Student Case Study Series

Local Government Fiscal Health & Deindustrialization in Michigan

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Executive Summary

In this case study, we analyze the financial health and Michigan Public Policy Survey (MPPS) responses for two municipalities in Michigan: Cities X and Y. Although both municipalities experienced industrial decline throughout the late 20th century, City Y presented stronger quantitative indicators of financial health than City X in 2016. Both municipalities, however, reported similar levels of financial stress through the MPPS survey. We theorize that the resulting gap between subjective and objective measures may result from inaccurate measures of stress, or from contextual differences in the demographic and economic characteristics of the cities.

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Background

Launched in 2009 by the Center for Local, State, and Urban Policy (CLOSUP), the Michigan Public Policy Survey (MPPS) is an annual state-wide survey of local government leaders in Michigan conducted in partnership with the Michigan Association of Counties, Michigan Municipal League, and Michigan Townships Association. These surveys gauge local officials' perspectives on a variety of public policy issues, including local finances and economic development. Included in the MPPS are questions concerning fiscal stress: respondents are asked to rate their municipality's fiscal stress on a scale from 1 to 10 (1 indicating perfect fiscal health, 10 denoting a state of fiscal crisis) in the present-day, as well as to provide predictions for financial stress in five years. This case study will focus on understanding the fiscal challenges of an anonymized municipality, City X, which rated its fiscal stress at six, by comparing it to a peer, City Y, which rated its fiscal stress similarly at five.[1]

As part of the Rust Belt, many communities in Michigan have experienced significant industrial decline since the late 20th century, leading to high levels of unemployment and population decline. Since its peak in the 1960s, City X's population has been approximately cut in half, and due to the multitude of abandoned homes, crime rates began to rise.[2] The city was hit particularly hard by the Great Recession. By July 2009, the unemployment rate in City X far exceeded the statewide rate of 15%, already the highest in the nation.[3]

The dominant industry of City X is currently healthcare and social assistance, followed by retail trade and manufacturing. With a population of about 50,000 in 2016, City X's residents are approximately 46% white, 44% African-American, and nearly 15% Hispanic or Latino.[4] The median household income in 2016 was approximately $29,000.

The following table shows demographic statistics of City X and City Y. City Y is similarly sized and has experienced similar industrial decline, although manufacturing remains its largest industry.

FY2016	City X	City Y
Population Size	50,000	40,000
Median Age	36	39
Median Household Income	$29,000	$55,000
Median Property Value	$40,000	$140,000
Poverty Rate	35%	15%
Unemployment Rate	18%	7.5%

Sources: U.S. Census Bureau

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1   Cases are anonymized to protect the confidentiality of the survey.
2   Census QuickFacts
3   Federal Reserve Bank of St. Louis
4   Census QuickFacts

Financial Condition Assessment

The cities are compared along three metrics of fiscal condition: liquidity, performance, and solvency.

Liquidity

Liquidity ratios explain how well governments can meet current obligations in a given fiscal year and measure the size of the "cushion" of resources that are available to deploy in the case of an emergency. In FY2016, City X struggled across multiple assessments of liquidity while City Y presented strong measures of liquidity across these same indicators.

The quick ratio, for example, measures a municipality's capacity to cover its current liabilities using its most liquid assets, such as cash, cash-equivalents, and certain investments. City X only has about 46 percent of the liquid assets it would need to cover current-year liabilities. City Y, however, could cover present obligations nearly 12 times over. Similarly, City X scores poorly on the short-run financial position ratio, which measures the relative size of the unassigned General Fund balance, a government's financial cushion to handle unforeseen expenses. Best practices suggest that fund balance should be about 15 – 20 percent of total revenue. At 13.6 percent City Y's ratio is slightly low, but City X shows clear signs of stress at only 7 percent. A final measure of liquidity is a municipality's days of cash on hand, which should typically be at least 90 days. City X only had enough cash to cover 25 days of operating expenses, while City Y had enough for 120 days.

2016 Liquidity Ratios	City X	City Y
Quick	0.46	11.93
Short-Run Financial Position	0.07	0.14
Days of cash on hand	25.1	120.4

Performance

Performance ratios measure the extent to which a government balances its budget and can be used to assess fiscal sustainability. City X struggled with performance ratios in 2016, while City Y performed relatively well across most measures of fiscal performance.

City X had a negative net position in 2016, which means it had more outstanding liabilities than assets. Unfortunately, this net position continued to decline during the year. City Y, however, had a positive net position, which grew by 13 percent during 2016. The operating margin ratio measures the extent to which government activities cover their own expenses, and lower values are better. On this measure City X and Y are comparable, with City X somewhat worse. The non-own-source revenue ratio measures the percentage of the municipality's revenue that comes from outside sources like state and federal aid. Although neither city is highly dependent on outside sources, City X is twice as dependent as City Y.

2016 Performance Ratios	City X	City Y
Operating margin	0.71	0.61
Net asset growth	-0.19	0.13
Non-own source revenue	0.22	0.11

Solvency

Solvency ratios take a long-term perspective on fiscal health and are intended to measure the government's ability to cover its long-term obligations as they come due. While City X and Y show clear differences on shorter-term measures of stress related to liquidity and financial performance, they are more comparable on longer-term measures of solvency.

Near-term solvency measures how many years' worth of revenue it would take to pay all outstanding obligations, including bonded debt and unfunded pension and retiree healthcare liabilities. While City Y has a much healthier ratio value, both cities are below the usual threshold for concern of four to five years. Both cities also have a similar amount of bonded debt per capita, although this burden falls more heavily on City X because of its lower household income. City X's debt burden also increases proportionally more than City Y's when unfunded pension and retiree healthcare liabilities are included.

Debt coverage ratios show what fraction of total annual expenditures are dedicated to debt service, and the number is of little concern for either city. The final ratio, capital asset condition, measures how much the value of capital assets have grown over the year. City Y's ratio shows positive growth, while City X has struggled to invest in capital assets.

2016 Solvency Ratios	City X	City Y
Near-term solvency	3.11	1.33
Debt burden (bonded debt only)	864.57	811.87
Debt burden (including pension/OPEB)	5231.87	4110.59
Governmental funds debt coverage	0.003	0.04
Capital asset condition	-0.01	0.05

Self-rated fiscal stress

Despite the differences in their fiscal health ratios, on the MPPS one to ten (best to worst) scale of fiscal stress, Cities X and Y rate themselves similarly at six and five, respectively. They also both report a somewhat optimistic outlook, with each expecting its score to fall slightly to four in the coming years.

Financial Ratio Analysis

Based only on the assessment of the financial condition ratios described above, it would seem that City X is experiencing higher levels of fiscal stress than City Y in 2016. City X's liquidity and financial performance ratios are considerably worse than City Y's, signaling that the City is experiencing distress in at least the near term. The cities' solvency ratios are generally more comparable, but City X does have a larger burden of long-term liabilities and may be struggling to invest in capital assets.

Nevertheless, the cities self-report comparable levels of stress and similar expectations that stress will decline in the future. Based on the ratios, it would appear that either City X is underestimating or City Y is overestimating their fiscal stress levels. This surprising result suggests that more context is needed to understand why local officials chose their respective ratings on the fiscal stress index score.

Demographic and Economic Factors

Looking over a broader historical time period, one dramatic difference between City X and City Y is in population trends. In 2016, the cities had comparable population sizes. City X, however, used to have about twice as many people in the 1960s as it does today. City Y, on the other hand, has experienced some growth over the past several decades instead of population decline. Its population is whiter and has higher income than residents of City X.

While much of the reduction in City X's population is attributable to the decline of manufacturing jobs, housing policy exacerbated outmigration in the 1950s and 1960s, as practices such as redlining prevented people of color from gaining equal access to financial services to buy homes. Meanwhile, wealthier white people who could get home loans were often offered attractive deals, and many residents moved outside the city limits. As a result of this out-migration and the consequent drop in revenues, City X has struggled to maintain its public infrastructure and services.

Shrinking cities like City X face unique fiscal challenges associated with "right-sizing" their services, such as addressing abandoned housing and scaling down infrastructure. However, while right-sizing strategies are often expensive in the short-term, they can contribute to improved long-term fiscal health and solvency.[5] Within this context, City X's apparent short-term fiscal distress, as illustrated by the ratios, may result from this process of shrinking. However, local officials may not be as alarmed by this short-term stress because it is an expected part of the right-sizing process.

An alternative interpretation of City X's self-assessed fiscal stress has to do with the fact that what is "normal" for one city may not be normal for another. Chronic population loss inevitably creates chronic fiscal challenges. If local officials have become habituated to operating under these conditions, they may not interpret the current year's level of stress as out of the ordinary. Therefore, City X and City Y's similar self-assessed fiscal stress scores may just reflect that while they do face challenges, it was a fairly "normal" year for both cities.

Another population-related source of fiscal distress for both cities is the aging workforce. An Urban Institute study suggests that the region will continue to experience a significant decline in labor force participation over time; as more people enter retirement, there will be fewer workers per every retired individual. This is partly attributed to the degeneration of the manufacturing industry, as well as the rapid rate of retirement among baby boomers.[6] These concerns may be particularly acute for City Y, which has a slightly older median age and a heavier reliance on manufacturing than City X.

Reliance on manufacturing may be another factor that tends to increase the fiscal stress perceived by local officials in City Y compared to City X. While City X has historically been reliant on manufacturing, it has had some success diversifying its economy. The city has made significant efforts to engage in clean economy segments such as solar power, energy-saving building materials, and HVAC and public transportation.[7] However, manufacturing is still the largest industry in City Y, and City Y's local officials may be worried about the city's future prospects if its manufacturing jobs decline.

5   Hummel, D. (2015). Right-Sizing Cities: A Look at Five Cities. Public Budgeting & Finance, 35(2), 1-18.
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7   "Michigan Economic Condition Assessment." Brookings Institution, www.brookings.edu/wp-content/uploads/2016/07/0223_michigan_mid_metros.pdf.

Lessons

There are many other municipalities in the Rust Belt that experience similar fiscal stressors to the cities examined in this case study. Beginning with the onset of industrial decline throughout the Rust Belt in the late 20th century, many localities have experienced financial stress associated with population decline, shrinking tax bases, and high levels of unemployment. In this case study, we have examined how financial stress manifests in struggles with liquidity and performance for City X. Although both cities presented substantially different financial measures of liquidity and performance in 2016, officials from both municipalities rated their financial stress at similar levels.

This dissonance between our analysis of standard financial ratios and subjective assessments of financial stress suggests that further research is needed to clarify what factors influence perceptions of financial stress for local officials. In other words, we expected to see higher rates of self-reported financial stress in City X, given its worse scores on financial ratios. We hypothesize several explanations that may help explain the gap. City X or City Y may either be underestimating or overestimating their financial stress, respectively. We also hypothesize that historical context may play a critical role in framing financial stress. Within the last few decades of managing financial stress related to industrial decline and population shrinkage, City X may not view its financial indicators as considerably stressful relative to its own history and perceived future. Understanding how local officials perceive and contextualize financial health is critical to forming cohesive and effective policies, particularly within the context of responding to the effects of post-industrial economies across America's Rust Belt.

About The Local Fiscal Health Project

The Local Fiscal Health Project is aimed at developing a deeper understanding of the fiscal health and fiscal challenges of local governments in Michigan. These case studies, authored by student Policy Analysts, focus on specific Michigan local governments and are intended to highlight some of the unique and possibly overlooked fiscal challenges they face.

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