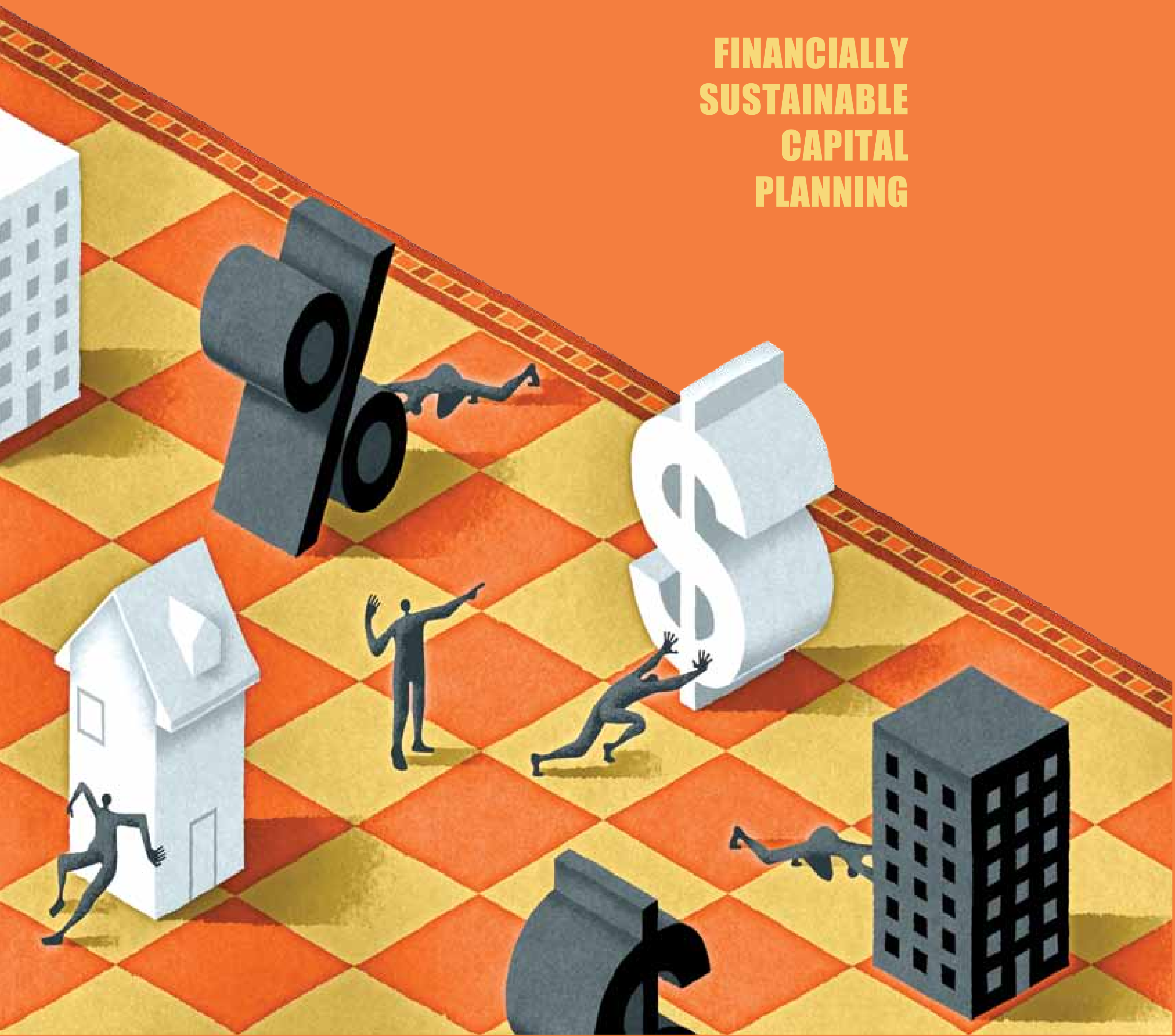
FINANCIALLY SUSTAINABLE CAPITAL PLANNING



By Shayne Kavanagh and Katie Ludwig

GFOA has been developing a new approach to local government financial sustainability based on a Nobel-prize winning body of work called "common pool resource theory." The dilemma that common pool resource theory is intended to solve is encapsulated by an economic parable called "the tragedy of the commons," which goes as follows.

A group of farmers have common ownership of a grazing area. An individual farmer has the incentive to send his animals to the common grazing area as much as possible because the additional cost for using the grazing area is near zero (it is commonly owned). In addition, if he doesn't send his animals, the other farmers' animals still graze, thus depriving the individual farmer's herd of potential food. All farmers face the same incentive, so they all send their animals to the common grazing area. The result is that the common area is eventually overgrazed and becomes barren.

A local government budget has a lot in common with the grazing area in this story. The budget is commonly owned by all the members of the community. Like the farmers, all of these stakeholders have the incentive to get as much as possible from the budget, lest they lose out to others. The eventual result is the same: a depleted resource.

To make its budget sustainable, a local government needs to take a long-term view. This is especially true for capital investment.

Common pool resource theory offers a number of proven solutions to this dilemma, which GFOA has translated to public finance. In this article we will examine the capital planning practices of Wake County, North Carolina, and how they align with what GFOA research has found to be some of the keys to a healthy, sustainable budget.

ADOPT A LONG-TERM TIME HORIZON

To make its budget sustainable, a local government needs to take a long-term view. This is especially true for capital investment. Many governments adopt capital planning horizons beyond one year. For example, a recent GFOA survey found that 78 percent of governments that participate in GFOA's program for distinguished presentation of annual financial reporting have a capital revenue forecast that looks at least three years into the future; 23 percent go further, with a forecast that looks at least six years into the future. Though the prevalence of long-term forecasting in local government capital planning is a positive development, adopting a long-term mindset requires other supporting practices as well.

Balance Short- and Long-Term Perspectives. In public finance, we often think of the short term and long term as mutually exclusive options: We must choose one or the other. However, the strongest planning processes balance the two in order to inspire a long-term view, while remaining relevant to the challenges that people feel right now.

Wake County does this by establishing annual "goal areas" with its board of commissioners. The county has seven broader goal areas that remain mostly consistent from year to year. Examples include:

- *Community Health.* Promote an effective behavioral and physical health system of care and practices that benefit all residents.
- *Economic Strength.* Create a business-friendly environment to attract, retain, and grow business, diversify the economic base, and create job opportunities for all citizens.
- *Growth and Sustainability.* Establish a deliberate and realistic approach to address growth and mobility while preserving the county's environment and healthy communities.

Each goal area has a number of more specific objectives associated with it. Then, there are even more specific initiatives associated with each objective. The objectives and initiatives provide the opportunity to address issues that are of immediate concern to the community, while remaining within a consistent long-term framework. For example, under the Growth and Sustainability goal, one of the initiatives is to maintain the affordability of transit services and address transit needs in vulnerable communities and rural areas.

When the county is considering potential capital investments, its goals, objectives, and initiatives are important influences. For example, an initiative will at times call for the development of a master plan to address some issue of the community (e.g., a park system master plan). The county's system for evaluating whether to undertake a capital project considers the presence of an approved master plan that supports the project, allowing it to maintain a long-term coher-

ency in its approach to providing services. This practice also allows the county to adjust its objectives and initiatives each year to respond to new or emerging concerns.

Checkpoints for Your Capital Planning

- ✔ Has your governing board set goals and priorities to define the community's needs?
- ✔ Are those goals and priorities used to determine capital investments?

Take a Principled Approach to Capital Investment. The county has defined other criteria to help select capital projects, in addition to the criteria for a master plan described above. To illustrate, here are two criteria with the most direct relevance to financial sustainability:

- *Provide Operating Expense Savings.* This includes energy-saving projects, technology infrastructure, or constructing libraries instead of leasing space to provide long-term operating cost savings.
- *Maintain the Integrity of Current Capital Assets.* This includes roof replacements, building system replacements, enterprise infrastructure replacement, and space renovations that improve service delivery.

Setting forth explicit criteria for evaluating capital investments makes it is easier for the county's decision makers to keep the county's long-term interests in mind, even when they are confronted with other, shorter-term interests.

Checkpoint for Your Capital Planning

- ✔ Have you defined a small, meaningful set of criteria to guide how capital investment decisions will be made?

Provide a Fair Distribution of Costs and Benefits among Generations. Because many capital assets have a lifespan measured in decades, there is a good chance that many citizens who are present when the asset is first acquired will no longer be in the community when the asset reaches the end of its useful life. Local governments must therefore find a way to distribute the cost and benefit of assets across the successive generation of citizens who will enjoy their use. For example, if an asset is funded completely with cash, then future generations may not contribute their fair share. Conversely, if an asset is funded with debt that has a back-loaded repayment schedule, then the current generation of citizens may not be contributing their fair share.

Wake County strives to adhere to what it calls an "80/20 rule" for debt versus cash funding of its capital program: 80 percent of the project costs will be financed by debt and 20 percent funded by cash. By not relying overly on cash funding, the county avoids over-taxing the current generation of taxpayers and frees up more current resources for high-priority current services. By using debt financing, the county can repay the cost of an asset over its useful life.

> In public finance, we often think we must choose between the short term and the long term. However, the strongest planning processes balance the two in order to inspire a long-term view, while remaining relevant to the challenges that people feel right now.

Checkpoints for Your Capital Planning

- ✔ Have you defined the acceptable mix of debt and cash financing for capital projects?
- ✔ Have you defined limits on the use of back-loaded repayment schedules?

Institutionalize Long-Term Thinking. The process for deciding how a local government will make its capital investments can be structured to encourage long-term thinking. The county tries to ground its capital planning in master plans developed for the services the county provides. The master plans are developed over multiple years, using extensive public input to assist in providing a clear, long-term vision for county services.

> Wake County balances short- and long-term perspectives by establishing annual "goal areas," including community health, economic strength, and growth and stability.

The master plans are most useful not only for major ongoing capital programs that require a significant portion of available county resources, but also for capital projects that aren't repeated on a routine schedule, like building a new facility. For projects that do happen regularly, like roof replacements or mechanical system replacements, the county makes sure these projects are accounted for and that the costs remain manageable.

Of course, circumstances change. Accordingly, each year Wake County reviews the last six years of its seven-year capital improvement plan (CIP) to update schedules, cost estimates, or any other important characteristics of the project that have changed. Departments can submit any new capital requests that are not in the plan. Departments are also invited to identify what Wake County calls "horizon issues," which are projects that are not included in the CIP because they do not have a funding source and/or a sufficiently refined scope, cost, or business case. Placing these projects in the category of "horizon issues" preserves the CIP as a serious planning document and keeps it from turning into a "wish list." At the same time, legitimate needs can still be identified, documented, refined over time, and considered annually.

When a department does wish to request that a project be included in the CIP, it must submit a short overview that addresses the following questions:

- What is the problem the department is trying to solve?
- Who will the project serve, and how will it improve services?
- What is the requested timing of project completion, and what is the implication if the request is delayed or denied?
- Is there a known tool or solution the department is interested in pursuing?
- Is this a replacement or a new project?
- Is there an estimated cost at this time? ("No" is an acceptable response.)

Each spring, the updated and proposed CIP is submitted to the board before its annual budget retreat. Any capital requests that aren't included in the CIP remain horizon issues that can be reconsidered in future years.

The standardized list of questions provides for consistency in how projects are evaluated, and the opportunity for projects to be reconsidered later means that people see that they will have other chances if their project doesn't get approved. Both of these features promote a sense of fairness in Wake County's process. When people sense that a process is fair, they are more likely to support the outcomes of that process, even when the outcomes aren't aligned with that person's personal preferences.

Checkpoints for Your Capital Planning

- ✔ Are your new capital investment decisions guided by master plans with a long-term time horizon? Were they were developed using input from the public?
- ✔ Do you have regular maintenance and renewal schedules for your existing assets?
- ✔ Do you have a way to recognize legitimate, but unfunded, capital needs without turning your capital improvement plan into a "wish list?"
- ✔ Have you taken steps to ensure that people feel that the process for making capital investment decisions is fair?

SET BOUNDARIES

A local government will be more financially sustainable when limits are placed on decision making and people respect those limits. When this happens, unsustainable decisions are "out of bounds." In this section, we'll discuss two types of boundaries Wake County has set to encourage sustainable capital investment in the best interest of the county and its citizens.

Debt Limitations. A recent GFOA survey showed that nearly 60 percent of governments that participate in GFOA's program for Certificate of Achievement for Excellence in Financial Reporting have adopted a policy that places limits on the amount of debt that the government will incur. Wake County has developed a comprehensive policy on this topic. The county uses six measures of indebtedness to define boundaries. Critically, the county's policy doesn't just identify each measure — it also describes parameters that the county wants to remain within. These parameters were arrived at primarily through consultation with the county's financial advisor and bond rating agencies on what is necessary to keep the county's AAA bond ratings. Let's briefly examine each of the six measures.

When the county is considering potential capital investments, its goals, objectives, and initiatives are important influences.

1. *Combined fund balance of general fund plus debt service fund should be equal to or greater than 30 percent of combined revenues of general fund plus debt service fund.* This policy demonstrates the county's desire to be well-positioned and to avoid undue tax increases or service reductions if it is faced with unexpected events or market shifts that detrimentally affect expenses and/or revenues.

2. *Seventy percent or more of debt principal should be repaid within 10 years.* This policy aligns the timing of debt retirement with the timing of benefits of the debt issuance to taxpayers. The county also does not want future generations of taxpayers to be burdened by a back-loaded debt retirement structure, especially when many assets might require maintenance costs as they age.

3. *Strive for a debt to pay-as-you-go ratio of 80/20.* The objective is to ensure that the county doesn't overuse current resources to pay for capital projects that will have a long useful life.

4. *Keep debt at or less than 2.5 percent of the county's assessed valuation.* This boundary ensures that debt is affordable, relative to the county's tax base. The rating agencies actually prefer a lower ratio for county governments, but because Wake County also has funding responsibility for the local school system (by state statute), its higher number can be justified to rating agencies. That said, Wake County actually endeavors to keep this ratio closer to 1.75 percent, even though the county's policy allows for it to be a little higher.

5. *Strive for debt service expenditures to be 20 percent or less of total governmental expenditures.* This measure makes sure that debt service is manageable within the county's budget.

6. *Total variable rate debt should be 20 percent or less of total outstanding debt.* Though variable rate debt can lower the total cost of financing for a local government, it can also introduce more risk and uncertainty into budgeting. This policy intends to limit Wake County's exposure. The county manages its variable-rate debt to much less than 20 percent. (Variable rate debt is currently limited to short-term construction financing.)

Because these measures offer diverse perspectives on how much debt the county can afford, the county must try to satisfy multiple, potentially competing, objectives. For example, the county strives to repay 70 percent of its debt within 10 years, while also keeping debt service at less than 20 percent of government expenditures. Repaying debt faster necessarily requires using a greater portion of the budget to pay it back. Hence, the county exercises more forethought and planning with its debt issuances by monitoring *multiple* debt policy measures, where each one brings a different perspective to bear (e.g., debt versus cash financing, property tax burden, etc.). If the county only monitored one or two measures, it might get a less accurate and more limited understanding of affordability in its debt planning.

Checkpoints for Your Capital Planning

- ✔ Have you established limits on how much debt is affordable for your community?
- ✔ Do these measures offer diverse perspectives on what is considered "affordable" debt?

Dedicated Revenue Stream for Capital Investments. Like most communities, Wake County will have many capital projects to undertake for the foreseeable future. To help ensure that the necessary resources are available, each year the board of commissioners has allocated a portion of the county's property tax rate specifically for debt and capital investment. For fiscal 2019, 18.76 cents of the total 65.44-cent property tax rate (per $100 of assessed valuation) is dedicated to debt and capital purposes. This establishes a lower bound on the amount of resources that will be used to make long-term investments in community.

Wake County strives to adhere to what it calls an "80/20 rule" for debt versus cash funding of its capital program: 80 percent of the project costs will be financed by debt and 20 percent funded by cash.

Checkpoint for Your Capital Planning

- ✔ Do decision makers in your local government have a strong understanding of where the resources will come from to fund capital needs?

Monitoring. After policy boundaries are set, each corresponding policy metric must be monitored to make sure it remains within the agreed-upon boundaries. Within its debt and capital financial model, Wake County uses an interactive dashboard (see Exhibit 1) to monitor the debt policy measures we reviewed in the last section. The measures are considered imperative to maintaining the county's AAA bond ratings. Bond ratings are critical because they influence the cost of borrowing. However, bond ratings are a "lagging" measure of performance. By the time the county would receive a downgrade, it might be very difficult or even impossible to reverse the decisions that led to the downgrade.

Therefore, to provide a "leading," or forward-looking, measure, the county's dashboard does not present just a historical view of the county's debt measures or even just a forward-looking view based on debt that has already been issued. The county anticipates future annual debt policy measures by projecting the debt and cash funding levels required to meet all its planned capital needs. Potential future indebtedness comes from the

Exhibit 1: Policy Dashboard from Wake County's Debt and Capital Financial Model

Policy Dashboard

		Percent				
	Policy Goal	FY2020	FY2021	FY2022	FY2023	FY2024
Combined Fund Balance as Percent of Total Revenues	≥30	30.5	31.6	32.0	31.7	30.7
Percent Debt Paid Off within 10 Years	≥70	73	72	71	70	70
Ratio of Debt/Cash used to Fund Capital	Strive for 80/20 (Debt/Cash)	80	79	78	80	79
Total Debt as Percent of Assessed Valuation	≤2.5	1.6	1.5	1.6	1.6	1.7
Debt Service as Percent of Total Expenditures	Strive for ≤20	20	19	20	21	21
Variable Rate Debt as Percent of Total Debt	≤20	10	9	5	6	6

county's seven-year CIP and CIP funding strategy. When modeling possible future capital investment strategies, the dashboard will adjust to show the resulting impact. This allows decision makers to explore possible futures and determine which path forward will make best use of the county's available debt capacity while remaining cognizant of the impact on service levels, citizens' taxes, and debt policy measures integral to maintaining AAA bond ratings.

Of course, circumstances change. Accordingly, Wake County reviews the last six years of its seven-year capital improvement plan each year to update schedules, cost estimates, or any other important characteristics of the project that have changed.

To illustrate how the dashboard can be used, in June 2018, the county board of commissioners decided to hold three bond referenda on the November 2018 voter ballot. Excerpts from the financial model were shared with the board and citizens at multiple meetings leading up to the vote. It proved to be a useful way to visualize how the bonds would affect the future financial condition of the county and the effect the bonds would have on taxpayers.

Checkpoints for Your Capital Planning

- ✔ Do you have a way to help decision makers visualize your current and expected future position relative to the key measures of the sustainability of your capital program?
- ✔ Can decision makers examine possible future scenarios to better understand how their choices could lead to different financial outcomes?

CONCLUSIONS

The experience of Wake County, North Carolina, illustrates some of the essential elements of financially sustainable budget:

- *Adopt a Long-Term Time Horizon.* This is a product of both leadership from forward-thinking government officials and designing decision-making processes to encourage forward thinking.
- *Set Boundaries.* Establish limitations on the decisions that can be made. When people agree to respect the boundaries, financial sustainability is more likely.
- *Monitor the Process.* Monitoring provides assurances to everyone that the boundaries are being respected. When a person believes that everyone else is respecting the boundaries, then that person is more likely to respect the boundaries, too.

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