



Student Case Study Series

Assessing Local Fiscal Health in Tourist Cities in Michigan

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Executive Summary:

This case study takes an in-depth look at the fiscal health stress of two tourist cities (City X and City Y) using a wide range of financial and demographic factors as well as findings from the Michigan Public Policy Survey. This case study highlights how growth and the economics of the tourism industry puts a strain on housing affordability, and these challenges manifest themselves in different ways in fiscal health.



Introduction and 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, focusing on 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 will examine two municipalities with tourism industries: City X and City Y. City X rated its fiscal stress at eight—very high stress—while City Y rated its fiscal stress at three—relatively low stress.¹

Both City X and City Y are popular summer destinations in the Midwest. In City X, tourism is very important to the local economy, making up about 30% of total employment. Other notable industries in City X are health care & social assistance, retail trade, manufacturing, and oil & gas extraction. City Y is also reliant on tourism but is also known for its fishery and farming industries.

City X's permanent resident population is almost twice as large as City Y, but both cities attract a significant number of part-year residents, tourists, and seasonal workers during the summer. The median household income is higher in City X than in City Y, but median property values are about the same.

The following table summarizes demographic data for the cities.

FY2016	City X	City Y
Population Size	15,000	8,000
Median Age	45	46
Median Household Income	\$53,000	\$40,000
Median Property Value	\$170,000	\$170,000
Poverty Rate	11%	16%
Unemployment Rate	18%	5%

Source: U.S. Census Bureau

¹ Case data are anonymized to protect the confidentiality of the survey.



Financial Condition Assessment

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

Liquidity

Liquidity ratios assess the extent to which governments can cover their current obligations and maintain a financial “cushion” or emergency fund to respond to unforeseen circumstances. In FY2016, both City X and City Y present generally strong indicators of liquidity, although City X has a relatively low amount of cash on hand.

Both cities present robust quick ratios, which means that both cities have enough liquid assets to finance their current liabilities. If anything, City Y may have too much liquidity in this regard. While it had smaller General Fund liabilities than City X, City Y actually had a larger amount of cash and cash equivalents, which is surprising given how much smaller City Y is. Both cities also perform well on the short-run financial position ratio, or the relative size of the unassigned General Fund balance, which means that both cities have a healthy reserve to respond to financial emergencies. Best practices recommend this ratio be around 15 to 20 percent. City X is just above this threshold, and City Y’s 60 percent value suggests that its General Fund balance is quite large for a city of its size. Our last measure of liquidity estimates days of operating cash on hand. A general rule of thumb suggests that a City should have around 90 days’ worth of cash on hand. In this regard, City X scores slightly below the standard, and City Y scores rather high.

Liquidity 2016	City X	City Y
Liquidity (Quick)	3.75	17.73
Short-Run Financial Position	0.29	0.59
Days of cash on hand	78.75	183.67

Performance

Performance ratios reflect how well a city balances its budget, and can be used to help assess fiscal sustainability. In FY2016, financial performance ratios for both cities present no real concerns. Across all three metrics, however, City X has stronger ratios.

Both cities experienced healthy growth in their overall net positions, meaning that revenues exceeded expenditures in FY16. City X grew its net position by 9 percent while City Y grew its net position by 5 percent. The “operating margin” ratio measures the extent to which government programs can fund themselves through service charges or external support. In this measure, a lower ratio means that a government’s programs are less reliant on general revenue sources. City X’s programs raise about half of the revenues to cover their expenses, but City Y’s programs rely more on general revenue support.

The Non-own-source ratio measures the percentage of total revenues that come from external sources such as state aid and grants. While higher reliance on external funding may be a source of risk if those funds are cut, a higher ratio may also suggest that the municipality has been successful in seeking external funding sources. City X gets about twice as much of its total revenue from external sources as City Y.

Performance 2016	City X	City Y
Operating margin	0.51	0.71
Net asset growth	0.09	0.05
(Non) Own-source revenue	0.14	0.07

Solvency

Solvency ratios help to assess fiscal health over a longer period of time. These indicators help us to analyze the extent to which governments can meet their long-term obligations as they come due. Both City X and City Y seem to have relatively strong measures concerning financial solvency, although City X presents a relatively high governmental funds debt coverage ratio.

In FY2016, both City X and City Y have good scores for near-term solvency, a measure that indicates how many years' worth of revenue it would take a government to pay all of its debts, including bonded debt, unfunded pension, and retiree healthcare liabilities (OPEB). City X's ratio suggests that it would take 1.2 years' worth of revenue to pay its debts while City Y would need less than one year's worth. For this measure, a typical rule of thumb for governments is that this ratio should not exceed four to five years.

Although City X has considerably more bonded debt than City Y, it has a lower level of bonded debt per capita. When pension and OPEB-related liabilities are included, however, this relationship flips because of City X's relatively larger amount of "legacy" liabilities. Although City X is twice the size of City Y, it has almost four times the amount of pension and OPEB debt.

Coverage ratios assess the impact of debt on current budgets by measuring debt service as a percent of total expenditures. Typically, a ratio below around 10 to 15 percent is healthy. In this City Y is well below this threshold, but City X's ratio is on the high side, suggesting that debt service may be constraining the budget and limiting funds available for other priorities.

The final measure of solvency is capital asset condition, which assess the extent to which a government has been able to invest in its capital assets and offset depreciation over a fiscal year. City X grew the value of its capital assets by eight percent in FY16, while City Y grew its value by three percent.

Solvency 2016	City X	City Y
Near-term solvency	1.20	0.72
Debt burden per capita (bonded debt only)	\$1,074.72	\$1,326.05
Debt burden per capita (including pension/OPEB)	\$3,281.51	\$2,880.69
Governmental funds debt coverage	0.10	0.03
Capital asset condition	0.08	0.03

Financial Ratio Analysis

In analyzing the financial ratios alone, neither city shows any signs of major fiscal stress, and it is not immediately clear why City X rates its fiscal stress (eight out of ten) so much higher than City Y (three). Both cities appear to have adequate to healthy liquidity levels, and financial performance measures show that both cities have adequate revenue to cover their expenditures.

Long-term solvency measures perhaps hint at some areas where City X struggles compared to City Y. City X has a relatively high governmental debt coverage ratio at 10 percent, which means that City X has to dedicate about ten percent of its budget dedicated to debt service while City Y only spends three percent. In addition, City X has much larger long-term liabilities associated with retiree pensions and healthcare, and according to financial statements, its pension and OPEB plans are well-below fully funded. In fact, City X's pension plan funded ratio declined during the prior year, suggesting that the budgetary burden of paying retirees is likely to grow in future years.

While long-term liabilities may explain some of the reason City X rates its fiscal stress so much higher, more context is needed in order to fully understand the City's challenges.



Demographic and Economic Factors

When understanding fiscal stress, it is important to assess standard financial indicators but we must also understand service-level distress: challenges cities face in delivering consistent and high-quality services to its residents. While City Y spends over \$2,000 per resident on governmental activities like public safety, public works, and recreation, City X spends about \$500 less per resident. Compared to City Y, City X is a larger population center and struggles with demographic shifts, housing affordability concerns, and fluctuations in service demand driven by the cyclical nature of the tourism industry.

While the state's overall population has fallen in recent decades, the population of City X and its surrounding county have increased by double digits, and many of the newer residents are higher-income retirees and young professionals and entrepreneurs looking for alternatives to more expensive cities. They are drawn to the area for the same reason tourists are—natural beauty and recreation opportunities—but they also want the amenities of city life. As a result, newer residents often have different needs and priorities for public spending compared to long-time residents. For example, newer residents may be more likely to favor investments in the downtown area, while long-term residents may be more interested in basic services.

This influx of affluent residents has stressed housing supply and driven up housing prices. While this is good for City X's property tax revenues, it has also created tension between new and existing residents who are increasingly finding their community unaffordable. According to Census data, only 12 percent of the people who work in City X also live there. While many urban areas of the state have had to contend with affordable housing challenges for decades and have networks of nonprofits to rely on, this is a relatively new problem for City X. There is a steep learning curve and few local resources to help guide decision-making. Nevertheless, the planning, zoning, and infrastructure decisions City X makes now will have long-term implications for its growth patterns for the next generation.

Housing affordability issues also interact with the region's reliance on the seasonal tourism industry. While the number of year-round residents is about 15,000, the population size increases several times over in the summer months with part-time residents, tourists, and seasonal workers, including a growing number of H-2B temporary foreign workers. The influx of summer seasonal workers in particular puts strain on City X's housing supply. Seasonal workers such as restaurant workers and housekeeping staff typically earn very low wages, so they may be competing with year-round residents for a diminishing number of affordable housing units.

The increase in summer residents and visitors also means that City X must scale up its services during the summer months. For example, police calls for service, water/sewer usage, and solid waste amounts increase directly with the number of people in town. In addition, City X probably also has higher annual fixed costs—for buildings, infrastructure, etc. — than a city of comparable size because it must maintain excess capacity to accommodate the summer peak in demand.

Another impact of tourism on City X's affordable housing challenges has to do with rental properties. City X's popularity with tourists has led many property owners to convert traditional housing units into short- or medium-term rentals, further restricting the supply of housing for residents. City X officials have to weigh the interests of residents who are looking for new sources of rental income versus residents who are priced out of their neighborhoods.

In sum, City X faces a unique set of challenges that City Y and other smaller towns largely do not. While challenges like demographic shifts, affordable housing, and fluctuations in service demand may not manifest in obvious ways in City X's financial statements, they do present financial management challenges that local officials account for when they rate their level of fiscal stress. These challenges may also be exacerbated by the possibility that City X's residents and long-time employees are used to (and may prefer) a more small-town feel and reduced scale and scope of city operations.

Lessons

City X and City Y are similar summer tourist destinations in Michigan. An analysis of fiscal health ratios reveals that in FY2016, both cities showed fairly healthy metrics for short-term liquidity, financial performance, and long-term solvency. While City X may be facing some concerns about the ongoing affordability of its long-term obligations — in particular, unfunded pension and retiree healthcare liabilities — nothing in the ratio analysis suggests that there are dramatic differences between City X and City Y when it comes to fiscal health.

However, survey data from the MPPS reveals that local officials in City X rate their fiscal stress level at eight out of ten while local officials in City Y give themselves a score of three. While it is possible that survey respondents in City X are over-estimating their true level of stress, a further exploration of some of the demographic and economic trends in the area can help explain City X's experience of stress. City X's population is growing and changing in dramatic ways, with new residents who often have higher incomes and different preferences for public services. The availability of affordable housing both for long-term residents and low-wage seasonal workers is presenting new political and management challenges for City X. And the ongoing stressors of the cyclical tourism industry mean that while City X is a small town most months of the year, it must have the capacity to accommodate hundreds of thousands of visitors and seasonal workers each summer.

This analysis suggests a few lessons about developing a better understanding of local government fiscal health:

1. **Financial ratios and metrics do not tell the whole story.** It is crucial to evaluate contextual demographic and economic factors to get a sense of the larger issues that are driving local policy and management decisions.
2. **Looking to the future.** In many cities, fiscal stress is driven by decisions of the past — for example, unaffordable debt or unfunded retiree liabilities or keeping up with infrastructure maintenance. In City X, however, it seems that the main stressors are emerging problems like housing affordability. These emerging stressors will be more difficult to identify and capture, especially using traditional financial and economic data sources. This is one reason that surveys can be helpful in identifying nascent sources of stress.
3. **Transition periods create fiscal stress.** While it is not yet clear which stakeholders will prevail in transforming City X according to their vision, it is clear that City X is not a small town anymore. This has direct implications for nearly every aspect of City X's financial policies and management—revenues, expenditures, capital projects, etc. In evaluating fiscal stress in other local governments, careful attention should be given to other municipalities who may be experiencing a similar time of transition.

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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The **Center for Local, State, and Urban Policy (CLOSUP)**, housed at the University of Michigan's Gerald R. Ford School of Public Policy, conducts and supports applied policy research designed to inform state, local, and urban policy issues. Through integrated research, teaching, and outreach involving academic researchers, students, policymakers and practitioners, CLOSUP seeks to foster understanding of today's state and local policy problems, and to find effective solutions to those problems.

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