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**Government Fiscal Sustainability Workgroup:**

**Local Government Fiscal Distress Early  
Warning Systems, Pensions & Long-Term  
Liability Management**

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**Policy Summary**

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The Michigan State University Extension Center for Local Government Finance and Policy is dedicated to applied research and outreach education that contributes to a Michigan where local governments thrive fiscally and economically, providing crucial public services in a transparent and civically engaged manner.

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# Summary

The Government Fiscal Sustainability Workgroup held its fifth annual meeting in Pittsburgh, Pennsylvania on October 21-23, 2018. The Pew Charitable Trusts financially supported the convening of state-level local government experts from 14 states.<sup>1</sup> This year's meeting was especially momentous thanks to Richard Vilello, Deputy Secretary for Community Affairs and Development with the Pennsylvania Department of Community and Economic Development (DCED) and his colleagues' exceptional hospitality and participation.

Workgroup members enjoyed an evening reception, under the direction of Johnna Pro, Director of the Southwest District Office of the DCED. Workgroup participants had the opportunity to talk with Aliquippa Mayor, Dwan Walker and New Castle Mayor, Anthony Mastrangelo, whose cities recently exited from Pennsylvania's state oversight program (Act 47) for financially distressed municipalities as well as with former York Mayor, Kim Bracey, currently the Executive Director of the Governor's Center for Local Government Services.

Pennsylvania Department of Community and Economic Development Secretary Dennis Davin welcomed workgroup members and commended the workgroup's efforts to work together, share best practices, and develop solutions to improve the condition of distressed municipalities across the United States. Secretary Davin stressed that community development and economic development are two sides of the same coin and you can't have one without the other. A safe, revitalized municipality with a strong sense of community attracts businesses to the area where employers are creating jobs and fueling the local economy, which attracts residents and lends itself to a higher quality of life and further investment in the area, therefore boosting community development.

Secretary Davin discussed some of the strategies that Pennsylvania uses to help distressed municipalities. He highlighted how the state has helped with the fiscal turnaround of Altoona after the DCED declared the city financially distressed under Pennsylvania's Municipalities Financial Recovery Act of 1987, (Act 47) in 2012. Under Act 47, DCED has a responsibility to provide technical assistance and funding support, and appoints 'recovery coordinators' to develop comprehensive, uniquely-tailored plans for the municipality to return to financial solvency. Altoona worked cooperatively and in collaboration with partners and the state, in order to emerge from Act 47. Mayor Matthew Pacifico took office the first year the city was in Act 47, and said that when he took office, he kept hearing from concerned citizens that they felt nothing would ever change about the city's financial condition. Altoona leadership decided to make the following tough decisions: 1) changed to a Home Rule Charter form of government; 2) increased revenues by increasing the resident earned income tax rate; 3) instituted a countywide property reassessment; 4) placed controls on expenditures; 5) focused on better overall management; 6) focused on elimination of debt; and 7) simultaneously promoted both community development and economic development. As a result, in September of 2017, DCED conducted a thorough review of the city's audits and financial data and terminated Altoona's distressed status.

Secretary Davin shared new and forthcoming tools and strategies, lead by the Governor's Center for Local Government Services within DCED and community leaders, which improve their ability to assist municipalities with recovering from financial distress. While Act 47 is a key tool, there needs to be more flexibility to adapt to each distressed municipality's unique needs. Not all fiscally distressed municipalities will "graduate" from Act 47, some will be "timing out" (due to a 5-year limitation enacted in 2014) and will need additional tools and assistance. Specific Act 47 tools the state is considering include 1) additional taxing options for all local governments; and 2) renaming the intervention program to "Strategic Financial Management" to better reflect the purpose of the program,

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<sup>1</sup> State-level staff participants from Colorado, Indiana, Louisiana, Maryland, Massachusetts, Michigan, New York, Ohio, Pennsylvania, Rhode Island, Tennessee, Utah, Virginia, and Washington.

providing technical assistance and financial support and to minimize stigma for the community. Additional policy initiatives include: 1) municipal pension reform; 2) expanding the reach and the impact of the Neighborhood Assistance tax credit program so more areas of Pennsylvania can reap the benefits of greater private investment; 3) modernize the way CDBG funds to low-income communities are distributed to have a larger and more strategic impact on the areas that receive the funds; 4) assist with police and fire departments mergers and consolidations; 5) better utilization of the Municipal Assistance Program, which provides funding grants for municipal planning and visioning, among other needs; 6) developed an Early Warning System to detect municipalities that are experiencing financial distress, or will experience distress in the near future; and 7) working through federal programs to address homelessness, hunger, blight, and flooding in municipalities all across Pennsylvania.

The program then turned to an overview of the city of Pittsburgh's exit from Act 47 in February of 2018 by Marita Kelley, Deputy Director of the Governor's Center for Local Government Services. ([Financial Distress in Pennsylvania](#)). The city entered Act 47 in 2003 due to debt issues and recurring net operating losses. When the city exited in 2018, the following good markers of its financial health included: 1) an operating surplus with a five-year projection of positive results; 2) a fund balance of 10-12% revenues; 3) gradually reduced debt burden; 4) more funding directed to infrastructure investments; 5) higher PAYGO contributions for OPEB; and 6) increasing pension contributions.

The program then turned to presentations from seven states on their local government/unit fiscal distress early warning system. Andrew Sheaf, Local Government Policy Manager gave an overview of Pennsylvania's early warning system that is mandated in Act 47 section 121, which the DCED developed ([Early Warning System](#)). The DCED system does not have a regulatory function, but an outreach function to ascertain the need for further investigation purposes. The Annual Financial Reports (AFR) have 90% response rate (stick: If not submit AFR on time (9-month grace period, then DCED grants will be withheld) and AFRs are internally audited by state-elected auditors. The financial indicators are only for general fund; 5 years trends are established. Noteworthy to municipal fiscal health in Pennsylvania, municipalities have the option to waive public safety and let the state police provide police services free of charge; however 3rd-class cities do not have this option. (Further reading on this issue and its impact on municipal budget burdens see the Communities in Crisis, PA Economy League Report at <https://pelcentral.org/wp-content/uploads/2017/09/Communities-in-Crisis.pdf>) Economic indicators include: 1) median HH income (municipalities have authority to levy income tax by residence, 1% max; however if entering Act 47, they can go above 1% limit AND taxing commuters); 2) median housing values; 3) unemployment rate; 4) % housing units vacant; 5) % owner-occupied housing units; and 5-year trends are established. Socio-demographic indicators are also established. The scoring is used only for internal purposes and the rankings are validated against multiple sources. The DCED uses the indicators as a tool not only to monitor but to outreach and to understand which and why local governments need support. The data is lagged; the 2018 update uses 2016 data.

Tracey Hitchen Boyd, Assistant Comptroller in the Division of Local Government and School Accountability, provided an update on changes the state has undertaken to New York's fiscal stress monitoring system ([Fiscal Stress Monitoring System](#)). The NY system is public facing and narrowly focused on budgetary solvency and the immediate future. The system considers both financial conditions and environmental factors. It avoids commenting on overall fiscal health. Municipalities are not ranked; however fiscal health designations based on 100 point scale classify local units as significant, moderate, susceptible, or no designation is assigned. Financial indicators include: 1) Year-end fund balance (unassigned and assigned, total fund balance, and bands: <10% revenue); 2) Operating deficits; Cash position; 3) Short-term cash-flow debt; 4) Fixed costs (salaries and benefits, debt service). Environmental indicators chosen use more consist and reliable publicly available data sources and include: 1) Change in population; 2) % of Households with public assistance; 3) % of population under 18 and over 65; 4) % 5) change in home value; 6) Median HH income;

7) Unemployment rate; and 8) Reliance on state and federal aid. Recent fiscal stress results (2017) found the number of local units with significant stress doubled, but fewer total local units were assigned the designation of some level of fiscal distress.

Ashley Perry, Quality Assurance Technical Specialist, discussed the financial health indicators that Ohio uses to identify local governments that may be experiencing fiscal stress ([Financial Health Indicators](#)). Ohio's system serves as a communication tool for the elected State Auditor with the state legislature to show resources needed for local governments (88 counties and 247 cities). The system is not posted on the state website, however, local governments are encouraged to post on their websites. Indicators include: 1) Unrestricted net position; 2) Capital investment (useful life of capital assets); and 3) Debt. There is no standardized chart of account required for local governments. The system applied indicators by GAAP filers or cash filers. It uses audited data. In 2017, there was a 33% increase of local governments in potential distress/fiscal caution. Dave Thompson, Assistant Chief of Local Government Services highlighted that Ohio has yet to incorporate fiscal indicators into Fiscal Watch and Caution Law ([Fiscal Caution, Watch and Emergency](#)). He shared that Manchester entered emergency status in October 1997 and is considered a success story. After 20 years it is finally out of fiscal emergency with audited 5-year projection of no deficit. An action the city took to address a significant cost center within its budget, the police department was disbanded and the city outsourced the service to the county sheriff. However, the City of East Cleveland, a suburban area of Cleveland is under emergency for the second time. East Cleveland initiated to merge with Cleveland and Cleveland rejected the merger. East Cleveland is in desperate need of economic development.

Daniel Horn, Manager, Analytics and Outreach Section, Michigan Department of Treasury, shared a summary of Michigan's former (2007) fiscal indicator system and Treasury's efforts to date to reestablish a system ([Early Warning and Prevention](#)). The 2017 system based on 9 indicators/metrics, was used as a preventative tool to identify potential fiscal problems among primary governments. Michigan was an early adopter of a local government fiscal indicator system. Various shortcomings and concerns with the system were expressed by local units and residents and the state was subject to lawsuits. The system was disbanded in 2012. Michigan local governments have had uneven experience with local government emergency management. Emergency management and the use of an EM has been the subject of ongoing discussion and whether the EM law needs revision, especially in recent years due in large part, to the Flint Water Crisis. There appears to be more reluctance to utilize state intervention options available under PA 436 of 2012, including employing and deploying emergency managers, and the state is looking for less invasive options to help fiscally distressed local units. The Department of Treasury has regained an interest in using an early warning system to help detect early signs of local distress as well as devoting resources toward early intervention and education efforts. Treasury is developing a new fiscal distress indicator system with a few financial indicators and service solvency indicator(s). A more coordinated effort between local government efforts within Treasury and the Michigan Economic Development Corporation (MEDC) program, Redevelopment Ready Communities is being fostered.

Colorado is taking a slightly different approach to local government fiscal stability measurement. Rachel Harlow-Schalk, Deputy Director of the Department of Local Affairs Local Government Division, presented Colorado's fiscal stability initiative framework ([Fiscal Stability Initiative](#)). A question Colorado is asking of its fiscal stability initiative is local governments' ability to recover from natural disasters and specifically their capacity to utilize disaster relief funds. The initiative is part of the Department's strategic plan and not statutorily required. Rachel stated that its purpose is not monitoring, but to understand where local units are at fiscally and to how the department could assist. She emphasized local ownership, and the goal to ensure local governments can take over when the state leaves. The system uses indicators of stability developed from input from entities including: 1) Community development, land use and planning; 2) Local government finance and budgeting; 3) Financial assistance and grants; 4) State

Demography office; and 5) Field data. Financial indicator data is taken from the financial compendium and includes: 1) Current ratio (3 year average); 2) Debt per capita; 3) Intergovernmental revenue dependence; 4) Operating deficit; and 5) Property class concentration. Socioeconomic indicators include: 1) Poverty and population over 65 years; 2) % Bachelor's degree or higher; 3) HH population change; 4) HH labor force age risk; 5) Single larger employer; 6) Local government share of jobs; and 7) Employment growth. Colorado's system also includes best practices in the area of financial policies, budget, management and operations. These are used to assist local government participants determine their best practices and assist them in evaluating where they are regarding fiscal health and asset inventory.

Washington's fiscal indicator system is housed within the office of the State Auditor. Sherrie Ard, Performance Center Manager, summarized the three data and indicator systems that exist and the updating of those into a single system ([Fiscal Indicator System](#)). The systems are: 1) Local Government Comparative Statistics Reports (financial indicators used by auditors) Strength: Unified standard chartered accounts. Concern: not audited every year, by the time there is flag it is too late; 2) Financial Intelligence Tool (Same financial indicators as LGCS, requires authentication) Strength: Addresses timeliness. Concern: transparency, not available to legislatures or public; and 3) Local Government Financial Reporting System (Public data system, no financial indicators) Strength: Governments are comparing themselves to their peers. Concerns: lack of data accuracy, no visualization or guideline and difficult for non-financial users to understand, static data, and only updated by legislative session. Washington is currently combining all three systems into a single Financial Intelligence Tool (FIT) system. The new FIT would be open to the public with authentication for identified groups. It will be an outreach tool for state legislators and the public. It will have enhanced visualization and guidelines. It will not rank local governments.

Utah is developing a financial health indicator system within the State Auditor's office. Aaron Shirley is leading their effort ([Financial Health Indicators](#)). Situation: Utah's rural towns and counties are struggling financially, some have had to lay off a quarter of their staff to maintain services. Local governments are not able to file for bankruptcy. Tensions exist between the state and local governments (Dillon's rule). It's envisioned that the system will be citizen-centric, and public-facing. Obstacles: no statutory authority requirement to develop the system and at this time, there are not many resources available to devote to the effort. A significant hurdle exists with the integrity of the data. There is approximately a 28% variance between Transparency.utah.gov data and CAFR source data. Financial indicators being considered include: 1) Cushion ratios (Unassigned FB ratio, FB expenditure Ratio, Total Governmental Revenue/Expenditures); 2) Liquidity ratios (Cash to Expenditure ratio, Debt service to Expenditure); 3) Behavioral ratios (Proprietary Fund transfers to GF revenue); 4) Accumulated depreciation of capital assets.

#### Key Summary Points from Small Group Break-Out Session on Early Warning Systems (Day I)

- There are a broad range of motivating factors for establishing systems, including legislative mandates, reactions to incidences of local fiscal distress, and a desire to identify communities for state-service provision.
- There is a 50-50 split between systems that publicize results, methodology, etc. There seems to be a correlation between publicizing and rating. States that calculate a score or rank are publicizing less and vice versa.
- Staffing for administering systems ranges widely, from a handful of dedicated, full-time employees (at the state-level) to a small contribution of time from many state employees across departments.
- None of the participants had engaged with local units in designing systems. None of the participants believed that there would be any benefit in doing so but did express an interest in engaging with other state agencies.
- Data is sourced from audits, the census bureau, and other state agencies. There is a trade-off between data timeliness and reliability.

- There is a challenge with uniformity in financial reporting from local governments and data collection generally.
- Participants aspire to incorporate or enhance forecasting in their systems.

The second day was dedicated to pension liabilities and long term liability management. Kelly Rogers, Deputy Treasurer of Rhode Island shared improvements in long-term liability management Rhode Island has under taken ([Rhode Island](#)). In 2011, Rhode Island enacted significant pension reform. The “report card” for the 34 plans not in the state pension plan system included: 1) Improved responsiveness to council (permanent pension advisory council) data; 2) 17 plans have increased funded statuses; 3) Combined \$2.4 billion of unfunded liabilities; 4) 13 plans have decreased funded statuses; 5) Unrealistic investment return assumptions; 6) Some communities do not make enough ARC; 7) ARC can get as high as 10-12% operating revenue. Proposed policy changes include 1) a glide path for the 34 plans to join RI MERS that addresses differences in plan assumptions and costs to join MERS; 2) assess and compare plans, work with state actuary to develop metrics for each of the 34 plans, including information on fees. In 2017 a debt affordability study was undertaken looking at the following: 1) State tax-supported debt and long-term liabilities; 2) State-level agency, public and quasi-public corporation debt and long-term liabilities; and 3) Municipalities, regional authorities, fire districts and other special districts debt and long-term liabilities. It compared state pension liabilities on a standardized basis. Indicators for debt affordability for State pensions include: 1) Debt service on Net tax supported debt to general revenues; 2) Debt service as % as personal income; 3) + ARC/general revenue; and 4) Net tax supported debt + UAAL as % of personal income. Indicators for debt affordability for municipalities include: 1) Net direct debt to full value; 2) Overall net debt to full value; 3) Overall debt + Net pension liabilities to full value; and 4) Overall debt + Net pension liabilities to personal income. The 2017 study impacted policy decisions regarding 1) the level of GO debt authorization incorporated into FY19 enacted budget; 2) appropriate level of state and local debt as a part of a deal to construct a new PawSox stadium; 3) appropriate levels of debt to issue to make a generational investment in RI’s K-12 school facilities.

Connecticut recently established a Pension Sustainability Commission and Michael Imber, Managing Director in the Financial Advisory Services Group of EisnerAmper, is a commission member. Michael shared a new approach to funding pension and OPEB liabilities ([Connecticut](#)). Connecticut has combined unfunded pension of \$33.6 billion for state employees retirement system and teachers retirement system. It is the second largest pension liability per capita in the U.S. The Connecticut Pension Sustainability Commission has 12 appointed members, including Treasurer, Comptroller, legislative leadership, governor, and labor appointees. The commission is charged to study the feasibility of placing state capital assets in a trust and maximizing those assets for the sole benefit of the state pension system. The commission is required 1) to do a preliminary inventory of state capital assets; 2) assess the potential impact on the unfunded liability of the state pension system; 3) assess the appropriateness of placing state assets in a trust and maximizing those assets for the sole benefit of the state pension system; 4) examine the state facility plan and make recommendations for establishing a process to (A) create and manage such a trust, and (B) identify specific state capital assets for inclusion in such a trust. The legacy obligation trust concept (LOT) would entail in-kind contribution of real assets to a professionally and independently managed trust for the benefit of pensions/OPEB plans. The trust issues Certificates to Trust (COT) similar to shares of stock and divides them among various pension/OPEB funds. Benefits to the government unit include: 1) Immediate credit against unfunded liability; 2) Improve credit rating; 3) Positive cash flow; 4) Independent professional manager in incented to create additional value. Types of capital assets for LOT include 1) Undeveloped assets: Raw lands, government occupied buildings; and 2) Developed enterprise assets: can be making money or losing money.

David Draine, Senior Officer in the Public Sector Retirement Systems Project, shared work Pew is doing on stress testing public pensions ([The Pew Charitable Trusts](#)). Stress testing in this context is a simulation technique used to assess the impact of different economic conditions on pension balance sheets and governmental budgets. It is central to actuarial reporting standards and can be a budget tool for policymakers. Model inputs include: 1) Actuarial projection, 2) Capital market assumption, and 3) State revenue forecasts. Outputs include: 1) Balance sheets, 2) Cash flow and contribution, and 3) Budget impacts. Example stress tests include: 1) Sensitivity of ARC to investment returns; 2) Risky investment will cause volatility in cost; 3) Funded status before and after pension reforms. Reasons stress testing is important for state and local governments include: 1) Pension risk reporting is coming, Actuarial Standard of Practice (ASOP) No. 51 goes into effect November 2018; 2) State budgets are more vulnerable to the next recession; and 3) Provides a scorecard to assess current and proposed policies, based on a range of possible market outcomes.

## Notes from Closing Debrief (Day II)

### **Q: What does an early warning system need to have?**

A: Local budget data

A: Real-time data (for example, quarterly reporting), including assumptions behind the budgets (cash-flow data for example)

### **Q: Who has easy access to local budgets?**

A: Less than half of the participants.

### **Q: Who gets local budgets submitted to State?**

A: The majority of the participants.

### **Q: Who has a good idea of what the state will do if there is a fiscal issue?**

A: About half of the participants. Several have no authority to do anything in a time of crisis.

### **Q: Are we fine with historical analysis, assuming that it's going to tell us something about the future?**

A: Yes. An attempt at forecasting will try to seek precision without accuracy.

A: Because municipal bankruptcy is so rare, there's no way to model it.

A: Several participants indicated that the historical data is useful for forecasting, but sometimes doesn't capture everything.

- Using data to make communities forward looking can help to drive reform. Having the data first helps you make the case for reform and helps you figure out what to do.

A: Some expressed doubt that historical financial data, or any data alone can accurately signal future fiscal distress.

- You don't have to quantify that someone meets a statutory criterion. If there are enough red lights, then that should provoke a dialogue.

A: Almost everyone is concerned about special districts and tracking them.

### **Q: Who has frequent conversations with local units outside of statutory requirements? Or, feel like the lines of communication are open?**

A: Basically all participants. A participant reminded that the indicators of their system are public but the follow-up assessments in the case of distress are not and are actually the most important. Largely because it's difficult to quantify organizational strengths/weaknesses (competency of officials, staff, etc.).

**Q: Does everyone think that we have a clear distinction between fiscal monitoring and early warning?**

A: There was inconclusive feedback.

**Q: What else should we be thinking about with these systems? (Open-ended for discussion)**

A: It would be nice if there was a universal format for systems.

A: What action does the state want to take? This should be defined before designing the system.

A: We need to encourage reporting that's comparing budget to actual – some local governments do but a lot don't.

A: Greater consistent cash-flow analysis.

**Q: Who is thinking about the next recession and how?**

A: Aware. Thinking about bandwidth and how the state will handle it, given that they are short-handed now and we're in a period of growth. Need to start planning now and we're late.

A: We're completely unprepared for another recession. There was a time period for municipalities in anticipating in the program, so they are timing out and they aren't healthy/prepared.

A: Will not have the resources to assist, beyond fiscal overseers.

A: These are areas of state government that are not well-funded. Local governments are the subject of state cuts. State governments are more volatile/vulnerable than local governments.

A: Recession creates opportunity, specifically to discuss consolidation and regionalization. This occurred post-2008 but faded as the economy rebounded.