- Balance sheet liquidity
- Tax collection rates
- Enterprise fund operations and ratios
- Enterprise fund cash flow and operating activities.

The factors of analysis used in North Carolina could be adopted for use in Michigan, or different measures could be developed (See **Appendix 1 – Potential Ratios for Fiscal Benchmarking**).

The process to trigger the Local Government Fiscal Responsibility Act could be shortened to acknowledge that the state is providing active fiscal oversight. That act currently requires that one of the triggers initiate the process, that the governor's office find evidence of fiscal distress, and then that a review team report back to the governor the existence of fiscal distress. If the state were providing active oversight, that process could be shortened so that a single finding of fiscal distress would trigger creation of a review team or the appointment of an emergency financial manager. In North Carolina, the state can assume control of a local government if a unit is in jeopardy of default, if financial policies and practices are not improved, or if a unit fails to comply with directives of the Local Government Commission.

Monitor debt management practices. Public Act 202 of 1943, the Municipal Finance Act, requires the state to review the applications for the issuance of bonds and notes by all local units of government. The Municipal Finance Section in the Local Audit and Finance Division currently requires a cursory review of applications for the issuance of bonds and notes for most units. This review generally checks to see that the forms are filled out properly, makes sure no accounts are in a defi-

cit position, and checks that the issuance of debt would not exceed the unit's debt limitation. Units with questionable credit are required to file longer applications that are given more scrutiny. With limited resources available, this dichotomous approach should be continued, with some modification.

The applications should be modified to request summary financial and debt information, projected tax rates required to fund the debt, and forecast enterprise operations if the debts are to be paid from enterprise earnings. Just as the Local Government Commission reviews debt applications of all units of government in North Carolina, the Municipal Finance Section should consider

- Is the bond issue necessary?
- Is the proposed amount adequate?
- Are the applicants' debt management policies and procedures acceptable?
- Will any tax rate increases needed to repay any debt be excessive?
- Can the proposed bonds be marketed at reasonable interest rates?

The review should also consider how a proposed indebtedness would interact with the indebtedness of overlapping units of government, by asking if the tax base relied upon to fund repayment of debt incurred by overlapping units can bear the combined burden.

F. The state should create a system of fiscal benchmarking.

By creating ratios of government finance and organizing governmental units into groups with other governmental units of comparable size and purpose, the state can monitor each unit's fiscal health unobtrusively. Ratios allow the state to oversee nearly two thousand governmental units in an efficient manner. Because the measures can be plotted in a grid, the finances of units that are unusually high or low are easily identified. By making the database available to local government officials, those officials can use the results to identify their own problems, strengths, or weaknesses and make changes accordingly.

Development of a database should follow the example of Washington and Montana. By consulting with local government officials in developing the database, measures that are of use to local government officials were included that would not have been included if the state were developing the database unilaterally. By reaching out in this manner, the state was able to turn development into a bottom-up process, resulting in the development of databases that are of use to both the state and to local government officials.

Because there are inherent problems with any system of using ratios to identify fiscal problems, actions of the state or another unit of government should not be triggered by the benchmarks. Rather, fiscal benchmarking should be a tool to assist the state in oversight of such a large number of units.

G. Adopt a "triage" strategy for keeping the number of units manageable.

Creation of three groups would allow staff to concentrate their efforts on the oversight on the governmental units that have become dangerously close to fiscal distress. The first group of property rich well run units needs little oversight. The second group are those units that have no history of financial problems. They will receive minimal oversight. The third group consists of units that have experienced trouble from time to time. They will receive the lion's share of the attention.

H. The state should look for "big picture" opportunities to create tax savings.

Beyond oversight of the financial affairs of each individual local unit of government, the Bureau of Local Government should be able to identify opportunities for efficiencies among governmental units. In some cases, savings might result from the identification of two or more units that are providing identical services. The Bureau might be well suited to bringing those units together to pursue intergovernmental cooperation in the provision of those services. It also might be able to identify instances where consolidation of local units of government would make sense. A more intensive role in state oversight might allow the Bureau to identify units that will have difficulty surviving with the resources available to them. Consolidation with a neighboring unit would broaden the resources available and create economies that result in savings. The Bureau and a university center will be in a position to study what laws work and to make suggestions to the legislature on ways in which those laws might be improved. As a collector and user of financial data on all local units of government, the Bureau of Local Government will be put in a strong position to study the overall environment local governments operate within and suggest changes to improve that environment.

VII. Conclusion

Local government fiscal distress can result from several origins, including:

- Erosion of the economic base leaving the local unit with insufficient resources to fund the needed or desired level of government services;
- The territory remaining after incorporation having insufficient economic base ;
- Management restrictions that hamper sound budgeting policies or require a level of services that cannot be met from current revenue sources;
- Unforeseen events such as a natural disaster or a lawsuit that adversely affect the tax base or create a necessary unbudgeted expenditure; or,
- Mismanagement in the form of corruption, embezzlement, or any other form of malfeasance.

Opportunities present themselves for cities to transfer individual functions to other levels of government, but because governments are defined geographically, no alternative governments are available to which businesses or residents can turn when a unit fiscally distressed. A fiscally distressed unit must be returned to fiscal health or become part of another fiscally healthy unit that can assume delivery of those government services.

For that and other reasons, the state has a strong interest in maintaining the fiscal health of its local governments. The state must assure a minimal level of local government services to protect the health and safety of its residents. Because enforcing contractual obligations is on the short list of functions that government must perform, it would be ironic if the state would allow one of its local units to default on an obligation. Beyond those reasons that affect private entities in their interaction with government, the state must also maintain local government fiscal health to keep its own house in order. The state must act to prevent collateral damage to its credit rating. It must protect the financial health of the local units that overlap the geographic area of the distressed unit. As some 70 percent of Michigan state tax collections are passed on to another unit of government to fund service delivery, the state must act to assure efficient use of its resources. Finally, in the case of cities and villages, the state must assure the success of local home rule.

The state must then decide how its interest in maintaining the fiscal health of its local governments should be expressed in public policy. While a range of options are considered, it is recommended that the most efficient, effective, and equitable approach to state oversight of local government finances is to take a more proactive involvement in the regular financial operations of the local units.

The state should study and emulate the example the state of North Carolina has set in its oversight of local government finances. While developing a level of local home rule on a par with Michigan, North Carolina has developed one of the strongest, most effective local government financial oversight systems in the nation. Like North Carolina, Michigan's local government financial oversight should include the management and budgetary policies, the financial management practices, and the debt management practices of the local units. Also like North Carolina, Michigan should establish a school for local government officials to learn and draw from at one of its three major universities. A proactive involvement in local government financial oversight could allow the state to identify problems before they reach crisis proportions and create tax savings by avoiding expenditures to repair a unit to financial health, by allowing units to benchmark their finances against comparable units, and by sharing innovative ideas with other local units.

The state has developed a number of laws over the years that allow the state Department of Treasury to respond to fiscal distress with a policy appropriate for the cause of the distress. By more proactively monitoring local government finances, the state could be better able to determine the causes of distress. By working with the local units over time, the state should be able to develop indicators of future distress that allow it to take actions to avert a financial crisis.

Most of the laws are already in place to allow the state to be more proactively involved in oversight of local government finances. It will merely require that the state make a stronger commitment to use the powers it has. By adopting a cooperative approach to monitoring local financial conditions, fiscal crises could be avoided with minimal loss of home rule.

End Notes

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Appendix 1 - Potential Ratios for Fiscal Benchmarking[32]

The ratios and indicators that can be used to analyze the financial condition of local units of government can be grouped into three broad categories

A. Environmental Factors – external influences that can (1) create demands (i.e., population increases); (2) provide resources (i.e., the ability of local units of government to adapt to changing working conditions);

B. Organizational Factors – reflects the accurate, timely release of financial information that is required of local units;

C. Financial Factors – measures of revenues, expenditures, debt, liabilities, and capital stock. These are the result of environmental and organizational influences, and it is here that untreated problems ultimately make themselves felt.

While it is not desirable to use all of the measures discussed, a wide range of measures is offered to illustrate the options.

A. Environmental Factors

These factors reflect the ability of governmental units to collect revenues, the demands placed on those units for governmental services, and the freedom of their locally elected officials to respond to changing circumstances.

Community Needs and Resources

Local government finances are affected as much by what happens outside their control as by the policy decisions that fall within their control. The people that live within their jurisdiction, changes to the tax base, and the economic conditions all stand to affect local government finances, but local governments have little if any control over these items. (Government programs and policies attempting to address many of these issues tend to have limited success.)

- *Population change* – rapid decreases in population can indicate a problem that is causing people to leave. Rapid increases can indicate a potential unmet service demand. Most likely to affect intergovernmental revenue distributed on a per capita basis.
- *Age distribution* – An aging population and an increase in the number of senior citizens can hurt both the revenue and expenditure profiles of a local government. Conversely, a growth in the number of young families and school age children could create demands for other types of government services.
- *Personal income per capita* – one measure of a community's ability to pay taxes: the higher the per capita income, the more tax a community can generate. Higher income also indicates a lower dependency on government services such as transportation, health, recreation, and welfare.
- *Change in personal income relative to the state average* – declining personal income can reflect disinvestment.
- *Number of poverty households* – an increase in the proportion of poverty households or public assistance recipients can signal a future increase in the level and unit cost of some services, because low-income households have relatively higher needs and a relative lack of personal wealth.
- *Percent of housing built before a given date* – an aging housing stock can reflect a lack of investment in a community and point to larger problems.
- *Property value per capita* – property values are significant in absolute terms and relative to past values. Like income per capita, property value per capita reflects a community's ability to generate tax revenues.
- *Property value change* – the effect of declining property value on governmental revenues depends on the government's reliance on property taxes. A decline in property value will most probably not be a cause but a symptom of other, underlying problems.
- *Tax collection by overlapping local governments* – while the tax rate of a single unit might be relatively low, the overall tax burden imposed on residents will affect the ability of a unit to respond to increasing needs with increased tax rates.
- *Residential development as a percent of total development* – the net cost of serving residential development is generally higher than the net cost of serving commercial or industrial development, because residential development usually creates more expenditure demands than revenue receipts.
- *Unemployment rate/Number of jobs in the community* – directly related to changes in personal income and act as an influence on the community's ability to support its business sector.

Intergovernmental Constraints

States play a major role in how local governments operate financially. Tax limitations, operating restrictions, expenditure mandates, and debt limitations all affect the flexibility local officials have to respond to changing financial circumstances.

- *Percent of expenditures due to mandates* – expenditures required by a higher level of government limit the freedom local officials have to adjust spending in response to economic changes.
- *Tax restrictions* – how close is the governmental unit to its charter or statutory tax rate limitation?
- *Incorporation laws* – does state law or municipal charter limit revenue options, require certain expenditures, or otherwise confine the freedom of local officials have to adjust spending in response to economic changes?

B. Organizational Factors

These factors reflect the accurate, timely release of financial information that is required of local units.

Management Practices/Legislative Policies

While states cannot manage local government finances for the local units, they can require certain procedures be followed and certain systems be incorporated in reporting financial data. The quality of financial reporting reflects the professionalism of the staff preparing the statements and the confidence that the conditions reported are accurate.

- *Use of GAAP for financial statements* – use of generally accepted accounting principles ensures comparability of data from year to year and comparability with other local governments.
- *Use of GAAP for budgeting* – as for financial statements, use of generally accepted accounting principles ensures a structure that is uniform across years and across local units of government.
- *Use of CAFR format* – the comprehensive annual financial report format reports all revenues and expenditures for each fund.
- *Unqualified audit opinion* – failure to include all appropriate entities or omissions of data will result in a qualified opinion.
- *Failure to file audit with Department of Treasury* – the primary means for overseeing local government finances for state oversight bodies is for those local governments to file their audit in a timely manner.
- *CAFR released within six months of end of fiscal year* – as is the case for audits, filing the comprehensive annual financial reports in a timely manner will avail the state of the information necessary to assess financial condition in a timely manner and take appropriate actions if necessary.

C. Financial Factors

These ratios measure the revenues and expenditures of local governments in a manner that allows comparisons among units and for multiple years.

Revenues

Revenues determine the capacity of a local government to provide services. These ratios measure growth, flexibility, elasticity, dependability, diversity, and administration.

- *Revenues per capita* – shows changes in revenues relative to changes in population size. If per capita revenues are decreasing, the government may be unable to maintain existing service levels unless it finds new revenue sources or ways to save money.
- *Revenues as a percent of personal income* – like revenues per capita, this measure reflects the ability of a community to pay for a level of services.
- *Revenues as a percent of property valuation* – also used for measuring the ability of a community to fund services.
- *Restricted revenues as a percent of net operating revenues* – restricted revenues are legally earmarked for specific uses, as may be required by state law, bond covenant, or grant requirements. As the percentage of restricted revenues increases, a local government loses its ability to respond to changing conditions and to its citizens' needs and demands. Increases in restricted revenues may also indicate over dependence on external revenues and signal future inability to maintain service levels.
- *Intergovernmental revenue as a percent of own source revenue* – reflects a level of dependence on budget and policy decisions made at another level of government. The reduction of intergovernmental funds leaves the municipal government with the dilemma of cutting programs or funding them from general fund revenues.
- *Elastic revenues as a percent of net operating revenues* – the yields of elastic revenues are highly responsive to changes in the economic basis and inflation. A balance between elastic and inelastic revenues mitigates the effects of economic growth or decline.
- *One-time revenues as a percent of net operating revenues* – one-time revenues are those that cannot reasonably be expected to continue, such as a grant or money from the sale of an asset. Continual use of one-time revenues to balance the budget can indicate that the revenue base is not strong enough to support current service levels. It can also mean that the government is incurring operating deficits and would have little room to maneuver if there were a downturn in revenues.
- *Uncollected property taxes as a percent of net property tax levy* – increases over time may indicate overall decline in the local government's economic health.
- *User charge coverage as a percent of expenditures for related services* – can fees and charges cover the entire cost of providing a service? As coverage declines, the burden on other revenues to support the services increases.
- *Revenue shortfalls as a percent of net operating revenues* – examines the differences between revenues estimates and revenues actually received during the fiscal year. Major discrepancies that continue year after year can indicate a declining economy, inefficient collection procedures, deliberate overstating in order to fit everything into the budget, or inaccurate estimating techniques. Discrepancies may also indicate that high revenue estimates are being made to accommodate political pressures.

Expenditures

Expenditures are a rough measure of a local government's service output. The aim of these ratios is to measure whether the local governments (1) are living within their revenues, and (2) have the necessary flexibility to adjust service levels to changing conditions.

- *Expenditures per capita* – increasing per capita expenditures can indicate that the cost of providing services is outstripping the community's ability to pay, especially if spending is increasing faster than the residents' collective personal income.
- *Employees per capita* – because personnel costs are a major portion of a local government's operating budget, an increase in employees per capita might indicate that expenditures are rising faster than revenues, that the government is becoming more labor intensive, or that personnel productivity is declining.
- *Expenditures as a percent of property tax revenue* – measure of a unit's ability to fund services from own source revenues, since the property tax is the primary tax source for most Michigan local governments.
- *Fixed costs as a percent of net operating expenditures* – the higher the level of fixed expenditures, the less freedom local officials have to adjust spending in response to economic change. Fixed costs become especially important during periods of financial retrenchment, since mandatory expenditures are usually unaffected by a reduction in service levels.
- *Fringe benefits as a percent of salaries and wages* – because the funding and recording of fringe benefits is a complex process, these costs can escalate unnoticed, straining the government's finances.
- *Current cash balances as a percent of operating expenditures* – measures a unit's cash and revenue solvency relative to its level of operating expenditures. Current fund balance ratios less than 10 percent means the government has low cash solvency; 10 to 25 percent – adequate cash solvency; 25 to 50 percent – substantial cash solvency; and greater than 50 percent, it is said to have high cash solvency.
- *Percent of expenditures for police and social services* – could be caused by budget decisions or increases in the proportion of elderly and youth in the population of the unit, thus placing greater demand on the provision of these services; middle income residents being replaced by less affluent groups which require public assistance; or the closure of major employers, thus creating additional unemployment.

Operating Policies

This refers to a local government's ability to (1) balance its budget on a current basis, (2) maintain reserves for emergencies, and (3) have sufficient liquidity to pay its bills on time.

- *Operating deficits as a percent of net operating revenues* – may not mean that the budget will be out of balance, because reserves from prior years can be used to cover the difference. It does mean, however, that during the current year, the government is spending more than it is receiving. A one-time occurrence might not be cause for concern, but frequent and increasing deficits can indicate that current revenues are not supporting current expenditures and that serious problems may lie ahead.
- *Enterprise losses* – because enterprise fund programs are expected to function as if they were commercially operated private entities, rather than governmental "not for profit" entities, such losses may point to a bigger problem. As is the case for operating deficits, a one-time occurrence might not be cause for concern, but frequent and increasing losses might indicate a need to consider the rate structure and operating expenditures.
- *Fund balances as a percent of net operating revenues* – the size of a local government's fund balances can affect its ability to withstand financial emergencies and its ability to accumulate funds for capital purchases without having to borrow. Therefore, changes in fund balances are not necessarily a sign of operating deficits, but they may mean that the government will be unable to meet a future need.
- *Liquidity as a percent of net operating revenues* – cash position, which includes cash on hand and in the bank, as will as other assets that can be easily converted to cash, determines a government's ability to pay its short-term obligations. Low or declining liquidity can indicate that a government has overextended itself in the long run. A cash shortage may be the first sign.

Debt Structure

A number of states have focused attention on debt issuance as an early indicator of much broader problems. Requiring state approval for debt issuance in other states provides the states a means of ensuring that the local units are maintaining a balanced budget during the period when they were repaying the debt.

- *Current liabilities as a percent of net operating revenues* – the sum of all liabilities due at the end of the fiscal year, including short-term debt, current portion of long-term debt, all accounts payable, accrued liabilities, and other current liabilities.
- *Increased cost for short-term loans* – whether borrowing from outside lenders or in anticipation of future tax revenues, increased costs for short-term borrowing reflects an inability to fund current expenditures with current revenues. Borrowing in anticipation of current year tax collections provides local units with a useful tool in managing cash flow. Borrowing in anticipation of the tax levy of the following year, however, if used improperly can encourage deficit spending, allow rolling over and accumulating deficits from one year to the next, and can permit the evasion temporarily at least of constitutional, statutory, and charter provisions limiting the rate of

taxation.

- *Long-term debt as a percent of assessed valuation* – net direct debt is direct debt (bonded debt for which the local government has pledged it full faith and credit) minus self-supporting debt (bonded debt that the local government has pledged to repay from a source separate from its general tax revenues). An increase in net direct bonded long-term debt as a percentage of assessed valuation can mean that the government's ability to repay is diminishing, assuming that the government depends on the property tax to pay its debts.
- *Net direct debt service as a percent of net operating revenues* – increasing debt service reduces expenditure flexibility by adding to the government's obligations. Debt service can be a major part of a government's fixed costs, and its increase may indicate excessive debt and fiscal strain.
- *Long-term debt per capita* — reflects the amount of long-term debt in terms relative to the size of the unit.
- *Long-term debt as a percent of personal income* — reflects the amount of long-term debt in terms relative to the ability of taxpayers in the unit to repay the debt.
- *Long-term overlapping bonded debt as a percent of assessed valuation* – the net direct bonded debt of another jurisdiction that is issued against a tax base within part or all of the boundaries of the community. This measure is an indicator of the ability of the community's tax base to repay the debt obligations issued by all of its governmental and quasi-governmental jurisdictions.
- *Credit rating* – reflects the opinions of outside raters of financial health.

Unfunded Liabilities

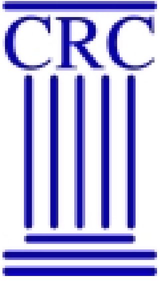
An unfunded liability is one that has been incurred during the current or prior year, that does not have to be paid until a future year, and for which reserves have not been set aside. If such obligations are permitted to grow over a long period of time, they can have a substantial effect on a local government's financial condition.

- *Unfunded pension liabilities as a percent of assessed valuation* – pension plans can be funded in two ways: either when benefits need to be paid ("pay as you go"), or as benefits are accrued, in which case the money is invested in a reserve until the time when benefits will have to be paid. Under pressure of balancing the annual budget, some governments choose the pay-as-you-go approach. Either approach can work on a short-term basis. Deferral, however, can create a problem in future years that is more serious than the problem being avoided in the current year—if the dollars are not available in the future years to meet the pension obligation.
- *Pension fund assets as a percent of annual pension benefits paid* – a decline in the ratio of plan assets to benefits can indicate serious problems in the management of the pension plan. The annual amount of pension receipts as a percentage of annual benefits paid focuses more specifically on a pension plan's ability to meet its current cash requirements.
- *Accumulated employee leave* – although leave benefits initially represent only the opportunity cost of not having work performed, these benefits become a real cost when employees are actually paid for their accumulated leave, either during their employment or at termination or retirement.

Condition of Capital Plant

If assets are not properly maintained or are allowed to become obsolete, the results are often (1) decreasing usefulness of the assets, (2) increasing cost of maintaining and replacing them, and (3) decreasing attractiveness of the community as a place to live or do business.

- *Maintenance effort* – deferring maintenance of capital assets can create significant unfunded liability. A declining ratio between maintenance expenditures and size of asset stock may be a sign that the government's assets are deteriorating, which in the long run will push up maintenance costs.
- *Capital outlay* – the ratio of capital outlay to net operating expenditures is a rough indicator of whether the stock of equipment is being adequately replaced. If this ratio declines in the short run, it may mean that the government's needs are temporarily satisfied, since most equipment lasts more than one year. A decline persisting over three or more years can indicate that capital outlay needs are being deferred, which can result in the use of inefficient or obsolete equipment.
- *Depreciation expense as a percent of depreciable fixed assets* – if depreciation costs are declining as a proportion of fixed asset costs, the assets on hand are probably being used beyond their estimated useful life. This can result in inefficiencies and higher costs.



About the Citizens Research Council of Michigan

The Citizens Research Council of Michigan is a private, not-for-profit public affairs research organizaiton founded in 1916 to provde unbiased, nonpartisan analysis of issues concerning state and local government organization and finance in Michigan. CRC is supported by the voluntary contributions of business, industry, foundations, and individual citizens.

The goal of the Citizens Research Council is to secure good government for the citizens of Michigan -- government that is representative of and responsible and accountable to the public; effective in carrying ouut its responsibilities and providing services; and efficient in the use of its resources.

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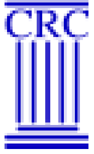

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