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Atlantic City's Watchdogs

How strong state oversight helps New Jersey municipalities avoid bankruptcy

Overview

When New Jersey Governor Chris Christie named an emergency manager in January 2015 to try to restore Atlantic City's precarious finances, the appointment marked the latest evolution of one of the nation's oldest, most aggressive state systems for supervising local government finances.

In a previous report, *The State Role in Local Government Financial Distress*, The Pew Charitable Trusts explored how some states intervene in municipal finances to try to avert fiscal crises. The report also included case studies such as New Jersey's intervention in the financial problems of Camden, one of the nation's poorest cities.[1]

Since that 2013 report was released, New Jersey has stepped up its involvement in Atlantic City, whose fortunes have dramatically shifted with the precipitous decline of its casino industry in the face of competition from nearby states. This brief describes the history of the state's intervention program, explains how it works, and details the steps New Jersey has taken to try to help Atlantic City.

New Jersey's long history of intervention

Since establishing its first oversight program in 1931, New Jersey has sought to manage local financial affairs so that cities, towns, counties, authorities, and special districts—such as those responsible for fire and utilities—can avoid defaults and bankruptcy. No municipality in the state has filed for Chapter 9 since Fort Lee in 1938;[2] Camden came close in 1999, but the state intervened and put up additional money so that the city could pay its bills.[3]

A handful of other states engage in varying degrees of monitoring, oversight, and control of local government finances, including North Carolina, which also launched its program during the Depression.[4] Unlike most of these states, however, New Jersey offers money to distressed local governments to help them balance their budgets in the short term until their revenue and expenses can be restructured. The state also is unusual for its

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dual oversight: One state agency supervises municipal finances, and the Department of Education intervenes with troubled school districts.[5]

New Jersey's tradition of intervention has endured for decades through Republican and Democratic governors and legislatures. By contrast, some states, notably California and Alabama, leave it up to local governments to resolve their problems.

"New Jersey is unique because it is densely populated yet small geographically," said Timothy Cunningham, director of the state Division of Local Government Services. "When you aren't that far away from people in other cities, you're all neighbors."[6]

Atlantic City intervention breaks ground

Atlantic City's emergency manager is a first for the state. Until Gov. Christie named Kevin Lavin to that job in January 2015, the iconic resort city had been operating under the supervision of New Jersey's Local Finance Board and a state monitor since 2010—the usual response when a local government experiences severe budget trouble.

Gov. Christie said he decided to take a more aggressive approach after a panel he appointed to examine Atlantic City's finances recommended urgent action in light of the city's weakening tax base.[7] Competition from casinos in other states triggered a steady decline for Atlantic City's gaming industry that was made worse by the Great Recession. Four of the city's 12 casinos closed in 2014, and two others may follow after the company that owns both filed for bankruptcy protection. As gambling revenue plummeted, so did the value of taxable property, falling from $20.5 billion in 2010 to $7.3 billion in 2015, a 64 percent drop that officials said was unprecedented in modern history.[8] Like other New Jersey cities, Atlantic City relies on property taxes for most of its revenue, and the casinos generate half of those taxes.

As the city's property tax base rapidly declined, the governor and other officials recognized that the state would have to act decisively to rescue Atlantic City from insolvency. Lavin's first report, in March 2015, painted a grim picture of the difficulty ahead: The $101 million city budget deficit and cash shortage could require layoffs, cutting services, tax increases, additional state aid, and delays in repaying debt and in making payments to the public employee pension and retiree health care systems.[9]

"The governor realized that the financial picture with the ratable tax base was worsening and that he needed to bring in people who could scope out the problem and figure out a long-term solution," said Cunningham, who previously served as chairman of the Local Finance Board.

Gov. Christie installed a high-profile management team in Atlantic City. In addition to Lavin, the team included lawyer Kevyn Orr, who had just spent 16 months serving as Detroit's emergency manager. Orr acted as a consultant to Lavin until May 2015.[10]

In New Jersey's system, the Local Finance Board or state-appointed monitor can hire and fire employees, authorize raises and promotions, renegotiate service and labor contracts, restructure or pay off debt, approve the municipal budget, and make changes in how a city delivers services. Lavin's powers are not very different from those, but Gov. Christie also directed him to develop a short- and long-term plan to stabilize Atlantic City's finances.[11] The final recommendations, which the Christie administration will review, have not been completed.

Fiscal monitors in other cities

Atlantic City is not the first New Jersey municipality to be placed under state control. State-appointed monitors have overseen Camden's finances since 2000, and the state took control of Newark in October 2014 after months of sparring with city officials over the city's structural budget gap, estimated at $60 million.[12]

State monitors are appointed in two situations spelled out in New Jersey law. The first occurs when a city requests state dollars known as "transitional aid," which constitutes an admission that the city is "incapable of meeting its obligations and managing its finances without special state assistance, oversight and intervention," according to the aid application. The other, more serious, scenario occurs when a city falls short on a set of state standards, including failing to collect at least 70 percent of taxes; defaulting on bond payments; running a cash deficit above a minimum amount; becoming unable to pay bills; or failing to substantially comply with New Jersey's local bond, budget, and fiscal affairs laws.[13] In the latter scenario, the Local Finance Board, rather than the municipality's elected officials, must approve the city budget. Atlantic City fit both of these preconditions, and particularly because of the record loss of property tax revenue, Gov. Christie opted to supplement the monitor with an emergency manager. The monitor still has a role in day-to-day matters, including reviewing and approving hires, promotions, and vendors.

Monitors are part of a watchdog structure administered by the Division of Local Government Services of the state Department of Community Affairs. With a staff of about 40, the division exercises tight control over about 1,000 cities, counties, authorities, and special districts.

It tests and licenses every municipality's chief financial officer, clerk, tax collector, public works manager, and procurement official. Only half of the applicants for these jobs pass the state's demanding test, an indication of the level of competency the state requires.

State officials mandate that local government budgets and audits comply with a series of statutes, regulations, and uniform accounting principles—going so far as specifying the forms that local officials must use for receipts, petty cash, purchase orders, and other financial documents.[14]

Each year, local governments must submit budget, financial, and debt information to the state for review. New Jersey uses its own method of accounting that is generally more conservative in its reporting of reserves than the Generally Accepted Accounting Principles (GAAP) that most local governments in other states adopt.[15]

Municipalities also are required by law to post three years of budgets on their websites and, starting in 2015, to include dashboards providing key cost, staffing, and revenue data in a format that the average citizen can understand.[16]

The Rise of Intervention in New Jersey

New Jersey's rigorous involvement in overseeing the finances of its local governments can be traced to the Great Depression and the township of North Bergen.

By 1931, it was clear to the Legislature that six years of overspending and misuse of money by North Bergen officials had brought the township to the brink of insolvency.[*] In response to the situation in North Bergen and to fiscal stress resulting from shrinking tax collections in other localities, lawmakers created the State Municipal Finance Commission, which acted as a receiver for troubled local governments.

Under the system, creditors or a municipality could ask the state Supreme Court to have the commission assume control of a city's finances until local officials could manage them again on their own. The state auditor headed the commission, ensuring that creditors would be paid and services would be delivered. The commission also set spending rules for all municipalities, such as prohibiting local officials from increasing a city budget by more than 10 percent a year.[†]

From 1931 to 1940, 16 New Jersey municipalities were placed under state supervision. The depth of the fiscal stress was understandable; many people simply could not pay their taxes during the Depression. Rural Voorhees Township (population 1,400) was typical: Officials had collected only 35 percent of the total annual tax levy when the state commission took over in 1938. "It's a workingman's community, and its plight is due simply to a failure to collect taxes due to conditions," George Rothermel, the town solicitor, said at the time.[‡]

After several years of effort by state officials to refinance debts owed to creditors, control of most of the troubled communities was eventually returned to local officials. The commission could not, however, resolve the most extreme situations. North Bergen, which defaulted on its bonds, became the first local government in the East to file for bankruptcy protection under a 1934 federal law.[§]

The U.S. Supreme Court declared that law unconstitutional in 1936. The revised law, known as Chapter 9, is still in effect today. In 1938, Fort Lee became the only local government in New Jersey since the Depression to file for Chapter 9 protection.[**] Eventually a federal judge and local liquidation board steered Fort Lee out of bankruptcy; North Bergen remained under control of the finance commission until 1941.

After the Depression, New Jersey officials renamed the commission the Local Finance Board and expanded its oversight with the goal of ensuring that no local government would slide into bankruptcy again. The independent board—which has eight members, seven of whom the governor appoints—has never approved a municipal bankruptcy.

"New Jersey is one of the most highly regulated states in the nation when it comes to the oversight of municipal fiscal operations, and that's a good thing," said William G. Dressel Jr., former executive director of the New Jersey State League of Municipalities. “Some people may say that in fact there’s too much government involvement, but we as an organization … believe that that is an appropriate role for the state to play, because it gives the taxpayer the assurance that local officials are in fact doing the public’s business in a sound financial way.” [††]

The agencies that rate state credit also praise New Jersey’s institutional framework. Moody’s Investors Service noted in a December 2014 report that New Jersey’s local governments generally are more stable because “state oversight of local governments is exceptionally strong.”[‡‡]

* “Mayor Is Arrested in North Bergen,” *The New York Times*, May 1, 1930; and “Urge Receivership for North Bergen,” *The New York Times*, March 7, 1931.

† “Asbury Park Put in Hands of State,” *The New York Times*, March 8, 1935.

‡ “Town’s $9.10 Tax Rate Forces It to Give Up,” *The New York Times*, April 14, 1938.

§ “Township Makes Bankruptcy Plea,” *The New York Times*, March 31, 1936.

** “Fort Lee, N.J., Files Bankruptcy Petition; Ask Federal Court to Let It Refund Debt,” *The New York Times*, Dec. 2, 1938.

†† The Pew Charitable Trusts, interview with William G. Dressel Jr., March 2015.

‡‡ Moody’s Investors Service, “New Jersey Cities and Counties Remain Resilient Despite State’s Credit Challenges” (Dec. 2, 2014), http://assets.njspotlight.com/assets/14/1203/1749.

The state can reject local budgets

Local governments with a history of fiscal distress must receive advance approval from the state each year before adopting their budgets. Those on more solid footing must get such prior consent only once every three years. This process includes a thorough state review of the budget and borrowing of each local government. If the agency staff determines that the municipality has not set aside enough money to cover its obligations—borrowing or public pension costs, for example—the state orders it to amend the budget and cover those costs.

The state also reviews local revenue estimates; if forecasts seem too optimistic, the local government must cut the projection. New Jersey also imposes a borrowing limit that localities cannot exceed without the state’s approval. “So at the front end, we don’t have a lot of municipalities in New Jersey that reach the level of financial distress that occurs in some other states,” said Thomas Neff, director of the Division of Local Government Services from 2010 to 2014.[17]

Despite the proactive approach, some of New Jersey’s cities are unable to avoid fiscal emergencies, often because of economic events over which they have no control. Casino gambling has benefited Atlantic City since it began in 1978, but more recently, competition from other states has triggered a steady industry decline. Pennsylvania, for example, opened 12 casinos from 2006 to 2012. “What was hoped to be Las Vegas East [in Atlantic City] never materialized,” said Peter Angelides, a Philadelphia consultant who has taught a class on Atlantic City at the University of Pennsylvania, where he is on the faculty.[18]

When New Jersey cities falter, the local government division, through the Local Finance Board, has several options for intervention. It may allow a city to pay back its debts through a repayment or liquidation plan. The state also can approve a municipality's proposal to refinance or restructure its debt: Instead of paying principal in equal amounts each year, the division may permit a city to spread its payments over a longer period until it recovers financially.

The town of Harrison, for example, complied with a state directive to restructure part of its existing debt because it lacked sufficient revenue to cover payments of the size necessary to meet the 10-year maturity. The payments were spread over 20 years instead.[19] The agency recently allowed Paterson to avoid increasing its budget deficit by borrowing to cover its current-year debt payments and shifting the interest costs on the new bonds to 2020-21. Separate from the debt restructuring, the local government division further asserted its broad powers by requiring Paterson to raise taxes and utility fees. State officials also routinely order distressed municipalities to reduce expenditures by instituting less expensive health benefits and excluding part-time elected officials and employees from health care eligibility, among other actions.

The state also has a program to back city-issued bonds by diverting a portion of regular state aid to the city for payment of the principal and interest. Under this program, the Local Finance Board recently approved Atlantic City's request to issue $43 million in general obligation bonds to cover repayment of a state loan and to refinance $12.8 million in bond anticipation notes.[20]

New Jersey also helps distressed municipalities by providing special state money, which it calls transitional aid, a name that underscores the expectation that taxpayer dollars are a temporary bridge until a municipality can improve its finances. Under Gov. Christie, this program has been scaled back, partly because of a decision to reduce cities' dependence on the state.[21] Since the governor took office in 2010, the number of cities receiving transitional aid has dropped from 75 to 11.[22] Paterson and Trenton got the highest recent awards, $25 million each. The state places a significant condition on the aid, however, by appointing a monitor to supervise the city's finances. Local officials must sign an agreement to comply with other conditions, such as banning campaign contributions from vendors who do business with the city, requiring competitive contracting, aggressively negotiating employee contracts, and refraining from nonessential spending.[23]

Separate from the $107 million in transitional money for fiscal year 2016 is regular, or what the state calls "ordinary" municipal aid—budgeted at $1.5 billion—which provides a sizable revenue boost to local governments to help them control property tax increases.[24] Despite reducing transitional aid, the Christie administration has increased regular aid to distressed governments that demonstrate need and whose actions show a good-faith effort to control expenses and increase their own revenue. Camden, for instance, has received an extra $55 million in regular aid since 2011. Atlantic City received a $10 million increase in state aid effective July 1, 2015; emergency manager Lavin has vowed to cut spending by the same amount.[25]

State-local dynamics

Once the state takes over a local government, the process can become adversarial. Among other points of contention, the state has the authority to fire the very city officials with whom it is working to fix the fiscal crisis. The October 2014 hearing at which the Local Finance Board placed Newark under state control provides insight into this dynamic. State officials ordered deeper cuts to salaries in the City Council's and city clerk's offices than local leaders had proposed, even suggesting that council members accept furloughs because other city employees had been laid off. Neff, then the board chairman, scolded city officials for failing to collect about $7 million in health insurance premiums from employees as required by state law. "Understand there's a real level of frustration at the division that these funds aren't being collected like the law requires and like is being required for 70,000 state employees and every other public employee around the state," Neff told Newark officials, who have since started collecting the premiums. "It's not right. It's not fair."[26]

Neff was frequently in conflict with the Atlantic City and Trenton mayors, who resented state oversight. Trenton's mayor was sentenced in 2014 to nearly five years in federal prison for corruption in office, and the mayor of Atlantic City lost his bid for reelection in 2013.[27]

Atlantic City's new mayor, Don Guardian, who initially opposed appointment of the emergency manager, said after the March report was released that he hoped Lavin and Orr could revitalize the city's finances. Guardian had his own recovery plan until the emergency manager came in with his.[28]

The state has had an easier time working with local officials in Camden, including Mayor Dana Redd, to improve the decades-old financial dysfunction stemming from the decline in manufacturing, a diminished tax base, and past corruption. Christie targeted Camden for state cooperation, resulting in efficiencies such as replacement of the city police force with one operated by Camden County and outsourcing of the city's old-debt collection. The crime rate is down, and revenue from fees and fines is up, officials say.[29]

> "We're going to do everything we can to fix it," Gov. Christie said of Atlantic City. "But it's not going to be pretty."

The state's monitoring also extends beyond cities and counties to local authorities and special districts. The Local Finance Board must approve authority and special district budgets, including financing plans to buy equipment. When Chesterfield Township Fire District No. 2 wanted to buy a $41,000 four-wheel-drive truck for its chief in January 2015, district officials had to convince the state board that it had chosen the cheapest of three financing options. Board members approved the purchase but not before checking out the fire district's budget, tax rate, and procedures for ensuring that the chief's truck was not used for personal purposes. "I'm made to understand that the district keeps fuel and travel logs for the use of the vehicle?" Cunningham, the board chairman, asked Raymond Hlubic, secretary of the Chesterfield fire district, at a hearing. "We just started doing that, yes," Hlubic replied.[30]

Such tenacity will be a factor in the success of Atlantic City's restructuring. Naming the emergency manager was a last-ditch effort to avoid a more drastic outcome such as a state bailout or bankruptcy filing. The Christie administration had tried for years to reverse Atlantic City's fortunes, approving loans and other aid and creating a tourism district with a state agency picking up the cost of increased police protection and trash pickup near the casinos, hotels, and convention center.[31] Gov. Christie hosted three stakeholder summits on the city's future and named a blue-ribbon advisory panel whose recommendations included appointment of an emergency manager. As 2015 began, the state got federal money to help laid-off casino workers find jobs, and education officials appointed a monitor to manage Atlantic City's schools.[32]

Gov. Christie has said that the state will do everything it can to avoid Chapter 9 in Atlantic City, provided that local officials can persuade stakeholders—workers, unions, residents, investors, casinos, and other businesses—to agree to cuts, layoffs, payment deferrals, tax increases, and restructuring of revenue and services. New Jersey has appointed a former bankruptcy judge as a mediator among Lavin, casino operators, and public safety unions.

Some analysts say an Atlantic City bankruptcy may be inevitable to provide a binding framework for the necessary restructuring.[33] Although Lavin stopped short of recommending bankruptcy in his opening report, he did emphasize that the city could not pay its bills for very long without a significant realignment of revenue and spending, including state aid. Half of Atlantic City's property tax revenue comes from the eight remaining casinos, whose gaming revenue has fallen with the opening of four competing casinos an hour away in Philadelphia and three more within 200 miles. "One thing is clear," Lavin said in the report. "There is no reasonable likelihood that these headwinds will abate at any point in the near future."

Underscoring the challenges ahead, in August 2015, Standard & Poor's downgraded its rating of Atlantic City's general obligation debt by three notches. The move reflects what an analyst called the continued uncertainty around the long-term fiscal stability and recovery of the city.

Neff said that during his years as chair of the Local Finance Board, when a municipality started hinting at bankruptcy, he would tell local officials, "Go fire your bankruptcy advisors and attorneys, because we are not going to let you do it."[34] But no New Jersey city in modern times has experienced anything close to the 64 percent decline in Atlantic City's tax base. In recent months, the gaming industry has reported slightly improving trends after months of declines, indicating that it may be stabilizing. Total gaming revenue reported by the city's casinos rose 5.5 percent in June 2015, compared with the same period the year before.[35] Still, the state may need to bail the city out in order to avoid a Chapter 9 filing. Such a rescue could be manageable, given Atlantic City's relatively small size. The city, with a population of 40,000, has a $411 million annual budget.[36] By contrast, Detroit, with a population of 688,000, has a $1.1 billion budget, and the state of Michigan could not rescue the city, which declared bankruptcy in July 2013.[37] "We're going to do everything we can to fix it," Gov. Christie said of Atlantic City. "But it's not going to be pretty."[38]

Conclusion

New Jersey has one of the nation's oldest and strongest municipal intervention programs, providing monitoring, oversight, and control of local government finances. It differs from those in the handful of other states in that it offers both regular and special aid to help prop up distressed localities. The state also stands out for the depth of its monitoring of local government finances. In worst cases, the state government can appoint monitors to supervise a municipality's finances in place of elected officials. In the case of Atlantic City, Gov. Christie went further and named an emergency manager to run the city and try to rebuild its finances.

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