The Task Force on Local Government Services and Fiscal Stability

Final Report to the Governor

May 2006

EXECUTIVE SUMMARY

Fiscally sound local governments, capable of creating safe, clean communities, are essential to a thriving Michigan economy. Despite the critical role that local government plays in attracting residents and businesses, many units of local government have already declared themselves unable to ride out the economic downturn that affected the United States in general and continues to affect Michigan in particular. Others warn that they are becoming increasingly unable to forestall their own slide into the same condition.

Governmental operations are labor intensive, and as such, the cost of providing services to residents has risen dramatically with recent increases in labor costs. Unfortunately, local governments in Michigan have become increasingly restricted as to how they raise revenues to cover these costs. Despite a long history of voter control over the levy of taxes, policy decisions have continually eroded the manner and method in which local officials can request necessary increases from voters. Additionally, many communities in Michigan have maximized their revenue generating capabilities, and are still struggling to provide the necessary services. With two Michigan cities currently in emergency financial management, and one recently coming out of emergency financial management, and dozens of others facing fiscal distress, the structure of municipal finance must be re-evaluated.

Public discourse often raises the question, “Why doesn’t the public sector operate like the private sector to gain efficiencies and lower the tax price of government to citizens?” One distinguishing characteristic between the two sectors is the ability of the private sector to select consumers and alter the demand for a service or product through market forces, advertising and marketing. The public sector does not have the luxury to choose its customers. Constitutions, enabling state statutes, court and administrative orders determine whom government serves. Often the imposed rules ignore price and capacity constraints. Unlike the private sector, which can adjust consumer demand through pricing, as well as cross-subsidizing services, government is left to accommodate new service demands within a fixed revenue stream. The demand for public or community services generally rises during a period when tax revenues are most constrained, such as during a recession, leaving governmental leaders caught between increased demand, especially for safety net programs, and declining ability to fund the services.

It is becoming increasingly evident that many local governments have experienced an increase in demand for services while revenues have not kept pace. In fact, income taxes and State Shared Revenues have fallen dramatically at the local level.

For these reasons, Governor Jennifer M. Granholm charged the Task Force on Local Government Services and Fiscal Stability to evaluate existing State statutes and policies hindering local units of government from carrying out their mission and to recommend new statutes or policies that will enable them to continue to deliver essential services in good economic times and bad.

The following summarizes the key findings and recommendations of the Task Force:

Key Findings

- Many local units of government have experienced flat or declining revenue. Revenue losses are the result of reductions in State Shared Revenue and the interaction of the Headlee Amendment and Proposal A. Fully developed and urban core cities have been the most adversely impacted.

- While revenues have been restricted, many expenditures are increasing beyond the control of local government.[1] The expenditures include, but are not limited to health care, pension liabilities and public safety costs subject to Public Act 312.

- The existing local government finance system, based on obsolete revenue foundations, is not resilient or flexible enough to withstand out-migration of taxpayers, whether due to economic downturns or availability of developable land.

- Legacy costs of post-employment benefits to retired workers threaten to overtake the majority of available new revenue of local governments.

- Local units of government deliver essential public services that entice and retain residents and businesses.

- Deferring maintenance on critical local infrastructure, such as roads, sewers, water mains and buildings, to meet ongoing increases in operating expenditures, has left many local governments with crumbling infrastructure and growing future cost liabilities.

- State policies could potentially play an important role in encouraging cooperation and helping local governments to overcome the initial hurdles of consolidation of services.

- There is a lack of sufficient relevant data to analyze the impact of economic change on various types of units of local government.

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[1] **This point is further illustrated by an MSUE/MACAO study, which estimates that Michigan's counties alone are mandated by state law to perform over $1 billion in services annually, and the state only provides approximately $550 million toward that end.**

Key Recommendations

- A permanent State supported institution is necessary to address local government issues and encourage cooperation. Included in the formal structure would be the standardization of financial reporting and collection and review of relevant comparative data.
- The General Property Tax Act can and should be amended to exempt increases in Taxable Value from Headlee millage rollback requirements following the transfer of property.
- State Legislation must encourage with incentives and mandates regional cooperation among local units of government and eliminate regulatory obstacles at the local and state level to consolidating services.
- Public Act 312 of 1969 must be reviewed to better define ability to pay and require specific, impartial actuarial cost information for pension modifications. Arbitrators must be better trained in municipal finance and legacy costs.
- Consider policy mandates to assure local governments have a long-term financial plan to adequately fund post retirement benefits. The State should adopt legislation allowing municipal bond obligations as a strategy to manage and reduce long-term liabilities.
- The State must rebuild its commitment and partnership with local government by fully funding the Revenue Sharing Act under the current statutory formula.
- The State must recognize that local government needs adequate revenue foundations for essential services in order to retain and attract business.
- The State should commission an independent evaluation of all components of government infrastructure to assure a long-term reinvestment strategy.
- The recommendations of the Final Report of the Michigan Land Use Leadership Council must be the basis of State development and growth policies.

LOCAL FUNDING OF ESSENTIAL SERVICES

Although economic decline has had severe effects at both the state and local level, State policy decisions have worsened the situation and created accelerated fiscal stress for even some of the best-managed communities in the State. A healthy fiscal balance between revenues and expenditures is necessary to the provision of local public services, without which economic development efforts will falter. While data is sparse, the experience of local leaders and available statistical analyses will demonstrate several representative cases of local governmental fiscal imbalance and stress. It must be emphasized that this local governmental fiscal imbalance is partly due to economic factors, but more importantly due to the restrictive legal structure of Michigan's public finance system, and State policy decisions that have reduced State taxes resulting in reduced financial support for local government.

Michigan has a strong historic connection to voter control of the levy of taxes at the local level. Other than taxes already authorized by the electors of the State in the Michigan Constitution of 1963 (county, general law townships and school property tax), all local taxes require approval of the local electorate. Home rule cities, all villages, special taxing districts such as community parks and district libraries, and charter townships, above 5 operating mills, must all seek voter authorization either of their general operating millage or of special millage for specific purposes.

Local units of government responding to various inquiries and surveys conducted by their representative organizations and by Michigan State University have consistently reported that they have experienced three phenomena simultaneously:

- The cost of providing essential services has risen at a rate greater than the CPI (the measure used to restrain growth in government revenues).
- Local units lack sufficient opportunity to obtain sufficient revenue from willing local electors who demand essential services.
- The State has either held constant or reduced the amount of money distributed by the State to units of local government. Since 2001, local units have received $1.5 billion less in revenue sharing payments when compared to the full amount outlined in the Michigan Constitution and state statute.

1. Increased Cost of Services

Government expenditures associated with basic and vital operations, such as public safety, have increased at levels exceeding general inflation. This problem is exacerbated by the high cost of providing health insurance and retirement benefits to employees. The largest component of local government labor costs are for police and fire protection, yet these costs are often outside of the control of local elected officials. Arbitrators appointed under provisions of Public Act 312 of 1969 determine a vast number of wages and benefits for police officers and firefighters. The arbitrator's decisions have additional roll-up costs by setting a pattern for wages and benefits of other unions and non-union employees. Government operations are labor intensive compared to the private sector, and as the cost of funding the labor force has risen, so has the price of government.

Given these trends and growing responsibilities passed down to local governments, it is not surprising to see direct expenditures by local governments have grown 46 percent during the ten-year period 1992 and 2002. Comparing the growth rates in revenues to that of expenditures during this same ten-year time period; reveals that expenditure growth has outpaced revenues by over two percent.[22] While this may seem manageable for any one individual unit, when aggregated across all local governments it signals a troubling fiscal imbalance.

There is a wide disparity in the compensation levels of various communities. Each community must assess whether the compensation paid is in line with the surrounding communities, comparable communities, and the private sector. Further exacerbating the situation is the out migration from the State's inner cities to its suburbs and rural communities. This has left the inner cities with increased demand for services and diminished revenues. Once an organization is confident that its level of wage and benefit compensation is appropriate, the only solutions remaining available are either to eliminate services or increase revenue.

Prices for health care related goods and services have grown faster than general price inflation (CPI) between 1990 and 2004. The Citizens Research Council of Michigan states that rising health care expenditures account for roughly one-third of the of the State's budgetary increases between FY 2001 and FY 2004. The audited financial statements for fiscal year 2004 of the City of Highland Park show that expenditures for retiree and employee health benefits equal half of its total general operating budget. According to information submitted to Michigan State University, employee and retiree health insurance costs increased over 18 percent between 2001 and 2004. Communities with aging populations face the added challenge of funding health care for an increasing number of retired employees. Hazel Park spends 50 percent of its $2 million health care budget on retirees. In October 2005 city officials in Royal Oak predicted a $6.4 million deficit in the $35 million general fund budget for the fiscal year 2005-06, in large part due to employee and retiree health costs[23].

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[22] Calculation completed by Michigan State University's State and Local Government Program, January 2006
[23] Detroit News. *Royal Oak manager hosts town hall meeting on deficit*. 10/17/2005

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LEGACY COSTS

The Task Force heard testimony that demonstrated that the biggest debt owed by local units of government is a debt no voter has approved, i.e., the debt owed for post-employment benefits to retirees when they retire.

The Task Force values the importance of a strong local public safety system in Michigan. This system and those employees protect our homes, places of work and schools, and provide the hometown security everyone feels is critical. Local public safety is a vital public service that encourages economic development efforts for local communities and the state.

The costs of these police and fire services represent a significant part of the budget of many local units, often to the detriment of other service cost centers. Many cities, villages, townships and counties provide benefits for their retirees. Article 9, Section 24 of the Michigan Constitution of 1963 addresses pensions, defining pension benefits as an “accrued financial benefit” and providing that “financial benefits arising on the amount of service rendered in each fiscal year shall be funded during that year…”

Local governments also provide an array of other benefits to their retirees including things like health care, vision, dental and other benefits, collectively referred to as Other Post Employment Benefits (OPEB). The largest component of OPEB is retiree health care. According to the Government Finance Officers Association (GFOA) 1998 publication Prefunding Retiree Health Benefits, 74 percent of state governments and 57 percent of local governments provide health benefits to retirees over age 65. Approximately the same percent provide health benefits to retirees under age 65. In 2002, a study by the Municipal Employees’ Retirement System of Michigan showed that 74 percent of the 353 municipal respondents provided retiree health care, with most offering both pre-65 and post-65 coverage.

Most of these arrangements resulted from negotiations with bargaining units at a time when employers could sponsor retiree health care for a few tenths of a percent of active employee payroll. More recently approved labor contracts have built on the labor contracts reached in the older, more established communities. The rapid increase in health care costs has increased the impact of this benefit on local budgets significantly. Most governmental employers have been financing the benefits on a pay-as-you-go basis.

In June 2004, the Government Accounting Standards Board (GASB - the organization that prescribes accounting standards for governmental entities), approved the final set of accounting standards applicable to OPEB, known as GASB 45. The GASB’s standards apply differently depending on whether the benefit is provided through a defined benefit plan or a defined contribution plan. For benefits provided through defined benefit plans, the primary requirement is that the long-term cost of the benefit (e.g. retiree health care) be measured and reported on the accrual basis using actuarial methods and assumptions applied in essentially the same way that they are applied to pension plans. Translated – this means that units of local government will have to fund these future costs on a present basis or their finances will show a deficit.

The offer of wages and benefits to public safety employees arises out of arbitration awards granted as a part of the process for binding arbitration outlined in P.A. 312 of 1969. These awards place upward pressure on the wages and benefits provided to general government employees as well.

The Fiscal Impact of Binding Arbitration: A Review of the Research

Wage Effect

Based on a review of the relevant labor economics literature, there is strong and consistent evidence that public sector union presence, particularly the existence of compulsory binding arbitration statutes (typically for public safety employees), leads to higher average wage levels for public safety employees (Ashenfelter and Hysolp, 2001; Freeman, 1986, Valetta, 1989).[29] These higher public safety wage levels have been shown to have the spillover effect of raising other public sector employee wages, albeit to a lesser extent. These wage effects have been found to be particularly strong in Midwestern states. Even stronger however, the evidence indicates that binding arbitration leads to an even greater impact on fringe benefit costs for municipalities. The overall effect is a significantly higher overall compensation package for binding arbitration states.

Employment Effect

There is also evidence of an employment effect due to unions (Ashenfelter and Hysolp, 2001; Freeman, 1986, Valetta, 1989).[30] The presence of binding arbitration leads to higher average employment levels for public safety employees. However, these higher employments are offset by lower employment levels for other non-public safety employees. The net effect is slightly higher public sector employment due to binding arbitration.

Overall Effect

The overall impact of these wage and employment effects due to binding arbitration is to raise municipal expenditures in binding arbitration states by 3 to 5 percent relative to other states. While small in percentage terms, this impact is large in dollar terms.

[29] Ashenfelter, Orley and Dean Hyslop, "Measuring the Effect of Binding Arbitration on Wage Levels: The Case of Police Officers", Industrial and Labor Relations Review Vol. 54, no. 2 (2001). Freeman, R.B. "Unionism comes to the Public Sector", Journal of Economic Literature XXIV (1986). Valetta, R.G. "The Impact of Unionism on Municipal Expenditures and Revenues, Industrial and Labor relations Review, vol. 42 (3) (1989).

[30] See above footnote for citations

The mandatory arbitration process acts as a safety valve for situations in which bargaining has reached an impasse and public safety employees would otherwise use strikes as a tool to overcome the impasse. Because of the importance of public safety as a service, the Task Force recognized that both local and State leaders must pay closer attention to the future affordability of present-day promises provided either through bargaining or mandatory arbitration while not disrupting the delivery of public service.

Recommendations:

I. Require all participants in the bargaining process, including arbitrators, to obtain actuarial statements of the future costs of retiree benefits that demonstrate the annual contributions required beginning in the first year of implementation to avoid a deficit in the fund.

II. The total economic cost of an arbitrator's award cannot exceed the total percentage of increase of the local units' General Fund Revenue, (excluding reappropriation of fund equity) or the Consumer Price Index, (C.P.I.), whichever is less.

III. Changes in working conditions relating to intergovernmental cooperation and agreements must be exempt from binding arbitration.

IV. Require all local units of government to develop a written plan that addresses how they plan to manage the post-employment benefit liability. These plans should include all of the following:

- **a.** Documentation showing that contributed funds will be adequate to meet the level of benefits provided
- **b.** An amortization of the unfunded actuarial liabilities and a description of actions to accomplish that amortization
- **c.** A description and explanation of any and all actuarial assumptions
- **d.** A schedule illustrating the amortization of any unfunded liabilities
- **e.** A comparative review illustrating the level of funds available to the plan from own-source revenues, including a statement of the assumptions used to predict those revenues
- **f.** A statement by an actuary that the plan is complete and accurate

V. As a short term opportunity for local units that have a large unfunded liability, legislation should permit local units to issue retiree health care bonds as a part of the overall strategy in managing the liability. (Draft legislation is included in Appendix D)

VI. Failure to adopt the plan and build sufficient funding for these legacy costs should result in some kind of regulatory control over the operations of the municipality.