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NO 978 DECEMBER 1988

INSURING FISCAL RESPONSIBILITY IN LOCAL UNITS OF GOVERNMENT

Introduction Local home rule is a basic concept in Michigan government. Various sections of Article 7 of the 1963 state constitution specify the rights of citizens in cities, villages, and counties to adopt charters which define their preferred form of local government. There is a strong tradition of local control of local school districts. Unfortunately, home rule and local control do not guarantee preservation of the tax base, adequate record keeping, or sound fiscal management by local public officials.

Local rights inherent in the concept of home rule must be balanced with the state's critical interest in the financial condition of local units of government. This interest derives from the state's need to protect its own credit and the credit of its subdivisions, to assure the performance of contractual obligations by local units, and to assure the continuation of necessary public services.

One such critical service is public education, although with the exception of the Municipal Finance Act and the budget provisions of Act 621 of 1978, financial controls in local school districts are generally addressed by different means than those affecting other governmental units. Section 2 of Article 8 of the 1963 Michigan Constitution charges the state legislature with the maintenance and support of a system of free public elementary and secondary schools as defined by law. The school code and other statutes define the role of local school districts in implementing that system. It is unfortunate that in some instances these statutes have also not guaranteed fiscally responsible behavior by local school officials.

Significant Statutory and Constitutional Provisions Numerous statutory provisions define the state's authority to monitor the financial affairs of local units of government. The uniform budgeting and accounting act, P A 2 of 1968 as amended, contains budgeting provisions that apply to all local units of government, including local and intermediate school districts. The original act required that local units of government, defined as cities, villages, townships, and any authorities, boards, or commissions established by those governments, maintain uniform charts of accounts; file annual financial reports with the state treasurer; and obtain described financial audits at specified intervals and file them with the state treasurer. The state treasurer was empowered to examine audits and conduct investigations, and report violations to the attorney general, who could pursue criminal or civil actions.

Budget provisions added by sections 14 to 20a of P A 621 of 1978, which amended P A 2 of 1968, applied to local and intermediate school districts as well as cities, villages, townships, counties, and authorities. The amendment defines the requirements of a comprehensive budget system for these local units of government.

One of the primary purposes of the act, to prohibit deficit spending by local units of

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government, is embodied in the requirement that budgets must be balanced and that no expenditure can be made without an appropriation. Section 20 of P A 621 provides that violations of the act, such as a local official authorizing or participating in the expenditure of funds not authorized by the general appropriations act, be filed with the state treasurer and reported by the state treasurer to the attorney general, who may institute court action. Infractions by officials of local and intermediate school districts are to be reported to the state superintendent of public instruction instead of the state treasurer.

Prior to this act, statutory budget provisions applicable to most local units were confined to initiating the budget procedure (the exception was P A 359 of 1947, which requires a comprehensive budget system for charter townships). Indeed, prior to the passage of Act 621, many local units of government began their fiscal year without adopting a formal budget, and many legislative bodies never did adopt a general appropriations act.

The Municipal Finance Commission was established by P A 202 of 1943 to protect the credit of the state and its subdivisions, review requests to issue notes and bonds and conduct investigations and enforce compliance with its orders; effective July 1, 1984, those responsibilities were transferred to the Department of Treasury. The state revenue sharing act was amended in 1980 to allow for the partial withholding of state revenue sharing payments if a general purpose local government fails to file an annual financial report or audit, or fails to file and abide by a deficit reduction plan when required. A comparable provision in the state school aid act (P A 94 of 1979 as amended) directs the Michigan Department of Education to withhold state aid from a local school district that adopts or incurs a deficit, until submission and approval of an acceptable deficit reduction plan. The Local Emergency Financial Assistance Loan Board, established by P A 243 of 1980, is empowered to review the finances of those governmental units that apply for loans, and to impose specific conditions on those units.

Failure of local officials to comply with constitutional or statutory requirements could, but as a practical matter does not, result in removal from office. The state constitution provides for the removal of any elected officer of a political subdivision who is guilty of egregious behavior. Article 7, Section 33, provides for the removal of elected officers of political subdivisions ‘in the manner and for the causes provided by law.” The Michigan election law, P A 116 of 1954 as amended, Section 207, states “the governor may remove any and all county officers named in section 200 of this chapter (county clerk, county treasurer, register of deeds, prosecuting attorney, sheriff, drain commissioner, surveyor, coroner) when he shall be satisfied from sufficient evidence submitted to him, as hereinafter provided, that such officer has been guilty of official misconduct, or of willful neglect of duty, or of extortion, or habitual drunkenness, or has been convicted of being drunk, or whenever it shall appear by a certified copy of the judgment of a court of record of this state that such officer, after his election or appointment, shall have been convicted of a felony...” Other sections provide for the removal of county auditors, county road commissioners, and elected city, township, and village officers. The state school code provides for the expulsion or removal from office of a member of a first or second class school board for corrupt or willful malfeasance or misfeasance in office, or for willful neglect of the duties of the member’s office, by a vote of 2/3 of the members serving.

Constitutional and statutory limits on local units’ rates of taxation, scope of activities, and manner of doing business are designed to protect Michigan residents from the worst effects of

ill-advised local ordinances and poor management. The lack of enforcement of these preventive measures combined with continued local fiscal mismanagement, including the failure to adopt balanced budgets, to adequately fund the retirement system, and to reduce service levels to accommodate a declining tax base, resulted in court appointment of the first receiver for a city in Michigan on December 3, 1986.

While some fiscal crises in general purpose governments have been handled through local courts, others have been handled by the state. The emergency loan board is empowered to impose conditions on local governments that apply for and obtain emergency loans: that intervention is triggered by the local government's application for an emergency loan. Several separate statutory authorizations for emergency loans to local school districts provided that school districts that received emergency loans, and then failed either to balance their budgets or repay the loans, would be reorganized by the state. Both the City of Detroit and the Detroit School District, among others, have sold deficit funding bonds: the city repaid those bonds with general fund revenues enhanced by a municipal income tax rate increase; the school district levied a 2.25 mill property tax to service the debt.

THE LOCAL GOVERNMENT FISCAL RESPONSIBILITY ACT

Public Act 101 of 1988 Until the passage of Public Act 101 of 1988, Michigan state officials lacked a precise structure for intervening in the governance of those general purpose, non-school, political subdivisions that were not requesting emergency loans.

Passage of Act 101, which became effective on April 11, 1988, was the culmination of efforts begun in the 1970s to define the local financial conditions that should trigger state intervention, and the form that response should take. Those efforts were reinforced by crises in New York City and Cleveland, by unauditable books and payless paydays in Wayne County in 1979, by the 1981 Detroit deficit of $115.7 million, and by a 1981 Advisory Commission on Intergovernmental Relations Information Bulletin describing other states' statutes. Agreement was not secured until April 1988, 17 months after the debt-ridden city of Ecorse was finally placed in receivership.

The local government fiscal responsibility act applies to any city, village, township, county, authority established by law, or public utility owned by a city, village, township, or county. The act makes the state treasurer, locus of many local financial oversight functions, responsible for responding to initial requests and conditions for state involvement. The situations identified define the local financial problems which allow state intervention.

Treasurer's Preliminary Review The act defines the conditions under which the state treasurer is directed to conduct a preliminary review to determine whether a local governmental financial problem exists: written request by the governing body or chief administrative officer, or by a major creditor; petition of 10% of the electors who voted in the last election for governor; notification by the trustee, actuary, or 10% of the beneficiaries of the pension fund that pension funding is deficient; notification that employees have not been paid and that payment is at least seven days late; notice of a default in a bond payment or violation of a bond covenant; a resolution from the state senate or house of representatives; a violation under the municipal finance act, the emergency municipal loan act, the uniform budgeting and accounting act, or the state revenue sharing act; failure to provide an adequate

annual financial report or audit to the state treasurer; request by a taxing jurisdiction to which the unit is delinquent in distribution of tax revenue; or court order of an additional tax levy without prior approval of the governing body.

The preliminary review necessitates notification and meetings with the unit to obtain information; the treasurer must inform the governor within 30 days whether a serious financial problem exists.

Review Team Investigation If the state treasurer does inform the governor that one or more conditions indicate a serious financial problem exists, or if the governing body of a local unit requests assistance in meeting the ordinary needs of government, the governor must appoint a review team consisting of the state treasurer, auditor general, a nominee of the senate majority leader, a nominee of the speaker of the house of representatives, and other state officials or persons with relevant professional experience.

The review team must conduct an investigation, and may enter into a consent agreement with the local unit whereby the unit agrees to a long-range financial recovery plan requiring specific local actions. The team must report within 60 days whether one of the following conditions has occurred or will probably occur unless remedial action is taken:

(a) default on a bond or note for which there are insufficient segregated funds on hand;

(b) failure for 30 days or more to transfer withheld employee income taxes, taxes collected for another taxing authority, or retirement system contributions;

(c) failure for 30 days or more to pay compensation owed to employees or retirees;

(d) current-year accounts payable in excess of 10% of total expenditures for the year;

(e) failure to eliminate an existing fund deficit within two years

preceding the end of the fiscal year during which the review team report is received; or

(f) a projected general fund deficit exceeding 10% of budgeted general fund revenues.

The report must also adopt one of three conclusions: a serious financial problem does not exist; a serious problem does exist, but a consent agreement containing a plan to resolve the problem has been adopted; or a local government financial emergency exists.

Action by the Governor The governor has 30 days after receipt of the report and conclusion within which to determine whether there is no problem, whether the consent agreement is sufficient to resolve the problem, or whether there is an emergency. If the governor determines that there is a financial emergency, he must so notify the local unit, informing the unit of the factual findings and advising the unit that it has ten days within which to request a hearing. Following the hearing or the day on which a hearing would have occurred had one been requested, the governor must confirm or revoke his determination. If determination has been

made that an emergency exists but is being addressed by the terms of a consent agreement, and the state treasurer or review team informs the governor that the local unit is not abiding by the terms of the agreement, the governor must declare that a financial emergency exists.

Appeal The declaration of a financial emergency may be appealed by a local unit to the local circuit court or the Ingham County circuit court, but the court may set aside the determination only if it is not supported by competent, material, and substantial evidence on the whole record, or if the determination was arbitrary, capricious, or clearly an abuse or unwarranted exercise of discretion. The right of the local unit to appeal the governor's decision to the courts provides protection against politically motivated acts.

The Emergency Financial Manager If a financial emergency exists, the governor must assign responsibility to the local emergency financial assistance loan board created by Public Act 243 of 1980; that board must appoint an emergency financial manager to serve at their pleasure. That person, who must be chosen on the basis of competence, may not have been an elected or appointed official of the local unit during the last five years. The financial manager is entitled to compensation and may hire staff and secure professional assistance.

The emergency financial manager must develop and amend as necessary, a financial plan that provides for conducting the operations of the unit within estimated revenues and for payment in full of debt service and uncontested legal obligations. The financial manager is authorized to: analyze conditions leading to the financial emergency and recommend corrective measures to local officials; exercise budgetary control; require and revise as necessary a plan for liquidating outstanding debt; require and define special reports to be made by the finance officer; have access to all records and require the attendance of witnesses and the production of documents relevant to the financial condition of the unit; make, approve, or disapprove any appropriation, contract, expenditure, loan, new position, or hiring to a permanent position; review payrolls and claims before payment; renegotiate existing labor contracts, negotiate collective bargaining agreements, and approve any contract or agreement; if allowed by law or charter, consolidate departments and transfer functions, and appoint, supervise, and remove nonelected department heads; engage technical personnel; require compliance by court order; except as restricted, sell or use assets to meet obligations; apply for an emergency loan; approve or disapprove the issuance of obligations; and contract with other local units for the provision of services.

If the manager determines that no feasible plan to resolve the financial emergency in a timely manner can be adopted and implemented, the emergency financial manager must first so notify the local financial assistance loan board, then authorize the local government to file for bankruptcy under Chapter 9, Title 11 of the United States Code. Chapter 9 is available only to entities that:

(a) are municipalities;

(b) are generally authorized by state law to file;

(c) are insolvent or unable to meet their debts as they mature,

(d) desire to effect a plan to adjust their debts; and

(e) have negotiated with creditors if practicable, or believe that a creditor may attempt to obtain a transfer that is avoidable under the bankruptcy code.

Neither the financial manager nor the local financial assistance loan board may impose taxes without approval granted by a vote of the people, but a federal bankruptcy or other judge could force the local government to impose additional taxes.

Failure of an elected official to provide the information and assistance requested is defined as gross neglect of duty, to be reported by the emergency financial manager to the local emergency financial assistance loan board. After a review and hearing, the board may recommend to the governor the removal of the elected official from office.

Revocation The governor may revoke the financial emergency on the recommendation of the local emergency financial assistance loan board.

Conclusion: P A 101 Potential problems with the structure instituted in P A 101 include the emergency financial manager's role in collective bargaining, the effect on tax limitations and credit ratings of the provisions authorizing local governments to file for bankruptcy, and the political complications arising from the governor's removal of authority from locally elected officials. Furthermore, the test conditions may be challenged as arbitrary; they provide a definition for the purpose of the law, but it may be difficult to defend the use of 10% or 30 days as absolute values for determining an emergency.

Although P A 101 provides a precise structure for state intervention in the affairs of local governments under specific conditions, the state treasurer will exercise a significant degree of discretion in determining whether state intervention is necessary. Supporters of the law hope that it will deter local officials who may be tempted to pursue irresponsible fiscal practices, but the avoidance of local financial problems in the future will require a commitment by state officials to use the authority P A 101 gives them.

SCHOOL DISTRICTS

Statutes Affecting School Districts The first statutory requirement that a school district maintain a balanced budget was contained in Sec. 35a, P A 22 of 1969, which amended P A 312 of 1957, the state school aid act: "School districts receiving moneys under this act shall not adopt or operate under a deficit budget." The provision was continued in the recodified state school aid act, as Sec. 102, P A 258 of 1972.

The 1973 state aid amendments, found in P A 101 of 1973, not only required each district to adopt and maintain a balanced budget, but the amended section 102 also required each local school district to submit its adopted budget for the current fiscal year to the Department of Education before November 1. The Department of Education thus became responsible for determining if the district had adopted a balanced budget. The sanction for adopting or operating under a deficit budget was the withholding of future state aid; this sanction was retained in the two most recent recodifications of the state aid act, P A 90 of 1977 and P A 94 of 1979.

Administration of Deficit Budget Requirements The Department of Education refused to approve any district's budget if it projected a deficit based on current-year estimated revenues

and expenditures, but there were districts that incurred deficits in spite of having adopted balanced budgets. In recognition of the facts that withholding state aid to school districts that incur deficits exacerbates those districts' problems, and that eliminating a deficit may require some time, language was added to the state aid act giving any such district two years time to eliminate its deficit. In addition, the district was required to submit a deficit elimination plan to the Department of Education for its review and approval. Ultimately, there were a number of districts that did not eliminate their deficits by the end of the second year. Rather than withhold state aid, the legislature again amended the state aid act to give districts additional time to eliminate their deficits.

Currently, the law states wIf a district is not able to comply with the (deficit elimination) provisions of this section, a district shall submit to the department (of Education) a plan to eliminate its deficit. Upon approval of the plan submitted, the superintendent of public instruction may continue allotment and payment of funds under this act, extend the period of time in which a district has to eliminate its deficit, and set special conditions that the district must meet during the period of the extension." As of the end of the 1987-88 school year, no school district has had its state aid withheld.

Although withholding state aid has not occurred, the existence and administration of deficit budget provisions have provided a mechanism for the Department of Education to pressure local school officials to operate in a fiscally responsible manner. Unfavorable public attention and the threat of consolidation with neighboring districts have had some effect. In fiscal 1969 there were 76 school districts reporting deficits; the comparable number in fiscal 1987 was 16. In the recession years of the early 1980s there were a number of executive orders reducing state aid to local school districts, resulting in 55 districts, nearly 10% of the 574 then-existing districts, to report deficits in 1981. That number fell to 39 the next year.

State Intervention Beginning with the Inkster School District in 1968, eight school district deficit situations have been so severe as to require state intervention. Seven of these situations involved small school districts whose problems could be addressed through an emergency loan from the state. In each of those instances, a special statute was passed authorizing the loan and appropriating the funds for the loan. Loans were for a maximum of ten years, and interest was charged each district. Other requirements imposed included requiring balanced budgets, levying a minimum number of operating mills, meeting the loan repayment schedule, and submitting monthly financial reports to the Department of Education. The sanction for failure to meet those requirements was reorganization by the State Board of Education with one or more contiguous districts. The seven districts met the statutory requirements including repayment of the loan.

The eighth school district which required state intervention was the Detroit School District. Although the Detroit district's operating deficit in 1973 as a percent of general fund revenues was not as large as some of the seven districts that received emergency loans, the absolute dollar deficit was too large for the state to provide an emergency loan. The state provided a statutory basis for a solution to Detroit's deficit through the adoption of P A 1 and P A 2 of 1973. P A 1 authorized the district to borrow up to $75 million, issue its notes or bonds, and levy a 2.25 mill property tax for up to ten years to retire the notes. Bonds in the amount of $48 million were issued; they were retired in 1980. (The Headlee Amendment to the state constitution would prevent a similar borrowing without a vote of the people.) P A 2 authorized

the state treasurer to borrow and make cash advances of up to $30 million to any district with an operating deficit in excess of $100 per pupil. The Detroit School District issued notes, in the amount of the advance, payable to the state within 180 days with interest at 5% per annum. This latter advance was required to allow the district to continue to operate until the longer-term solution authorized by P A 1 was implemented.

The school districts of Highland Park and Romulus subsequently issued notes to eliminate operating deficits. In both cases, the electorate approved the issuance, allowing imposition of an additional property tax levy sufficient to meet annual debt service.

Conclusion: School Districts More aggressive use of statutory authority by the state Department of Education, combined with the fear of consolidation with neighboring school districts at the local level, have generally been effective in insuring the financial solvency of Michigan school districts. However, the huge Detroit School District, which has no fear of consolidation (just as it had none in 1973), has reported general fund deficits every year since deficit funding bonds were retired in 1979-80. The Detroit School District now projects a June 30, 1989 deficit of $158.2 million, based on generally accepted accounting principles, and requests for voter approval for authorization of deficit funding bonds and for a 6-mill increase in operating revenues have been denied.