Local Capital Budgeting

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Overview

- What is involved in capital budgeting
- Rationale for capital budgeting
- Capital improvement programming
- Capital financing: pay-as-go sources, debt, & debt capacity
- Policies to guide local capital budgeting process and decisions
Sources

- Observation of local capital budgeting and finance practices in N. C. and elsewhere over the years.


- Recent conversations with and information provided by LGC staff and local finance and management officials in Chatham County, Winston-Salem, and elsewhere.
What is Involved in Capital Budgeting

- **Capital budgeting is meant broadly**, including planning, financing, budgeting per se, & implementation.

- **Specific components or strategies:**
  - **Planning**: policies to guide process, preferably adopted by governing board; capital improvement programming; multi year financial forecasting; long term capital needs assessment.
  - **Financing**: development of pay as go sources; use of suitable debt for major projects; determining debt capacity; obtaining/maintaining good bond rating; financing economic development
  - **Budgeting per se**: Inclusion of recurring capital spending in annual budget, use of project ordinances for major projects
  - **Project implementation**: acquiring revenues & financing, project management, etc.
Rationale for Capital Budgeting

- Many capital projects are very expensive. A great deal of money is at stake in decisions about those projects. Let’s have good policies and procedures in place to make those decisions.

- Capital projects or assets have long useful lives. Must live with the results of capital budget decisions for many years.

- Large capital projects take years to plan and build, and expensive equipment can take more than a year to acquire. Difficult to plan & budget in annual budget process.

- Debt financing is often involved, which commits future annual revenues.
Capital Improvement Program (CIP)

What is a CIP: A forecast over a future period, usually 5 to 7 years of:
- Major capital projects and acquisitions,
- The appropriations or expenditures to be incurred for the projects and acquisitions,
- The sources of financing for them, and
- The impact of the projects and acquisitions on future operating or annual budgets

Illustration: Chatham County 2015-2021 approved CIP. Illustration is a project summary form for entire county & its major funds. A CIP also uses project detail form for each project, etc.
Why Use a CIP?

- Facilitates orderly replacement or renovation of existing capital assets.
- Allows time for project design, to arrange financing, & to identify sites & purchase land, etc.
- Provides opportunity to coordinate projects and acquisitions
- Helps to maintain or improve the city/county bond ratings
Issues in Developing and Using a CIP

- Who coordinates the CIP process: Finance-Budget, Pub. Wks, Manager’s Office
- How long is CIP forecast period: 5 to 7 years, shorter, or longer
- What is the CIP preparation and approval calendar and how does it relate to annual budget preparation?
- How is inflation or cost increases for projects handled in the CIP?
- Are citizens involved in identifying needs?
- How much emphasis is given to projects and costs in the first or “budget” year of the CIP forecast period?
Capital Financing: Pay-AS-Go Sources and Rationale

○ **Pay-As-Go Sources:**
  - Annual revenues in operating budget
  - Undesignated general/operating fund balances
  - Capital reserves established under G. S. 159-18
  - Charges to property: special assessments, impact fees, other development charges

○ **Reasons for pay-as-go financing:**
  - Recurring capital outlays, e.g., many vehicles, are suitably financed from annual budget.
  - Capital outlays for expensive equipment & modest-sized renovation projects can be financed from capital reserves.
  - Pay as go financing avoids/limits interest and issuance costs for debt and over-reliance on debt
  - Small units face challenges accessing debt Mkt.
Pay As Go Capital Financing: Fund Balance & Capital Reserves

- **Not really financing sources.** Rather, devices for accumulating money from revenue/financing sources.

- **Undesignated general fund balance:**
  - Allocate amounts in fund balance above amount or percentage needed to support annual budget.
  - Budget or transfer to a capital projects fund or to a capital reserve fund.

- **Capital reserve funds.** Separate fund set up under G. S. 159-18.
  - Once money is in such a fund, it has to be spent for capital purposes;
  - **Funding sources for capital reserves:** excess operating fund balance; portion of annual revenue sources, e. g., 2 pennies on tax rate, % of sales tax revenue, etc.
Capital Financing: Types of Local Debt in N. C.

- **G. O. bonds or debt (GO):** unlimited tax or full faith & credit pledge; voter approved or two-thirds; Typically least expensive; recent example: $139.4 million approved by Winston-Salem voters 11/4/14

- **Limited obligation bonds or debt (LO):** secured by limited taxes or revenues, property, and/or annual appropriation pledge; formerly called certificates of participation (COPs) or installment purchase debt; grew out of equipment financing; now probably largest type of local debt in NC

- **Revenue bonds or debt.** Secured by net earnings/revenues of self-supporting public enterprise, e. g., water sewer.
Capital Financing: Determining Local Debt Capacity

- **Use of debt ratios:**
  - General or non-enterprise debt (outstanding and authorized & unissued) *per capita*
  - and as % of tax or market value of property
  - Maximum annual debt service on general or non-enterprise debt as % of the annual revenues or expenditures of the general fund and other general operating funds

- **Illustrations:** see general debt per capital and as % of tax value for counties & municipalities of different size, 6/30/2013
Policies To Guide Capital Budgeting and Finance: Introduction

- **Capital budgeting activities for which policies can be helpful:** capital improvement programming, debt, fund balance and reserve.

- **Are the policies approved by the governing board?** See “Resolution Adopting Financial Policies”
Policies to Guide Capital Budgeting and Finance: Chatham County

- Policies are reviewed & approved by Board of Commissioners.
- See Chatham County Financial and Budgetary Policies”, in particular:
  - Debt Policies: Objective, Types of Debt, What debt is appropriate, Debt limitation, Relationship to operating and capital budgets.
  - Capital Improvement Program (CIP) Policies: Objectives, Process, Relation to annual budget, Capital project ordinances.
  - Fund Balance: Objective, Allowable uses, Excess fund balance
  - Capital Reserves: Objective, Annual contribution
Conclusions

- Local capital budgeting is important as growth of N. C. continues.
- Capital Improvement programming is at heart of capital budgeting.
- Using both pay as go and debt sources is needed for most units.
- Governing board adopted policies should guide local capital budgeting.