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DISTRICT OF COLUMBIA

Actions Taken in Five Cities to Improve Their Financial Health

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DISTRICT OF COLUMBIA
ACTIONS TAKEN IN FIVE CITIES
TO IMPROVE THEIR FINANCIAL HEALTH

Summary of Statement by
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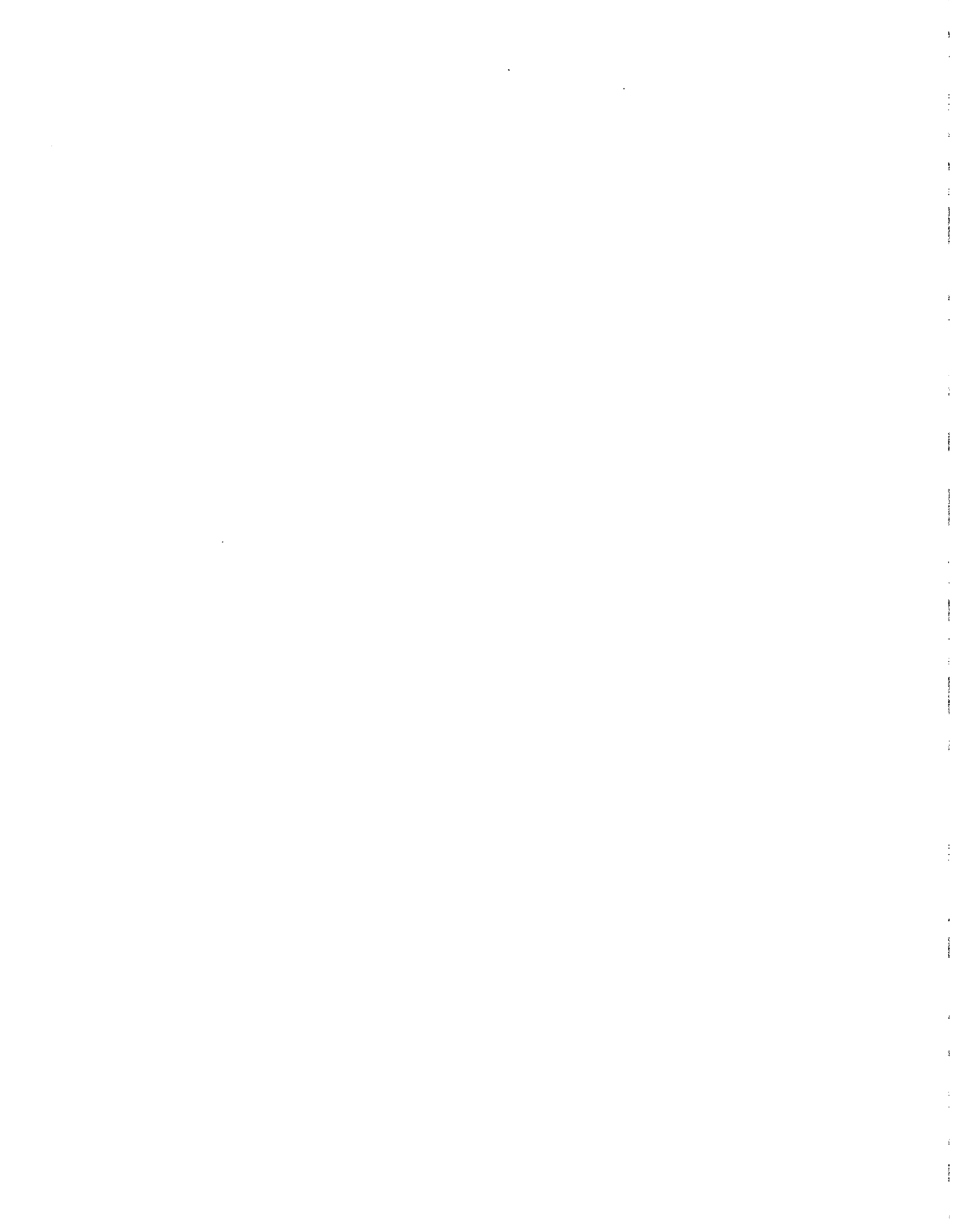
GAO visited five cities--Boston, Chicago, Cleveland, New York, and Philadelphia--that experienced problems similar to those faced by the District of Columbia. The problems were similar in that some were caused by the cities' changing demographics. Others were due to the cities' inability to make the hard financial decisions needed to live within their means. The cities began defaulting on loans and losing their ability to borrow. Eventually, each city was faced with such unstable financial conditions that a financial crisis occurred or was imminent.

As conditions worsened, Boston and Chicago had sufficient financial discipline to restore their credibility and their financial health without state aid or oversight. However, Ohio, New York, and Pennsylvania wanted some assurance that financial discipline would be restored and maintained in Cleveland, New York City, and Philadelphia. Illinois wanted similar assurance for Chicago's school district. To achieve such assurance, these states established oversight boards for the three cities and Chicago's school district. The boards helped the cities take actions that resulted in the cities being better able to manage their financial affairs. In addition, the cities began to improve city management and operations and address their structural problems.

The cities' and the school district's boards shared some common characteristics. Each board contained from five to seven members. In general, board members were (1) committed to the cities' or school district's future and (2) qualified, that is, had a strong background in financial and business management. Often, the board members included partners of law or accounting firms and business executives from the private sector. In addition, state legislation tied changes to the boards' duration or power to specific improvements in a city's financial condition.

All five of the cities have now improved their financial stability, management, and operations. The cities are also addressing their structural problems and are finding them particularly difficult to solve.



Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the actions taken by five nearly insolvent cities to improve their financial health. Recent congressional hearings and GAO reports have identified severe financial, management, and structural problems in the District of Columbia similar to those in the five cities. Such problems include inadequate financial systems, inefficient city operations, and changing demographics. To identify actions the District government and Congress might take to improve the District's financial health, we reviewed past actions taken by five cities that experienced similar problems. These cities--Boston, Chicago, Cleveland, New York, and Philadelphia--and their states made management changes that improved their financial condition. As a result of these changes, they are now better able to manage their financial affairs.

On the basis of information obtained from these cities and their respective states, our discussion centers on the following three areas: (1) problems experienced by all five cities, (2) actions taken by state-established boards to oversee city finances and by the cities to improve the cities' financial health, and (3) common characteristics of these boards. Because we sought to identify the relevant experiences of the cities and boards we visited, we relied on available data and evaluations provided by city and board officials. We did not independently evaluate the information provided.

FIVE CITIES EXPERIENCED SIMILAR PROBLEMS

The five cities we visited experienced similar problems. Some of the problems were caused by the cities' changing demographics. Others were due to the cities' inability to make the hard financial decisions needed to live within their means.

Over the past few decades, these cities like other eastern and midwestern cities faced a migration of tax-paying residents and employers to the suburbs and other locations. Their remaining populations contained an increasing proportion of residents, such as the poor and elderly, who needed relatively more services but could pay little for them. During this same period, the federal and state governments sharply reduced aid for social and other city programs. Collectively, these changes--shifting demographics, increased needs for costly services, and reduced federal and state aid--resulted in a declining revenue base.

Even as their revenue bases continued to decline, the cities were reluctant to take the hard financial and managerial steps necessary to adjust for these changes. According to studies on the cities' finances, the cities in general did not want to disclose the severity of their conditions. Therefore, according to current and former city officials, the cities often resorted to accounting and budgeting schemes. These schemes included paying for operating expenses from capital budgets, accumulating

deficits from one year to the next, and understating expenses.

City officials told us that when the state governments, local businesses, and bond rating agencies discovered the cities' true financial positions, the cities began to lose their credibility. These officials said that this loss of credibility created an environment of distrust and confrontation. In general, this loss of credibility caused the bond rating agencies to lower the cities' bond ratings. As a result, the cities that received lowered bond ratings lost their ability to borrow and began defaulting on prior loans. Eventually, each city was faced with such unstable financial conditions that a financial crisis either occurred or was imminent.

STATE OVERSIGHT BOARDS AND CITIES TOOK ACTIONS TO IMPROVE CITIES' FINANCIAL HEALTH

As conditions worsened, Boston and Chicago had sufficient financial discipline to restore their credibility and their financial health without direct oversight. However, Ohio, New York, and Pennsylvania wanted some assurance that financial discipline would be restored and maintained in Cleveland, New York City, and Philadelphia. Illinois wanted similar assurance for Chicago's school district. To achieve such assurance, these states established oversight boards for the three cities and Chicago's school district. The boards helped the cities take actions that resulted in the cities being better able to manage their financial affairs. In addition, the cities began to improve city management and operations and address their structural problems.

Improved Financial Stability

To help improve financial stability, Cleveland, New York, and Philadelphia worked with their oversight boards to obtain needed funds. Chicago worked with the school district's oversight board to obtain additional funding for its school district. Boston also obtained state aid, although it did not require the assistance of an oversight board. In addition, Boston sold a convention center and a parking garage for $40 million in 1982. All five cities, at times through their boards, obtained additional funds by raising taxes or issuing bonds. Cleveland, New York, and Philadelphia set aside sources of revenue, usually new or increased taxes, to repay borrowed funds.

In addition, the cities took immediate actions to establish credible budgeting and accounting numbers. Getting credible numbers, generally with the help of independent accounting firms, was essential for the cities and their oversight boards to determine the extent of the cities' financial difficulties. Getting such numbers also was essential for showing areas for

cost reduction and the extent to which existing financial systems needed improvement.

Once their financial difficulties were identified, the cities took immediate cost-cutting measures. All five cities cut costs by reducing the number of their full-time employees. For example, by 1978, New York reduced its workforce by about 20 percent, or 60,000 employees, primarily through involuntary layoffs. When it improved its financial health in the 1980s, the city increased its workforce to previous levels. Philadelphia did not reduce its number of employees through involuntary layoffs. However, Philadelphia negotiated with labor unions, which led to immediate reductions in benefits and a freeze in wages. To quickly reduce costs, some of the cities also restricted overtime, froze wages and hiring, and tightened controls over new contracts.

Another important action that each city took was to improve its working relationships with others that had a stake in the city's future. Local businesses offered managerial and technical support and advice to improve city management and operations. City employees, through their unions, in general became more willing to negotiate lowering wages and benefits. During the cities' financial difficulties, strong city leadership was essential to restoring financial health and promoting cooperation. For example, the new Mayor of Philadelphia worked with the President of the City Council to shape and implement an agenda of city reform.

Improving City Management and Operations

While improving their financial stability, all five cities realized that if they were to avoid more financial difficulties, they also would have to improve the efficiency of city management and operations. In fact, the cities realized that their periods of financial instability could be used as opportunities to make strong reforms. Accordingly, they began to restructure the way they did business. They did so by improving their financial and workforce management and by introducing productivity initiatives throughout city government.

The cities often hired new financial managers and gave them authority and responsibility to strengthen the cities' accounting, budgeting, and cash management operations. In addition, the cities installed or upgraded their financial management systems and improved their financial reporting. These cities also introduced or strengthened budgeting of their capital accounts. In addition, Boston and Chicago included reports in their annual budgets of how well city departments performed against preestablished measures.

In general, these improvements provided the cities with new and better financial information so they could actively monitor cash balances and outstanding debt. The cities also were able to monitor differences between budgeted and actual spending among their departments. This monitoring enabled the cities to examine how costs, such as a multiyear labor contract, could affect future budgets.

The financial improvements permitted the cities to identify areas in city operations where costs could be reduced. The cities made their most significant cost reductions in the area of workforce management. Personnel costs generally represented between 40 and 75 percent of the cities' operating costs. The cities reduced these costs by such actions as voluntary and involuntary layoffs; transfer of staff; changes in work rules; and better controls over overtime, leave, and workers' compensation. For example, between 1990 and 1994, Chicago reduced the costs of its health benefits by a total of $225 million.

In addition, the cities that administered their pension programs, Boston, New York, and Philadelphia, reduced their pension costs in various ways. In 1988, Boston began to eliminate its unfunded pension liability by establishing an updated funding schedule that based payments to its pension fund on independent actuarial estimates. The city reduced its pension costs through a better investment return from its pension assets and by a workforce reduction of about 2,000 employees. As a result of these efforts, according to city estimates, Boston's pension costs decreased from $130.5 million in fiscal year 1988 to $112 million in fiscal year 1993. New York reduced pension costs by requiring increases in employee contributions. In addition, Philadelphia raised retirement ages.

Cities also began to implement productivity initiatives, often with help from their local businesses. For example, in Philadelphia, a group of executives and managers from 130 businesses worked with a mayor's task force on productivity to identify and track productivity initiatives. In its fiscal year 1995 to 1999 financial plan, the city estimated that it had saved a total of about $450 million in fiscal years 1993 and 1994 through these initiatives. According to the plan, Philadelphia increased productivity across city operations through more contracting out, better use of technology, and consolidation of previously fragmented services, such as building, fleet management, and information services. Boston, Chicago, Cleveland, and New York identified and implemented similar productivity initiatives.

Addressing Structural Problems

The strong reforms introduced by the cities, such as more credible information, reduced operating costs, and increased productivity, stabilized the cities and made them healthier financially. However, these reforms did not eliminate the cities' structural problems that led to their restricted and declining revenue base. The five cities could no longer simply raise taxes for local residents and businesses to pay for rising costs. New York, for example, reduced local taxes by about $1 billion between 1978 and 1981 to keep residents and businesses in the city. In addition, studies showed that raising city taxes beyond a certain point in Philadelphia could cause some residents and businesses to leave the city, thus resulting in a loss of total revenue.

To address their structural problems, the cities adopted three strategies. These strategies were (1) identifying new revenue sources, (2) shifting city functions to other sectors, and (3) establishing sound economic development programs. To obtain new revenue, cities introduced nontax alternatives. Boston and Philadelphia began requiring certain tax-exempt institutions to make annual payments to the city. For example, Philadelphia reported that the assessed value of nonprofit property was $3.1 billion in fiscal year 1993. The city estimated in June 1994 that by having nonprofit institutions pay 40 percent of what they would have been taxed, these institutions would pay the city and its school district more than $40 million annually. Philadelphia subsequently implemented this payment for nonprofit institutions.

Cities also resorted to introducing or increasing taxes, such as hotel/motel and parking taxes. Also, the cities established new or increased fees for certain city services. Further revenue was obtained through more efficient revenue collections in Boston, Chicago, and Philadelphia.

However, because the cities had few prospects of raising additional revenue on their own, they had either reached or were near what one city described as "revenue lock." The cities began to question what should be the core activities of a municipality. When the cities viewed their operations as being better provided by states, counties, or the private sector, they sought to either have these activities so transferred or to seek better cost-sharing arrangements. For example, the state of New York assumed the local costs of New York City's court system, city university, and supplemental income security following the city's financial crisis. New York has requested that its state and the federal government reduce the city's share of Medicaid costs. According to city estimates, Medicaid is expected to cost the city about $2.4 billion for the current fiscal year. City budgets indicate that this program was a significant contributor to the city's escalating cost growth in the 1970s. City officials in Boston

and Chicago told us that not having responsibility for traditional state and county functions, such as prisons, welfare programs, and universities, has been a contributor to their cities' improved financial health.

To better prepare for the long-term future of the cities, the cities, especially in Chicago and Cleveland, strengthened their economic development programs to revitalize neighborhoods and to retain or attract businesses. According to city estimates, Chicago leveraged $150 million in city funds to provide more than a billion dollars in economic development between 1990 and 1994, with additional funding provided through low-interest loans from the business community. Chicago's development was often targeted to neighborhoods most in need. Cleveland formed public-private partnerships with local businesses, neighborhood organizations, and foundations. These partnerships have stimulated housing development in poor and blighted neighborhoods and built Cleveland's new sports arena and convention center, earning national praise.

COMMON CHARACTERISTICS OF OVERSIGHT BOARDS

The oversight boards established for Cleveland, New York, Philadelphia and Chicago's school district played key roles in improving the cities' and school district's financial stability. These boards had some common characteristics. Each board contained from five to seven members. In general, board members were (1) committed to the cities' or school district's future and (2) qualified, that is, had a strong background in financial and business management. Often, the board members included partners of law or accounting firms and business executives from the private sector.

In addition, state legislation tied changes to the boards' duration or power to specific improvements in the city's financial condition. For example, the period of active control by the New York board ended in 1986 after the city was able to balance its budget for 3 years and improved its access to the credit markets. The New York board continues to monitor the city's budgets and financial plans. The board's period of active control can be reactivated if the city fails to maintain its improvements and certain statutory criteria exist, such as having a deficit of more than $100 million. Philadelphia's board is to exist for no more than 1 year after all its liabilities, including its bonds, have been paid. The board that oversees Chicago's schools is to be reactivated if the school district fails to (1) adopt a balanced budget by the beginning of each fiscal year or (2) achieve a balanced budget for 2 consecutive fiscal years.

All the boards required certain financial reporting from their respective city or school district. In general, the cities and

the school district were required to provide the boards with annual balanced budgets and multiyear financial plans. The boards then either approved or disapproved these budgets and plans. If any of the cities or the school district did not submit an acceptable financial plan or meet the approved plan, certain enforcement action could occur. For example, by law, in Cleveland failure to submit a financial plan by the stated deadline could have resulted in the city's spending being limited to 85 percent of the prior year's spending. Cleveland's spending was to be limited only until a new financial plan was approved. Cleveland's board was terminated in 1987. Philadelphia's board can withhold state money and certain bond proceeds from the city if the city fails to comply with its financial plan. New York's board can recommend that either the Governor or the Mayor, both of whom are board members, remove city officials if they fail to comply with the board's direction.

During our visits, city and school officials acknowledged the value of these boards in helping the cities and school district improve their financial discipline in three ways:

-- first, by requiring adherence to approved plans;

-- second, by providing leverage that helped the cities or school district to negotiate cost reductions with employees and contractors; and

-- third, by increasing public disclosure of and confidence in the financial condition of the cities and school district.

SUMMARY

In summary, either on their own or with the assistance of state oversight boards, the cities all took actions to improve their financial discipline and stability. They established credible accounting numbers to clearly identify their financial situations and needs. They also took immediate cost-cutting measures and began longer term efforts to improve management and operations. The cities are also addressing their structural problems and finding them particularly difficult to solve.

Mr. Chairman, this concludes my statement. My colleagues and I will be glad to answer any questions you or other Members of the Subcommittee may have at this time.

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