Joint Public Hearing on Act 47
Senate Committees on Community, Economic and Recreational Development and Local Government
House Committees on Urban Affairs and Local Government
Testimony of Dean A. Kaplan
October 20, 2011

Thank you Chairwoman Earll.

Good morning members of the Senate Local Government and Community, Economic & Recreational Development Committees and the House Local Government and Urban Affairs Committees.

My name is Dean Kaplan and I am a Managing Director of the Strategic Consulting Group at Public Financial Management. Thank you for the opportunity to testify on the issue of Pennsylvania's municipal financial recovery program, known as Act 47.

Public Financial Management, or PFM, is a national financial services and management consulting firm that works predominantly for state and local governments and non-profit institutions. We have offices in over 20 states across the country and we are headquartered in Pennsylvania, with over 225 employees located in Philadelphia, Harrisburg, Pittsburgh and Malvern. The Strategic Consulting group is the national leader in the development of multi-year financial plans in the public sector – helping distressed governments to achieve fiscal recovery. In addition, we provide a broad range of services to state and local governments, including operational and efficiency reviews, workforce analysis, governmental consolidation and shared services studies, and program analysis for decision-making.

For example, we have helped the City of New Orleans restructure its budget process after the disastrous effects of Hurricanes Katrina and Rita; the City of Vallejo, California analyze labor costs during its bankruptcy proceeding; Nassau County, New York recover from significant financial distress; and the City of Gary, Indiana restructure its expenditures and revenues, just to name a few places.

Here in Pennsylvania, our team serves as the appointed Act 47 Coordinator for the cities of Pittsburgh, New Castle and Reading, in the first two serving together with Jim Roberts from Eckert Seamans, who is on your next panel this morning. We have also prepared multiyear financial plans under the Commonwealth's Early Intervention Program for the cities of York, Allentown, Easton, Wilkes-Barre, and for Luzerne County.

Approaches to Municipal Distress in Other States

As detailed in the white paper that is an appendix to our testimony, we have developed and/or implemented various approaches to municipal financial recovery in the states of Pennsylvania, New York, Georgia, Florida, Indiana, California and Massachusetts. We have also worked with financially challenged school districts under oversight in Michigan and Pennsylvania.

States throughout the country approach municipal fiscal distress in various ways and with different levels of intervention. In general, these approaches to state-administered municipal financial recovery can be described as monitoring, assistance, oversight, or control. Some states blend these approaches based on the severity of the financial crisis, while others will take a municipality through a series of steps from monitoring to control.

For example, the State of Georgia monitors municipal fiscal distress.

If local government financial statements do not comply with generally accepted accounting principles the government is required by the Georgia Department of Community Affairs to submit audited financial reports to the State Auditor. State agencies are prohibited from transmitting grant funds to a local government that fails to submit an audit within the previous five year period. Georgia does not provide financial assistance to distressed municipalities and it prohibits municipalities from filing for Chapter 9 bankruptcy. According to the statute, if a local government faces insurmountable financial problems, the municipality may be dissolved and its assets and related liabilities will be transferred to the county.

In comparison, the State of Ohio takes a more active approach.

The State Auditor's Office monitors local governments by providing them with ratio indicators to benchmark financial performance and identify fiscal strain. Ohio identifies three levels of fiscal distress: Caution, Watch and Emergency. Under Fiscal Caution, the State Auditor identifies conditions in a local government's finances that could lead to more serious problems if not addressed. The Governor can request that a municipality be placed under a Fiscal Watch if a deficit exceeds two percent of revenue or forecasted expenditures will exceed forecasted general fund revenue by eight percent. A municipality under Fiscal Watch will receive state technical support to resolve their financial issues.

If revenues exceed expenditures by more than 16 percent, a Fiscal Emergency may be declared. A municipal Fiscal Emergency triggers a Financial Planning and Supervision Commission to develop a multi-year financial plan to resolve the municipality's fiscal distress. The Commission will make recommendations to improve the local government's accounting and financial reporting, and the governing body will submit a plan to the Commission on how it will implement the changes. There are currently 24 Ohio municipalities under the supervision of a Financial Planning and Supervision Commission.

The State of Florida approaches local government distress by installing an oversight board.

The board is triggered when the local government fails to pay debts, transfer taxes withheld on the income of employees, make payroll, or proves unable to resolve operating deficits. Once constituted, the Board has broad authority over municipal fiscal affairs including budgetary and debt approval, and the power to review operations and management. In addition, the Board has some ability to limit the financial impact of employee collective bargaining agreements. If needed the board may recommend that the local government file for Chapter 9 bankruptcy.

For example, an Oversight Board was established for the City of Miami in the 1990s. The Board was authorized to remain in existence for three years after the City produced two successive years of balanced operations and proved that it no longer met any of the financial emergency conditions. The Oversight Board had a substantial amount of control over the City's budget, including the power to prohibit the City from spending any funds which were not authorized by the Oversight Board, except if needed to pay debt service. However, the Board had limited control over collective bargaining agreements. While it could disapprove of agreements that were inconsistent with the multi-year financial plan, the Board could not nullify a non-compliant labor agreement.

The State of Massachusetts approaches municipal fiscal distress by installing a Control Board, similar to the Management Board structure under Senate Bill 1151 here in Pennsylvania.

In Massachusetts, the Board will assume the authority of the Mayor and Council over the government in exchange for State backing of new debt issued on behalf of the City. The Board's mission is to initiate and assure the implementation of appropriate measures to secure the financial stability of the city. The Board's powers include the ability to:

- Institute budget guidelines and procedures for all departments;
- Appoint, remove, supervise and control all city employees and set the terms and conditions of employment held by other employees or officers of the city;
- Replace binding arbitration with voluntary mediation for future labor contracts;
- Review and approve or disapprove all proposed contracts for goods and services;
- Raise or reduce any fee, rate, or charge, for any city service, license, permit or other activity;
- Reorganize, consolidate or abolish departments, commissions, boards, offices or functions of the city, and to establish such new departments, commissions, boards, offices or functions as it deems necessary.

The State of Michigan has a similar approach using a single overseer. Before the passage of Act 4 in 2011, Michigan used appointed Emergency Financial Managers (EFMs) with broad powers to rectify the local government's financial emergency. Those powers included the authority to amend, revise, approve or disapprove the municipal budget; assume and exercise the authority of the local pension board; authorize borrowing; and sell assets to pay the municipality's outstanding obligations. With the enactment of Act 4 this year, the state granted the new emergency managers the power to modify or terminate collective bargaining agreements.

A number of states such as North Carolina, New York, Connecticut, Illinois, Indiana and New Jersey blend or use parts of these various approaches.

Drivers of Municipal Financial Distress

In our national and local experience with municipal financial recovery programs, we have seen consistent drivers of fiscal distress for local governments throughout the country and here in Pennsylvania. While there are obviously individual variations, several major themes are regularly found across many states.

Capacity

There are several major underlying issues of distress that members of the four Committees have undoubtedly encountered. I will discuss all of these in my testimony, but I want to begin by highlighting something we discuss less frequently – capacity. Local governments in

Pennsylvania and throughout the country have extremely limited resources to deal with daunting financial and organizational challenges. The combination of the relatively small size of many local governments, the focus on core public safety and public works services, and an overlap of increasing expectations for local government reporting and documentation at a time of diminishing resources means that many local governments simply don't have sufficient qualified personnel to address the myriad challenges that come with financial distress. In fact, the spiral toward financial crisis often includes the departure of experienced municipal employees through downsizing, retirement and simple employment stress.

Many local governments operate with a minimal number of personnel in the critical areas of finance and operations management. The majority of labor expenses are for frontline employees such as police, fire, emergency medical services, street repair, and traffic maintenance. Therefore, many critical back office services such as budgeting, accounting, finance, asset maintenance and management, and general operations are put on the desks of the same small set of employees. The demanding workload and comparatively low compensation for professionals limit the scope of the labor force that is attracted to these positions. Moreover, the resources and time needed to send managers to routine and specialized training are often the first things to disappear as financial conditions deteriorate. Finally, as an aging state, recruiting and retaining young, talented Pennsylvanians to be the next generation of local government managers is a challenge in this environment.

During a period of fiscal distress, senior employees are often called on to be subject matter experts – especially in the financial realm – but also to serve as in-house management consultants who analyze structural alternatives, prepare and assess the responses to competitive contracting or outsourcing initiatives, and help implement radical revisions to tax collection, operations and personnel procedures, all while running the government on a day-to-day basis. A surprising amount of time is consumed reviewing proposals for assistance that arrive from every corner, ranging from debt ideas to offers to buy local assets.

In its role as Act 47 Coordinator, PFM has had some success in recruiting in-house financial professionals to improve financial management, bookkeeping and reporting, and we have learned as overseers to consistently focus on a manageable number of prioritized changes to avoid overwhelming in-house resources. DCED has also provided technical assistance through its peer-to-peer program to help local government managers evaluate operations and programs, though these assignments are usually temporary and focused on a specific area like police operations or information technology systems implementation.

In summary, based on our experience in Pennsylvania and throughout the country, local governments frequently lack the capacity to manage their way out of a fiscal crisis.

Diverse Local Government

The challenges posed by limited capacity are compounded by the sheer number of local government entities in this state. In Pennsylvania as in many states with changing demographics, local governments are struggling to right-size infrastructure and services for the current demands of new, different population. Many cities and boroughs in Pennsylvania have far fewer residents than their municipal infrastructure was built to serve. For example, in 1950 the City of Reading was home to approximately 110,000 people, but it currently has 88,000; the City of Pittsburgh's population was once more than twice the most recent census estimate of about 306,000. These cities were built to serve populations they no longer have, and the infrastructure and inefficiency costs their local governments. The problem is exacerbated by significant and important commuter populations which require service, too; the difficulty of downsizing geographically-based infrastructure and services ranging from drinking water to fire protection; and reverses to this trend – Reading's population grew by 12.4 percent since 1990.

This body reconstituted the State Planning Board under Act 42 of 1989, and the Board has subsequently done extensive work on behalf of the legislature to research and articulate the need for right-sizing local government. Right-sizing local government could mean establishing regional agencies, or giving municipalities incentives to contract with each other or the county for services. This approach can be unfamiliar in a strong local autonomy state like Pennsylvania, but it is widely used elsewhere. You'll find regional or consolidated fire departments in Washington, Nevada, Kansas and California and consolidated or county police departments in Nevada, Indiana and Maryland.

There has been some movement toward these structures in York, Berks, Pike and Lancaster counties, and the Commonwealth has also made progress in this area. A number of counties have regional police departments serving multiple communities. The City of Pittsburgh has taken over fire service for adjacent Wilkinsburg, and the City of Reading polices nearby Kenhorst. The Commonwealth has helped by consolidating 911 and offering facilitation and support for joint working and collaboration initiatives. The creation of school district intermediate units in Pennsylvania several decades ago instituted a form of shared services in the local education sector. Given the significant and understandable organizational and financial barriers to local government merger, alternative approaches to shared services may be the initial focus.

In summary, local governments throughout Pennsylvania and other similar states must continue to restructure service delivery with an eye toward joint working, shared services and regionalization where appropriate.

Workforce

Managerial and operational capacity and fragmented government are critical issues. However, the day-to-day driver of local government finance is the cost of providing basic services ranging from public safety to sanitation. For most local governments in the Commonwealth, employee wages and benefits make up most of this cost, with two-thirds to as much as four-fifths of a municipality's expenditures dedicated to salaries, overtime, health care benefits, pension and other workforce costs.

In Pennsylvania and throughout the country, the continuously rising cost of health care, pensions and other post-employment benefits threaten local government budgets. Benefits typically grow faster than the major local government revenue sources, creating a mismatch that is unsustainable in the long run. In its most recent report on state and local government finances the federal General Accountability Office draws specific attention to the negative impact of employee health care and retiree cost growth that exceeds the expansion rate of the larger economy.

This is not a new trend. According to the US Census Bureau's 2010 survey of state and local government employee retirement systems, benefit payments by state and local retirement systems increased nationally by 263 percent from 1993 to 2008, while the combined employer and employee contributions to replenish these systems increased by only 133 percent in the same time period. As baby boomers begin to retire the gap between pension benefit payments and pension fund contributions will continue to expand, increasing costs to local governments. According to the Kaiser Survey of Employer-Sponsored Health Benefits, from 2001 to 2011 the cost of health insurance premiums nationally increased more than three times faster than consumer prices.

In Pennsylvania, a task force co-chaired by Senator Orie and Representative Frankel in conjunction with the Institute of Politics at the University of Pittsburgh produced a 2009 report on the municipal pension crisis that found that municipal pension plans are significantly underfunded. The report identified pension underfunding as a long-term risk to municipalities' ability to provide primary services to taxpayers.

Other post-employment benefits, known colloquially as OPEB, are retiree benefits other than pensions. OPEB generally takes the form of health insurance and dental, vision, prescription, or other health care benefits provided to eligible retirees, including in some cases their beneficiaries. OPEB liabilities may also include some types of life insurance, legal services, and other benefits.

In September of 2011, Standard & Poor's reported that states had unfunded other post employment benefits total $545 billion in 2010. Based on 2009 CAFRs, local governments in Pennsylvania have over $11 billion in unfunded OPEB liabilities. Although OPEB may not have the same legal standing as retirement pensions, the Governmental Accounting Standards Board, or GASB, has taken the position that pension benefits and OPEB are a part of the compensation that employees earn each year, even though these benefits are not received until after employment has ended. Therefore, the cost of these future benefits is a part of the cost of providing public services today. Like pensions, OPEB liabilities are additional burdens on local government budgets today and into the future, and are now being shown more clearly on local government financial statements.

Salaries face similar challenges. While there are competing studies, it is clear that at the senior managerial levels recruitment and retention are difficult due to the gap between public sector salaries and private sector opportunities. EMTs and paramedics can often find more agreeable schedules at competitive compensation levels with private ambulance services. For police officers, the relative salaries offered by urban and suburban jurisdictions have been raised as an issue, and the structure of uniformed collective bargaining limits a local government's ability to control total compensation.

In summary, in most cases nationally, OPEB, health care, pensions and salaries are growing at a rate faster than local government revenue sources.

Limited Revenue Options

The primary sources of local revenue for municipalities in Pennsylvania are property, earned income and business taxes. In certain cases other taxes are temporary or permanent major sources of revenue, including the Local Services Tax, real estate transfer tax, and the sales tax.

However, the current economic climate and housing crisis of the past three years has highlighted the strengths and weaknesses of these revenue sources for local governments. Property taxes have been a traditional source of stability in the municipal revenue budget; in fact, concerns historically focused on the lack of growth in such a major revenue, especially given sporadic county reassessments, and pressure on homeowners due to competition for the revenue source given its use by municipalities, school districts and counties. Now, however, declining valuation and appeals by homeowners and businesses have threatened this core revenue when it is needed most. Likewise, the earned income tax had been a fairly reliable source of modest growth, with wage increases over time offsetting periodic drops due to the employment cycle. In the last few years, though, wages have stagnated and in most cases local employment has dropped. This has eroded a significant support for local governments. Even Act 32 of 2008, which will provide positive benefits as county-wide collections are implemented, will have some growing pains as collectors absorb complicated new urban taxpayers.

An effective revenue support system for local governments will provide a variety of tax and fee options to provide revenue diversity beyond property and income taxes; will include a mix of revenues with growth potential like wage and income-based alternatives balanced by core revenues like the property tax to provide a reliable base; and account for the dynamics of potentially lucrative but highly cyclical taxes like the real estate transfer tax and even the sales tax. Finally, it is important to match the revenue menu with the real expenditure need: a panoply of small levies like the per capita tax, hotel tax, rental car fees, or a drink tax may be part of a solution but are not robust enough to rely on alone for basic long-term revenue consistency.

In summary, revenue options are needed to match the growth rate of expenditures for services we wish municipalities to provide.

Alternatives for Assisting Distressed Municipalities in Pennsylvania

Lack of capacity, obstacles to right-sizing local government services, and a workforce cost structure that is not aligned with revenue options are key factors that drive municipalities toward fiscal distress throughout the country and in Pennsylvania. In this state, the Early Intervention Program has provided numerous governments with the forecasting, planning and implementation resources to avoid more serious distress. For those that do receive a distress designation, Act 47 provides additional important tools to return local governments to financial stability. However, the number of governments that continue to struggle even after completing an EIP, and the small number of local governments that have transitioned out of Act 47 highlight the challenges posed by the underlying structural factors facing them.

As you review Act 47, based on our national experience with similar programs in other states we suggest that you consider alternatives to make state oversight stronger, providing more help sooner. Faster, earlier, more comprehensive intervention with stronger terms may allow oversight to be more effective and shorter in duration. More powerful, but more temporary oversight could be combined with various structural revenue and service options to make local government in Pennsylvania more viable and sustainable.

The options that follow may not appeal to all of us, but they are noted here because of their use in other comparable states as described in the white paper included as an appendix to my testimony. They provide a tangible set of concepts based on what other states have done and show what they might mean for Pennsylvania. Members of the Committees will note that these ideas run the gamut from expansion of the Commonwealth's current collaboration model to more "hard control" approaches. The common thread through these options is additional monitoring, rapid and more aggressive intervention, the involvement of additional levels of government, and greater authority to make institutional changes to local governance.

An initial step used in other states would involve providing the DCED with greater resources to improve the quality of financial data it receives from local governments and counties, to analyze that data, and to require local governments failing tests of financial health to file corrective action plans. A more expansive version of this idea might require local elected officials to formally agree to the corrective plan; set up a joint internal-external panel to monitor compliance; and provide resources for remedial action. Members will see in the white paper that several states take some form of this approach, including Ohio, North Carolina, New Jersey, and Georgia. Different aspects of this concept could be integrated with the existing Municipal Statistics Program and the Early Intervention Plan concept; for example, DCED already asks local Councils to formally adopt remedial plans developed as part of EIPs.

Once local governments are under oversight, another option would be to provide a Coordinator under Act 47 with additional powers to implement changes. Rather than the current approach of developing a plan that the municipality must adopt and then providing limited implementation tools, the Commonwealth could grant the Coordinator, a new oversight body, or the DCED greater power to implement an approved plan. The broad powers granted to the oversight or control boards in Florida, Massachusetts, and Connecticut and New York and the successful termination of state oversight in many of these cases highlights the institutional change that may be accomplished in relatively short period time. Such changes, which would certainly require detailed scrutiny by these Committees and all stakeholders, might include steps taken in other states to modify the collective bargaining process, review and approve budgets and major contracts, and restructure departments and services.

For centuries Pennsylvania has valued local autonomy. The benefits of this approach are well known. However, the self-determination and self-reliance which characterize this state's philosophical approach are challenged by a global economy that rewards the largest, most nimble and dynamic political entities, and the reality of numerous poor, economically-challenged communities even in some of the wealthiest Pennsylvania counties. Many of the most resilient and successful states in the nation have established county government as the primary service provider. Pennsylvania is not likely to move to a more county-based government like near neighbors Virginia or Maryland. However, in recent decades local governments and you and your colleagues here in Harrisburg have recognized the importance of a more substantial role for counties.

For example, the legislature has recognized an expanding role for counties in service delivery. The Public Safety Emergency Telephone, Act 78 of 1990, vested with the counties the statutory authority to create 911 dispatch services; Act 32 of 2008 raised earned income tax collection to the county level; Act 105 of 2010 provided matching funds for counties administering affordable housing programs. Counties have also played important roles in promoting regional police and fire services and studies in York, Berks, Pike, and Lancaster counties to name a few.

There are numerous ways that the state could empower counties to directly assist local governments, ranging from funding studies and selected consolidation costs for regional public safety services to requiring all police detective services to be provided at the county level and providing transition funding. The state could also encourage regional recreation services in lieu of local programs, or ban charges or charge backs for county 911 services while making counties whole by providing full state operating funding through landline and mobile phone fees.

In turn, County governments often express frustration with the decisions taken by distressed communities, which are not infrequently their county seat. Defining a more formal role for counties in assisting distressed municipalities – even something as simple as the designation of a specific ongoing, engaged liaison from the County Commission or senior executive corps – would be beneficial. In certain cases, seconded or loaned County executive programs would be highly beneficial to distressed municipalities and would give the County insight for ongoing support and collaboration. The involvement of County officials in various forms of oversight is a characteristic of programs in North Carolina and Indiana.

Regional cooperation can take other forms as well. As previously discussed, regional service delivery can reduce expenditures for each participating municipality, and the overall costs for the delivery of service. This is not a new model for this state – there are 39 regional police departments in Pennsylvania, over a hundred regional authorities for water and sewer service, and a number of regional planning commissions. There are numerous ways the state can provide incentives for shared services such as residential property tax credits to municipalities that collaborate, transitional aid for police or fire operational or employee benefit consolidation, or priority matching funds to groups of municipalities that take substantial strides toward shared-services such as study commission.

The state can take a more active role as well. One alternative is to provide a statewide health plan alternative for local governments that would provide economies of scale similar to those achieved by the Pennsylvania Employees Benefit Trust Fund. Several years ago, in response to a request from Pittsburgh for a regional public sector health consortium to create larger employee pools to improve rates, the PEBTF spent months researching the potential creation of a legally-separate municipal pool affiliate. The Commonwealth chose not to pursue the idea at that time, but there may be a very useful role for the state to help create optional regional health benefits funds even they are not administered them directly through PEBTF.

Many Members have seen or made suggestions to sell local government assets in order to fund legacy cost like OPEB, pensions, workers' compensation and long-term debt. In many cases, local governments do have assets – ranging from golf courses to parking garages – that may involve businesses that local governments do not run particularly well. As you will see in the white paper, some states do include this as an oversight option. To the extent the Committees see this approach as desirable I encourage you to insist that the local bodies receive financial and structural advice from qualified professionals, as distressed governments rarely have the capacity and expertise to manage such transactions. We also suggest that any proceeds from long-term asset transfers be matched to solve long-term liability problems, so that asset sale proceeds are not merely used to patch over recurring structural operating budget gaps.

Thank you for the opportunity to talk to you about this important public policy issue and to discuss what other states are doing. As noted, we have developed a whitepaper on municipal financial recovery programs throughout the country that outlines many of the topics I briefly discussed, provided that paper to each of the Committee Chairs, and would be happy to provide the members of this committee with copies upon request or you can download it from our website at www.pfm.com.

I will be happy to answer your questions.