Financial Management

Training Packet
In an era of economic uncertainty, local government officials are forced to better utilize their limited resources. They must make more efficient use of their revenues to provide an ever-increasing array of public services demanded by their constituents. This growing responsibility is generating a greater “need to know” for local officials as well as other individuals who play a role in the decision-making process.

The materials in this packet cover the broad spectrum of financial management in local government. The packet is intended to aid local officials and technical assistance personnel in coping with the problems they encounter in financial management.

The contents of the packet include:
1. A research report. In a survey conducted by SRDC, city and county officials in 13 Southern states were asked to identify the most pressing financial management needs of Southern localities.
2. A bibliography of financial management training materials. The bibliography, which lists training materials available in the United States, was designed for use by elected officials and technical assistance specialists.
3. Elements of Financial Management Series. The ten papers in this series were reproduced here with the permission of the Government Finance Research Center of the Municipal Financial Officers Association. The areas of financial management covered in the series overlap the major areas of need for technical assistance found in the SRDC survey.

It is hoped that this packet will prove helpful to those charged with the responsibility of local government operation.

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ELEMENTS OF FINANCIAL MANAGEMENT

Governmental Budgeting
The budget function in many local governments is restricted to estimating the cost of providing current services, allocating funds throughout the organization, detailing the categories of expenditure and monitoring specific expenditures. This "control orientation" of budgeting evolved from the desire to fix spending and taxing levels in order to constrain impulsive and unplanned spending.

Several factors have recently changed the environment in which local government budget practices operate and have resulted in increased emphasis being placed upon local government accountability to federal and state governments and the public. This accountability goes beyond fidelity in using funds for particular objects of expenditure. Rather, it seeks to maximize efficiency of resource utilization in meeting program objectives by strengthening the budgetary process itself.

The impact of tax and expenditure limitations, coupled with the unpredictability of the amount and timing of intergovernmental transfers, has forced government to view the budgeting process from a "cutback" perspective rather than from an incremental basis. Government must now develop new processes and analyses in applying this new budgetary art.

This paper provides an overview of present practices and problems in local government budgeting. The major elements reviewed are budget classification and organization, capital budgeting and trends in budget reform.

**Budget Classification**

Budgets are classified both by form and by the period they are intended to cover. As classified by time span, there are both current annual and long-term budgets. The current budget, frequently known as the current operating budget because it authorizes and controls current financial operations and is the budget applicable to each year, while the long-term budget is restricted to the capital improvements program or capital budget. Long-term budgets represent estimates of public expenditures for several years and the proposed means for financing them.

There are three basic types of current budgeting formats: line-item, performance, and program. The discussion of these kinds of budgets will be followed by a review of two major variants, the planning-program and zero-base budgets.

**Line-Item Budget.** Budgets whose expenditures are organized entirely or primarily in terms of the objects of expense (i.e., salaries, supplies, and other services or goods bought) are generally referred to as line-item budgets. Typically, they are organized by department without regard to interdependencies among the various departments and activities, without reference to programs or accomplishments, and without provision for comparisons among programs.

Line-item budgets are limited to one year in duration, and their emphasis is on control.

Dissatisfaction through the years with the line-item budget and its emphasis on inputs and control has led to several reforms.

**Performance Budget.** In performance budgeting, expenditures are based primarily upon measurable performance of governmental activities. A performance budget may also incorporate other bases of classification, such as character and object, but these are subordinate to performance of the activity. The goal of performance budgeting is to relate the input of resources to the output of services. Performance data are used in preparation of the budget as a basis for increasing or decreasing the amounts of resources devoted to various functions. The principal emphasis of the performance budget is the measurement of efficiency in performing various activities as opposed to the measurement of effectiveness in reaching higher-level goals.

Because it emphasizes what a government does rather than what it buys, the performance budget requires greater integration of planning, budgeting, accounting and performance measurement.

The control features associated with the line-item budget are not incorporated into the performance budget. Furthermore, local government has encountered difficulty developing acceptable units of measure to determine program performance.

**Program Budget.** Instead of looking at how many resources are used by organizational units, the program budget tries to measure the total cost of a function or activity in accomplishing program objectives. Thus, it is an attempt to classify governmental activity by goals and objectives, stressing the end product as opposed to the means. The advantage of this approach is that it makes it easier in analyzing a budget to grasp quickly the relative emphasis being given to a particular program as compared to alternatives, regardless of the number of agencies affected or activities involved.

As with other budget classifications, program budgeting comes in a variety of forms. However, its distinguishing feature is that it compares broad costs without outcomes (cost-effectiveness or cost-utility analysis) and explores alternative methods of achieving outcomes. Typically, program budgeting seeks to incorporate long-range planning of governmental programs with budgets.

**Planning-Programming-Budgeting Systems.** Besides the three basic types of budgets described above, procedures have been developed for the specific purpose of integrating long-term planning of activities with the annual budget process. These procedures may be classified broadly under the planning-programming-budgeting systems (PPBS) approach to budgeting.

As a system, PPBS represents a blend of program and performance budgeting, combining the identification of fundamental objectives by the government with
selection among alternative ways of achieving these objectives. A thorough analysis of the cost implications and expected benefits underlies the selection among alternatives. Thus, while PPBS is similar to performance budgeting, it is distinguished by its multiyear perspective and by its systematic analysis of alternatives. It also strives to make a balanced presentation of all costs associated with expenditures and to compare these costs with anticipated benefits.

PPBS is important because it marks the formal integration of the planning and budgeting processes, moving them toward a common focus of long-term program design carried through to implementation and assessment. It also recognizes the need for multiyear information and takes account of the implications of expenditures for government programs. Conceptually, at least, PPBS should integrate the divergent perspectives of the budgeter and planner.

**Zero-Base Budgeting.** Zero-base budgeting (ZBB) is the newest entry in budget techniques. The aim of ZBB is to set up a structure for reexamining all programs on a regular basis, ranking alternative levels of activity in order of priority. The system is organized in such a way that programs can be shown at successively increasing levels of funding, starting from zero or some other base below current levels. A two-step process, ZBB calls for the review and justification of all programs, emphasizing (in step one) the disaggregation of all activities into “decision packages” and ranking (in step two) these packages in order of priority. Zero-base budgeting is an attempt to get around what some consider to be the traditional proclivity of government managers to spend any additional funds above the budget base that come from regular growth in the local government revenue base. In theory, ZBB is designed to perform a complete inspection of new and old programs alike. It emphasizes formal planning and analysis, building a pyramid of optimal decisions so that the chief executive may concentrate on a few troublesome packages and major new programs or cutbacks.

**Capital Budgeting**

Perhaps nowhere in financial planning is the relationship between present actions and future costs and benefits more vital in theory or more accepted in practice than in the development of the capital budget. With its emphasis on long-term investments and large and typically intermittent requirements for resources to pay for those investments, the capital budget plays a unique role in the transition between the annual budget process and long-term planning.

By its very nature, the systematic review and scheduling of capital projects forces decision makers into a long-term consideration of the economic and demographic trends, land-use patterns and future revenues which a government can anticipate.

Capital budgeting decisions involve a particular form of analysis above and beyond the simple physical segregation of the capital budget items into the budget document. With the introduction of the time element and — uniquely — the availability of debt financing as an alternative source of long-term funds, the capital budget takes on many dimensions.

In its initial phases, the capital budget decision is concerned with questions relating to the need for construction of a new physical facility or the timing of projects for rehabilitation of existing facilities. Each decision requires a comparison of costs versus benefits among alternative investments. These comparisons require the use of diversified skills and procedures, including analysis of such elements as rate of return and discount factors, the future versus current value of money, the useful life of a facility, the impact of the capital item on the future growth of the community, and the long-term need for the capital improvement based on the future community profile.

The capital budget process naturally stimulates sophisticated financial planning. Projects involve multiyear acquisition and construction decisions. They have long-term implications for the operating budget itself and in most cases require debt financing or long-term commitments for appropriations through leases or on a pay-as-you-go basis. Furthermore, local governments’ capacity to repay and their financial planning and administrative apparatus are often subjected to rigorous review by investors and participants in the bond market. As recent events have shown, the bond market’s scrutiny of economic conditions and financial plans can be a major — if not the major — stimulus for reform in both the process and substance of financial planning.

Few budgets can be rigorously classified by any of the above budgetary techniques. There are varying degrees of control, management and planning reflected within both the budget process and document. This is bound to be the case when the institutions and activities that budgets attempt to organize financially are so diverse and complex.

**Trends in Budget Reform**

Numerous textbooks have been published on government budgeting. Primarily, they survey and discuss various budgetary theories and systems, but neither dwell on techniques nor establish basic budgetary standards, particularly for local governments. Unfortunately, while local governments are searching for new budget alternatives and techniques, there is a dearth of information regarding what constitutes successful budget reform in the “real” world. There is a wide rift between the real and what is thought to be the ideal budgetary procedure.

A number of disappointments have been associated with new programmatic approaches to budgeting. System approaches have not been the panacea for improving budgetary decision making, although some jurisdictions have made significant progress. In most cases, however, effective innovative techniques have not been devised to transfer successful applications
from one government to another. Large studies of finance practices have failed to achieve the level of awareness needed for implementation of partial systems.

To bring workable budget reform and innovation to local government, some suggest it will be necessary to do the following:

1. Create an authoritative body of budgetary principles that link theoretical innovation with the practical reality of local needs and capabilities;
2. Review existing state law and practice to determine factors which inhibit and enhance budget innovation and reform;
3. Develop model state legislation relating to the local budget function;
4. Develop a program of technical assistance for local government; and
5. Review the impact of other elements of financial management, particularly accounting, on budget reform.

Elements beyond budget format and process are critical to the art of budgeting. Other papers in this series look at cash management, analysis of fiscal condition, debt management, accounting, performance measurement and the formulation of local fiscal policy. Clearly, the skilled budgeter must link each of these components to the budget.

Bibliography


A synthesis of literature on (1) current coordination techniques of local governments for planning and programming their capital facilities to help carry out development objectives, (2) the effects of public investments on central-city maintenance and suburban development patterns, and (3) the legal ramifications and constraints on public use of investments to manage development. Includes an extensive annotated bibliography on the subject. Available from the Division of Product Dissemination and Transfer, Office of Policy Development and Research, HUD, Washington, D.C. 20410.


Looks at current governmental budget systems and their relationship to financial management systems, which may be inadequate to determine how public monies were spent. Available from the Center for Public Policy and Administration, California State University, Long Beach, Calif.


Describes the strengths and weaknesses of line-item budgeting, performance budgeting and PPBS. In addition, it discusses three approaches to decision making: pure rationality, muddling through and limited rationality. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


A classic of budgeting literature. Has a chapter on accounting and auditing, and contains many references and exhibits that serve to alert the reader to the budgetary "gimmicks," "chart of accounts," "interfund transfers," etc. Must reading for those interested in the relationship between accounting and budgeting.

Governmental Finance. Two special issues. Chicago: Municipal Finance Officers Association, vol. 5, no. 3 (August 1976), and vol. 7, no. 3 (August 1978).

The August 1976 issue of Governmental Finance deals with some new approaches that question the value and effectiveness of various city services instead of merely comparing costs and figures. The entire August 1978 issue is devoted to current topics in budget policy. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


A primer on municipal budgeting intended primarily for chief budget officers. The author takes the position that budgeting is a craft which can be learned and that good budgeting starts with good programming.


Addresses the broad field of public budgeting. Various chapters deal with the history of public budgeting, modern budget reforms, the effects of government economics on budgeting, budget behavior and program analysis. In addition, cash management, accounting and auditing, capital budgeting and debt administration, revenue systems, budget analysis and financial management are discussed. Available from the publisher, Englewood Cliffs, N.J. 07632.


Discusses all phases of budget preparation and administration. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


Describes efforts to implement PPB in five states, counties and cities in fiscal 1978. The main purpose of PPB was to provide decision-making information. However, the report concludes that there was no firm foundation for PPB, and no measurable accomplishments were made because of the short time period (one year). It closes with numerous recommendations regarding formal structure, analyses, staffing and training.

The National Association of Counties through its Decision Makers Resource Exchange recently produced a video tape of a unique budget cutback process conducted in the fall of 1979 in Genessee County (Flint), Michigan. The tape, approximately 25 minutes in length, is available for loan at workshops and other meetings. For more information, contact: Elizabeth Rott, project director; National Association of Counties, 1725 New York Ave., N.W., Washington, D.C. 20006. (202) 753-9577.


Recognizing the fiscal pressures facing many local governments, this resource packet offers some ideas for coping with them. Prepared with funding from HUD's Financial Management Capacity Sharing Program, it is designed to be used by local officials and people who provide training and assistance, seminars and workshops for local officials. The material discusses three topics: revenue management, improving productivity and controlling expenditures. It reviews a variety of effective revenue-generating and cutback budgeting practices developed by counties across the country. Available from NACo, 1725 New York Ave., N.W., Washington, D.C. 20006.


Under the premise that government tends to regard current operating and expenditure levels as an established base and as a result to budget incrementally, Pyhrr argues that ZBB is a "practical managing tool for evaluating expenses" which can actually reduce budget. Available from the publisher, 605 Third Ave., New York, N.Y. 10016.


Outlines the basic components and organization of a sound capital improvement program. Presents a variety of steps necessary to implement and maintain a capital improvement budget, including taking an inventory of existing facilities, analyzing fiscal capability, approaches to financing capital improvements, evaluating and scheduling project requests, and monitoring implementation. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


Presents a set of techniques a municipality may use to develop an annual operating budget. Provides detailed information on budget organization, adoption and implementation, as well as service planning. Consists of instructional material, worksheets and sample ordinances, all designed to make the development of the local government budget a more useful and relevant process. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


Examines the application of performance budgeting and planning processing budgeting systems (PBPS) in state government. Finds that both have been hindered by the difficulty of changing budget practices and traditions, but also that some states are more advanced than others in the development and use of modern budget techniques. Available from the publisher, 1775 Massachusetts Ave., N.W., Washington, D.C. 20036.


A compendium of technical background papers on the feasibility and advisability of advancing all or some budget decisions so that instead of making them just before the start of a fiscal year, they would be made at least 12 months earlier. Available from U.S. Government Printing Office, Washington, D.C. 20402.


Although it deals with the federal budgetary process, this is a classic in the field of public administration, with points made that are applicible to budgeting at all levels.

State and Local Government Cash Management
Cash management involves handling cash receipts and disbursements, relationships with financial institutions and the investment of idle funds. The primary goals of cash management are to maximize the availability of cash to meet daily needs and for investments, and to earn the highest possible return on cash invested consistent with acceptable levels of risk.

These goals can conflict with each other in that cash to meet daily needs cannot produce a yield. To resolve this conflict, it is necessary to determine the "optimal" cash balance; that is, the minimum of cash needed to meet daily disbursement needs while permitting the rest to be invested and earn a satisfactory return.

Finding the optimal levels of cash balances and maximizing returns on those resources that are invested involves identifying and working with a set of underlying concepts and processes. While the details may vary from government to government, the basic components that go into the cash management activity are:

- Constraints on cash management programs;
- Administrative framework;
- Measures of effectiveness;
- Maximizing cash available for investment;
- Acquiring bank services; and
- Investment procedures.

**Constraints on Cash Management**

A number of constraints limit the ability of a local government to achieve its cash management goals.

1. Legal restrictions are the most predominant constraints. State and local laws, and even federal laws, restrict many cash management practices of a local government by determining when monies can be collected, when obligations must be paid, where deposits can be placed, and what securities can and cannot be purchased.

2. Cash management goals may also be restricted by local politics and past practices. Local political circumstances can determine which cash collection and disbursement procedures are acceptable and which are not.

3. Risk is a constraint in conducting a cash management program. Risk represents the possibility of losing a portion of an investment. To obtain a yield, a local government must invest. Usually the greater the risk it is willing to take, the greater the potential return. Risk is legally recognized as a constraint because state and local laws frequently limit cash investments of local governments to securities of minimal risk.

4. Local banks may employ certain business practices, such as "redlining" (refusing to loan money to residents of certain districts), which a local government may find repugnant. In such cases, investment for maximum return should be weighed against these policies and practices in decisions regarding bank relationships.

**Administrative Procedures and Framework**

Cash information and control systems provide information to help conduct a cash management program. There are two sources of information — formal and informal. Formal information is drawn from computer-based or manual systems producing daily or periodic reports of cash received, cash disbursed and account balances. Formal systems serve the purpose of: operating and capital budgeting, centralized purchasing, cash accounting, cash budget status reporting, investment status and earnings reporting, reconciliation of cash accounts with bank records, apportionment of earnings, and performance reporting.

Informal information regarding significant revenues or expenditures that are unplanned is drawn from communications with internal departments, with those who know about the availability of state and federal grants, or with external financial institutions concerning investment advice and information.

Administration of a cash management program should be as centralized as possible, with proper safeguards. An administrative document should describe the policy, legal and procedural requirements for carrying out an effective program on a day-to-day, year-to-year basis. The administrative framework primarily is concerned with establishing and understanding the constraints that govern the conduct of the cash management program; establishing annual objectives, and evaluating the ongoing performance.

To contribute to the achievement of cash management goals, a local government must have at least the following:

- A compendium of the federal, state and local laws that affect the operation of a cash management program;
- A written policy statement or ordinance adopted and approved by the local legislative body governing the conduct of the program; and
- A written statement of administrative procedures governing the activities of the program.

**Measures of Effectiveness**

Governments should establish annual performance objectives toward which the efforts of the program can be directed. Objectives should be established in at least two areas:

- **Cash availability.** The first and possibly the most difficult objective to set is that of cash availability. That is, how much cash should be available to meet cash needs at specific points during the fiscal year? Correctly done, this involves determining the "optimal cash balances" for or, that amount of cash on hand which will meet all daily cash needs leaving a maximum amount free to be invested.

- **Yield and return.** Yield is the measure of net return on invested cash expressed in percentage terms. A target yield figure — either a single
number or a moving average — should be stated as an objective for the cash management program. A yield objective has the advantage of being comparable to market indicators and permits evaluation and comparison to other investors in the markets for certain securities.

Closely related to yield is total dollar return. This measure combines an estimate of the cash available for investments and yield. The dollar return is a good measure of the overall performance of a cash management program because it takes into account the earnings per dollar invested (yield) and the amount of average daily balances available to invest (availability), as well as the percentage of available funds invested.

Maximizing Cash Available for Investment

Procedures for the collection, deposit and disbursement of funds are possibly the most important factors in achieving maximum availability of funds to meet cash needs and for investment purposes. The development of procedures that bring revenues into the treasury as quickly as possible and keep them as long as possible can net a significant increase in investment dollars earned. Collections, for example, can be increased by such methods as billing outside agencies on a regular and timely basis for services performed, establishing good relationships with intergovernmental funding sources, or by increasing the ease with which citizens can pay taxes and fees. Deposits can be expedited by improving internal processing arrangements with departments that directly receive cash payments. Disbursements can be delayed until the invoice payment dates without adverse effects on credit standing.

To ensure that such procedures will contribute to the achievement of cash management goals, a locality should have:

- Revenue collection policies and procedures for each major source of revenue;
- Established deposit procedures for each type of revenue and collection location; and
- Disbursement procedures which permit cash flow forecasting while minimizing service interruptions.

Investment Procedures

Even if a local government settles on one bank for cash deposits and services, it still should not limit the competition for its investment business. Investments should be "shopped"; that is, once it has been decided what to purchase, a local government should contact a number of potential sources in order to get the best return available.

Ideally, a local government may use a variety of investment instruments at any given point, based on (1) the period of time in which different blocks of cash are projected to be available and (2) the need to retain some cash in highly liquid form to meet unforeseen emergencies. It is important to realize, however, that eligible investments, like bank services, may be regulated by state and/or local law.

"Money markets" is a term commonly used to denote the place where local governments invest idle cash. In primary money markets, investors may bid directly for the purchase of a security with the issuer — and usually at more favorable prices. Secondary markets allow an investor to purchase a security on other than the date of issuance or to sell a security prior to its maturity date, in order to achieve rapid liquidity. It is important for cash managers to understand the difference between the two money markets and to use each when most feasible.

In addition to direct investments by local governments, another instrument — local government investment pools — operates in some states. Through a pool, local governments can commingle their funds, generally through a state agency, for investment purposes on a voluntary basis. Pooling has several advantages: (1) it provides professional investment management to local governments which might not possess the necessary expertise to determine "best" investments; (2) it provides immediate liquidity; and (3) local governments may invest small sums of money into a larger pool, which in turn can invest in securities that require larger initial investments but give higher returns.

Acquiring Bank Services

A local government may place its deposits with a bank or banks in three ways: (1) share the business with all the banks or with the largest banks in the city or county, (2) place the business with one bank and rotate business periodically, and (3) select one bank through competitive bidding. Each method has distinct advantages and disadvantages. The method by which a bank is selected will often vary with state and/or local legal restrictions, the government's size, the size of its accounts, the number of banks in the area, and the potential interests of the governing body. Those involved in the selection process may also want to consider the bank's attitude toward such local government program concerns as low-cost housing rehabilitation loans, "redlining" and minority hiring practices.

Evaluation of the relationship between the local government and its bank(s) should not end with the selection of a bank for deposit accounts, but should be repeated at least on a quarterly basis. The evaluation should include the verification that the local government is receiving the services for which it has contracted at the agreed-upon compensation and that its banking needs are being adequately met.
Conclusion

The cash management function is one frequently overlooked as a means of improving local government management. Improving cash management deserves increased attention for two reasons. First, improved cash management can produce additional revenues at low cost and in a short time. Secondly, the changes required to achieve these results can usually be obtained with political support and a minimum of bureaucratic resistance.

Bibliography


Advocates a variety of changes that would encourage state and local governments to invest a higher proportion of their demand deposits. Following a summary, the work contains information concerning: (1) statutory and constitutional provisions governing state and local government cash management; (2) technical and operating factors in cash management; (3) investment portfolio management by state and local governments; (4) a detailed analysis of recent survey evidence concerning government portfolios; and (5) state-sponsored investment pools for local governments.

Not intended as a cash management text, the report summarizes what is being done in the area and what policies and practices could be adopted to improve cash management. Available free from ACIR, 1111 20th St., N.W., Washington, D.C. 20575. (202) 643-5540.


Describes the implementation of a cash management system in a nontechnical and comprehensive manner. After a description of the alternatives available, it concentrates on the cash management objectives and implementation process that were tailored to the organization of the borough and its needs. Available from the Consortium for Public Administration Field Services, University of Pittsburgh, Forbes Quadrangle, Pittsburgh, Pa. 15260.


Written by a finance director, a city manager and a town manager. Helps a finance director get to step one in setting up a cash management and investment program. Necessary schedules and practices are described. Available from Bureau of Public Administration, Division of Research and Public Services, University of Maine, Orono, Maine 04473.


Of particular interest to a cash manager. A concise description of the securities issued by the U.S. government, by federal financial instrumentalities, and by certain international institutions — some of which are eligible investments for state and local funds. Sections also present information on various types of money market instruments, on the U.S. government securities market, and on the tax status of U.S. government securities. Available from the First Boston Corporation, 20 Exchange Place, New York, N.Y. 10005.


Geared toward the public policy decision maker. Studies the various factors which affect state portfolio management and concentrates on investment guidelines (given by state), portfolio composition and other portfolio characteristics. Available from The Council of State Governments, Iron Works Pike, P.O. Box 11910, Lexington, Ky. 40578.


The audit staff of King County presents an assessment of the county's overall cash management practices. An excellent model for others to use in evaluating the various components of their cash management operations. Available from the County Auditor, King County, Room 402, King County Court House, Seattle, Wash. 98104.


Geared toward the cash manager of a small- to medium-sized municipality. Defines the benefits and practices that are appropriate for someone with money to invest and with limited time to manage cash balances. Focuses on maximizing earnings through noncomputerized cash budgeting and through other means of managing cash flows. Available from the Municipal Finance Officers Association, 190 North Michigan Ave., Eighth Floor, Chicago, Ill. 60601.


Although the title implies that this manual is geared only toward the municipalities in Missouri, its applications can be extended to any municipality. Organized to help cash managers, particularly new ones, implement new or improved practices. Contains a checklist to evaluate the manager's expertise. Covers the following topics: (1) establishment of financial goals; (2) review and projection of cash flow; (3) investment of idle funds; (4) analysis of short-term borrowing needs; and (5) choice of financial services and institutions. Available from the Missouri Municipal League, 1913 William Street, Jefferson City, Mo. 65101.

Municipal Finance Officers Association. MFOA has sponsored numerous meetings and seminars on the topic of cash management. From the MFOA Annual Conferences...
Deals with many of the finer points of cash management. With larger and/or more complex cash management systems, more developed cash management operations can increase total return on cash assets. Using lock boxes and wire transfers, formulating an investment strategy, and projecting cash flows are examples of the topics and levels of difficulty described. Available from Municipal Finance Officers Association, 180 N. Michigan Ave., Eighth Floor, Chicago, Ill. 60601.


A finance director who is newly implementing a cash management and investment program should find the content and organization of this work useful. It discusses the establishment of sound financial control and information systems prior to reviewing ways of maximizing idle cash and investing that money. Available from the Municipal Finance Officers Association, 180 N. Michigan Ave., Eighth Floor, Chicago, Ill. 60601.

Public Employee Retirement Systems
Public employee pensions are gaining increasing attention from financial administrators and government policy makers. In a nutshell, there is growing concern over the ability of governments to finance pensions in the face of competing demands for public resources. Part of the problem in current discussions is the shortage of adequate data about the performance and condition of pensions, which reflects both the low visibility and historic lack of consistent policies regarding their structure and behavior. At present, there are numerous efforts at all levels of government to upgrade both general knowledge of and policy control over public employee retirement plans.

This paper provides a brief overview of current topics in state and local government retirement systems and their financing. The principal issues reviewed are the size and scope of public pensions, the administrative structure of pension systems, their financial condition and fiscal impacts, benefit levels, investment policies, reporting, and analysis, and state and federal regulatory roles.

Size and Scope of Public Pensions

State and local public employee pension systems finance retirement benefits paid to eligible employees. In most cases, payments are made from a fund which consists of resources received and held by a governmental unit. There are approximately 6,000 public pension plans in the United States, but the overwhelming bulk of employees are covered by 3,000 systems that provide coverage to 11 million state and local government employees. Most employees belong to large systems (about 80 percent belong to the 100 largest), but as the foregoing numbers indicate, there are hundreds of small local government systems.

The sources of revenue available to public employee retirement systems are members' contributions, employers' contributions and investment income. A few systems continue to pay benefits out of current revenues, but most attempt to "advance fund" their liabilities for future payments by setting aside assets in advance of the time when benefit payments will come due.

At present, public employee funds have approximately $135 billion in assets, equal to $13,500 per member employee, and assets are growing at the rate of 12 percent a year. As in the case of employee coverage, assets are concentrated in the largest plans, making them financial giants in the national economy.

Administrative Structure Of Systems

Public employee pensions show a great variety of administrative structures. Local government retire-

Financial Condition and Fiscal Impact

Be they large or small, public employee pension plans usually involve large amounts of dollars and substantial future obligations. Most pensions involve defined benefits where the governmental unit promises to pay a specified level of benefits to retirees in the future. These are typically based on formulas that reflect years of service and rising salaries and prices. By the same token, funds that set aside money have an opportunity to earn income on their investments to help defray future costs. As a result of the large number of factors that influence the fund size of the government's obligation, specialists (known as actuaries) are used to make the assumptions and calculations needed to determine the level of contributions needed to fund the systems.

Determining the financial condition of a retirement fund means measuring the condition of the plan in relation to the benefits it will need to pay out in the future. There are, unfortunately, a variety of ways in which this can be done, and not all actuaries are agreed on how the level of funding should be measured, much less on what level is optimal. Nevertheless, it is agreed that plans should be setting aside assets to meet their pension costs as they accrue each year ("normal costs"); plus catching up on past liabilities that have not been funded (the supplemental or accrued liability). In popular discussions, a common focal point in assessing a plan's condition has been the level of unfunded accrued liability, which is the extent to which benefits earned to date are not covered by assets. However, without agreement on how to calcu-
late liabilities or standard assumptions used in the actuarial calculations, the meaning of unfunded liability is ambiguous.

Essentially, the question is whether or not systems will have an adequate flow of cash in the future to pay promised benefits when employees retire. An important concern is the consequences for systems that are not setting aside sufficient funds to pay future benefits.

Recent studies indicate that for public pensions to meet the current actuarial costs of their plans and to start to pay off their accrued liabilities, the typical government contribution rate would have to double. In the case of many smaller systems (especially in the case of fire and police), contributions are as high as 50 per cent or more of payroll. Further progress in funding pensions will no doubt lead to many more such situations.

Without systematic advance funding of liabilities, there will ultimately need to be increased pension contributions. Since most government employers are legally (and morally) responsible to see that pensions are paid in full, this will mean increased tax levels or reduction of expenditures for other purposes. The longer the delay, the greater the impact.

**Benefit Levels**

The subject of benefit levels is also a matter of great concern, both because they drive the cost of pension plans and because increasing numbers of retirees depend on them for part of their livelihood. Although progress has not been universal, the trend over the past two decades has been to liberalize benefits to public workers, with earlier retirement, better death and disability benefits, lessened service requirements and cost-of-living escalators. By and large, public employees now receive benefit levels proportionately higher than those enjoyed in the private sector for a given job classification and wage level. Traditionally, public employees contribute to their retirement funds, unlike the private sector. Here again, however, the trend has been toward enlarging the employees' contributions.

Benefit levels contribute directly to the cost of programs, and there has been a state of legislation over the last few years to try to curb or cap the benefits paid to state and local employees. A related issue of concern is that of integrating public pensions with social security coverage. Many public plans do not coordinate benefit levels with those provided by social security, or do so only imperfectly. In part, this is because many state and local systems under special provisions of the Social Security Act have either opted not to join the system or, in some cases, have withdrawn. As a result, many public employees benefit from overlapping coverage, while others do not enjoy the expanding benefits of the federal system.

Disability benefits are another problem of major expense to some systems. In some plans, very lax eligibility rules have led to wholesale disability retire-

ments that amount to nothing more than tax-free early pensions. Such abuse can lead to funding problems unless actuaries realistically adjust their assumptions to reflect the great financial burden such practices entail.

**Investment Practices**

Having once gotten its contributions in hand, how a pension fund manages its assets is of critical importance. Investment earnings can accumulate and over the years pay for a substantial portion of the ultimate cost of benefits. A rough rule of thumb is that, other things held constant, every extra percentage point added to the rate of earnings can lead to a reduction of 20 to 25 percent in the annual contribution rate needed to keep the fund financially sound. At the same time, investment policies of public employee funds have typically been subject to statutory and political pressures to avoid risks and, resulting, the highest rates of return.

State and local pension fund investment policy is governed by two fundamental concepts — the long-range preservation of principal and the realization of a good rate of return on invested assets. The desire to guard against loss of principal has subjected the investment decisions of public retirement systems to numerous statutory restrictions and limitations. Commonly found restrictions relate to avoiding or limiting equity (common stock) investments, lower-grade and less marketable assets, and investments in small, unknown firms. As a result, public pensions tend to favor high-grade corporate bonds, widely held blue-chip stocks and U.S. agency securities. In the past, pension funds were invested in the tax-exempt obligations of their own state or its local jurisdictions; but aside from New York, such activity is now rare.

A new wave of interest has developed in a new idea — the use of public investment funds to stimulate local development by directing their investment toward local housing, industrial and commercial opportunities. The practice is controversial, but the substantial assets of the pensions and their ability to make very long-term investments make them natural targets for such proposals.

**Reporting and Analysis**

Reporting and interpreting information on pension plan behavior are by their very nature complicated. Unfortunately, the problems are compounded by a lack of uniformity in the accounting and financial reporting practices of public systems. At present, there is no national collection, and there are few state collections, of data sufficient to support analysis of pension condition or to project the future financial requirements. Individual states are making headway, but there is no universal requirement that actuarial studies be performed or that such information be reported to the public at large.
Related problems have to do with the definitions used in measuring pension costs. As noted, cost estimates of pension benefits depend on a variety of assumptions regarding such factors as mortality, disability, investment rates of return; growth rates; new membership and salary levels. Assessments of condition rely heavily on the actuarial assumptions, but assumptions used are often unknown, may be unrealistic and may be noncomparable among jurisdictions.

Disclosure and fiduciary responsibilities of plan administrators also must be considered. It is important that plan operations and condition be fully disclosed to members and the public at large and that conflicts of interest be carefully avoided. But how to best go about that is a matter of debate among government officials, scholars and professional organizations. First, however, steps will need to be taken to achieve concurrence on a basic set of measures and definitions and the consistent application of generally accepted accounting principles.

**State and Federal Regulation**

Either as sponsors of their own funds or as overseers of those of their localities, state governments are taking an increasingly active interest in the structure and operations of public employee pension systems. As a first step, most have authorized comprehensive studies of those areas requiring action. Typically, studies concentrate on measuring financial condition, adequacy of retirement income, potential for plan consolidation, and improved administration and financing arrangements. Another task being used by the states is the establishment of permanent pension commissions as mechanisms for studying pension issues, analyzing fiscal implications of proposed legislation and developing recommendations for improvements.

Other state activities relating to local pensions include the passage of legislation governing plan operation. Several states have passed legislation stipulating that increased retirement benefits shall not be paid unless funding for the increase has been provided. In Tennessee, for example, law was enacted which requires that any bill which creates a financial liability for the public retirement system must include a funding plan. Other states are following this trend by requiring that fiscal notes accompany all pension legislation. To implement such analysis, states are also building more professional expertise, such as hiring actuaries.

Policies cannot be made nor performance monitored without good data. Thus, several states have enacted laws requiring frequent actuarial studies of local pension systems, in some cases following prescribed procedures and definitions.

Local government retirement systems have also attracted federal attention. Under the Employee Retirement Income Security Act of 1974 (ERISA), a study of state and local systems was mandated to determine whether federal regulation is needed. The final report of that study, the House Pension Task Force Report, released in March 1978, criticized existing fiduciary standards and reporting practices and called for regulation of these aspects of plan operation. Meanwhile, the federal Internal Revenue Service has begun enforcing certain reporting requirements for pension funds that long had not been applied to public systems.

Several versions of a federal regulatory plan have been introduced and debated in Congress. The most recent approach has been to develop a federally sponsored framework that would stipulate the contents and frequency of plan descriptions and annual reports, including actuarial reports. Also covered would be fiduciary standards for plan administrators. Such matters as benefit levels and funding policies would not be included in the regulation. Also, states would have the option of enforcing the standards themselves if their laws comply with the federal requirements.

The desirability, scope and mechanics of federal regulation continue to be hotly debated. The adoption of such a regulatory scheme will probably hinge on how quickly and well the states and their local governments can move to solve their own pension problems and avoid major breakdowns and bankruptcies in the process of meeting their financial commitments.

**Bibliography**


Discusses some of the issues in retirement system financing and reviews the actions of several states and the ACIR policy in the field of pension reform. Available from ACIR, 1111 20th St., N.W., Washington, D.C. 20575.


Deals with three important intergovernmental questions related to state-local retirement policy: (1) What form of federal regulation of state and local retirement systems is justified, if any? (2) Should the federal government mandate compulsory social security coverage for state and local employees, or if not, should state and local governments be allowed to retain their current option to withdraw from social security? (3) What should state and local governments do to address the needs of their state and local retirement systems? Available from ACIR, 1111 20th St., N.W., Washington, D.C. 20575.


Maps out a strategy for regions and cities to obtain capital by reclaiming control of pension funds from the corporate/banking community. Examines the historical
development of pension fund capital, the ways in which it is presently being used, and the claims and counter-claims by the unions, states and financial community to control it. The final section focuses on the potential for using capital in the development of basic economic alternatives within the United States. Available from the publisher, 25 Beacon St., Boston, Mass. 02108.


A comprehensive review of public pensions written for the nonspecialist. Available from the publisher, South Holland, Ill. 60473.


A report to the Task Force on Pension Investments of the Massachusetts Social and Economic Opportunity Council, which looks at role their pension fund investments play in local economic development and in the social impacts of business activity. It considers what is and is not known about the indirect effects of pension fund investments, and what can be done to assure that pension fund investments work for the benefit of participants and their communities. Available from Low Income Planning Aid, 2 Park Square, Boston, Mass. (617) 426-4563.


A GAO report describing the magnitude of unfunded accrued liabilities and actions or lack of actions being taken to fund the plans on a sound actuarial basis. Available from the General Accounting Office, Distribution Section, Room 1518, 441 G St., N.W., Washington, D.C. 20548.


A report to the U.S. Senate Committee on Human Resources analyzing several aspects of public-sector retirement plans, including the adequacy of financing arrangements and fiduciary standards. Fourteen public-sector retirement plans were surveyed resulting in case studies focusing on the structure for each plan (membership requirements, financing, and benefits), its framework for investment management, and its investment experience. Available from the General Accounting Office, Distribution Section, Room 1518, 441 G St., N.W., Washington, D.C. 20548.


Edmonds contends that, given the present-oriented time reference of politicians, public-sector employees and taxpayers, the natural trend will be toward increased benefits and postponement of needed reform in financing public employee retirement systems. The study defines the scope and causes of pension underfunding and evaluates the appropriateness and effectiveness of the proposed reform legislation. It also develops criteria for the documentation of pension underfunding. For information, contact the author, c/o Joint Center for Political Studies, 1425 H St., N.W., Washington, D.C. 20005.


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Presents an overview of the characteristics and condition of 11 Florida local government retirement systems. Benefit characteristics are examined with respect to common provisions, adequacy and equity. A discussion of disability provisions, cost-of-living adjustments and portability provisions is also included. Also deals with financing local government retirement systems. Available from Florida Advisory Council on Intergovernmental Relations, Suite 40, House Office Building, Tallahassee, Fla. 32304.


Two issues of Governmental Finance magazine devoted entirely to current public pension problems and practices. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


Presents the results of a survey of 160 public pension funds conducted in 1976. Data are tabulated and analyzed on the type and size of the funds, as well as rate-of-return expectations, investment policy and forms of management. Available from the publisher, 135 Putnam Ave., Greenwich, Conn. 06830.

A basic treatment of retirement system management for public retirement administrators; local, state and federal finance officials; students and all others concerned with the operation of public employee retirement systems. A collective reference source and management tool providing information on public retirement organization, financing, investments, accounting, reporting, public relations, record management, actuarial requirements, benefits, legislation and legal considerations. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


Provides an overview of public employee pension systems and identifies basic issues and problems associated with them. The authors conclude that the problems are large and complex and that a concerted educational program is required to assure public understanding so that a climate can be created in which any needed reforms can be considered and adopted. Available from the publisher, 1500 New Hampshire Ave., N.W., Washington, D.C. 20009.


The current high rates of inflation erode the value of workers' pension benefits. Inflation-adjusted benefits would be possible only by a dramatic restructuring of the entire private pension system and the introduction of index bonds. Available from the Research Department, Federal Reserve Bank of Boston, Boston, Mass. 02106.


Provides legislators and their staffs with an introduction to how pensions work and suggestions on how they can be made better. Cites the necessity for legislative oversight of pension laws and reviews briefly types of controls, impact of collective bargaining, pension loopholes, cost-of-living adjustments and integration with social security. Available from the National Conference of State Legislatures, 1405 Curtis, Suite 2300, Denver, Colo. 80202.


Studies the reporting of financial data by public pension plans. Identifies the major users of pension disclosure information, the kinds of information they use, the vehicles by which disclosure is made and what the current state of disclosure appears to be. Available from the author, GFRM-MFOA, 1750 K St., N.W., Suite 650, Washington, D.C. 20006.


Evaluates the policy questions affecting public employee retirement plans. Discusses such topics as benefit levels, goals and limits of a retirement income program, portability of pension credits, preretirement security, and a possible approach to integration of social security with public employee retirement programs. Various funding methods and investment policies and procedures are analyzed, and the operations and benefits of public and corporate pension funds are compared. Available from the publisher, 41 East 70th St., New York, N.Y. 10021.


An encyclopedic analysis of the nature and scope of the characteristics and operations of public employee retirement systems as of the late 1970s. Also contains a review of various federal laws that presently affect public employee retirement systems, an analysis of state statutory provisions and reprints of a Department of Labor bibliography (May 1977) on pensions and a Twentieth Century Fund report by Louis M. Kohlmeier on Conflicts of Interest: State and Local Pension Fund Asset Management. Available from GPO, Washington, D.C. 20402.


Public employee retirement systems tend to have problems in benefit design, funding policy and reporting. This research examines the adequacy and appropriateness of alternative policies in these three areas. Available from the publisher, 1818 Ridge Rd., Homewood, Ill. 60430.


The transcript of a symposium held in March 1979 at the Wisconsin Center for Public Policy. Available from the Wisconsin Center for Public Policy, 1665 Monroe St., Madison, Wis. 53711.
State and Local Debt Policy and Management
Even for the smallest governments, the raising of capital through the selling of securities to private investors can involve unfamiliar processes, technical experts and relatively large amounts of money. Therefore, public officials and administrators are well advised to be aware of the fundamental procedures and practices used in designing and marketing municipal securities. This paper reviews the following elements: formulating a debt policy, uses of debt, types of instruments, design and sale of issues, debt limitations, debt capacity and credit ratings.

Formulating a Debt Policy

Because of its visibility and long-term consequences, debt management can be a particularly important element in local government decision making. In order to borrow, governmental borrowers must appeal to the investing public for their funds. Emergencies have arisen from time to time that have caused defaults or near-defaults on the part of state and local units. Along with high rates of interest, such periods — as occurred in 1975 and again in 1980 — usually bring intense examination of the public’s debt.

Debt management policies and issuing procedures should meet four requirements:
- Guidelines as to the appropriate and prudent uses of borrowing;
- Statutory and constitutional requirements placed upon the use of debt;
- Acceptable disclosure practices as enforced in the private financial markets; and
- Consideration of questions of timing and design to maximize the efficiency of borrowing under various market conditions.

For most governments, debt management involves a complex of factors born out of both practical necessity and legal tradition. A “debt policy” as such is seldom found in a particular document or set of principles, and the financial planner must take into consideration several factors in policy formulation. First, debt sold today must be repaid in the future and with interest. This will create an added fixed obligation in subsequent budgets. Furthermore, according to both practice and law, most long-term borrowing is done for purposes of financing long-lived, major capital projects. These projects become part of the public physical establishment and thereby influence patterns of growth and generate future operating expenditure requirements.

Types of Borrowing

There are two basic choices that must be made at the outset of a borrowing decision: the type of security and its maturity.

General Obligation vs. Revenue Bonds. As a general rule, the securities market is sensitive to the differences among the security types. Given a level of indebtedness, the broader the security base in terms of potential revenues to repay the obligation, the better the market will treat the security.

With general obligation debt, the general taxing power of the jurisdiction is pledged to pay both principal and interest. To sell such debt, voter approval may be required, and various debt and tax limitations usually restrict its use.

Various types of limited obligations, known as revenue bonds, frequently are sold for purposes, such as water and sewer systems, that produce revenues. Such bonds usually are not included in debt limits, as are general obligation bonds, nor do they usually require voter approval because they are not backed by the full faith and credit of the local jurisdiction, but rather are repaid from various service charges or fees.

Generally speaking, tax-supported general obligation debt is considered a superior form of debt by the market because of its standing as a full-faith obligation of the unit. It typically carries a lower interest rate than revenue-secured debt. There are many circumstances, however, where revenue-secured debt has advantages, particularly when it comes to allocating the costs of facilities to the actual users. But, the most frequent reason for using the revenue bond (and associated special-purpose funds or districts) has been to circumvent debt and referendum requirements or to finance purposes that are beyond

Uses of Debt

Most borrowing is done to finance capital facilities. This is true not only because of restrictions on the use of public debt, but also because capital facility financing possesses certain attributes that make the use of credit efficient and equitable. Capital investments are those whose useful lives exceed more than one period and, therefore, whose benefits accrue over time. Such expenditures in some cases may be financed by current taxes or grants, but they are usually financed by borrowing.

The need for borrowing to finance public facilities may be particularly great in growing areas. Growth in population and income almost always requires capital outlays that anticipate the ultimate growth in tax revenues. Exclusive reliance on the pay-as-you-go approach to finance capital investments out of current savings can inhibit the growth of a jurisdiction and deter the efficiency of capital investment.

Overall debt policy must be meshed clearly with growth planning and a prudent concept of what the fiscal and economic capacity of the debtor will be in the future. It should be integrated with the process of capital programming and budgeting. Making commitments to carry out specific projects necessarily involves planning for their financing. If the capital improvements program is to be an effective guide for financial planning and a means of achieving a government’s long-range physical, social and economic goals, then the capital planning and budgeting process should connect all projects systematically.
the legal authority of a general unit of government.

The rapidly growing use of revenue bonds to finance a variety of quasi-public purposes (such as industrial development, housing and pollution control) has added greatly to the size and complexity of the tax-exempt bond market.

**Long-Term vs. Short-Term Borrowing.** Another important choice in security type is between long-term borrowing (that which extends beyond a year) and short-term borrowing (that with a maturity of a year or less).

There are three types of short-term debt: (1) the bond anticipation note, which anticipates the ultimate sale of a long-term bond; (2) the tax anticipation note, which is sold to bridge gaps between expenditures and expected tax proceeds; and (3) revenue anticipation notes, short-term securities that are sold in anticipation of general revenues or grant receipts. The bond anticipation is the form of short-term security most suited to the overall problem of debt management, whereas short-term instruments in anticipation of taxes and revenues typically are cash management concerns.

### Debt Limitations

Most states have enacted constitutional or statutory restraints on the debt powers of local government units. The two primary types of restrictions that have been applied to local jurisdictions are:

- A limit on the level of debt outstanding (frequently expressed as a percentage of the taxable real property in the jurisdiction); and
- A requirement for a local referendum to authorize the issuance of bonds.

Other legal restraints have been placed on the purposes for which debt could be incurred and upon characteristics of the transactions such as maximum maturity, interest rate, and method of sale.

Over the years, several problems have arisen with the use of legalistic controls on local debt activity. Debt limitations and restrictions on the use and design of financing instruments frequently proved to be too restrictive and inflexible in the flow of changing conditions. The referendum requirement likewise proved to be an obstacle to financing projects that many voters — if not a majority — thought unnecessary. Major consequences of the traditional requirements were the development of the “special fund” doctrine and the “limited obligation,” and the birth of special districts and authorities that have been empowered to issue debt outside of the traditional constraints.

### Debt Capacity

Legal limitations on the amount of outstanding debt provide a ceiling that is seldom hit by borrowers. Of greater practical importance is how much debt and what composition of debt is acceptable to the municipal bond market. The market is particularly concerned about the unit’s capacity to support debt-service payments along with its other expenditures, and its overall economic and fiscal climate. Furthermore, the market’s perceptions of what is desirable or at least acceptable will change, depending on conditions in the securities market.

Not surprisingly, the bond market does not use one individual indicator of debt capacity. Standard measures of debt capacity usually relate to the revenue base and the general level of economic activity. They can also be heavily influenced by the unit’s fiscal behavior, whether or not it has operating deficits, and also the market’s perception of the desirability and financial integrity of the programs being financed.
Credit Ratings

The great number of state and local issues that come to market has led to an institutionalization of much credit opinion in the form of bond ratings. Issued by rating agencies, the best known and most widely accepted opinions are those of Moody's Investor Service and Standard and Poor's. For a fee, the agencies express an opinion as to the credit quality of individual bond issues or, in the case of general obligation issues, of the borrower itself. There is no formula for weighting factors that determine the agency's opinion, but they include fiscal standing of the borrower, general economic conditions, and certain legal and administrative qualities.

The most important thing about the rating is its impact on interest costs. Although the differences among the various security grades will fluctuate depending upon market conditions, the very highest grade bonds (Aaa) often sell at interest rates a full percentage point or more below those of the lowest grade securities (Baa).

For all practical purposes, a bond issue of even small size must have a rating in order to be sold in the national markets. Ratings typically cost between $1,000 and $5,000, depending on the size and complexity of the bond issue.

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Provides a brief technical description of municipal bonds, how to issue them, and the parties involved in the various transactions. Available from the publisher, 20 Broad St., New York, N.Y. 10005.


Provides basic information for those with little exposure to the area of municipal finance. Besides helpful with terminology, it gives a "how to" lesson, including making the decision to issue long-term debt, a step-by-step description of the process of issuing bonds and the administration of outstanding debt. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


A comprehensive treatment of the new role of financial reporting and disclosure in the municipal bond market. For information, contact Northwestern University School of Law, Chicago, Ill. 60611.


Discusses what should be done to improve the overall structure of the municipal bond market so that it can function effectively and equitably in serving local governmental borrowers, investors and the taxpayer. Available from the publisher, 1221 Avenue of the Americas, New York, N.Y. 10020.


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A guide to the credit aspects of municipal bonds and notes. Divides the components of municipal credit evaluation into five areas: (1) population, wealth and income; (2) governmental organization and powers; (3) financial operations; (4) general debt obligations; and (5) special and limited debt obligations. An excellent reference. Available from the publisher, 99 Church St., New York, N.Y. 10007.


Focuses on the factors included in the rating process. Includes specific discussions of general obligation bonds and of specialized types of revenue bonds. Available from the publisher, 25 Broadway, New York, N.Y. 10004.
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Measuring Governmental Financial Condition

Reprinted by the Southern Rural Development Center, Mississippi State University, with the permission of the Government Finance Research Center, Washington, D. C.
The ability of local governments to control their financial destiny can be undermined by eroding tax bases, mandated programs, costly employee contracts, growing retirement burdens, continued cost inflation and inelastic revenue structures. State and federal grant programs have been increased to fill fiscal gaps, but they carry with them the uncertainties of increased dependency on resources beyond local government control.

Another concern of many local governments is the growing taxpayer resistance to increased local taxes — dramatized by the adoption of Proposition 13 in California. While inflation chips away at the buying power of the tax dollar, local ability to raise additional tax revenue to pay for public services is being severely constrained.

Are local governments headed for financial difficulty? There is little doubt that the financial problems faced by a number of jurisdictions can be called fiscal crises. However, the situation confronting many others is less extreme. This paper is intended to provide insights into the indicators local officials can use to assess their government's fiscal condition. Two cautionary notes before proceeding:

1. Analysis of fiscal condition is an art, not a science. Assessment requires an understanding and analysis of the factors unique to the community. Furthermore, poor financial management practices may hide or obscure certain elements relating to fiscal condition.

2. Indicators provide information on fiscal condition. They do not offer guidance or solutions to solving fiscal problems.

A Definition

There can be various definitions of a governmental financial emergency, but the touchstone is where a unit is running out of cash and cannot quickly raise more. This is the definition adopted by the Advisory Commission on Intergovernmental Relations (ACIR), which defines a financial emergency as an inability to perform existing levels of service, including meeting payrolls, paying current bills or paying debt service.

Such a definition is a starting point for the analysis. However, for many purposes, it is too restrictive and, to some degree, artificial. Where the likelihood of default is low, the jurisdiction is presumed to be in good condition. A financially strong government can exist in the context of a weak or even disintegrating local economy or society. But the long-term prospects for such a situation continuing are not bright — at least as long as the government is subject to the desires of its citizens and reliant upon their resources. Ultimately, the measure of fiscal condition, if it is to have analytical and predictive value, must deal with more general circumstances relating to the destiny of the governmental unit. While default on debt payments is a sure sign of fiscal distress, concentrating an analysis on this single event may provide too narrow a focus.

The ability of local governments to continue to provide needed services under a variety of fiscal and economic circumstances is a more important concern from a resource and policy-making standpoint. A recent report by Sanford Groves of the International City Management Association, defined good fiscal condition as having the ability to:

- Maintain existing service levels;
- Fund normal demands for additional service;
- Withstand local and regional economic trauma; and
- Meet demands of natural growth and change.

This broader definition appears more useful for policy makers than the simple default test. Obviously, the two definitions are related, but default is such a remote possibility in most communities that using it as a guidepost for analysis is inadequate.

Several other problems must also be overcome in implementing the broader definition. There are few standards against which municipal finances can be measured. While state laws and municipal charters frequently establish legal limits on debt levels and tax rates, such limits are prescriptive in nature and have not been determined through empirical research on the causes of fiscal stress.

Because valid standards have been lacking, researchers generally have had to resort to comparisons among local governments as a means of identifying those likely to experience fiscal distress. Under this approach, governments that vary widely in the wrong direction from the mean or median for their group are considered fiscally distressed, while others are deemed healthy. The validity of such comparative analysis is questionable in some cases because of differences in local government populations, services provided, legal requirements and financial information reporting techniques.

Despite the lack of theory and the paucity of data, analysts tend to agree that good fiscal health depends on two interrelated conditions:

- A strong economy that produces sufficient revenue to meet the cost of public services, while simultaneously providing private employment and income that reduces the need for some public expenditures; and
- Sound resource and fiscal management that minimizes waste, provides the information needed to make sound fiscal choices, and avoids the spending of more revenue than can be raised dependably.

Practical Problems

Beyond the basic issues relating to definition, officials attempting to analyze their local government's fiscal condition may encounter certain of the procedural problems listed below:

- Fiscal stringency is seldom a singular event, such as a default on a bond. Usually it is a matter of degree — both in the necessity of making
choices among alternative courses of action and in the severity of their consequences. Fiscal stress can be managed successfully for many years, if circumstances permit. Or, it can be brought on by a relatively major and dramatic occurrence, such as the sudden loss of a major taxpayer or, as in the case of New York City, the closing off of some other heavily relied upon source of cash.

- There are few standards against which municipal government can be compared with confidence.
- It is not easy to compare one local government to another because of differences which exist in populations, services provided and legal requirements.
- It is difficult to measure factors external to the local government itself — such as political, economic and social forces — which have a strong influence.
- The problems which create fiscal difficulties seldom emerge overnight. Rather, they develop slowly, thus making potential difficulties less obvious.
- The information needed to assess problems is not usually readily available in a usable format.

Research to Develop Indicators

Approaches to fiscal indicators fall into two general categories. In the first category are those analyses that seek to further the development of the theory of fiscal condition analysis and to draw general conclusions based on a group of sample cities. The second category worries less about developing theory and concentrates on intuitively appealing measures of variables that common sense tells us are important to fiscal condition.

A Touche Ross-First National Bank of Boston study, entitled Urban Fiscal Stress: A Comparative Analysis of Sixty-Six U.S. Cities, falls into the first category. The study defines fiscal distress in terms of expenditures, taxation and debt per capita and correlates these variables with various socioeconomic, demographic and structural factors. It found that fiscal distress is not the inevitable result of a weakening economy. The study concluded that good management can forestall, at least for a time, the fiscal decline of a local government even in the face of the economic decline of its community. Conversely, poor management can create fiscal difficulties for an otherwise economically healthy local government. The report also concluded that “fiscal stability between the demand for public services and financial resources appears to be within the grasp of most cities.”

Terry Nichols Clark of the University of Chicago has also examined the problem of developing measures of urban fiscal strain. Among the indicators identified by this study are short- and long-term debt, revenue and flow-of-funds measures. Sources of fiscal strain include intergovernmental relations, municipal employees, the poor, loss of jobs, nonpoor residents and fiscal management procedures. Policy choices available to local officials to avoid or ameliorate stress are one product of the analysis.

Phillip Dearborn of the Center for Municipal and Metropolitan Research has compiled a series of reports describing elements of municipal fiscal analyses that present methods of identifying municipalities that are on the brink of financial emergency. Operating statement and balance sheet analysis is used to evaluate a municipality’s financial condition. Various budget performance indices are developed to explain changes in financial condition. Welfare-related expenditures and tax and debt burden data provide measures of budget flexibility used in evaluating a municipality’s ability to deal with a financial emergency.

The Urban Institute, in its draft report entitled Urban Fiscal Monitoring, has also developed a guide and reference for better fiscal monitoring. It considers the following factors in arriving at measures of fiscal stress:

- Indicators of economic condition and their impact on fiscal condition;
- Long-term fiscal measures such as local tax and revenue capacity;
- Short-term factors, including operating deficits and surpluses, net cash position and liquidity;
- Dependence on federal and state aid;
- Long-term and short-term debt; and
- The amount of outstanding pension obligations.

Recently, the Government Finance Research Center of the Municipal Finance Officers Association (MFOA), in conjunction with the congressional Joint Economic Committee, completed a survey of the current fiscal trends and conditions of U.S. cities. The results of the survey are in the first stages of analysis and have not yet been released. In all, more than 300 cities of various sizes responded, giving detailed information about their fiscal 1978 and 1979 budgeted and actual results, as well as what they anticipated their results would be for fiscal 1980. These data, when tabulated, will give a most up-to-date picture of financial performance and conditions.

(For further review of recent efforts to develop fiscal indicators, see the bulletin Municipal Fiscal Indicators prepared by J. Richard Aronson for the Urban Consortium.)

Assisting Local Officials

The International City Management Association (ICMA) is completing a series of practical handbooks that managers of local governments can use to assess their fiscal condition. The handbooks present detailed measures in three broad categories of variables:

- External influences, including local demands and resources, the national and regional economy and intergovernmental issues;
- Organizational practices and policies in issues management; and
Signs of Fiscal Decline

The five variables noted in the MFOA report and the trends which local officials should monitor in guarding against fiscal decline are described in the following sections.

The Economic Base of the Municipality. A strong economic base produces the revenue to support services and creates the community environment which attracts residents and business. Moreover, when the economic base is strong, the need to expend public funds on such services as police protection, social services and housing rehabilitation is less severe. The following specific trends may indicate that the economic base of the community is declining:

- Appraised value of real estate per capita in the community is growing too slowly or declining;
- Number and value of building permits are declining or growing too slowly;
- Number and value of business licenses are declining;
- Retail business is declining or growing at a slower pace;
- Expenditures for police and social services are growing as a percentage of total expenditures;
- Total population is declining; and
- Income per capita is declining.

Financial Independence of the Local Government. Typically, a financially sound municipality has sufficient control over its finances to enable it to weather financial problems and emergencies without a crisis. In addition, such municipalities usually have the financial flexibility to respond to the need to support critical programs. This flexibility is a by-product of financial independence; it permits a jurisdiction to control its own destiny.

Financial independence can be lost in several ways:

- Becoming overly dependent on volatile outside funding sources, with their matching fund and administrative requirements;
- Incurring excessive debt, which creates heavy demands on future revenues; or
- Committing funds to programs whose costs cannot be readily controlled.

Specific trends to watch in this area include:

- A growing percentage of expenditures for basic services funded by categorical grant funds;
- A growing proportion of own-source revenues committed to matching funds;
- Tax rates in key tax sources approaching legal ceilings;
- A growing debt burden;
- A steady pattern of budget overruns in specific programs; and
- Rapid increases in fringe benefits for employees.

Municipal Productivity. Municipal productivity is not an easy factor to measure because many of the services and benefits which municipalities provide are intangible. The following trends are generally useful measures:

- The number of municipal employees per capita is increasing;
- Municipal expenditures after adjustments for inflation are increasing;
- Municipal enterprises are incurring operating losses;
- Customer rates for municipal enterprises are rising rapidly; and
- Unit output per dollar expended in selected local services is not increasing.

The Amount of Current Costs Deferred to the Future. Trends which should be closely watched to determine if an unreasonable level of cost is being deferred to the future include:

- Short-term debt and other obligations outstanding at year end growing as a percentage of total own-source revenues;
- Long-term debt being applied to operating programs;
- Declining funding of capital items such as street repaving, new equipment, etc.; and
- Increasing deferral of current pension costs.

The Effectiveness of Financial Management Practices. Sound financial management practices can provide information which local officials need to evaluate the fiscal posture of their jurisdictions. Financial management is a factor which is under direct management control. Thus, problems in financial management may be easier to solve than those in the other subject areas just discussed. There is no acceptable justification for having inadequate financial management practices.

Some trends which could indicate that a municipality’s financial practices are inadequate include the following:

- Real estate assessments vary greatly from true market value;
- Earnings on short-term investments are declining;
- The interest cost of short-term loans is increasing;
- The incidence of budget-expenditure overruns is increasing;
- The incidence of estimated/actual revenue shortfalls is increasing.
The amount of taxes and fees uncollections at year end is increasing; and
The municipality consistently fails to obtain an unqualified opinion on financial statements from an outside auditor.

Procedures for Developing Indicators

The indicators just described can be developed and analyzed on a regular basis. The process would include the following steps:
1. Assemble the data needed to compute the indicators;
2. Calculate the indicators for each of several (at least five) prior years; and
3. Identify significant trends and assess the underlying causes for those trends.

If potentially unfavorable trends are identified, underlying causes should then be ascertained. A trend which appears unfavorable on the surface may be harmless. Its impact cannot be known until a background analysis has been completed. The development of the indicator is not the end, but rather the beginning of the analysis.

This portion of the process is the most subjective and, therefore, requires the greatest degree of analytical skill. It is also the most important task because the results will indicate whether the unit of government is heading for financial trouble. To assist in performing the analysis of underlying causes, a checklist of the most likely causes associated with each indicator should be developed as a guide.

Bibliography


Describes efforts to develop fiscal indicators and concludes with recommendations for topics requiring further study. Also describes the methodology and conclusions of recent research on fiscal indicators. Available from Urban Consortium, 1140 Connecticut Ave., N.W., Washington, D.C. 20036.


A series of papers which assess the fiscal outlook for cities against a background of current federal policy toward cities. The writings cover four topics regarding federal policy — the particular case of distressed Northeastern cities, capital obsolescence and financing, federal grants, and the impact of the federal budget. Available from the publisher, Syracuse, N.Y. 13210.


A series of papers that look at various indicators of fiscal strain. Sources of strain analyzed include inter-governmental relations, loss of jobs, the poor and municipal employees. For further information contact the author, University of Chicago, 1126 E. 56th St., Chicago, Ill. 60637.


Describes elements of municipal fiscal analyses. Two reports present methods of identifying a municipality nearing a financial emergency; the third examines debt-related factors to determine how an investor may be treated in a financial emergency. Available from First Boston Corporation, 20 Exchange Place, New York, N.Y. 10005.


Five practical handbooks designed to help local government managers assess their fiscal condition. They focus on three broad variables: external influences such as local demands for resources and national and regional economy; organizational issues including management practices and policies; and internal financial characteristics such as revenue and expenditure patterns, debt, and unfunded liabilities. For information contact ICMA, 1140 Connecticut Ave., N.W., Washington, D.C. 20036.


Examines the scope of the federal government's response to the fiscal crises of cities. Provides an extensive discourse on the emergency measures and programs enacted during the mid-seventies. Changes in the more established programs of the late sixties and early seventies are also scrutinized. Taken together, the assembled papers evaluate the bulk of the federally initiated programs aimed either directly or indirectly at assisting financially troubled cities over the past decade. Available from the publisher, Cambridge, Mass. 02138.


Intended to help clarify the debate over what constitutes fiscal stress and how it might be measured. Seeks to determine whether any major cities may face a financial emergency by 1982, given a number of possible economic and policy scenarios.


Provides local officials with step-by-step procedures for analyzing their government's financial condition.
Focuses on five major variables that contribute to fiscal decline: economic vitality declining; financial independence being lost; declining municipal productivity; deferral of current municipal costs to the future; and ineffective municipal financial management practices. A series of detailed indicators is presented to assess each variable and a methodology for collecting and analyzing data on the variable is outlined. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


The results of a study that focused on the impact of economic-social-structural-financial linkages on local government fiscal stress. The study found that fiscal distress is not the necessary result of a weakening economy. Available from Touche Ross & Co., Client Services and Development, 1633 Broadway, New York, N.Y. 10019.


Presents statistical information on various elements of municipal finances of individual cities, towns, and townships having 50,000 population or more. Updated regularly.


Provides estimated nationwide financial aggregates covering local government, together with state and federal government data.
Elements of Financial Management

Alternative State and Local Revenue Sources
Recent taxpayer insistence on checking the growth of taxes combined with the rising revenue requirements of state and local governments have challenged the traditional methods of financing state and local government services. The need for new or alternative sources of revenue is compounded by taxpayers' demands for more services without necessarily increasing taxes or other charges.

State and local governments have been forced to seek out previously unused sources of revenue — either tax or nontax sources — to balance their budgets. This paper focuses on recent experiences in coping with this problem and discusses alternative revenue sources available to state and local governments.

Background

Finding new sources of revenue is not an easy task. Arguments can be found against almost any new source. Either it is politically infeasible, too hard to collect, not a large enough revenue raiser, too difficult to explain, not equitable or does not provide immediate remedies to the problem. For these and many more reasons, there is no simple answer to the question: How will revenues be increased?

Defining revenue alternatives for state governments is much easier than for local governments since state governments determine their own fiscal structure and are only limited in increasing revenues by political acceptability, constitutional authority and what the market will bear. Local governments, constrained because their fiscal structures are set by state law, find it more difficult to acquire alternative sources.

Revenue Alternatives

Revenue alternatives that can be used by state and local governments fall into four broad categories:

- Increased intergovernmental revenues;
- Improved financial management techniques;
- Expanded tax bases; and
- Improved tax administration.

Intergovernmental Revenues. The area of intergovernmental revenues is a logical place to begin search for additional funds. Governments should be certain that they are obtaining every dollar they are eligible to receive from higher levels of government. "Grantsmanship" is a skill and the payoffs can be high for the governments that are adept at finding what is available. Governments should not overlook the possibility of lobbying higher levels of government for increased intergovernmental revenues.

In a similar vein, local governments may press for more shared taxes. Although these are state-imposed levies that the state collects, the receipts are shared with local governments. Thus, the state taxes an activity that local governments are not permitted to tax, and then distributes the funds to local governments on the basis of a formula after taking out some portion to cover administrative costs. Obviously, the details of the formula are important.

Financial Management. Improved financial management techniques can result in savings for all governments, but perhaps one area — cash management — offers the greatest potential. A significant feature of a good cash management program is the ability to invest formerly idle funds and earn additional money.

One example of a government which "found" money by changing practices is Albuquerque, New Mexico. In the late 1970s, the city consolidated bank accounts, obtained bank services through competitive bidding, and with other changes, earned more than $350,000 in additional interest income in the first year of the program.

Another program, which can increase investment earnings for local governments, is the formation of statewide investment pools. Through these pools, local (and sometimes state) investable funds are commingled and frequently invested in higher-yielding instruments.

Tax Base Expansion. For governments to expand their tax bases they must be sure that they are within their legal authority. This applies at both the state and local levels. For example, a state income tax is prohibited by the state constitution in Florida. Once states have determined that they have the legal authority to tax new sources, other factors — such as acceptability — must be taken into account.

For example, gambling, in many forms — casino gambling, harness and thoroughbred racing, off-track betting and lotteries — can be a major revenue producer. One of the states most successful at raising gambling revenues is Maryland, which in fiscal 1979 realized $1.66 per capita in lottery revenues. Originally expected to produce about one-half of one percent of the state's annual revenues, Maryland's lottery presently accounts for 3.7 percent of the state's $4.6 billion budget.

However, attempts to legalize gambling as a revenue source frequently encounter opposition from groups and individuals who dispute its acceptability on moral grounds. Some states have offset opposition to these revenue-raising activities by earmarking the revenues for programs that are deemed generally worthy. For example, the state of Massachusetts returns all revenues from the state lottery to its cities and towns based on a percentage of sales in each jurisdiction. As mandated by New York's constitution, all proceeds for gambling in that state are earmarked for education. In Pennsylvania, senior citizens are the primary beneficiaries of lottery revenues.

Expanding the tax base is difficult for local governments because the state usually determines what localities can use as revenue sources. Since local governments typically must rely almost exclusively on the property tax, they have looked for ways to make this source more efficient. One way has been to improve the assessment function. Montgomery County,
Maryland, has recently instituted a levy known as the recapture tax. The purpose of the tax is to recapture, at the time of sale or transfer of real property, those revenues which would have been collected in the most recent year or years if the assessment had reflected the actual market value of the property, as demonstrated by the selling price. Although the formula for the tax excludes minor (under $5,000) under-assessments, the county has realized over $2 million in revenues during the two and one-half years that the tax has been in effect. In Maryland, the state assesses the value of properties, to which the individual county's tax rate is applied, producing the property tax revenue enjoyed by the county. The recapture tax represents an attempt by the county to recoup some of the revenue lost as a result of inaccurate assessments.

Another method that has been explored is a compensatory payments program to reimburse governments both for the revenues lost due to tax-exempt property and for the costs of providing services to tax-exempt facilities. A federal program already provides compensation to local governments for tax-exempt federal lands. In addition, a study is being conducted by the U.S. Advisory Commission on Intergovernmental Relations (ACIR) to examine the intergovernmental implications of federal real property. Specific attention is being directed toward the question of whether Congress should enact a broad-based system of payments-in-lieu-of-taxes (PILOTS) designed to compensate state and local governments for federal ownership of lands.

Although the property tax is the main source of local revenues, in recent years the public finance community has recognized the need to diversify the local tax structure to reach a broader range of activities and taxpayers. Earliest experiences with diversifying the local revenue structure came in the form of local sales, income and excise taxes for local jurisdictions as authorized by their states. The favorable experiences in administering these taxes allayed the fears of many critics and opened the way for a more favorable attitude toward nonproperty tax revenues, generally, such as user charges and fees or the imposition of a commuter tax.

Forty-nine large cities currently impose a non-resident (commuter) income tax on individuals who work in the city and reside in another jurisdiction. The commuter tax is a method of raising revenues from people who work in the city and benefit from its services, yet pay no income or property tax to the city. The majority of the cities which impose the charge do so by extending the income tax paid by its residents to nonresidents who work in the city.

To avoid dual taxation, the money paid to the city by the nonresident is often allowed as a credit towards the individual's income tax payment to the state in which he resides. This provision results in an increase in revenues for the jurisdiction in which one works and a decrease in revenues for the jurisdiction in which the commuter resides — if that jurisdiction also imposes an income tax. To alleviate this problem, some cities collect only the difference between their tax rate and the tax rate of the jurisdiction in which the commuter lives. In its last fiscal year, the city of Cincinnati, Ohio, collected $250 million through its tax on nonresidents.

Generally, administrative costs involving the collection of a commuter tax have been minimal, requiring only a small staff to insure that tax forms are filed by those on the payrolls of the city's businesses.

**Tax Administration.** Improving tax administration can be an effective means of increasing revenues. Several states have banded together to form the Multistate Tax Commission. Its objective is to guarantee that corporate taxpayers pay the proper amount of taxes owed to individual states. Tax delinquency can mean the loss of millions of dollars in revenue. For instance, many states on the East Coast have joined together to stop cigarette smuggling because of the large revenue loss they have suffered from tax avoidance.

One approach being used to improve tax administration is reciprocity, which involves a mutual exchange of enforcement and/or collection responsibility. The District of Columbia is proposing a unique type of reciprocity. It involves an agreement between the city and its neighboring states, Virginia and Maryland, whereby outstanding parking tickets received by a resident of one jurisdiction in another jurisdiction must be paid before that individual can renew his/her automobile registration. While there are several areas in the country with intrastate reciprocity (a state holding up renewal based upon locally issued violations), the concept of interstate reciprocity for parking violations, as practiced by the District of Columbia, Virginia and Maryland, does not exist anywhere else in the nation. The District of Columbia estimates that approximately 45 percent of its outstanding parking violations are issued to residents of Virginia and Maryland, representing over $4 million in potential additional revenue for the city.

**Other Alternatives.** Other sources that do not fall into the broad categories listed above include the sale of property and the leasing of buildings, unused equipment or vacant property. Another is economic development.

A final alternative for governments at all levels is to press for fewer mandated expenditures. Government officials, and local governments especially, should make lawmakers aware of what mandates actually cost local governments. This can be facilitated by seeking fiscal note legislation, which calls for independent cost estimates of a bill's impact. Some local governments have gotten legislation passed that requires the state government to reimburse local governments for the full amount or some percentage of the state-imposed costs. And in some states, governments have assumed responsibility for traditional local government functions. From the service delivery point of view, there may be drawbacks in transferring responsibilities to the state, but from a budgetary standpoint, the local government gains.
Recent Trends

One direction in which many governments are moving, or are interested in moving, is toward increased reliance on user charges and fees. These non-tax revenues are not a new phenomenon in public finance, but local governments have not yet relied on these devices extensively to pay for public services. Their use is reportedly becoming more widespread in the current era of tax limitations.

Fees and charges can and have been used to finance a wide range of services in different areas. However, officials are often unaware of the great diversity of applications. The fees and charges that are employed can be either fixed or variable. If the charge or fee is fixed, the user pays a flat amount regardless of how much of the service is used. Otherwise, fees can vary with the level or quantity of service used.

The distinction between a fee and a charge is often lost when discussing these alternative revenue sources. A charge is essentially a payment for a good or service that is received and can be paid for by an individual. The charge is a voluntary payment for a service that is excludable. A fee is basically a regulatory device. Fees are imposed as a result of the public need to regulate private activities for health, safety or other protective purposes and result in the purchase of a privilege or authorization. They may or may not cover the actual cost of regulation.

Charges can be placed on recreational activities such as golf and swimming as well as the more traditional charges for water service, sewerage and mass transit. Bridge and ferry tolls and parking fees are common examples of city services financed by a charge, and the list of potential applications of charges is growing. Some local governments have instituted library charges, dangerous tree removal charges, animal shelter charges, school lunch charges and tuition for adult and other continuing education programs.

Fees have been applied to such activities as restaurant inspections, swimming pool inspections, land fill use, building permits, and fire and food inspections. Fees are also paid for marriage licenses, bicycle registrations and garage sales.

Special assessments, a unique type of user charge that has received more attention recently, are levies against particular property owners for such improvements as roads and sewers, based on the theory that much of the benefit is derived by property owners and not the general populace. The important difference between these charges and those discussed above is that they are not voluntary.

The case for charges when local government resources cannot keep pace with the demand for services is strong. However, there are several issues which must be considered by local governments before or shortly after embarking on such a program. First, there is the question of how much to charge. Economic theory tells us that to achieve efficient use of resources, prices should be related to the costs of producing a good or service. However, the difficulties of administering such a system may outweigh the benefits of being able to ration public services on the basis of a price.

Pricing for services is an efficient approach and provides government with a means for determining how much of a public good or service should be produced. Charges have the benefit of extracting payment from those who use the service. However, charges are often criticized for their violation of the ability-to-pay principle. User charges place a disproportionate burden on low-income individuals.

Two other criteria that must be met by charges — and they are important ones — relate to the cost of collecting the charges and the charges' political acceptability. If collection costs are too high, the charge may not be advantageous. If the charge is going to be politically controversial, it will not be adopted.

Reliance on user charges and fees varies from state to state and city to city. It is difficult to make comparisons among jurisdictions of their use of charges and fees because the data are dependent on the various types of services that are being offered. Data collected by the U.S. Census Bureau show that local governments in the South rely on these sources more than governments elsewhere, and the New England area uses them the least.

Conclusion

Any state or local official looking for new revenue options must consider some guiding principles before embracing a new source. Otherwise, the alternative revenue source may not be an appropriate response to the government's fiscal problems.

The new source must be evaluated for its revenue-producing capability. Put simply, will the new source produce enough receipts to make it worthwhile? And, related to this is whether it is a dependable source of income.

In the midst of a period of high inflation, state and local governments have become aware of the need to have revenue sources that are responsive to rising prices. The decision maker should be concerned with finding elastic revenue sources, that is, those whose yield responds to economic growth. Volatility due to changing conditions can cause instability in revenues.

The decision maker also must consider whether the new source is fair. If the good or service is excludable, are those who are benefitting the ones who are paying? The question that also arises is whether there is a fair distribution of the cost. Are those individuals who do not have the ability to pay for charges on goods or services being treated unfairly?

The government official must weigh the impact of the newly enacted tax, charge or fee on the business climate of the locality or the state. An action that would hurt the business climate can have an unfavorable impact on the government tax base.

Another important fact that may be easily for-
gotten is whether administration of the new source is simple and efficient. If these two criteria cannot be met, the new source may be more trouble than it is worth.

From the state or local standpoint, it may be important to have a revenue source that can be controlled at the level where the money is being used. Relying on higher levels of government has its drawbacks because of the uncertainty of such resources. A governor and legislature may decide to reduce state aid to local governments, and the President and Congress may do the same with federal funds to state and local governments.

And finally, consideration must be given to what it will take to implement the new revenue raising program. If action is required by another level of government — such as state government authorization for local governments to tax new sources — then it will be necessary to allow enough time for the action and to devote sufficient resources to promotion of the program.

**Bibliography**


A model bill that provides for the establishment, maintenance and periodical publishing of an inventory of state-owned property. It also provides three methods of compensation, each directed primarily at a broad category of state property. For ordering information contact ACIR, 1111 20th St., N.W., Washington, D.C. 20575. (202) 653-5540.


Looks at local sales and income taxes and user charges as mechanisms to diversify state-local revenue systems and seeks to answer the question: Should states authorize widespread local use of income and sales taxes? The chapter on user charge financing provides a theoretical discussion of the issues, examines intergovernmental constraints, and ends with a review of specific types of charges which exemplify basic issues or which are promising areas for innovation. Available from ACIR, 1111 20th St., N.W., Washington, D.C. 20575. (202) 653-5540.


Provides information on the current status of service charges and fees as a means of financing local governments. Benefits, problems, issues and policies related to public pricing systems are reviewed. The report makes the point that "adjusting the price system to promote more efficient use of resources and programs is frequently ignored as a management strategy." Single copies available from the University's Bureau of Governmental Research and Service, P.O. Box 3177, Eugene, Ore. 97403. (503) 686-5232.


A handbook on special assessments. Defines areas where special assessment financing can be appropriately used and provides formulas for allocating benefits along with guidelines useful in making maximum use of this financing approach. Available from the Municipal Finance Officers Association, 180 N. Michigan Ave., Suite 800, Chicago, Ill. 60601. (312) 977-9700.


Highlights the basic advantages of pricing government goods and services whenever possible. Attempts to answer such basic questions as what services can be financed by user charges, what price should be charged, and what benefits accrue from substituting prices for taxes. For ordering information contact the National League of Cities, Publications Office, 1620 I St., N.W., Washington, D.C. 20006. (202) 293-7530.


Discusses the forces giving rise to the drive for property tax relief, including assessment reform and inflation. Chapter II offers some observations on the relative desirability of user charges as a form of property tax relief. Gold notes that while user charges could bring in considerably more revenue than they do at present, their potential is limited by the nature of certain services and by political resistance to unconventional policies. Available from D.C. Heath & Co., Distribution Center, 2700 N. Richard Ave., Indianapolis, Ind. 46219.


Discusses how fees and charges can be used to increase the self-sufficiency of public agencies or nonprofit organizations in providing leisure services and heritage protection. Included is a discussion of the benefits and issues which face agencies and organizations considering a new or expanded fee program. Available free of charge from the U.S. Department of Interior's Heritage Conservation and Recreation Service, Washington, D.C. 20240. (202) 343-1100.

State-Local Financial Management Relations
Improvements in local financial management can be motivated and supported through a properly constructed state role in regulating, supervising and assisting local financial management. Additional background papers in this series discuss the individual elements of financial management and the federal-local relationship.

Intergovernmental financial relationships among state and local governments are directed by state laws. Local governments are creatures of the states, which have the legal authority to (1) regulate local fiscal affairs, (2) provide financial assistance, (3) mandate local expenditures and (4) assume local financial responsibilities.

State regulation and supervision of local government financial management and fiscal policy have a material effect on all aspects of local finance. In most states, there is significant potential for instituting practices that will motivate and support improvements in local operations. Recent studies have shown that states play many varied roles in regulating and supervising the financial management practices of their local governments and in providing technical assistance and training to help strengthen local financial management.

**Forms of State Involvement**

The enormous diversity in the states' involvement in local fiscal affairs suggests that there are no model systems. However, five general variations of the role of states can be identified:

- **State statutory and constitutional prohibitions and restraints placed on local financial activities;**
- **Financial reporting and disclosure requirements promulgated and enforced by state authorities;**
- **Collection and monitoring of local government financial data by state officials;**
- **Direct supervision and regulation of local activities by state authorities; and**
- **Technical assistance and training programs for local governments sponsored or conducted by state authorities.**

Exactly how a state's role is defined is very much a matter of local conditions and leadership. The major components of the state-local financial management system are:

- **Budgeting;**
- **Accounting, auditing and financial reporting;**
- **Debt management;**
- **Cash management;**
- **Pension administration;**
- **Property tax assessment; and**
- **Revenue administration.**

An individual state's involvement in these areas can range from state mandated and enforced requirements to the provision of voluntary services for local governments.

A second aspect of state-local financial management relations revolves around the entire matter of grants, reimbursements and other forms of state aid to local government. State aid accounts for one-third of total local spending, making it an important aspect of intergovernmental financial relations. The major forms of state aid are:

- **Shared Revenues** — revenues received from the state either on a non-string-attached or an earmarked basis that are some portion of the yield of a state revenue source.
- **Block Grants** — grants made to local governments for broad purposes as authorized by legislation. Recipients have a great deal of flexibility in distributing such funds as long as the basic purposes are fulfilled.
- **Categorical Grants** — grants similar to block grants in that they are distributed according to an established formula, but the funds must be expended within specific categories.

Another form of state involvement in local finances relates to state mandating of local government expenditures. States can require local expenditures to be made for specific programs either as an exercise of their inherent power or as strings attached to grant programs. At the local level, officials decry the practice of state mandates without commensurate assistance. Local officials and their advocates see the problem of financial management as one of inadequate finances.

The direct assumption of certain financial responsibilities by the state also has a direct influence on the state-local financial management relationship. The transfer of functional responsibility from the local government to the state reduces the administrative and financial burdens on local governments and lessens state-level concern about local financial matters. An example of this approach is a state-administered pension system through which local governments provide pensions to their employees.

As a result of their legal authority and in response to various external demands, such as those from federal programs and and from investors, states have strengthened their roles in local finance. They are working as a partner with their local governments to help them attain fiscal control, remain financially solvent and manage their resources wisely. In addition, states are exercising their authority to solve perceived difficulties in local financial processes.

The remainder of this paper discusses state-instituted programs of regulation, supervision and assistance that are directed toward various major local government financial management activities.

**Budgeting.** Budgeting procedures for local government—hearings, timing and format—are now established in nearly one-half of the states. There is pressure in several other states to require budgets to be submitted to the state on prescribed forms. Once budgets are received by the state, they can be
reviewed for problems or approved prior to implementation. State involvement may take the form of expenditure or revenue ceilings. This form of state-imposed restraint has become more prevalent in the recent "cutback" era. States, often through departments of community affairs or in cooperation with state municipal leagues, are also providing handbooks and other technical assistance guides to improve local budgeting methods. These handbooks and guides run the gamut from program and performance budgeting to zero-base budgeting systems.

**Accounting, Auditing and Financial Reporting.** State regulation and supervision of local government accounting and auditing practices (as well as technical assistance efforts) are on the increase. However, a research effort is needed to identify information requirements and effective ways of satisfying them. Local government financial reports come in a variety of formats: They frequently are addressed to a small audience, and their publication is not necessarily required. There is increased pressure to have local government financial statements prepared on a uniform basis for consistency and comparison purposes. There is also a demand for reports that meet a variety of user needs and that appear regularly and in an intelligible form.

**Debt Management.** Historically, states have placed special legal restraints and controls on local borrowing behavior. These include various traditional limitations on outstanding debt and requirements for local referenda prior to the issuance of bonds. Other limitations may be placed upon (1) the purposes for which debt can be incurred and (2) the characteristics of transactions, such as maturities, interest rates and methods of sale.

**Cash Management.** State laws regarding local cash management procedures often place various constraints on local governments. For example, they may require placing cash balances in certain types of depository institutions for predetermined periods of time with defined pledging requirements. They may also specify eligible investment instruments in which cash balances may be placed. States now play an extensive role in determining cash management practices of their local governments, and this level of involvement is likely to increase. Such requirements vary from state to state and often do not apply to all types and sizes of governments within a state.

Examples of assistance in the areas of debt and cash management abound. States have created loan guarantee programs to assist local borrowers, and some have centralized borrowing through the use of bond banks. Small units of government, frequently without large cash balances or available expertise to determine good investment practices, can be aided by statewide investment pools. Such pools already exist in several states.

**Pension Administration.** State after state has had to confront the issues surrounding public pensions, and many have instituted pension reforms. One frequently proposed solution has been the development of a voluntary or mandatory statewide pension system for local employees. Another proposal involves the establishment of a permanent state agency or commission to oversee all pension systems in the state. The powers of such an agency might vary from simple surveillance (collection of data, advice and comment) to actual regulation of local systems.

A nationwide trend of increased state interest in controlling local pensions is evident. States are seeking to obtain better information on the financial condition of local pension systems through actuarial reporting requirements. They are also attempting to ensure that the impact of benefit modifications is fully understood at the time they are enacted.

**Property Tax Assessment.** Despite efforts to broaden the local tax base, property taxes remain the largest single source of revenue for most local governments. Keeping property tax assessments current has become more difficult in recent years because of the rapid inflation in real estate values. Attempts to reform the property tax range from tax relief proposals to improvements in the assessment process, including state regulation of the function.

Good property tax assessment practices depend on the level of professionalization in the area. States can promote improvements by establishing professional standards for assessment personnel, providing technical assistance and training to local assessment offices, and requiring periodic reappraisals. The state can help assessors appraise complex or unusual property and can provide such services as tax mapping and automated data processing. Ironically, the state of California played its most extensive role in improving property tax assessment practices by requiring regular reviews of assessment quality and providing technical assistance. Some observers felt that the sophistication and efficiency of the assessment process in California was the cause of Proposition 13.

**Revenue Administration.** Local governments receive their revenue-raising authority from the state. Unless home rule powers provide otherwise (and they typically do not), the revenue base that a local government may tax and the maximum rates at which that tax may be applied are specified by state law. In recent years, many local governments have complained that their authority to raise revenue is too limited. In particular, they point to the need to broaden their tax bases to include such things as retail sales, income and amusements. In some cases, local governments have also sought to have tax-rate limits, such as millage limits on the property tax, increased or removed entirely.

States have responded to these pressures for increased local revenue-raising capabilities in a variety of ways, including the following:

- Enlarging the property tax base by requiring frequent reassessment and the application of sophisticated real property assessment techniques.
- Removing millage limits on property taxes;
- Broadening the revenue structure to permit local taxes other than the property tax;
- Increasing state transfers or grants to local governments; and
- Undertaking to deliver services directly.

In addition to the diversification of the state-local fiscal system, there has been increased state interest in reimbursing local governments for state-mandated expenditures and adopting state legislation requiring fiscal notes (independent estimates of the cost to local government of proposed state programs).

Recent State Efforts

Many states have instituted programs of regulation, supervision and technical assistance for local financial management. Qualitative analysis of these programs is often as much a comment on the overall quality of local financial operations and personnel as it is on the state activity itself. Therefore, apart from a broader recognition of a positive interrelationship among the states and their constituent municipalities, appraisals are difficult. Nevertheless, these examples of good practice are noteworthy:

**North Carolina** — The North Carolina Local Government Commission, a division of the Department of the State Treasurer, is probably the most well-known national example of state supervision. Its powers are comprehensive, and it seeks to balance its role of regulator with technical assistance to localities in such areas as budgeting, debt management and accounting systems.

**Oregon** — The Oregon Municipal Debt Advisory Commission assists local governments in marketing bonds and notes. In addition, Oregon's pooled cash investment approach has been used as a model by many other states.

**New Jersey** — The Office of Local Government Services, contained jointly in the Departments of Community Affairs and Treasury, combines the state's technical assistance and oversight functions in a comprehensive program of local government financial review.

**Florida** — The state has passed a comprehensive law governing local government retirement systems. It prohibits public pension systems from increasing benefits without concurrently making provision for the funding of those benefits on a sound actuarial basis.

**Tennessee** — The State Comptroller’s office approves the budgets of local governments that have outstanding short-term obligations. The purpose of the approval is to determine whether projected revenues will be adequate to meet budgeted expenditures.

**Washington** — The State Auditor’s office has developed a financial reporting system for all local governments to meet the Legislature’s need for better fiscal information about local programs. The resulting Budgeting, Accounting and Reporting System (BARS) has received statewide and nationwide acclaim as an innovative and effective financial information system.

**Conclusions**

As the level of state regulation and supervision of local government financial management practices increases, the disparity between individual state practices may become pronounced. Innovative practices will be developed and instituted, but such changes are not without costs. For example, uniform budgeting, accounting and reporting standards will necessitate some basic changes in local operations and will require more highly trained personnel. These new demands may have a serious impact on the work load and cost of local government financial management operations. Long-term improvements, however, will provide greater accountability and will result in greater investor confidence.

The potential for state responses to local problems and issues in financial management is extensive and varies among jurisdictions within each state. A U.S. Advisory Commission on Intergovernmental Relations report, *Improving Urban America: A Challenge to Federalism*, lists the following recommendations for an overall state program to improve urban financial management:

- States should regulate locally administered pension systems and provide consolidation of small or poorly financed ones with each other or with centralized state systems;
- States should designate a single state agency to assist in improving local financial management and in detecting the early signs of financial trouble;
- States should establish guidelines to determine when state intervention is warranted; and
- States should regulate the use of short-term operating debts by local governments.

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Deals with alternative methods of local government organization, planning and fiscal conditions. Presents a review of urban America and its governmental capabilities. Recommendations provide a foundation for a philosophy of intergovernmental relations and for a coordinated urban program of federal, state and local action. For more information, contact ACIR, 1111 20th St., N.W., Washington, D.C. 20575 (202) 653-5540.


Summarizes research done on problems which impede the effectiveness of the federal system. Presents in-
formation on the extent of reasons for and results of municipal transfers of functional responsibilities. For more information, contact ACIR, 1111 20th St., N.W., Washington, D.C. 20575. (202) 653-5540.


Deals with state-initiated mandates, with particular emphasis on the California reimbursement experience. The principal arguments made for and against state mandating are presented, as well as the results of a Commission questionnaire dealing with fiscal notes, an increasingly used procedure for estimating the additional costs that proposed state legislation will impose on local governments. For more information, contact ACIR, 1111 20th St., N.W., Washington, D.C. 20575. (202) 653-5540.


In this essay, the author looks at research related to state-local fiscal relations. He finds that the subject matter has not developed much of a literature and the research conducted is often devoted to fill the policymaking needs of a single state.

Other essays in this publication provide comprehensive literature reviews of the individual financial management areas such as debt and cash management, and accounting, auditing and financial reporting.

Lovell, Catherine H.; Kneisel, Robert; Neiman, Max; Rose, Adam Z.; and Tobin, Charles A. Federal and State Mandating on Local Governments: An Exploration of Issues and Impacts. Riverside, Calif.: University of California, 1979. 263 pages.

A broad look at the issues and impacts of "mandating" by the federal and state governments on local governments. Findings delineate the issues, wrestle with definitional questions, provide a snapshot of the universe of mandates, and give preliminary indications of the costs, both financial and political-institutional to local governments of mandates. Policies which can mitigate negative mandate impacts are discussed. For more information, contact Catherine Lovell, Graduate School of Administration, University of California, Riverside, Calif. 92521.


Reviews the role the state now plays in the supervision of local government fiscal affairs, compares that role to both a general model of fiscal supervision and to North Carolina, and suggests a course of action which could strengthen the state-local fiscal system. Examines the functions of three state agencies which monitor and supervise the fiscal affairs of local government in the state. Also reports a lack of explicit uniform policy concerning the state's role in local government fiscal affairs and the absence of an appropriate framework within which to develop and promulgate such policy. Recommendations are designed to give local governments a sound and workable financial framework and to provide the necessary management and technical services they need. For more information, contact John L. Hardy, Secretary to the Ways and Means Committee, State Capitol, Room 412, Albany, N.Y. 12224. (518) 455-4026.


Presents the findings of a nine-state, in-depth study of the state role in local financial management. Combines and integrates data obtained from on-site discussions with state and local officials and an examination of local government financial reports with an analysis that suggests several major ways states choose to exercise their oversight and regulatory role in local finance. Available from Publications Department, MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


Governmental Risk Management
Risk management involves the protection of a governmental unit's assets and resources against loss created by various legal liabilities that may arise from the conduct of a government's operations.

The concept of risk management, although not new, recently has begun to generate widespread interest as a result of more frequent lawsuits brought against municipal governments and subsequent findings against those governments.

This paper highlights the following issues related to risk management by local governments:

- The objectives of a risk management program;
- The availability of municipal liability insurance;
- Alternatives for financing risk; and
- Local government officials' liabilities.

Risk management might involve the purchasing of insurance to provide financial protection against loss. However, it also provides the option of self-insuring through reserves or pooling risks and reserves with other governments.

Liabilities to which a government is subject, and for which protection should be provided, include property, i.e., fire, riots and natural perils; personal injury in a public building; contractors' coverage for someone under contract to the city causes damage to public or private property; products liability coverage; public officials and workers' compensation. Excess liability insurance usually supplements basic protection programs and provides higher liability limits.

The objective of risk management is conservation of a governmental entity's resources from accidental loss. To meet this objective, a risk management policy statement should be formulated. It should include:

- The goals of the risk management program;
- Definition of the authority and responsibilities of those who are to design and oversee the program;
- Coordination of the risk management activities of the various departments;
- Guidelines on the use of such features as deductibles or self-insurance;
- Centralization of insurance purchasing responsibilities; and
- Complete support of government officials and employees for the risk management philosophy of loss reduction and prevention.

Such a policy statement is necessary in light of (1) the erosion of governmental immunity to third-party liability suits, (2) the lack of effective risk controls, (3) the rising cost of municipal insurance and (4) the unwillingness of insurers to underwrite governmental entities.

**Municipal Liability Insurance**

In recent years, most municipalities have experienced skyrocketing insurance costs, particularly in the field of third-party liability. In large part, this is due to rapidly accelerating insurance premiums, which are caused to some degree by inflation, the narrowing of the scope of policy wording and high deductibles or the imposition of high self-insured retentions. There is also a general feeling on the part of insurers that the whole field of governmental liability is highly uncertain and very risky. In fact, some municipalities have found it impossible to obtain insurance at all.

A recent study of California municipalities highlighted the problem. In late 1975, a survey by the League of California Cities showed that municipal liability insurance premiums for fiscal year 1974-75 had increased by an average of 96 percent over fiscal year 1973-74. Furthermore, in 1976 many California cities were faced with additional large premium increases and nonrenewal by previous insurers.

The unavailability of insurance is a particular problem for certain types of municipal risks, such as any type of professional or "errors or omissions" liability exposure (including paramedics), water works and other public utilities, bus lines, etc.

### Alternatives to Financing Risk

There exist at least two alternatives to financing risk for those municipalities unable to obtain insurance or unwilling to pay extremely high premiums:

- Self-insurance; and
- State or regional insurance pools.

**Self-insurance.** With a self-insurance program, a municipality usually retains a certain amount of risk and purchases insurance for excess losses. This plan, carrying with it high deductibles, generally represents a more economical cost to the unit of government.

Under a program of self-insurance, a municipality agrees to retain a set dollar figure per occurrence. The government places itself in the role of insurer and should be able to perform specific functions, such as accounting for premiums, a safety and loss-control service, adjusting services, legal services and, perhaps most important, funding losses.

The amount of risk retained will vary from government to government and should be based upon the financial capacity of the municipality after taking into consideration bonded debt, types of services provided and other budget limitations. Professional risk managers, however, have a general formula: a municipality should be able to retain (1) up to one-tenth of one percent of its annual operating budget for any one occurrence, and (2) up to one percent of its annual operating budget for any one year. These percentages relate to all losses, not separately to fire, worker's compensation, public liability, etc.

**Pooling.** Self-insurance does not always solve the problem for smaller municipalities with few employees and small budgets. For these units and others unable to obtain insurance, the concept of risk-sharing through pooling is becoming a viable alternative.
The California study cited earlier showed that pooling of self-insured losses and joint purchase of excess insurance and administrative services is economically feasible, with long-term savings estimated to exceed 20 percent.

The savings would come from the reduction or elimination of expenses such as taxes, commissions, etc.; economies in premiums; and reductions in administrative costs.

Insurance pooling is becoming more common among communities within a specific county or counties as well as communities within a state. Statewide insurance pools for local governments, administered by the state, are also being studied in some areas.

Identifying and Controlling Risk

The key to risk management is to identify and measure all risk of loss to which a unit of government is exposed, and then to eliminate or control the potential losses. Losses are bound to occur regardless of controls, and therefore, a good system of monitoring and accounting is necessary to lessen their financial impact.

The types of risks to which a municipality is exposed and of which a risk manager must beware are manifold. They are based in large part on services and facilities provided — such as parks, utilities, transportation, roads, and schools — and involve potential loss from both property and liability exposure.

A municipality should appoint a risk manager on at least a part-time basis. In many communities, the risk manager is the finance director or someone who reports directly to the finance director. Responsibilities for the job should include reducing hazardous conditions and educating elected officials, managers, municipal employees, taxpayers, and others of the impact of losses and ways to avoid losses.

In addition, legal contract review is necessary to avoid possible exposures. This also applies to a strict review of bond indentures and joint powers agreements to assure that the risk potential is minimized.

Local Government Officials’ Liabilities

In the securities area as well, officials and employees of special and utility districts have been held personally liable as a result of their actions in connection with bond sales.

Conclusion

Reduction or loss of sovereign immunity for both municipalities and their officials has contributed to a growing concern about, and interest in, risk management. However, the problems remain, and cooperation on the part of all units of government is essential to maintain current levels of services and sound financial management.

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Governmental Leasing Techniques
Leasing, a contract by which one party conveys property to another for a period of time in exchange for the payment of rent, can be a useful financing technique in the public sector. Many units of government may find themselves in situations in which it makes good economic sense to lease a public facility or piece of equipment to another entity; or, when they themselves are in need of a particular type of facility or equipment, to lease it from another party. This paper will focus on the basic characteristics and uses of the technique of leasing as it applies to local governments.

Types of Leases

Essentially, leasing is a financing technique which provides an alternative to outright sale or purchase of property. Perhaps most importantly, it recently has become a feasible alternative to the traditional bond issue as a means of acquiring the use of a certain capital facility.

At some point, every local government will find it advantageous to be either a lessor or a lessee, or both. Acting as a lessor, the government typically leases equipment or facilities to another entity — governmental or private. In the role of a lessee, the unit pays a charge to use a capital good, perhaps making installment payments to acquire assets over a period of time. Lease arrangements with a governmental unit as either lessor or lessee can take many different forms. Rarely is a local government able to pull a lease agreement "off the shelf" and use it. Each agreement will be dictated by economic and political factors existing at that time. Thus, leases should be entered into only after a careful review by all appropriate officials.

Leases where the government is lessee can be arranged either directly from the vendor or from a lease-financing company. The difference between the two is that a lease-financing company can be used for any brand or type of equipment or facility desired, whereas the vendor can only arrange leasing of its own assets.

Government as Lessor

Whenever the local government is a lessor, it typically has several options for structuring the lease. Three of the most common lease arrangements in use today are the (1) straight operating lease, (2) lease-purchase agreement and (3) lease-sublease agreement.

A straight operating lease is usually very simple to structure. The terms of the lease, as well as the rental fee, are negotiated by both parties. Thus, the possible variations are limited only by the parties' imaginations. While the terms can range from a short period of time (one month) to a very long period (99 years in the case of ground leases), they are typically five to 10 years.

Lease-purchase agreements permit the eventual sale of the asset to the lessee. Although the market value of the asset is often used as a guide in determining the monthly rental fee, this too can be negotiated. The important point is that this arrangement is essentially an installment sale and is structured around the estimated life and/or the lessee's (purchaser's) ability to pay.

A variation of the above two leases is the lease-sublease. For example, a government may lease an entire building or other asset to another entity and then lease back a portion for its own use. The principal advantage of this arrangement is that it relieves the government of operational maintenance costs for the entire asset while providing it revenue for the portion that it does not need. Similar terms can also apply to equipment that a government needs only occasionally and shares with other local governmental units or private contractors, which also need to use it less than full time.

A lease-sublease often results from an operational change, such as a shift in maintenance responsibility for primary roads from a city to a county. The city would still need equipment for maintenance of secondary and collector streets, but its usage would be somewhat less than before. In this instance, it might sublease part-time use of road machinery to the county.

Government as Lessee

Government's role as a lessee has increased dramatically in the past few years. Leasing now is viewed as a feasible alternative financing mechanism for assets with short to intermediate useful lives. Leasing is also used for long-term assets, i.e., facilities. However, equipment leasing is still the most popular application. The two predominant lease arrangements used when government acts as lessee are the straight operating lease and the lease-purchase.

Again, the straight operating lease is simple to structure for both parties. Terms and rental fees are usually less negotiable when the government is the lessee than when it operates as a lessor. The primary reason is that the assets are being acquired from a vendor who is expected to recover a fair market value for the leased asset. The asset is leased for the time that the government desires and reverts to the lessor at the termination of the lease. Typically, these have been for short-term use, such as during an emergency or when a program is temporary and ownership is not desirable.

A straight operating lease also is used when a program does not have sufficient funds to acquire an asset because of budget constraints or grant requirements. Items normally rented include office space, vehicles and other major hardware, and all types of office equipment, including computers. This type of lease is frequently used when other factors are deemed more important than pure financial considerations. For instance, computers are leased, rather than purchased, due to the high obsolescence factor, regardless of the likelihood of more favorable financial
terms if they are purchased. A disadvantage to this type of arrangement is that the government does not build equity through its rental payments.

A lease-purchase arrangement, on the other hand, has the important characteristic of equity accumulation. Vendors and lease-financing companies are especially interested in lease-purchase arrangements because the interest portion of the lease is tax-exempt under federal regulations. This fact should make the cost of leasing less for governments than for private businesses. All vendors offer essentially the same lease options, especially in the area of equipment leasing. Recently, there has been an increase in lease-purchase arrangements for other types of assets, such as ports, parking facilities, and even a golf course.

When assets are financed in this manner, they are essentially being purchased on an installment basis. Ownership is often acquired for as little as $1 at the termination of the lease. Regardless of the amount needed to acquire ownership, it is usually much less than the true value of the asset, with the lessor having received an adequate return on its investment through rentals and tax benefits over the term of the lease.

**Legal Considerations**

In the role of lessor, a government typically faces legal considerations similar to those associated with a sales contract. However, due to the political sensitivity often accompanying public lease arrangements, it is important that the legislative body be consulted and its requirements reflected in the lease. Leasing of excess school facilities is one example of leasing that can be politically sensitive.

The most important legal consideration for a government acting as lessee is the "fiscal-funding clause" in lease-purchase agreements. This clause makes the lease a one-year contract with automatic renewal, unless the government notifies the lessor that funds are not available for a renewal period. The effect of this clause is significant for two reasons: (1) the lease does not apply to the debt ceiling, consequently voter approval is not required; and (2) the risk of cancellation increases the lease interest rate.

Lease-purchase contracts are fairly standard among the various vendors and lease-financing companies. The majority of the contractual provisions cover the lessee's ownership of the asset. Title to the leased asset normally passes to the lessee, but appropriate liens are recorded by the vendor. Additionally, the local government's attorney must certify that the governmental unit is properly incorporated, that the persons signing the lease contract are authorized to do so, and that the agreement is a legal, binding obligation of the government.

**Financial Aspects**

As a lessor, the government receives a financial benefit from the revenue that is generated. Whether this revenue flow will be sufficient to offset the government's costs of maintenance depends upon both the government's philosophy and the desirability of the particular asset.

Many times, the government chooses to rent an asset (such as a building) to a nonprofit organization, minority business or other governmental unit at less than a fair market rental. In doing so, it may decide that assisting these organizations or encouraging local economic development are more important than potentially higher rents. It should be remembered that often these buildings, because of their location, condition or design, are not attractive to private businesses able to afford higher rents. Thus, for relatively little or no additional cost, the government can derive revenue from an asset that might otherwise sit idle. On the other hand, if the government is willing to spend the money needed to place the building in a more leasable condition, it would be justified in requiring higher rent.

A variation on the role of government as lessor can occur when the government purchases a specialized facility, such as a parking lot or auditorium, over a period of time through a lease-purchase agreement. These particular assets, while not truly excess facilities, are nonetheless leased to private organizations. In numerous instances, the private organization actually manages and operates the facility in addition to sending monthly rental payments to City Hall. Here the city has acquired a socially needed facility in its name and has leased the operation to a private organization. Usually the revenues will offset the costs so as not to make the facility a burden to the taxpayer.

Regardless of which philosophy is followed, the total costs of operating the building should be identified and assigned to either the lessee or the lessor. The relevant costs would include taxes, maintenance, rehabilitation costs, utilities, licenses and security.

As a lessee, the government also gains substantial financial benefits. Aside from leasing, the only methods of acquiring assets are from current operating revenues, intergovernmental grants or through sale of bond issues. Current trends in tax-limitation legislation, double-digit inflation, uncertain aid programs, difficulty in passing bond referenda, and demands for spending that generally exceed revenues frequently make the outright purchase options unrealistic or unreliable. Consequently, many people view leasing as the wave of the future. However, this technique should not be abused, or governments are likely to find additional legal constraints placed on their leasing options in the future.

Properly structured, a lease-purchase contract can be more efficient and less expensive than the traditional bond issue for two reasons: practicality and economic feasibility.

The practicality of the lease-purchase contract is demonstrated in a number of ways, such as (1) elimination of the expense and delay caused by a bond referendum; (2) the capacity it has for use by small governments which have limited access to the capital
markets; and (3) its ability to finance relatively small capital needs that are too large to be funded from current revenues, yet too small to even be considered for bond financing.

Leasing can be more economically feasible than bond issues. Frequently, this is not understood when the lease interest rate is higher than the projected rate of interest on a bond issue. To evaluate fully a "lease vs. bond" decision for acquisition of capital items, a "total cost analysis" should be performed. In a total cost analysis, it is necessary to add all the costs in securing the financing and then compare the totals. A lease typically has few, if any, additional costs. However, a bond issue normally has referendum costs, legal fees, printing costs, rating costs, fiscal advisory fees and accounting fees, all in addition to the interest costs. A comparison of total costs for "lease vs. bond" may show leasing to be less expensive, especially for smaller items.

Another benefit of leasing is that the terms of the lease tend to parallel the assets life. That is usually not the case when bonds are sold. Hence, with bonds it may be necessary to borrow longer to finance short-term projects. To borrow (via lease) for a shorter term at a higher interest rate is less expensive than to borrow for a longer term at a lesser interest rate, plus bond costs.

**Accounting Treatment**

Accounting for leases is a complicated subject, but there are two basic rules that can help:

- If the lease is an operating lease, i.e., no equity accumulation and no ownership transfer, then the rental payments are treated as revenue by the lessor and expenses by the lessee.
- If the lease is a lease-purchase arrangement, i.e., there is an equity accumulation and ownership transfer with little or no additional payment, then the leased asset is capitalized by the lessee along with the associated liability. As its lease payments reduce the liability, a corresponding equity increase is recorded by the lessee so that by the time ownership is transferred no further debt remains outstanding. From the lessor's standpoint, a reduction in asset value occurs during the lease term due to depreciation, and the lease payments are distributed between principal (a return of capital) and interest income.

General fund assets are capitalized, whether paid for by cash, through a lease or through a bond issue. The important point to emphasize is that entering into a lease gives rise to an obligation that should be recorded properly.

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Federal Grants Management
Background

A considerable portion of all local government current revenues are received in the form of intergovernmental grants or transfers. The funds received may be for specifically defined purposes or may be designated for certain broadly defined purposes. Some funds must be formally applied for by a locality, whereas others are automatically distributed by formula or program criteria.

The receipt of grants funds by a municipality typically imposes new demands on its financial management systems and procedures. There are specific reporting, accounting and program requirements which must be met by a grantee. These compliance features may not be compatible with the city’s fiscal period, chart of accounts, reporting formats, etc. Failure to comply with grant regulations and rules could result in the municipality having to repay grant funds. Consequently, grant financial administration and management systems are important elements of a local government’s overall financial management system.

This paper reviews the following issues in grants management: impact of grants on local financial management, categorical grants, block grants, general revenue sharing, advance funding of federal grants, integrating grants into local management and federal management circulars.

Impact of Grants on Financial Management

The management principles for federal programs frequently are at odds with accepted local practices. For example, the standards for accounting may be different for federal programs than for local programs. Consequently, a dual management system at the local level is sometimes created — one to deal with federal programs and another to provide management support for locally funded program activities. Management elements that might be affected by a dual system include:

- Timing;
- Location and format of financial records;
- Planning;
- Management capacity;
- Operating and maintenance costs;
- Local government priorities;
- Flow of revenues; and
- Compliance with federal requirements.

Timing Problems. The difference between a municipality’s fiscal year and the associated budget preparation cycle, on the one hand, and the federal program year and grant application cycle, on the other, makes it difficult to determine the total resources required to provide necessary services. It can also complicate grants reporting, which typically must be done according to the federal program format.

Location and Format of Financial Records. Financial records for an individual federal program are often separately maintained by the local government department or agency responsible for carrying out the federal program. Whether these separate accounting systems are maintained by line departments or independent agencies, their existence means that local government administrative departments, which are legally responsible for this function, may lack the necessary fiscal information and control over federal program funds. Although federal financial management requirements do not mandate the accounting basis upon which a local government’s records must be kept, the unit must be able to report on the accrual basis of accounting. In addition, the variety of federally prescribed budget formats may be inconsistent with local expenditure categories.

Uncertainty in Planning. Recognizing that there are no guarantees that the funds requested will be received, local officials may be either unwilling to include them in the annual budget or prohibited by statute from doing so. The variations in federal program requirements and funding cycles from year to year inhibit the development of an overall, standardized monitoring, reporting and evaluation framework. As a result, chief executives and local legislative bodies are not able to consider overall service levels or determine total resource commitments, and implementing agencies are unable to coordinate or effectively program expenditures over a uniform period.

Management Capacity. Federal grant programs frequently place additional management responsibilities upon local governments. These responsibilities are sometimes inconsistent with local practices and procedures. They often require system control and monitoring capabilities that do not currently exist within the city. Furthermore, certain federal programs require additional staff to adequately manage the programs. There is hesitation on the part of some local officials to hire the needed staff due to the uncertainty of future funding. The decision not to hire additional staff places additional duties upon existing staff.

Impact of Grants On Operating and Maintenance Costs. Federal construction programs may provide facilities that the local government could otherwise not afford. However, federal funds typically do not finance operating and maintenance costs. This could result in additional stress on the city’s own-source revenues and staff.

Local Planning Skewed. Local government program priorities often do not correspond with federal program priorities. This frequently results in local governments adjusting priorities in order to match those of the federal program.

Dependency on Federal Monies. As current economic and financial conditions reduce local governments’ ability to support services and programs with own-source revenues, the governments become...
more dependent on federal monies. This increased dependence on federal funds decreases local governments' autonomy and also places them in an untenable position if federal programs are discontinued.

**Compliance Features.** Along with federal monies come an array of compliance features, many of which must be satisfied prior to expenditure of the funds. Often, if the compliance features are not met prior to the expenditure of federal funds, the non-compliance will be the subject of audit findings. More importantly, however, this may result in the local governments being required to refund the federal funds.

**Categorical Grants**

According to the Advisory Commission on Intergovernmental Relations, the number of categorical grants (now 492) available to state and local governments has almost tripled since 1963, while funding has increased tenfold in that period to the current $82 billion level. These grants are directed at specific programs and limited to narrowly defined activities. Categorical grants have many positive features:

- They stimulate state and local governments to meet specific national goals such as antidiscrimination, environmental protection, or the promotion of arts and culture;
- They act as a catalyst in numerous program areas that warrant exploration, such as national research and demonstration in health and natural resources;
- They attract the attention of appropriate aid recipients; and
- They ensure, as a result of the various strings and conditions attached to the funding, that the monies are used for the purposes intended by Congress.

However, the categorical grant system makes it difficult for local government to plan and manage a unified local program area. Each program has its own budgeting, financing, accounting and reporting forms and requirements. In addition, categoricals tend to be overly specific, fragmented or duplicative, and difficult to administer.

**Block Grants**

Block grants offer the potential for removing many barriers to improved budgetary and financial management of all the resources to be spent in a locality. Local officials are now able to play a far more substantive role in determining how federal funds may be allocated locally.

The basic characteristics of the block grant are:

- The eligible activities are fairly broad and stated in general terms within an overall program area;
- The amount to which a local government is entitled is determined by a formula;
- Local officials have the opportunity to determine their own priorities and allocate resources to meet identified local needs within broad national objectives;
- An annual application indicates the activities to be financed and how resources are to be distributed; and
- In lieu of lengthy application requirements and extensive application reviews, emphasis is placed on post-approval monitoring and audits.

The block grant approach affords local government certain advantages:

- Local government program consolidation facilities better use of central administrative functions (such as budgeting and accounting);
- The program year may be made coterminous with a local unit's own fiscal year, thus facilitating monitoring and performance evaluation; and
- Block grants provide greater flexibility and fluidity in local decision making, thus permitting local priorities to be reconsidered and funds reallocated during a program year.

**General Revenue Sharing**

In response to pressures from local officials to provide predictability and flexibility to the flow of funds and the discretion on how to use and manage them, the federal government enacted the general revenue sharing (GRS) program in 1972. Transferring more power regarding grants to state and local governments, general revenue sharing funds are distributed by formula with few restrictions concerning their use.

The revenue sharing program affords recipient governments the ability to:

- Plan, control and modify expenditures and tax policies, as well as assimilate citizen views into the budget process;
- Define, address and act on community problems;
- Promote and adopt new and innovative programs; and
- Improve planning due to the five-year certainty of the program, the simple availability of more money, and the opportunity to make needed expenditures.

The State and Local Fiscal Assistance Amendments of 1976 extended the general revenue sharing program for another three and three-quarter years. This act allows local governments virtually complete freedom in determining the use of the monies. On the other hand, the amendments extend the nondiscrimination provision to encompass religion, age and handicaps and to require that, with limited exceptions, each recipient obtain an audit of all its funds and groups of accounts in accordance with generally accepted auditing standards at least once every three years. Recently, the predictability in the program has been placed in jeopardy by calls for the removal of
states from the general revenue sharing program and for the reduction in the amount of funds to local governments.

**Advance Funding**

While there may be an increase in the number of both categorical and block grants available to local governments, the delivery mechanism for these grants may be revised to reduce many of the uncertainties associated with the flow in federal funding. An important way to accomplish this would be through multi-year budgeting on the part of the federal government. For most expenditures, the approach seems feasible and has been recommended by the Congressional Budget Office. Such forward budgeting would make it easier for local governments to plan, budget and implement grants programs.

**Integrating Grants Management at The Local Level**

Officials should review their systems to determine the local unit’s capacity to undertake integrated grants management, i.e., the incorporation of grant program management elements with local government management systems and procedures. This review should compare existing organization, policies, personnel skills and support systems with estimated resource requirements for the described integration process. To facilitate this review, officials should analyze current practices. For example, in the areas of budgeting and accounting, a government may review its existing structure and process to determine the following:

- How federal program and project cost estimates are aggregated into an overall budget within the grant limit;
- The relationship (both programmatically and in terms of timing) between the grant budgeting process and the city’s normal budget process;
- The format for the prescribed grant activity budget, e.g., program versus line item, project versus objects of expenditure;
- The format employed for the city departments compared to that used for grant budget estimates and with any impediments to a common budget process and format;
- The approach and method used to account for grant programs and projects; and
- The relationship between grant program/project accounting and the municipality’s own accounting and record-keeping practices, on the one hand, and impediments to an integrated program/project accounting system, on the other.

After such self-analysis, local government officials may wish to design and implement integrated grants management.

**Federal Management Circulars**

Regardless of how a local government chooses to manage the various elements of a federal program, it may comply with the ever-increasing requirements that various federal agencies impose in the audit, accounting and reporting areas.

The two major documents that govern the administration of federal grants at the state and local levels are Office of Management and Budget Circular A-102 and Federal Management Circular 74-4. Circular A-102 sets grant administration procedures in a number of areas, including financial management, and is designed to restrain federal agencies from imposing additional requirements on grantees, although it does not preclude them from doing so. While it does not impose or describe specific procedures, Attachment G of Circular A-102 presents the following standards for an adequate grant financial management system:

- Current, accurate and complete disclosure of financial results;
- Records that identify the source and application of funds;
- Effective controls and accountability for funds, property and other assets;
- Comparison of actual expenditures and budgeted amounts;
- Methods that minimize the time between receipt and expenditure of funds;
- Financial and compliance audits at least every two years; and
- Accounting records supported by source documentation.

Within this context, recent studies have shown the need for a single total audit, one in which an organization as a whole is audited, not just individual grants. Numerous federal audits, each attempting to examine a particular program, become wasteful of both federal and local resources and disruptive to operations.

In response to these demands for a “single audit,” OMB recently published Attachment P to Circular A-102. Attachment P states that grantee audits are to be made on an organizationwide basis, rather than grant by grant. Furthermore, the authority of federal agencies to make audits of a recipient organization is limited. However, if independent audits arranged for by state and local governments meet the requirements prescribed, all federal agencies must rely on them, and any additional audit work should build upon the work already done.

Federal Management Circular 74-4 provides uniform rules for determining costs applicable to grants and contracts with state and local governments. It defines allowable costs and sets forth the procedures to recover them. The costs may be direct or indirect, but must be necessary, reasonable and directly related to the grant. The basic underlying
intent of the circular is that federally assisted programs bear their fair share of costs. The circular also provides that one federal agency will negotiate a grantee’s indirect cost (indirect or overhead costs which are common to two or more projects or operations) on behalf of all other federal agencies.

The federal executive branch has sought to coordinate, standardize and simplify categorical grant application and administrative procedures through governmentwide management and other circulars, organizational reforms and decentralization of management responsibilities to the federal field offices. Nevertheless, the record thus far would indicate there is much to be done.

Bibliography


Focuses chiefly on organizational and procedural efforts undertaken at the federal level to remedy some of the operational defects in the intergovernmental grant system. In addition, ACIR has published numerous books and articles related to grants management. For more information, contact ACIR, 1111 20th St., N.W., Washington, D.C. 20037.


Highlights most grantors’ financial management requirements and discloses the adequacy of grantees’ financial management systems. Covers grantees’ accounting, budgeting, procurement and property systems. OMB is asking federal agencies to test the guide as a method of simplifying federal grant program administration. Available from U.S. Government Printing Office, Washington, D.C. 20402. Stock No. 041-001-0062-0.


A guide for use in auditing federally assisted programs. Replaces almost a hundred individual program guidelines that were previously in use. Issued as part of an overall program of improving government accountability. Available from the General Accounting Office, Distribution Section, Room 1518, 441 G St., N.W., Washington, D.C. 20548.


A detailed basic resource on federal grant administration. Identifies and analyzes the major requirements affecting federal grants. Organized in a loose-leaf binder, fully indexed and cross-referenced. For information contact the publisher, 2120 L St., N.W., Washington, D.C. 20037.


Enunciates the applications of generally accepted accounting principles to grants, entitlements and shared revenues received by state and local governments. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


Designed to acquaint county officials and their executive officers with the need for a coordinated and properly managed federal/state grants-in-aid program. Documents the growth and changing nature of federal grants-in-aid. Sets forth the need for a grants management system, maintaining that effective use of grants by a county can help elected officials provide the most economical and efficient county government. Describes in detail the position and functions of the grants coordinator and presents organizational models from five counties from various parts of the country. An appendix lists federal grants programs and the requirements for notifying the appropriate planning and development clearinghouses of intent to apply in accordance with OMB Circular A-85 (Revised). Available from NACo, 1735 New York Ave., N.W., Washington, D.C. 20006.


This publication reviews the management impact of federal grants on county and city government. Available from ICMA, 1140 Connecticut Ave., N.W., Washington, D.C. 20036.


A guide for local government officials. Intended to provide constructive guidance to improve management of the Community Development Block Grant. Although the manual deals specifically with one program in the panoply of federal grants to local governments, the principles and methodologies should also have applicability to many other federal grant programs. It should be of special interest to those interested in integrating the financial management of the grants with the city’s financial management. Available from MFOA, 180 N. Michigan Ave., Chicago, Ill. 60601.


A compendium of technical background papers. Focuses on the feasibility and advisability of advancing all or some budget decisions so that instead of making them just before the start of a fiscal year, they would be made at least 12 months earlier. Available from U.S. Government Printing Office, Washington, D.C. 20402.

Sets forth uniform financial and other administrative requirements for grants to state and local governments. Only those specific requirements imposed by legislation establishing a grant program can take precedence over Circular A-102. Available from the Publications Office, OMB, Washington, D.C. 20503.


Summarizes a series of federal circulars, including A-102, that establish uniform simple rules for dealing with the federal government. Since many of the circulars use rather technical language, this booklet is intended to provide a brief overview in layman's terms of their various requirements. Available from the Publications Office, OMB, Washington, D.C. 20503.


A report on a series of hearings exploring suggestions for improving the management of the federal grants system. The goal of the hearings was to seek ways to reduce the red tape and high overhead which prevent the grant dollars delivered to state and local governments from being used as effectively and efficiently as Congress intended. Available from Government Printing Office, Washington, D.C. 20402.


Explains what the grant business is all about, from what a grant is to how to find out where the funds are, to how to go about getting a project supported properly. A good introduction to grants and the types of grants available. Available from the publisher, 227 West 17th St., New York, N.Y. 10011.


A description of intergovernmental fiscal relations. Provides much detail for a better understanding of fiscal federalism in its actual perspective. Available from the publisher, 6 Bound Brook Court, North Scituate, Mass. 02060.
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