THE FISCAL HEALTH OF MICHIGAN'S LOCAL GOVERNMENTS

Update since the Great Recession

Fall 2018

Michigan Department of TREASURY

EXECUTIVE SUMMARY

Michigan local governments are tied to the general economy via their reliance on local property taxes and state revenue sharing as their primary sources of funding, followed by items such as charges and fees, grants, and city income taxes for a few select cities. The 2008-09 recession (often referred to as the Great Recession) hit Michigan very hard following what was a stagnant economic decade after the 2001 recession. This paper reviews the post-recession change and current status in the fiscal health of Michigan's local governments.

While revenues are growing in the aggregate and overall fiscal health has improved, it is clear that now is the time to address long-term challenges that continue to stress many local governments.

Local government revenues are the first key to understanding local fiscal health. In Michigan, between 2008 and 2012 *taxable values* fell 13 percent, leading to declines in local government property tax revenues. Beginning in 2013, taxable values began to climb. To offset the declines in property tax revenues, some local governments were able to successfully levy higher millages.

Total local government property tax *revenues* are up since 2012 and have reached the prior peak of 2008. At the same time, local government revenues other than property tax have risen. State revenue sharing has been increasing at a slow but steady pace since 2011. For those cities that levy an income tax, income tax revenues have risen. Overall, local government revenues have improved since the Great Recession, especially during the last few years.

On the spending side of the equation, since 2009 local governments have been cutting the number of employees in their ranks. At the same time as cuts were being made, local governments have been forced to reckon with growing pension and retiree health care burdens. In particular, required pension spending in many communities has nearly tripled over the past five years. As a share of the local budget, pension and retiree health care costs are increasingly crowding out other critical public service needs.

Bringing together the revenue and spending sides of the equation, overall local fiscal health has improved in Michigan. Since 2010, revenues on average have grown faster than spending for all types of local governments in the state. This has led to improved general fund balances as the number of local governments with less than the recommended level of reserves has fallen from 2012 through 2016. Further, the number of local governments with a general fund deficit elimination plan has decreased by half since 2010. This evidence all points to improved local fiscal health and strong fiscal management by local governments.

Even with improvements in fiscal health for some Michigan local governments, there remain significant and important risks. First, the financial improvement has not been experienced by all local governments. There is a group of local governments who have less than the recommended level of general fund balance and remain mired in difficulty and face many pressures even in a good economy. Further, there is a significant group of local governments whose average revenue growth barely exceeds or even falls below their average needed level of spending growth. Some governments, while having fiscally balanced their books, can only provide a minimally adequate level of public services. Second, legacy costs are crowding out other expenses even as overall fiscal health is improving. Finally, infrastructure needs are posing great challenges moving forward as governments must seek resources to meet these investment gaps.

Based on these critical risks, now is the time to act to ensure the local government system is as robust and resilient as possible to economic shocks. Even while local finances are improving, these improvements are not universal. It is clear, even in a strong economy, that a significant number of Michigan local governments remain at serious risk of a potential fiscal crisis. Now is the time to act with a balanced policy approach that includes tools for addressing legacy costs, intergovernmental cooperation, efficiency improvements, and establishing a stable revenue base. This four-pronged approach can mitigate risks and ensure that the vast majority of local governments will be resilient to future challenges.

INTRODUCTION

Local governments in Michigan have faced a long decade of fiscal challenges. Going back to the early 2000s and Michigan's economic stagnation beginning in 2001, revenue sharing cuts, growing legacy costs, and low-growth local revenues combined to create a series of local fiscal problems.[1] These problems cumulated in the Great Recession[2] during which Michigan was hit very hard, leading to severe fiscal difficulties in many communities.

Since the end of the Great Recession, overall local fiscal health has improved. In the post-recession period from 2010, there are several signs of improvement. Revenues have grown across the board including property taxes and state revenue sharing and expenses have been adequately controlled in general. Even with these improvements, significant problems remain, and risks are evident in the short and long-term. Furthermore, these improvements are not across the board and a number of communities remain in fiscal distress.

The purpose of this report is to consider the fiscal health of Michigan's local units of government, with a focus on how they have fared since the Great Recession. Using key financial data such as revenues, expenditures and the changes in fund balance year over year, this report seeks to understand the general fiscal health of Michigan's local units today and how well-positioned they are to manage any future downturns.

First, revenues are reviewed including state and local based sources. Next, local government expenditures are reviewed in terms of overall cost trends and personnel and benefit cost trends. Finally, the revenue and expenditure sides are brought together to measure and assess the current state of fiscal health for city, county, township, and village governments in Michigan. The conclusion outlines some of the important risks and challenges facing Michigan local governments in the future.

[1] https://www.michigan.gov/documents/FINAL_Task_Force_Report_5_23_164361_7.pdf

[2] The Great Recession of 2008-2009 began in December 2007 and ended in June 2009. Throughout this report, we refer to it as the Great Recession.

REVENUE TRENDS IN MICHIGAN'S LOCAL GOVERNMENTS

A complete picture of fiscal health is comprised of looking at revenue and expenditure patterns and pressures. In Michigan, local governments rely primarily on two sources of revenue: property tax revenue and state revenue sharing. Additionally, there are 22 cities in Michigan levy a city income tax.

The pie chart in *Figure 1* provides a breakdown of the distribution of general fund revenue sources for Michigan's local governments. Property tax revenues are the primary source of revenue for local governments. Property tax revenues make up more than 85%[3] of the tax revenue local governments receive. Other important categories include state revenue sharing and charges and fees. The category called "Other" includes miscellaneous revenues, bond and note proceeds, and transfers to the general fund.

[3]*Source: U.S. Census Bureau,. 2016 Annual Surveys of State and Local Government Finances.*

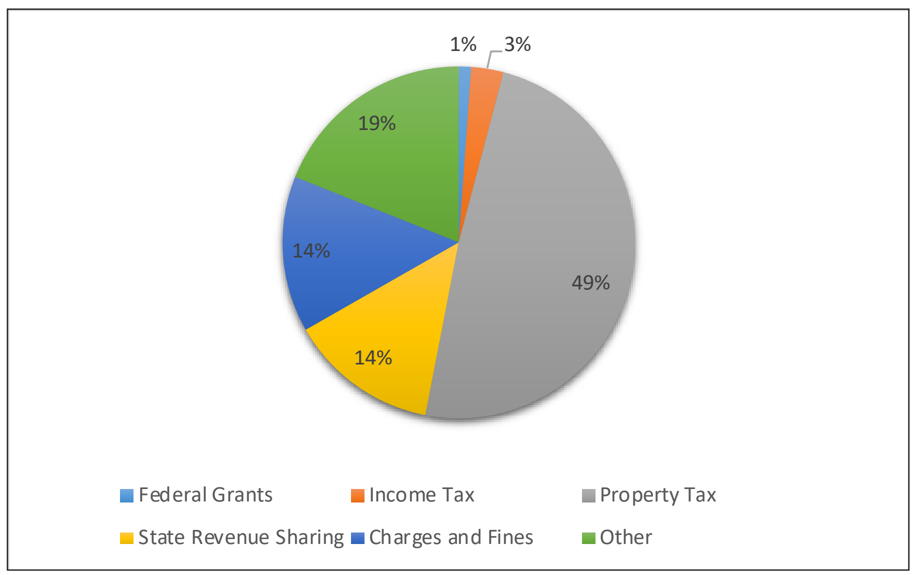


Figure 1:
Local Government General Fund Revenue Sources
Cities (excluding Detroit [4]), Counties, Townships, and Villages

Source: Form F-65 data reported by local units to Treasury

The following sections review local and state-based revenue sources and how they have changed over the last decade.

Property Values

Property tax revenues are a function of taxable value and millage rates. Over the last decade, taxable values in Michigan have fallen due to the Great Recession and the related housing crisis, and then began a small and steady upward trend since 2013. After the peak in 2008, taxable values declined until 2012, at which time they began a modest three-year climb. As demonstrated in *Figure 2*, total taxable value statewide fell from $363 billion in 2008 to $316 billion in 2012, a drop of 13 percent and increasing to $327 billion in 2016. [5]

[4]Throughout this report, the city of Detroit is either presented separately or excluded (and indicated as such) due to its size and therefore potential to skew the results of the analysis of financial data.

[5]The climb in total taxable value continued in 2017 at $335.5 billion.

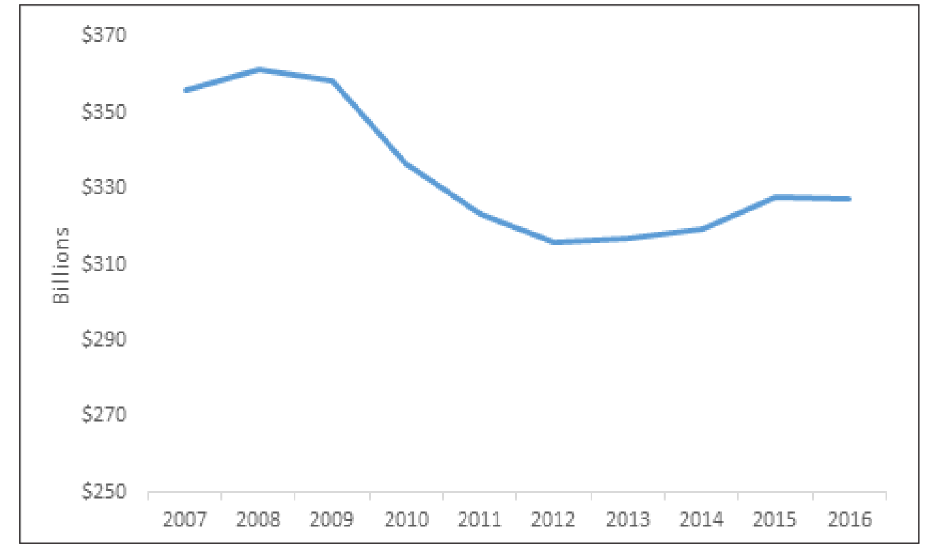


Figure 2:
Total Taxable Value, 2007-2016
($ billions)

Source: Ad Valorem Property Tax Reports, State Tax Commission

This aggregate picture does not provide a complete story given the distribution of challenges across the state. Several cities and townships had inflation-adjusted taxable values in 2016 that were below their respective 2000 taxable values. For those communities whose inflation-adjusted taxable value remains below the level it was in 2000, this is a significant risk to their fiscal health.

Property Tax Revenues

Like taxable values, property tax revenues have also declined and then slightly increased from the bottom. As demonstrated in *Figure 3*, statewide property tax revenues decreased from $5.6 billion in 2008 to $5.4 billion in 2016, a decrease of 2.4 percent. Since the bottom, property tax revenues have climbed back somewhat and are five percent above the nadir in 2012.

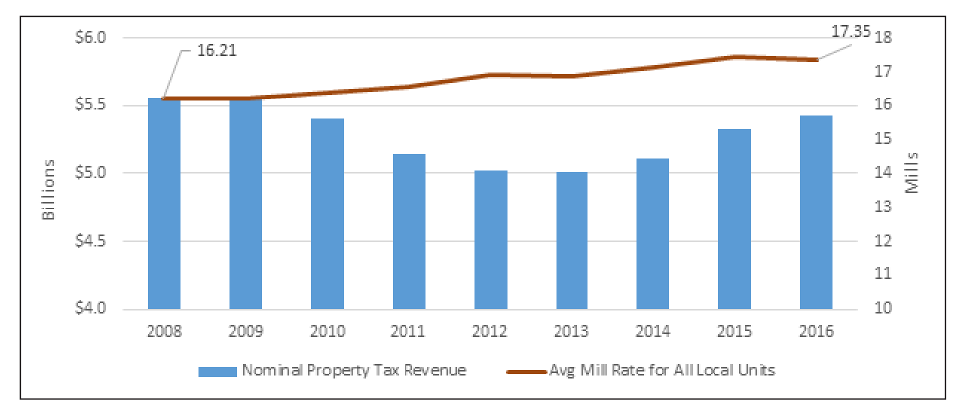


Figure 3:
Statewide Local **Government Property Tax Revenue with Average Millage Rate**
(2008 to 2016)

Sources: Form F-65 data reported by local units to Treasury and data from State Tax Commission Ad Valorem Property Tax Reports. Data excludes the city of Detroit.

During this time, millage rates had their own trends. Some communities addressed the loss of revenue problem via changes in tax rates. Average local millage rates increased from 16.21 mills in 2008 to 17.35 mills in 2016, an increase of 7%. *Figure 4* shows the effects of the increased millage on the collection of property tax revenue for local units of government. The 1.14 statewide average increase in mills generated approximately $1.672 billion in taxes levied from 2009 through 2016. This reflects revenue that would not have been captured had the local units not raised the millage rates. This increase in millage was perhaps a means of compensating for the reduction in taxable value.

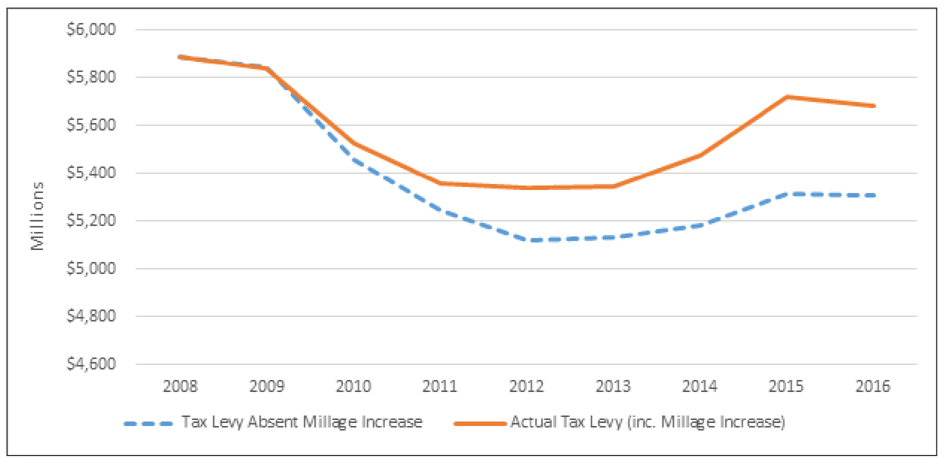


Figure 4:
The Effect of Millage Increases on Property Tax Revenues
(Using 2008 Millage Rates)
($ Millions)

Source: Ad Valorem Property Tax Reports, State Tax Commission. "Tax Levy Absent Millage Increase" impact was extrapolated based on actual tax levy data.

State Revenue Sharing

On a statewide basis, from its high watermark in 2002 general revenue sharing (constitutional and statutory) decreased sharply until 2005, after which it began to level off and then continued to somewhat fluctuate. Overall, revenue sharing saw a 20 percent decrease from 2002 to 2016 (see *Figure 5*).

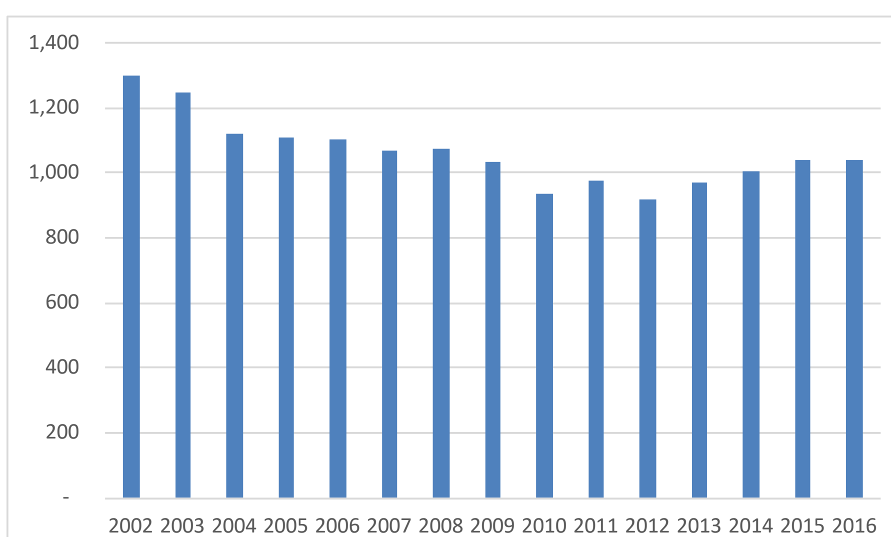


Figure 5:
Total General Revenue Sharing 2002 - 2016[6]
Cities, Townships, and Villages
(Not Including Counties)
($ Millions)

Source: Michigan Department of Treasury, Office of Revenue and Tax Analysis.

[6] For 2017, total general revenue sharing decreased by less than $3 million to approximately $1.21 billion.

Over the last decade, in the aggregate, general revenue sharing has increased from $1.07 billion in 2007 to $1.21 billion in 2016 (an increase of 13 percent). Revenue sharing in FY 2018 is projected to reach $1.4 billion. However, this increase was not true for all types of municipalities. Cities and villages took in less general revenue sharing dollars in 2016 than in 2007 (see *Figure 6*). This is true for the city of Detroit as well. From 2007 to 2016, revenue sharing received by cities (excluding Detroit) decreased by nearly $45 million dollars (a 10 percent decrease) and revenue sharing received by villages decreased by over $2 million (a decrease of over 8 percent). A factor contributing to the reduction in revenue sharing for cities may have been the completion of the 2010 Census Bureau, which showed population loss for many Michigan cities.

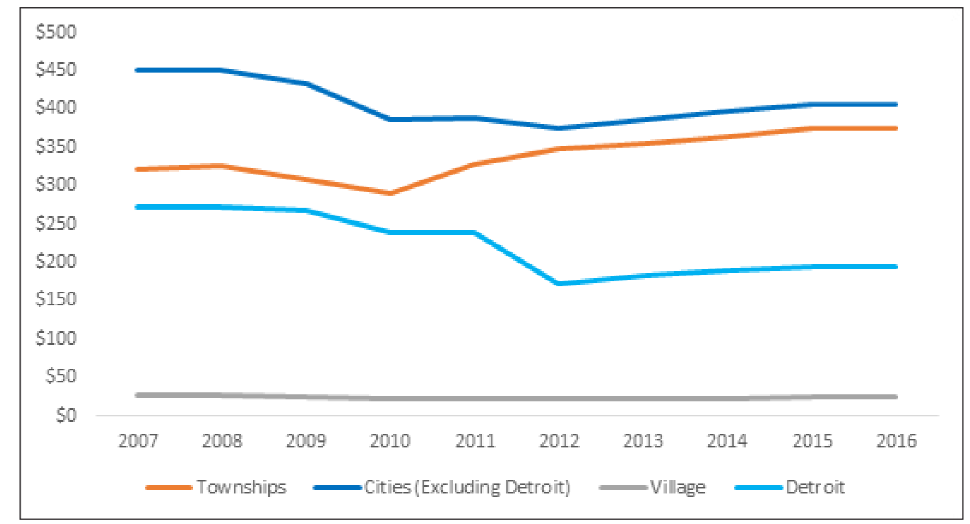


Figure 6:
Total General Revenue Sharing by Type of Local Unit 2007-2016
(Not Including Counties)[7] ($ millions)

Source: Michigan Department of Treasury, Office of Revenue and Tax Analysis.

[7] Counties are not included in this figure due to the legislative changes that impacted county revenue sharing during this period. In short, legislation enacted in December 2004 eliminated revenue sharing to counties beginning in FY 2004-05 and instead permitted counties to accelerate over time the collection of property taxes, place the tax revenues in a revenue sharing reserve fund, and utilize the funds in amounts determined by the State based on prior years' revenue sharing distributions. Once the revenue sharing reserve funds were depleted (which began in FY 2008-09), revenue sharing payments to counties resumed.

City Income Tax Revenues

There are 22 cities in Michigan that levy a city income tax. *Figure 7* provides a summary of city income tax revenues since 2010. In the aggregate, general fund income tax revenues have grown from $378.7 million in 2010 to $476.1 million in 2016. For those cities with an income tax, there has been some degree of revenue growth following the recessionary period, although it has been slower in the more recent past.

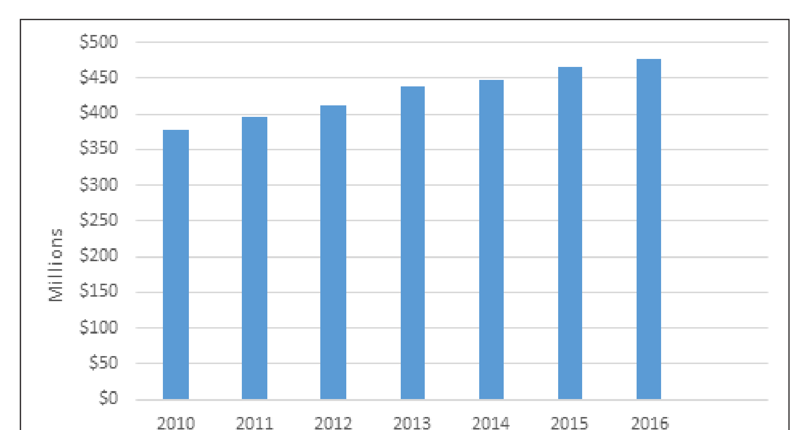


Figure 7:
Statewide City Income Tax Revenue 2010 - 2016
(General Fund) ($ millions)

Source: Form F-65 data reported by local units to Treasury

Summary of Revenue Trends

In total, local government revenues have recovered since the Great Recession. Since 2012, general fund revenues are up $753 million or 9.8%. State revenue sharing has been up slightly since the recession although the distribution of revenue sharing has changed over time. City income taxes have provided some revenue growth to a select number of cities and local property taxes have rebounded from their low point in the 2010-2011 period. That said, revenue growth remains sluggish in many communities. In fact, a number of community's revenues are still stagnant even from the recessionary period. Revenue improvements are not evenly distributed, and a number of locals continue to experience stagnant or declining revenues even in the strong economy we are experiencing. The improvements since the low point from the recession may not be sustainable and may threaten local fiscal health especially during the next economic downturn.

EXPENDITURE PRESSURES AND TRENDS

Besides revenues, expenditures make up the other side of the local government fiscal equation. Local governments spend funds on a variety of critical public services including police and fire protection, medical services, corrections facilities, parks and recreation, roads, zoning and code compliance, economic and neighborhood development, and sewer and water provision. In our federal system of government, local governments are the front-line providers of many services directly to citizens and their major expenses are often in personnel.

The next section outlines the expenditure pressures and trends facing Michigan local governments. Local governments are typically driven by a high percentage of personnel costs. This review includes personnel expenditures, legacy costs, and general inflationary trends as well as the breakdown of spending categories.

Breakdown of Local Government Spending

Local governments spend funds on a variety of important functions. The pie chart in *Figure 8* provides a breakdown of spending by various major functional categories.

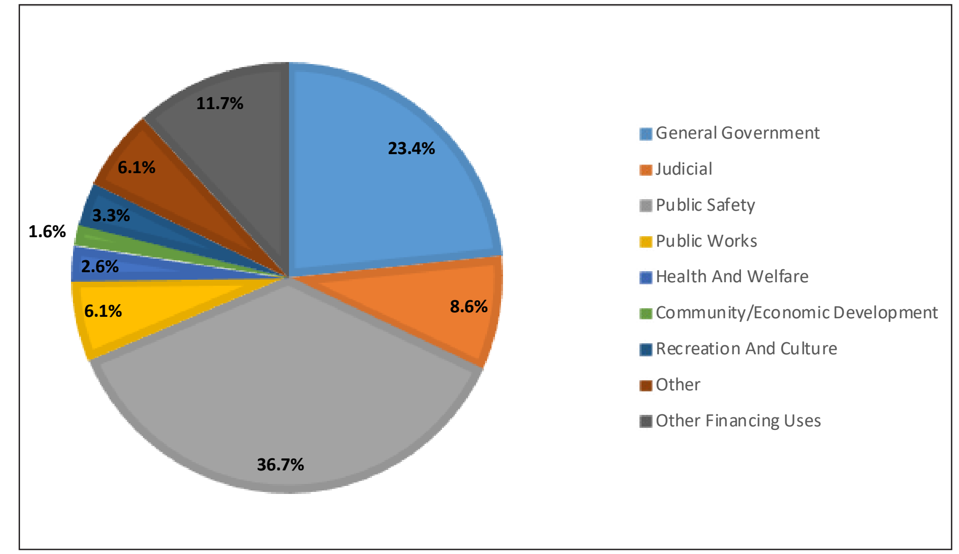


Figure 8:
Local Government General Fund Spending by Category*

Source: Form F-65 data reported by local units to Treasury
**Does not include city of Detroit*

Local Government Workforce Cost Trends

As previously stated, personnel costs represent the largest component of a local government budget, especially in comparison to a state budget. Therefore, a more careful examination of personnel costs is to determine cost pressures. Michigan local units appear to have responded to the aftermath of the economic and financial crisis by, among other things[8], reducing employees. As demonstrated in *Figure 9*, workforce numbers have been in decline for Michigan's local governments since 2009. From 2007 to 2015, there was an eight percent drop in total number of local government employees. This drop has flattened out since 2011.

[8] Some of the decrease may also be due to outsourcing.

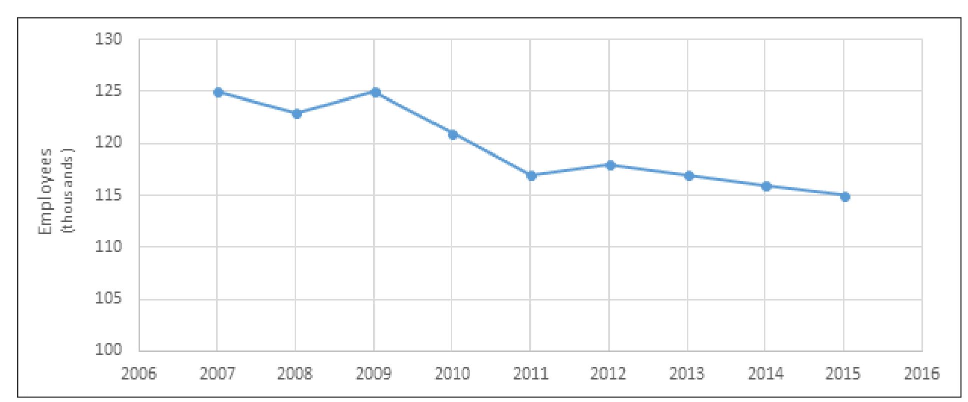


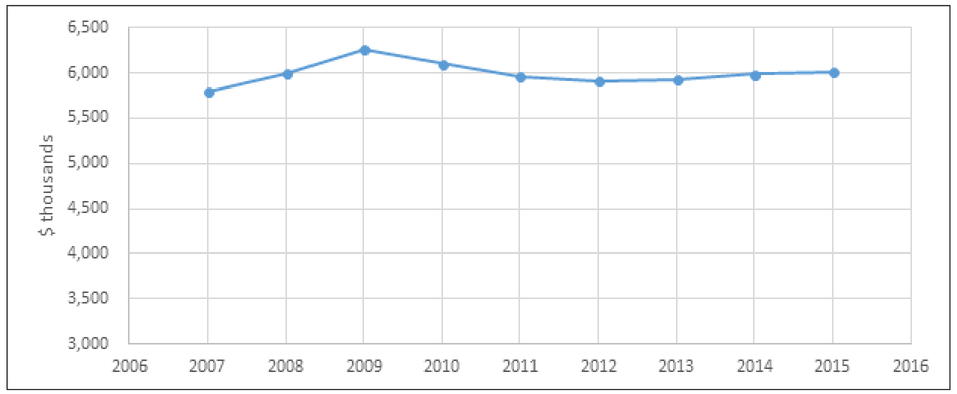
Figure 9:
Michigan Local Government Municipal and County Workers 2007 - 2015
(Thousands)

Source: Compiled using U.S. Census Bureau data.

Even while employee numbers were dropping, payroll expenditures, which do not include benefit costs, have been relatively flat since the Great Recession. *Figure 10* presents the overall trends in total payroll expenditures for local governments in Michigan. They have only dropped four percent since 2009 and are up since 2007, as compared to the eight percent drop from 2007 to 2015 in overall number of employees. Thus, one can surmise that per employee cost has risen.[9]

Figure 10:
Aggregate Payroll Expenditures Municipal and County Workers
($ Thousands)

Source: Compiled using U.S. Census Bureau data.



Local Government Benefit Costs and Trends (Active and Retired Employees)

These payroll and employee figures on workforce do not take into account the benefit costs of active and retired employees. Taking into account active and retiree benefit costs, cost pressures are even greater than the payroll chart in *Figure 10* indicates. Between 2001 and 2014, annual health care inflation was nearly twice the rate of consumer inflation at four percent compared to two percent.[10] At the same time, pension contributions have also risen much faster than general inflation. Benefit cost pressures have been a major driver of overall expenditures.

One of the biggest cost pressures comes in the area of retirement benefits. Local government pension and retiree health care (OPEB) obligations are formidable. The most current data suggest a $9.1 billion unfunded pension liability and a $9.1 billion unfunded OPEB liability for local governments collectively. These unfunded liabilities translate into nearly $1.5 billion in employer contribution costs in FY 2016 (see *Tables 1 and 2*). This is a significant increase from an estimated total annual cost of only $800 million in FY 2010.[11] Further, these costs are rising as unfunded liabilities grow and as pension systems continue to update demographic and workforce assumptions, which result in higher required contributions.

[9] In January 2018, the University of Michigan Center for Local, State and Urban Policy (CLOSUP) reported in a survey of local officials that in fact slight employee pay increases had been occurring since 2011. See http://closup.umich.edu/files/mpps-workforce-2017.pdf

[10] https://fredblog.stlouisfed.org/2017/07/healthy-inflation

[11] This estimate is based on approximations from existing data including data from the annual financial reports from 2010 through 2016 and Treasury collected legacy cost data in 2016 and 2017.

Local Government Pensions

Table 1 provides a view of the pension challenges facing local governments in Michigan. There are almost 600 pension plans amongst primary units of government and they collectively owe over $9 billion in unfunded liabilities. Generally, local governments are paying at or above the actuarial required contribution, but this amount has been rising over time as actuarial assumptions are changed or not met. However, the cost of pensions continues to rise even as local governments are meeting or, in the case of FY 2016, exceeding their actuarial required contribution.

Table 1: Pension Plans in Primary Local Units as of FY 2015-16

	Number of Plans	Assets	Liabilities	Employer Contribution	Annual Required Contribution
County	85	$ 7,169,871,705	$ 9,502,858,415	$ 283,347,531	$ 238,362,414
Township	102	$ 1,438,578,164	$ 2,016,894,564	$ 54,539,391	$ 50,311,488
City	306	$ 16,292,729,790	$ 22,304,563,245	$ 613,271,139	$ 570,297,676
Village	80	$ 139,938,431	$ 215,279,508	$ 6,742,694	$ 5,886,095
TOTAL	**573**	**$25,041,118,090**	**$34,039,595,732**	**$957,900,755**[12]	**$864,857,673**

Source: Treasury review of local unit FY 2015-16 financial statements

[12] Overpayments of the ARC may be due to pension bonds or a voluntary over-contribution by an employer.

Employer contributions to local government pension plans have increased over time. The Municipal Employees' Retirement System (MERS) of Michigan is an independent retirement services company that administers the retirement plans for a majority of Michigan's municipalities. *Figure 11* shows employer and member contributions from 2004 to 2016. From 2004 to 2016, employer contributions to local government pension plans administered by MERS increased by 238 percent. From 2011 to 2016, the increase was 78 percent. It should be noted pension costs are not paid from the local unit's general fund exclusively, but are also paid from other funds such as water and sewer enterprise funds.

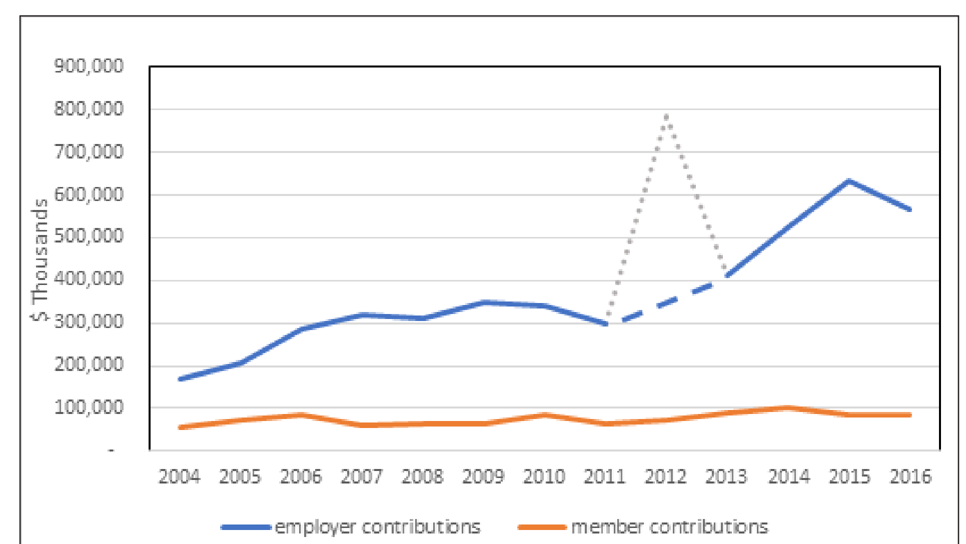


Figure 11:
MERS Employer and Member Contributions 2004 to 2016[13]
($ thousands)

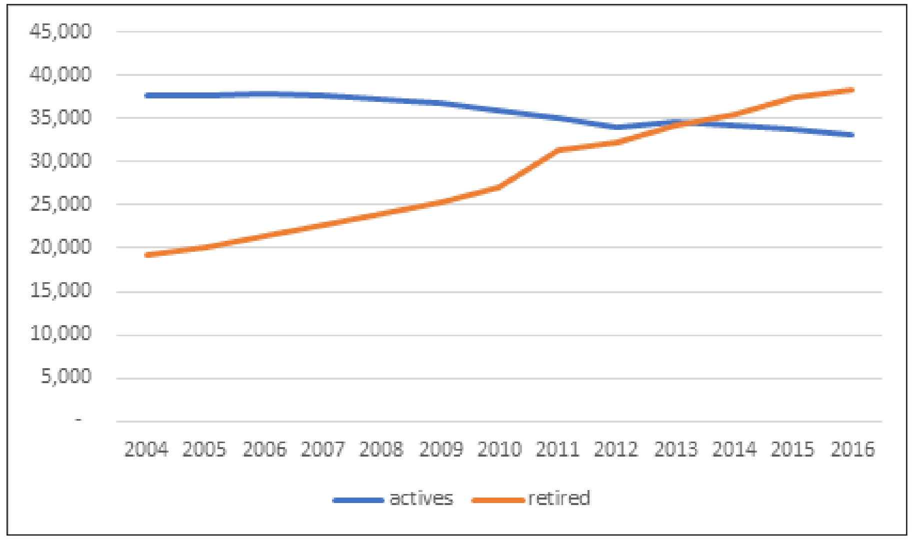
Source: Compiled using MERS data

[13] The spike in employer contributions in FY 2012 (dashed gray line) is due to the city of Flint and Hurley hospital becoming members of the MERS system and their one-time deposit of all city and hospital pension assets into MERS, which were treated as employer contributions. The dashed blue line demonstrates the trend without this one-time occurrence.

At the same time employer contributions are going up, the ratio of active members to retired members is going down. *Figure 12* shows the change in the number of active members compared to retired members, which is clearly trending downward. This trend is not expected to change. This trend places additional cost pressures on employers as they seek to make up lost ground in their retirement systems.

Figure 12:
Number of Active and Retired Members of MERS

Source: Compiled using MERS data



The pattern of increasing employer contributions to local government pension plans holds true for pension plans that are not administered by MERS as well. A review of 30 local governments with high pension liabilities shows that from 2010 to 2016 employer contributions went up by 70 percent.

Local Government Retiree Health Care Costs (Other Post-Employment Benefits - OPEB)

Unlike with pensions, local units are neither constitutionally nor statutorily required to make annually determined contributions to fund their retiree health care.[14] For Michigan local units' defined benefit retiree health care plans, the total unfunded actuarial liability is nearly $9.1 billion.

There are fewer retiree health care plans for primary units of government in the state as compared to pension systems. For FY 2015-16, even though an annual contribution of $742.4 million would have been the amount to set aside to fully pre-fund retiree health care, local units were only able to contribute $503.4 million, an annual shortfall of approximately $239 million. Although OPEB assets have risen recently, much of this has been due to OPEB bonding and represents the exchange of one liability for another. At the same time, total OPEB liabilities have fallen, but this was generally due to major changes in very few jurisdictions.

[14] Public Act 202 of 2017 requires local units to fund an annually determined contribution for employees hired after July 1, 2018, if retiree health care is offered to the employee.

Table 2: Retiree Health Care Plans in Primary Local Units as of FY 2015-16

	Number of Plans	Assets	Liabilities	Employer Contribution	Annual Required Contribution
County	55	$ 1,746,895,532	$ 3,604,138,807	$ 119,764,247	$ 170,460,965
Township	88	$ 251,391,058	$ 1,294,379,895	$ 77,097,693	$ 87,797,351
City	197	$ 1,351,887,612	$ 7,490,669,306	$ 303,973,714	$ 479,878,800
Village	22	$ 11,007,494	$ 52,423,374	$ 2,597,052	$ 4,245,538
TOTAL	**362**	**$3,361,181,696**	**$12,441,611,382**	**$503,432,706**	**$742,382,654**

Source: Treasury review of local unit FY 2015-16 financial statements

Unlike with pension, OPEB employer contributions have not gone up. Since 2011, they have remained relatively flat at about $500 million annually.[15] With some exceptions due to voluntary pre-funding contributions, changes in benefits or OPEB bonding, most Michigan local government employers are still dealing with this issue on a pay-as-you-go basis.

Summary of Overall Expenditure Trends

A major component of a local government's spending is on personnel costs. From 2007 to 2015 there were 10,000 fewer local government workers in Michigan, yet payroll costs remained relatively flat. This suggests that payroll cost per employee has risen. With respect to annual pension costs for active and retired employees, it is estimated that the average percentage of combined governmental funds spent on these pension benefit costs rose from approximately five percent in 2010 to approximately ten percent in 2016.[16] Contributions to OPEB are flat while liabilities are increasing. As the baby boomers continue to retire and health care costs increase, legacy costs will continue to place large pressures on municipal and county budgets as they grow faster than revenues. Finally, infrastructure expenditures on roads and water and sewer systems are estimated to be inadequate. Failing to make the necessary investment in infrastructure when needed can result in even higher gaps in the future.

[15] Based on Treasury and Michigan State University collected data from the past six years.

[16] This estimate is based on Treasury and Michigan State University data collected from 2010 through 2018.

FISCAL HEALTH OF MICHIGAN LOCAL GOVERNMENTS

Having reviewed the condition of revenues and expenditures for Michigan local governments, we can now turn to bringing them together to assess the status of fiscal health. In order to do this, we will review revenue versus spending growth, general fund balance, general fund deficit elimination plans, and several other factors.[17]

[17] Except for *Table 5*, the analysis in this section is based on financial data for 1,587 primary local units of government in Michigan for the period of FY 2009-10 through FY 2015-16. This financial information is self-reported by local units to Treasury via Form F-65. Local units that had missing data or had consolidated or changed local unit type during this period were not included to avoid skewing the analysis due to incomplete or inconsistent data.

General Fund Revenue versus General Fund Expenditure Growth

As reviewed in previous sections, revenues have in general been increasing for local governments since the Great Recession. At the same time, there are growing expenditure pressures from a variety of sources including legacy costs.

The Compound Annual Average Growth Rate (CAAGR) is a good measure of determining the typical patterns of rates of change for revenues and expenditures for the period FY 2009-10 through FY 2015-16. Across this period, average revenue growth for cities was 1.0 percent, while county revenue growth was 1.3 percent and township revenue growth was 2.3 percent. Villages declined at negative 0.8 percent. In contrast, on the expenditure side, city spending grew by 0.4 percent and counties were at 1.2 percent, townships at 2.1 percent, and villages at negative 0.8 percent (see *Table 3*).

Table 3: General Fund Revenue and Expenditure Compound

	Cities	Villages	Townships	Counties
Revenue CAAGR	1.0%	-0.8%	2.3%	1.3%
Expenditures CAAGR	0.4%	-0.8%	2.1%	1.2%

Source: Form F-65 data reported by local units to Treasury

Comparing these values for revenue and expenditure growth rates, all types of local governments, (except villages which experienced both falling revenues and spending over the entire time period), generated a surplus of revenues over spending on average over this time period. These averages mask the fact that the most significant changes occurred in the later years of 2015 and 2016, where the earlier years were much closer between revenues and spending. Overall 57 percent of local units have a revenue CAAGR that exceeds their expenditure CAAGR. That means there are over 40 percent for which the CAAGR of revenues does not exceed expenditures. These are the local units that likely do or will not have adequate fund balances to weather future economic downturns.

These growth rates can also be shown in another format to provide an overall assessment. As seen in *Figure 13*, for Michigan's local units of government in the aggregate, general fund revenues and expenditures were flat to decreasing from FY 2009-10 to FY 2011-12 and then began increasing for the next two years until leveling out in FY 2015-16. The two trends were much tighter in the period 2010 through 2013 as shown in the figure below. More importantly, at that time, a larger number of governments were facing fiscal distress. Since 2014, the pressure has been slightly alleviated in a larger number of local governments, but that trend may not continue.

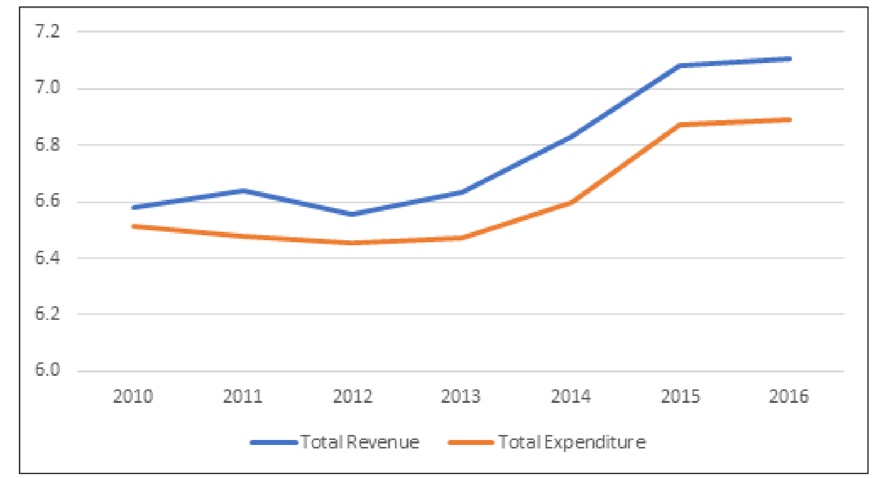


Figure 13:
Total General Fund Revenues vs. Expenditures for Michigan Local Governments ($ Billions)[18]

Source: Form F-65 data reported by local units to Treasury

[18] The city of Detroit is excluded due to the bankruptcy and volatility of its finances during that period.

General Fund Balance

The difference between total general fund revenues and total general fund expenditures (as explained above) provides a view of the overall increase in resources for a local government year over year. This change in resources is known in local government accounting as total fund balance. Fund balance is often considered a good measure of local government fiscal health. Total fund balance is typically divided into unrestricted and restricted.[19]

Unrestricted fund balance reflects residual net resources that do not have externally imposed limitations on their use; it is the cushion that local units have against unforeseen circumstances. In addition to the size of a local unit's general fund unrestricted fund balance, the level as a percent of total revenue provides useful information on the financial health of the local unit. When compared over time, this statistic can also provide information on the fiscal direction in which the local unit is heading. When considering levels of fund balance, it is more useful to compare similar types of governments to one another (i.e., compare cities to cities, townships to townships, etc.) due to differences in fiscal years and liquidity needs.

[19] In February 2009, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions. Under this standard, fund balance components are reported based on the type and source of constraints on how they can be spent. The five categories of fund balance are (from most constraining to least constraining): non-spendable (not in spendable form), restricted (external legal restrictions), committed (internally – by formal action), assigned (internally - less formally), and unassigned. Unrestricted fund balance refers to the sum of committed, assigned, and unassigned fund balance; these are the categories for which the only constraint on spending, if any, is imposed by the government itself.

The Government Finance Officers Association (GFOA) recommends, at a minimum, that general-purpose governments, regardless of size, maintain unrestricted budgetary fund balance in their general fund of no less than two months of regular general fund operation revenues or regular general fund operating expenditures.[20] This is generally interpreted to suggest a fund balance of at least 16.67 percent be maintained.

[20]GFOA: Fund Balance Guidelines for the General Fund - https://www.gfoa.org/fund-balance-guidelines-general-fund

Table 4: Distribution of Unrestricted General Fund Balance as Percent of Total Revenue By Type of Local Unit FY 2012 and FY

	Counties		Cities		Townships		Villages	
	2012	2016	2012	2016	2012	2016	2012	2016
# of units above 16.67%	58	65	222	235	1008	1011	200	204
# of units below 16.67%	20	13	46	33	10	7	23	19
% of units below 16.67%	25.6%	16.7%	17.2%	12.4%	.9%	.7%	10.3%	8.5%

Source: Michigan Department of Treasury

Since FY 2012, the number of governments with a fund balance greater than the GFOA recommended value is up substantially. Across every type of government, the number of units above the threshold has increased from FY 2012 to FY 2016. This corresponds to the results from the previous section showing that on average governments have generated revenues above expenditures over the past six years in their general funds.

The downside is that there are still 72 local governments in Michigan with less than the recommended average. While this number is down from FY 2012, it remains a substantially high number. This creates a potential risk in the face of some type of economic shock, should it occur.

Deficit Elimination Plans

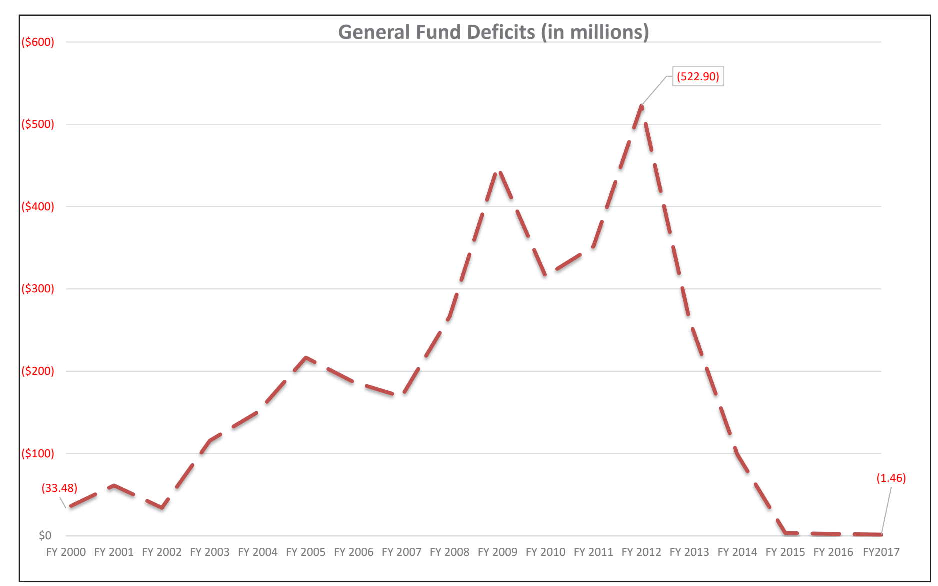
Another way to assess fiscal health is through a review of changes in general fund deficit elimination plans (DEPs). These plans are required when any local government in Michigan runs a negative total general fund balance. The previous two sections showed that on average general fund revenues have exceeded general fund expenditures and that general fund balances have on average improved. A review of the change in the number of DEPs over time bolsters the case that fiscal health has improved across Michigan local governments.

Table 5: General Fund Deficit Elimination Plans FY 2011 – FY 2016

	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
# of DEPs	28	22	20	20	12	14

As seen in *Table 5,* the number of general fund deficit elimination plans has dropped in half from FY 2011 to FY 2016. The drop in DEPs corresponds to the overall improvement in local fiscal health, revenue over expenditures and the growth in overall general fund balance.

The following graph illustrates this overall improvement by showing the decrease in the total dollar amount of deficits within the general fund from 2000 to 2017. General fund deficits have been reduced to just over $1.2 million dollars in 2017. At the high point in 2012 general fund deficits totaled just over $522 million dollars. Of the 22 communities with a general fund deficit, 95% of the total dollar amount was from just three communities. These were the city of Detroit, county of Wayne, and the city of Flint.



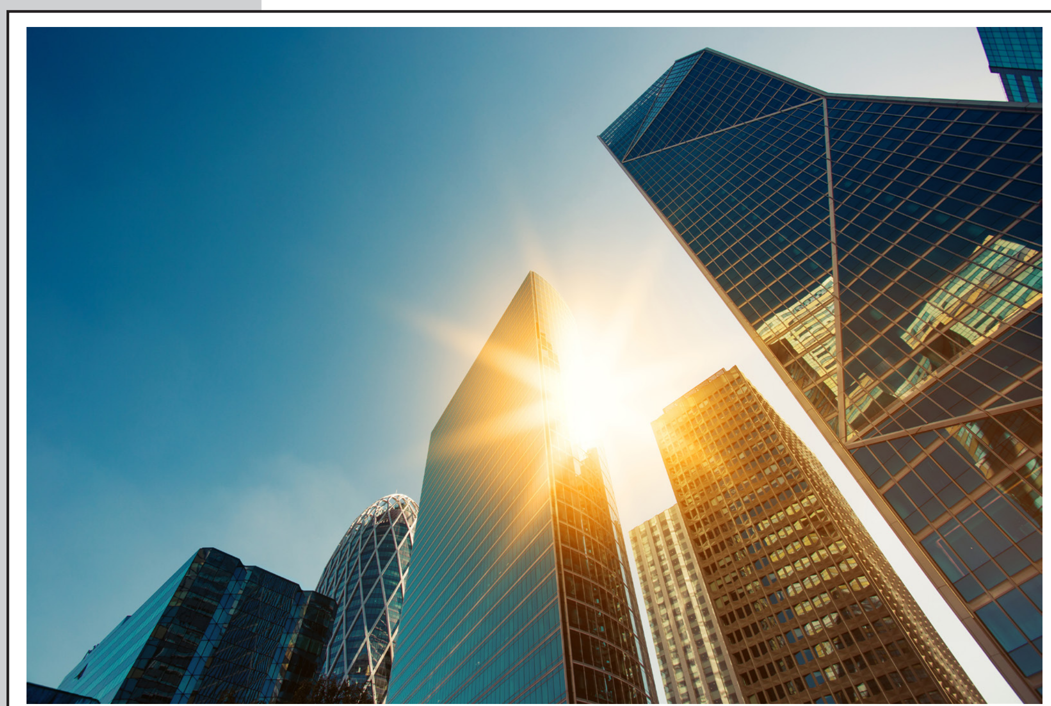
Summary of Overall Fiscal Health

Overall, fiscal heath has been improving across local governments in Michigan. In line with economic improvements across the state, local government fund balances have been improving, particularly in the last few years. Fund balances are now at a more sustainable level. However, a significant number of government entities remain below recommended levels and remain potentially at risk in the face of an economic shock.

Thanks to careful cost control and some revenue improvements, local fiscal health is in better shape than where it was just after the Great Recession. According to the Michigan Public Policy Survey conducted by the University of Michigan's Center for Local, State, and Urban Policy (CLOSUP), [21] beginning in 2011 Michigan's local government leaders' assessment of their jurisdictions' fiscal conditions gradually improved, with 2016 being the first time since the end of the Great Recession that this trend reversed. In its most recent survey, CLOSUP stated that the reports for 2017 showed, overall, a move back toward fiscal improvement.

[21] http://closup.umich.edu/files/mpps-fiscal-health-2017.pdf

At the same time, major risks remain and, while cost controls have been effective, there has been a major shift in spending as pension and legacy costs continue to increase much faster than inflation or revenues and crowd out other spending on public services.



CONCLUSION AND RISKS

Since the end of the Great Recession, many of Michigan's local units of government have managed their finances relatively well. This is partially demonstrated by their ability to maintain and increase positive unrestricted general fund balances. Although revenues have risen, so too have costs. Yet, even with rising costs, local units have found ways to control expenditures to keep them from rising faster than revenues. The evidence shows that general fund deficits are down, fund balances are up, and governments are keeping costs below revenues. However, these may be only temporary trends as new risks and challenges are rapidly emerging.

Given that there have been improvements in the fiscal health of Michigan local governments, they are somewhat better prepared to handle the potential risk of an economic recession, natural disasters, or other problems that may face the community than they were in the depths of the recession. However, even while budgets are generally balanced and fund balances are improving, many important issues remain to be addressed and are critical risks facing the future of local governments in Michigan. These risks may be classified into legacy costs, infrastructure funding gaps, service provision deficiencies, and low economic and fiscal capacity as some of the top issues.

While revenues are growing in the aggregate and overall fiscal health has improved, it is clear that now is the time to address long-term challenges that continue to stress many local governments.

Legacy Cost Challenge

Legacy costs are the costs of ensuring that active and retired employees receive the pension and retiree health care benefits they have been offered and promised. These are essentially a form of deferred compensation. Michigan local governments are paying nearly $1.5 billion annually in costs to maintain these programs and this cost is rising rapidly, in many cases faster than revenues. Beyond this $1.5 billion, governments should be paying several hundred million more to fully pre-fund retiree health care benefits.

Infrastructure Funding

A second challenge is infrastructure funding gaps. Based on the Michigan 21st Century Infrastructure Commission report in 2017,[22] the state faces a $4 billion annual gap in paying for the maintenance and development of transportation, water, energy, and communications infrastructure. Of this, the local government gap, which typically owns most of the water and sewer systems and some of the roads, is approximately $1.2 billion annually. This level of funding is clearly not available in today's local government budgets. It will require new strategies for raising funds. The maintenance of this infrastructure is crucial for community and economic development and poses a significant challenge.

[22] https://www.michigan.gov/ snyder/0,4668,7-277-61409_78737---,00.htmlsnyder/0,4668,7-277-61409_78737---,00.html

Service Provision Deficiencies

In some communities, the ability to balance the local budget has come at the expense of critical public services like public safety. These deficiencies can lead to reductions in the quality of life of residents and an inability to attract new residents and business investment. These are also communities where the local tax burden may already be quite high and the capacity to raise local taxes further is extremely limited.

In a longer-term perspective, a number of Michigan communities face the challenge of a very low taxable value per capita that places them at risk of budgetary difficulties. As reported in a Center for Local Government Finance and Policy report from Michigan State University, 32 cities were identified as having a low fund balance and a low taxable value per capita.[23] These communities have been identified as being potentially service insolvent in the near or medium term.

[23] http://msue.anr.msu.edu/uploads/235/75790/GMI_062_Service_Solvency_Report-9-2017.pdf

Fiscally Challenged Communities

As noted earlier in the report, at least 72 communities in Michigan have a fund balance below what is recommended by the Government Finance Officers Association *(see page 16).* In an immediate crisis, these communities may have difficulty raising monies to address the problem. A number of other communities, as noted in the revenue section of this report, still have a severely reduced property tax base level even below where it was in 2000. These communities will face an uphill battle if an economic shock were to occur in the near to medium term. In general, this highlights that while there have been improvements in overall fiscal health, serious challenges remain for a number of Michigan's local governments.

Moving Forward

These major risks, along with others not enumerated here, mean the improvements in fiscal health since the Great Recession are potentially precarious and now is the time for action on local fiscal reforms. Further, aggregate and average values partially obscure the fact that local fiscal health improvements are not evenly distributed, and many pockets of distress remain in the state. Reforms can be enacted that will help local governments address legacy pension and health care costs, improve the way services are provided to constituents, and maintain an adequate revenue base. These reforms and changes can help ensure that long-term fiscal health, as opposed to only short-term fiscal health, is more sustainable in Michigan communities.