



The State Role in Local Government Financial Distress

As cities confront financial challenges, states weigh whether to help them pull through

The Pew Charitable Trusts

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Overview

Within a two-week span in the summer of 2012, three California cities moved to file for bankruptcy protection.¹ By the end of the year, nine others had declared financial emergencies.² The state government offered no help, sticking to a long-standing tradition of leaving it up to local officials to fix their broken finances.

Rhode Island, by contrast, responded aggressively when Central Falls filed for bankruptcy protection in 2011. State officials appointed a financial manager, called a receiver, to make sure the city could pay its bills by cutting spending, raising taxes, slashing employee retirement benefits, and paying investors on the bonds they bought. The state's action was a reason for Central Falls' exit from bankruptcy last year after only 13 months, the shortest of several recent, high-profile municipal bankruptcies.

The difference between hands-off California and hands-on Rhode Island illustrates two sides of a discussion that is increasingly taking place in statehouses and city halls around the country because of cities' particularly slow recovery from the Great Recession of 2007-09. The question comes down to what role, if any, states should play in helping cities, towns, and counties recover from serious financial trouble—what officials generically call intervention.³

Against this backdrop, The Pew Charitable Trusts conducted a study that examined the range of state involvement in local government finances, drawing on current literature, statutes, a survey of state officials, and interviews with government finance analysts. It focused on identifying the characteristics of local financial distress, how those difficulties can escalate to state intervention or, in extreme cases, bankruptcy, and the relevant laws that states have in place. The research also considered the history of state intervention in the financial practices of embattled cities, why it matters to states, and how their practices differ. The findings are explored in detail in this report, but, briefly, Pew's research shows:

- Fewer than half of the states have laws allowing them to intervene in municipal finances.
- Intervention practices vary among the 20 states that have such programs.⁴
- In most cases, states react to local government financial crises instead of trying to prevent them.
- States intervene to protect their own financial standing and that of their other municipalities, to enhance economic growth, and to maintain public safety and health.
- Among states that intervene, some are more aggressive about stepping in to help.
- Local officials often resent state officials infringing on their right to govern their affairs.

Not every state may find that it needs to set up programs to intervene in local government finances. Of those that do, differences such as economic structure and political traditions underscore that there is no single model to follow in designing an intervention program.

Some states claim success from interventions. Most recently, Rhode Island's effort helped to bring a quick end to Central Falls' bankruptcy. Pew's analysis found other promising approaches as well. Most notable among them is monitoring the financial condition of cities to mitigate and contain local budget stress. When state and local officials are vigilant in identifying local budget trouble early, they can act decisively to prevent a crisis that could force the state to step in. For example, North Carolina, despite high unemployment, has managed to escape serious local government budget problems in part because of its strong centralized system of monitoring and oversight.

Whatever approach state policymakers consider, it is important to design the intervention so that state officials turn the day-to-day management of city finances back to local officials as quickly as practical. In this way, state officials can reduce the tension between the city and the state that often accompanies interventions. Despite Rhode Island's relative success in Central Falls, for example, there was lingering resentment over how long the state overseers would stay in the city to monitor its actions. The dispute went to a mediator, and the state returned control to city officials in April 2013.⁵

Pew researchers also conducted a series of quantitative analyses to determine whether state intervention programs are correlated with strong local government financial health in the aggregate and found no such relationship, highlighting the largely reactive nature of state policy.

This report presents the findings of Pew's analysis and also profiles seven states with and without oversight programs. By examining these individual states, Pew researchers were able to understand the patterns of state and local experiences with financial distress, including what motivates states to intervene or not, how political and economic conditions can affect a state's decision on whether to get involved, and what results the state efforts have yielded. The following cases were studied:

- **Alabama**, with the largest county bankruptcy in U.S. history, and **California**, where Stockton's bankruptcy has generated recent attention, were chosen as examples of states that historically do not assist local governments. **New Jersey** pared back on financial aid to troubled cities, including its capital, Trenton, during the Great Recession, and is trying to figure out the state's role going forward.
- **North Carolina** has the oldest intervention program in the country, emphasizing state-level monitoring to detect early signs of trouble.
- **Michigan**, where Detroit filed for bankruptcy in July 2013 and five other cities⁶ are under emergency managers,⁷ and **Pennsylvania**, where Harrisburg is run by a receiver, are deeply involved in their local governments' finances but are similarly affected by changing economic conditions that are out of their control and make it harder for cities to rebound.
- **Rhode Island** strengthened an existing weak program after the budget emergency in Central Falls, including a first-of-its-kind provision protecting investors in the city's bonds.

State differences aside, Pew's research did find a set of principles for states considering intervention programs:

1. States and cities should be proactive in detecting and tackling local government financial challenges through oversight of local finances and offering technical advice. Monitoring local government finances can result in early warnings and the avoidance of crises as well as send a positive signal to bond markets. This has been seen in states such as New York and North Carolina.⁸ Pew also suggests that states and cities adopt multiyear financial plans, a practice that compels governments to match expenses and revenues over several years.
2. In difficult economic times, creating state intervention programs could come with costs during a period when states are facing limited funds and staffing, which tests their ability to monitor local government fiscal trends or offer direct aid to struggling cities. As a result, state policymakers must understand the trade-offs within their own budgets and determine both whether to intervene and what level of support they can afford. Officials in Massachusetts and New Jersey have engaged in such balancing by choosing

the extent to which they bail out struggling local governments, and policymakers in New York have found ways to provide assistance without providing direct aid.

3. States, when possible, should design interventions to involve all stakeholders in discussions, to be transparent with financial information, and to return control to local officials quickly. This promotes better cooperation between all concerned parties as a local government recovers from a crisis. In Michigan, for example, several cities, including Detroit, have pushed back against what they consider to be state interference. Throughout the Detroit financial crisis, city and community leaders tried to resist state intervention, fearing it could lead to long-term state control, as in other Michigan cities such as Pontiac.⁹

This paper examines various intervention practices, identifies challenges, and elaborates on these three key policy guidelines. The analysis and state profiles can help inform state decision-making about whether, when, and how to assist municipalities facing fiscal stress, the likely outcomes of various approaches, and the implications for cities, counties, states, and taxpayers.

Key findings

- **Twenty states have enacted laws allowing the state government to intervene in a city, town, or county financial crisis.** These laws were approved to provide an alternative to filing for bankruptcy or to prevent cities from filing.
- **Intervention practices vary among the states that have them.** States first designate an intervenor: a receiver, emergency manager, state agency head, or financial control board. Depending on the state, the intervenor is allowed to choose among restructuring debt and labor contracts, raising taxes and fees, offering state-backed loans and grants, providing technical advice, and even dissolving the local government.
- **Some states are more aggressive than others when they step in to help.** Michigan, North Carolina, Pennsylvania, and Rhode Island are among the states with the most extensive assistance programs. Alabama and California are among those without programs. Connecticut, New York, and Massachusetts decide the level of involvement on a case-by-case basis, depending on the severity of a city's financial emergency. Some states have not set up intervention programs because their cities have not experienced the same level of stress as those in other states.
- **Local governments often accept state intervention begrudgingly.** Several Michigan cities have pushed back against what they consider to be state interference. This organized resistance culminated with the November 2012 defeat by state voters of the mandatory emergency manager system.¹⁰ Michigan replaced that top-down structure with one that allows local officials to decide their fates by choosing among several options. But resentment remained when, in March 2013, Governor Rick Snyder appointed an emergency manager to take over the day-to-day operation of Detroit.¹¹ Despite the emergency manager, the city filed for bankruptcy protection in 2013.
- **It is rare for a local government to seek bankruptcy protection from a court.** Despite the recent wave of publicity about bankruptcies in places such as Stockton, CA, and Jefferson County, AL, of the nation's 55,000 municipal governments that sell bonds, fewer than 10 file for bankruptcy each year. A filing usually has a single identifiable cause: a bad investment decision (Orange County, CA); a failed infrastructure project (Jefferson County, AL, and Harrisburg, PA); an expensive legal decision (Mammoth Lakes, CA); or escalating public pension costs (Central Falls, RI). State and city officials want to avert bankruptcies for several reasons, including the fact that the stigma of receivership and a state takeover can remain for years and increase borrowing costs for capital projects such as roads, parks, and public buildings.

Why cities are in trouble

The discussion about intervention has surfaced in the face of slow recoveries by cities after the worst economic downturn since the Great Depression of the 1930s. Local governments were the last to emerge from the Great Recession because of the lag time between the decline in home values and the drop in property tax revenue. In addition to the decline in real estate tax revenue, states have cut aid to local governments. These two sources, which together account for more than half of local revenue, dropped simultaneously for the first time since 1980. Cities also have laid off workers and scaled back services. More cuts are likely in the coming years as the federal government slashes spending to reduce the federal budget deficit. In the coming months, Pew will explore how economic trends, demographic shifts, and changes in service delivery are affecting 30 major cities. The research will help policymakers understand shared challenges and promising approaches.ⁱ

i The Pew Charitable Trusts, "The Local Squeeze: Falling Revenues and Growing Demand for Services Challenge Cities, Counties, and School Districts," June 2012.

The stages of municipal difficulty: Distress, crisis, and bankruptcy

States generally classify troubled cities as being in distress, crisis, and, in extreme cases, bankruptcy. Although states use different terms to define these categories, the concepts are the same: distinguishing between cities experiencing some sort of distress and those facing a full-blown crisis. This section explains some of the criteria for both.

Distinguishing between distress and crisis

In managing revenue and expenses, local governments occasionally confront deficits and periods when they lack enough cash to cover expenses. Most of the time, they find ways to get through the temporary trouble by, for example, borrowing money over the short term. But when budget gaps widen and a city cannot pay its bills, meet its payroll, balance its budget, or carry out essential services, the local government is viewed as distressed. Officials usually respond with some combination of service cuts, worker layoffs, tax and fee increases, reserve spending, and borrowing. If those measures do not work and the city no longer has the money to meet its obligations, the distress can escalate into a crisis or financial emergency, which may include defaulting on a bond payment or, in rare instances, filing for Chapter 9 bankruptcy protection.

Of the 20 states that have enacted laws allowing intervention, definitions of these terms vary. Nevada, for example, lists 27 conditions that the state weighs before determining that a local government is in “severe financial emergency,” including budget deficit, late payments to vendors, inability to meet payroll or pay bondholders, losses from imprudent investments, and failure to keep up with public pension payments.¹² Florida considers a local government or school district to be in an emergency if officials determine that state assistance will be needed to resolve or prevent the crisis.¹³

To define municipal distress and crisis, these states use different fiscal indicators, though many of the standards are common, overlapping measures. Over the years, a number of federal agency officials, researchers, and organizations, particularly the International City/County Management Association, have developed early-warning indicators upon which states can draw. The association’s 42 indicators include financial measures, such as whether a local government is spending more money than it is taking in; benchmarks, such as a city’s political culture; and outside economic events, for example, downturns.¹⁴

Florida’s extensive monitoring requires local governments to hire independent certified public accountants to review municipal finances and suggests that the accountants evaluate them based on an intricate system of 13 indicators.¹⁵ Among these are revenue and expenses; ability to raise cash to meet current needs; capacity to pay long-term debt; whether a city’s tax structure can support its level of services over time; changes in the amount of outside revenue, such as state aid; and whether the property tax rate is close to a state-imposed limit and thus would make it difficult to raise additional money.

If the outside accountants determine that a city’s financial condition is deteriorating, they are required to report that to city officials. The city, county, or school board must then tell the governor and legislature if it meets one or more of the conditions needed for the governor to declare a financial emergency and offer state assistance. The conditions, spelled out in Florida statutes, include failure to pay short-term loans or debt service expenses because of a lack of funds and the inability to cover a budget deficit.

State laws vary in defining local distress, allowing municipal bankruptcies, and providing intervention programs

Table 1: Local distress policies, 50 states

State	Law Designating Local Fiscal Distress ⁱ	Bankruptcy Authorization ⁱⁱ	Intervention Program ⁱⁱⁱ
Alabama	no	yes (bonds only)	no
Alaska	no	no	no
Arizona	yes ^{iv}	yes	no*
Arkansas	no	yes	no*
California	yes ^v	conditional (use of a neutral evaluator or declaration of fiscal emergency)	no*
Colorado	no	limited	no
Connecticut	no	conditional	yes
Delaware	no	no	no
Florida	yes	conditional	yes
Georgia	no	no (specifically prohibited)	no
Hawaii	no	no	no
Idaho	no	yes	no ^{vi}
Illinois	n/a ^{vii}	limited	yes
Indiana	yes ^{viii}	no	yes
Iowa	yes ^{ix}	no (with exception)	no*
Kansas	no	no	no
Kentucky	no ^x	conditional	no
Louisiana	no	conditional	yes
Maine	yes	no	yes
Maryland	no	no	no
Massachusetts	no	no	yes
Michigan	yes	conditional	yes
Minnesota	yes ^{xi}	yes	no
Mississippi	no	no	no
Missouri	no	yes	no*
Montana	no	yes (but not counties)	no

State	Law Designating Local Fiscal Distress ⁱ	Bankruptcy Authorization ⁱⁱ	Intervention Program ⁱⁱⁱ
Nebraska	no	yes	no
Nevada	yes	no	yes
New Hampshire	no	no	yes
New Jersey	yes	conditional	yes
New Mexico	yes	no	yes
New York	yes	conditional	yes
North Carolina	yes	conditional	yes
North Dakota	no	no	no
Ohio	yes	conditional	yes
Oklahoma	no	yes	no
Oregon	yes	limited	yes
Pennsylvania	yes	conditional	yes
Rhode Island	yes	conditional	yes
South Carolina	no	yes	no
South Dakota	no	no	no
Tennessee	yes	no	yes
Texas	no	yes	yes
Utah	no	no	no
Vermont	no	no	no
Virginia	no	no	no
Washington	no	yes	no*
West Virginia	no	no	no
Wisconsin	no	no	no
Wyoming	no	no	no

*Interventions occur in school districts only.

Sources: National Conference of State Legislatures survey of legislative fiscal officers, November 2011. James Spiotto, et al., "Municipalities in Distress?: How States and Investors Deal with Local Government Financial Emergencies," Feb. 2012. The Pew Charitable Trusts analysis of state statutes.

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Table 1 endnotes

- i These data come from a survey of legislative fiscal officers by the National Conference of State Legislatures in November 2011.
 - ii As noted in “Municipalities in Distress?: How States and Investors Deal with Local Government Financial Emergencies,” 12 states specifically authorize a bankruptcy filing, another 12 states have conditional authorization, three states have limited authorization, two states generally prohibit a filing, and the remaining 21 states provide no authorization for a municipal bankruptcy filing. Without specific authorization from the state, a municipality may not file a petition under the U.S. Bankruptcy Code.
 - iii Arizona, Arkansas, California, Iowa, Missouri, and Washington have laws in place to intervene within their distressed school districts but not within their localities. They were not included in our typology.
 - iv For school districts only.
 - v For local education agencies—school districts and county offices of education only. While the survey response was limited to education agencies, a statute that declares fiscal emergency by local public entity has since been put in place. See CA GOVT § 53760.5 (AB 506).
 - vi Idaho intervenes within its school districts, but it does so to recoup expenditures made to repay debt on behalf of the district rather than to restore the locality’s fiscal health. In addition, the state’s provision for debt readjustment plans for irrigation districts should be noted. It has significance given the importance of irrigation and highway districts in Idaho’s economy. Such districts, however, were not included in this typology.
 - vii Illinois did not respond to the NCSL survey. However, the state has a legal process in place to designate a local government in fiscal distress or fiscal emergency—see 65 ILCS 5/8-12-2. The triggering conditions can be found in statute. See 50 ILCS 320 [<http://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=706&ChapterID=11>].
 - viii Only at the township level.
 - ix For school districts only.
 - x Kentucky responded “no” to the NCSL survey, but some literature (Richard Ravitch and Paul A. Volcker, “Report of the State Budget Crisis Task Force,” *State Budget Crisis Task Force*, July 2012, and Charles K. Coe, “Preventing Local Government Fiscal Crises: Emerging Best Practices,” *New Perspectives on Local Government Leadership*, 68 (2009): 762) describes the state as having effective early fiscal distress detection and intervention mechanisms. This seems to be in the form of the Department for Local Government—where the state local finance and state local debt officers establish and monitor compliance with statewide financial management guidelines for counties, cities, and special districts and require all local governments to notify (and in some cases gain approval from) the state before issuing any debt. See KRS 68.250 and KRS 66.310. Kentucky proactively manages the fiscal governance of its municipalities to avoid ever having to declare a locality in fiscal distress.
 - xi For school districts only.
-

North Carolina has a sophisticated tracking system.¹⁶ Local governments submit financial data extracted from state-mandated reports by independent auditors. Working with the U.S. Census Bureau, the staff of North Carolina's Local Government Commission develops a financial profile of each city and county that is shared in a public database. The profile lists many of the same financial indicators that Florida uses. When commission staff members spot a potential difficulty in the indicators, they send city officials a letter asking about plans to correct the problem. The state has the authority to intervene and run the city's day-to-day operations if local leaders are reluctant.

Michigan fiscal indicators

Michigan treasury officials asked Michigan State University to help develop a set of measures the state could use to evaluate local governments' financial health. With these measures, state officials analyze nine categories and assign points to determine the municipalities' financial "stress" scores, which are posted on the Michigan Department of Treasury website.ⁱ Among the categories are population trends, increases and decreases in property tax value, general fund spending as a percentage of property tax value, budget deficits in current and prior years, and long-term debt as a percentage of property tax value.

i State of Michigan Department of Treasury website, http://www.michigan.gov/treasury/0,1607,7-121-1751_47023-171423--,00.html.

Bankruptcy

In the most extreme instances, municipal crises can lead to bankruptcy, an event that state and local policymakers work to avoid. Such filings are rare, drastic alternatives to direct intervention. Even if local government budget distress is widespread, as it was in many cities during the Great Recession, states generally limit the use of Chapter 9 bankruptcy protection as a solution.

Cities cannot file for bankruptcy without the state's permission. Twenty-seven states authorize some form of bankruptcy with varying conditions.¹⁷ Two states—Georgia and Iowa—have enacted statutes prohibiting cities from seeking Chapter 9 protection.¹⁸ The remaining 21 states do not have laws allowing or prohibiting municipal bankruptcies. (See Table 1, page 9.)

Oregon allows only irrigation districts to seek reorganization. In Connecticut, the governor must approve a Chapter 9 filing. California sets a 60-day period for the local government and the parties affected by a potential bankruptcy—bankers, suppliers, vendors, and public labor unions—to first attempt a settlement negotiated by a mediator. The state also allows cities the option of skipping mediation and filing for bankruptcy protection after declaring an emergency, as San Bernardino did in July 2012.

Federal judges decide municipal bankruptcy cases, but a judge cannot liquidate a city as the court can liquidate a corporation in other federal bankruptcy categories such as Chapter 11. Instead, the judge is limited to determining the fairness of the city's plan to adjust debts and pay creditors after discussions among the stakeholders. Christopher M. Klein, chief judge of the U.S. Bankruptcy Court for the Eastern District of California, who is overseeing Stockton's bankruptcy, says Chapter 9 filings are "intensely a negotiation model because the judge's powers are greatly limited."¹⁹

Municipal bankruptcy is infrequent

“Municipal government” is a broader term than “city.” It also can include towns, villages, boroughs, counties, and special districts covering schools, hospitals, and utilities. Municipal bankruptcies are rare. Of the 55,000 municipal governments in the United States that sell bonds, only 276 have filed for bankruptcy protection since 1980.ⁱ Most of those filings were by special districts, not cities. Nebraska leads all states in municipal bankruptcy cases, with 55 since 1980, but those were special tax districts, not local governments.ⁱⁱ In 2013, Detroit filed the largest municipal bankruptcy in U.S. history. In 2011, Jefferson County, AL, filed the largest county bankruptcy in U.S. history at \$4.2 billion.ⁱⁱⁱ A year later, Stockton, CA, became the largest city to file for Chapter 9 until Detroit.^{iv} Before Jefferson County, the record for the largest Chapter 9 filing by population had been held for 17 years by Orange County, CA.^v

- i The Pew Charitable Trusts, email with James Spiotto, May 6, 2013. According to Spiotto, as of March 31, 2013, there had been 276 Chapter 9 filings since 1980 and 58 filings since 1984.
- ii James Spiotto et al., “Municipalities in Distress?: How States and Investors Deal with Local Government Financial Emergencies,” Feb. 2012.
- iii Verna Gates, “Alabama county fires attorney in largest U.S. municipal bankruptcy,” *Thompson Reuters News & Insight*, April 12, 2013. http://newsandinsight.thomsonreuters.com/Legal/News/2013/04_-_April/Alabama_county_fires_attorney_in_largest_U_S_municipal_bankruptcy.
- iv “Bankrupt Cities, Municipalities List and Map,” *Governing*, last updated April 2, 2013. <http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html>.
- v “Orange County no longer No. 1 when it comes to municipal bankruptcy,” *Los Angeles Times* blog L.A. NOW, November 10, 2011. <http://latimesblogs.latimes.com/lanow/2011/11/oc-loses-standing-biggest-us-bankruptcy.html>.

A spate of recent high-profile local government defaults and bankruptcy filings in Alabama, California, Pennsylvania, and Rhode Island coincided with the Great Recession and the sluggish recovery that followed. Although the downturn worsened local finances, it was not the main reason the cities and counties declared bankruptcy or default. In fact, almost every recent emergency can be traced to a one-time blow or a structural problem that worsened over time. For example, Jefferson County, AL, and Harrisburg, PA, mismanaged large infrastructure projects over several years. Vallejo, CA, and Central Falls, RI, could not keep up their dramatically rising payroll and public pension costs. Mammoth Lakes, CA, and Westfall Township, PA, did not have the money to cover multimillion-dollar legal judgments against them.²⁰ Wenatchee, WA, promised to backstop bonds for a regional hockey and concert arena but came up short of the revenue needed to honor its guarantee. Bell, CA, defaulted on part of its bonds after a corruption scandal in which eight city officials were charged with misusing taxpayers’ money.²¹ Stockton and San Bernardino, CA, sold millions of dollars of so-called pension obligation bonds before the recession to help cover the cost of their employee retirement benefits. But the interest costs of borrowing exceeded the assumed rate of return, a major reason why Stockton and San Bernardino filed for bankruptcy.

The stakes: Why states may intervene in local government problems

States have many different motivations to intervene. Preventing stigma, credit downgrades, and contagion as well as preserving public health and safety, and economic growth and stability are all potential drivers of state action.

States have a long history of intervening

State officials have attempted to help cities avoid financial disaster for years. In 1921, the New Hampshire governor created a commission to oversee Manchester's troubled finances, an early example of a state intervening with a financial control board.ⁱ Ten years later, the North Carolina Legislature responded to a wave of municipal defaults at the start of the Great Depression by creating a commission to advise troubled cities and impose budget controls if necessary. New York state lawmakers advanced money to New York City in 1975 and set up an independent corporation to sell bonds backed by state taxes to help the city avoid bankruptcy. Then, in 1978, after Cleveland became the first major city since the Great Depression to default on short-term notes, the Ohio Legislature allowed the city to borrow money from the state to avert bankruptcy. That set in motion the creation of a state-run system for monitoring local government finances. In 1987, following a rash of local government financial problems stemming from the decline of manufacturing, Pennsylvania started a program to keep an eye on its cities' finances and rescue the worst ones. The state created a separate agency in 1991 to help Philadelphia overcome its budget crisis. The Pennsylvania Intergovernmental Cooperation Authority exists to this day, with the power to review and approve the city's five-year financial plans. If the authority rejects a plan, it has the power to withhold a share of the city wage tax.

i James Spiotto et al., "Municipalities in Distress?: How States and Investors Deal with Local Government Financial Emergencies," Feb. 2012.

Stigma

One common motivation for states that have set up intervention programs is protecting their reputations. "They can't sit there and watch their cities suffer, because it's their own fate that will suffer, too," says municipal bankruptcy attorney James Spiotto.²² States that intervene often want to avoid the stigma that would come from their cities filing for bankruptcy protection. Bankruptcy is usually an act of desperation that damages a city's prospects for economic growth and its ability to borrow money for improvements to roads, sewers, schools, and other capital projects. Its image can be damaged for many years, as Vallejo, CA, has demonstrated in a state that does not assist troubled local governments.

During its bankruptcy from 2008 to 2011, Vallejo could not borrow money to maintain its streets or replace its aging police cars and fire trucks. After the city cut its police force by 42 percent and firefighters by 47 percent, violent crime rose, as did response times to fires and medical emergencies. The city saved \$34 million by avoiding paying a portion of interest costs on its bonds and rejecting expensive labor agreements, but it spent more than \$13 million on legal fees, which counteracted the savings. The city's troubles made national headlines ("Broke Town, U.S.A.," *The New York Times* called it²³), and Vallejo lost population as other large San Francisco Bay Area cities gained residents.²⁴

Other states, concerned about similar consequences and publicity, are more active in attempting to halt their cities' financial slides. Michigan's current and former governors rejected requests from Hamtramck, a suburb of Detroit, to file for bankruptcy protection in both 2010 and 2011. State officials said they were worried that

it would have a ripple effect on other distressed Michigan governments and reflect poorly on a state trying to emerge from a decade-long decline. Likewise, two Pennsylvania governors and Legislatures have blocked Harrisburg's efforts to file for bankruptcy protection since 2010, saying the state government should help its capital city before a court steps in.

Bridgeport, CT bankruptcy is blocked

Connecticut lawmakers agreed to guarantee loans to Bridgeport in 1988 after the state's largest city could not plug a widening budget gap. Three years later, Bridgeport filed for bankruptcy protection, but the state successfully blocked it in court after a federal judge said the city had enough cash to pay its bills. It was the first time a major U.S. city had attempted to use bankruptcy as a remedy for its fiscal mismanagement. State officials intervened because they were worried it would set a precedent for other Connecticut cities and would diminish the state's own financial standing. "The fact that the state's position was sustained puts us into the position where we can help all the other cities in this state, including Bridgeport," said then-Governor Lowell P. Weicker Jr.ⁱ

i Janet Cappiello, "Federal Judge Rejects City's Bankruptcy Petition," Associated Press, Aug. 1, 1991.

Credit downgrades

Another concern of states is that the agencies that rate municipal bonds for investors, including Moody's, Standard & Poor's, and Fitch, could downgrade the state's credit rating if its local governments are unhealthy. That could raise the cost of borrowing by the state, inhibiting short-term cash flow as well as long-term capital financing. It could also cause bond buyers to stop investing in state debt.

Protecting the state credit rating was a clear motivation behind Rhode Island's decision to reinforce its intervention program in 2010 after Central Falls was heading toward bankruptcy. "The governor and General Assembly have been united on the need to be proactive with state oversight, which has proven valuable with rating agencies," said Rosemary Booth Gallogly, Rhode Island's revenue director.²⁵ Moody's, which considers many factors in its credit ratings, says it will not raise a state's bond rating simply because it has a local government intervention program. But the agency notes that such oversight strengthens the state's financial standing by ensuring that its local governments are secure.²⁶ All three major credit rating agencies have rewarded North Carolina and many of its local governments with the highest rating, citing the state's culture of prudent financial management, which includes strong intervention in municipal finances.²⁷

But it is unclear whether a state's rating is affected by the financial health of its cities. Standard & Poor's does list local government financial difficulties among a broad set of criteria that may move a state's rating up or down.²⁸ S&P, Moody's, and Fitch place greater emphasis on a state's overall budget management and its economy in determining credit ratings. S&P has never lowered a state's bond rating specifically because one or more of its cities was distressed or because of the lack of an oversight program.²⁹

Detroit is the most financially troubled big city in the nation. Despite this, Fitch upgraded Michigan's general obligation bond rating in May 2013, and S&P and Moody's elevated the state's bonds from stable to positive. The agencies cited Michigan's improving economy.³⁰

Contagion

Closely related to the worry about lowered credit ratings as a motivating factor for state intervention is concern over a phenomenon called contagion, when distress in one city spreads to the state or other local governments. Concern about contagion surfaced during the New York City financial crisis of 1975, when the governor and Legislature stepped in to help rescue the city in part because they were nervous that the city's distress would hurt the state's ability to sell bonds. "Had the city's financial situation not been at the very least stabilized, the state itself and its agencies and indeed every local community would have been in drastic financial difficulty," Felix Rohatyn, chairman of the Municipal Assistance Corporation, which lawmakers set up to sell bonds to aid the city, said at the time.³¹ More recently, California Treasurer Bill Lockyer said after the Stockton and San Bernardino bankruptcy filings that local governments could wind up paying more to borrow money if financial troubles spread from city to city. He said local fiscal distress, especially bankruptcy, "does more than inflict long-term harm on the community. The reputational stain can bleed onto other local issuers and the State, and that can hurt taxpayers in the bond market."³²

Concerns about contagion were a reason that Pennsylvania advanced \$4 million in loans so Harrisburg could make a bond payment in 2010. Then-Governor Edward Rendell said he was worried that missing the payment "would devastate not only the city, but the school district, the county, and central Pennsylvania."³³

A year after strengthening their state's intervention program, Rhode Island lawmakers were so concerned about fallout from the Central Falls bankruptcy filing that they approved a law giving investors holding bonds in bankrupt cities the right to place liens on tax revenue, an unprecedented guarantee of repayment aimed at preventing contagion. Municipal bond market analysts praised Rhode Island's move, saying a city's default could thin the number of lenders in the state, potentially push interest rates higher, and encourage underwriters to view other local governments within Rhode Island more conservatively.³⁴

Although the risk of distress in one local government widening to its peers, or its state, has motivated state interventions, the actual threat can be overstated. Fitch raised Michigan's credit rating in April 2013, despite the struggles of Detroit, its largest city.³⁵ Alabama municipalities have issued debt despite the bankruptcy of Jefferson County. The bankruptcies and financial emergencies in California cities have not had widespread effects on other local governments, Standard & Poor's has observed. "The small number of municipal bankruptcies is a testimony to the resilience of local governments and their ability and willingness to scale back expenditures and align them with lower revenues," S&P said in January 2013.³⁶

David Skeel, a professor at the University of Pennsylvania and one of the nation's top bankruptcy law experts, says: "The restructuring of one city is a lot less likely to have contagion effects on other cities in those states than people in the bond market tend to believe."³⁷

Public health and safety

States have another motive for getting involved: avoiding service interruptions, especially those threatening public safety and health. In 2011, when city officials in Harrisburg failed to name a manager to implement a state-supervised recovery plan, state lawmakers intervened with legislation allowing the governor to appoint one. (See profile of Pennsylvania, page 27.) In signing the bill, Governor Tom Corbett cited the need to maintain order. "I remain a strong proponent for municipal governments tackling their own problems and coming together to develop a fiscal recovery plan when necessary," Corbett says. "But when that fails to happen, the state has to take action to ensure public safety."³⁸

Some troubled cities have sought to balance budgets by cutting police officers and firefighters, jeopardizing public safety. In 2011, New Jersey Governor Chris Christie sent state troopers to help patrol Camden after cuts to the city's police force led to an increase in crime, including murder.³⁹ (See profile of New Jersey, page 33.) Under prodding from the state, the mayor and police chief disbanded Camden's police force and persuaded the county to create a department with a division dedicated to the city. "If we can help them get a more efficient county police service—so that they get more service for the same amount of money—then that will get people saying the city is on an upturn," says Thomas Neff, the state's director of local government services.⁴⁰

Economic stability and growth

Another motivation for state intervention is strengthening the state's economy. Avoiding contagion, securing high bond ratings, and maintaining safety and health are important for overall state economic health. The financial condition of cities is closely intertwined with their ability to borrow the money they need to build roads, schools, and amenities such as parks that attract residents and businesses to create good-paying jobs. "The municipal securities market is the bedrock for funding of local government projects throughout our country," says Securities and Exchange Commission Chairman Mary Schapiro.⁴¹

Vibrant, financially stable communities are the building blocks of strong statewide economies and help produce tax revenue that pours into state government coffers. Michigan leaders say they cannot retool their economy unless their largest city, Detroit, is financially healthy. "The state can only be as strong as its component parts," says Terry Stanton, communications director for the Michigan Department of Treasury. "Having financially sound, vibrant local units only makes the state better from an economic standpoint, a livability standpoint, and from the standpoint of attracting companies that will create jobs and call the state home."⁴²

State approaches to intervention

State laws on local intervention vary regarding who carries out the action and what practices are used. The following sections take a closer look at these differences between states.

Who conducts the intervention?

States generally choose from among three groups to carry out the intervention, or use a combination of them:

Receiver, financial manager, overseer, or coordinator. States may appoint an outside person, usually with an extensive financial and legal background, to take charge of the distressed city's operations and budget. Such a receiver or overseer is in place temporarily, until the city recovers. Rhode Island Governor Lincoln Chafee first turned to Robert G. Flanders, a specialist in municipal restructuring, to guide Central Falls out of bankruptcy in 2011-12.⁴³

State agency. Another approach used in some states, such as Pennsylvania, is to designate an agency within the state government instead of an outside person to supervise the city's restructuring. The secretary of the Pennsylvania Department of Community and Economic Development appoints a coordinator to develop and manage a city's recovery plan. The coordinator may be a state employee within the agency but more often is a local expert, such as the Pittsburgh law firm that handled that city's recovery.

Financial control board or state-appointed board or commission. Finally, a state may opt to appoint a financial control board or commission, usually consisting of a combination of local and state officials, some with budget expertise.

A state may use just one of these strategies or a combination. Massachusetts does the latter, deciding which approach to take on a case-by-case basis. The state may send an overseer to a severely distressed city or appoint a financial control board. The legislature dispatched a receiver to Chelsea in 1991 after the city ran out of cash to pay workers and bills. The receiver restored Chelsea's finances with spending cuts and left in 1995.

Springfield, Massachusetts' third-largest city, was similarly distressed in 2004 when state lawmakers established a five-member financial control board made up of state and local appointees.⁴⁴ In exchange for taking over the city's day-to-day operations, the state guaranteed a \$52 million interest-free loan so that Springfield could pay its bills. The board's powers were significant, including the authority to replace binding arbitration with voluntary mediation for future labor contracts; hiring and firing city employees; approving all contracts for goods and services; organizing the city government as it saw fit; and raising or cutting any fee, rate, or other charge for a city service, license, or permit. The board was dissolved and management of the city restored to the local government after Springfield ended the 2009 budget year with \$35 million in reserves.⁴⁵

Intervention practices

Apart from who administers the oversight, the actual intervention practices vary among the 20 states that have laws in place. No two are alike, but there are similarities in the types of assistance they extend to local governments. Some allow restructuring of finances, including debt, labor contracts, taxes, fees, and credits. Some provide technical assistance, while others offer loans and grants. Here are examples of intervention practices:

Debt. Fifteen of the 20 states allow the receiver, state agency, or control board to approve bond sales or renegotiate the terms of existing bonds on behalf of the city government. New York state lawmakers created corporations in New York City in 1975 and Troy in 1995 to sell bonds to help those cities raise money and balance their budgets, among other things.⁴⁶ The Illinois Legislature stepped in to rescue East St. Louis in 1990 with an unprecedented package of loans, state bonding authority, a financial manager, and a five-member Financial Advisory Authority.⁴⁷

Labor. Seven states permit intervenors to reduce labor costs in distressed cities by giving them the authority to renegotiate existing labor contracts, including multiyear pacts that called for increases in salaries, benefits, or other compensation. Nevada's "severe financial emergency" law allows a manager, appointed by the state Department of Taxation, to negotiate and approve most collective bargaining agreements for a city in a crisis.⁴⁸ Rhode Island gives its state-appointed receivers the ability to negotiate new union contracts.

Taxes, fees, and credits. Eleven states give intervenors authority to increase existing taxes and fees or implement new ones. The Central Falls receiver used his power to raise property taxes 4 percent in five successive years as part of a plan for the city to emerge from bankruptcy in 2012.⁴⁹ The tax hikes, public pension benefit cuts, and reductions in city services he implemented were not popular with residents.

Emergency financing. Although 14 states provide in statute for state loans (often no- or low-interest loans), grants, or credit guarantees, few offer these options to municipalities in practice because of dwindling state revenue and the risk that the states will have to dole money out to every city or county that asks for help. New Jersey gives cities modest amounts of money, which it calls transitional aid. After years of escalating state aid, the program has contracted under Governor Chris Christie from about \$200 million when he took office in 2010 to about \$95 million in fiscal 2014.⁵⁰

Technical assistance. All of the states with intervention programs, except New Hampshire, offer technical advice to financially troubled local governments. The assistance includes auditing records, creating a financial plan, putting together a balanced budget, negotiating and approving labor and other contracts, and approving spending. In Ohio, the state auditor charges local governments for technical help with financial reports, accounting, and forecasts. The consulting is free if the auditor has placed the city, county, or school district under a fiscal caution, watch, or emergency, the three designations of financial distress.⁵¹ In 2012, the mayors of the villages of Tiro and Newcomerstown asked auditor Dave Yost to conduct an analysis of village finances. After the audits, Yost placed them both in the fiscal emergency category and offered support in developing a recovery plan.

Dissolving or consolidating local government involuntarily. Michigan, Nevada, and Tennessee allow the intervenor to dis-incorporate and dissolve a city and consolidate it with other nearby jurisdictions. The Nevada Department of Taxation, the state agency charged with intervening in local government financial emergencies, took over the small city of Gabbs in 1999 after concluding that increasing property taxes and water and sewer fees would not raise enough money to balance Gabbs' budget. Two years later, the Nevada Legislature, which originally had incorporated Gabbs, voted to dissolve and dis-incorporate the city and place it under control of the county government.⁵²

States' intervention programs for distressed localities reflect a range of practices

Table 2: Strategies employed in the 20 states that allow intervention in local finances, early 2013

State	Receiver/ Financial Manager/ Overseer/ Coordinator	State Agency	Financial Control Board/ State- Appointed Board or Commission	Restructure Finances: Renegotiate, Approve, or Issue Debt	Restructure Finances: Labor	Restructure Finances: Taxes, Fees, Credits	Emergency Financing (Enhanced Credit Backing, Loans, Grants)	Supervise Finances/ Technical Assistance (Including Approving Budgets)	Disincorporate/ Dissolve/ Consolidate Local Government
CT	✓		✓	✓	✓	✓		✓	
FL		✓	✓				✓	✓	
IL	✓	✓	✓	✓	✓	✓	✓	✓	
IN	✓	✓			✓		✓	✓	
LA	✓			✓		✓	✓	✓	
ME		✓	✓	✓		✓	✓	✓	
MA	✓	✓	✓	✓		✓	✓	✓	
MI	✓	✓	✓	✓	✓		✓	✓	✓
NV	✓	✓		✓	✓	✓	✓	✓	✓
NH	✓						✓		
NJ	✓	✓	✓	✓		✓	✓	✓	
NM		✓					✓	✓	
NY			✓	✓	✓		✓	✓	
NC		✓	✓	✓		✓		✓	
OH	✓		✓	✓				✓	
OR			✓	✓				✓	
PA	✓	✓	✓	✓	✓	✓	✓	✓	
RI	✓		✓	✓		✓		✓	
TN	✓	✓		✓		✓	✓	✓	✓
TX	✓							✓	

Source: The Pew Charitable Trusts analysis of state statutes

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Table 2 endnotes

Connecticut:	The state deals with fiscal distress in an ad hoc manner. Four special acts have been enacted to restore fiscal sustainability within municipalities. See LCO 4532 (Waterbury); SA 92-5 (West Haven); SA 88-80, 89-23, 89-47, 90-31, 91-40 (Bridgeport); and SA 93-4 (Jewett City) [http://cga.ct.gov/2001/rpt/2001-R-0312.htm].
Florida:	See F.S.A. § 163.05, 163.055, and 218.50-218.504.
Illinois:	See 65 ILCS 5/8-12-1 through 65 ILCS 5/8-12-24 (Financially Distressed City Law) and 50 ILCS 320/1 through 50 ILCS 320/14 (Local Government Financial Planning and Supervision Act).
Indiana:	See IC § 6-1.1-20.3-1 through 6-1.1-20.3-13 (Distressed Unit Appeal Board).
Louisiana:	See RS 39:1351 through RS 39:1356 Chapter 9-B. Fiscal Administrator for Political Subdivisions
Maine:	See 30-A M.R.S.A. § 6101-6113 (Municipal Finance Board).
Massachusetts:	The state deals with fiscal distress in an ad hoc manner. See MA Session Laws: Chapter 58 of the Acts of 2010 and Chapter 169 of the Acts of 2004. Given this ad-hoc approach, we reviewed the text of the two Acts dealing with the Lawrence and Springfield fiscal crises.
Michigan:	See M.C.L.A. § 141.1541 et al. (Local Financial Stability and Choice Act). On November 6, 2012, Michigan voters rejected Public Act 4; Act 436 of 2012 took effect on March 28, 2013 [http://www.legislature.mi.gov/(S(dcdnrmz50xehu45crrgy3iy))/mileg.aspx?page=PAsearch&paNumber=436&paYear=2012].
Nevada:	See N.R.S. 354.655 through 354.725.
New Hampshire:	See N.H. Rev. Stat. § 13:1 through 13:7.
New Jersey:	See “Special Municipal Aid Act” N.J.S.A. 52:27D-118.24 to 118.31; “Local Government Supervision Act” N.J.S.A. 52:27BB-1 et seq.; “Municipal Finance Commission” R.S. 52:27-1 to R.S. 52:27-66; “Municipal Rehabilitation and Economic Recovery Act” N.J.S.A. 52:27BBB-1 et seq., and 18A:7A et seq.
New Mexico:	See N.M.S.A. 1978, § 12-6-1 through 12-6-14 (Audit Act), N.M.S.A. 1978, § 6-1-1 through § 6-1-13, § 10-5-2, and § 10-5-8.
New York:	The state deals with fiscal distress in an ad hoc manner. New legislation is passed for each municipality, establishing an emergency financial control board and laying out its powers. We looked at two cases in which such boards were established, for New York City and for Yonkers. See New York State Financial Emergency Act for the City of New York [NY Unconsolidated Law Ch. 22 § 5, http://public.leginfo.state.ny.us/]; Financial Emergency Act for Yonkers [http://codes.lp.findlaw.com/nycode/YFA/notes]; and Local Finance Law [§ 85.00 to 85.90, http://public.leginfo.state.ny.us/].
North Carolina:	See N.C.G.S.A. § 159-1 through 159-180; N.C.G.S.A. § 63A; and § 159D. School districts are explicitly excluded from these provisions in the statute.
Ohio:	See Ohio’s R.C. § 118, 133.34, and 3735.49. In the event that fiscal emergency is declared, a Financial Planning and Supervision Commission is formed for each distressed locality, or the state auditor becomes the financial supervisor if the locality has fewer than 1,000 people.
Oregon:	See O.R.S. § 203.095-100 and § 287A.630. Oregon’s fiscal control board is established in the event that a county is declared to be in a state of public safety emergency.
Pennsylvania:	See PA ST 53 P.S. § 11701.101-712 (Municipalities Financial Recovery Act and Intergovernmental Cooperation Authority Act).
Rhode Island:	See RI GEN LAWS § 45-9-1 through 45-9-14.
Tennessee:	See T.C.A. § 9-13-201 to 212 (Emergency Financial Aid to Local Government Law of 1995), T.C.A. § 9-13-301 to 302 (Financially Distressed Municipalities, Counties, Utility Districts and Education Agencies Act of 1993), and T.C.A. § 9-21-403 (Local Government Public Obligations Act).
Texas:	See T.C.A., Local Government Code § 101.006. Municipalities that cannot pay their debts can voluntarily request that a receiver be appointed (this is a court-appointed receiver).

Challenges and solutions

Although no single intervention approach fits every state, Pew's research did identify several practices that states should consider in adopting or altering their intervention programs:

Local governments will continue to confront slow revenue growth and spending pressures in the near term. State governments should not merely react to local crisis. Rather, states need to be proactive in monitoring local government financial challenges and instituting long-term financial planning.

Challenge: Detecting local government financial challenges

Historically, states react to crises instead of trying to prevent them. Gina Raimondo was a partner in a venture capital firm before she was elected treasurer of Rhode Island. The greatest lesson she learned in the private sector was that the best chief executive officers recognize and tackle problems early instead of waiting for them to escalate. States should do the same, she says, with the executive branch leading the way. Adds Rosemary Gallogly, Rhode Island's revenue director: "The goal is to help cities avoid oversight" in the first place.⁵³

Solution: Establish a local government monitoring system

That is the aim of New York state's new local government monitoring system, established by Comptroller Thomas DiNapoli, in which cities and school districts send him financial data throughout the year. Using that data and nine financial indicators, DiNapoli created a stress-scoring system similar to Michigan's. The scores classify levels of distress—significant, moderate, "nearing fiscal stress," or none of those. The comptroller's office offers technical assistance such as early-stage budget planning to help the city or school district correct problems and forestall a deeper crisis. In this way, DiNapoli says, "We can have a more honest conversation about the status of their budgets, what the numbers are, as a way to come up with solutions."⁵⁴

In North Carolina, the high credit ratings of cities and towns mean their borrowing costs are low. Investors know that their bonds are relatively safe because of the structure in place to support and advise North Carolina cities. "The framework has been very effective," says Matt Fabian of Municipal Market Advisors.⁵⁵ (See profile of North Carolina, page 30.)

If California had a monitoring system in the 1990s, state officials might have detected that Orange County had a large amount of interest income from risky investments that accounted for a higher-than-average percentage of its revenue. That information could have indicated that Orange County was headed toward trouble.⁵⁶ In 2012, driven by the series of recent municipal bankruptcies in the state, California Treasurer Bill Lockyer proposed an early warning system for California similar to the New York model.⁵⁷ (See profile of California, page 39.) James Spiotto, the municipal bankruptcy lawyer, says that although some financial monitoring triggers are unique to certain states, it would be helpful for all states to develop objective criteria that everyone could use to detect trouble in local governments.⁵⁸

Challenge: Short-term financial outlooks

So many decisions that cities and states make are long term—leases, retirement benefits, and bonds—yet officials generally take a short-term, year-to-year approach to managing their finances. Richard Ravitch, a former New York lieutenant governor who helped New York City avert bankruptcy in 1975, says too many local governments use one-time measures to paper over ongoing problems. For example, some local (and state) governments borrow to solve short-term budget and long-term pension problems. One reason for New York City's 1975 financial crisis was that the city used short-term debt to cover budget deficits and repay past borrowings.⁵⁹ Ravitch and other specialists say states should encourage local governments to borrow only when it makes sense, such as for long-term capital needs.

Solution: Cities and states should institute long-term financial planning and offer technical advice to localities

To limit intervention, states and cities should learn how to look to the future by developing multiyear financial plans to guide their decisions. This strategy provides governments with a structure to match expenses and revenue over several years. Ravitch says one of the reasons that New York City has avoided another budget crisis is its emphasis on long-term plans.⁶⁰

Those plans should include a focus on so-called legacy costs such as retirement benefits. One reason Pittsburgh has stabilized its shaky finances in the past few years is its reliance on five-year plans to increase public pension contributions and pay down debt.

States should also consider offering city officials more technical finance training. Michigan Treasurer Andy Dillon says he is amazed in some instances by the lack of budget sophistication at the local level, even on such basics as comparing actual financial results to projections in budgets. "It's stunning to me how much lack of training there can be," Dillon says.⁶¹

Creating state intervention programs would come with costs at a time when states are facing limited funds and staffing, which test their ability to monitor local government fiscal trends or offer direct aid to struggling cities. State officials will need to balance assisting cities with managing their own resources and making strategic decisions about whether to intervene and, if so, how.

Challenge: States are facing their own budget constraints and have limited resources to help localities

Direct aid to local governments, though an option for states, is not easy. States may not have money to offer grants or loans to cities, as some once did. And some officials worry that the availability of state aid could serve as an incentive for localities that are experiencing financial distress to neglect their problems. New Jersey Governor Chris Christie cut state aid to distressed local governments in part because he said cities could become too dependent on state money. (See profile of New Jersey, page 33.) Even if money is available, state officials say they may be leery of bailing out cities for fear of sending a signal to other local governments that it's OK to overspend because the state will rescue them. When Massachusetts leaders considered giving Springfield a \$20 million cash grant and \$30 million interest-free loan during its 2004 budget crisis, the House speaker blocked the grant, saying it would prompt other local lawmakers to ask for money, burdening the state treasury.⁶²

Some costs are necessary. Michigan and Rhode Island, two states squeezed by the Great Recession, are hard-pressed to take on additional spending. Yet Michigan is paying Detroit's state-sponsored emergency manager \$275,000 a year.⁶³ Rhode Island, after expanding its intervention program in 2010, enlarged the state finance department and gave Central Falls a one-time allocation of \$2.6 million to soften the impact of public pension benefit cuts on retirees over five years.⁶⁴

Solution: States can make strategic (and creative) choices about how they intervene

Some states have mitigated the costs of helping local governments by using existing resources. New York is using current staff to oversee its recently expanded local monitoring system. Although tradeoffs remain, the state has avoided the immediate expense of hiring and training additional employees.

And there are times when the state can help cities with limited risk, such as when New York state agreed in March 2013 to advance the timing of a \$7.8 million payment due to Albany to balance its budget.⁶⁵

New York also demonstrated how states can be creative with financial aid. During the 1975 New York City financial crisis, the state essentially used its credibility in the bond market to assist the troubled local government. The state advanced the city about \$800 million, but it also created the Municipal Assistance Corporation to sell up to \$3 billion in state-backed bonds to refinance the city's debts. This form of bridge financing gave New York City much-needed immediate cash and helped it climb back without dipping into the state's coffers.⁶⁶

City officials and local residents often resent state government stepping in to manage their affairs. When possible, the intervention should be designed to involve all stakeholders in discussions, to be transparent with financial information, and to limit tension by resolving financial problems and returning control to local officials as quickly as possible.

Challenge: Balancing state oversight with local control

Pew's research shows that state intervention often is viewed as a usurping of local democracy because unelected state officials make decisions usually left up to local mayors and councils. Unions, a powerful political force in some states, often resist state oversight because they are afraid it could affect wage and benefit negotiations. Protests and division among city and labor leaders marked Michigan's takeover of Detroit in 2013. In nearby Allen Park, officials unsuccessfully contested Governor Rick Snyder's September 2012 decision to appoint an outside emergency financial manager. "Any city that has an EM [emergency manager] has suffered a tremendous erosion in how people view that city," says Mayor William Matakas. "An EM is a very harmful thing for the future of a city."⁶⁷ Despite Rhode Island's positive portrayal of the Central Falls bankruptcy, resentment lingers. "It looks like the Germans occupying Paris, that's what it looks like," said a lawyer for some members of the Central Falls City Council, which reluctantly moved aside when the state-appointed receiver took over in 2011.⁶⁸

Solution: Engage stakeholders, be transparent, and be efficient

To overcome those fears, intervenors should engage the entire community—unions, elected officials, city employees, investors, municipal bond lawyers, and other stakeholders—to gain its trust. Rhode Island officials' intervention in Central Falls was relatively fast because they emphasized negotiation, not litigation and confrontation, says Theodore Orson, the attorney who represented the state and receiver in the bankruptcy. It was not easy at first, because the state was trying to persuade city employees and retirees, most of whom were represented by a labor union, to voluntarily roll back their pension benefits. State officials say they convinced the stakeholders of their sincerity through transparency: showing the retirees the numbers and building the case that they would otherwise eventually lose benefits altogether. Also key was a signed pledge by city officials that they would not cut pension benefits again for at least five years.⁶⁹

In their effort to be inclusive of all stakeholders, Rhode Island officials also did something no state had ever done to reassure investors. Lawmakers approved a measure guaranteeing bondholders top priority for payment over other creditors in municipal bankruptcies. The law ensured that Central Falls would not default on its bond obligations. Including bondholders favorably in the process contributed to the relatively fast resolution of the bankruptcy. In September 2012, a federal judge approved a plan allowing the city to come out of bankruptcy after only 13 months. "It's record time, and record efficiency," Judge Frank Bailey said from the bench. "In a way, I think this is an example—for not only Rhode Island, but maybe the nation—on how to run a Chapter 9."⁷⁰

Within two months, the credit-rating agencies raised Central Falls' rating. The debate on the bondholders-first law lingers, however, because some analysts say it is not needed to ensure that a bankrupt city will still be able to borrow. "The bond market view tends to be if you do anything that prevents us from getting 100 cents on the dollar, the world is going to come to an end," says David Skeel, a University of Pennsylvania law school professor and bankruptcy expert. "And my view is, there's just no evidence of that."⁷¹ Matt Fabian, a managing director at Municipal Market Advisors, counters that bond buyers, nervous about a distressed city, would be more curious about the safety of the city's bonds, adding hours of research for underwriters and slowing the pace at which bonds come to market.⁷²

Faced with sluggish revenue growth, limited money to aid their localities, and resentment from local officials for intervening in the first place, some states struggle to find the right intervention strategy to fit their needs. Fortunately, steps can be and have been taken to strike that balance. With the help of states, cities can act early to monitor and, hopefully, mitigate financial problems. In addition, states can use existing resources to decide upon the best intervention strategy by creating a plan that values transparency.

State profiles

By examining seven individual states, Pew researchers explored patterns of state and local experiences with financial distress, including what motivates states to intervene or not, how political and economic conditions can affect a state's decision on whether to get involved, and what results the state efforts have yielded.

Alabama's largest county must resolve bankruptcy without the state's help

A historical unwillingness to raise taxes and political divisions deterred the state government from heading off the largest county bankruptcy in U.S. history

After the worst recorded tornado outbreak in Alabama history struck two-thirds of the state in 2011, killing 230 people, the governor and lawmakers immediately united to lead an effort to clean up debris, speed aid to victims, and repair and rebuild roads, bridges, schools, and other public buildings.⁷³

But six months later, when Alabama's largest county was nearing insolvency, state leaders declined to intervene to avert the largest county bankruptcy in U.S. history. Jefferson County, which includes Alabama's most populous city, Birmingham, faced years of restructuring its finances, paying creditors, and trying to deliver services that were cut sharply for four years.

"We're letting Jefferson County die on the vine," says state Rep. Jack Williams, a Republican from the Birmingham suburbs. He worries that the bankruptcy will impede economic growth in the jurisdiction, which brings in the most revenue of Alabama's 67 counties and affect growth in the state as a whole.⁷⁴

In declining to assist Jefferson County, Alabama is an example of a state that has chosen to stay out of local government financial problems even when the consequences seem clear. This has been a controversial choice among some people. "The state is like a parent to a city," says James Spiotto, a Chicago attorney who specializes in municipal bankruptcy matters. "Sometimes you want to call Child and Family Services on them."⁷⁵

Part of the difficulty with Jefferson County is that officials must sort out three separate but related issues simultaneously. One is the bankruptcy, which stems from the mismanaged and corrupt financial dealings around the rebuilding of the county sewer system. In June 2013, the county filed a plan in federal court to exit the bankruptcy in part by raising sewer fees.⁷⁶ A second issue is Jefferson County's operating budget. Officials have slashed \$119 million from the budget in the past two years and may need to consider future cuts.⁷⁷ In 2011, the Alabama Supreme Court struck down an occupation tax on workers' salaries that provided more than a quarter of the county's general fund revenue, and state lawmakers have been unable to approve legislation for a new tax.⁷⁸ Finally, the county has struggled to meet fast-rising costs for a public hospital that serves the indigent. Officials took a big step to slash those expenses by eliminating inpatient care and reorganizing the hospital as an ambulatory and urgent care facility beginning in 2013.⁷⁹

Alabama's constitution limits county government power

Viewed through the lens of Alabama history, the state's lack of intervention with Jefferson County is understandable. The 777-page state constitution, drafted in 1901, reinforced the long-held view of rural lawmakers that urban county governments should have little power. Alabama is a Dillon's Rule state, meaning that the Legislature determines how much authority counties can have. Under this system, Jefferson County must have the state's permission to raise revenue, and state lawmakers, eager to avoid being accused of raising taxes, are loath to give counties approval to levy taxes. (By contrast, Alabama cities do not need state approval to manage their finances.)

Also, Alabama has a limited state government and lacks experts to monitor the financial condition of local governments or advise them when they need help. For example, lawmakers did not rescue the town of Prichard when its public pension fund ran out of money in 2009 and officials stopped sending retirees their checks.⁸⁰ The city later reached an agreement with the retirees to resume benefits at a reduced amount.

The state's problems often end up with the federal government or courts, which have had to untangle state issues created from crowded prisons, gerrymandered legislative districts, inadequate mental health care, and insufficient civil rights protections.

"The problems at the state level are so severe that the Legislature feels it has its hands full just dealing with the state's financial problems," says Bill Stewart, a professor emeritus at the University of Alabama.⁸¹

State leaders have not ignored Jefferson County. Governor Robert Bentley and his predecessor, Robert Riley, convened several meetings of elected officials and county business leaders to press for a solution. Riley unsuccessfully tried to negotiate an agreement with the county's creditors. But neither Riley nor Bentley elevated the crisis as an urgent state matter, as only a governor can do.

"The primary problem is, it's not viewed as a statewide issue," says David Carrington, president of the Jefferson County Commission.⁸²

He worries that the state will miss opportunities to add jobs and revenue if its leaders do not help resolve the county's troubles. Alabama recently has reinvented itself as an automobile and aircraft manufacturing center, but those companies have bypassed Birmingham for Tuscaloosa, Montgomery, Mobile, and Anniston.

State and county leaders are often split

Governor Bentley has said he understands the stakes involved, calling Jefferson County's financial troubles "an impediment to economic growth."⁸³ His spokesman, Jeremy King, stressed that the leadership and fiscal breakdown is unique to Jefferson County and does not reflect on the rest of the state. Bentley is willing to intervene to help find a solution, King says, but the governor cannot go to the Legislature with a proposal until Jefferson County's senators and representatives first reach a consensus.⁸⁴

"Without a unified delegation to go to Montgomery, there's very little that Jefferson County can get done," says Mark Griffith, a professor at the University of West Alabama.⁸⁵

The county's eight senators and 18 representatives are split on proposals asking the GOP-controlled legislature to allow Jefferson County to impose taxes that would help it cover the budget gap and resolve the bankruptcy faster. Urban lawmakers generally favor taxes, while their suburban counterparts oppose them. The latter group says their

constituents do not see why they should bail out a local government that mismanaged its finances while raising sewer bills to finance the malfeasance of former elected officials. Seventeen people were convicted of bribery and fraud in the sewer scandal, which centered on risky interest-rate swaps connected with refinancing bonds.

Many lawmakers across Alabama embrace the same thinking. In the past three years, various proposals permitting Jefferson County to raise taxes have cleared either the House or Senate but have never been approved by both chambers and sent on to the governor.⁸⁶ Many lawmakers believe a compelling case for state intervention has not been made.

“In areas outside Jefferson County, the feeling is, why should we bail them out for their poor financial management, for their bribery and kickbacks, and for what was a seedy, nefarious indebtedness?” says state Senator Arthur Orr, who represents the Huntsville area.⁸⁷

“That’s an excuse for not solving the problem,” responds Carrington, whose two predecessors on the county commission went to prison. He says residents in Jefferson’s richest suburban district support his rescue efforts. The county has laid off hundreds of workers; closed satellite courthouses; crammed its jails beyond capacity; stopped responding to minor traffic accidents; and curtailed mowing, weeding, and repaving.

Orr says economic studies are inconclusive as to whether Jefferson’s bankruptcy will damage Alabama’s other metropolitan areas. So far, the Chapter 9 filing has not affected the state’s borrowing costs. Surveys show job creation is state lawmakers’ top priority.⁸⁸ Still, Carrington says potential businesses that once listed Jefferson County/Birmingham among their top five potential sites have dropped the area to a lower spot on the list.

Outside Alabama, analysts who follow municipal finances say state lawmakers’ recalcitrance can only hinder the state’s ability to emerge from the Great Recession. Matt Fabian, a managing director of Municipal Market Advisors, calls Alabama an example of “state exacerbation” instead of intervention.⁸⁹

Pennsylvania's intervention program, one of the first, has had mixed success

State laws and poor local decision-making have hamstrung already struggling cities

Brian Jensen, an economic development specialist, calls it “the measles map.”⁹⁰ A drawing shows an outline of Pennsylvania with 27 red splotches marking financially distressed cities in every corner of the state. Four in 10 Pennsylvanians have lived in one of them.

The 27 cities and towns have qualified for a 26-year-old state intervention program aimed at rescuing worst-case local governments that have chronic budget deficits, are in danger of failing to pay employees, or face default on bond payments.⁹¹ Officials simply call the program Act 47, the title of the legislation.

Pittsburgh is the largest Act 47 city.⁹² Harrisburg, the state capital, is the best-known recent addition because of its fight to avert bankruptcy. There is also Scranton, which raised taxes 22 percent in January 2012 to stay afloat.⁹³ Reading, which has the largest share of residents living in poverty among U.S. cities of more than 65,000 people, is an obvious participant.⁹⁴ Philadelphia would qualify, but lawmakers created a separate oversight board to handle its problems.⁹⁵ More cities may be added in this state, which has the second-highest number of local governments in the country after Illinois.⁹⁶

If Pennsylvania's goal is, as the law says, “to foster fiscal integrity” of its local governments, Act 47 has had modest results. Only six of the 27 cities have successfully emerged from the program, and a dozen others have been distressed for more than 10 years. Johnstown has submitted five recovery plans since joining in 1992. Aliquippa and Farrell, the first two Act 47 cities, are still in the program 26 years later.⁹⁷

“We've had success with it, and we've also had failure with it,” says Fred Reddig, head of the state department that runs Act 47.⁹⁸

However well intentioned the act may be, Pennsylvania demonstrates how a combination of forces beyond a state's control as well as outdated state policies and local governments' mistakes can block progress in helping cities rise from a cycle of despair.

“The problems that Pennsylvania municipalities face run far deeper than Act 47 can or was intended to resolve,” says Jensen, executive director of the nonprofit Pennsylvania Economy League of Southwestern PA.⁹⁹

Outside events play a role in local economics and in states' ability to help

The drop in manufacturing jobs in Pennsylvania, especially in the steel and textile industries, hurt cities large and small. It was caused by external events, including increased foreign competition, advances in worker productivity, and a series of crippling recessions. From 1990 to 2009, manufacturing jobs declined 40 percent in Pennsylvania.¹⁰⁰ Aliquippa, northwest of Pittsburgh, was typical. Its main job provider was an LTV Corp. steel mill that employed 14,000 workers at its peak but fell to about 3,500 by 1988, when the city entered the Act 47 program. The collapse of the plant, which closed in 2000, drained so much tax revenue that the city had trouble delivering basic services.¹⁰¹

Aliquippa and Pennsylvania were caught in the recession of 1981-82, when the steel and coal industries began their decline, and the Great Recession of 2007-09, which resulted in four municipalities being added to Act 47 and prevented others from escaping it. One of the latter is Chester, a Delaware River city south of Philadelphia that was among those affected by the realignment from manufacturing to service and technology. Companies and people, most of them affluent whites, started fleeing Chester in the 1960s for jobs, better housing, and

superior schools elsewhere in the area. Tax revenue fell so precipitously that the city failed to balance its budget for six consecutive years before state officials accepted Chester into the Act 47 program in 1995. The financial challenges have continued ever since.¹⁰²

On a larger scale, Pittsburgh went through a similar emptying of its urban core, culminating in a 2003 financial crisis that led to layoffs of 446 city workers, including 100 police officers. Though still in Act 47, Pittsburgh has recently improved its financial condition significantly by replacing manufacturing with health care, education, and technology jobs.¹⁰³

Local officials also cannot predict when natural disasters might occur or when a judge might rule against them. In Plymouth, in northeast Pennsylvania, extensive flooding from the remnants of Hurricane Ivan in 2004 heightened the borough's financial crisis. Three months later, a fire swept through the Municipal Building, disrupting operations for months and delaying Plymouth's recovery.¹⁰⁴

Westfall Township in northeast Pennsylvania took the rare step of filing for bankruptcy protection in 2009 after a federal judge awarded \$20 million to a developer whom local officials had refused permission to build houses and a hotel. The township brings in only about \$1 million a year in revenue.¹⁰⁵

A 2011 state Supreme Court ruling created barriers to Scranton's efforts to exit Act 47 after 20 years.¹⁰⁶ As part of its financial recovery plan in 2002, the city tried to check rising labor costs by freezing wages and cutting benefits for unionized police and firefighters. Arbitrators awarded workers bonuses and raises, but a lower court reversed them, saying the pay increases would make it difficult for Scranton to carry out its financial recovery plan. After years of litigation, the high court sided with the workers, saying that a city's Act 47 recovery plan does not negate Pennsylvania's law promising binding arbitration to public safety workers in return for their agreement not to strike. Essentially, the decision meant that Scranton and other cities do not have the power to adjust public pension and retiree health care benefits and arbitration awards. The ruling knocked a \$20 million hole in Scranton's budget. Mayor Chris Doherty said: "Scranton did everything we were asked to do, and then we got bit by the state."¹⁰⁷

Pennsylvania has failed to address the underlying causes of municipal woes

Doherty and other city officials say the court ruling is further proof that state law has tipped in favor of organized labor in arbitration awards and public pension and retiree health care benefits. They say that until the Legislature, local officials, and union leaders collaborate to change state law and allow municipalities to cap personnel costs based on a government's ability to pay, Pennsylvania inevitably will have more Act 47 cities.

York, just south of Harrisburg, could eventually join the program because its revenue and spending cuts cannot keep pace with fast-growing police and firefighter costs. Arbitrators have twice boosted public safety retirement benefits, triggering job cuts and steep increases in sewer fees and property taxes. City officials are projecting several more years of budget shortfalls. "We try to write as many parking tickets as we can," quips Michael O'Rourke, York's business administrator.¹⁰⁸

Jensen argues that state law protects defined benefit pensions for police and firefighters, which he says will strap local governments for decades unless state lawmakers allow cities to cut benefits, including shifting to defined contribution, 401(k)-style plans for new hires. He says the unfunded local government pension liability statewide is \$7 billion, of which Philadelphia accounts for \$5 billion.

Local government officials also have urged state legislators to improve what they call Pennsylvania's antiquated, unfair tax structure. State law bars cities from collecting property taxes from government buildings, churches,

hospitals, colleges, and social service agencies. This restriction removes a huge potential revenue source for many cities at a time when costs are rising faster than revenue. More than half of the assessed value of property in Harrisburg and Johnstown is tax exempt. State legislators have considered but not approved a bill that would channel money to local governments with large amounts of tax-exempt property. In 2013, some lawmakers proposed allowing the Legislature, instead of state courts, to decide which institutions should be deemed “purely public charities.”¹⁰⁹

In many places, the tax-exempt properties primarily serve people who live outside the city but do not pay taxes to finance city services. Pennsylvania has an earned income tax, but suburban commuters pay that to the communities where they live, not where they work. In York, 8,000 residents pay the tax on \$345 million of income while 38,000 commuters earn \$1.1 billion in the city but pay nothing to the city.¹¹⁰ Former governor Edward Rendell says the cities’ inability to collect tax from nonprofit organizations is their “single biggest problem.”¹¹¹ Lawmakers from suburban jurisdictions tend to fight commuter wage tax proposals to protect their constituents. “There’s no political will to address the underlying causes of distress,” says York’s O’Rourke.

State officials say they hope that hydraulic fracturing, or fracking—the extraction of oil and gas from shale—could replace lost local government tax revenue through impact fees, a potential boost for Pennsylvania’s economy. The fracking issue is complicated by political and environmental concerns, however.¹¹²

Cities’ poor decisions have contributed to their fiscal troubles

Pennsylvania’s cities contribute to their own distress through mismanagement, political infighting, and poor financial judgment. Reading has a history of sloppy recordkeeping, borrowing from its sewer fund for other operations without paying the money back, and failing to make its annual public pension payments.¹¹³ In Scranton and Harrisburg, the mayor and council are split over how to manage their fiscal crises. Scranton Mayor Doherty cut city workers’ pay without the council’s consent.¹¹⁴ Harrisburg’s collapse is due in large part to bad decisions by elected officials about a failed trash incinerator.¹¹⁵ The mayor and council officials have often fought between themselves; when the City Council filed for bankruptcy protection in 2011, the mayor blocked it.¹¹⁶

Harrisburg and Scranton officials also engaged in a risky pattern of guaranteeing the obligations of financially shaky independent authorities that issued debt for the incinerator and downtown parking garages, respectively.¹¹⁷ When the authorities could not pay their debts, the cities were stuck with those costs on top of their other financial challenges. Taxpayers were left out of these decisions because bond guarantees are not put to popular vote.

The state can do only so much through Act 47. A state-appointed coordinator prepares a recovery plan for each distressed city but cannot force the jurisdiction to carry it out. The act also allows local officials to raise taxes above what the state usually permits, but they are often reluctant to do so. In a separate program, the state offers emergency loans and grants to help cities pay bills, but it is not as if Pennsylvania has plenty of spare cash. It advanced Harrisburg more than \$4 million in 2010 to avert default, but that was an exception. “It’s not a panacea,” state administrator Reddig says.

One way to strengthen the program, Reddig says, would be for the state to offer incentives to relatively healthy local governments to merge with weaker neighbors. In this way, governments would share the tax base; the Minneapolis-St. Paul region pioneered this tax-sharing concept.¹¹⁸ Combining governments is difficult, however. In 2004, voters in five jurisdictions in Pennsylvania’s Mercer County rejected consolidation because they did not want to subsidize the two poorest cities.¹¹⁹

“We’re going to have to come to a point where labor and taxpayers grapple with what it will take to operate a municipality and what sacrifices will have to be made,” Jensen says. “We’re not yet set up to have that conversation.”

Special North Carolina agency is a local government lifeline

State oversight and intervention help cities avoid distress

Nevada, Rhode Island, California, and North Carolina have some of the nation's highest unemployment rates.¹²⁰ All except North Carolina are replete with financially challenged local governments.

North Carolina's success at dodging similar crises is due in large part to a little-known state agency called the Local Government Commission.¹²¹ Other states have formal and informal tools to assist local governments, but none has the same reach as North Carolina's commission, which imposes budget controls and advises troubled communities.¹²²

The three large credit rating agencies that evaluate municipal bonds think so highly of the commission that they have rewarded North Carolina communities with bond ratings higher than those in most of the United States.¹²³ The higher the rating of bonds sold by local governments, the more money taxpayers save on borrowing costs.

"The influence and oversight of the Local Government Commission is a major reason why North Carolina local government issuers have been able to weather this recession to this point," says Andrew Teras, an associate director of Standard & Poor's Financial Services rating agency. "North Carolina's oversight model is one of the strongest of any state."¹²⁴

The state program has its roots in the Great Depression

The commission is one of the oldest agencies in the state, created by the North Carolina Legislature in 1931 after a wave of municipal bond defaults in the first years of the Depression. The idea was to apply the state government's conservative fiscal management philosophy to local governments.

The approach has largely worked. Since 1942, when most of the 414 Depression-era defaults had been refinanced, no North Carolina city, county, or special district has failed to meet a bond obligation. The local government commission has had to take financial control of only four cities¹²⁵ and one water and sewer district during that 70-year period, a remarkable run considering the frequency of hurricanes that strike the state and the vulnerabilities created by the recent Great Recession.¹²⁶

"A lot of the credit [for avoiding financial troubles] goes to the presence of the commission," says North Carolina Treasurer Janet Cowell, whose office includes the oversight agency.¹²⁷

The North Carolina commission does not back up its financial management of local governments with actual state dollars if a city, county, or special district is nearing default. Some states give cash to troubled governments; Pennsylvania advanced its capital city of Harrisburg \$4.2 million in loans, grants, and state funds in 2010 to avoid a default on municipal bonds. California offers emergency loans to school districts, reducing their borrowing costs because the rating agencies rate the bonds more favorably. North Carolina's Local Government Commission does nothing like that.

Still, North Carolina's program is relatively trouble free, a key reason the state is one of only eight in the country with the top bond grade from all three credit rating agencies. Says Rob Shepherd of the state's League of Municipalities: "I've got to believe we'd have more local governments in distress, perhaps even in default, if we didn't have an authority like this."¹²⁸

North Carolina's commission keeps local debt in check by approving and selling bonds issued by cities, counties, and special districts for capital projects such as fire stations, water plants, and parks. In 2012, the commission

rejected the town of Navassa's request for a loan to finish a sewer project, insisting that the town plug a budget gap first.¹²⁹ By contrast, the commission approved a request by the beachfront town of Nags Head to sell tax-financed bonds to pay for the replacement of eroding sand, deeming the city fiscally strong enough to manage the additional debt.¹³⁰

A watch list helps state oversight by keeping troubled localities on the radar

The commission, which has a professional staff and a nine-member board, also examines local governments' financial reports to spot problems and recommend fixes. Governments in the worst fiscal shape go on a watch list; if they cannot correct their difficulties, the commission can step in and run their day-to-day operations, including raising taxes, until local officials resolve the underlying crisis. The state is proactive so that local officials can work out their problems before the commission is forced to assume control. Other states are more reactive. Instead of detecting distressed localities, for example, Pennsylvania aids cities only after state officials declare a financial emergency.

Adding to the centralized financial oversight of state and local governments, North Carolina lawmakers set up a single, consolidated public-sector pension system. The system, operated from the treasurer's office, is one of the best-funded in the nation, so strong that local government contributions are scheduled to decrease 2 percent in fiscal 2013, something almost unheard of nationally.¹³¹

There is nothing complicated about the commission's oversight. The key indicator is a local government's fund balance, or the difference between its assets and liabilities. A healthy level of reserves—the Government Finance Officers Association suggests at least 16 percent of operating expenses, or about two months' revenue—protects against downturns and natural disasters and ensures stable services.¹³²

The commission suggests a minimum fund balance of 8 percent and will not approve a bond issue if the level slips below that. Many local governments in North Carolina require reserves higher than 8 percent, another reason the credit rating agencies say the state has weathered a prolonged downturn driven in part by the decline of its tobacco, textile, and furniture-manufacturing base.

The state relies on low fund balance as a key indicator of municipal fiscal distress

"It's typically a telltale sign if the local government keeps dipping into their fund balance," says Shepherd of the state's League of Municipalities. "Once below that 8 percent, the warning letters start to come. If they don't right the ship, the commission will sound the warning horn a little louder."¹³³

Bob Davis, former chair of the Scotland County Commission, received such a warning letter in January 2012. "The county has serious financial problems which the county's governing board must address immediately," the commission's letter said, noting that the fund balance had fallen from 9 percent to 6 percent in one year and ordering county officials to submit a plan detailing how they would resolve the problem.¹³⁴

Like many local governments, Scotland County overestimated the amount of tax revenue it would receive. In addition to revising those estimates, the local government responded to the state commission's warning by raising taxes, cutting 25 jobs, ordering furloughs, and reducing its 401(k) contributions for county employees. "They're on the right track now," says T. Vance Holloman, the deputy state treasurer who supervises the Local Government Commission.¹³⁵

Chowan County erred in its revenue estimates for several years, prompting the commission to bar officials there from borrowing money until the county worked out its finances through tax hikes and spending cuts, a cycle that ended in 2010.¹³⁶ The town of East Spencer was not so fortunate. The commission took control of the town's finances in 2001 after officials failed to go along with its directives to erase a budget deficit, improve property tax collections, and correct internal accounting methods.¹³⁷ Eventually the town regained management of its affairs, though officials had to raise residents' water and sewer rates by 23 percent, among other corrective actions needed to balance the budget.

Negligence is often the core problem for cities in fiscal trouble

Sometimes the problem is mismanagement or wrongdoing, especially in small jurisdictions that lack financial expertise. The commission took over Princeville in July 2012, saying the town's staff lacked the ability to manage a crisis stemming from a budget deficit and an was unable to keep up with loan payments. The state auditor also found in 2013 that the mayor and former finance officer improperly used the town credit card without keeping appropriate receipts.¹³⁸

In Maxton, a former town manager overestimated revenue for several years but did not cut expenditures when the mistakes were revealed, the commission said. The manager spent down the town's reserves, contending that the commission's 8 percent target was excessive. After state officials warned the Maxton town board that it would run out of money, local officials laid off two of the town's 11 police officers and raised taxes and fees.¹³⁹

"I'm so grateful the local government commission is working with us so we can resume our stance as a town," Maxton Mayor Sallie McLean said in May 2012. "I think they're doing what they got to do."¹⁴⁰

There is undeniable tension at times between the state agency and local governments, forcing the commission to navigate tricky political circumstances. Although McLean welcomed the commission's involvement, her predecessor and others in Maxton did not.

"We've always tried to serve an advisory rather than regulatory role, even though we have that authority," says Holloman. Cowell, the North Carolina treasurer, adds that the commission includes members who have served as elected officials and understand the political sensitivity of asking a local government to raise taxes and cut services to balance a budget. "We don't ask them to do anything that we aren't doing ourselves at the state level," she says.

Distressed New Jersey Cities struggle despite state aid

The state has a long history of helping its cities, but some, like Camden, may never be self-sufficient

New Jersey has tried just about everything to help Camden, one of the nation's poorest cities. The state has poured millions of dollars in loans, grants, and direct aid into Camden over the past 15 years to plug persistent budget gaps. It has pumped money into major development projects, especially along the waterfront across from Philadelphia. State dollars also went to universities and a hospital for new or expanded buildings. New Jersey even assumed control of the city's government, school system, and police department.

Despite this broad intervention, Camden has largely been unable to regain its footing. In the most recent sign of failure, the city laid off all of its police officers in April 2013 and is using state aid and its own tax dollars to pay Camden County to patrol its streets at a lower cost.¹⁴¹ Camden set a record in 2012 with 67 homicides, a rate that makes it one of America's most violent cities.

Governor Chris Christie announced the state takeover of Camden schools in March 2013.¹⁴² Christie also approved a program under which private nonprofit companies would build schools in Camden under state oversight.¹⁴³

New Jersey historically has been more willing than many other states to assist troubled local governments and school districts and to intervene in emergencies, as it now is doing on a broad scale in shore communities ravaged by Hurricane Sandy in 2012. Despite New Jersey's aim to wean local governments from state assistance, some cities, such as Camden, seem destined to permanently depend on the state government to avoid insolvency.

State officials created an agency called the Division of Local Government Services, with a governing board, to keep an eye on local government finances. The division must approve local budgets to ensure that localities can pay their debts. If a city fails to show it can meet those obligations, the state has the authority to raise taxes on city residents.¹⁴⁴ The agency also has approval power over local requests to file for Chapter 9 but prides itself on the fact that because of its oversight, which includes technical advice, no New Jersey city has ever gone into municipal bankruptcy. "The reason all New Jersey municipalities have made their full debt payments for over 80 years, even in the most trying times ... is strong state oversight," state officials said in January 2013 in analyzing the impact of Hurricane Sandy on local governments.¹⁴⁵ After the storm, the division proactively contacted each coastal community to discuss its financial situation.

Programs aid cities, but money is dwindling

In the most severe cases of financial distress, such as Camden, the state intervenes with money and takeovers. For years, three state programs—Extraordinary Aid, Special Municipal Aid, and Capital City Aid (aimed at Trenton)—handed out money to New Jersey's most distressed cities. Christie consolidated them into a single program known as Transitional Aid, which does what the name implies. The intent, according to the state's Division of Local Government Services, was to allocate scarce funds to only those municipalities with severe fiscal distress that agreed to pursue structural budget reforms overseen by the state.¹⁴⁶ Overall, the state handed out \$170 million in Transitional Aid in the 2012 budget year, falling to \$109 million in 2013 and \$95 million planned in 2014.¹⁴⁷ The number of cities receiving state aid dropped from 22 in 2011 to 10 by early 2013.

The lesson of Camden may be that state involvement can go only so far to rescue cities facing difficult economic challenges. How Camden got to this point is hardly unique. "It's in the same category as Bridgeport [CT] or Gary [IN] or even Detroit," says Rutgers University-Camden historian Howard Gillette. "All the factors that affected

other cities after World War II hit Camden but hit it with a particular intensity."¹⁴⁸ Although they lasted longer than those in many industrial cities, Camden's mainstay employers—New York Shipbuilding Corp., Campbell's Soup, the Esterbrook Pen Co., and, above all, RCA Victor—did what most urban manufacturers in the Northeast and Midwest did from about 1960 onward: They shut down or moved to the suburbs and elsewhere.¹⁴⁹ Half the city's manufacturing jobs disappeared between 1950 and 1970;¹⁵⁰ today, only the Campbell's headquarters remains.

The middle class fled, too, leaving "an enclave of concentrated poverty, with no pockets of wealth to balance the city's demographics," according to a report by the Annie E. Casey Foundation.¹⁵¹ Bad decisions by government at every level degraded whole neighborhoods in Camden. One mayor located a county waste plant in a south Camden neighborhood in exchange for money to close a budget gap. Another arranged for a state prison along the waterfront. The county built a trash-to-steam plant in another neighborhood, next to the city's last remaining working-class enclave. "At the point where the tax base was already being eroded by the loss of the working class, you got pretty much every kind of not-in-my-backyard intrusion into Camden's neighborhoods," says Gillette.

Corruption is another reason for Camden's decline

Things were no better at Camden City Hall than they were in the residential neighborhoods. The city was rocked by a series of corruption scandals that led to the imprisonment of three mayors. By 1998, Camden was so broken that then-Governor Christine Todd Whitman put in place a financial control board, only to propose a full state takeover two years later. After Whitman left to head the federal Environmental Protection Agency, then-Governor Jim McGreevey handed the Camden reins to an appointed chief operating officer with extensive powers, effectively stripping the mayor and City Council of their power. City leaders are split over whether the takeover made a significant difference; much of the \$175 million the state gave Camden went to a handful of major institutions and developers and others connected to the Democratic Party.¹⁵²

The takeover money did help a few "anchor" institutions in the city, such as the aquarium, which prevented further economic decay. What is also undeniable, though, is that Camden's reliance on state subsidies grew worse under the takeover because the size of government expanded instead of contracting. In the first year of state control alone, city spending rose 20 percent, fueled by spikes in public employee salaries and benefits—especially for police and firefighters—that arose from a state arbitration ruling. Overall, total pay for city employees rose from \$73 million in fiscal 2000¹⁵³ to \$83 million by fiscal 2008 while state aid quadrupled.¹⁵⁴ The steady pay increases were a main reason that officials cut hundreds of jobs and dissolved the police department. The police job losses were so deep that Governor Christie sent state troopers to help patrol the city for a few weeks in 2011 because of rising crime, especially murder.¹⁵⁵

Even so, Camden's financial picture has improved slightly after two years of budget cutting under Mayor Dana Redd that included the elimination of more than 400 jobs.¹⁵⁶ In 2011, the city undertook its first property reevaluation in two decades, and the net taxable value of its property doubled. City leaders raised property taxes in part to meet Governor Christie's request to reduce Camden's reliance on state aid.¹⁵⁷ "They've taken so many steps that are structurally positive," says Thomas Neff, director of the Division of Local Government Services.¹⁵⁸

Still, Camden's fundamental conundrum is its tax base, which is the smallest among the state's major cities. The city spends \$150 million a year, but its annual tax revenue is less than \$25 million. Governments and nonprofits own the most valuable property along the waterfront, a big reason that more than half of Camden's land is tax-exempt. Bill Dressel, executive director of the New Jersey State League of Municipalities, says: "What makes New Jersey unique, at least in the Northeast, is that municipalities in other states have revenues other than property taxes to pay for the broad spectrum of services. We don't."¹⁵⁹

Christie said his goal is to make New Jersey's local governments self-sufficient. But in taking over Camden's schools and putting its police department under regional control in 2013, he was conceding that the state is justified in intervening more heavily in some cities than others. "Camden needed the help they're getting today, and they needed it badly," Christie said in announcing the regional police department. "I can't sugarcoat what the reality was. The reality was citizens feeling unsafe and risking their lives merely by walking the streets. The basics of public safety were diminished, and we needed to rebuild them."¹⁶⁰

Rhode Island adopts aggressive intervention stance

The state's proactive approach provides a way to trim rising public pension costs

The phones began ringing at the Rhode Island Department of Revenue after a Superior Court judge appointed a receiver to oversee Central Falls' deteriorating finances in May 2010. Stunned municipal officials and bondholders were asking the same question as the state government: Why had Central Falls unilaterally decided to go into receivership, and what impact would that have on the rest of Rhode Island's local governments?

"If a municipality could choose on its own to go into judicial receivership, the credit markets might view that as a threat to [the cities'] payment of debts," says state revenue director Rosemary Booth Gallogly.¹⁶¹ "We wanted to make sure access to credit markets was protected for all the communities in Rhode Island."

Gallogly and lawmakers quickly responded with a plan to scrap the state's limited intervention program and replace it with an expanded version that would allow Rhode Island to get involved with distressed cities earlier. Until that point, state law had called for a budget commission to take over a city's finances, but only if a local government defaulted on its debt or if its bond rating dropped to junk grade.

Under the revised program, the revenue director supervises a graduated, three-step process for financially shaky cities. First, the state appoints an overseer to advise officials on whether the city is able to balance its budget on its own. If the city cannot square its books, the revenue director appoints a budget commission, which supplants the city's elected leaders. The commission consists of the mayor, the chief local legislative official, and three state appointees. If the panel cannot balance the budget, the state appoints a receiver, whose powers include declaring the city bankrupt. Central Falls' finances were so dire that Gallogly skipped the first two steps. The state replaced the court-appointed receiver with its own.

Other Rhode Island cities share Central Falls' distress

Rhode Island's rush to tighten its approach to faltering cities may have been kick-started by Central Falls, but as House Speaker Gordon Fox said, the city was "the canary in the mine shaft."¹⁶² By the end of 2010, the state had intervened in three more distressed cities: North Providence, Pawtucket, and Woonsocket. Providence, the capital and largest city, later joined the list. The Moody's rating agency said Rhode Island local governments had experienced "economic weakness, revenue stagnation and pension expense growth that are more acute than in most other states."¹⁶³ Or to put it more bluntly: "You have a state that is literally on the brink of economic disaster," said Edward Mazze, co-director of the state economic forecast.¹⁶⁴

Rhode Island's cities face a confluence of harmful forces. The state's economy has been ailing for decades, ever since its manufacturing base began to decline. Manufacturing accounted for more than one-third of total statewide employment in 1970 but now is less than 9 percent. Few new jobs have been created since 2006.¹⁶⁵ Rhode Island routinely ranks at or near the bottom among states in economic competitiveness.¹⁶⁶ On top of a moribund economy, direct state aid to local governments and schools fell 20 percent from fiscal 2008 to 2013.¹⁶⁷

But a major cause of the need for state intervention is the cities' poor decision-making on spending, labor contracts, and public pensions. Central Falls was an extreme example of that. The city sits amid a string of old textile towns that stretch north from Providence along the Blackstone River Valley, called the "birthplace of the American industrial revolution."¹⁶⁸ Central Falls never really got over the shuttering of the textile mills and other factories that anchored the area's economy. With about 19,000 people¹⁶⁹ crammed into slightly more than one square mile, Central Falls is Rhode Island's densest city. It is also among the poorest, with a quarter of its residents below the poverty level—twice the statewide percentage.

Central Falls' downfall was triggered by budget mismanagement and escalating labor costs

In the years preceding the bankruptcy filing, city leaders not only failed to engage the community about the challenges but also mismanaged Central Falls' finances, piling up multimillion-dollar budget deficits. The city's cash was divided among 54 accounts, some of which had been created years and even decades in the past and forgotten. Invoices for some unpaid bills were stuffed into a desk drawer. The most serious financial issue, though, lay in Central Falls' labor and public pension agreements with firefighters, police officers, and other municipal employees. Each contract was calculated and paid differently, producing disparities among employees. The city was paying \$1 million a year in overtime to police and firefighters. "If you're only bringing in \$16 million in revenues, then \$1 million in overtime is crazy," says Gayle Corrigan, chief of staff to Robert Flanders, the second state-installed receiver.¹⁷⁰

The labor contracts also called for generous retirement benefits that the city promised to workers but failed to fully pay for. By the time the receiver took over, Central Falls had racked up an \$80 million shortfall between what it had promised in pension and health care benefits and what it had set aside to finance them.¹⁷¹ The city skipped its required pension fund payments altogether in fiscal years 2009-11. Officials were allowing many police officers and firefighters to retire as early as age 43 on reduced salary, between 50 percent and 66 percent, along with lifetime health benefits for themselves and their families if they went out on disability. And about 60 percent of the public safety workforce took advantage of this option, says Corrigan. The pension-funding crisis came to a head in July 2011 when Flanders, Gallogly, and other state officials met with the city's 144 retirees to ask them to voluntarily cut their retirement benefits, including the annual cost-of-living increases. If the retirees failed to agree, Flanders warned them, Central Falls would be forced to file for bankruptcy protection. The workers overwhelmingly rejected the proposal, and on Aug. 1, 2011, Central Falls became the state's first city to file for Chapter 9 bankruptcy.¹⁷²

The filing coincided with an extraordinary statewide discussion about public finances in general and public pensions in particular. It was spearheaded by state treasurer Gina Raimondo, a Democrat who won election in 2010 largely on a promise to fix the pension challenge—arguing that unless it was dealt with decisively, the state's ability to provide services would be hampered. Governor Lincoln Chafee, a Democrat, also had been touting the need for pension reform. In a little-noticed move in spring 2011, he helped persuade Rhode Island's retirement board to lower the estimated investment returns on the state's pension funds from 8.25 percent to 7.5 percent. The funds had averaged a return of only 2.28 percent over the previous decade,¹⁷³ but the board's move had a bracing political effect. It meant that starting in July 2013, the strapped state and its cities and towns would have to contribute an additional \$250 million a year to finance the public pension system.¹⁷⁴

Central Falls' bankruptcy hit a few months later. "You can never say any bankruptcy is fortuitous, since it involves a lot of fiscal strain and human suffering," says Raimondo. "But having said that, throughout 2011 I would often say if we didn't fix this pension mess, bad things would happen, like people wouldn't get their pension checks, municipalities would go bankrupt, and budgets would explode—and the fact that this was now happening in our backyard lent credibility to the argument. People realized it wasn't just a theoretical possibility."¹⁷⁵

The state was the first in the nation to cut core pension benefits for current workers

In the fall of 2011, the state legislature met in a special session to adopt the most comprehensive pension measure in the country—unusual because it was the first to call for most current and newly hired workers to agree to reduced retirement benefits. As far-reaching as it was, the pension reform bill did not cover the 36 local plans that are not part of the state-run system. Those plans face a collective unfunded liability of \$5.6 billion for pensions and health care.¹⁷⁶ Chafee and the state legislature are still trying to come up with a solution for that.

Though significant, pensions are just one of the issues facing Rhode Island's cities in which the state is involved. Woonsocket's city government asked the state to take over its cash-strapped school system.¹⁷⁷ In Providence, working with Chafee and other state officials, Mayor Angel Taveras has used layoffs, spending cuts, increased state aid, and renegotiated contracts with workers to cut into a budget deficit and avert bankruptcy. East Providence was placed under a state budget commission in 2011. West Warwick's bonds were downgraded in 2011 after the city, which has an annual budget of less than \$80 million, piled up a \$98 million unfunded pension liability.¹⁷⁸

Central Falls, meantime, avoided the kind of prolonged bankruptcy of cities such as Vallejo, CA, which took three years to emerge from Chapter 9. That was largely because of another way the state intervened. In 2011, the Legislature approved a law guaranteeing that bondholders affected by a municipal bankruptcy would be paid in full. Usually creditors in a bankruptcy are all treated equally, but the Rhode Island law gave bondholders the right to place liens on a city's tax revenue. The repayment guarantee helped Central Falls emerge from bankruptcy in a little over a year. "It's record time, and record efficiency," U.S. Bankruptcy Court Judge Frank Bailey said from the bench the day he approved the city's debt-restructuring plan. "In a way, I think this is an example—for not only Rhode Island, but maybe the nation—on how to run a Chapter 9."¹⁷⁹

But the bankruptcy came at a cost for Central Falls' workers and residents. Property taxes will go up 4 percent a year for the next five years in a city where the median income is about \$34,000 a year.¹⁸⁰ There are 56 fewer city workers, so services and programs have been cut. Workers will collect less in retirement benefits, saving the city about \$1 million a year.¹⁸¹ The receivership and bankruptcy cost the city treasury nearly \$4 million.¹⁸²

The state government, which ended the receivership in April 2013 and turned the city back over to Central Falls' elected officials, has been careful to stress that it sees its intervention in Central Falls as an anomaly, in part because of the toll it has taken on the community.¹⁸³ "I don't view bankruptcy as a tool in the toolbox," Gallogly, the state revenue director, said. "It's a last resort and only should be utilized if there are no other options for a community."¹⁸⁴

California aids its school districts but not its cities, a practice tied to state history

The state and city governments operate independently, and they like it that way

The Great Recession struck Stockton and San Bernardino harder than most California cities. Home values and tax revenue plummeted when the housing bubble burst in 2008. Neither city could keep up with rising labor costs, including public employee retirement and health benefits. Officials in both cities made a series of poor financial decisions in the face of the sudden downturn. Finally, in the summer of 2012, Stockton and San Bernardino ran out of cash to pay their employees and bills. Both cities filed for bankruptcy protection within five weeks of each other.

In many states, the difficulties of major cities such as Stockton and San Bernardino would mobilize the state government to intervene and help them recover. But California offered no such aid, because it has long adhered to the belief that its cities should operate independently from the state. Nor did Stockton and San Bernardino officials ask for assistance, because, like most California cities, they prefer that the state keep out. “Cities are like the famous line from Greta Garbo, you know, ‘I want to be left alone;’ ” says Peter Detwiler, who was a longtime top California Legislature finance staffer before he retired. “We’re terribly decentralized in California. We love it that way.”¹⁸⁵

The self-governing tradition goes back as far as the 19th-century pueblo governments of Mexican rule and the Gold Rush mining camps. Early lawmakers ensured the right of cities to govern themselves by including a home rule provision in California’s Constitution in 1879. They strengthened it during World War I by giving local governments exclusive control over the spending of their property tax revenue and authorizing cities to adopt charters spelling out their public safety, health, zoning, and other laws.¹⁸⁶ Los Angeles, Sacramento, San Diego, San Francisco, and San Jose are among the 121 charter cities, out of 482 cities overall.

The power to dispense local property tax revenue shifted back to the state in 1978 after California voters approved Proposition 13, which slashed those receipts by 60 percent.¹⁸⁷ To offset that loss, lawmakers channeled money from the then-flush general fund to school districts and to counties, which administer state and federal programs including health care, jails, foster care, and elections. As a result, schools and counties came to rely more heavily on the state for revenue, while cities increasingly depended on revenue from sales, business, and other locally imposed taxes. State and federal sources account for less than 10 percent of California cities’ revenue.

How California distributes property tax collections is important, because it helps explain why lawmakers are willing to help school districts, but not cities, that experience financial problems. Because the state has a direct financial stake in its nearly 1,000 school districts, lawmakers set up an elaborate fiscal oversight system in 1991 requiring county offices of education to monitor school district revenue, enrollment, spending, cash flow, debt, and other costs at specific points during the year, such as when the budget is approved.¹⁸⁸

If the county-level education office identifies problems but cannot correct them on its own, the state arranges an emergency loan from the general fund. State officials issue bonds, allowing the school district to repay the loan, and appoint an administrator to run the day-to-day operations until the district is solvent. Since 1991, nine school districts have received such loans. The most recent was \$55 million to the Inglewood schools in suburban Los Angeles, a victim of declining enrollment, cuts in state aid, and ill-advised financial decisions. State officials warn that more takeovers are possible in similarly troubled school districts.¹⁸⁹

Counties and cities are left alone

Although California's 58 counties also are dependent on the state for revenue, lawmakers have not created a fiscal monitoring system or bailout fund for them. State officials oversee how counties administer federal- and state-funded programs but do not extend that scrutiny to county finances. California lawmakers treat counties much like cities, as autonomous entities created by the state that are responsible for managing their own affairs.

The state almost intervened in 1994 after Orange County, one of its most populous, filed for bankruptcy protection following a series of risky investment choices. Both chambers of the Legislature approved a plan allowing the county to cover its debts with money that had been allocated for transportation.¹⁹⁰ But then-Governor Pete Wilson vetoed the measure because it also would have allowed Los Angeles County to pay some of its bills using the same gimmick. In addition, he rejected a proposal allowing a state trustee to run Orange County, saying the county should resolve its problems on its own.¹⁹¹ Orange County reorganized and bounced back 18 months later—without any significant help from Sacramento.

The state has given distressed local governments one tool to keep out of bankruptcy. In 2011, the Legislature approved a bill establishing a 60-day “neutral evaluation process” in which labor unions, creditors, and other interested parties have the option of choosing an outside mediator to attempt to settle their differences so the city can avoid bankruptcy. “This bill does not prevent a municipality from declaring bankruptcy or even throw roadblocks in its path,” Governor Jerry Brown said when he signed it. “The goal is to find alternative, less drastic solutions whenever possible.”¹⁹²

The legislation stemmed from the Vallejo bankruptcy in 2008, when city officials won permission from a judge to nullify collective bargaining agreements with four city employee unions, giving Vallejo officials the ability to renegotiate cheaper contracts. California's public employee labor unions, fearing similar moves by other cities, persuaded the Democrat-led General Assembly to create the third-party mediation process. Local government officials opposed the bill, contending that cities already were doing everything they could to prevent filing for bankruptcy and would lose their ability to limit labor costs under the new system.¹⁹³

The state's new mediator law is having varied effects

So far, the effectiveness of the mediation process has been mixed. Under the law, a city can bypass the 60-day system and file for bankruptcy if it can prove an immediate financial emergency. San Bernardino headed straight for bankruptcy court in July 2012 after determining it was running out of money to pay workers.¹⁹⁴ Stockton did negotiate with creditors for 90 days, but the talks failed to produce an agreement. In Mammoth Lakes, a federal bankruptcy court named a judge to serve as mediator between the town and its largest creditor after the company initially refused city officials' invitation to meet.¹⁹⁵ The bankruptcy was dismissed in November 2012, after the town and the creditor agreed to a settlement. Thus none of the first three municipal bankruptcies after the mediator law was passed resulted in the out-of-court agreements its sponsors envisioned. State finance analysts inside and outside California say the state could preempt problems like those in Stockton and San Bernardino through aggressive monitoring of local finances and assisting those cities that are in the most trouble. They stop short of proposing that state dollars be directed to distressed localities, as is the case with school districts, in part because the state government has its own budget squeeze. State Treasurer Bill Lockyer is pushing for a modest system in which state officials would examine municipal government finances to detect signs of danger and offer technical help. “If the spectrum of state engagement is doing nothing on one side to a complete, total takeover on the other side, we're talking about something in the middle,” he says. “We're concerned about the local bankruptcies because of the stress on local services but also the worry about it being

infectious and causing more widespread credit downgrades. The policy, however, would not be to take over and assume liability for local debts."¹⁹⁶

Cities are likely to resist state-level oversight of their finances, not only because of their historical sovereignty but also because of labor's political clout with lawmakers. City officials fear that any state intervention arrangement would favor employee unions, whose members have some of the most generous benefits in the country, says Michael Coleman, the principal fiscal policy advisor to the California Society of Municipal Finance Officers and the League of California Cities.¹⁹⁷

Michigan sees state intervention as a key to its economic revival

Emergency managers run six cities, including Detroit

For years, state officials had warned Detroit's elected leaders to stop bickering. If the council and mayor could not resolve the city's budget mess, Michigan's leaders said, the state government might have to intervene to ensure that residents would get basic services and programs. This was a city so broken that at one point almost half its streetlights did not come on at night.

Detroit's elected officials ignored the threats, and, in April 2012, a state-appointed financial advisory board stepped in to help the city avoid running out of money. That did not work either, as Mayor Dave Bing and the City Council battled the advisory panel over the best way to restructure city services. In a last attempt to assist the state's largest city, Governor Rick Snyder in March 2013 named an emergency manager with the power to remake its budget and services instead of Detroit's elected officials. But the emergency manager could not repair the city's finances in time to avert bankruptcy.

Detroit has been at the center of an unusually public statewide debate over the role of the state government when cities and school districts are in financial distress, culminating in a voter referendum on the intervention program in 2012. Five other cities and three school districts, including Detroit's, are in receivership and run by an emergency manager.¹⁹⁸ From 2000 to 2010, the unemployment rate in Michigan increased from 3 percent to 14 percent, well above the national rate of 10 percent.¹⁹⁹ Dozens of cities were hit with huge drops in tax revenue and could not cover expenses. The Great Recession made the problem worse.

Michigan was one of the first states to conclude that the government should have a formal program for intervening in local financial crises. In 1990, the Legislature enacted a law allowing the state to appoint emergency managers in dire situations where a city or school district had no plan to resolve its budget problems and could not deliver services. Managers were sent to seven cities from 1990 to 2010.²⁰⁰ In 2011, with municipal strain escalating from the recession, the state legislature strengthened the emergency managers' powers, in particular allowing them to break union contracts to control rising labor costs. It also gave the state the authority to intervene earlier if officials determine through a financial review that a city is headed to insolvency.²⁰¹

The state revised its manager program after voters rejected the law in a statewide referendum

The enhanced powers to disrupt labor contracts were a flashpoint in an automobile-producing state with a long-standing union presence. After a divisive campaign pitting the popular Republican governor against Democrat-dominated unions, voters in November 2012 repealed the revised emergency manager law. In effect, voters sided with those who said the state program was too intrusive in local government affairs. Governor Rick Snyder and state lawmakers regrouped after the election and approved a more flexible intervention program that allows troubled local governments to choose among four options, including an emergency manager.

State oversight of Detroit is more urgent than it is for Michigan's other local governments, not only because the metropolitan area includes half of the state's population but also because of the important role it plays in the state's economy. "The reinvention of Michigan will not be complete without a strong Detroit," Snyder said in December 2012 as he signed a package of city revitalization initiatives.²⁰²

There is no mystery as to why Detroit eventually became insolvent. The city that 50 years ago served as the symbol of American optimism and prosperity is no less an icon today, only this time for urban ruin.²⁰³ Deindustrialization, decaying schools, racial tension, white flight, increasing crime, and, most recently, the foreclosure crisis—all the destructive forces that have hammered the country's industrial cities since the 1960s—ran rampant through Detroit. Only New Orleans lost more population than Detroit from 2000 to 2010, and that was because of a natural disaster, Hurricane Katrina.²⁰⁴

Great swaths of the city lie abandoned, with close to 70,000 unimproved vacant lots.²⁰⁵ No one knows how many tens of thousands of windowless, boarded-up, abandoned houses the city has. "Each of those houses is like a black hole for the property values on that particular block," says Lyke Thompson, director of the Center for Urban Studies at Wayne State University. Whole blocks have been bulldozed.²⁰⁶

Detroit borrowed to cover its public pension gap

Detroit city government has shrunk, too, from about 29,000 workers in 1951 to just over 10,500 today, many taking pay and benefit cuts.²⁰⁷ Gone is the historical sense that part of the value of city government is as a jobs provider for residents, says Bettie Buss, who analyzes Detroit's budget issues for the nonpartisan Citizens Research Council of Michigan. That role has grown less fiscally tenable for the city because of the accumulating budget deficit that reached \$327 million by the end of fiscal 2012 and rose throughout 2013, reaching about \$380 million at the time of this publication.²⁰⁸

Falling revenue from property and city income taxes and cuts in state aid make it unlikely that the city can balance its budget anytime soon. Detroit's approach to closing its budget shortfall has been to sell bonds. But, as former city auditor Joseph Harris warned elected officials, "Borrowing, as a quick fix to plug budget gaps, may be feasible when the gaps are cyclical. However, the city's budget gaps are structural, i.e., they are not going to go away by themselves." The city paid its employee retirement system bills the same way, through pension bond sales. All told, Detroit's long-term obligations rose to nearly \$15 billion by 2012, a staggering constraint.²⁰⁹ By summer 2013, as this report was being prepared, Detroit lacked the cash to pay all of its bills, and officials filed for bankruptcy in July 2013.

The deterioration of the city's finances coincided with a political crisis that diverted leaders' attention away from judicious management. Beleaguered Mayor Kwame Kilpatrick was beset by a series of scandals, including an affair with his chief of staff they both had denied under oath. That led to perjury charges followed by assault charges, Kilpatrick's removal from office in 2008, a prison sentence, federal fraud and tax charges, and a federal grand jury indictment for racketeering, fraud, extortion, and tax evasion.²¹⁰ In addition to the unflattering headlines, Detroit suffered because local officials were preoccupied with Kilpatrick's troubles instead of the city's finances.

Then came a political shift. The 2010 election of Gov. Snyder, a Republican, to replace Democrat Jennifer Granholm was accompanied by a new GOP majority in the House and Senate. Led by Gov. Snyder, GOP leaders pushed through a stronger state intervention program because, they argued, it was an essential tool to rejuvenate Michigan's economy. As Terry Stanton, a spokesman for State Treasurer Andy Dillon, put it, "Having financially sound, vibrant local units only makes the state better from an economic standpoint, a livability standpoint, and from the standpoint of attracting companies that will create jobs and call the state home."²¹¹

A coalition of community, labor, and religious groups collected the required signatures to challenge the emergency manager statute in the 2012 election. The sticking point these groups cited was that citizens and elected officials of the communities taken over by the state were rendered essentially powerless. In Pontiac, which has had an emergency manager since 2009, the overseer has consolidated employee health plans, put city

property up for sale, persuaded firefighters to dissolve their contract in favor of a shared-services arrangement with the neighboring township, and outsourced a host of city services, from permitting to tax collection.

Supporters of the program argued that emergency managers beat the alternative. “The most anti-democratic thing you can do is have your town in front of a federal bankruptcy judge, who will tear up your contracts and doesn’t care if you have police service or not,” says state Rep. Al Pscholka.²¹² After voters repealed the law, state legislators crafted a replacement program that gives local governments a choice of having an emergency manager, entering into a consent agreement with the state, asking the governor for permission to file for bankruptcy, or instituting a mediation process to negotiate with creditors on a restructuring plan.

Detroit’s mayor and council are split on policies for the city’s fiscal future

Detroit’s leaders tried to cut costs without state intervention, but Mayor Bing and the council clashed frequently over the best approach. No one was spared in what the mayor dubbed his “reform agenda,” especially city workers, who were laid off and furloughed and agreed to pay, benefit, and pension cuts.²¹³ But these steps were not enough to head off an emergency manager, who now is charged with moving the city into a more financially sound position.

But Detroit could not prevent bankruptcy because of its cash shortage, immense debt, and obligations to bondholders and current and future retirees. The imposition of the emergency manager came at a fractious time when internal divisions within the city and antipathy toward the state may make it more difficult for everyone to accept the solutions. “This pits stakeholders against each other instead of against the problem,” says Matt Fabian of Municipal Market Advisors.

Michigan’s experience with Detroit, a majority black city, also highlights the racial and political sensitivities that often accompany intervention. Protests in the city after Snyder’s appointment of the emergency manager stemmed in part from the fact that a white Republican governor and GOP-led legislature supported the takeover despite the objections of a black, Democratic City Council and mayor. “The goal isn’t to take them over,” Gov. Snyder says. “It’s to be a good partner to help them get back on their feet.”²¹⁴

For all the challenges the city government faces, life goes on in Detroit. Its image got a lift when the Detroit Tigers won the American League pennant in 2012. City boosters note that Whole Foods—widely considered a harbinger of up-and-coming neighborhoods—opened its first Detroit store in June 2013.²¹⁵ Certain neighborhoods are attracting new homebuyers with incomes over \$100,000.²¹⁶ Dan Gilbert, the founder of Quicken Loans, has been buying and renovating downtown properties and attracting businesses to them—including his own and Chrysler.²¹⁷

“Detroit is a place where it’s possible to be a very big fish in a pond that really needs big fish,” says Bettie Buss. “It’s a place where a young person can come and make a difference—and who are, in fact, working very hard to make downtown and Midtown and historic neighborhoods like Corktown work. So when you’re talking about city government, you’re really talking about just one of many Detroits—and it’s not necessarily representative of the whole city.”²¹⁸

Appendix: Methodology

This report identifies which states intervene in local fiscal distress and whether these programs strengthen state and local finances.

We first considered whether a state has a formal mechanism for dealing with local fiscal distress. Drawing on a special focus question from the 2011 original survey of legislative fiscal officers by the National Conference of State Legislatures, or NCSL, we identified state **laws designating local fiscal distress**, and determined whether states have a legal process in place that specifically defines distress of localities. Using data from the 2012 book “Municipalities in Distress?: How States and Investors Deal with Local Government Financial Emergencies,” we identified **bankruptcy authorization**, whether a state explicitly allows localities to file for bankruptcy.

We then identified which states require or allow for formal state action in the event of local fiscal distress—a category that we have termed **intervention program**. Informal efforts that can be undertaken by states to monitor or help remedy distress are not included here—only formal mechanisms set in place by statute. Our focus is on existing laws as of May 2013. We do not address what a state that does not have such a law in place **would** do in the event of a local fiscal crisis.

We conducted a series of analyses to determine the relationship between the existence of an intervention statute and various policies and external factors. We tested whether the existence of an intervention statute is correlated to the share of the state budget that is made up of intergovernmental transfers; the per-capita income of a state compared with its region; the number of tax limits in place; credit ratings; bankruptcy provisions; home rule provisions; and the region of the country. We found that the existence of an intervention statute varied by region of the country, but otherwise we did not find statistically significant relationships.²¹⁹ We also grouped individual intervention programs to determine whether there were connections or similarities among them and to attempt to measure their strength. We found that intervention practices share similar characteristics and can be grouped accordingly. However, we were unable to measure the relative strength or effectiveness of the individual intervention programs. Such a measure proved to be challenging for a number of reasons. Primarily, choosing specific measures placed too much pressure on any one type of outcome. We found that the differences between states, such as the structure of their economies and their political traditions, underscore that there is no single model for designing an intervention program. The highly context-driven nature of state interventions in local fiscal distress led us to explore these issues on a case-by-case basis through state profiles.

We undertook a more nuanced study of selected states based on a state profile methodology, which, paired with the typology, leads us to our findings and promising approaches. These states were selected to include those with state intervention legislation (New Jersey, North Carolina, Michigan, Pennsylvania, Rhode Island) and those without (California, Alabama). Among those with intervention legislation, we selected the oldest program in the country (North Carolina), a state that has recently scaled back its role (New Jersey), a state that has recently beefed up its role (Rhode Island), and two states that have struggled particularly with distress (Michigan and Pennsylvania). An in-depth look at these seven states allowed Pew researchers to understand the range of state experiences, motivations for state intervention, the role of political and economic conditions on the decision to get involved, and the results of state efforts over time.

In developing our typology for states’ variation of intervention activity, three sets of categories were considered. The first addressed whether the state has any laws in place to intervene within its localities in times of fiscal crisis. If so, the second set identifies the entity (person, agency, board) responsible for carrying out the intervention. The third set details the specific powers granted to the intervening authority. Together these lay out the range of formal intervention mechanisms available to states.

The category definitions are as follows:

Does the state have any laws allowing it to intervene in the event of fiscal crisis?

Laws included in this category do not have to be universally applied to all localities of the state. States are categorized as having laws in effect even if only subsets of local governments within that state are affected by the statutes (i.e., the law applies only to cities of a certain size). Therefore, regardless of whether the law allowed for comprehensive or ad hoc intervention, it was included in our review.

Laws that affect cities, towns, villages, counties, boroughs, and/or school systems fall into this category. Because our primary focus is on intervention mechanisms that are in place to aid distressed localities, we do not include special district governments with narrow responsibilities, such as hospitals and fire protection, nor do we include school system intervention if it is the only intervention law in the state. Arizona, Arkansas, California, Iowa, and Washington allow for some form of formal school district intervention. There are however, instances where school system interventions are combined with or dependent upon existing local government laws. In those cases, we were unable to separate them, and they are included in the analysis. This specification does not align with the scope of the NCSL survey question; the definition of “local government” in the special focus question, unlike that of our typology, is broad enough to include school systems.

State actions can apply universally to all localities, or the intervention can differ based on the size of the locality or the type of government. Likewise, states can dictate intervention efforts for certain sizes or types of local governments while having no intervention mechanism for other localities. Excluded from this category are informal efforts that can be undertaken by states to monitor or help remedy distress. Only current formal mechanisms established by statute as of December 2012 are included.

Who is given responsibility for undertaking or overseeing the state’s intervention efforts in the event of fiscal crises?

- Receiver, financial manager, overseer, or coordinator: Applies to all states that appoint an individual to take charge of the state’s intervention. A new position is created, the individual is appointed, and the position is terminated when the intervention is complete. Excluded from this category are receivers who are appointed in the event of default on debt that funded a particular improvement project. In such cases, the receiver takes over operation of the project in question, but the receivership is so limited in scope that we have decided not to include it in our typology.
- State agency: Applies to any existing agency within the state government that is designated as responsible for intervening in fiscally distressed localities. The agency may not have purposes and responsibilities other than intervention, and it supervises an intervention when needed. An individual within the agency may oversee the effort but is in a permanent position and handles any distressed locality.
- Financial control board, state-appointed board, or commission: Applies to a group appointed by the state to address a specific locality’s fiscal problems. The makeup of the board or commission and the method of its appointment are specified in the establishing legislation. The board is a temporary entity and is dissolved when the intervention is complete.

What authority or power is given to the intervenor by the state to help a locality in crisis? What can be done once the state intervenes?

- Restructure finances—renegotiate, approve, or issue debt: Applies to states that explicitly give the intervenor the power to issue new debt on behalf of the locality, authorize the locality to issue debt, or renegotiate existing debt as an agent of the locality.
- Restructure finances—labor: Applies to states that give intervenors the specific authority to renegotiate existing labor contracts. Included in this category are states that allow the intervenors discretion on whether to honor provisions of existing multiyear labor contracts that called for increases in salaries, benefits, or other compensation after the first year of the contract. Note that this category does not include instances in which the intervenor is authorized to negotiate new labor contracts as an agent of the locality.
- Restructure finances—taxes, fees, credits: Applies to states that give intervenors the power to change existing tax rates, fees, or credits or to enact new taxes, fees, or credits as deemed necessary. This category does not apply to revenue raised by the project-specific receiverships discussed above.
- Emergency financing: Applies to states that offer loans (often no-interest loans), grants, or enhanced credit backing (i.e., state-guaranteed debt) to localities in fiscal distress.
- Supervise finances, or technical assistance: Applies to a range of state actions meant to aid localities in developing balanced budgets, including financial auditing, assistance in creating a financial plan, development or approval of budgets, negotiation or approval of contracts (labor or otherwise), and approval of expenditures and appropriations.
- Dis-incorporate, dissolve, or consolidate local government: Applies to states in which the intervenor has the ability to dis-incorporate the locality if such action is deemed necessary to consolidate the locality with other local governments.

To address whether states specifically require or allow for formal state action in the event of a local fiscal crisis, we started with a review of the 22 states (and the District of Columbia) that were identified in “Municipalities in Distress?: How States and Investors Deal with Local Government Financial Emergencies” as having existing state-imposed or state-enforced debt restructuring laws aimed at crisis intervention. For those 22 states (and the District), we conducted a comprehensive scan of each statute. This involved a manual review using a customized search query. Next, we used Westlaw’s online legal research services to conduct a scan for all states and the District, again using a customized search query.

We reviewed the statutes that were identified to determine which met our definition of a crisis intervention. Those that met the definition were then categorized within our typology (detailed in the bullets above), which identifies the range of intervention mechanisms in which states engage. For each state, every search and categorization was performed a second time by a different analyst to help ensure quality control.

We supplemented the Internet and Westlaw searches in all 50 states and the District by contacting officials in relevant state agencies. Our analysts reviewed state statutes and websites to determine the state agency responsible for local intervention. When that designation was unclear or unavailable, we directed our emails to the state’s legislative fiscal office or similar body. We received responses from more than half the states. In their replies the officials confirmed or made suggested edits to our categorization and the identified statutes.

Also, none of the categories are mutually exclusive: A state may fall into any or all of the categories, regardless of which others apply.

Endnotes

1. The cities are Mammoth Lakes, San Bernardino, and Stockton. Mammoth Lakes' case was dismissed in November 2012 after the town settled a lawsuit filed by its largest creditor. Another California city, Vallejo, was in bankruptcy protection from 2008 to 2011. The Pew Charitable Trusts research.
2. The nine cities are Atwater, Culver City, El Monte, Fairfield, Fillmore, Fresno, Indio, Hercules, and La Mirada. The Pew Charitable Trusts research.
3. Municipal governments also can include towns, villages, boroughs, counties, and special districts covering schools, hospitals, and utilities. This report focuses mainly on cities and counties and, to some extent, school districts.
4. The states are CT, FL, IL, IN, ME, MA, MI, NV, NH, NJ, NM, NY, NC, OH, OR, PA, RI, TN, and TX. Although the District of Columbia has a formal intervention mechanism, it is not included in our analysis. Congress exercises exclusive legislative authority over the District of Columbia, so it is up to Congress to decide how it would resolve a future DC financial crisis: re-imposing the District of Columbia Financial Responsibility and Management Assistance Authority, or "control board," with the same authority, re-imposing it with different authority, or creating a mechanism other than a control board going forward.
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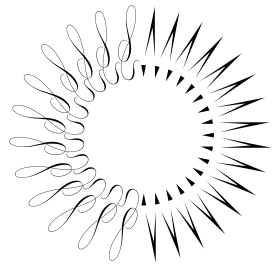
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