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## **Unreserved Fund Balance and Local Government Finance**

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Local governments in the United States are operating in an increasingly difficult fiscal environment which has been made worse by the effects of an economic slowdown. Of particular concern to many finance officers has been a decreasing revenues from economically sensitive sources, which has led to budget shortfalls and deficits. Compounding problems in local revenue collection are similar problems occurring at the state level which, in some instances, have resulted in cutbacks in state aid to localities.<sup>1</sup>

A number of actions can be taken by local governments seeking to improve their chances of avoiding financial difficulty during periods of sluggish or negative economic growth. Those actions include:

- The use of budgetary/expenditure controls, such as the establishment of an allotment system that would require the careful planning of all departmental expenditures and budget office approval of spending plans, or the limiting of departmental expenditures to amounts less than that budgeted (95% for example).
- The use of contingent spending and tax rules that would make levels of spending and tax increases contingent upon the amount of revenues collected during the fiscal year.
- The use of other budgetary controls including restrictions on travel and budgetary transfers, deferral of purchases of goods and services, and a hiring freeze.
- The use of unreserved fund balance resources or monies held in a fund established specifically for contingencies (such as a budget stabilization or “rainy day” fund).

The first two are anticipatory mechanisms which can be used to minimize the chances of budget shortfalls developing during a fiscal year. The latter two are options available to finance officers after a financial problem has developed. While all represent useful tools in difficult fiscal times, this paper will focus on the use of unreserved fund balance resources for contingencies.<sup>2</sup>

Sufficient levels of unreserved fund balance(or monies set aside in a budget stabilization fund) can ensure the continued orderly operation of government and provision of services to residents and the continued stability of the tax structure. Local governments that have built up sufficient levels of unreserved fond balance can avoid or reduce budget cutbacks and tax increases if budget shortfalls develop during a fiscal year. The maintenance of fiscal stability is a particularly important factor considered by credit rating agencies in their evaluation of the credit worthiness of local government debt, with instability potentially leading to a credit downgrade and increased borrowing costs.

The purpose of this paper is to discuss the significance of unreserved fund balance to local governments, and provide guidance to those finance officers concerned about the possible effect of a sluggish economy (or other external influences) on their government's financial condition. The development of a policy that establishes the appropriate level of unreserved fund balance for a government, a difficult task, will also be discussed. Complicating this issue is the existence of some confusion over what is meant by the term "fund balance," and the fact that there is no nationally uniform standard regarding the appropriate level of unreserved fund balance that local governments should maintain. There is also a paucity of literature and other information on the use of unreserved fund balance or other financial resources for contingencies, with much of it devoted to the establishment of budget stabilization or "rainy day" funds at the state level.

### **What is Fund Balance?**

Prior to discussing the issues related to the establishment of an adequate level of unreserved fund balance for contingencies, it is important to define what is generally meant by fund balance. Fund balance does not refer to cash balance, nor is it the difference between revenues and expenditures. Rather, fund balance is the cumulative difference of all revenues and expenditures from the government's creation.<sup>3</sup> It can also be considered to be the difference between fund assets and fund liabilities, and can be known as fund equity.<sup>4</sup>

For accounting purposes, a distinction is often made between reserved and unreserved fund balance. Reserved fund balance consists of portions of fund balance that are either legally restricted to a specific future use or are not available for appropriation or expenditure. Legally restricted portions of fund balance include "fund balance-reserved for encumbrances" and "fund balance-reserved for debt service." The portion(s) of fund balance that is not available for appropriation or expenditure represents assets that are not considered "expendable available resources." Reserved fund balance is often further broken down into several categories based on the purpose of the monies held. Exhibit 1 shows typical fund balance accounts.

Unreserved fund balance is often subdivided into designated and undesignated portions. The former reflect tentative management plans for future financial resource use, such as the replacement of equipment.<sup>5</sup> Other designations include "for contingencies" and "for appropriation in future years." Undesignated portions of unreserved fund balance represent expendable available financial resources that can be used to meet contingencies and working capital requirements.

The emphasis of this paper will be on the level of unreserved fund balance that local governments maintain in their general fund for contingencies and which is available for use in the event a government experiences financial difficulty. The general fund is singled out because it contains the bulk of monies appropriated for general government operations. Most governments seeking to set aside financial resources for contingencies assign them to the general fund's unreserved fund balance, either in the "unreserved, undesignated" account or in the "unreserved, designated for contingencies" account.<sup>6</sup> Some local governments create a separate fund for contingencies or financial emergencies, such as a budget stabilization or "rainy day" fund. The creation of such a fund will be discussed later in this paper.

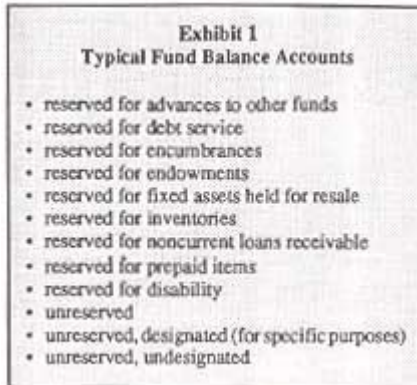
### **Why Is an Unreserved Fund Balance Necessary?**

Two important goals of local governments are the maintenance of a stable tax and revenue structure and the orderly provision of services to residents. Such stability is necessary to

maintaining or improving the jurisdiction's credit standing, but can be threatened by uncertainty emanating from a number of areas; foremost is economic uncertainty.

### **Economic Uncertainty**

Determining how well the local or regional economy will perform and its subsequent impact on local government finances is one of the more difficult tasks facing the finance officer. Changes in economic activity affect both the revenue structure and government spending, with the effects varying from jurisdiction to jurisdiction. Of critical importance to governments attempting to maintain fiscal stability is that the growth in revenues continue to match or exceed the growth in expenditures.



The finances of governments that are dependent on economically sensitive revenues, such as general sales or income taxes, will be more affected by a downturn in the economy than governments that are dependent on more stable tax sources, such as the real property tax. The former are more likely to benefit from the maintenance of an adequate level of unreserved fund balance. Governments that are dependent on the real property tax may also be affected by an economic slowdown, however, particularly if the market value of real estate and assessed values decline. In addition, economic downturns may also contribute to the loss of major taxpayers in some jurisdictions, severely depressing local revenue collections.

In some cases, governments have little control over the factors that affect expenditures. This is particularly true of governments responsible for entitlement programs such as public welfare services, expenditures which quite commonly increase dramatically during economic downturns. In addition, the impact of inflation on local government costs is often hard to anticipate.

### **Other Forms of Uncertainty**

While the health of the economy often has the major effect on local government finances, other forms of uncertainty must also be taken into consideration, such as:

- Unanticipated changes in the tax and spending policies of federal and state governments. Changes in federal and state tax policies can have an impact on local governments, which must compete for increasingly scarce tax revenues. Similarly, changes in federal and state spending policies can impact local governments, particularly if reductions in spending force local governments to increase their own spending to make up for the loss in federal or state monies.
- The imposition of mandates by federal and state governments, which often have uncertain economic and financial impacts on local governments. Court decisions that result in

unexpected local expenditures, such as court-mandated improvements to correctional facilities or the invalidation of a major revenue source that requires a government to return revenues already collected.

- Limitations on a government's taxing and spending powers as the result of the passage of voter referendums.
- Financial impacts of labor agreements, particularly those stemming from binding arbitration.
- Unanticipated expenditures resulting from natural disasters.
- Unforeseen increases in energy costs.
- Unexpected capital expenditures resulting in water main breaks, bridge collapses, etc.
- Extraordinary employee overtime costs.
- Errors in revenue and expenditure estimation due to the difficulty in identifying the turning point in the business cycle.
- Unexpected variations in a government's cash flow that necessitate the use of short-term borrowing if sufficient monies are not available to cover shortfalls.

Although there is more maneuvering room in some budgets than others, particularly when it is possible to defer purchases of goods and services, all finance officers should accept the fact that uncertainty exists and hedge against it through the development and use of adequate levels of unreserved fund balance.

The adequacy of a jurisdiction's unreserved fund balance will depend to a great extent upon an accurate assessment of the uncertainty it faces. Such an assessment will include an examination of past experiences, including an analysis of cash flows that looks at revenue collection and spending patterns. Without such a review, and without adequate resources to deal with financial emergencies, budget cutbacks and tax increases during a fiscal year may become a real possibility, and credit ratings may be threatened.

### **Why Not Maintain an Unreserved Fund Balance?**

Arguments for the establishment and maintenance of adequate levels of unreserved fund balance for contingencies reflect financial management imperatives. This perspective often finds itself under attack from taxpayer advocates and proponents of greater government spending who may oppose the establishment and maintenance of any level of unreserved fund balance, but whose views contribute to the debate over the appropriate level and uses of unreserved fund balance.

Taxpayer advocates argue that when the government establishes an unreserved fund balance it is attempting to hoard monies that it does not need, resulting in higher than necessary tax burdens. They argue that monies should remain in the taxpayers' hands until needed to pay for services and that if surpluses exist, they should be returned to the taxpayer through tax cuts and tax refunds. Resources should be accumulated prudently, kept only for specific purposes in formally created reserve funds, with little or no unreserved fund balance. This view is commonly expressed during periods of rapid increase in the market and assessed value of real property, particularly if property tax rates are not lowered and property tax bills increase significantly.

Spending advocates argue that when a government allocates financial resources to unreserved fund balance it is hoarding monies that would be better spent on some public good or service. While this viewpoint could be expressed at any time, it is more likely during periods of fiscal uncertainty, especially when cutbacks in key programs are threatened.

## **Establishing a Fund Balance Policy**

All governments should have a policy that accurately reflects their financial objectives. These objectives encompass a wide range of activities from raising revenues through specific forms of taxation to adequately accounting for assets and liabilities and investing public funds. Such policies should be in written form, and subject to review by elected officials on a regular basis.

As part of their comprehensive financial policy, local governments should have a formal policy regarding the level of unreserved fund balance that they wish to establish and maintain for contingencies and other purposes. An important reason for developing such a policy is to provide the taxpayers with an explanation of why financial resources have been set aside and the conditions under which such resources will be expended. This policy should cover all fund balance accounts. This paper, however, limits its focus to those accounts used for contingencies.

A government's fund balance policy should address:

- Setting aside financial resources for contingencies;
- Allocating financial resources to unreserved fund balance (or a budget stabilization fund);
- Utilizing unreserved fund balance resources; and
- Determining the appropriate size of unreserved fund balance (or budget stabilization fund).

Some governments have included a statement regarding the level of financial resources that they will set aside for contingencies in the Summary of Significant Accounting Policies (SSAP) or the letter of transmittal accompanying the government's Comprehensive Annual Financial Report (CAFR). These policy statements along with the jurisdiction's comprehensive financial policy should be reviewed and updated on an annual basis to reflect current economic and financial conditions.

### **Setting Aside Financial Resources for Contingencies**

Local governments committed to setting aside financial resources to hedge against economic and other forms of uncertainty can choose among the following options:

- The fund balance of the general fund;
- A fund established specifically for budget stabilization or "rainy day" purposes; and
- Other funds.

**General Fund.** The general fund provides the simplest and most direct way of setting aside financial resources for contingencies. Allocating such resources to the general fund's unreserved fund balance makes clear the jurisdiction's policy regarding the establishment and maintenance of financial resources for contingencies. The main problem with this approach is that allocations to unreserved fund balance are readily identifiable and represent an attractive pool of monies that taxpayer advocates will eye for tax cuts and that spending advocates will eye for spending increases. The major questions facing finance officers adopting this approach will be:

- How can monies not be earmarked for something and be unavailable?; and
- Under what circumstances can these monies be utilized?

From an accounting perspective, it is preferable that financial resources set aside for contingencies be assigned to unreserved fund balance or a fund established specifically for that

purpose. Resources allocated to unreserved fund balance should be either “designated for contingencies” or maintained as an “unreserved, undesignated” balance. That has not stopped some finance officers from assigning such resources to some of the reserved fund balance accounts. This practice may result in the development of misleading financial statements, however.

**Budget Stabilization Funds.** A number of governments, particularly at the state level, have established special funds for the purpose of guarding against such negative effects of an economic downturn as revenue shortfalls and increased expenditure demand, which can lead to operating budget deficits. At present, 35 states have established budget stabilization or “rainy day” funds to guard against these effects.<sup>7</sup> The availability of monies in such a fund can minimize the need for tax and spending changes during the fiscal year.

The proliferation of budget stabilization funds among state governments is primarily due to their sensitivity to economic downturns. Some local governments are also sensitive to economic downturns, particularly those dependent on general sales and income tax revenues and those with economically sensitive expenditure structures. Budget stabilization funds are not without their problems, some of which include:

- Lack of sufficient funding;
- Discretionary deposit methods that have resulted in little or no money going into the funds; and
- Withdrawal of monies for reasons unrelated to budget problems.

**Other Funds.** Finance officers interested in the indirect approach to setting aside financial resources for contingencies have utilized a variety of funds, including: self-insurance funds and claims reserve funds. The use of other funds represents the least obvious method of developing adequate levels of resources for contingencies. The other funds approach has sometimes resulted in abuses of proper accounting standards and procedures, however.

It is important to note that there is no economic difference between the general fund, budget stabilization fund, and other funds alternatives. Total cash position will be the same, as will the amount available for use during a budget crisis and the amount withheld from current spending or for tax reduction. There are other differences among the three approaches, however. Budget stabilization funds for example, will almost always require the passage of enabling legislation prior to their creation, while the other two alternatives would not. This is a major drawback to the use of budget stabilization funds.

The other drawback to the budget stabilization approach is the high visibility of financial resources set aside in a fund established specifically for contingencies (also a problem for the general fund approach), which represents a tempting pool of monies to both taxpayer and spending advocates, a fact that underscores the need for a formal fund balance policy. Finally, the other funds approach is less desirable than the other two approaches because it is an indirect method of setting aside financial resources for contingencies and, in some cases, has resulted in abuses of accepted accounting standards and procedures.

### **Allocating Financial Resources to Unreserved Fund Balance**

While decisions related to the establishment of an unreserved fund balance have often been left to the discretion of the finance officer or executive, this is a decision which could benefit from greater formality. A mechanism can be established through which financial resources can be set

aside for contingencies. This mechanism must be clearly identified and explained in the jurisdiction's financial/fund balance policy. Options available to local governments include:

- Formulas that determine unreserved fund balance amounts (typical formulas include: 1-3 month's operating expenditures or unreserved fund balance as a proportion of annual operating expenditures, such as 5 percent);
- Requirements that a portion of any operating surplus be deposited into unreserved fund balance; and
- Dedication of revenues from a specific source, such as the real property tax, to the establishment of an adequate level of unreserved fund balance.

The assignment of financial resources to unreserved fund balance or a budget stabilization fund is most often done during good economic times for use in bad times.

### **Utilizing Unreserved Fund Balance Resources**

It is important that criteria be developed to guide the use of financial resources set aside for contingencies, whether those resources have been allocated to unreserved fund balance or to a fund established specifically for that purpose. Of critical importance are two questions:

- Under what circumstances should unreserved fund balance resources be utilized?; and
- Who should make the decision regarding their use?

In response to the first question, the primary reason for the use of unreserved fund balance resources is to alleviate unanticipated short-term budgetary problems, such as revenue shortfalls or budget deficits. These problems are often uncovered during routine analysis of a government's cash flow patterns. Returning to the two major goals of local government **financial management, the resources** should be utilized to stabilize the tax structure and ensure the orderly provision of services to residents. It would not be appropriate to use these resources in an attempt to solve long-term financial problems, which should be dealt with in other ways.

Often, the decision on whether to use financial resources set aside for contingencies is a political one, determined by spending needs or the desire to maintain tax stability. These decisions are typically made by the executive or the legislative body. In this case also, a mechanism must be established for determining when those resources should be used. A number of methods are available, including:

- Supplemental appropriation of the resources to correct revenue shortfalls or budget deficits;
- Executive orders requiring the transfer of resources to operating accounts;
- Formula disbursement of the resources to various operating accounts; and
- Automatic appropriation or transfer in case of budget shortfalls.

### **Determining the Appropriate Size of Unreserved Fund Balance**

Determining the appropriate size of unreserved fund balance (plus monies set aside for contingencies in other funds) is one of the more formidable tasks facing local government finance officers and elected officials. Clearly, what is an adequate level of unreserved fund balance for one jurisdiction, given its particular financial and economic characteristics, may not be adequate for another. In this section, the following will be discussed:

- The computation of an unreserved fund balance ratio;

- The use of unreserved fund balance as an indicator of financial condition; and
- The determination of the appropriate size of unreserved fund balance.

**Unreserved Fund Balance Ratio.** Prior to discussing the issue of the appropriate size of unreserved fund balance, the concept of the unreserved fund balance ratio should be introduced. This ratio is important because it is often used as a measure of a government's financial health. The first step in the computation of this ratio is the determination of what financial resources are available to meet contingencies. In some jurisdictions, this amount will be equal to the resources contained in the general fund's unreserved fund balance account in other jurisdictions. Resources contained in other places, such as a budget stabilization fund, should be considered for inclusion.

In computing the unreserved fund balance ratio it is important to exclude the legally restricted portions of fund balance (that reserved for encumbrances, and for debt service) and those resources reserved for other purposes. It is not critical that resources "designated" for specific purposes in unreserved fund balance be excluded from this calculation, as the designations reflect only tentative plans for use, although it may be appropriate to do so.

The amount of resources available for contingencies is then compared with annual operating expenditures (for the general fund in this case).<sup>8</sup> The resultant ratio (or a variant thereof) is often used by the credit rating agencies and other analysts in measuring financial condition.

**Unreserved Fund Balance as an Indicator of Financial Condition.** Because of the importance of unreserved fund balance to the credit rating agencies' evaluation of a local government's creditworthiness, it is appropriate to discuss their views regarding the subject. The rating agencies' primary concern is that governments have an adequate level of financial resources to ensure the timely payment of principal and interest on their outstanding debt.

Of particular importance to the credit rating agencies are the size of "fund balance" (resources available for contingencies) and the trend in the size of fund balance.<sup>9</sup> Fund balance that decreases in size from year to year is sometimes seen as a problem and as an indicator of fiscal weakness. A small fund balance (under 5 percent of annual operating expenditures) could also be looked upon negatively if the government has experienced financial difficulties in the past due to external factors, such as a slump in the economy. A fund balance deficit would be looked upon very negatively since it clearly indicates that a government has had prior difficulty balancing its budget and is in a weakened position to deal with future financial problems.

In the following paragraphs, the views of the major credit rating agencies regarding the subject will be presented. Although Moody's Investors Service, Standard & Poor's Corporation, and Fitch Investors Service take similar approaches to the issue of adequate fund balance, there are differences among them.

*Moody's:* The Moody's analyst is interested in measuring control, or the ability of the government to call forth and manage financial resources so that debt obligations can be met in full and on time. The availability of adequate financial resources that can be used to address unforeseen contingencies adds to an issuer's control.

Although a "fund balance" that equals 5 percent of budgeted expenditures is deemed prudent by the Moody's analyst, the appropriate level of fund balance will vary from jurisdiction to jurisdiction. The level of fund balance that an analyst would like to see is directly related to the likelihood of the government being forced to call upon these resources. A fund balance below 5 percent of budgeted expenditures may not adversely affect an issuer's credit position if the lower

amount is justified by a long-term trend of annual operating budget surpluses. On the other hand, a larger fund balance may be necessary in jurisdictions with economically sensitive revenues and expenditures that are not easily forecasted.<sup>10</sup>

*S&P's:* S&P's considers an adequate level of "fund balance" to be a credit strength because the level of fund balance measures the flexibility of an issuer to meet essential services during transitional periods. While S&P's considers 5 percent of annual operating expenditures to be an adequate level of fund balance for some governments, it may not be for others. Of particular importance to the S&P analyst is the maintenance of a stable level of fund balance over time: sudden, sharp decreases in fund balance levels are generally looked upon unfavorably.

The S&P analyst takes into account several variables when evaluating fund balance size: the cash flow of an issuer (i.e., tax collection practices v. spending patterns); other reserves or contingency funds available to meet "unforeseen expenses; and the philosophy of government officials and the community toward large government revenue surpluses.<sup>11</sup>

*Fitch:* Fitch, which recently began to rate general obligation bond issues, offered the following statement describing its approach to the issue of adequate "fund balance":

An unreserved fund balance provides a government with available resources in the event of unforeseeable occurrences, budget variances or for cash flow purposes. Most analysts look to a fund balance of about 5 percent of revenue as a prudent level to allow for a reasonable degree of error in budget forecasting or other occurrences within the definition of a casual event. Fitch believes this is a reasonable benchmark recognizing that the appropriate level may vary according to needs. For instance, a municipality that relies on a large percentage of its taxes collected late in the fiscal year may need higher balances for cash flow requirements. Also, a locality which possesses a cyclical economic base may be more susceptible to wider budget swings requiring a larger and more liquid contingency. Conversely, an entity with a more even flow of receipts throughout the year, which has good capabilities in accurate budget forecasting and monitoring, may not need as large a balance. Fitch places less emphasis on actual fund balance level, but rather stresses longer term financial balance and management. In the long run, the fundamental economic, capital and financial management factors more heavily influence credit quality and ratings.<sup>12</sup>

**Size of Unreserved Fund Balance.** Traditionally, two methods have been used by finance officers in determining the appropriate size of unreserved fund balance:

- Allocating financial resources equal to a percentage of annual operating expenditures;
- Allocating financial resources equal to a certain number of months' operating expenditures.

A common standard of measuring unreserved fund balance (or resources available for contingencies) holds that an amount equal to 5 percent of annual operating expenditures is sufficient to guard against the effects of most types of uncertainty. To some extent, this standard has been supported by the credit rating agencies.

Other governments utilize a different method of measuring the adequacy of resources available for contingencies. This method involves the establishment of an unreserved fund balance equal to a certain number of months of operating expenditures. While the equivalent of one month's operating expenditures (equal to 8.3 percent of annual operating expenditures) appears to be widely used, two to three months or more is not uncommon.<sup>13</sup>

In both cases, the method utilized should be incorporated in the jurisdiction's financial policy. Again, this will help to ensure that all concerned are aware of why the resources have been set aside.

It should be made clear that while these standards are in use by a large number of governments, they will not be appropriate for all. One of the reasons why there is no nationally uniform rule for use in measuring the amount of resources available for contingencies is that all governments are different in terms of their economic and financial characteristics. Instead of a rigidly defined standard that dictates what level of financial resources local governments should maintain for contingencies, it is more appropriate for those governments to make their own decisions about whether to set aside more or less resources based on their assessment of the uncertainty that they face.

Is there a level of unreserved fund balance that is considered to be excessive? An informal standard that is utilized by some governments holds that an unreserved fund balance in excess of 10 percent of annual operating expenditures should be examined carefully.<sup>14</sup> The general feeling is that if an unreserved fund balance is in excess of 10 percent, there should be some notion as to what the resources will be used for. For governments facing a high degree of uncertainty, however, an unreserved fund balance in excess of 10 percent of annual expenditures may not be high enough.

What level of unreserved fund balance should a local government maintain? The level established should be directly related to the degree of uncertainty which it faces: the greater the uncertainty, the greater the financial resources necessary. Each government must evaluate the degree of risk that it faces on an annual basis and make a decision as to the level of financial resources that it wishes to maintain for contingencies. This evaluation will involve an analysis of past experiences, including an examination of cash flows, and an estimate of the degree of uncertainty currently faced by the government in question.

As a general rule, local governments should maintain an amount equal to 5 percent of annual operating expenditures. This should satisfy some of the credit rating agencies' concerns regarding the adequacy of resources available for contingencies.<sup>15</sup> Those governments facing greater uncertainty should maintain a higher level of unreserved fund balance. Those governments that maintain an unreserved fund balance above 10 percent of annual operating expenditures should be able to provide appropriate justification for maintaining that level. This in turn will satisfy the concerns of those analysts who consider an unreserved fund balance in excess of 10 percent to be unwarranted.

Like many other things in government finance, the determination of the appropriate level of unreserved fund balance that should be maintained for contingencies is an art, not a science. Past experience can be used as a guide, with particular attention paid to the following:

- Governments with more volatile revenue structures (such as those dependent on general sales tax revenues) will need a larger unreserved fund balance than others to provide the same stabilization result;
- Governments dependent on one or two major revenue streams may need a larger unreserved fund balance if those revenues are sensitive to the effects of the business cycle;
- Those governments with greater ability to defer purchases can operate with a smaller unreserved fund balance than governments which do not have such ability;<sup>16</sup>

- Larger governments, which typically possess broader and deeper tax bases, may be able to function with a smaller unreserved fund balance than other governments;
- Governments with consistent operating surpluses may not need a large unreserved fund balance;
- Governments with occasional or frequent operating deficits will need a larger unreserved fund balance;
- Governments with uneven cash flows can minimize the need for short-term borrowing by maintaining a larger unreserved fund balance;
- Governments with economically sensitive expenditure structures (i.e., those governments with large public welfare responsibilities) will need a larger unreserved fund balance.

### **Conclusion**

Finance officers concerned about the possible effects of an economic downturn (or other external influences) on their government's financial condition should consider the development of a sufficient level of unreserved fund balance that can be used for contingencies. Sufficient levels of unreserved fund balance can help to ensure the continued orderly operation of government and provision of services to residents and the continued stability of the tax structure. The maintenance of such stability is a particularly important factor considered by the rating agencies in their evaluation of the creditworthiness of local government debt, with instability potentially leading to a credit downgrade and increased borrowing costs.

Determining what level of unreserved fund balance to maintain is a difficult task. Because of differences in the economic and financial characteristics of local governments around the country, no nationally uniform standard exists regarding the level of unreserved fund balance that local governments should maintain. Instead, each government must assess the degree of uncertainty which it faces and make a decision as to the level of financial resources it wishes to maintain for contingencies.

As economic conditions worsen, a growing number of local governments will find themselves in an increasingly difficult financial position. Those governments that have recognized the economic uncertainty facing their governments, and that have had the foresight to develop adequate financial resources in response to this uncertainty, will be much better able to deal with the consequences of a slowing economy than those who have not.

### **Endnotes**

1. During FY90, 20 states--up from 8 in FY89 -- were compelled to reduce the size of their adopted budgets. Marcia Howard, Washington, DC: National Association of State Budget Officers. September 1990.

General deterioration in the state and local fiscal position, as measured on a national income and products accounts (NIPA) basis has been noted since 1984. This according to David F. Sullivan in "State and Local Government Fiscal Position in 1989." *Survey of Current Business*, Washington, DC: U.S. Bureau of Economic Analysis, January 1990.

2. There are a number of other purposes for which unreserved fund balance resources can be designated including: capital improvement, self-insurance and debt service. More will be said about "designations" in the next section.

3. Fund balance is also directly affected by other financing sources and uses (e.g., operating transfers), as well as by residual equity transfers. For additional information on fund balance see: *Governmental*

*Accounting, Auditing, and Financial Reporting*. Chicago, IL: Government Finance Officers Association, June 1988.

4. It should be noted that unreserved fund balance may not represent “specific assets” of the fund (e.g., cash or a particular investment instrument). Because of this, some governments may find their access to unreserved fund balance resources limited, at least in the short term.

5. The American Institute of Certified Public Accountants (AICPA) audit and accounting guide, *Audits of State and Local Governmental Units*, provides that “such designations should be supported by definitive plans and approved by the government’s chief executive officer or the legislature.” It should also be noted, however, that section 1800.124 of the Governmental Accounting Standards Board’s 1990 *Codification of Governmental Accounting and Financial Reporting Standards* states, “such plans or intent are subject to change and may never be legally authorized or result in expenditures. Designated portions of fund balance represent financial resources available to finance expenditures other than those tentatively planned.”

6. It is important to note that: a) unreserved fund balance resources “designated for contingencies” can be made available for self-insurance purposes, although they would not be restricted to that use; and, b) governments may have some flexibility in transferring resources between some of the reserved fund balance accounts and the unreserved fund balance account, although resources assigned to legally restricted reserve accounts could not be utilized in this manner (legal restrictions on transfers between reserve accounts vary from state to state). This flexibility may improve the ability of governments to respond to a fiscal crisis, although movements of this type may constitute an abuse of the fund balance reserve account structure.

7. For more information on State Budget Stabilization Funds see: Corina Eckl. “Planning Ahead with Budget Stabilization Funds,” *The Fiscal Letter*. Denver, CO: National Conference of State Legislatures, March/April 1990; and, *Budgeting Amid Fiscal Uncertainty*, Washington, DC: National Association of State Budget Officers and National Governors Association’s Center for Policy Research, June 1985.

8. In computing this ratio, information from the same fiscal year is obtained from the latest available Comprehensive Annual Financial Report (CAFR).

9. It should be noted that the rating agencies sometimes use the term “fund balance” in discussions related to the issue of a government maintaining adequate financial resources for contingencies. This is imprecise language because not all of fund balance would be available for contingencies and this has led to confusion on the part of finance officers, elected officials, and other interested parties. Finance officers should assume that when the rating agencies use this term that they may be referring to the level of financial resources that a government has available for contingencies. In this section, the term “fund balance” will be used, but only to avoid misrepresenting the credit rating agencies’ positions regarding this subject.

10. Summarized from *Moody’s on Municipals: An Introduction to Issuing Debt*. New York, NY, Moody’s Investors Service, 1989; and, “Moody’s Rating Process: Frequently Asked Questions,” New York, NY: Moody’s Investors Service, 1990.

11. Summarized from S&P’s *Municipal Finance Criteria*, New York, NY: Standard & Poor’s Corporation, 1989. Additional information on S&P analysis was obtained in telephone a conversation with Hyman Grossman, Managing Director of S&P’s Municipal Department.

12. Correspondence with Richard Raphael, Senior Vice President of Fitch Investors Service, Inc. (October 9, 1990).

13. From a conversation with Paul E. Glick. Director of the Financial Management Program at the University of Georgia, and a veteran reviewer of Comprehensive Annual Financial Reports (CAFRs).

14. The City of Minneapolis, for example, has decided that it will not maintain an unreserved fund balance in excess of 10 percent of annual expenditures so as to avoid “banking” the taxpayer’s money. See: Mark Wetmore, “Minneapolis Productivity Investment Fund: Looking at the Rate of Return on Projects Funded,” *Government Finance Review*, October 1989. Auditors in the Office of the State Comptroller of New York also use the 10 percent figure as an informal standard for determining excessive levels of unreserved fund balance, although it is not a hard and fast rule. See: *Financial Management Guide for Local Governments*, Albany, NY: Office of the State Comptroller, July 1985.

15. While size is of some importance, the rating agencies primary concern will be the trend in size of fund balance, with sharp drops in size possibly indicating fiscal weakness.

16. The Payment of Principal and interest on a government’s outstanding debt obligations, of course, could not be deferred. At the same time, deferral of payments for other items, such as actuarially required pension contributions may create or contribute to long-term financial problems. Given this, it is important that governments examine the ramifications of fiscal strategies involving the deferral of purchases/expenditures very carefully.

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