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# THE CHALLENGES AND IMPLICATIONS OF FISCAL HEALTH

*Bruce D. McDonald, III\**

*The condition of a local government's fiscal health presents challenges to those working for the government, but also to those who rely upon the goods and services that it provides. Significant attention has been paid to improving our understanding of fiscal health to improve the decision-making process of administrators. Unfortunately, little consensus has emerged concerning how it is defined and how it is measured. How we view the defining terms and resulting measurement, however, has differing legal implications related to a government's bankruptcy or the imposition of an emergency manager by the state. Our understanding of fiscal health can also*

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*affect the recognition of a government's liability. This article seeks to bring some understanding to the fiscal health of local governments. This is accomplished by defining fiscal health, providing an overview of how the health is measured, and discussing the legal implications that emerge as a result.*

## I. INTRODUCTION

In recent years interest in government sustainability has increased.<sup>1</sup> Administrators of local governments face declines in their available revenue while demand for public goods and services increases.<sup>2</sup> At the same time, states shift more responsibility of providing services onto local governments.<sup>3</sup> While the Great Recession brought the financial condition of local governments to the forefront,<sup>4</sup> events such as the bankruptcies of Jefferson County, Alabama, in 2011, and Detroit,

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<sup>1</sup> See Craig S. Maher, Bruce D. McDonald, and Steven C. Deller, *The Fiscal Health of U.S. Cities*, New York, NY: Routledge (forthcoming) (on file with authors).

<sup>2</sup> See D. Roderick Kiewiet & Matthew D. McCubbins, *State and Local Government Finance: The New Fiscal Ice Age*, 17 ANN. REV. POL. SCI., 105-22 (2014); E. A. SCORSONE, H. LEVINE & J. B. JUSTICE, HANDBOOK OF LOCAL GOVERNMENT FISCAL HEALTH., 1-7 (E.A. Scorsone et al. eds., 2013).

<sup>3</sup> See *id.*

<sup>4</sup> See SCORSONE, *supra* note 2, at 11-41; Bruce D. McDonald, *Does the Charter Form Improve the Fiscal Health of Counties?*, 75(4) PUB. ADMIN. REV. 609-18 (2015) (discussing general theory and history of administrative roles governments play) .

Michigan, in 2013, exposed the implications of poor financial planning.<sup>5</sup>

The problem remains more widespread than Jefferson County and Detroit. Since 2010, more than 50 local governments in the United States have filed for bankruptcy.<sup>6</sup> Even more employ emergency managers to address their financial problems and others struggle to stay solvent.<sup>7</sup> Some states established financial monitoring systems to provide an early indication of problems to allow for early intervention and prevention.<sup>8</sup>

Although rarely phrased in the context, the position of a local government's fiscal health is inherently a legal issue, as many of the services provided by local governments are done as a result of state mandate.<sup>9</sup>

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<sup>5</sup> See Bruce D. McDonald, *Measuring the Fiscal Health of Municipalities* (Cambridge, MA: Lincoln Inst. of Land Pol'y, Working Paper No. WP17BM1, 2017).

<sup>6</sup> See *Bankrupt Cities, Municipalities List and Map*, GOVERNING, <http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html>; McDonald, *supra* note 5.

<sup>7</sup> See Evgenia Gorina, Craig Maher, & Marc Joffe, *Local Fiscal Distress: Measurement and Prediction*, 38(1) PUB. BDGT. & FIN. 72-94 (2018) (discussing financial conditions and a need for a fiscal reporting device).

<sup>8</sup> See generally SCORSONE, *supra* note 2, at 77-124 (citing Dean Michael Mead, *The Development Of External Financial Reporting And Its Relationship To The Assessment Of Fiscal Health And Stress* (2013)); PEW CHARITABLE TRUSTS, STATE STRATEGIES TO DETECT LOCAL FISCAL DISTRESS: HOW STATES ASSESS AND MONITOR THE FINANCIAL HEALTH OF LOCAL GOVERNMENTS (2016).

<sup>9</sup> See SCORSONE, *supra* note 2, at 43-74; Junghack Kim, Bruce D. McDonald, & Jooho Lee, *The Nexus of State and Local Capacity in Vertical Policy Diffusion*, 48(2) AM. REV. OF PUB. ADMIN. 188-200 (2018)

States also typically impose restrictions on the capacity of local governments to adjust their current tax policies or impose new ones.<sup>10</sup> The legal requirement of local governments to do more with less creates a financial tension. In some instances, this results in skirting other responsibilities that could have long-term implications for the government and its employees.<sup>11</sup> While the ability of a local government to effectively manage is tied to its financial constraints, there is little available to help the administrators of local governments determine when the problems have become too much and the fiscal health of the government is at risk.<sup>12</sup>

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(discussing vertical policy diffusion from a state and local perspective); Bruce D. McDonald & Carl J. Gabrini, *Determinants of County Charter Decisions: An Event History Analysis of Florida Counties*, 24(4) J. OF PUB. ADMIN. RES. & THEORY 721-739 (2014) (discussing demographic, economic, and political determinants in localized charter adoption).

<sup>10</sup> See Judith I. Stallmann, Craig S. Maher, Steven C. Deller, & Sungho Park, *Research on The Effects of Limitations on Taxes And Expenditures*, 3(2) J. OF PUB. & NPRFT. AFF. 197-222 (2017) (discussing the history, application, and theory of tax and expenditure limitations).

<sup>11</sup> See *id.*

<sup>12</sup> See John M. Trussel & Patricia A. Patrick, *The Symptoms and Consequences of Fiscal Distress in Municipalities: An Investigation of Reductions in Public Services*, 13(1) ACCT. & THE PUB. INT. 151-71 (2013) (discussing financial condition and testing a specific assessment model to provide warnings prior to fiscal distress); John M. Trussel & Patricia A. Patrick, *Assessing and Ranking the Financial Risk of Municipal Governments: The Case of Pennsylvania*, 19(1) J. OF APPL'D ACCT. RES. 81-101 (2018).

## II. WHAT IS FISCAL HEALTH

The concept of a government's fiscal health is defined loosely both in the literature and in practice.<sup>13</sup> However, the definitions can be categorized as either accounting/budgetary or economic in nature.<sup>14</sup> Although both relay similar concepts about the condition of a government, they do so in the context of their respective fields.<sup>15</sup>

Accounting and public budgeting literature presents a definition of fiscal health that is centered on the capacity of a government to provide or expand a program or service.<sup>16</sup> Historically, the budgeting side of the literature has pointed towards an understanding of fiscal health as simply "the extent to which [a government's] financial resources exceed its spending obligations."<sup>17</sup> Although this was a simple view of fiscal health, it had the advantage of clarity and comprehensibility.<sup>18</sup> If revenue was available to cover the cost of a program or service, the government was considered fiscally

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<sup>13</sup> See SCORSONE, *supra* note 2, at 43-74; Bruce D. McDonald, *Local Governance and the Issue of Fiscal Health*, 50(1) ST. & LOC. GOV'T. REV. 46-55 (2018) (discussing fiscal health and how to measure it).

<sup>14</sup> *See id.*

<sup>15</sup> *See id.*

<sup>16</sup> *See id.*

<sup>17</sup> Frances Stokes Berry, *Stokes Innovation in Public Management: The Adoption of Strategic Planning*, 54(4) PUB. ADMIN. REV. 323 (1994).

<sup>18</sup> *See* Beth Walter Hondale, James M. Costa, & Beverly A. Cigler, *FISCAL HEALTH FOR LOCAL GOVERNMENTS: AN INTRODUCTION TO CONCEPTS, PRACTICAL ANALYSIS, AND STRATEGIES* (London, UK: Elsevier) (2004).

healthy.<sup>19</sup> However, with the financial crisis of New York City in 1975, an interest in a more complete understanding of a government's condition emerged.<sup>20</sup> The improved understanding of a government came in the form of the Governmental Accounting Standards Board (GASB) in 1984.<sup>21</sup>

Currently, while GASB holds little regulatory authority, the statements the board produces guides local governments' financial disclosures.<sup>22</sup> As governments adhere to the guidance, there has been an increase in publicly available data, which can be used to get a more nuanced perspective of the government's financial position.<sup>23</sup> This increase in data has allowed scholars to draw on the accounting literature to establish an understanding of fiscal health, specifically focused on an all-inclusive fiscal health, rather than the singular focus of the budgetary approach.<sup>24</sup>

Consequently, scholars have expanded the definition of fiscal health to reflect a government's ability to balance its financial obligations with its available

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<sup>19</sup> *See id.*

<sup>20</sup> *See* Junghack Kim, Bruce D. McDonald & Jooho Lee, *The Nexus of State and Local Capacity in Vertical Policy Diffusion*, 48 AM. REV. OF PUB. ADMIN. 188, 189 (2018).

<sup>21</sup> *See id.*

<sup>22</sup> *See id.*

<sup>23</sup> *See id.* at 188.

<sup>24</sup> *See id.*

revenue streams.<sup>25</sup> From this definition, a government is considered fiscally healthy if its resources meet its obligations. On the contrary, if it does not have the resources, then it may be experiencing fiscal stress.<sup>26</sup> The ability to balance the obligations is viewed across four solvencies. These are:

1. *Cash Solvency* - the ability of the government to meet its immediate or short-term financial obligations;
2. *Budget Solvency* - the ability of the government to meet its financial obligations over a budgeted fiscal year;
3. *Long-Term Solvency* - the ability of the government to meet its long-term financial obligations; and
4. *Service-Level Solvency* - the ability of the government to finance the base level programs and services as required by law.<sup>27</sup>

The benefit of the expanded approach to fiscal health is it allows for the consideration of where the

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<sup>25</sup> See David J. Helpap, *The Importance and Complexity of Assessing Urban Fiscal Health*, 48 ST. & LOC. GOV'T REV. 208, (2016); Rebecca Hendrick, *Assessing and Measuring the Fiscal Health of Local Governments: Focus on Chicago Suburban Municipalities*, 40 URB. AFF. REV. 78, (2004); Craig S. Maher & Karl Nollenberger, *Revisiting Kenneth Brown's "10-Point Test"*, 25 GOV'T FIN. REV. 61, (2009); Sarah Arnett, *State Fiscal Condition: Ranking the 50 States* (George Mason Univ. Mercatus Ctr., Working Paper No. 14-02, 2014).

<sup>26</sup> See Hendrick, *supra* note 25, at 80

<sup>27</sup> See *id.* at 84



government is in meeting the needs of the citizenry while considering the demands that are placed on the organization in the future.<sup>28</sup> Innate to this is the ability of the government to withstand unforeseen disruptions, such as a recession or change in the demographics of the residents.<sup>29</sup>

The second lens of fiscal health is economic in nature. While the accounting/budgetary lens focuses on the financial capacity of a government, the economic lens focuses on the capacity of the community.<sup>30</sup> Local governments are established as a reflection of the community they serve, but they comprise only a small portion of the community's resources.<sup>31</sup> The expectation behind this approach is that governments have the capacity to commandeer the resources of the community should the need arise.<sup>32</sup> This could be accomplished through policy tools, such as an increase in tax rates or by imposing new taxes, as well as through legal tools, such as eminent domain.

One way to think about how the accounting/budgetary and economic lenses compare is to put them into the context of a typical household. On the accounting/budgetary side, the fiscal health of the house is a reflection of their ability to pay their mortgage and

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<sup>28</sup> *See id.*

<sup>29</sup> *See id.*

<sup>30</sup> *See id.*

<sup>31</sup> *See* Howard Chernick & Andrew Reschovsky, *The Fiscal Condition of U.S. Cities: Revenues, Expenditures and The "Great Recession."* 39(4) J. OF URBAN AFF. 488-505 (2017) (Discussing the comparison of expenditures and revenues of local governments across several U.S. cities).

<sup>32</sup> *See id.*

other bills. The healthiness of the household is then reported as a credit score in order to allow banks and credit companies to understand the position of the household. The economic side is focused on the resources that the household may have available but has not yet effectively utilized. This includes the opportunity of members in the household to seek out employment with higher income, taking on a second job, short-selling or renting the house, the selling of family heirlooms, or even liquidating books and movies that are in a home collection.

As our understanding of fiscal health has grown in recent years, the use of the economic lens in the academic literature as a primary definition has diminished. The imposition of tax and expenditure limitations by states has limited the capacity of local governments to seize the resources of those in the community.<sup>33</sup> Although not proponents of the economic approach themselves, Wang, Dennis, and Tu<sup>34</sup> relied on the economic conditions of a state as a secondary lens to

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<sup>33</sup> See Ji-Hyung Park, Sungho Park, & Craig S. Maher, *The Effects of Tax and Expenditure Limitations (TELS) on Municipal Fiscal Outcomes During a Period of Fiscal Distress*, 18(1) PUB. FIN. & MGMT. 84-110 (2018) (Discussing the practical effects of TELS on fiscal decision-making); Judith I. Stallmann, Craig S. Maher, Steven C. Deller, & Sungho Park, *Research on the Effects of Limitations on Taxes and Expenditures*, 3(2) J. OF PUB. & NPRFT. AFF. 197-222 (2017) (Discussing the reasons for lower revenue generation in local and state governments).

<sup>34</sup> See Xiaohu Wang, Lynda Dennis, & Yuan Sen Tu, *Measuring Financial Condition: A Study of U.S. States*, 27(2) PUB. BDGT. & FIN., 1-21 (2007) (introducing a new method for calculating measurements that provide insight into a government's financial condition).

justify the financial indicators that they used in the model of fiscal health.<sup>35</sup> Unsurprisingly, the lens does continue to be prevalent within the practice of economic development; conversations on lost opportunities for Benton Harbor, Michigan, due to the poor economic planning surrounding its golf course are evidence of the lens's use.<sup>36</sup>

### III. THE MEASUREMENT CHALLENGE

While the two lenses of fiscal health may present a picture and definition that is relatively straightforward, the variation in how fiscal health is understood becomes much more complicated when considering how it should be measured. Although considerable attention has been given in literature to the measurement of fiscal health, no consistent system has emerged.<sup>37</sup> In the absence of a definitive approach to the measurement, researchers often take an ad hoc approach.<sup>38</sup> In an ad hoc approach, researchers are free to choose their variables based on the

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<sup>35</sup> See Chernick, *supra* note 31.

<sup>36</sup> See *id.*

<sup>37</sup> See ROY BAHL, FINANCING STATE AND LOCAL GOVERNMENT IN THE 1980's (1984); E.D. Benson, B.R. Marks & K.K. Raman, *Tax Effort as an Indicator of Fiscal Stress*, 16(2) PUB. FIN. Q., 203-18 (1988); Evgenia Gorina, Craig Maher & Marc Joffe, *Local Fiscal Distress: Measurement and Prediction*, 38(1) PUB. BDGT. & FIN., 72-94 (2017); BETH WALTER HONADLE, JAMES M. COSTA & BEVERLY A. CIGLER, FISCAL HEALTH FOR LOCAL GOVERNMENTS: AN INTRODUCTION TO CONCEPTS, PRACTICAL ANALYSIS, AND STRATEGIES (2004); Robert Kleine, Philip Kloha & Carol S. Weissert, *Monitoring Local Government Fiscal Health: Michigan's New 10-Point Scale of Fiscal Distress*, 19(3) GOV'T. FIN. REV., 18-23 (2003).

<sup>38</sup> See McDonald, *supra* note 13.

availability of data or ease of estimation.<sup>39</sup> The ad hoc approach gives administrators the ability to relay a perspective of financial condition based on the audience and the story they want to tell.<sup>40</sup>

Despite the ad hoc nature of most approaches, at the center of the accounting and budgetary lens is the use of financial ratios. Ratio analysis is “the examination of a financial relationship between items as a means of identifying trends in financial behavior or position.”<sup>41</sup> Ratios express the relationship between two pieces of financial data as a proportion, rate, or percentage.<sup>42</sup> An example of a ratio’s expression using a 1.15 current ratio (the ratio of current assets to current liabilities) is provided in Table 1.

Table 1. Example of Expressing Financial Ratios

Expression	Example
Proportion	The relationship between current assets and current liabilities is 1.15:1.
Rate	Current assets are 1.15 times as great as current liabilities
Percentage	Current assets are 115% of current liabilities

<sup>39</sup> See *id.*

<sup>40</sup> See *id.* at 2-3.

<sup>41</sup> *Id.* at 3.

<sup>42</sup> See *id.* at 3.

Financial ratios emerged in the 1890s as a result of the introduction of single-name paper loans.<sup>43</sup> In the 1870s, commercial banks began requesting the financial statements of companies for use in lending decisions, but the volume of information presented in the statements became a hindrance in any analysis being conducted.<sup>44</sup> As commercial banks looked for ways to improve their work, they experimented with different approaches.<sup>45</sup> One of these approaches was the development of the current ratio, which compares a company's current assets to its current liabilities.<sup>46</sup>

In the years after the development of the current ratio, dozens of ratios were created to provide a more in-depth understanding of the financial condition of a business and to reflect activities the business is involved with.<sup>47</sup> Their numbers grew so rapidly that by 1919 researchers were looking for ways to mitigate the proliferation of ratios by clarifying which ratios should be utilized in measuring the fiscal health of a corporation.<sup>48</sup> Financial ratios may provide a picture of

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<sup>43</sup> See James O. Horrigan, *A Short History of Financial Ratio Analysis*, 43(2) THE ACCT. REV., 284-94 (1968) (discussing the origin and history of financial ratios).

<sup>44</sup> See *id.*

<sup>45</sup> See *id.*

<sup>46</sup> See ROY A. FOULKE, PRACTICAL FINANCIAL STATEMENT ANALYSIS 178 (6<sup>th</sup> ed. 1961).

<sup>47</sup> See Horrigan, *supra* note 43.

<sup>48</sup> See *id.*; Alexander Wall, *Study of Credit Barometrics*, 5 FED. RES. BULL., 229-43 (1919).

an organization's fiscal health, but utilizing too many ratios or incorrect ratios can produce misleading results.<sup>49</sup> Ultimately, it was Altman's (1968) work on corporate bankruptcy that clarified which ratios should be used in the consideration of a firm's financial position.<sup>50</sup> Altman's work may have resolved the debate on how to measure fiscal health for businesses, but the understanding of which ratios are important to governments has never been clarified.<sup>51</sup>

Without any clarification on which ratios matter, some measurement systems emerged that produce an image of fiscal health based on the type of financial obligation the analyst is interested in.<sup>52</sup> An analyst concerned about the immediacy of a government's capacity to provide services may focus on the measurement of its efficiency ratio (the ratio of total expenditures to total revenue).<sup>53</sup> Alternatively, someone that is concerned about the government's ability to pay for its pension programs may reference coverage ratios (ratios that reflect the capacity of an organization to meet its short-term and long-term liabilities).<sup>54</sup> Such approaches provide an interesting insight into the

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<sup>49</sup> See Edward I. Altman, *Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy*, 23(4) THE J. OF FIN., 589-609 (1968) (discussing misleading results due to faulty interpretations of methodologies).

<sup>50</sup> See *id.*

<sup>51</sup> See McDonald, *supra* note 5, at 3-4.

<sup>52</sup> See *id.* at 4.

<sup>53</sup> See *id.*

<sup>54</sup> See *id.*

financial health of the organization, but that insight focuses narrowly on a single aspect of the broader fiscal condition.<sup>55</sup>

Similar to the work of Altman (1968), public administration researchers have looked for ways to constrain the prevalence of ratios for governments. In 1981, the International City/County Management Association developed its Financial Trend Monitoring System (FTMS) that incorporates thirty-six different financial indicators across twelve areas.<sup>56</sup> The authors readily admit the infeasibility of calculating all of the ratios, thus giving administrators discretion to choose among the ratios based on their need.<sup>57</sup> The system was updated in 2003 to incorporate a government's environmental and organizational factors.<sup>58</sup> In total, FTMS now combines forty-two different indicators to produce its version of fiscal health.<sup>59</sup> Finkler, Smith, Calabrese, and Purtell's (2017) pivotal textbook on financial management for public administrators recommends the use of nineteen different ratios, though

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<sup>55</sup> *See id.*

<sup>56</sup> *See generally* Sanford M. Groves, W. Maureen Godsey, & Martha A. Shulman, *Financial Indicators for Local Governments*, 1 PUB. BDGT. AND FIN. 5-19 (1981) (describing common issues with evaluating financial condition and a suggested method for combatting those issues).

<sup>57</sup> *See id.* at 9-11.

<sup>58</sup> *See* McDonald, *supra* note 5, at 3.

<sup>59</sup> *See* KARL NOLLENBERGER, SANFORD M. GROVES & MAUREEN G. VALENTE, *EVALUATING FINANCIAL CONDITION: A HANDBOOK FOR LOCAL GOVERNMENT* (Int'l City/County Mgmt. Ass'n., 4th ed. 2003).

they also note other ratios which might tailor the image of healthiness.<sup>60</sup>

Several notable attempts have been made to follow in the footsteps of Wall (1919) not just to establish a set system of ratios that should be used, but transition that system into a single number that reflects whether a government is healthy or stressed.<sup>61</sup> Brown (1993), for instance, developed a points-based text around ten ratios that summed the points on a “10-to-20” point scale as a way of measuring fiscal health in comparison to other governments.<sup>62</sup> Wang, Dennis, and Tu (2007) tried to address the issue of condensing the number of ratios into something useable by focusing on the measurement of a government’s fiscal health rather than factors that may drive or determine it.<sup>63</sup> Their system incorporates a series of eleven indicators that reflect the solvency of a government.<sup>64</sup> Some more recent work, similar to Altman (1968), has sought to clarify the appropriate

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<sup>60</sup> See STEVEN A. FINKLER, DANIEL L. SMITH, THAD D. CALABRESE, & ROBERT M. PURTELL, *FINANCIAL MANAGEMENT FOR PUBLIC, HEALTH, AND NOT-FOR-PROFIT ORGANIZATIONS* (CQ Press, 5th ed. 2017).

<sup>61</sup> See generally McDonald, *supra* note 5 (providing an overview of various methods that have been developed in an effort to accurately measure financial condition).

<sup>62</sup> See generally Ken W. Brown, *The 10-Point Test of Financial Condition: Toward an Easy-to-Use Assessment Tool for Smaller Cities*. 9 GOV’T. FIN. REV. 21-26 (1993) (detailing how to calculate ten ratios and how each can be used to assess a city’s financial condition).

<sup>63</sup> See generally Wang, *supra* note 34, at 1-21. (introducing a new method for calculating measurements that provide insight into a government’s financial condition).

<sup>64</sup> See *id.* at 8; McDonald, *supra* note 13, at 49.



measure of fiscal health by estimating the impact of the ratios on instances of municipal bankruptcy, though this work is still in progress.<sup>65</sup>

The economic lens is also plagued by measurement issues, albeit the plague is much more contained than that of the accounting and budgetary lens. Measurement approaches within the economic lens typically turn to the economic growth and development literature for guidance. Because fiscal health reflects the capacity of a community's economy, fiscal health indicators often mirror those that drive economic growth: the gross domestic product of the community, physical capital, private investments, and the size and skill of the labor force.<sup>66</sup> On occasion, the research might take it further and focus less on the overall size of the economy, choosing instead to focus on the government to draw on those resources.<sup>67</sup> An example of this in practice is Ladd and Yinger's 1989 study that focused on the capacity of the government to raise additional revenue from the economy.<sup>68</sup> While the economic lens is diminishing in

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<sup>65</sup> See generally Altman, *supra* note 49. (analyzing and applying results from a discriminant analysis of financial ratio used to predict corporate bankruptcies); McDonald, *supra* note 13 (providing an overview of various methods that have been developed in an effort to accurately measure financial condition).

<sup>66</sup> See Wang, *supra* note 37.

<sup>67</sup> See *id.* at 10.

<sup>68</sup> See Michael A. Pagano, *Book Review*, 23 POL'Y SCIENCES 331 (1990) (reviewing HELEN F. LADD & JOHN YINGER, *AMERICA'S AILING CITIES: FISCAL HEALTH AND THE DESIGN OF URBAN POLICY* (1989)); Howard Chernick & Andrew Reschovsky, *The Fiscal Condition of U.S. Cities: Revenues, Expenditures and the "Great Recession"*, 39 J. URBAN AFF. 488,

importance, the statistical relationships between financial ratios and economic data have encouraged those utilizing the accounting/budgetary lens to incorporate economic variables as controls within their models.

#### IV. LEGAL IMPLICATIONS

A central legal concern behind fiscal health is the capacity of a local government to meet its financial and service obligations.<sup>69</sup> The full extent of the legal implications behind how fiscal health is defined and measured, however, is not well understood. We do know that there are implications. The flexibility for administrators to choose the definition and measurement system of fiscal health that they use may allow them to tailor their discussion to the situation or audience, but it also opens the possibility that an approach can be selected as a way to hide or mask the true status of the government.<sup>70</sup> Brown's 10-point test, for example, allows the analyst to select the comparative governments that are used in the analysis.<sup>71</sup> By including governments with financial difficulties, a government can be

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488-505 (2017) (discussing different means and examples of assessing fiscal health).

<sup>69</sup> See Charlie K. Coe, *Preventing Local Government Fiscal Crises: Emerging Best Practices*, 68 PUB. ADMIN. REV. 759, 759-67 (2008) (Discussing the roles of both the state and local government in handling fiscal crises).

<sup>70</sup> See Richard M. Bird, *Reflections on Measuring Urban Fiscal Health*, 35 MUN. FIN. J. 45, 50 (2014).

<sup>71</sup> See Brown, *supra* note 62.

presented as fiscally healthy regardless of their true condition.<sup>72</sup> The same masking can be done when a more ad hoc approach is utilized by removing financial ratios that paint a government in a negative light.<sup>73</sup>

Although no statistics on the frequency of this kind of masking are available, we know that it happens in practice. McDonald noted that the constructive use of Brown's test established Detroit, Michigan as being among the healthiest cities in the United States in 2013, the same year that the city filed for bankruptcy.<sup>74</sup> Marlowe's analysis on the capacity of the local governments that were vying for Amazon.com's "HQ2" to afford the incentives that were offered concluded that most of the cities were unhealthy.<sup>75</sup> Additionally, in applying Brown's test, Marlowe measured the relative health of the cities in comparison and not their actual status.<sup>76</sup>

Local governments frequently offer businesses incentives for the expansion or relocation of the business into a community and businesses frequently incorporate the financial condition of a government into their

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<sup>72</sup> See *id.* at 24.

<sup>73</sup> See McDonald, *supra* note 13, at 47.

<sup>74</sup> See *id.* at 51; Brown, *supra* note 66, 21-26.

<sup>75</sup> See Justin Marlowe, *A Public Finance Take on HQ2*, LINKEDIN (Jan. 26, 2018), <http://www.linkedin.com/pulse/public-finance-take-hq2-justin-marlowe/>.

<sup>76</sup> See *id.*

decision-making process.<sup>77</sup> After all, financially sound governments are better able to provide incentives. If the condition of a government is worse than what was relayed, the government may be susceptible to litigation from the business in order to ensure the incentives are provided.

Additionally, the methods of collecting data for the underlying ratios of fiscal health also pose concerns.<sup>78</sup> A staple of financial ratios is the inclusion of an organization's liabilities.<sup>79</sup> In an accounting context, the calculation of a government's liabilities can often be uncertain.<sup>80</sup> Administrators have been known to use this uncertainty to their advantage by adjusting parameters of a liability to make it appear lower than it really is.<sup>81</sup> For example, administrators can adjust and mask liabilities through defined benefit public pension plans.<sup>82</sup> As cost and amortization payments increase, there is evidence suggests administrators have taken less than prudent methods to defer the government's required

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<sup>77</sup>See David Heald, *Accounting for Government Guarantees: Perspectives on Fiscal Transparency from Four Modes of Accounting*, 48 ACCT. & BUS. RES. 782 (2018).

<sup>78</sup>See Timothy C. Irwin, *Defining the Government's Debt and Deficit*, 29 J. ECON. SURV., 711, 718-20 (2015).

<sup>79</sup>See *id.*

<sup>80</sup>See *id.* at 726.

<sup>81</sup>See generally William Easterly, et al., *When is Fiscal Adjustment an Illusion*, 14 ECON. POL'Y 55, 57 (1999).

<sup>82</sup>See Jeffrey Diebold, et al., *Sweat the Small Stuff: Strategic Selection of Pension Policies Used to Deter Required Contributions*, 36 CONTEMP. ECON. POL'Y 505-525 (2018) (Discussing the influence of amortization payments on administrator's decisions regarding state finances).

contributions.<sup>83</sup> Ultimately, these methods can mask the true size of the liability and portray the government as healthier than it is.<sup>84</sup> More importantly, masking the liability can impact a government's capacity to pay on the liability when it comes due.<sup>85</sup> At its worst, this could leave the thousands of local government employees without a pension.<sup>86</sup>

On the side of service provision, fiscal stress can hinder a local government's ability to meet its required service and goods obligations.<sup>87</sup> Both states and the courts often require that certain goods and services be offered; occasionally, the mandate may even include the extent to which the goods and services are funded.<sup>88</sup> This is more common with education funding.<sup>89</sup> Improper financial planning or a poor understanding of a government's position can result in more control by the mandator, or the local government's forced disillusionment.<sup>90</sup>

It is also worth noting the legal implications surrounding fiscal health extend beyond the local level. Traditionally, counties were established as administrative branches of the state to manage public

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<sup>83</sup> *See id.* at 506.

<sup>84</sup> *See id.*

<sup>85</sup> *See id.*

<sup>86</sup> *See id.*

<sup>87</sup> *See McDonald, supra* note 4, at 609.

<sup>88</sup> *See id.*

<sup>89</sup> *See McDonald, supra* note 13, at 48.

<sup>90</sup> *See id.*

safety, dispense social services, and administer public works programs.<sup>91</sup> Although some states have created distance from their counties by granting home rule, states are ultimately responsible for county actions and must address problems when they emerge.<sup>92</sup> The same responsibility does not exist between the state and municipalities; however, states have typically stepped in when municipalities experience severe financial hardship to avoid negatively affecting the state as a whole.<sup>93</sup>

## V. CONCLUSION

Understanding a local government's fiscal health is a key aspect of effective administration.<sup>94</sup> Unfortunately, the literature on fiscal health has provided little certainty in terms of how fiscal health is defined and how it should be measured. Researchers in fields such as public administration, accounting, and economics have stepped forward to solve the fiscal health dilemma.<sup>95</sup> The fiscal health of local governments is an amazingly complex,

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<sup>91</sup> See David R. Morgan & Kenneth Kickham, *Changing the Form of County Government: Effects on Revenue and Expenditure Policy*, 59 PUB. ADMIN. REV. 315, 317 (1999).

<sup>92</sup> See Bruce D. McDonald & Carl J. Gabrini, *Determinants of County Charter Decisions: An Event History Analysis of Florida Counties*, 24 J. PUB. ADMIN. RES. & THEORY 721, 722-23 (2014).

<sup>93</sup> See PEW CHARITABLE TR., *supra* note 8, at 4.

<sup>94</sup> See *id.* at 2.

<sup>95</sup> See generally Gorina, *supra* note 7.

multi-dimensional issue. Despite a large and growing literature, no resolution has emerged.

The absence of a resolution presents a challenge for administrators which has been confounded by the Great Recession.<sup>96</sup> The recession has been over for nearly a decade, but the increased service commitments imposed upon local government have largely continued and the tax limitations have only grown as residents demand lower taxes in a good economy. As researchers and academics have struggled with the challenge, their view of fiscal health has taken on a mono-dimensional quality that has ignored the legal implications of fiscal health.<sup>97</sup> This does not mean the implications are not there, but rather that we have to seek them out.

This article has certainly not sought to provide a comprehensive understanding of those legal implications. It has not even sought to provide a complete understanding of fiscal health. Rather, it has merely attempted to connect the two and start a conversation on the legal dimensions. We know how we define and measure fiscal health can have legal implications for both the government at hand and the constituents it represents. These implications need to be clarified and better understood. The financial condition of local governments is destined to continue playing a central role in their decision-making process and those who practice the law must be prepared to confront it.<sup>98</sup>

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<sup>96</sup> See McDonald, *supra* note 13, at 46.

<sup>97</sup> See *id.*

<sup>98</sup> See generally McDonald, *supra* note 1.