State Notes

TOPICS OF LEGISLATIVE INTEREST

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An Analysis of Emergency Financial Conditions in Local Units of Government

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As a follow-up to the Senate Fiscal Agency Issue Paper entitled, "Local Government Financial Emergencies and Municipal Bankruptcy", this State Notes article is devoted to an analysis of a part of the local financial emergency process entailing the Michigan Department of Treasury review of a local unit before the appointment of an Emergency Financial Manager (EFM) or the negotiation of a consent agreement. This is a crucial part of the process whereby the underlying financial difficulties that must be addressed via a consent agreement or EFM are established. An analysis of these reports may assist policy makers in understanding the common type of problems that emerge in emergency financial situations across local units of government.

Emergency Financial Conditions

The process leading up to the appointment of an Emergency Financial Manager or a consent agreement is governed by the Local Government Fiscal Responsibility Act. The Act describes several mechanisms through which the Michigan Department of Treasury may be made aware and notified of a pending financial emergency concerning a local unit of government. These mechanisms include notification by a creditor of a government, the governing body or chief administrative officer of a local government, a petition from registered voters of the jurisdiction, pension trustees or beneficiaries, employees, or bondholders, or from a resolution from the Senate or House of Representatives.

If such a proper notification is made, the Michigan Department of Treasury initiates a preliminary review. In statute, there are nine emergency financial conditions that are to be reported upon during the preliminary review. In essence, these conditions serve as the type of events that have occurred or are likely to occur, indicating that a serious financial problem exists. These conditions include:

- Default in the payment of principal or interest of bonded obligation;
- Failure to transfer to appropriate authorities any of the following:
  - Employee taxes,
  - Taxes collected for another government,
  - Pension or retirement contribution;
- Failure for 30 days or more to pay wages or compensation;
- Accounts payable exceeding 10% of total expenditures;
- Failure to eliminate any fund deficit within two years;
- 10% or greater operating general fund deficit.

If the preliminary review finds that one or more of these adverse financial conditions exist, the State Treasurer is to notify the Governor, who then must initiate a formal financial review team process. The financial review team report must indicate whether any of the nine situations discussed above could occur or has occurred. The financial review team has 60 days in which to report their findings.

Once the financial review team process is completed, the report is provided to the Governor with the three following options:

- A serious financial emergency exists and a consent agreement is possible.
- A serious financial emergency exists and an emergency financial manager should be appointed.
- No serious financial emergency exists.

Thus, one will find in each financial review team report a discussion of these issues as well as the findings from the preliminary review. These reports provide a wealth of information regarding local financial conditions.

Emergency Financial Manager in Action

The law states several important conditions surrounding the appointment and activities of the EFM. The Governor assigns the responsibility for hiring and overseeing the EFM to the Local Emergency Financial Assistance Loan Board (LEFAB). There are several conditions related to the hiring of the EFM which include:

- Must not be an elected or appointed official of the local government in question for at least five years before appointment.
- Does not have to be a resident of the local government jurisdiction.
- Serves at the pleasure of the LEFAB.
- Is entitled to expenses from the local government as approved by the LEFAB.
- With approval of the LEFAB, may secure other professionals and appoint staff to assist with activities and analysis.

Following his or her appointment, the EFM may engage in certain activities to address the financial emergency. Among other things, the EMF may do the following:

- Implement a written financial plan.
- Analyze and assess the financial condition of the local unit of government.
- Require, amend, and approve or disapprove a plan for paying obligations of the local unit.
- Amend, revise, and approve or disapprove the budget of the local unit.
- Require special reports from the finance officer of the local unit.
- Examine all books and records as specified under the Uniform Budgeting and Accounting Act.
- Make, approve, or disapprove any contract, appropriation, expenditure, or loan by the local unit.
- Review all payroll claims and other financial claims before payment.
- Exercise all appropriate authority regarding union contract negotiations.
- Within limits of a governmental charter, consolidate departments, remove appointed officials, and transfer functions.
- Seek court action to require compliance with orders.
- Within charter limits, sell assets to meet current or past obligations.
- Apply for a State loan on behalf of the local unit.

- Enter into intergovernmental agreements.
- Exercise adoption and implementation authority regarding financially based resolutions and ordinances.

These activities are designed to allow the EFM to correct the deficiencies noted in the financial review team report as well as any financial problems uncovered by the EFM. The philosophy underlying this approach is that local government officials have been unable to address the problem via the normal mechanisms and channels and that a different set of actions is required to ameliorate a financial emergency.

Review of Select Financial Review Team Reports

This article reviews two financial review team reports to provide legislators with a sense of what is contained and what actions follow the release of a report. A sample of reports for two local units is reviewed here:

- Village of Three Oaks, MI
- City of Ecorse, MI

Village of Three Oaks, MI

The Village of Three Oaks was under the purview of an EFM from December 2008 through 2009. Three Oaks is located in southwestern Michigan and is very close to the Indiana border. It has a population of 1,829 people. It has a median household income of $34,000, which is significantly below the U.S. average of $41,000. However, its poverty rate is actually lower than the U.S. average.

In June 2008, the Michigan Department of Treasury initiated a preliminary financial review. The review found several significant issues:

- A new accounting system was not properly functioning and the prior system was not being maintained; this led to a loss of reliable financial records.
- Major and local street fund expenditures consistently exceeded available revenue and both had accumulated deficits.
- The Village failed to file deficit elimination plans.
- The Village had significant cash flow shortages as well as significant and at times improper interfund borrowing.
- Restricted revenue from extra voted millages and special assessments was improperly deposited into the General Fund.
- The Department of Transportation had been withholding road funding due to the Village's failure to reimburse the Department for a required reimbursement.

Based on a preliminary analysis, the State Treasurer instituted a financial review team that met in September and October 2008. The financial review team reported the following:

- Village department heads indicated that they played no role in the budget process and were seldom given information after the budget was passed.
- There were wide variances in the budgetary and actual expenditures across a wide range of departments and service areas.
- Summer property taxes, intended for the following fiscal year, were being used for expenses in the current fiscal year.
- The Village had a significant cash flow problem; lack of records made it difficult to assess the existence of an operating deficit.

Based on these findings, the State Treasurer recommended the appointment of an EFM on July 25, 2008. In fiscal year (FY) 2008-09, the Village had $1.3 million in government revenue and $980,000 in expenses, leading to a nearly $400,000 operating surplus. This was a significant improvement from the previous fiscal year which had seen a $100,000 operating deficit.

City of Ecorse, MI

The City of Ecorse is another local unit of government in Michigan that has been placed under an EFM. Ecorse is located in Wayne County and has a population of 11,299. The mean household income is $27,000, which is much lower than the U.S. average, and the poverty rate is 17.3% almost double the U.S. average.

A preliminary review of Ecorse's finances was started by the Michigan Department of Treasury on March 17, 2009. The preliminary review found the following factors:

- The City had borrowed $2.6 million in property taxes from other units that were owed.
- There was significant cash flow shortage including unauthorized borrowing from the street funds to the general fund.
- Six financial audits were late since FY 2002-03.
- The general fund had an accumulated deficit.
- Internal control problems existed.

These types of problem are indicative of the types of serious financial conditions that lead to a consent agreement or the appointment of an EFM. One can see specifically the problem of an accumulated deficit and accounting control problems.

On June 29, 2009, the Governor appointed a financial review team. The team met throughout July and August. The review team found the following conditions:

- The accumulated deficit had increased from $5.2 million in FY 2006-07 to $9.2 million in FY 2007-08.
- $6.8 million in property taxes were owed to other government units.
- A judgment levy of $1.1 million for pension funds was transferred to the general fund and not to the Municipal Employees Retirement System.
- Financial audit contained adverse or negative opinion from auditors.
- 13 material weaknesses were found in financial audits.

- General fund expenditures consistently exceeded general fund revenue, creating an operating deficit.

The review team concurred with the findings of the preliminary review. These findings amounted to a series of serious accounting and financial errors and missteps. Serious material weaknesses in a financial audit often means the government is unable to properly track and account for funds. An inability to track funds is then very likely to lead to financial mistakes. An accumulated deficit and the failure to properly remit taxes owed to other governments is often a consequence of these problems. This led to a recommendation for the appointment of an Emergency Financial Manager.

Summary

Since 2001, Michigan local governments have faced a series of significant financial difficulties. Revenue sharing reductions, declines in property taxes and fees, and increasing health care costs have all placed a major squeeze on local finances. In some units, these problems have led to the need for State intervention in the form of consent agreements or EFMs. This article reviewed some of the financial review reports before the appointment of an EFM.

A sample of preliminary reviews and reports from financial review teams reveals a number of common factors across financially troubled local units of government. Often, part of the problem can be traced to a lack of internal controls and proper accounting procedures. Without adequate financial information, local officials cannot make sound financial decisions and analysis. This type of situation often leads to serious mistakes and financial difficulties. These problems often show up as inadequate cash flow, significant fund deficits, and inability or unwillingness to transfer funds owed to other units of government or other delayed payments.

The statutory process is focused on financial challenges such as internal control problems, cash flow shortage, or fund deficits. It should also be clear that long run economic problems that may be present in these communities are not easily or readily addressed through a consent agreement or EMF process. In fact, the financial review team is explicitly focused on the issue of addressing short- and medium-term adverse financial problems and not necessarily the long-term economic and fiscal health of the community.

A Timeline of EFMs, Consent Agreements and Financial Review Teams

City of Pontiac, MI

Financial Review Team (April and May 2008)
Fred Leeb (March 2009 - June 2010)
Michael Stampfler (July 2010 - ongoing)

City of Benton Harbor, MI

Financial Review Team (October and November 2009)
Joseph L. Harris (April 2010 - ongoing)

City of Ecorse, MI

Financial Review Team (August and September 2009)
Joyce A. Parker (October 2009 - ongoing)

City of Hamtramck, MI

Financial Review Team (May and June 2000)
Louis Schimmel (November 2000 - February 2007)
Financial Emergency declared over

City of Highland Park, MI

Financial Review Team (September and October 2000)
Ramona H. Pearson (June 2001 - February 2005)
Arthur Blackwell (March 2005 - April 2009)
Robert Mason (April 2009 - July 2009)
Financial Emergency still in place

City of River Rogue, MI

Financial Review Team (October and November 2009)
Consent Agreement (December 2009)

City of Flint, MI

Financial Review Team (March and April 2002)
Ed Kurtz (July 2002 - June 2005)
Financial Emergency declared over

Village of Three Oaks, MI

Financial Review Team (October and November 2008)
Pamela Amato (December 2008- December 2009)
Financial Emergency still in place