



Steps States Can Take to Monitor Local Governments' Fiscal Health

Tracking early signs of distress can avoid costly intervention



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Overview

Most states do little to analyze the fiscal health of their local governments. As a result, policymakers can be caught by surprise when counties, cities, or towns fall into fiscal distress—events that have proved costly to state budgets. States can be proactive by assessing and tracking the fiscal health of their localities, as 23 states currently do, according to research by The Pew Charitable Trusts. By detecting the early signs of fiscal distress, states can help local governments address problems before they become more difficult to manage or costly to resolve.

There is no one-size-fits-all method for monitoring local government fiscal health. Effective policies and procedures should take into account a state's unique economic, legal, and political context. But policymakers should consider each of the following steps when creating or improving policies to evaluate local fiscal conditions.

1. Establish a clear definition of 'distress'

To establish an effective monitoring system, states should clearly define what they are trying to detect. There is no standard definition of distress. Some states identify specific conditions or criteria that signal distress while others use broad parameters to define it. In Louisiana, for example, state officials review such factors as whether a locality has sufficient revenue to meet current expenditures or make debt service payments.¹ A clear definition of distress provides transparency for the state's analysis, sets a guidepost for local governments, and allows a state to evaluate how well the system is working.

2. Identify the departments or agencies responsible

Detecting fiscal distress in local governments is handled by various departments in the 23 states² that conduct this monitoring, including the offices of auditors, comptrollers, and treasurers. Policymakers should consider which departments or offices already collect some of the relevant information from local governments, have the capacity to conduct the analyses required, and already work with local governments on related issues.

3. Identify data sources that will meet the system's purpose

States typically rely on data collected from audits, budgets, and financial statements to assess local governments. While audits and financial statements offer the advantage of final numbers, the lag time involved means that data are from the previous fiscal year so are of limited use for detecting early signs of distress. Budgets offer states the chance to look ahead, but the data are not audited and any projections are subject to change. On the other hand, audited financial statements permit an examination of assets and liabilities beyond the current budget year's cash flow.

4. Determine what indicators the state will monitor and with what frequency

States use a variety of indicators to detect distress, monitoring them as often as monthly or quarterly. Setting a clear purpose for monitoring can inform which indicators will best achieve the system's goal. There is broad variation in the number and type of indicators used to analyze the fiscal condition of local governments. For example, Michigan relies on a single indicator—the presence of a deficit—while Nevada examines 27. Many states have indicators to assess financial, economic, and demographic information in categories such as revenue, debt, expenditures, and operating position.

Defining an indicator includes identifying what is being measured, such as debt service, operating position, or reliance on intergovernmental revenue; and establishing the level of that condition that indicates potential stress.³

After selecting which metrics or indicators to monitor, states must determine how to translate these measures into a score or other determination of stress. States use indicators in different ways in their assessments of local government fiscal health. Pennsylvania, for example, reviews surveys from local governments. If one of the state's 11 indicators marks a potential problem, the staff can recommend that the local government participate in an early intervention program.⁴ Some states, including Nevada and North Carolina, rely on their analysts' expertise to determine at what point a measurement indicates distress for a given locality. A few states, including Louisiana, New York, and Ohio, create composite scores, combining indicators to classify local governments in various levels of distress. Most grant state officials the authority to designate a locality in distress.

5. Ensure monitoring takes place consistently

Formal systems and processes help promote transparency and predictability. Establishing specific indicators, for example, helps ensure that monitoring is conducted consistently, no matter who does the analysis. Codifying policies strengthens the commitment to detect fiscal distress and help local governments make the appropriate adjustments, even in times of tight budgets and through changes in administration.

Conclusion

Strategies to identify the early warning signs of financial strain can better prepare both state and local policymakers, create more opportunities to respond and avert a larger crisis, and promote robust communication between levels of government. The steps outlined in this document are important for states to consider as they explore options for putting policies in place to detect, track, and respond to signs of fiscal distress.

Endnotes

- 1 Louisiana R.S. 39:1351.A.(2)(a), <https://www.legis.la.gov/Legis/Law.aspx?d=95839>.
- 2 The 23 states are Colorado, Connecticut, Florida, Iowa, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Virginia, and Washington.
- 3 Ohio Auditor of State, "Financial Health Indicators" (2017), <http://ohioauditor.gov/FHI/fhi%20report%20FINAL.pdf>.
- 4 Pennsylvania Department of Community and Economic Development, "Municipal Survey of Financial Condition" (2014), <https://dced.pa.gov/download/municipal-survey-of-financial-condition-form-dced-clgs-69-tip-sheet-year-2014-archived>.

For further information, please visit:

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