BUDGET DEFICITS: Transforming Challenges into OPPORTUNITIES

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Most governments—state and local—face budget gaps during the fiscal year. A gap is a budgetary imbalance that occurs when anticipated revenues fall short of proposed expenditures or when expenditures exceed appropriations—or both. It also is referred to as a budget imbalance. If such gaps are not closed during budget development, or by management during the year, they turn into deficits. The best solution is to pull current resources into line with current obligations by year-end.

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Too often, however, governments flinch from inflicting the pain of that solution, instead using last year's surplus as this year's resource. This short-term answer creates a longer-term problem: the surplus is no longer available as a cushion against such unanticipated events as revenue shortfalls, higher-than-expected labor costs, or unforeseen litigation settlements. In addition, because there is no longer a surplus available for the next year's budget, the government becomes vulnerable to budget gaps in future years.

When governments draw down surpluses, municipal credit rating agencies such as Standard & Poor's scrutinize the process closely to ensure that this cushion does not disappear and that the use of surpluses does not lead to future budget gaps.

This is just one example of the industry's approach. Credit rating agencies do not make management decisions, but they do assess management choices and their impact on credit quality. How a government manages its finances and debt through budgetary operations is one key factor the agencies examine. The other is economic: diversity and depth of the economy as well as growth in employment and income. All ratings reflect the severity of the impact of a national recession on individual governments. Ratings also reflect an evaluation of the likely courses of action that governments will take to address budget gaps or deficits, if and when they occur.

This is the area of most concern to us, given today's financial environment. Economic credit factors, strong enough to qualify a government for a high credit rating under ordinary circumstances, can be undermined by weak financial practices.

Evaluation of Financial Well-Being

A local government's budget reveals much about its financial well-being. Factors that are considered in evaluating a local government's financial status are:

- budget limitations imposed by statutory limits on taxes and other revenues and by nondiscretionary expenditures;
- the political willingness to make adjustments;
- realistic budget projections;
- the approach to the budget revealed in the budget message;
- the effectiveness of budget controls in

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showing governments whether they are on target;
- the timeliness of adoption and execution of the budget;
- long-range planning and adequacy of funds to meet those plans;
- responsible cash management.

Sources of financial distress often are found outside the realm of balance sheets and operating statements. Such economic factors as local industrial strength, employment, and demographics eventually show up in a government's finances. To evaluate a government's financial well-being, credit rating agencies look at trends in an area's economic base, as well as management's ability to be innovative in response to those trends.

What Is a Distressed Government?

Financial difficulties mean different things to different governments. They can range from a cut in services to a default on debt. In general, a municipality in financial distress is one that cannot maintain existing services because it cannot meet payrolls and current bills, it cannot pay amounts due other governments, or it cannot pay debt service on long and short-term debt because it lacks the necessary cash or appropriation authority. Such difficulties may, but do not always, precede actual default on debt service.

Although many financial difficulties have their roots in adverse trends in the economic base, case histories of many local governments show that other factors also are present. A manager's response to these trends is often a major factor in determining whether the government avoids the problem, works its way out of difficulty, or surrenders entirely to the rising tide.

Early Warnings

Seeds of potential problems are planted early and include many of the following: declining population, changes in age and income of the population, impact of collective bargaining, impact of inflation on labor-intensive services, erosion of the tax base, slow growth in revenue from ongoing sources (as opposed to one-time revenues), and management's response to these trends.

More specifically, rating agencies look for early indicators of potential trouble as they evaluate and monitor financial conditions. These indicators can be used to track positive as well as negative trends. One positive indicator, for example, is a set of effective budget controls. Another is realistic budgeting and planning.

Budget Guidelines

- Institute effective budget and expenditure controls year round.
- Be realistic in planning and budgeting—goals should be achievable.
- When possible, avoid deferrals, because they will have to be dealt with the next year.
- Avoid chronic short-term borrowing, particularly in steadily-increasing amounts.
- Do not agonize. Identify the problem and act quickly and decisively to correct it.
- Do regular economic and revenue reviews to facilitate early identification of budgetary problems.
- Use ongoing rather than one-time revenues to close gaps or eliminate deficits.
- Keep the rating agency informed on any problems and on the remedial action being taken.

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The key negative indicators are: an operating deficit for the current year, two consecutive years of operating fund deficits, a current-year operating deficit that is larger than the previous year's deficit, a two-year trend of increasing short-term debt outstanding at fiscal year-end, property taxes greater than 90 percent of the tax limit, debt outstanding greater than 90 percent of the debt limit, total property tax collections less than 92 percent of total levy, a trend of decreasing tax collections (two consecutive years in a three-year trend), declining market valuations (two consecutive years in a three-year trend), and expanding annual unfunded pension obligations.

Poor Financial Practices

Looking beyond the numbers themselves, rating agencies examine local government management's financial practices. The worst of these, though each by itself may not result in a rating adjustment, are the foremost indicators of fiscal stress and major ingredients in long-term fiscal imbalance.

Deferrals. Rather than cut spending, management defers payments from one year to the next. Wage deferrals, shifts in local aid, and delayed vendor payments, for example, are all signs of budgetary problems. Deferred pension funding is particularly tempting in times of fiscal stress, because there is no immediate impact on payments to pensioners. But the deferral still represents an increase in debt. It is a one-time revenue measure, which must be dealt with the next year. Deferred payments can be viewed as budget deficits.

Accruals. Accruing revenues not previously counted adds respectability to the fund balance on paper. In reality, however, it provides no new real resources to fund ongoing programs. The likely result of such actions is a permanent increase in seasonal cash flow borrowing.

Sales of Assets. Sale of unnecessary assets is sometimes described as smart public policy. But in a budget crisis, the practice raises several questions, including timing and availability of the proceeds and the accuracy of the projected sale price. Asset sales work better for capital projects or debt reduction in a non-crisis environment.

In the vast majority of cases, however, chronic short-term borrowing, especially when the amounts borrowed increase steadily, is a sign of a weak budget.

Restructuring of Debt. Known by many names, such as "current refundings" or "smoothing out the amortization schedule," debt restructuring tells the rating agency that the government is under budgetary stress and is postponing debt to give itself more time to pay.

Short-Term Borrowing. Short-term borrowing, as a cash/investment management tool, is an acceptable fiscal procedure for improving cash flow. In the vast majority of cases, however, chronic short-term borrowing, especially when the amounts borrowed increase steadily, is a sign of a weak budget.

Over-Optimistic Budgeting. Optimistic revenue estimates based on aggressive economic assumptions are probably the leading cause of budgetary stress.

Non-Action. As governments agonize over the actions needed to correct the budget gap or deficit, the situation becomes worse each day.

Deficit Bonds. Issuing deficit bonds does not solve the financial problems that result from mismanagement or an economic downturn. This course of action increases longer-term fixed costs for payment of principal and interest, shifting the financial burden to taxpayers in the future. If the causes of the problem persist, this gimmickry often becomes repetitive, resulting in snowballing debt and debt-service costs.

How to Deal with Budget Gaps and Deficits

Today, the budget process is carried out in an environment of constraint. Continuous revenue appreciation does not exist, and governments are hard-pressed to supply services at a level to which citizens have become accustomed. Budget gaps and deficits are part of the estate inherited by government administrators. Innovation, however, can help fend them off. Here are a few suggestions:

- Establish or rebuild rainy-day funds against economic uncertainty. Structure them so that they are used specifically for that purpose.
- Incorporate regular economic and revenue review cycles into the financial policy to identify budget problems early.
- When budget gaps or deficits appear, act quickly to address them with ongoing, rather than one-time, revenue or spending actions.
- Establish priorities in spending plans. Identify those areas that if the unexpected occurs can be eliminated or deferred with the least impact on essential services.
- Encourage the inclusion in the general budget of some pay-as-you-go financing of capital projects. If you must use one-shot budget measures, do so on the expenditure side—by paying for something today that will not recur in the future, you build a cushion to reduce future budget gaps or deficits. **PM**

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