agement practices. The FTMS groups the indicators by factors, using historical profiles for each indicator.

Exhibit 8–5 illustrates that state constitutions and laws do establish artificial debt limits. They vary greatly from state to state as well as by type of local government. Typically, they express the limit as a percent of the property tax base. Often state laws add provisions so those jurisdictions that tax the same citizens have lower limits. This avoids greater taxpayer liabilities for citizens from two or more overlapping jurisdictions. Also state laws sometimes establish artificial limits based on the tax imposed for servicing the debt. Another common state limitation is the procedural requirement calling for a referendum on long-term indebtedness bond issues.

Investors treat revenue bonds much like private corporation bonds. State law often does not prescribe limits and the market establishes the limits. Investors examine forecasts of income to ensure local governments will meet their debt services and the investors' investments are safe.

## LOOKING BACK FOR FUTURE LESSONS: SOME IMPORTANT CASES

### New York City Financial Crisis

In April 1975, New York City hovered on the brink of default on its obligations. With help from New York State, the federal government, and others, it averted default, but two significant consequences emerged after the crisis. The first was that state and local governments now paid higher interest rates. The second was the financial community now required more elaborate financial disclosures.

The nation felt the effects of the New York crisis, and North Carolina is one example. In *Southern City* Kenneth Murray (1976, 6) reported that a study by the Municipal Finance Officers Association (MFOA) showed "that the New York City financial crisis already cost local governments in North Carolina $424,000 in first-year added interest costs on bonded indebtedness and $5.1 million total in interest over the life of municipal bonds issued in 1975."

Exhibit 8–6 shows the credit rating change for New York City. Notice from 1965 to 1975 the remarkable drop to a low of Caa. Also note that since 1977 the rating has improved. In the precrisis era, state and local governments sold their bonds without revealing much about their financial situation. Since the crisis, investors have demanded greater disclosure of facts about the community and bonds.

### Washington State Public Power Supply System (WPPSS)

In 1983, the WPPSS defaulted on its revenue bonds because the revenue from the nuclear power electric generation did not meet debt service requirements. WPPSS defaulted on payments of $2.3 billion in bonds issued to finance two nuclear power plants in the state of Washington. Epple and Spatt argued that the default of the WPPSS raised that state's general obligation borrowing costs. Because the market held the jurisdiction responsible for repayment of principal and interest of this revenue bond default, potential GO bondholders viewed the revenue bond default as

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**EXHIBIT 8–5 State Debt Limitations of the 50 States**

| STATE | AMOUNT OF GO DEBT LIMIT | CONSTITUTIONAL OR STATUTORY | OVERRIDE PROVISIONS | AMOUNT OF SHORT-TERM DEBT LIMIT | CONSTITUTIONAL OR STATUTORY | OVERRIDE PROVISIONS |
|---|---|---|---|---|---|---|
| Alabama | U | C | — | $300,000 | C | — |
| Alaska | U | — | — | U | C | — |
| Arizona | $350,000 | C | — | — | — | — |
| Arkansas | $1,350,000,000 | C | — | N | — | — |
| California | U | — | — | — | — | — |
| Colorado | U | C | — | N | S | X |
| Connecticut | 1.6 × Rev. | S | — | — | S | — |
| Delaware | — | S | — | — | — | — |
| Florida | — | C | — | N | — | — |
| Georgia | 10% Rev. | C | — | — | — | — |
| Hawaii | — | C | — | — | — | — |
| Idaho | $2,000,000 | C | X | $2,000,000 | C | X |
| Illinois | — | C,S | X | 15% total app. | C,S | — |
| Indiana | N | C | — | N | C | — |
| Iowa | $250,000 | C | — | U | S | — |
| Kansas | $1,000,000 | C | X | U | — | — |
| Kentucky | $500,000 | C | — | U | — | — |
| Louisiana | — | C,S | X | — | — | — |
| Maine | U | — | — | 5% of G.F. | S | 0 |
| Maryland | — | — | — | $100,000,000 | S | — |
| Massachusetts | — | S | — | — | — | — |
| Michigan | — | C,S | — | — | C | — |
| Minnesota | 3% non—ded. Rev. | — | — | — | S | — |
| Mississippi | 1.5 × Rev. | C | — | 5% of G.F. | S | — |
| Missouri | 1,000,000 | C | C | N | C | X |

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| | | | | | | |
|---|---|---|---|---|---|---|
| Montana | U | — | — | U | — | — |
| Nebraska | N | C | — | N | C | — |
| Nevada | 2% of assessed val | C | — | — | — | — |
| New Hampshire | 10% Rev. | S | — | $125,000,000 | — | — |
| New Jersey | 1% of G.F. | C | Referendum | N | — | — |
| New Mexico | — | C | — | $200,000 | C | — |
| New York* | U | C/S | — | $1,000,000,000 | S | X |
| North Carolina | U | C | Popular Vote | 50% yr. total | C | X |
| North Dakota | $10,000,000 | C | X | N | — | — |
| Ohio | — | C | — | — | C,S | — |
| Oklahoma | U | — | — | U | — | — |
| Oregon | — | C | Const. Amendment | — | — | — |
| Pennsylvania | — | C | Referendum | 20% of rev. | S | — |
| Rhode Island | $50,000 | C | Referendum | $150,000,000 | C,S | — |
| South Carolina | — | C | — | N | — | X |
| South Dakota | N | C | | $100,000 | C | — |
| Tennessee | — | S | X | N | — | — |
| Texas | 5% of GR | C,S | X | — | — | X |
| Utah | 20% of state appr. limit | C,S | C | — | — | — |
| Vermont | U | S | — | — | S | — |
| Virginia | 9,425,434,000 | C | — | 3,310,975,000 | C | — |
| Washington | 7 or 9% of general Rev. | C,S | — | — | — | — |
| West Virginia | per amendment | C | — | per statute | S | — |
| Wisconsin | formula | C | X | 10% of G.F. | S | S |
| Wyoming | 1% assessed value | C | — | N | — | — |
| Puerto Rico | Annual pmt. < — 15% | C | — | — | S | — |
| Codes: | C . . . Constitutional | | | U . . . Unlimited | | |
| | S . . . Statutory | | | N . . . No debt allowed | | |

*Source:* As adapted from National Association of State Budget Officers. *Budget Processes in States*, Washington, DC: NASBO, 2002.



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**EXHIBIT 8–6 Moody's Rating for New York City**

| DATES | RATINGS |
|---|---|
| 07/65 | Baa |
| 05/68 | Baa1 |
| 12/72 | A |
| 10/75 | Ba |
| 10/75 | Caa |
| 05/77 | B |
| 11/81 | Ba1 |
| 11/83 | Baa |
| 07/85 | Baa1 |
| 08/88 | A |
| 07/93 | Baa1 |
| 02/98 | A3 |

*Source: Moody's Municipal Credit Report.* Used by permission. City of New York, Bureau of Debt Management, 2002.

evidence that the jurisdiction managed itself poorly. Epple and Spatt posited that reputation costs affect borrowing across all jurisdictions within a state when a local bond default occurs. Moreover, following years of contentious bankruptcy proceedings, the jurisdiction did make some $500 million in payments to bondholders.

### Orange County, California

The more significant local government financial crisis was the Orange County situation discussed earlier in this chapter. Orange County, one of the wealthiest local governments in the world, defaulted on general obligation bonds. Prior to that time, American local government, with very few exceptions, considered GO debt "sacred," with governments going to great lengths to protect their GO bond rating. Overnight, Orange County changed the rules and traditional financial emergency signals, which this chapter explains later, were inadequate in dealing with poor financial management using derivatives.

What are the consequences of Orange County? Fortunately, investors did not abandon the municipal market, which investors had considered about the safest place to invest. Interest rates did not spike up, except for California issuers. Most of Orange County bond investors were money market fund managers, and they reacted by either buying at par or by acquiring letters of credit or portfolio insurance with the permission of the U.S. Security Exchange Commission. Fortunately, the bond fund managers sold off their shares to investors because they realized that the Orange County median family income was a full 20 percent higher than that of the state as a whole. Unfortu-

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nately, the county's voters rejected a half-cent increase in the county sales tax to address the debt problem, but the county did divert other revenues to debt service, did radically cut services (41 percent), and selectively did refinance portions of the debt. Unlike when other cities fell into fiscal disgrace, California State government did nothing due to its own weak fiscal situation and the antigovernment citizen attitude in the state. One clear consequence is that Orange County and California taxpayers in general shall pay many millions more for debt service for many years in the future.

### Government Financial Emergencies

There are rather clear warning signs for a municipality that is in financial trouble:

- an operating fund revenue/expenditure imbalance in which current expenditures significantly exceed current revenues in one fiscal period (a well-managed government, under some conditions such as an excessively large fund balance, could properly have this type of imbalance);
- a consistent pattern of current expenditures exceeding current revenues by small amounts for several years;
- an excess of current operating liabilities over current assets (a fund deficit);
- short-term operating loans outstanding at the conclusion of a fiscal year, the borrowing of cash from restricted funds, or an increase in unpaid bills in lieu of short-term operating loans;
- a high and rising rate of property tax delinquency;
- a sudden substantial decrease in assessed values for unexpected reasons;
- an unfunded or underfunded pension liability, unless done over a long period of time such as 40 years; and
- poor budgeting, accounting, and reporting.

Once the government recognizes that it has financial problems, it and the financial community can consider financial management improvements. Typically, the first major hurdle is the government's self-recognition that a problem exists. Acquiring the courage to communicate that problem to the public including the financial community is the second hurdle. The most common remedy is to eliminate the imbalance between revenues and expenditures. Often, an appropriate remedy is to develop safeguards against misuse of short-term operating funds. Another common remedy could be to fund the retirement system adequately. Governments in trouble must make significant improvements in their municipal accounting and reporting systems as they commonly do not have financial reporting systems that communicate bad news to the key decision makers in a timely manner.

If self-remedies are ineffective, then governments in trouble and others can take more significant steps. For example, some states create administrative bodies to assist troubled local governments. If that is inadequate, the courts can demand that local governments in trouble hire consultants such as Morgan Guarantee Trust and, if necessary, they can arrange for direct agreements with creditors. This is usually adequate for temporary or technical financial emergencies. If the problem continues, states sometimes have the power to force special remedies on a local government. Agreements usually undergo state review, approval, and supervision. The federal role is to provide a means to devise financial adjustments, which a majority of the creditors approve.

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Under chapter 9 of the federal bankruptcy law, the government facing bankruptcy must develop a plan of composition or financial adjustments. First, the eligible local government unit must file a voluntary petition for bankruptcy and a plan of composition with the petition. Those holding 51 percent of the securities affected by the plan must accept it. Upon filing, judges enter an order either approving or dismissing the plan. If approved, the resources of the debtor come within the jurisdiction of the court and the court fixes a time and place for a hearing. The court gives notice to the creditors, creditors and others can file answers, and the court holds the hearing. After the hearing, the court may confirm a plan of composition that the creditors involved in two-thirds of the aggregate amount accepted. The court may but seldom does continue jurisdiction after the confirmation of the plan.

## CAPITAL BUDGETING

### Operating versus Capital Budgeting

Most local and state governments have two types of budgets: operating and capital. The operating budget deals with everyday types of activities. The capital budget deals with large expenditures for capital items. They differ in the nature of items that they purchase, the methods of financing, and even the accompanying decision-making process. In most instances, government depletes operating expenses in a single year. Typically, capital items have long-range returns and useful life spans, are relatively expensive, and have physical presence, such as a building, road, water supply system, or sewage system. Fifty-six percent of American cities have a separate capital budget, and 73 percent of cities over 100,000 have them. Over forty states have capital budgets. Interestingly, the U.S. federal government does not have a capital budget, but the U.S. General Accounting Office champions this reform strongly.

The most significant difference between operating and capital budgeting is the method of financing. Governments finance capital budget items through borrowing, but they can also fund them by saving money over a period of years for the capital item or by using grants, special assessment, and the general revenue fund. Because government debts are often complex and can create financial hardships if local governments manage them incorrectly, state laws, not surprisingly, do establish debt limits (usually associated with the assessed value of property). Also, states often require equalization rates to ensure consistent treatment throughout each state. The debt limits vary from state to state, and there are exceptions to the limit and application of equalization rates.

Some local governments shift as many expenses as possible from operating to capital budgets. For example, in both West Point, Mississippi, and New York City, the local governments called band uniforms capital budget items. This tendency can lead to corruption of the concept of a capital item to such an extent that the government has two operating budgets, with one financed through borrowing. That situation in turn leads to overuse of bonding, greater government resources used for debt retirement, and proportionately less money used to meet operating budget demands. Eventually, the debt can become large enough that a government cannot meet its payments, and the community must face the possibility of management bankruptcy. Tradition-

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ally, government uses debt to finance items with a life expectancy that lasts as long as the debt payments. The effect of this practice is to limit the overuse of debt financing and to make the debt more politically defensible as the future taxpayers identify how they benefit from the decision to finance the item by borrowing money.

In capital budgeting, planning and careful, deliberate actions are essential. Government needs planning to integrate the capital items with the remainder of the physical structure in the community. Capital improvement plans are essential to coordinate the work by time, funding possibilities, and physical plans. If capital budgeting involves a building, then the process of executing decisions involves study of the possibilities, site selection and acquisition, and planning and design as well as construction financing. Delays translate to higher construction costs due to inflation, especially rising labor costs; thus, government must avoid delays. Also, the increased operating and maintenance expense incurred on account of the new facility is an important factor, which government should consider in the planning phase. Communities have built facilities they cannot afford to operate or maintain (for example, stadiums).

### Capital Facilities Planning

Governments can make decisions to add a public facility or make extensive repairs on the basis of understanding the needs of the community and the resources available. The best approach to identifying the resources is to inventory the existing public facilities. The next step is to catalog the proposed public facilities. The key facts in the catalog include the location of the proposed facility, the year of construction, cost priority, project description, financing schedule, prior or sunk costs, projection of future related fund requests, operating costs, and savings in operating and maintenance costs. Public managers can update their inventory and file of proposed projects at least once a year to ensure that policy makers base their decisions on the correct facts.

Making decisions on proposed projects is not easy, and managers can aid policy makers greatly if there are clear, detailed answers to the following questions:

- What is the relationship of the proposed project to the overall development of the city?
- The project will help how many citizens and it will harm or inconvenience how many citizens if the government does not construct the project? Which citizens will benefit or hurt from the project?
- Will the proposed project replace a present worn-out service or structure or is it an additional responsibility of government?
- Will the project add to the property value of the area, thus increasing the value of city property and receipts from property tax? How much will the city realize from the increase?
- Will the construction of the improvement add to the city's operation and maintenance budget? How much?
- Will the project increase the efficiency of performance? How much and where? What cost savings will result? Will the project reduce the cost of performance for a particular service? How much and where?
- Will the project provide a service required for economic growth and development of the municipality?
- Is the estimated cost of the improvement within the city's ability to pay?

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