

Stateline Midwest

Vol. 22, No. 10 • October 2013

THE MIDWESTERN OFFICE OF THE COUNCIL OF STATE GOVERNMENTS

After Detroit's filing ...

Bankruptcy case a reminder of states' role in local governments, from debt limitations to financial aid and supervision

by Tim Anderson (tanderson@csg.org)

When his hometown of Detroit filed for bankruptcy this summer, Michigan Rep. David Nathan had two reactions. One, it was unfortunate. Two, it had to be done.

"My perspective is that it can help our citizens who have been sticking it out here, through thick and thin," Nathan says.

From the trash that is no longer picked up in a timely manner to the slow response times of police and fire departments, Nathan says, city services have deteriorated to unacceptable levels.

"It is all related to a financial situation that the city is in," Nathan says, "and it didn't look like the creditors were going to help unless they were forced to."

Detroit's bankruptcy filing was a milestone in the 79-year history of Chapter 9. Municipal filings have been rare and, for the most part, inconsequential because they have involved small taxing bodies.

Some states, in fact, do not even authorize municipal bankruptcies in statute and, in the case of Iowa, prohibit them (see map).

In the Midwest, not a single municipal bankruptcy filing occurred between 1980 and 2011 in seven states (see map on page 6). And only Nebraska had a large number of filings during that period (55, most in the nation), but those all involved specially designated sanitary and sewer tax districts.

Detroit's case is much different — and consequential.

"The tradition has been that any city of size viewed Chapter 9 as an option to be avoided at all costs, because the city did not want to interfere with its ability to borrow and access markets at a low interest rate," says James Spiotto, a partner with the firm Chapman and Cutler LLP and a leading national expert on bankruptcy law.

He believes the stigma and negative consequences of bankruptcy will keep municipalities from viewing Chapter 9 as anything but a "last, last resort."

Spiotto adds that bankruptcy is a messy process; in Detroit, there will be a fight

between workers, retirees, creditors and public officials over "a piece of a pie that isn't much to begin with." That process, Spiotto says, keeps the parties involved from focusing on the most important goal — finding a path to long-term economic recovery and fiscal health.

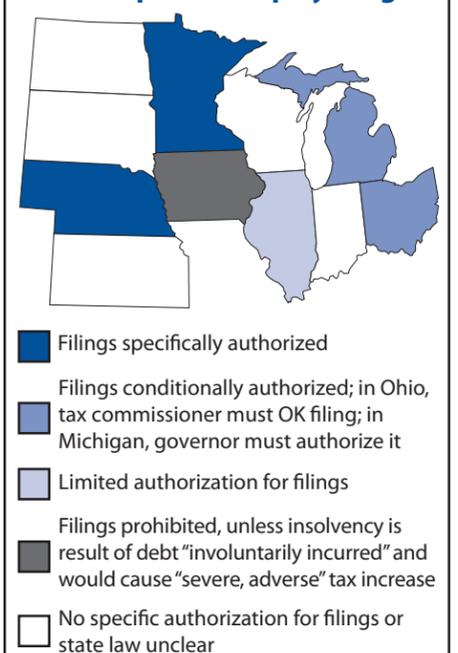
"You can adjust the debt without solving the systematic problems, and then you just repeat the problems," he warns.

Nathan says a long list of factors led Detroit down the road to bankruptcy, and he includes policy decisions made by the state in that list.

In the late 1990s, for example, the city agreed to reduce income tax rates in exchange for more revenue-sharing dollars from the state. But subsequent crises in Michigan's fiscal conditions meant those dollars never came in at expected levels.

"Detroit was counting on that revenue

State laws in the Midwest on municipal bankruptcy filings



▶ PLEASE TURN TO PAGE 6

State aid, intervention plans for local governments in Midwest

State	Law or program	Details
Illinois	Financially Distressed City	Distressed city may receive financial assistance from state to provide basic services and to meet credit obligations; city's finances overseen by state authority
Illinois	Local Government Financial Planning and Supervision Act	For public entity in "fiscal emergency," state commission intervenes with authority to change local budgeting and debt issuance; commission does not have power to change labor agreements
Indiana	Distressed Unit Appeals Board	If petitioned by a financially distressed political subdivision, a state board creates a financial plan and employs an emergency manager with power to cut spending (including renegotiating labor contracts) but not raise taxes
Michigan	Local Financial Stability and Choice Act	State review team and governor decide if financial emergency exists; if it does, local government has one of four options: 1) consent agreement to address financial distress, 2) appointment of emergency manager with broad powers, 3) neutral evaluation process involving negotiations between local government, its creditors and other interested parties or 4) Chapter 9 bankruptcy
Minnesota	City & County and School District Credit Enhancement Program	To help public entities reduce borrowing costs, state provides limited bond guarantees, agreeing to make bond payments if local entity cannot and if money is available in state general fund
Ohio	Fiscal Caution/Watch/Emergency	Ohio auditor identifies problematic budgetary practices/conditions, provides early warnings to public entities approaching fiscal emergency; state commission oversees entities in fiscal emergency
Wisconsin	Deficiency Protection for Public Improvement Bonds	Provides broader statutory powers for local governments to levy taxes in order to pay debt service on public improvement bonds

Sources: "Municipalities in Distress: How States and Investors Deal with Local Government Financial Emergencies" and CSG Midwest research

INSIDE

CSG Midwest Issue Briefs 2

- 'Work share' bills aim to reduce unemployment
- Strategies to prevent Medicaid fraud, abuse
- Minnesota nixes high school graduation exam
- Kansas' future hinges on fixing water scarcity

Around the Region 4

Trends in Midwest's income levels, poverty rates; changes in food policies for the poor

Question of the Month 5

How do Midwestern states encourage doctors to volunteer their time and services?

First in the Midwest 5

A look back at Minnesota's groundbreaking charter school law, and its continued legacy

Profile 8

Illinois House Assistant Majority Leader Elaine Nekritz

FirstPerson 9

South Dakota Gov. Dennis Daugaard on his state's path to criminal justice reform

CSG News & Events 10

Justice Center continues work in Midwest; legislators travel to Canada's oil sands

Capitol Clips 12

- States look to improve early reading results
- Illinois bans teens from tan-bed facilities
- Michigan eyes more mental health courts
- E15 fuel now offered in most Midwest states

Stateline Midwest is published 12 times a year by the **Midwestern Office of The Council of State Governments.**

Annual subscription rate: \$60.
To order, call 630.925.1922.



CSG Midwestern Office Staff

Michael H. McCabe, *Director*
 Tim Anderson, *Publications Manager*
 Cindy Calo Andrews, *Assistant Director*
 Ilene K. Grossman, *Assistant Director*
 Lisa R. Janairo, *Senior Policy Analyst*
 Laura Kliewer, *Senior Policy Analyst*
 Gail Meyer, *Office Manager*
 Laura A. Tomaka, *Senior Program Manager*
 Kathryn Tormey, *Policy Analyst/Assistant Editor*
 Kathy Treland, *Administrative Coordinator and Meeting Planner*

▶ CONTINUED FROM PAGE 1

Legislators re-examine state laws that aid, supervise distressed local governments

to help pay the debt and provide its services,” Nathan says.

Evolution of state policies continues

In fact, one reason for today’s heightened concerns about municipal bankruptcy is tight state budget conditions. States are an important source of revenue for local governments, and either because of fiscal choice or necessity, cuts have been made in recent years.

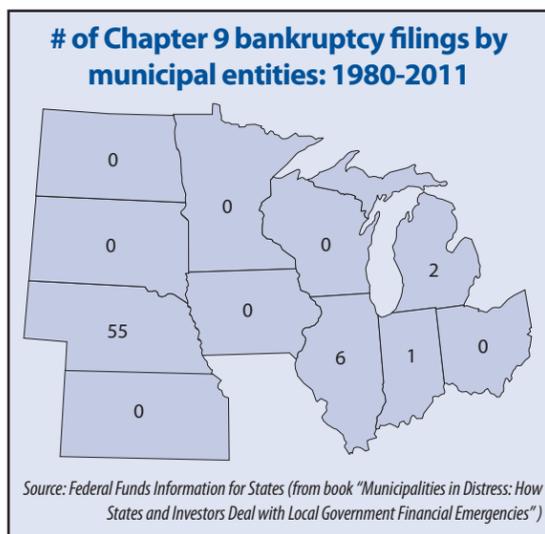
Ohio Rep. Lou Terhar points to recent reductions in local government funding as one cause of difficult financial conditions for some of his state’s political subdivisions. He also cites the impact of the recent recession, elimination of Ohio’s estate tax and “questionable financial decisions made at the local government level.”



Michigan Rep. David Nathan

Partly in response to Detroit’s bankruptcy, and his subsequent research into the financial health of Ohio’s local governments, Terhar crafted legislation — set to be ready for General Assembly consideration in the fall — that places new fiscal restraints on the state’s political subdivisions. The measure would require jurisdictions to maintain balanced budgets, adhere to stricter debt limits and meet new standards for funding locally administered pension systems.

“Municipal bankruptcies hurt not only the political entity going through bankruptcy and its local residents,” Terhar said in a statement announcing



the new legislation, “they also negatively affect the economic health of the region.”

As Spiotto notes, too, the financial credibility of local governments — and their ability to access low interest rates in capital markets — “is at the heart of our system of federalism.”

“It’s essential to allowing decisions to be made locally on what local officials believe is right,” he says. “Imagine if you had to go to the federal government and ask permission to build a road or school. Our infrastructure would be in the dark ages.”

States have long recognized the vested interest they have in maintaining the financial stability and health of their political subdivisions.

One traditional policy approach has been to set debt limits on municipal entities — either a set monetary amount or, more common in the Midwest, a percentage of assessed property values in the local

taxing body. As the page 7 map shows, every state in the region has statutory or constitutional debt limits.

The efficacy of these state laws can be limited, however. Michigan, for example, sets a debt limit of 10 percent for its cities, but as a recent *Wall Street Journal* article points out, exceptions to the law allowed Detroit to accumulate a “mountain of debt,” with the city spending more than 40 percent of its revenue on borrowing costs and retirement benefits.

When push comes to shove, too, states might not see any other choice than to raise the debt limit. In recent years (including with passage of HB 2420 in 2012), Kansas lawmakers have established a higher debt limit for the town of Junction City because of concerns that the local government would otherwise not be able to pay its bills.

Beyond debt limits, Spiotto says, many states have been taking a more hands-on approach to local governments in financial distress — and even those simply at risk of falling into distress.

“The earlier states can detect potential problems and start to help, the better off they are and the more constructive their help can be,” he notes.

Two years ago in Ohio, lawmakers passed HB 153, which includes a “fiscal caution” provision that gives the state auditor authority to provide technical assistance to a local entity found with problematic fiscal practices and budgetary conditions.

This recently enacted legislation added a third layer to Ohio’s plan for dealing with local governments in distress. After “fiscal caution” comes “fiscal watch,” when jurisdictions are required to come up with a financial plan reviewed and approved by the auditor.

Bankruptcy option not available for states, which say they don’t want or need it

For local governments, the filing of Chapter 9 bankruptcy remains an option of “last resort.” For states, it is not an option at all — and that seems to be exactly how leaders in state government want to keep it.

The idea of giving state governments a path to declare bankruptcy last gained some momentum in 2011, and even became the subject of a U.S. House Judiciary Committee hearing. The hearing was held at a time of immense budget difficulty for states and after a crash of the nation’s financial markets had heightened concerns about the long-term solvency of public pension systems.

Any attempt to extend bankruptcy protection to states would have to overcome multiple political and legal hurdles, including whether it would be allowed at all under the Contracts Clause of the U.S. Constitution.

Since that congressional hearing, talk of state bankruptcy has quieted down; at the time, state leaders made it clear to the U.S. Congress that they could find solutions to their fiscal problems without federal intervention. And in a Jan. 21, 2011, article that appeared in the *The Huffington Post*, CSG Executive Director David Adkins wrote that states already were moving ahead with innovative solutions to address their short- and long-term fiscal challenges.

In the Midwest, most states over the past few years have adopted cost-cutting measures to shore up their retirement systems for public employees: for example, raising contribution rates, lengthening vesting periods, raising the retirement age, reducing cost-of-living increases, capping benefits and changing how a worker’s “final average salary” is calculated.

In Illinois — the state with the worst-funded pension system (see table) — lawmakers continue to seek a legislative solution that would improve the system’s fiscal health and sustain a constitutional challenge in state courts. As of late September, Illinois lawmakers expected to once again take up pension reform during the legislature’s fall veto session.

Could a public retirement fund itself file for bankruptcy?

That question was addressed in a court case last year involving the Northern Mariana Islands, a commonwealth of the United States. (Commonwealths, like states, cannot file for bankruptcy.) A U.S. bankruptcy judge ruled that the commonwealth’s retirement system was not eligible for Chapter 11 bankruptcy because it was “a governmental unit.”

Financial state of public pension systems in Midwest		
State	% of pension liability funded ¹	Details on funding ratio/retirement systems
Illinois	40.4%	Ratio of five state-funded retirement systems
Indiana	76.6%	Ratio of Indiana Public Employees Retirement Fund
Iowa	79.9%	Ratio of Iowa Public Employees Retirement System
Kansas	59.9%	Ratio of Kansas Public Employees Retirement System
Michigan	64.8%	Combined ratio of 2 largest systems for school and state employees
Minnesota	76.8%	Combined ratio of 2 largest systems for state and local employees
Nebraska	78.2%	Combined ratio of 5 state-administered systems
North Dakota	62.8%	Combined ratio of 2 largest systems for public employees and educators
Ohio	65.5%	Combined ratio of 2 largest systems for public employees and teachers
South Dakota	92.6%	Ratio of South Dakota Retirement System
Wisconsin	99.9%	Ratio of Wisconsin Retirement System

¹ Percentage/ratio is based on the difference in the pension system’s assets and liabilities

Sources: Ballotpedia and latest state Comprehensive Annual Financial Reports

The last layer is “financial emergency,” when a local entity is overseen by a state financial planning and supervision commission. There currently are 24 local governments in fiscal emergency.

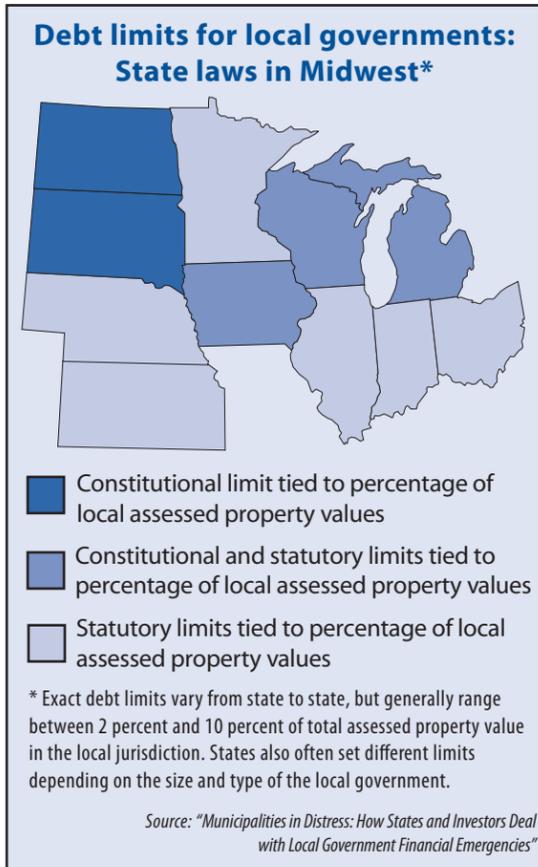
Like Ohio, other states in the Midwest have plans to manage or oversee financially strapped municipalities (see table on page 1). In Illinois, state legislators two decades ago passed a law to help the town of East St. Louis. The city gets special state assistance in the form of loans and state bonding authority, while a five-member state board oversees the city’s finances.

Illinois also has a separate statute for towns in “fiscal emergency”; its provisions include intervention by a state commission to change local budgeting and debt issuance.

In 2012, Indiana lawmakers added a provision to its law establishing the position of a state-appointed emergency financial manager to oversee the finances of a local government in distress. Under HB 1192, this emergency manager cannot raise taxes, but he or she does have the power to cut spending, including through a renegotiation of labor contracts. (In contrast, the Illinois commission does not have the power to change existing labor agreements.)

Michigan’s 2011 change in its law became the subject of a statewide vote in 2012, in large part because of the broad powers granted to a state-appointed emergency manager (including the power to redo labor contracts). Michigan residents voted to repeal that law. The next month, the Legislature passed a new law (SB 865) that took effect earlier this year.

Under the statute now in place, a state review team and the governor decide if a financial emergency



exists in a local unit of government. If such an emergency is determined, the local government is given one of four alternatives:

- enter into a consent agreement that addresses the emergency;
- have a state-appointed emergency financial manager act in place of the local governing body;
- agree to move forward with a “neutral evaluation process” involving negotiations between

local government officials, creditors and other interested parties; or

- file for Chapter 9 bankruptcy.

Spiotto says the most effective state laws and programs find the right middle ground between adequate state oversight and local autonomy. On the issue of debt limits, for example, limits that are too high are useless, while those that are too restrictive can impede local control.

State intervention into local financial affairs works best, he adds, with buy-in from the community and its elected leaders.

“They don’t want someone coming in who doesn’t know the neighborhood, so to speak,” Spiotto says. “They want somebody to give them the technical advice, and then they can make the policy decision.”

For state legislatures, he has proposed creation of a Municipal Protection Commission to deal with financial emergencies in local government. This independent state commission would start by offering recommendations on how to resolve a fiscal emergency. The recommendations would be voluntary and based on input from financial experts, local leaders, creditors, workers and other affected parties. If that first step didn’t work, the commission would then have the power to adopt a financial recovery plan, which could include a “pre-packaged” Chapter 9 plan.

“This recent economic downturn helped crystallize the necessity of dealing with these problems early and the importance of having a recovery plan,” Spiotto says.

“It’s not only, how do you control your budget and expenditures, but how do you stimulate your tax revenues and create jobs?” ★



The Council of State Governments congratulates the outstanding state leaders from the Midwestern Region selected to participate in the

2013 Henry Toll Fellowship Class

Grant Barry Anderson

Associate Justice, Minnesota Supreme Court

Philip Boots

Indiana Senator

Philip Cavanagh

Michigan Representative

Andrew Gerlach

Cabinet Secretary, South Dakota Department of Revenue

Mary Elizabeth Gill

Judge, Franklin County Court of Common Pleas, Ohio Domestic Relations Division and Juvenile Branch

James Holden

Chief Deputy and General Counsel, Office of the Indiana State Treasurer

Scot Kelsh

North Dakota Representative

Dan Lederman

South Dakota Senate Majority Whip

Tim Mapes

Chief of Staff, Office of the Illinois Speaker

Rena Moran

Minnesota Representative

Katrina Shankland

Wisconsin Representative

Valdenia Winn

Kansas Representative

Applications for the 2014 Toll Fellows Class will be open Oct. 1, 2013– May 2, 2014. The program will run Sept. 5–10, 2014. For more information, visit the CSG National Leadership Center at www.csg.org/leadershipcenter.

