MUSKEGON COUNTY

FIVE-YEAR FINANCIAL FORECAST OF THE COUNTY GENERAL FUND

May, 2017

Municipal Analytics

Insights and applications for better financial management

Municipal Analytics
Insights and applications for better financial management

1550 Westfield Avenue
Ann Arbor, MI 48103
Phone: 734.277.4454
Fax: 206.984.2798
www.MunicipalAnalytics.com

May 11, 2017

Muskegon County Board of Commissioners
141 East Apple Avenue, 4th Floor
Muskegon, MI 49442-3404

Dear Honorable Commissioners:

We have completed developing a five-year financial forecast of the General Fund for Muskegon County. An integral part of this project has been the development of an interactive and dynamic forecasting tool, which is intended to serve the County on an ongoing basis for years to come. This final report document summarizes the approach taken in developing the model, findings related to the future financial outlook of the General Fund, and recommendations for addressing key findings.

The focus of the financial model, and of this report, is the County's General Fund. All General Fund operating department revenues and expenditures have been forecasted for the future five-year period, using assumptions developed in conjunction with County administration. Due to the significance of several other operating funds to the financial outlook of the General Fund, we have also included in our analysis the following funds:

- Friend of the Court
- Public Health
- Brookhaven
- Child Care

The financial forecast includes a "base" model, which assumes no significant changes from current operations. The financial model was then utilized to test a number of scenarios, which could be useful as the County considers its options going forward.

We sincerely hope that this management tool will be useful in planning for the future of the County. We have enjoyed partnering with Vettraino Consulting and Muskegon County on this important project, and we appreciate the time and input your staff, especially Beth Dick, have devoted to the development of the model.

If you have questions related to the five-year forecast or the financial model, please do not hesitate to contact me at 734.277.4454 or johnk@municipalanalytics.com.

Very truly yours,

John Kaczor
Principal

MUSKEGON COUNTY

FIVE-YEAR FINANCIAL FORECAST

Table of Contents

EXECUTIVE SUMMARY

Muskegon County's General Fund is the primary operating fund of the government. As such, it is important for the County to maintain a healthy and sustainable General Fund. In recognition of the value of ensuring long-term fiscal health, the County contracted with Municipal Analytics to prepare a five-year forecast of the General Fund. The previous five-year forecast was completed in 2010. A significant difference between the 2010 study and the current project has been the development of a financial forecasting model, built in Excel specifically for Muskegon County. The model is dynamic, expandable and interactive. The County is encouraged to utilize this tool as it prepares budgets, considers financial impacts of proposed policies, evaluates options for collective bargaining, and communicates with elected officials, staff and the public.

The general outlook for Muskegon County's General Fund for the next five years is unsustainable. Revenues are forecast to remain fairly stagnant, increasing only about 0.4% per year. Expenditures are expected to increase substantially, due largely to jail debt service obligations and pension contribution requirements. This persistent difference between revenues and expenditures is forecasted to result in a $38 million negative fund balance in FY 2022. Clearly, changes must be made to correct this outlook. Fortunately, the County is in a position to begin addressing the impending challenges, as it now understands the direction the General Fund is headed, and there is still time to take corrective action before conditions deteriorate in the coming years.

Key findings and recommendations of this study include:

1. The General Fund is in a Structural Deficit and the County is Not Meeting its Internal Fund Balance Policy Goals
    a. Review the reserve policies for the General Fund
    b. Ensure reserves in the Budget Stabilization Fund are sufficient to meet cash flow needs
2. Appropriations from the General Fund to other Funds in the County represent a significant burden for balancing the General Fund
    a. Explore special millage to support specific services funded through General Fund contributions
    b. Ensure all operations supported by General Fund resources are operating efficiently and achieving desired levels of service
    c. Consider requiring the Airport Fund to operate without a General Fund subsidy
    d. Maintain a limit on contributions to Brookhaven; maximize operational efficiency
3. Jail debt service payments, which began during FY2017, will have a significant negative financial impact on the General Fund; annual debt payments will increase substantially over the next two years and dramatically by FY2026
    a. Jail debt should be refinanced at earliest possible opportunity
    b. Prior to refinancing debt, funds should be set aside to pay down the principal
    c. If possible, consider borrowing from other County funds to pay down principal
    d. The County should work with a bond advisor to develop a strategy to ensure the bond refinancing will comply with all applicable regulations
    e. Consider an advance refunding of the bond

4. The fund balance of the Delinquent Tax Revolving Fund (DTRF), is no longer available to support the structural deficit of the General Fund at the level it has in the recent past
    a. General Fund expenditures will need to be reduced to make up for the reduced support from the DTRF
    b. Transfers out of the DTRF could be limited, and a reserve could be established in this fund for paying down the jail bond principal at the time of refinancing
5. The County's annual required contribution to fund Pension liabilities will significantly increase
    a. Consider selling bonds to fund the accrued liability in the pension plan
    b. Work closely with MERS and an independent actuarial firm to evaluate options and impacts of using pension bonds
    c. Research how bonding might impact reimbursements from grant agencies
6. Other Post Employment Benefit (OPEB) liabilities are underfunded
    a. Limit contributions to the OPEB trust to only the annual required contribution
    b. Explore options for reducing the cost of retiree health insurance premiums
7. New revenue generation should be part of the County strategy
    a. Update fees and charges
    b. Expand fee-for-service opportunities with local units of government
    c. Consider other special millages that may be supported by taxpayers
    d. Dedicate some jail beds for rental to other jurisdictions
    e. Sell or lease County assets currently unused or underutilized
8. The County has and will need to continue to limit the funding of its Capital Improvement Plans (CIP)
    a. Seek external funding for capital whenever possible
    b. Prioritize General Fund stability over non-essential capital
    c. Establish criteria for capital funding, and limit purchases to only those items which meet the requirements

DEVELOPMENT OF THE FINANCIAL FORECAST

Developing a comprehensive financial forecast requires a detailed understanding of the County's General Fund financial framework, budgeting practices, anticipated needs and revenue trends. To adequately develop the necessary knowledge for this project, input from a variety of internal and external sources was required. Our approach to conducting this project included substantial data collection and analysis, prior to developing assumptions and setting up the forecasting spreadsheet. The scope of review included:

- Collection and review of a wide range of financial documents including audited financial statements, current budget documents, equalization reports, debt schedules and other documents.

- Interviews and discussions with County staff regarding the most likely future trends of primary revenue and expenditure line items.

- Data collections from other sources including State of Michigan departments, economic research reports, pension and insurance actuarial reports, as well as the 2010 Financial Analysis and Forecast Report.

Following the initial data collection and review process, we began setting up the spreadsheet file that would become the basis for the financial forecast model. In addition to one workbook containing all line items of the included funds, the spreadsheet contains more detailed workbooks related to assumptions, debt service, pension, and retiree healthcare. Several additional worksheets present summary data by fund, department, revenue and expenditure categories, and in easy-to-understand charts.

Based on the input provided by County administration, as well as an analysis of economic trends within the County and State, we developed a number of primary assumptions that became the basis for future year estimations. Generally speaking, assumptions include:

- General inflation estimates
- Wage and salary adjustments
- Benefit cost inflators (healthcare, retirement, and all other health and welfare benefits)
- Utility inflation estimates
- Property tax growth factors
- Anticipated contributions to and from other funds.

Assumptions were established for each future year in the model (FY 2019 through FY 2022). This approach allows the County to more readily input specific data related to each assumption, by fiscal year.

The various assumptions were then linked to each line item, reflecting the “best guess” estimate of each line item over the next five years. The base year for each assumption is the current budget year. As the budget is revised, the estimates for future years will automatically change to include the latest numbers. Similarly, changes made to any assumption will automatically result in a recalculation of future estimates.

In this “base model,” it is assumed that General Fund operations will not change. Related to this, the estimates that have been derived in the model reflect “business as usual” for the next five years. Should the County desire to modify operations by adding or reducing services, pursuing special millages, or adjusting employee levels, changes could be made to the model in the appropriate fiscal year. The spreadsheet would then calculate the overall impact of each proposed change and carry those changes into future years.

After reviewing the initial results of the model with the County, appropriate adjustments were made to assumptions, formulations and data presentation. The County was provided with a draft working model, so staff could become familiar with its utilization. Staff will be provided training in how to use, maintain and update the model, prior to project completion.

Following revisions to the current and subsequent fiscal year budgets, this final report document was prepared for the County.

FINANCIAL FORECAST

This financial forecast has been developed with the use of a custom spreadsheet tool to assist administrators and policymakers in making effective financial decisions within a longer-term framework. The model cannot include all possible variables, and some assumptions will prove to be false. Related to this, we cannot claim that the financial forecast presented in this report will actually be realized. The forecast is not intended to be a financial plan. Rather, the purpose of the model is to illustrate one potential outcome, based on reasoned and realistic assumptions of future revenue and expenditure trends. By changing inputs and revising budget variables, the County will be able to better anticipate future financial outcomes, thereby allowing the County to better plan for and manage its financial resources. Included in this report are several alternative scenarios, which may provide insights into possible solutions to the County's budget challenges.

With these caveats in mind, we present below some general findings, as determined using the assumptions developed for the initial model. (Appendix A includes the primary assumptions.)

Economic Outlook

Muskegon County's economy has historically been, and continues to be, largely oriented to manufacturing, which accounts for 22% of the jobs in the county[1]. The next largest employment sectors are trade, transportation and utilities, followed by education and health services. According to Dr. Paul Isely of the Siedman College of Business at Grand Valley State University, manufacturing employment in Muskegon County has seen the largest increase of all sectors since 2010, with the addition of over 4,000 jobs[2]. Overall, Muskegon County's unemployment rate has been declining in recent years, and wages have been rising in response to the tighter labor market. This trend has also been seen at the state and national level.

As the economy has recovered from the Great Recession of 2008-2010, the country, state and county have seen an increase in manufacturing output, housing growth, and general economic expansion. There is some concern that the economy could face another slowdown, and may even enter another recession. According to Isely, the next recession could happen within the 2018-2020 timeframe. The expectation is the potential recession will be less severe that the Great Recession, and the west Michigan economy may be minimally impacted, due to its more modest recovery over the past 8 years.[3]

In addition to the threat of an economic slowdown, other pressures facing municipalities over the next five years include healthcare costs, wage inflation, accrued liabilities for pensions and retiree health insurance benefits, and the uncertainty of federal and state funding for critical

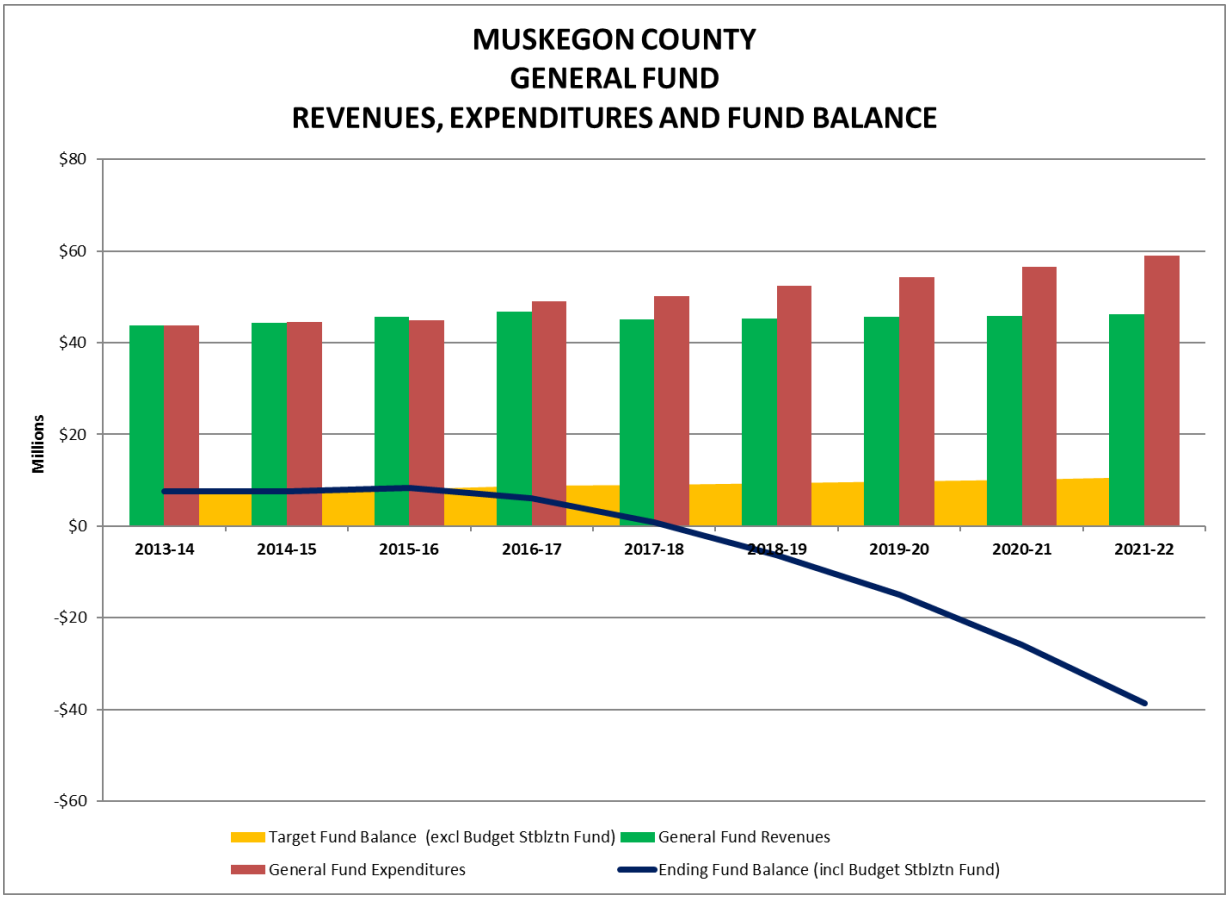
[1] McGuire, J. (2017, January 30). Recession probable in 2019, 2020; but don't panic, economist says. *MLive*. Retrieved from http://www.mlive.com
[2] Ibid.
[3] Ibd.

programs. On the revenue side, most Michigan counties continue to face only modest increases in tax base, and voters are often hesitant to approve new taxes.

Muskegon County Financial Outlook

As a result of these statewide and national issues, as well as specific financial obligations of the County, Muskegon County is facing the potential of an extended period of structural budget deficits. Given the County's current level of services and limited revenue growth options over the next five years, the County may fully deplete its General Fund reserves (fund balance) within the next two fiscal years (see Exhibit 1).

Exhibit 1
General Fund Forecast



This economic outlook is the result of constrained revenue potential and the rising cost of services. More specifically:

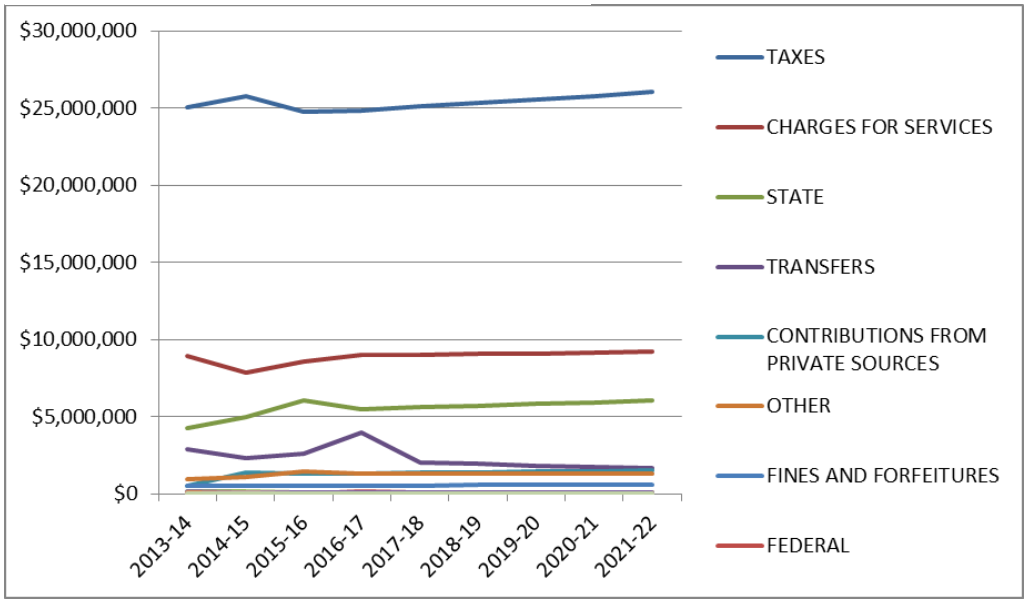
- **Revenue constraints such as:**

  - Limited growth in taxable valuation due to Proposal A, property tax-based economic growth programs (DDA's, TIFA's, LDFA's, IFT's, Renaissance Zones), and a generally stagnant economy

- Statutory limits on fees
- Anticipated limited increases in State funding for a number of line items, including judges' salaries and court costs

As illustrated in Exhibit 2, the County's General Fund revenues are expected to remain nearly unchanged over the next five years. As evidence, we can see the actual revenue for FY 2016 was $45.58 million. In FY 2022, revenues are estimated to be only $46.13 million. This represents a 1.7% increase over 6 years, or about 0.3% per year

Exhibit 2
General Fund Revenue Categories



While the outlook for revenues is minimal, expenditures are expected to increase substantially, rising from $44.8 million in FY 2016 to $58.9 million in 2022. On average, costs are forecasted to grown at a rate 4.6% per year.

- **Expenditure issues that continue to grow in importance, including:**

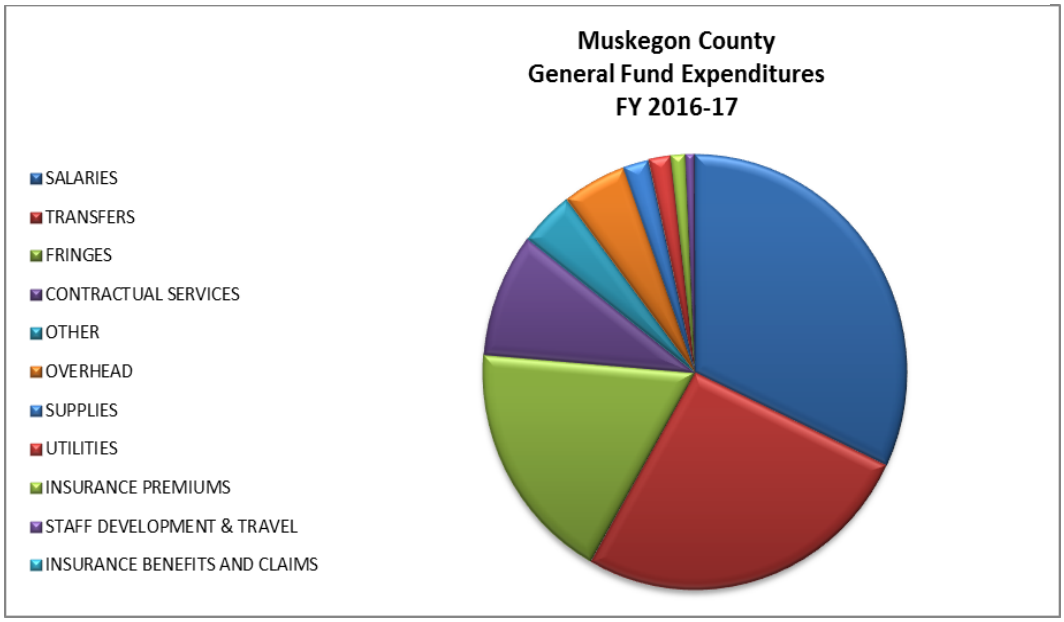
  - Personnel costs:
    - Wages and salaries comprise the largest portion (33% for FY 2017) of General Fund expenditures (Exhibit 3). Over the next five-year period, these costs are estimated to increase an average of 2.5% per year, primarily due to step increases

    - Fringe benefit costs, the second largest expense category in the County's General Fund, are expected to increase by 10% per year, driven largely by expected increases in required pension contributions.

    - The County's defined benefit pension plan annual required contribution (ARC) is expected to increase dramatically over the next five years. The

FY2017 ARC is $6.9 million. By FY2022, the County could be faced with a payment of $15.7 million. This represents an *annual increase* of nearly 18%. About 43% of the pension is directly chargeable to the General Fund, and most of the remainder is paid out of funds which require General Fund support.

Exhibit 3
General Fund Expenditure Categories Current Fiscal Year



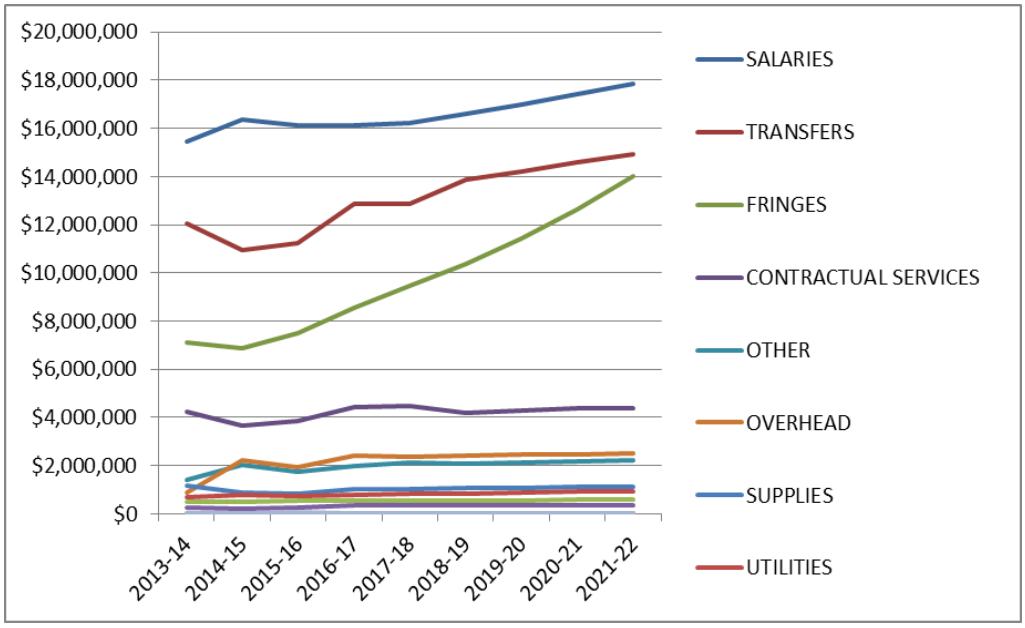
- Annual jail debt service expenditures will soon increase $1 million, rising from $1.85 million in FY2018 to $2.83 million in FY2019. This represents a 2.2% increase in total General Fund expenditures. In Exhibit 4, the change in Transfers is driven largely by jail debt service payments.

    - Jail debt service will increase to $3.4 million in FY 2023, then increase again to over $6 million in FY 2026. These years are beyond the five-year horizon of this forecast, but the County will be required to prepare over the next five years for these increased debt costs.

As a result of these major expenditure increases, combined with cost increases for supplies, utilities, professional services and most other expenditures, Muskegon County could face annual cost increases close to 4.3%.

In summary, under the base scenario, the County could see expenditures outpace revenues by an increasing amount each year. **The General Fund outlook is unsustainable**; changes will need to be made to stabilize the fund, through both revenue increases and expenditure reductions. Changes will need to be made as early as this fiscal year, to bring expenditures more in line with revenues.

Exhibit 4
General Fund Expenditure Category Trends



KEY FINDINGS AND RECOMMENDATIONS

Throughout this project, input was elicited from administrators regarding the financial challenges and opportunities of the County. These conversations, combined with the General Fund model, form the basis of the key findings and recommendations. The model is not a prediction of what will happen; it is a projection of direction based on past trends and known information. The administrators and policymakers will use the model to make decisions that will change revenues and expenditures in future years, and thereby lead the County towards a different outcome than the model projects.

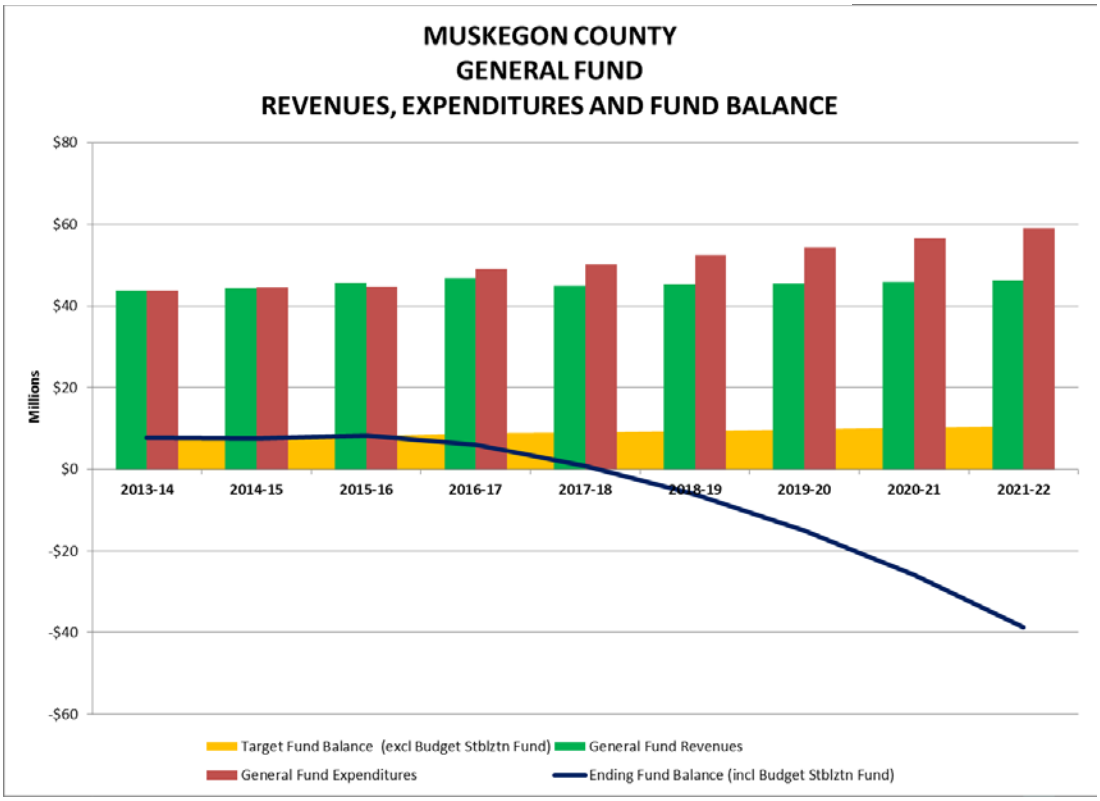
While it is not possible to project every potential financial issue the County will need to address in the next five years, the following key findings and recommendations have been identified as important issues for the County to address in the near term in order to improve the financial health of the County in the longer term. Each year corrections are delayed will result in a larger correction required the subsequent year. As an example, to resolve a $1 million imbalance five years from now can be achieved through a reduction in recurring expenses of $200,000 in year 1, or a reduction of $1 million in year 5.

<u>Key Finding #1</u>
The General Fund is in a Structural Deficit and the County is Not Meeting its Internal Fund Balance Policy Goals

At the end of FY2016, the County total General Fund balance was 17.3% of expenditures. This includes $6.0 million of unreserved fund balance and $2.3 million in a Budget Stabilization Fund; for a total fund balance of $8.3 million. The County's financial policies indicate a goal of 18% of expenditures as an unreserved fund balance **and** 5% of expenditures in a budget stabilization fund, for a combined goal of 23% of expenditures. At this time the County is not meeting its fund balance policy goals.

Based on significant known increases in expenditures for Jail Bond Debt cost (Key Finding #3), employee retirement funding (Key Finding #5), a stated goal of increased funding of other post-employment benefits (Key Finding #6) and lower funding available from the delinquent tax revolving fund (Key Finding #4), the County is projected to be in a structural deficit, with a negative fund balance starting during FY2019 and continuing into the future.

Exhibit 5
General Fund Forecast



Clearly, this projection is unacceptable and the County must take action to reduce expenses, increase revenue and stabilize its fund balance. The model and key finding recommendations provide several alternatives to improve the General Fund revenues, expenses and fund balance. County administrators and policymakers will use their experiences and opinions in interpreting these recommendations and prioritizing the implementation timeline; but it is very important that changes be implemented immediately.

Recommendations:

1A – Review the current policy of 18% of unallocated fund balance and determine if this is the appropriate level of reserve. Using the model, and in order to accomplish specific goals, the County should examine its fund balance policy on an annual basis and formally recognize and provide justification for spending the fund balance below the policy goal. An example of a reason to reduce fund balance below the policy goal would be to fund debt reduction (see Key Finding #3).

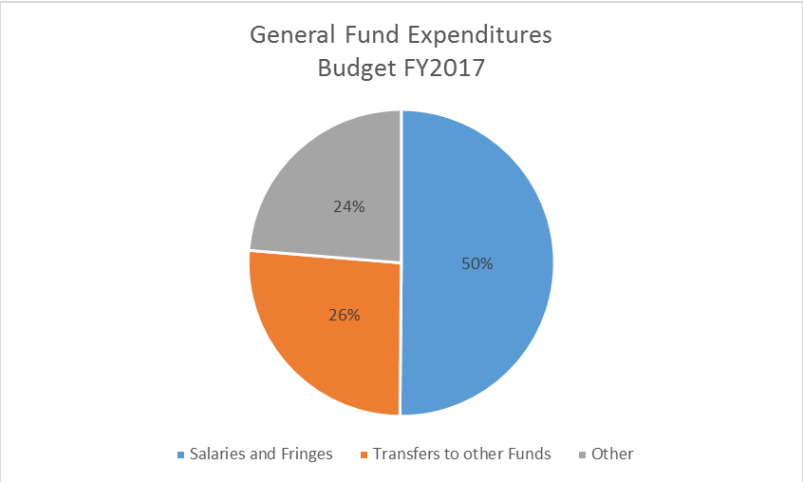
1B – Develop a policy for the budget stabilization fund to justify or change the goal of 5% of General Fund expenditures. A suggested policy would be to set the budget stabilization fund balance goal at the amount of cash needed on-hand during the County's lowest cash month, likely the month just before most of the County's real estate taxes are collected. By establishing this "low water mark" the County can justify the necessity of the budget stabilization fund level.

Key Finding #2

Appropriations from the General Fund to other Funds in the County represent a significant burden for balancing the General Fund

The General Fund supports approximately 28 other County Funds. The level of support provided by the General Fund to the other Funds varies from a few thousand dollars to multi-million dollars per year. In total, transfers to other Funds represents over 26% of the County's General Fund expenditure budget.

Exhibit 6
Primary General Fund Expenditure Categories



Below is a list of the Funds that have received more than $1 million from the General Fund over the prior three fiscal years (FY2014, FY2015 and FY2016) and the budgeted amount to be appropriated from the General Fund for FY2017.

Actual	Actual	Actual	Description	TOTAL	BUDGET
2013-14	**2014-15**	**2015-16**	**General Fund Appropriation to:**	**Prior 3 Years**	**2016-17**
3,909,040	4,207,901	4,155,318	***Child Care Fund***	***12,272,259***	4,599,647
1,770,857	1,708,859	1,456,784	***Health Department***	***4,936,500***	1,562,904
1,560,293	1,001,111	1,537,951	***Friend of the Court***	***4,099,355***	1,409,683
786,937	786,935	736,935	***HealthWest***	***2,310,807***	1,068,899
559,474	511,667	520,274	***Airport***	***1,591,415***	376,713
665,348	350,000	519,000	***Brookhaven***	***1,534,348***	180,748
FY2017 is the first appropriation year			***Jail Debt Service Fund***	*N/A*	1,784,079

The model focused on the General Fund, but the operation of the above funds and the important financial impact they have on the General Fund must be reviewed annually by the County.

Recommendations:

2A –Consideration should be given to a new special millage to fund specific services. One idea being explored is a millage of 1.5 mills for juvenile justice, which could generate approximately $6 million in new revenue to be used for juvenile justice. Approximately $5 million of the new revenue could be appropriated to the Child Care Fund, which would eliminate the appropriation from the General Fund to the Child Care Fund. The remaining balance of the millage would be used to expand services to children and youth in the County. If the millage is approved, it will have a meaningful positive impact on the structural deficit of the General Fund. Further, by removing the $5 million expense from the General Fund, the County will improve its fund balance reserve ratio (Key Finding #1).

2B – Though services provided by the Health Department, Friend of the Court and HealthWest are State mandated, the County should review the level of service being provided by the departments to assure the General Fund allocation is being used as effectively and efficiently as possible.

2C – The Airport receives a significant subsidy from the General Fund, totaling nearly $2 million over the past 4 years. The Airport provides a valuable service to the County, but it is not a State mandated service. The Airport should be evaluated to determine if it could increase its user fees and reduce costs to operate as a balanced Enterprise Fund. The County could also change the appropriations from the General Fund to a loan. If, in the future, the Airport is able to generate revenue above its expenses it should reimburse the General Fund for past appropriations. The County may also explore the option of creating an Airport Authority supported by a tax millage, similar to the Southwest Regional Airport Authority supported by millages from six member communities in Berrien County, Michigan.

2D – The County has significantly reduced the appropriation from the General Fund to the Brookhaven Fund for FY2017. For the three prior years, the subsidy exceeded $1.5 million. It will be important to continue to be diligent in maintaining the reduced level of subsidization. Consideration should be given to undertaking a study of the operational efficiency of Brookhaven, with the goal of identifying any opportunities to manage costs within available

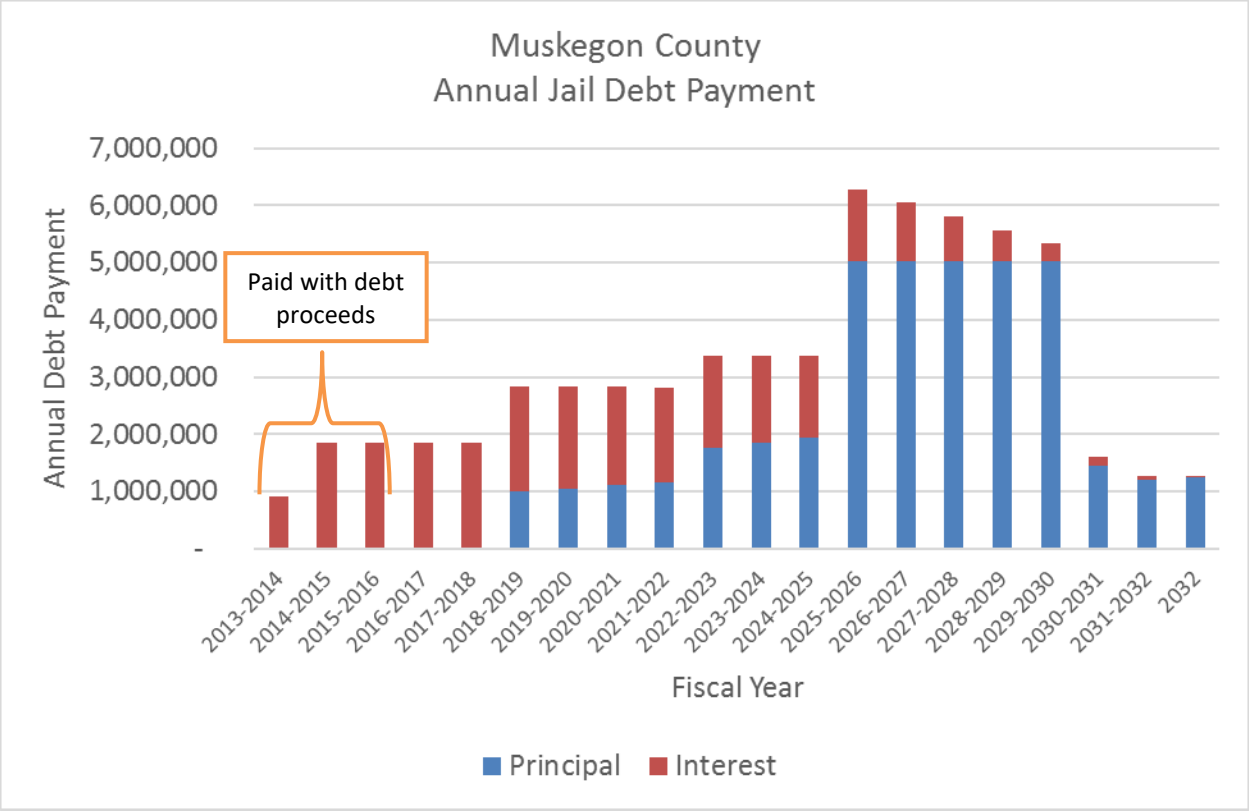
revenues. Additionally, the County should evaluate whether Brookhaven can successfully operate at a break-even point, given current and anticipated Medicare and Medicaid reimbursement rates. Many county medical care facilities have been closed in recent years, due to insufficient reimbursement rates and other conditions imposed by these programs.

Key Finding #3

Jail debt service payments, which began during FY2017, will have a significant negative financial impact on the General Fund; annual debt payments will increase substantially over the next two years and dramatically by FY2026

In 2013, the County issued a General Obligation Tax Bonds for the purpose of constructing a new jail and juvenile transition center (JTC). The jail bond debt was structured so that the County did not pay any debt service from its General Fund during the first two-and-a-half years of the bond. The FY2017 budget includes the first General Fund payment to the Jail/JTC Debt Service Fund, in the amount of $1,784,079. As illustrated in the below graph, the County's payments will increase in FY2019 (FY2017 and FY2018 are interest only payments); and then spike to over $6 million in FY2026.

Exhibit 7
Jail Debt Service: Principal and Interest



It is unlikely the County General Fund will be able to support a jail debt bond payment of over $6 million in FY2026. The jail debt bonds can be redeemed early (refinanced without penalty)

on or after October 1, 2023. While an Advance Refunding is possible, it is unlikely that an Advance Refunding will make economic sense until sometime closer to the early redemption date of October 1, 2023.[4]

A significant concern for the County to be aware of is the State law that requires that bond refinancing produce a net present value savings to the County. The jail bond debt was structured to have no principal payments for the first five years. Additionally, the interest payments for the first three years were paid from the debt proceeds. After the first five years of repayment, the principal payments are significantly "back loaded" (see above chart). The result of this structure is that, even though the County will make ten years of payments on the jail bond debt before it can be refinanced on 10/01/2023, very little principal will have actually have been paid. In such a situation, it can be difficult to refinance the debt to realize a net savings. The most assured strategy will require refinancing a lower principal amount in 2023.

Recommendations:

3A – The County should be prepared to refinance the jail debt on October 1, 2023. Refinancing will allow the County to extend the repayment period and possibly obtain a lower interest rate, depending on the market at the time of the refinancing.

3B – At the time of refinancing, the County should pay down as much principal as possible on the debt. Reducing the principal to be financed will have significant benefits to the County, as future interest on the debt will be less and the principal portion of debt service would be smaller. It is recommended that the County set-up a savings plan with a goal to save a minimum of $4 million to $5 million to pay-down the principal of the jail debt in 2023. There are six budget years prior to 10/1/23, which means the County will need to save an average of at least $667,000 per year to fund the principal pay down. Ideally, the savings target should be closer to $850,000, due to the uncertainty of interest rates at the time of refinancing. Besides operational savings, the County may be able to generate funds for principal reduction through the sale of assets or the capitalization of leases (Key Finding #7E). The savings should be specifically identified in the County's financial plans (either by setting-up a specific savings fund or by identifying funds in the Delinquent Tax Revolving Fund that are being saved for the purpose of jail debt principal reduction (Key Finding #4). By paying down the principal, the annual debt payment after refinancing is projected to be around $3.3 million, which is close the annual jail debt payment the General Fund will pay in FY2023.

[4] Local governments are allowed one Advance Refunding of taxable bonds during the bond term. Refunding bonds are issued in advance of the early redemption date (for the Jail Debt this is the date of 10/01/23) and the new bond proceeds are deposited into an escrow fund. At the early redemption date the new bond proceeds are used to redeem the original bonds. When the time between the new bonds and the early redemption is long, an Advance Refunding can result in "negative arbitrage;" whereby the interest earned on the new bond escrow is less than the interest owed on the new bonds, resulting in a local government paying interest on both the Advance Refunding bonds and the original bonds during the period prior to the early redemption date. The combined interest cost during the first years of the Advance Refunding costs more than the saving generated by the transaction.

3C – Another potential source of funds that could be used to pay down the jail debt in 2023 may be low-cost loans from internal County Funds (non-General Fund funds) that have cash reserves in excess of anticipated needs for 5-10 years. The inter-fund loans should be provided with terms clearly stated and approved by the County Board. This option will need to be evaluated closer to the time of refinancing, to know which funds may have available cash.

3D – Based on the significant amount of principle ($32.8 million) that will be still be due in 2023 and the cost of the refinancing, the County may find it difficult to achieve a net present value savings, even with utilizing cash to pay-down the principle at the time of refinance. It is very important for the County to work closely with a bond advisor, as soon as possible, to develop a strategy to meet the net present value savings test when the bonds may be refinanced in 2023.

3E – The County should work with a bond advisor to monitor timing and interest rates in the years just prior to 2023 to determine if there is any benefit to consider an Advance Refunding.

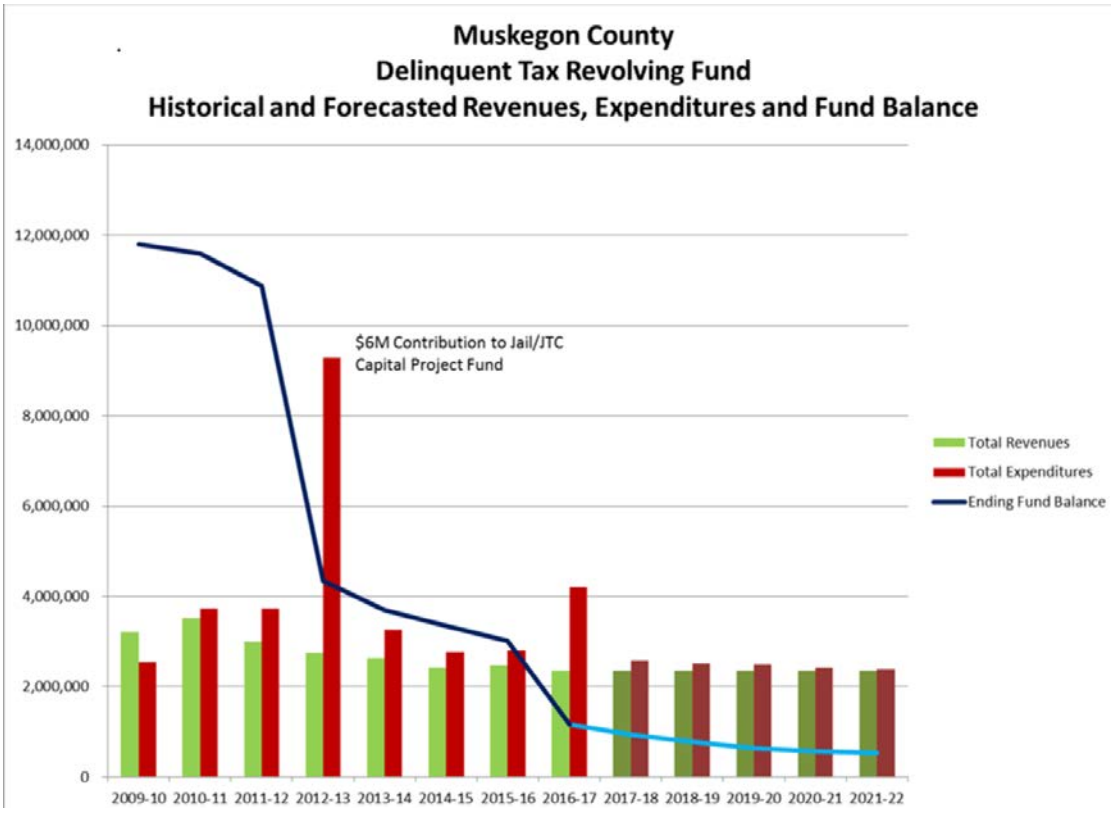
Key Finding #4

The fund balance of the Delinquent Tax Revolving Fund (DTRF), is expected to decline to a level insufficient to support the structural deficit of the General Fund at the level it has in the recent past

The County has used transfers from its DTRF to balance its General Fund. Further, the DTRF, during FY2013, provided a $6 million contribution to the jail project. Below is a seven-year historical look at the DTRF, this year's planned transfer, and a five year projection. During this period, the DTRF fund balance has gone from nearly $12 million in FY2010 to a projected $540,000 at the end of FY2022.

After the County's $3.469 million transfer to the General Fund during FY2017, the DTRF fund balance will be close to $3 million. During the prior three years, (FY2014, FY2015 and FY2016), the County has transferred an average of $2.23 million from the DTRF to balance the General Fund. As the County moves forward for the next five budget years (after FY2017), in order to sustain a minimum fund balance in the DTRF, the County's transfer from the DTRF will need to be an average of $1.57 million per year.

Exhibit 8
Delinquent Tax Revolving Fund Summary



Recommendations:

4A –It is important to recognize that, while the DTRF has been a consistent source of funds to balance the General Fund, fund capital projects and provide additional revenue when needed, going forward the County will be "locked in" to a transfer from the DTRF close to what the DTRF generates in one year. This amount is, on average, $660,000 less than the prior three fiscal years. The $660,000 will need to come from lowering the structural deficit of the General Fund.

4B – In the short-term (next five years), it will be difficult for the County to reestablish a DTRF fund balance by transferring less than an average of $1.57 million per year. If the County is able to reduce its transfer from the DTRF over the next five years, the DTRF fund balance should be considered for use to lower the principle due on the Jail Debt Service in 2023 (Key Finding #3).

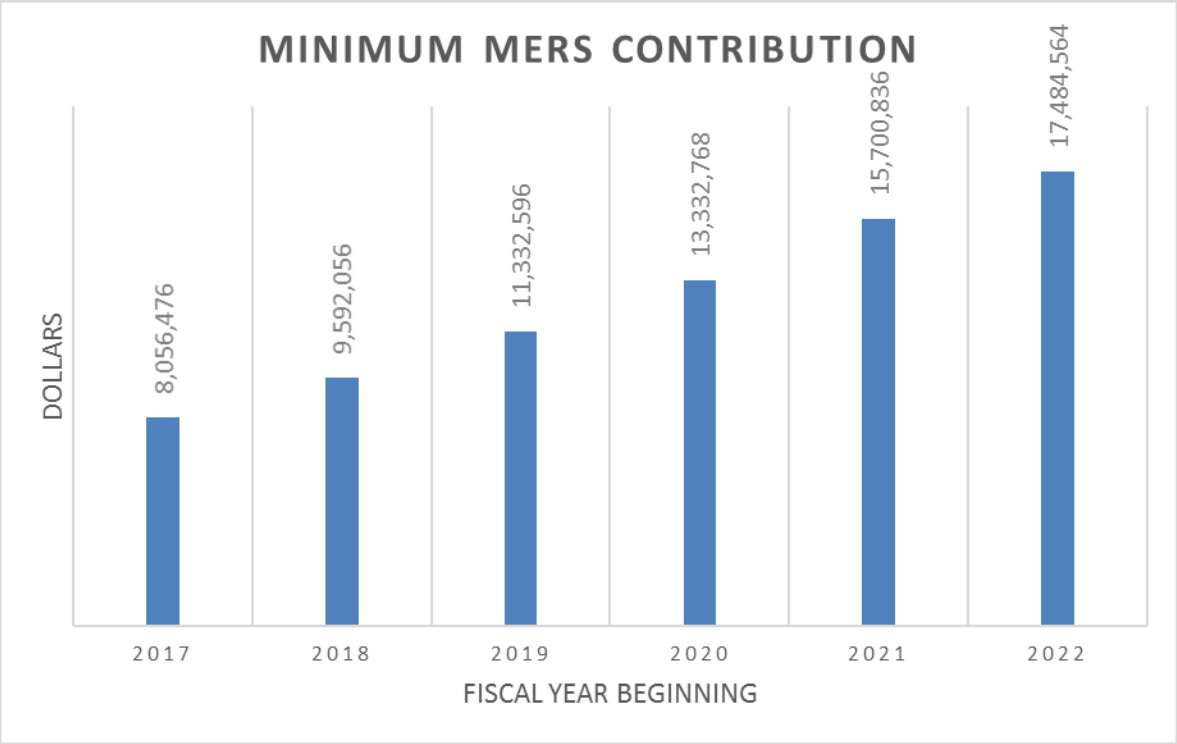
<u>Key Finding #5</u>
The County's annual required contribution to fund Pension liabilities will significantly increase

All of the County employment agreements have already closed defined benefit employee pension plans, and new employees are instead provided a defined contribution retirement benefit. While

the closed plans do limit the County's future pension liabilities, the funding requirement for the closed funds is accelerated, resulting in a funding spike for the County. The Annual Actuarial Valuation Report, December 31, 2015, from the Municipal Employees' Retirement System of Michigan (MERS) indicated that the County's pension obligation is 67% funded (down from 73% funded a year prior).

The County's minimum pension contribution will increase by a projected $1.9 million each year from FY2018 through FY2022, with a total cumulative increase of more than $9.4 between those years. The result will be a doubling of the required contribution, from $8 million in FY2017 to $17.5 million in FY2022. Due to the short time period of this increase, it will be difficult for the County to identify internal revenue sources or reduced expenses to cover the increase.

Exhibit 9
MERS Annual Pension Contributions



State law allows counties to issue bonds to fund outstanding pension liabilities. A bond issuance to fund the pension obligation can be used to provide a more constant year-over-year payment, rather than the funding spike that results from accelerated funding of closed plans. As part of its investigation into bond issuance to pay for pension liabilities, the County must be very aware of the impact of market fluctuations and the potential need to supplement bond payments with pension contributions from the General Fund (during periods of lower than projected market returns in the Pension Fund).

Recommendations:

5A – The County should explore the opportunity to sell bonds to fund its employee pension obligation. The bond issuance should fund a targeted amount of the liability, but not fund 100% of the liability. By requiring the County to continue to fund some part of the pension costs, the County General Fund will remain engaged in pension funding, both in good market conditions, when funding requirements may be lower, and in poor market conditions, when additional funding will be needed from the General Fund.

5B – As the County prepares to develop its funding split between pension bonds and annual contribution from the General Fund it will be important to work with MERS to understand, in detail the actuarial calculations. It is further recommended that the County consider retaining an independent actuarial consultant who can assist the County in developing several customized funding assumptions. While MERS is an important resource, an actuarial consultant may be able to assist the County through developing multiple funding scenarios and options.

5C – The County will need to be aware of the impact bond funding of pension costs may have on the charges it assesses to granting agencies for employee benefits. The pension cost will shift pension obligation payments from MERS to making payments on the pension bond debt; the County will need to clearly identify this as an employee benefit cost, to be reimbursed by the granting agencies, and take action to certify that the granting agencies concur that this is a reimbursable expense.

<u>Key Finding #6</u>
Other Post Employment Benefit (OPEB) liabilities are underfunded

The County's OPEB liabilities, the future costs related to the provision of healthcare benefits to current and future retirees, are underfunded. Similar to the County pension plans, employment agreements have already closed the defined benefit healthcare benefit to new employees. This limits the growth of the County's future OPEB liabilities, but the County remains responsible to fund its current and future retiree OPEB obligations. The actuarial report, October 1, 2015, prepared by Lewis & Ellis, Inc., indicated that the County's OPEB obligation is 49.4% funded (down from 54.1% funded as of 10/1/14, but up from 27.6% funded as of 12/31/09).

During 2016, the State Legislature considered a package of bills to try to help local governments in Michigan address their OPEB liabilities. These legislative proposals included a number of provisions to lower OPEB costs for local governments, including requiring unvested employees to contribute 20% toward the cost of the retiree health insurance and required all retirees to be on Medicare when eligible. The package of bills died at the end of the 2016 legislative session. As part of the legislative discussion, the Michigan Association of Counties and other municipal advocacy groups provided important data to the legislators regarding current OPEB funding levels. While there are certain State laws requiring the pre-funding of pension obligations, governments have more flexibility in funding their OPEB obligations. The approach communities have taken varies widely from pre-funding (100%) their OPEB liability to "pay-as-you-go" (0% funding of their liability).

Exhibit 10
Comparison of OPEB Funding in Michigan Counties

Counties over 80% Funded	%	Counties 1-79% funded	%	Counties 0% funded	Non-Participating Counties
Oakland	118	Livingston	78.9	Baraga	Alcona
Clinton	116	Oceana	76	Alger	Allegan
Cass	110	Mason	60	Antrim	Alpena
Barry	101	Berrien	55	Calhoun	Arenac
Macomb	100	Muskegon	49	Clare	Benzie
Ottawa	88	Washtenaw	40	Crawford	Branch
		Midland	38	Gladwin	Cheboygan
		Kent	31.6	Grand Traverse	Delta
		Charlevoix	31	Gratiot	Emmet
		Gogebic	29	Hillsdale	Houghton
		St. Clair	28	Huron	Iosco
		Bay	23	Ionia	Iron
		Monroe	23	Kalkaska	Isabella
		Chippewa	15	Lake	Keweenaw
		Mackinac	14	Leelanau	Lapeer
		Newaygo	14	Manistee	Lenawee
		Dickinson	13	Marquette	Luce
		Eaton	13	Montcalm	Mecosta
		Genesee	12	Montmorency	Menominee
		Saginaw	9	Ogemaw	Missaukee
		Kalamazoo	6	Oscoda	Ontonagon
		Ingham	4.5	Otsego	Osceola
		Jackson	1	Sanilac	Presque Isle
		Wayne	1	Shiawassee	Schoolcraft
				Van Buren	St. Joseph
				Wexford	Tuscola
				Roscommon	

Provided by the Michigan Association of Counties, Updated 1/3/17

If the County would like to explore options to better manage its OPEB obligations, it may be able to do so through modifications both the level of benefits and the required employee/retiree funding of the benefits.

Recommendations:

6A – The Statewide significance of this issue remains high, but it is uncertain if there will be a State legislative change. Based on this uncertainty, the County should consider funding only required annual contributions to the OPEB trust in the short term. While allocating additional funding toward the OPEB liability is an important and valuable goal, the County's need to fund its pension plan (Key Finding #5) and jail debt (Key Finding #3) are higher priorities for the limited General Fund funds available.

6B – The County should actively engage its health insurance consultant in identifying plans that may lower costs for the County and the retirees, while continuing to provide appropriate health insurance benefits to the retirees.

Key Finding #7

New revenue generation should be part of the County strategy

During the five-year financial model project several opportunities were discussed for additional revenue generation. While individually the additional revenue generated may be modest, the County should take every opportunity to make sure that it is covering its cost when providing services to specific constituencies and/or provide additional value for a fee to its customers.

Recommendations:

7A – *The County should perform a comprehensive fee study and adopt formal policies regarding setting and amending fees.* The County generates fees for providing specific services which benefit a particular individual or group; it is important that the fees match the cost of the service being provided and that all services that provide specific benefit to an individual or group are evaluated to determine if a fee should be charged; and that the service is not being subsidized by tax revenue. Generally, the cost to provide service increases more quickly than the fees (for example, the cost for labor to provide a service can increase annually, based on the cost of healthcare insurance, pension contributions, etc., yet the fee may not be adjusted for several years). The Government Finance Officers Association (GFOA) offers local governments guidance on how to establish government charges and fees.[5] Fees must be justifiable based on the cost to provide the service and within a range provided by comparable counties. A fee study and adoption of a formal fee policy can help the County achieve both of these objectives.

7B – *The County should continue to explore providing services to local jurisdictions, including public safety and assessing services.* Just as the County is feeling budget pressure, local jurisdictions are looking for ways to reduce expenses, while still providing quality public services to their citizens. The County is mandated by law to provide certain services, and it has developed highly skilled staff to provide the services. Specifically, the provision of law enforcement, through the Sheriff's Department, and assessing, through the Equalization Department, can be considered core competences of the County. The County should diligently pursue providing these services, for an appropriate fee, to the local jurisdictions. Both the Sheriff's department, through its Partnership in Neighborhood Safety (PINS) program, and the Equalization office offer models for contracting service with local jurisdictions. In every case where the County provides value-add services to local jurisdictions, beyond the State mandated level of service, the County must cover its cost (both direct and indirect), plus an administrative fee. Expansion of these fee-for-service examples, and the provision of other services, should be studied. If the service meets all three of the following goals, then the County should consider expanding its service offering:

(1) it is a service that the County can provide well;
(2) the County can (or is) recover(ing) the cost to provide the service, plus an administrative fee; and
(3) the cost to the local jurisdiction will be lower and/or the provision of service will be better than if the local jurisdiction provided the service themselves.

[5] http://gfoa.org/establishing-government-charges-and-fees

External assistance to study the current and potential services may help the County in determining if the service meets all three of these criteria.

7C – *The County should study millages assessed in other Michigan counties to determine "best practice" ideas.* The County is considering a juvenile millage (Key Finding Recommendation #2A) and this report recommends studying an example of an "Airport Millage" (Key Finding Recommendation #2C); in addition there may be other millage options available to the County to supplement its revenue needs. Local policymakers are most knowledgeable of the likelihood of their constituents supporting additional millages and each millage question must be approached with due care and study, but additional millages should be a part of the County's continued budgetary discussions. The scope of this report does not include development of a list of millage options; it is recommended that the County utilize its internal staff, and potentially coordinate a research project with local college interns, to develop a comprehensive list of Michigan county millages.

7D – *The County should designate a consistent number of jail beds available for rent to the State.* It is understood that the opportunity to rent beds to the State was a plan when the size of the new jail was established. The Sheriff and judges of Muskegon County will need to assist the administration in determining the minimum number of beds required for the County's own needs; and any additional beds should be made available to the State. This revenue generating option should be formalized, to the extent possible, by specifically reserving a number of beds in the jail for rent and negotiating agreements with the State (or if possible, other counties). The jail debt places a major economic strain on the County (see Key Finding #3); any opportunity to generate revenue from the facility should be explored.

7E – *Consideration should be given to selling or leasing County assets that are not providing a long-term benefit to the County*. The County has real estate, equipment, office space and other assets that are not being utilized to meet core service needs. These assets could be sold or leased, as a means of generating income and reducing the costs of maintenance, insurance, utilities, security and repairs. An inventory of all real and personal property assets should be taken, and each property should be evaluated with respect to optimal usage, efficiency, necessity and cost to maintain. Additionally, any legal or contractual restrictions on the property should be noted (such as zoning limitations, grant restrictions, etc.). As discussed in Key Finding #3, revenue received from the sale of assets could be set aside to pay down the Jail bond principal. The recurring cost savings from reduced operations and maintenance costs would benefit the General Fund directly (or indirectly if costs in other funds requiring General Fund contributions could be reduced).

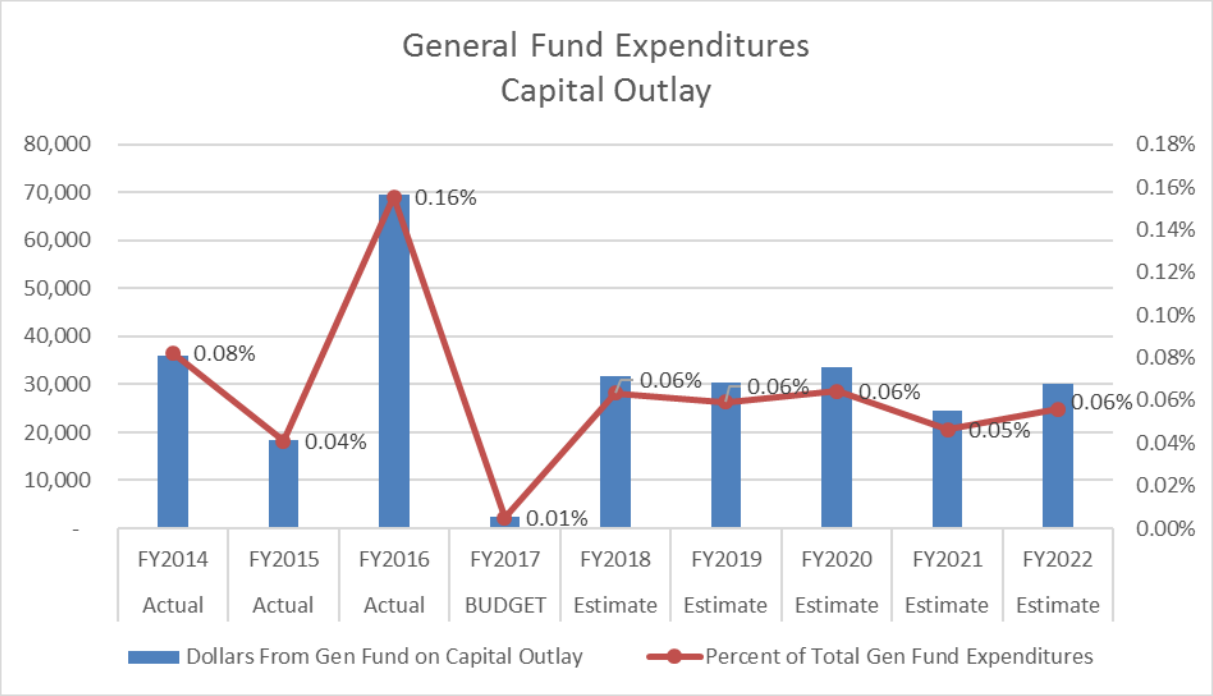
<u>Key Finding #8</u>

The County has and will need to continue to limit the funding of its Capital Improvement Plans (CIP)

As noted in the above Key Findings, the County faces significant economic pressure due to its jail debt, and long-term pension and OPEB liabilities; this pressure will limit the County's ability to fund its CIP needs. Over the past three fiscal years (FY2014, FY2015, FY2016) the County

has funded Capital Outlay an average of $41,303 or 0.09% of General Fund expenditures. The model projects a Capital Outlay amount of an average of $30,053 or 0.06% General Fund expenditures over the next five years. It is important to note that the County also maintains other funds that make capital expenditures, but the County is dependent on the General Fund to provide funding for many of its capital needs.

Exhibit 11
General Fund Capital Outlay Expenditures



Recommendations:

8A – The County has numerous capital assets, many of which may require attention over the next five years. Specifically, the County has recognized the need to renovate the 6th Floor of the Hall of Justice and improved security in the courtrooms. While these projects are important to continuing to provide quality services to its citizens, the County does not have funds available for capital projects. Over the next five year period, the County is encouraged to find external funding (grants) to fund capital projects or reduce expenditures further than what is necessary to fund the identified Key Priorities of this report before funding its Capital Improvement Plans.

8B – It will be critical for the County administrators and policymakers to involve "everyone" in the review of the results of the financial model and the implementation of the recommendations in this report. Limiting Capital Improvement Plans can be difficult when each department has important priorities to accomplish. All departments and County personnel need to understand the prioritization of budget stabilization and the importance of their contribution to implementing the recommendations offered in this report. Future funding the County's CIP will be first built on the County's ability to fix the structural deficit of the General Fund.

8C – Not all capital needs can be ignored. Deferred capital replacement can result in higher maintenance costs, and may increase the risk of equipment failure, operator injury or structural integrity. The County should ensure it has sufficient resources to replace equipment or invest in property if:

1. The cost of maintenance exceeds the cost of purchasing and maintaining new equipment.
2. Personal safety is truly compromised.
3. Significant operational efficiencies can be gained through the purchase or lease of new equipment or real property improvements (a life cycle analysis may help determine if a proposed capital project or expenditure meets this criteria).

It is recommended that every capital purchase request be required to include an analysis based on these three criteria, prior to funding of the purchase is considered.

UTILIZING THE FINANCIAL MODEL

As noted, the estimates of County finances projected in this financial model are based on a number of assumptions, including no major changes to current operations. As County officials consider how to address the problems of anticipated revenue stagnation and continued increases in expenditures, the model can be utilized to test the potential impact of cost-saving efforts or revenue enhancement proposals. The effect of proposed changes could be evaluated in the proposed budget year of implementation, as well as in following years. Since no single change will address the full problem in one year, it is useful to see the potential long-term impact of any adjustment or combination of adjustments.

The financial model can be utilized to test a number of potential scenarios, including:

- Reductions in the scope of operations and services
- Increases in revenues, such as taxes, grants, fees, charges and fines
- State legislative issues, including revenue sharing, supplementary funding of county services, etc.
- Staffing changes
- Changes to benefit offerings
- Proposed labor agreement contract terms
- Additional expenditures to enhance services
- Debt refinancing
- Other proposals that may be put forth.

In the following section of this report, several alternative scenarios are presented. These are some examples of the many potential "what-if" analyses that could be performed using the financial model spreadsheet.

To maintain the functionality of this tool, regular updates to the model will be required. At a minimum, the model should be updated with approved budget and actual year-end numbers. More frequent updates will allow the County to more readily adjust forecasts based on budget revisions and the latest information available regarding assumptions. A regularly updated model will ensure the most accurate and appropriate estimate of future finances.

The County is encouraged to utilize the model to plan for the future and better ensure positive financial outcomes. As the County becomes familiar with the model, more opportunities for its use will become apparent.

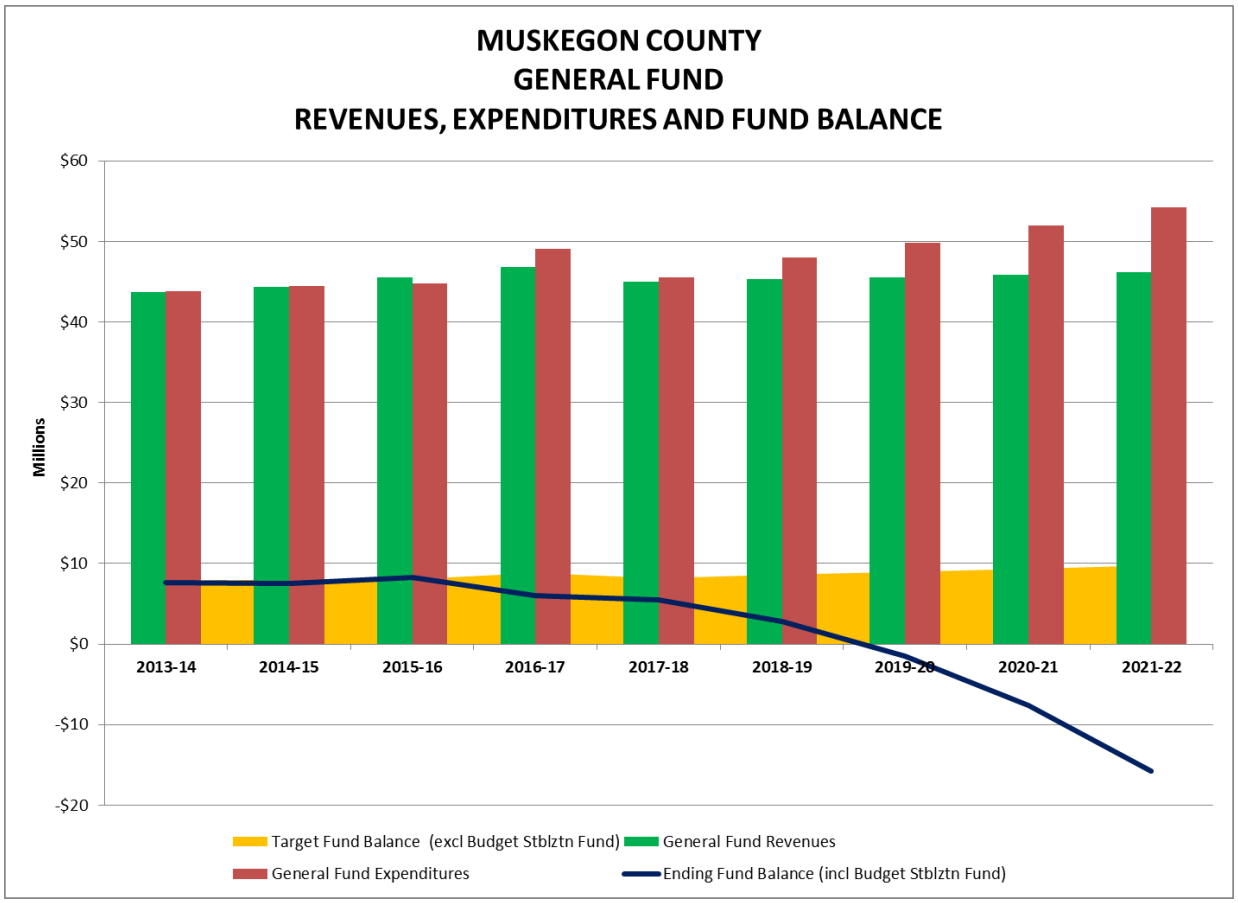
ALTERNATIVE SCENARIOS

As noted, the base forecast model assumes "business as usual." The financial projection for this scenario is clearly unsustainable. The County will need to develop strategies to address the structural deficit in the General fund, and identify alternative means of paying for rapidly increasing jail debt service and pension obligations. Several of the above-noted recommendations have been tested in the financial model, and the results are presented below. Policymakers and administrators will need to evaluate these and many other scenarios, and make decisions to ensure the long-term sustainability of the General Fund.

Scenario 1: New Millage

The County is considering putting a millage on the ballot, which, if approved by voters, would reduce General Fund expenditures nearly $5 million per year. The following chart illustrates the forecasted outcome of this single budget adjustment. The net impact would be a reduction of approximately $22.8 million over five years. While this is a significant impact, it is likely insufficient to address the total structural deficit in the General Fund.

Exhibit 12
Scenario 1: New Millage

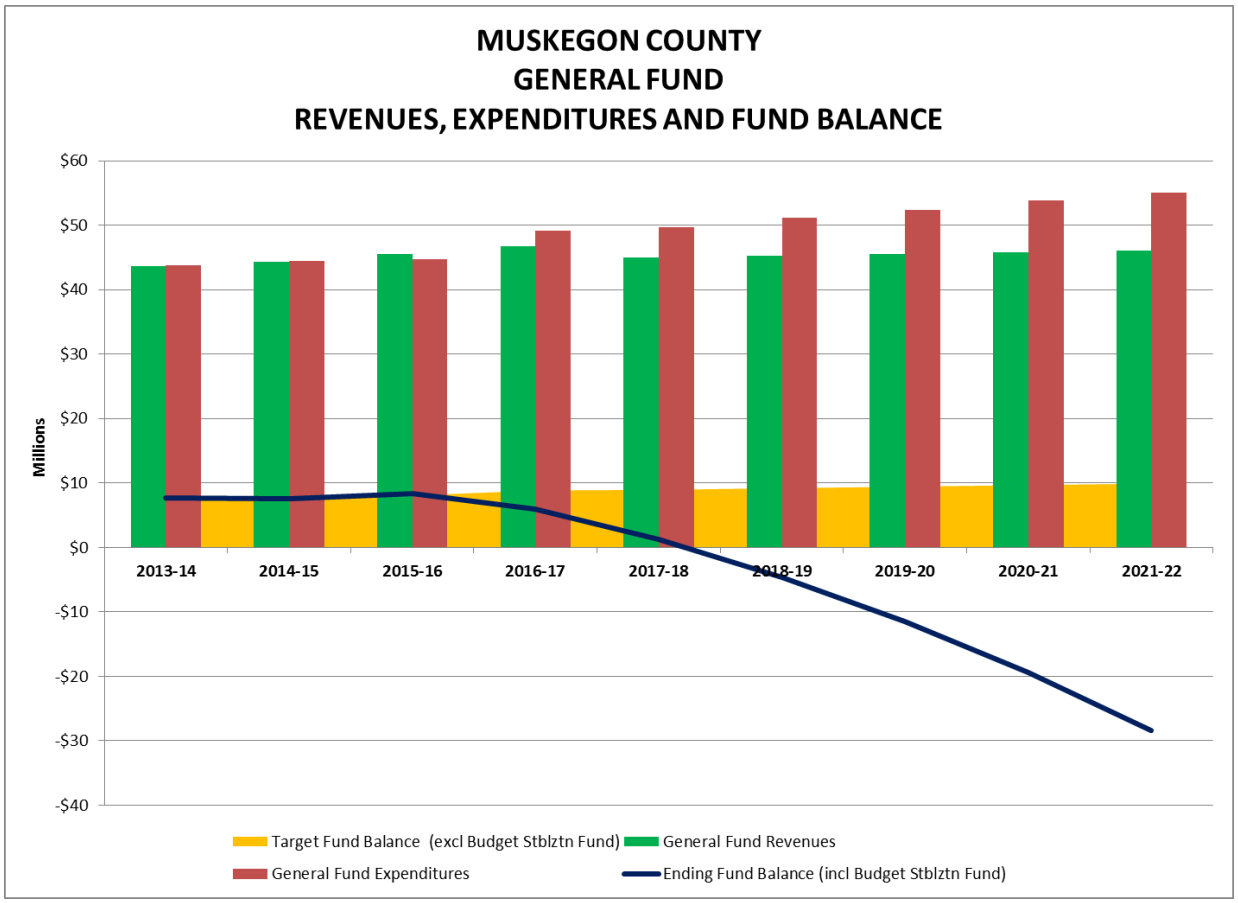


Scenario 2: Bonding for Pension

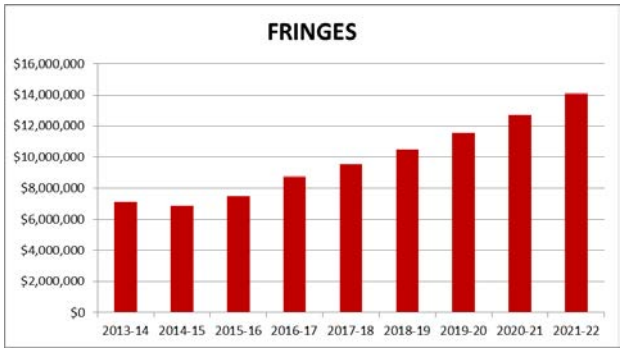
As the County faces an ever-increasing burden to fund its defined benefit pension plan, it may consider selling bonds to fully (or partially) fund the pension in the immediate term, then pay off the debt over 10-20 years. Exhibit 13 displays the potential budget impact if the County borrows $90 million at 3.5% interest for a term of 20 years. The cash flow savings to the General Fund over five years is estimated to be about $10 million. This is only an estimate, based on general assumptions.

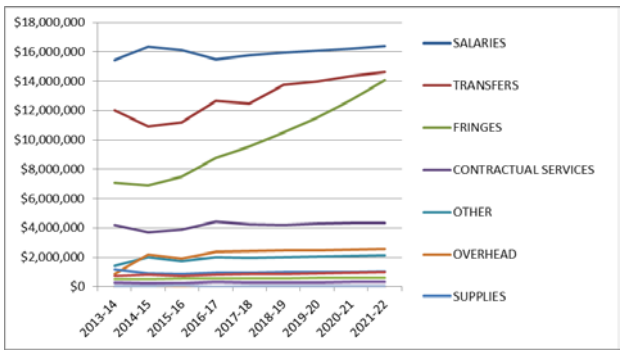
If the County is interested in exploring a pension bond, it should consider undertaking a more detailed analysis to ensure funding is adequate to meet the pension system needs. In addition to debt service on the bond, the County will need to consider the ongoing normal costs for active employees, and include a contingency amount, due to the uncertainty of actuarial valuations. The more detailed analysis may determine the savings are greater or lesser than estimated in this report.

Exhibit 13
Scenario 2: Bond for Pension

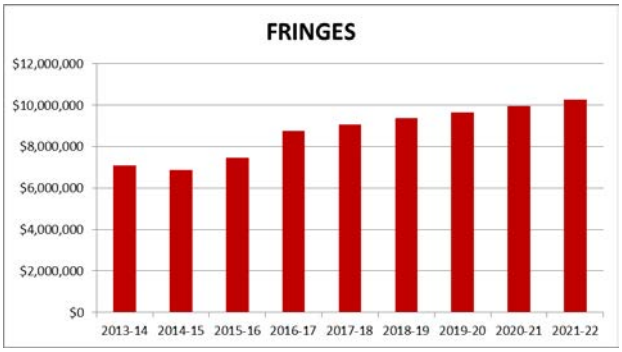


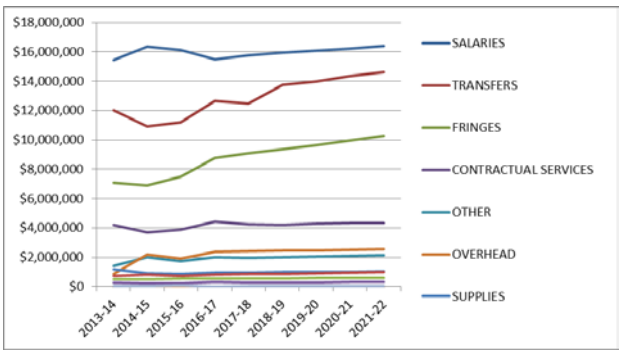
Status Quo: Pay ARC as Calculated





Estimated Outlook: Bonding for Pension

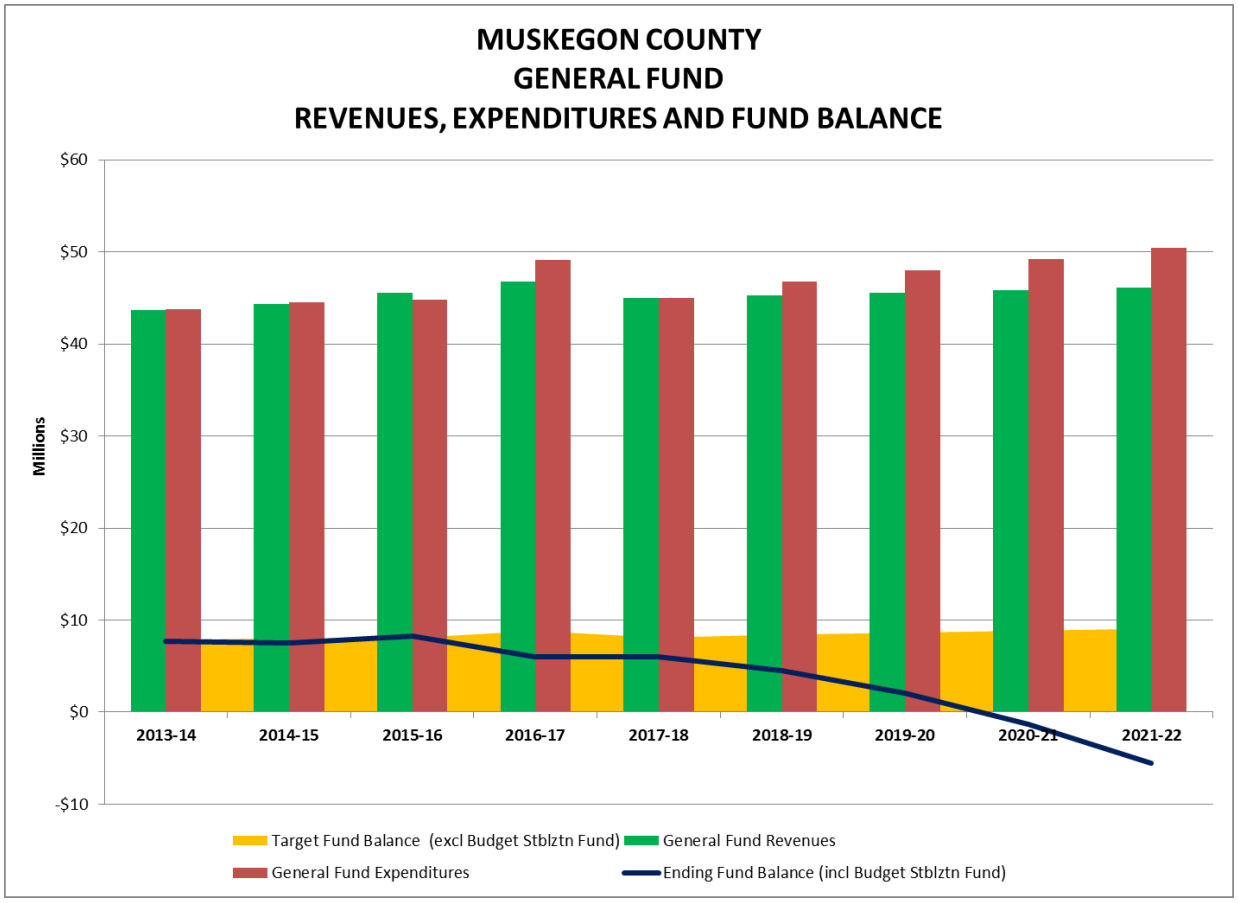




Scenario 3: Combining New Millage and Bonding for Pension

The County will need to consider a variety of options to address the challenges in the General Fund over the next five years and beyond. In this scenario, we have combined the new millage revenue and the estimated cash flow associated with bonding the unfunded pension liability. By combining these two options, the outlook of the General Fund improves substantially. However, a structural imbalance persists, as indicated by the declining fund balance line in Exhibit 14. The estimated ending fund balance in 2022 is about $14.5 million less than the target level. This difference could be addressed by making a recurring adjustment of $3 million in the FY 2018 budget (reduced expenditures and/or increased revenues), or through larger adjustments in future years.

Exhibit 14
Scenario 3: New Millage Combined with Bonding for Pension



Additional scenarios could be evaluated to determine the impact on the General Fund. Based on the findings of this study, the County should consider evaluating the operational impacts of reducing General Fund expenditures by at least $2,500,000 annually, in addition to new tax revenue and bonding for the pension. This is the minimum amount needed to adjust for the anticipated reduction in Delinquent Tax Revolving Fund support, bring operating costs in line with revenues, and build a reserve of $4 million by 2023 to pay down principal on the jail debt.

In total, the General Fund will require an adjustment of nearly $48 million over the next five years. Clearly, this cannot be achieved through any one single solution. It may be possible if the County receives $5 million per year in new tax revenues, reduces the annual cost of employee pension funding by $2 million per year, and finds other savings or revenue increases of $2.5 million per year. The County is urged to begin immediately exploring all available options to bring the General Fund back to a sustainable position. This will be particularly critical as the County tries to accumulate funds to pay down the principal on the jail debt by FY 2023.

Appendix A: Primary Assumptions used in Forecast

MUSKEGON COUNTY
FIVE-YEAR FINANCIAL FORECAST
MASTER ASSUMPTIONS

Fiscal Year:	2017-18	2018-19	2019-20	2020-21	2021-22
General Inflation	2.00%	2.00%	2.00%	2.50%	2.50%
Property Taxes	1.00%	1.00%	1.00%	1.00%	1.00%
State Rev Sharing	1.00%	1.00%	1.00%	1.00%	1.00%
PPT Essential Svcs	2.00%	2.00%	2.00%	2.00%	2.00%
State Court Fund Dist	0.00%	0.00%	0.00%	0.00%	0.00%
Court Costs	1.30%	1.30%	1.30%	1.30%	1.30%
Fees, Lic, Permits	1.00%	1.00%	1.00%	1.00%	1.00%
DTRF appropriation	-50.00%	-5.00%	-5.00%	-5.00%	-5.00%
Public Health Fund Rev	8.41%	6.43%	5.91%	6.31%	6.60%
QAS Revenue (Brookhaven)	-2.89%	1.66%	1.63%	1.60%	1.58%
Wages	2.50%	2.50%	2.50%	2.50%	2.50%
Medical Ins	3.00%	6.00%	6.00%	6.00%	6.00%
Dental Ins	1.50%	1.50%	1.50%	1.50%	1.50%
Vision Ins	1.00%	1.00%	1.00%	1.00%	1.00%
Longevity	-5.00%	-5.00%	-5.00%	-5.00%	-5.00%
Retirement	16.50%	19.00%	18.00%	18.00%	18.00%
OPEB	25.00%	6.00%	6.00%	6.00%	6.00%
Utilities	4.00%	4.00%	4.00%	4.00%	4.00%
IT Support	2.00%	2.00%	2.00%	2.00%	2.00%
Cost of Living	-5.00%	-5.00%	-5.00%	-5.00%	-5.00%

Additionally, some line items are assumed to remain unchanged, and some are based on the average of prior years' experience. When specific future revenues or expenditures are known, those values were inputted based on actual known values.

Appendix B: Summary Revenues and Expenditures by Classification

MUSKEGON COUNTY						
FIVE-YEAR FINANCIAL FORECAST						
SUMMARY OF REVENUE AND EXPENDITURE CLASSFICATIONS						
	Revised	**Proposed**	**Estimate**	**Estimate**	**Estimate**	**Estimate**
Fiscal Year:	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**	**2021-22**
REVENUE CLASSIFICATIONS						
TAXES	24,658,877	24,908,877	25,145,826	25,374,629	25,606,936	25,844,014
CHARGES FOR SERVICES	9,126,388	9,077,474	9,100,777	9,144,879	9,196,459	9,249,515
STATE	5,513,371	5,551,233	5,597,872	5,645,077	5,692,855	5,741,214
TRANSFERS	3,944,809	2,050,000	1,938,750	1,848,063	1,762,847	1,676,814
CONTRIBUTIONS FROM PRIVATE SOURCES	1,364,487	1,355,283	1,452,486	1,480,105	1,514,838	1,550,728
OTHER	1,281,314	1,138,525	1,189,905	1,181,296	1,174,858	1,171,480
FINES AND FORFEITURES	537,436	537,436	538,887	546,580	551,815	556,815
FEDERAL	143,610	143,550	96,327	108,716	123,036	117,907
RENTALS	116,671	116,671	117,838	119,016	120,206	121,408
INVESTMENT INCOME	93,106	85,345	86,524	86,548	85,940	86,089
SPECIAL ASSESSMENTS	10,000	10,000	10,000	10,000	10,000	10,000
LICENSES AND PERMITS	6,200	6,200	6,262	6,325	6,388	6,452
GAIN ON SALE	-	-	95	24	30	37
INTERGOVERNMENTAL REVENUE	-	-	-	-	-	-
UNCLASSIFIED	-	-	-	-	-	-
TOTAL REVENUES	46,796,269	44,980,594	45,281,548	45,551,257	45,846,207	46,132,472
EXPENDITURE CLASSIFICATIONS						
SALARIES	16,121,259	16,195,619	16,588,181	16,991,174	17,404,828	17,829,379
FRINGES	8,542,456	9,450,098	10,392,425	11,434,651	12,627,349	13,995,487
TRANSFERS	12,868,238	12,852,740	13,885,790	14,190,975	14,585,828	14,930,111
CONTRACTUAL SERVICES	4,419,104	4,466,129	4,167,911	4,270,679	4,371,120	4,373,036
OTHER	2,000,876	2,107,997	2,062,329	2,103,745	2,160,701	2,213,146
OVERHEAD	2,399,766	2,377,177	2,411,252	2,446,008	2,482,101	2,518,932
SUPPLIES	1,029,962	1,042,931	1,056,661	1,073,612	1,093,993	1,118,979
UTILITIES	799,386	818,970	848,501	879,150	911,797	945,688
INSURANCE PREMIUMS	541,772	541,772	552,607	563,660	577,751	592,195
STAFF DEVELOPMENT & TRAVEL	358,219	335,758	330,499	345,361	361,940	359,005
INSURANCE BENEFITS AND CLAIMS	11,647	11,647	11,880	12,118	12,420	12,731
INTEREST EXPENSE	4,950	4,950	4,913	4,797	4,903	4,891
CAPITAL OUTLAY	2,500	2,500	23,229	24,469	13,175	15,843
TOTAL EXPENDITURES	49,100,135	50,208,288	52,336,179	54,340,398	56,607,905	58,909,421
Net General Fund Surplus (Deficit)	**(2,303,866)**	**(5,227,694)**	**(7,054,631)**	**(8,789,141)**	**(10,761,698)**	**(12,776,949)**
Unassigned Fund Balance, beginning of year	8,309,630	6,005,764	778,070	(6,276,561)	(15,065,702)	(25,827,400)
Unassigned Fund Balance, end of year	6,005,764	778,070	(6,276,561)	(15,065,702)	(25,827,400)	(38,604,349)