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After Detroit: How will Illinois and its communities respond?

by Richard H. Mattoon, senior economist and economic advisor, and Sarah Wetmore, vice president, Civic Federation

Detroit's bankruptcy filing has highlighted fiscal pressures being experienced by communities across the nation, including Chicago. Problems such as flat or declining property tax revenues, underfunded public pensions, and reduced state support are straining local government operations. To investigate how municipalities are adjusting to fiscal stress, the Civic Federation and the Federal Reserve Bank of Chicago held a forum on April 23, 2014, that brought together over 140 participants.[1]

Some materials presented at the forum are available at www.chicagofed.org/webpages/events/2014/after_detroit_chicago_fed_civic_federation.cfm.

To kick off the event, Robert Inman, professor, Wharton School of the University of Pennsylvania, explained that city finances should be of concern to the entire nation because cities are the drivers of economic growth. The key to a fiscally healthy city, he contended, is to gain more residential and commercial property owners, as well as businesses, with a stake in the city's long-term success; city policies that produce such stakeholders ultimately lead to a strong and sustainable level of financial performance for the local government. Moreover, local policymakers must recognize that a city is an open economy, where the failure to deliver services at competitive prices will drive out economic activity.

Inman said that to achieve good fiscal health, cities should start by determining what services they should and should not provide. According to Inman, cities should provide the following residential services (and goods): education through the community college level, public safety (i.e., police and fire protection), courts and prisons, sanitation, water and sewer, and neighborhood roads, as well as amenities such as open spaces for recreation, parks, and libraries. He said that cities should also provide business services that are similar to these residential services but a little narrower in scope (e.g., commuter roads and parking garages). Inman argued that it is appropriate and efficient for cities to deliver social services to local low-income households, but financing for social services should occur at the state, regional, or federal level; efforts to fund these services at the city level would put undue stress on the local tax base and likely drive out economic activity, and city funding for them might crowd out funding for other vital services. (Inman also noted that keeping low-income households out of poverty helps keep local home values up: A 3% increase in the poverty rate translates into a 25% fall in home values.)

Cities should be attuned to how they pay for the services they provide, Inman noted. User fees are the best option for services that can be easily priced per use—usually services considered "excludable" (i.e., services that are not rendered if an individual does not pay for them). For services that are difficult to price per use—usually those deemed "nonexcludable" (such as public safety, roads, and courts)—general, broad-based taxes are needed. It is also important that taxes are not based on mobile factors but instead on where economic activity is located, Inman said. This criterion favors residential income taxes,

land value taxes, and localized property taxes that benefit either a specific neighborhood or business district. Finally, to the extent possible, residential and business taxes should be separated and should only be used to pay for the services that residents and businesses consume, respectively, said Inman.

Inman concluded by outlining some steps that cities can take to attain a strong and sustainable fiscal performance. First, he said, cities should adopt his preferred form of local governance: a mayor who has broader authority than the city's legislative body (e.g., veto powers requiring a two-thirds majority of the city council to be overridden). This type of government concentrates financial control (as well as accountability to voters citywide) in a single individual, rather than dispersing it among multiple parties with disparate aims. Additionally, Inman said that cities should use competitive bidding for the provision of services, which creates price transparency. Inman also promoted strategies that decentralize a city's fiscal structure. Specifically, he said that both neighborhood and business improvement districts should be permitted so that locally instituted taxes could be used to pay for expanded services (beyond those already provided by the city)—e.g., more police patrols and street cleaning—and additional capital improvements—e.g., further upgrades of roadways. These special districts would make certain that some tax payments are connected to locally provided services. Finally, Inman recommended putting in place a fiscal enforcer for the city. This could be a strict balanced budget requirement from the state, with independent assessment and penalties for noncompliance. It could also be a politically independent fiscal control board with credible enforcement measures, including the abilities to deny state aid and limit municipal bond issuance guarantees.

Greater fiscal transparency would help localities avoid fiscal stress or detect and address it early.

Chicago: City at a turning point

Lois Scott, chief financial officer, City of Chicago, spoke about the central importance of pension reform to improve Chicago's fiscal future and ensure the long-term sustainability of the pension funds. She described how Chicago got into such a difficult pension situation over the past 20 years and explained that new legislation that was then awaiting Illinois Governor Pat Quinn's signature would put two of Chicago's four pension funds (the municipal employees and laborers pension funds, but not the police and firefighters pension funds) on the road to recovery at a more sustainable cost to taxpayers.

Scott said the largest contributing factors to pension underfunding in Chicago were a state-imposed funding system that does not adjust the city's contributions to match the financial needs of the fund, a compounded automatic annual annuity increase, and investment losses during the two economic downturns in the 2000s. Scott noted that in the low inflationary environment of the past decade, the 3% compounded annual increase that annuitants receive has been a major source of underfunding because the annual increase has significantly outpaced inflation. The new legislation therefore focuses on tying the automatic annuity increase to a measure of the level of inflation.[2] Additionally, Scott praised labor groups for being partners in developing the reform package. She said that Chicago Mayor Rahm Emanuel will continue to call on Governor Quinn to sign the legislation and then will urge the Illinois General Assembly to move forward with equally important reforms to police and firefighters pension benefits.

Richard Ciccarone, president and chief executive officer, Merritt Research Services, examined the rationale behind how rating agencies assign their public debt ratings and took a look at the role these organizations play in creating fiscal discipline in the public sector. Ciccarone said ratings have been based on the default history of the class of securities, combined with the strength of the city (or state) government's underlying economic base. This basis of evaluation has led the three major rating agencies (Moody's, Standard & Poor's, and Fitch Ratings) to give at least 79% of cities top ratings of AA or AAA. Ciccarone questioned how such a large percentage of high ratings could create fiscal discipline among local governments. He said that instead of the current ratings methodology that focuses mostly on "here and now" fiscal conditions, a better approach would add a consideration of a city's long-term vulnerabilities earlier in the ratings process.

Ciccarone compared the City of Chicago with other cities, using various measures of financial condition to see if the city's debt rating was fair and consistent with its financial results. He explained that Chicago is an outlier with regard to funding its pension liabilities in comparison with other cities with an A bond rating; e.g., Chicago's pension funding ratio was 35.2% versus a median of 78.8% for A-rated cities in fiscal year (FY) 2012. Moreover, Chicago has low indicators of cash on hand and fund balance relative to other A-rated cities. However, Chicago has a level of taxes per capita ($1,955 in municipal and school district taxes combined for FY2012) that is only a little higher than the median for big cities (with populations over 500,000); Ciccarone concluded that it might be possible for Chicago to increase taxes to take care of its pension liabilities, which would be more difficult for higher-rated big cities with larger per capita tax burdens (e.g., New York) to do.

Looking at the national context in which pension reform litigation in Illinois will play out was Stuart Buck, vice president of research integrity, Laura and John Arnold Foundation. Buck described recent decisions by state supreme courts and lower courts from around the country on whether governments can modify public pension benefits for current employees and retirees. He highlighted the similarity between Arizona's and

Illinois's constitutional protection of pension benefits, which could mean that state supreme court justices in Illinois will consider the Arizona Supreme Court's decision to strike down pension changes in their own rulings. However, there will likely be a difference in how the cases are argued as the State of Arizona did not use the fiscal emergency framework that will be central to the State of Illinois's argument for the constitutionality of pension reform.

Buck emphasized that under constitutional law, exceptions to even the most absolute language are often found, and he opined that state constitutional pension clauses would be no exception. That said, Buck recommended that in order to be prepared for any eventuality, Chicago should look to the experience of San Jose, California, when drafting future pension legislation: The Santa Clara County Superior Court struck down pension reforms implemented via referendum in San Jose but held that wages can be reduced even if pension benefits cannot. The City of Chicago might therefore include provisions that reduce employee wages if a pension reform bill is ruled as unconstitutional under the Illinois Constitution.

State intervention

Stephen Fehr, senior officer, Pew Charitable Trusts, presented findings from a study on the state's role in addressing local government financial distress.[3] The study found that 19 states have laws that allow the state government to intervene in fiscally distressed localities; however, the laws vary widely in regard to the powers given to the states. In practice, only a handful of states intervene aggressively when a municipality is in fiscal trouble. Fehr pointed out that the most aggressive state assistance programs are in Michigan, North Carolina, Pennsylvania, and Rhode Island.

For states with active state assistance programs, Fehr said, the approach to helping cities in fiscal distress varies but usually starts by appointing an intervener—e.g., a receiver, emergency manager, state agency head, or financial control board. Depending on the state, the intervener is granted the authority to restructure debt and labor contracts, raise taxes and fees, offer state-backed loans and grants, provide technical assistance (such as financial management advice), and even dissolve the local government. Fehr added that given the wide-ranging powers of the intervener, local governments tend to grudgingly accept state intervention.

Fehr noted that a particularly good example of state oversight of localities' financial standing is North Carolina's Local Government Commission—which was created in 1931 in response to several municipal bond defaults associated with the Great Depression. The commission oversees and regulates financial reporting by local governments and monitors their fiscal health. If problems are severe enough, local governments can be taken over by the state. Additionally, local governments must seek approval from the commission to issue debt, and the commission is responsible for selling their bonds. To complement the Local Government Commission, North Carolina uses a centralized pension system to avoid underfunding pension funds. North Carolina's efforts to monitor and manage local fiscal distress have resulted in its having a large percentage of AAA-rated local governments.

Fehr concluded with some recommendations offered in the study:

- States and cities should be more proactive in detecting local government fiscal stress through strong oversight, and states should address municipal financial problems early on with the provision of technical assistance.
- Multiyear budgeting for cities should be adopted to better manage finances.
- Intervention programs should involve all stakeholders in discussions to find a solution and should explain upfront that control will be returned to local officials as quickly as possible in order to promote better cooperation among all the interested parties.

Jim Spiotto—managing director, Chapman Strategic Advisors LLC, and co-chair, Pension Committee of the Civic Federation—presented the Civic Federation's proposal to create the Illinois Municipal Protection Authority (IMPA). IMPA would be a quasi-judicial mediation and arbitration program for fiscally troubled municipalities seeking assistance on a *voluntary* basis—a key quality in that the authority's recommendations would have a greater chance of getting buy-ins from all parties in the community. Spiotto said IMPA would allow local governments facing fiscal turmoil to develop sustainable fiscal structures that ensure that essential government services (such as public safety, sanitation, and education) can continue to be provided. Through a fact-finding process for the fiscally distressed city, IMPA would establish what the costs are for local government services and what resources are available to pay for them. After that, it would help the municipality develop a recovery plan that prioritizes paying for essential services and then restructures legacy costs (such as those associated with funding public pensions), which may have been one of the chief sources of its fiscal troubles. As part its work, IMPA would determine whether a local government has additional capacity to raise taxes and

Charles L. Evans, *President*; Daniel G. Sullivan, *Executive Vice President and Director of Research*; Spencer Krane, *Senior Vice President and Economic Advisor*; David Marshall, *Senior Vice President, financial markets group*; Daniel Aaronson, *Vice President, microeconomic policy research*; Jonas D. M. Fisher, *Vice President, macroeconomic policy research*; Richard Heckinger, *Vice President, markets team*; Anna L. Paulson, *Vice President, finance team*; William A. Testa, *Vice President, regional programs, and Economics Editor*; Helen O'D. Koshy and Han Y. Choi, *Editors*; Rita Molloy and Julia Baker, *Production Editors*; Sheila A. Mangler, *Editorial Assistant*.

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examine whether service provision should be transferred to other governmental bodies and if other remedies such as privatization should be considered. In closing, Spiotto said that IMPA could be established so that fiscally distressed cities are *required* to seek its assistance: In this alternative vision for IMPA, trigger events (such as the failure to make statutory or annual required contributions to public pension funds from existing operating revenues for two years in a row) would require a municipality to create a recovery plan with IMPA's guidance.

Michael Pagano, dean, College of Urban Planning & Public Affairs, University of Illinois at Chicago, described limitations that states have placed on local revenue-raising options, as well as trends in federal and state aid to localities. Pagano explained that municipal tax authority varies greatly from state to state. Some states allow local governments to levy a broad range of taxes, such as property, sales, and income taxes. Others are more restrictive, limiting not only their municipalities' choice of tax bases but also the annual increase in a particular tax. This state-to-state variation in local governments' ability to levy taxes has contributed to differences in their fiscal condition as they recover from the Great Recession. Pagano proceeded to highlight trends in intergovernmental fiscal relationships. First, he noted that federal aid as a percentage of municipal general fund revenue had fallen from a high of 11.9% in 1977 to 3.0% in 2011; over the period 1992–2007, this measure of federal aid ranged from 2.1% to 2.4%. Second, he said that state aid as a percentage of municipal general fund revenue stayed within a reasonable compact range of 17.3% to 19.9% over the period 1982–2007; however, by 2011 this figure had dropped sharply, to 12.4%. Pagano said that he found evidence for a decline in state aid between 2007 and 2011 regardless of how restrictive a state was about localities' revenue-raising options. States that had imposed strict revenue-raising limitations on local governments during the late 1970s and early 1980s initially boosted state aid to them following the action, but the level of aid declined in the past decade, he noted.

Keynote address

John Hill, chief financial officer, City of Detroit, compared the fiscal crisis experienced by Washington, DC, in the 1990s with the one experienced by Detroit over the past decade. Hill noted some similarities in the circumstances that precipitated fiscal turmoil in both cities: falling population, declining revenues leading to budget deficits, lack of financial controls, and high unfunded pension obligations. In the case of Washington, the U.S. Congress stepped in to create a financial control board with significant financial and lawmaking authority. This board was to retain control over local finances until the city's budget met certain financial criteria for a number of consecutive years. An independent chief financial officer position was created whose incumbent could not be removed except with the permission of the financial control board. After fiscal controls were imposed by both the board and chief financial officer and after Congress relieved Washington of certain expensive programs (such as its court system and Medicaid), the city was able to perform well enough to have the board be dissolved within six years. Since then, Washington has maintained budget surpluses every year and still has an independent chief financial officer; moreover, the threat of the imposition of a new financial control board has given Washington an incentive to keep its fiscal house in order.

In addition to the types of problems Washington faced during the 1990s, Detroit must currently deal with other difficulties, including a large geographic footprint relative to its population (which makes the delivery of services expensive and inefficient) and significantly deteriorated infrastructure. Hill went over the state intervention process that resulted in Michigan Governor Rick Snyder's appointment of an emergency manager for Detroit and the city's eventual bankruptcy filing in July 2013.[4] He told attendees that Detroit's emergency manager has filed a plan of adjustment with the court and hopes to have the city exit bankruptcy in October 2014. However, it is extremely important for city and state leaders, as well as residents, to focus not only on the exit from bankruptcy but also on the formulation and execution of a plan for recovery. Currently, there are several proposed recovery plans, but none of them have associated plans for implementation. The emergency manager's plan of adjustment could lead to a recovery, but that would require the stabilization of the city's revenue collection and other systems, as well as broad buy-in from the city's elected officials. To conclude, Hill said to improve Detroit's fiscal performance in the future, the following would be needed: a commitment to restructure the city from the bottom up, the provision of new services that would make the city attractive to new residents (such as mass transit), a commitment from business leaders to support the city's restructuring process, and long-term financial monitoring after exiting bankruptcy.

Conclusion

Greater fiscal transparency would help localities avoid fiscal stress or detect and address it early. For communities already in fiscal trouble, the creation of a recovery plan that ensures that there will not be severe disruptions to essential services will be vital to restoring firm fiscal footing. Finally, new institutions and rules may be necessary to ensure that an independent review of city fiscal plans occurs regularly.

[1] Some speakers at this forum also made presentations at a 2013 Chicago Fed conference summarized in Richard H. Mattoon, 2014, "What happens after Detroit's bankruptcy? Lessons in reform," *Chicago Fed Letter*, Federal Reserve Bank of Chicago, No. 318a, January.

[2] The annuity increase would be a simple (instead of compounded) 3% or half of the Consumer Price Index, whichever is less.

[3] For the full report (and related materials), see www.pewstates.org/research/reports/the-state-role-in-local-government-financial-distress-85899492075.

[4] For more details on the filing, see Gene Amromin and Ben Chabot, 2013, "Detroit's bankruptcy: The uncharted waters of Chapter 9," *Chicago Fed Letter*, Federal Reserve Bank of Chicago, No. 316, November.