**SNTA Brief #[\*]**

**AVOIDING FINANCIAL MANAGEMENT DISASTERS: PART ONE**

Introduction:

Avoiding financial management disasters is a basic goal of all local governments[[1]](#footnote-1) and their leaders. There are many types of financial disasters that can befall a local government: budget disasters, cash crises, fund management problems, and debt defaults are some of the most common ones. There is also an array of proven good practices that can be used to avoid these disasters. Part one of this SNTA Brief points the way to avoiding budget disasters and cash crises. Part two focuses on avoiding fund management problems and debt defaults.

Budget Disasters:

Avoiding local government financial disasters starts with following good practices for budgeting operating and capital expenditures. Maintaining separate operating and capital expenditure budgets is essential. The operating budget enables local leaders to understand the cost of providing the current services and functions of the local government. The capital budget enables them to make well-informed decisions about priorities for investing in long-term improvements to the community. Keeping these two types of budgets separate avoids any confusion over the fundamental purposes for which the budgeted funds are to be used.

Operating expenditures are **only** for keeping the routine functions and services of the local government running. Operating expenditures include paying for personnel and goods or services that are used during the budget year; such as specialized professional services, supplies, fuel, and electricity. Operating expenditures also include money spent on routine maintenance of equipment and other assets, but only the kind maintenance that is small enough to be paid from annual revenue; for example scheduled repairs to leaking water mains.

Capital expenditures are those that pay **only** for community improvements, especially infrastructure, that can be expected to have a long useful life. Capital expenditures also cover investments in vehicles for public transportation and emergency services. The key is that these are major expenditures for things that will last a long time; for example construction of new network of water mains to serve a previously un-served neighborhood.

“Major” maintenance, including purchase of expensive replacement equipment, is a gray area between operating and capital expenditure; for example replacement of a high capacity water pump that can no longer be repaired. Because it is a gray area, it is important for each local government to follow a written policy for classifying these expenditures as “operating” or “capital”.

Although operating budgets are typically one year long, operating expenses need to be projected into the future as far as possible. This enables local leaders to anticipate changing revenue needs beyond the current budget year. Anticipating change avoids the problem of having to suddenly attempt to increase operating revenues to cover increases in operating expenses. In this regard, it is especially important to estimate as far ahead as possible the impact on the operating budget of completing capital improvement projects. For example, a new water treatment plant will require staff, chemicals and electricity when it is completed; adding busses to the public transport system will require additional drivers, fuel, and insurance. On the positive side, both the new water plant and the additional busses should produce additional operating revenue for the municipality.

The “essence” of creditworthiness is the ability of a local government to maintain a reliable surplus in the annual operating budget (a positive “operating margin”). Planning and managing annual operating revenues and operating expenditures should be based on achieving an agreed “target” for the annual operating margin. This target should be established and monitored by the local government’s leaders to avoid year-end surprises, especially the disaster of an unexpected budget deficit.

**Effective public budget professionals are a special breed because they have to succeed in an especially difficult environment…**

Whether they have PhDs in back of their names or not – they often have to play ‘**Dr. No**’ in political and bureaucratic and political environments where there is great pressure to say ‘**Yes**,’

They also have to herd all the different ‘**cats**’: the revenue receiving and the cost-incurring – and any debt-issuing - units of the governmental entity into a well-scheduled uniform budget planning, adoption, and execution process. And they have to be able to communicate and deal effectively with the appointed and elected decision-makers in both the executive an legislative branches.

Capital expenditures for projects that may take several years to complete must be **budgeted on a multi-year basis** so that local leaders can understand *in advance* the funding requirements in each year of the project. This enables local leaders to avoid running short of funds unexpectedly by providing for the availability of capital resources in each year as well as in total for the approved investment project. It is never prudent to budget for capital projects without determining specifically where the resources will come from to pay for the investments, and when the funds will be needed.

Another type of financial disaster associated with capital investment projects is cost overrun. Careful project management is required in order to prevent cost overruns that result in capital expenditures exceeding available capital resources. Cost overruns can cause projects to go uncompleted and therefore unproductive. This kind of financial disaster can be an enormous problem for local leaders and the community.

Cash Crises:

Cash shortagesare the mark of poor liquidity management. Liquidity refers to the degree to which a local government has access to the money necessary to pay its bills when they are due. Liquidity is a “relative” term: one local government can be more liquid or less liquidthan another. Liquidity is a positive attribute for a local government. Since liquidity means that a local government has access to money to pay its creditors (of all kinds, including personnel), the more liquid the municipality the more likely it will be considered creditworthy.

Liquidity can come from reserves built up over time or from access to resources from an external source such as a line of credit from a bank or a “bail out” from a higher level of government. The preferable source of liquidity is a reserve fund. A reserve fund can be built up over time, or it could be the result of a fortunate financial “windfall”, or selling unneeded assets could create it. Relying on external sources to provide liquidity is less preferable because it makes the local government vulnerable to decisions and/or demands that are beyond the control of local leaders. Local governments that rely on external sources of liquidity are likely to be considered less creditworthy that those that rely on internal reserve funds because the resulting loss of financial control creates uncertainty about the local government’s ability to repay its debts.

Liquidity is a quantitative concept that can be measured by the number of months (weeks, or days) of normal expenditure that can be covered from the local government’s reserve fund or line of credit. The chief financial officer of a local government needs to constantly compute and monitor liquidity and seek to improve it over time. Local governments that are unable to pay their bills on time due to a shortage of cash are not managing their liquidity adequately. They lurch from one cash disaster to the next and will not be seen to be creditworthy.

Cash disasters can be avoided by estimating the normal patterns of revenue collections and expenditures. Revenue typically arrives at very specific times when tax bills come due or transfer payments are made from higher levels of government. The more predictable the pattern of revenue in-flow, the easier it is to manage liquidity since local government expenditures tend to be fairly even and predictable over time. Analysis makes it possible to identify likely periods when there may be cash shortages in any given year. Once the potential size and timing of “normal” cash shortages are identified, a local government’s chief financial officer can take steps to assure that there is adequate cash on hand to cover the gaps if they occur. These steps include creating reserves to cover “normal” and “extraordinary” periods of low liquidity as well as stand-by lines of credit in the event that reserves prove to be inadequate or have not yet been fully funded.

Reserves can be built by actually budgeting a portion of the annual surplus operating margin to go into reserves. It is a good practice to have both a “cash reserve” for normal liquidity management and a “rainy day fund” for unexpected financial requirements as a way to protect the local government from paying for high cost short-term borrowing. However, since it may take time to build up adequate reserve funds, it is usually a good idea to pre-arrangeshort-term debt financing from a bank rather than having to seek a loan during a cash crisis.

Having written policies and procedures governing liquidity management is a practice that should be followed by all local governments. Such written policies and procedures include:

* Regular forward projection of monthly revenues and expenditures and backward review of “planned versus actual” revenues and expenditures.
* Establishing targets for annual contributions to liquidity reserves.
* Rules for managing the investment of the money in the reserves.
* Rules for drawing money from the reserves.
* Rules for the use of short-term loans.

Written policies and procedures for liquidity management assure that the local government’s good practices are understood and followed consistently over time.

Conclusion:

Following sound principles for budgeting operating and capital expenditures as well as careful liquidity management enables a local government to avoid budget deficits, unfinished capital improvement projects, cost overruns, and cash crises. See Avoiding Financial Management Disasters: Part Two to learn about ways to avoid other potential disasters.

1. This SNTA Briefing Note frequently refers to “local government”, but the issues and advice contained in the note are equally applicable to all types of sub-national authorities and utilities. [↑](#footnote-ref-1)