

A METHOD TO EVALUATE THE FINANCIAL CONDITION OF
MONTANA'S SMALL LOCAL GOVERNMENTS

by
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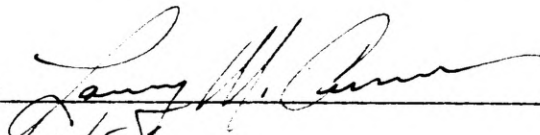
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ABSTRACT

The new fiscal policies of the Federal government during the 1980's are creating an era of austerity for local governments. The days of extensive federal assistance are quickly coming to an end and if local entities are to survive and prosper they must begin serious long-range financial planning.

This paper provides an overview of the measures of financial condition that have been developed by municipal credit rating firms, local government associations, and progressive state governments to analyze local fiscal position and assist local officials in improving their government financial posture. Several measures of financial condition that may be applied to small towns in Montana are developed. The indicators are grouped into five categories: community wealth, tax effort, revenue and expenditure patterns, operating position and debt. The analysis demonstrates that it is possible for small towns in Montana to evaluate fiscal posture without the need for costly professional assistance.

CHAPTER 1

THE NEED FOR FINANCIAL PLANNING

The election of Ronald Reagan in 1980 marked the beginning of a dramatic change in the financial policies of the federal government as the "New Federalism" of the Reagan administration swapped functional responsibility for a number of federal assistance programs among levels of government. The new "block grants" to state government of the early 1980's and the curtailment of other assistance programs were welcomed by many as a means to curb the dramatic growth of federal spending witnessed during the 1970's, and cursed by others as the beginning of an era of decline for local and state governments. While states have responded to federal cutbacks through the development of state funded assistance programs, few state governments, including Montana's, can generate the resources necessary to totally offset the impact of reduced federal aid.

Beginning with the well publicized financial emergencies in New York and Cleveland, the issue of local government fiscal condition has received considerable national attention over the last decade. Slow economic growth and inflation during the 1970's coupled with shrinking federal

assistance in the 1980's have forced local governments to raise taxes, reduce services and defer improvements to public operated utilities.

One of the first public alarms of the widespread financial problems of local governments was sounded by the U.S. Congress. In 1980, the subcommittee on Fiscal and Intergovernmental Policy of the Joint Economic Committee of the U.S. Congress reported in Trends in the Financial Condition of Cities: 1978-1980 that the operating expenditures of a majority of the major cities in the United States had grown at a much faster pace than operating revenues and had forced many municipal governments to halt capital spending on basic public improvements.¹

Related reports prepared during the early 1980's support the Joint Economic Committee's conclusions. Business Week Magazine, in an October 26th, 1981, special report, "State and Local Governments in Trouble," reported that an almost four-fold growth in federal assistance averted a severe financial crisis for many local governments during the 1970's, but warned that as federal assistance is curtailed during the 1980's, the local sector's ability to remain financially solvent while meeting the growing

¹Trends in the Fiscal Condition of Cities: 1978-1980, Subcommittee on Fiscal and Intergovernmental Policy, William S. Moonhead, Penn., Chairman. (Washington, D.C.: U.S. Government Printing Office, 1980), pp. 3-4.

demands for public services will be seriously jeopardized.²

In October, 1981, in response to concerns raised by state and local officials across Montana, Governor Ted Schwinden appointed a Special Temporary Committee on Local Government Finance to examine the financial condition of Montana's city, town and county governments. The Temporary Committee reported in "Local Government Financial Condition 1981" that the financial condition of Montana's local governments had deteriorated during the period from 1979 to 1981 and that the majority of the entities studied had reduced employee levels and implemented other cost saving efforts in order to maintain basic services.³

Since this report was prepared, no further State studies have been published to indicate that the financial condition of Montana local governments has significantly improved from the 1982 level.

The seriousness of the deteriorating financial posture of Montana's local governments is exacerbated by the need for substantial improvements to the basic infrastructure maintained by local entities.

²Lewis H. Young, ed., "State and Local Governments in Trouble" Business Week, October 26, 1981, pp. 135-181.

³Larry Curran and Scott Lockwood, Local Government Financial Conditions - 1981 (Helena, Montana: Temporary Committee on Local Government Finance), State of Montana, 1982, p. 5.

In January, 1984, Governor Schwinden appointed a Task Force on Infrastructure to compile information on the replacement and new construction needs of counties, and incorporated cities and towns in Montana. The Task Force estimated that over \$230 million dollars is immediately needed to bring existing public water and sewer systems across the state up to current health standards, over \$8 billion is needed to bring the existing network of 78,000 miles of streets and roads in Montana into good condition, over \$330 million is needed to provide necessary improvements to water and sewer systems, and over \$56 million is needed to bring existing jails up to constitutional standards.⁴ Unquestionably, this report identifies a serious need for substantial public investment that existing state and federal assistance programs, and current local financial practices and policies cannot address.

The poor economic condition of Montana's local governments, and the need for substantial public improvements, occur at a time when federal assistance to local governments is being drastically curtailed. Federal funding for many of the "block grant" programs established in the early 1980's is being substantially reduced, while the Federal Revenue Sharing Program to state and local

⁴Montana Department of Commerce, Montana's Infrastructure Crisis: A Report to the State. (Helena: Montana Contractor's Association, 1984), pp. 2-5.

governments has been scheduled for elimination at the end of fiscal year 1986.⁵

Statement of the Problem

Taken together, the poor financial condition of Montana's cities, towns, and counties, the need for substantial improvements to basic public infrastructure, and the decline in available federal assistance will place increased pressure on local governments to seek local solutions to the problems of funding local services and promoting sustained long-term growth.

To avert a serious future financial crisis local governments must take immediate, positive actions to meet and solve the upcoming financial and infrastructure replacement problems.

Options

At least four options appear available to local officials to ease the financial problems of local governments:

1. Request and obtain increased State assistance to support local services and rebuild local infrastructure;
2. Obtain authorization from the legislature to remove statutory prohibitions which limit local revenue raising capabilities;

⁵David Rogers and Paul Blustein, "Reagan Gives Cabinet Drastic Cuts in Many Widely Popular Programs, "Wall Street Journal," 6 December 1985.

3. Develop and implement new and dynamic sources of revenue to fund local services; and
4. Begin serious long-range financial planning to identify local financial weaknesses and develop financial strategies to best utilize existing revenues.

Each of these options has merit and perhaps a combination of all four can help cure the final resolution to the fiscal problems of local governments. However, three of the four solutions cannot be implemented without legislative or constituent approval.

The concept of obtaining increased State aid is a desirable if not the preferred option by many local officials. However, the problems of shrinking federal aid, inflation, and a dwindling revenue base plague State Government with a severity similar to those of the local sector. The competition for scarce State resources with other State funded entities, such as the University system, will become increasingly keen as time passes and revenues tighten. While local governments should continue to seek increased financial assistance from the State, this option should not be the sole strategy for improved financial health.

The removal of statutory prohibitions on local revenue raising capabilities would, in the short-term ease the revenue problems local governments face. However, implementing this option would meet with opposition

from citizens and taxpayer lobbying groups who already consider the statutory ceilings on property tax levies too liberal. Recent efforts to impose a local income tax option during the 1983 and 1985 Legislative sessions were soundly defeated, thus implementing this strategy would be difficult. While local governments should continue to work for greater freedom in handling their fiscal affairs it is unwise to entrust the long-term financial future of local governments to the actions of a legislature that will probably be facing a general tax hike to balance the State's budget.

The option of developing new and dynamic revenue sources to fund local services has been an issue of national attention for several years. Local government organizations, such as the National Association of Counties, have actively promoted the concept of fee-for-service payments as a means to increase local revenues for some time.⁶ However, it is widely recognized that such fees are difficult to implement, and often meet with political resistance.⁷ Additionally, users' fees do not provide a realistic method to fund all of the services local governments must provide. Some services, such as police

⁶National Association of Counties Research, Inc., Bridging the Revenue Gap (Washington: National Association of Counties, 1980), p. 21.

⁷Ibid.

services or fire protection are extremely difficult to charge back to residents on a fee basis. User fees also tend to be regressive. Often those constituents most in need of the service (e.g., county health services) are the least able to pay. While the identification and implementation of new and dynamic revenue sources is a realistic and desirable option, it cannot provide the sole cure to the fiscal ills of local governments.

The option of serious long-range financial planning provides a realistic and sensible strategy for local governments to immediately implement. Of all the available options it is the only strategy that does not require external assistance to accomplish.

Additionally, if local officials can conclusively prove through meaningful financial analysis that their financial problems are real and that all possible local options to correct the deficiencies have been exhausted, the long-term opportunities for State financial assistance and increased freedom in developing alternative revenue sources will be enhanced.

Many of the financial problems local governments currently face, such as growing debt burden or rapidly increasing expenditures for public services, are within the control of local officials. However, few invest the time and resources needed to review current fiscal trends to

analyze the possible effect of current policy decisions on the long-term ability to pay all of the costs of doing business.

The need for financially solvent local governments in Montana cannot be overstressed. Local governments are no longer the caretakers of a few minor public services. They are important partners in the overall financial health of the community. Not only are local governments major employers in Montana, they also have the ability to exercise a variety of financing powers to upgrade community facilities and aid business expansion. In collaboration with local business and banking leaders, local officials can directly influence the economic future of their communities. However, if local governments are in poor fiscal health, they may not be able to stimulate growth. In fact, the reverse may occur. A financially ailing local government may be a roadblock to growth and economic expansion because it may not be able to provide the public services required to support growth in local industry or population. Local governments, therefore, need to establish their "financial condition", and take positive actions to preserve or improve financial health. Nevertheless, though officials in smaller entities may recognize this need to develop sound financial management policies, they are often unaware of the methods and techniques available to address the problem.

Many of Montana's larger communities have the resources to employ specialized financial personnel to develop long-range financial strategies. However, in small communities, full-time staff is often limited to a town clerk and a utility maintenance crew of two or three. Long range planning and financial condition assessments for these smaller entities are either not performed or are limited to assistance offered by the County Planning Office or Extension Agent. In these smaller jurisdictions, the clerk is typically responsible for conducting the town's daily business leaving little time for reviewing and analyzing available financial data. Local planners and extension agents on the other hand often lack the financial expertise needed to sort through the detailed annual financial reports and assess the entity's financial condition.

Ways of Assessing Financial Condition

The term "financial condition" has many meanings. In a specific accounting sense, it can describe a government's ability to generate enough cash in 30 to 60 days to pay its bills. This is defined as "cash solvency." Financial condition can also refer to whether or not a local government can generate enough revenue over its normal budget period to meet its obligations without incurring deficits. This is called "budgetary solvency."

The ability of local government to meet all its obligations, both those occurring normally in any year and long-term expenditures, is referred to as "long run solvency." Financial condition can also refer simply to whether a government can provide the level and quality of service required by its constituency for the general health and welfare of the community. This concept has been referred to as "service level solvency." A lack of such solvency is exemplified by governments that appear to have sufficient revenues, but suffer from inadequate police or fire services, deteriorating roads, etc. Taken together, these concepts lead to financial condition broadly defined as "the ability of the local government to pay its way on a continuing basis, and the ability to maintain appropriate service levels, withstand local or regional disruptions and meet the demands of natural growth, decline or other change."⁸

Most of the financial problems that local governments face do not develop suddenly. Instead they build over time. If local officials are able to identify negative trends in financial condition over a three to five year time period they can modify public policy to improve

⁸Sanford M. Groves, Evaluating Financial Conditions: An Executive Overview for Local Government, Handbook 1 (Washington, D.C.: International City Managers Association, 1980), p. 2.

the financial posture of their government three to five years into the future.

Reviewing financial trends over time offers several advantages over examining financial records at a fixed period in time. First, it allows cities to determine the direction a fiscal trend is headed, and how quickly the change is occurring, thus, allowing time to correct undesirable situations. Second, it allows comparisons of trends over a period of time, thus equalizing out "good" or "bad" years. And third, it provides a database entities may use for making three to five year projections necessary for effective budgeting, capital facility planning, and general policy making.

Unfortunately there is no simple way to establish current financial condition and prognosticate future financial status. Existing research in local government financial analysis is not to a point where a single number or index can measure financial health and predict future needs.

Moreover, most of the research conducted on local financial condition over the past several years has centered on the needs of metropolitan areas, rather than small or rural jurisdictions. Metro areas have been the most challenging for research because of the special problems which confront urban areas--urban to suburban migration, racial

unrest, pollution, deterioration of inner-city infrastructure, declining industrial capacity, and the growth of public services and taxes. During the mid-sixties, many researchers linked the developing social problems of urban areas to the out-migration of rural poverty victims into the major cities.⁹

Because urban areas have been the focus of attention for much of the research on long-range financial planning and indices of financial condition, one must question whether it is practicable for rural communities to examine financial condition without professional assistance.

Rural areas have only recently received serious attention to the special problems they face. The long-term population decline and fiscal retrenchment of rural America have long been considered a regrettable but necessary by-product of the economic progress of the twentieth century.¹⁰ Small towns and rural areas have suffered as a result of the industrial revolution of the twentieth century.

With this challenge in mind, this paper addresses the following question:

Has the research and development of indicators of financial condition of local governments reached

⁹Richard J. Reeder, Non-Metropolitan Fiscal Indications: A Review of the Literature, (Washington, D.C.: U.S. Department of Agriculture, 1980), p. 6.

¹⁰Ibid., p. 7.

such a point where small municipalities in rural states can examine and evaluate their fiscal posture without the need for costly professional assistance?

In the development of this paper, four computer searches were conducted to obtain current relevant literature on local government financial condition. Additionally, municipal bond rating firms, the Municipal Finance Officers Association, the International City Management Association, and the local government assistance divisions of several states were contacted to determine the methods each utilizes to analyze local government financial condition.

The various approaches are summarized and discussed in the next chapter under these headings:

- Indicators of financial condition utilized by municipal credit rating firms;
- Measures of financial condition developed by progressive state governments; and
- Financial condition indicators developed by local government associations.

Based on this review the succeeding chapter outlines and discusses a system for assessing financial condition that could be implemented by municipalities in Montana. The system is designed for towns of less than 1,000 in population, but with minor changes in data sources it could serve any size of municipality.

CHAPTER 2

APPROACHES TO MEASURING FINANCIAL CONDITION

The need to evaluate local government financial condition is not a recent development. Analysts of local government have been concerned about fiscal health for some time. However, only recently has the issue received national attention. This chapter reviews the approaches taken by four significant sets of analysis.

Financial Condition Measures Developed by Municipal Credit Rating Firms

For many years, practitioners and researchers in the field of public finance concerned themselves primarily with the issues of cash and budgetary solvency. When the financial condition of a local government was analyzed, it was generally conducted from a credit analysis perspective to determine an entity's debt carrying capacity and ability to repay municipal bonds.

Standard and Poor's

One example of the methodology used by credit rating firms is found in Hugh Sherwood's How Corporate and Municipal Debt is Rated.¹¹ Sherwood explains that unlike

¹¹Hugh Sherwood, How Corporate and Municipal Debt is Rated (New York: Standard and Poor's Corporation, 1976), pp. 115-135.

corporations, public entities who issue municipal bonds do not have to register these bonds with the Securities and Exchange Commission (SEC). Therefore, for many years investors in municipal bonds knew much less about the credit liability of individual municipal bond issues than individual corporate debt. Only the larger underwriters, such as Standard and Poor's, have historically required detailed information on municipal issues. More recently, as the number of municipal issues have increased, underwriting firms have been more closely investigating the fiscal posture of smaller entities.

For many years, Standard and Poor's has required municipalities to submit ten separate pieces of information on municipal financial condition so the credit risk of the entity could be assessed. The information included:

1. A statement of overall debt, broken down by maturity date and type of security pledged for each issue;
2. A summation of the total assessed valuation of all property for the past four years;
3. Tax collection statements for each of the past four years;
4. A recent estimate of population;
5. Copies of the two most recent annual reports and most recent budget;
6. List of the ten largest taxpayers;

7. A brief description of the area's economy including the nature and character of its economic development, level of building activity, and the market valuations of homes;
8. If applicable, school enrollment in each of the last ten years;
9. A summary of future borrowing plans for approximately five years; and
10. A copy of its capital improvement program for the next five years.

Standard and Poor's would use this data and other pertinent information obtained from the U.S. Census, business journals or other sources to analyze the strength of the municipality. This analysis includes 19 measures of financial condition divided into four categories:

- A. Economic Factors;
- B. Administrative Factors;
- C. Financial Account Analysis; and
- D. Debt Factor Analysis.

Appendix A lists the 19 measures of financial condition.

Sherwood states that the first and third categories; Economic Factors, and current Financial Account Analysis, are considered the most important for the assessment of the entity's financial position.¹²

The issuer's economy has a direct impact on its ability to service its debt. A diverse tax base and multiple employment opportunities mean prosperity and

¹²Ibid., p. 121.

revenue stability to municipal governments. The lack of such economic stability often indicates current or upcoming fiscal problems.

A poor performance in the local government's fiscal accounts also provides cause for concern. If fiscal trends indicate frequent and recurring operating deficits, in time the entity will be unable to meet its financial obligations.¹³

Moody's Investment Service

Another example of the measures of local government financial condition used by municipal credit rating firms can be found in The Appraisal of Municipal Credit Risk by Wade S. Smith.¹⁴ Smith explains that credit investigators evaluate financial posture in terms of those attributes, characteristics, and situations which traditionally assure punctual repayment of debt or indicate a likelihood of repayment difficulties.¹⁵ Because the majority of municipal issues go into bond portfolios which are professionally managed, investigators make extensive use of credit information available from the U.S. Census, business journals, other rating firms, and other sources.

¹³Ibid., p. 121.

¹⁴Wade S. Smith, The Appraisal of Municipal Credit Risk, (New York: Moody's Investment Service, 1979).

¹⁵Ibid., p. 6-7.

In their assessment of municipal credit ratings, Moody's uses 20 measures of financial condition which can be divided into four categories:

- A. Population, Wealth, and Income;
- B. Governmental Organization and Powers;
- C. Financial Administration; and
- D. Debt Obligation.

Appendix B provides a detailed listing of the measures.

Smith reports that credit factors in the form of financial statements, level of taxation and current debt loads are important considerations in financial condition. More importantly, Smith cautions analysts and investors that credit judgements are strongly based on information gathered and submitted by the entity itself.¹⁶ Because of resource constraints, it is impossible for a credit rating firm to verify each piece of submitted information. The quality of data is important.

State Efforts to Assess Local Financial Condition

The well publicized fiscal emergencies of New York City and Cleveland in the 1970s, prompted many state governments to develop a more comprehensive approach to the problem of local governments. Sparking the increased state action is the concern that a default by a large local government could adversely affect the credit ratings

¹⁶Ibid., p. 323.

of the state and other local governments as well. Past solutions of increased financial assistance to fiscally ailing local governments were no longer viable as state governments found themselves in a similar bind with steadily increasing costs fueled by inflation and dwindling or stagnant revenue sources.

Contributing substantially to the felt need for state action was a report issued by the Advisory Commission on Intergovernmental Relations (ACIR) in 1973, City Financial Emergencies: The Intergovernmental Dimension.¹⁷ The report recommended that states more actively assist local governments with financial management, and that they establish a set of statutory guidelines that indicate the need for state intervention when the financial condition of a local government falls below an acceptable level.¹⁸

The Commission recommended state intervention in local affairs if any of the following four criteria were met:

1. Default in the payment of principal or interest on bonded debt or other obligations;
2. Failure for a specified time period to pay withholding taxes or other contributions such as social security;

¹⁷Advisory Commission on Intergovernmental Relations, City Financial Emergencies: The Intergovernmental Dimension, (A-42), (Washington, D.C.: Government Printing Office, July, 1973).

¹⁸Ibid., p. 7.

3. Failure for a specified period (for example, two or more consecutive pay periods) to pay salaries due employees or pension benefits due retirees; or
4. Attainment of a floating debt in the form of accounts payable or other unpaid obligations which after deduction of reserves for payment exceeds ten percent of the total appropriation of the last fiscal year.¹⁹

The report also highlighted certain trends that suggest that the financial condition of a local government may be tailing. The "warning signs" as ACIR called them include:

- an operating fund revenue expenditure imbalance in which current expenditures significantly exceed current revenues in one fiscal period;
- 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);
- a short-term loan for operating expenses outstanding at the conclusion of a fiscal year;
- a high and rising rate of property tax delinquency; and
- a sudden substantial decrease in assessed taxable valuations for unexpected reasons.

Numerous states elected to follow the suggestions of the ACIR report. In a follow-up bulletin, State Efforts to Prevent and Control Local Financial Emergencies,²⁰ the ACIR reported that at least sixteen states have implemented

¹⁹Ibid., p. 7.

²⁰Ibid., p. 4.

legislation to deal with the problems of local government financial condition.²¹

The ACIR explained that states have chosen distinctly different approaches to deal with the problem. Some states, including Ohio, New Jersey, Illinois, Florida and Nevada have passed "intervention" legislation that allows the states to assume control of local financial affairs if a financial emergency is deemed to exist. Other states, including Minnesota, New York, Texas, Massachusetts, Indiana, West Virginia, Tennessee, Virginia, New Mexico, Michigan and North Carolina developed a "preventative" approach designed to monitor local finances and avert fiscal crisis by identifying problems while they are still manageable. Most of the "preventative" programs track indicators of financial condition over a three to five year period. Generally, the programs were developed around measures of financial condition originally designed by the Municipal Finance Officers Association (MFOA), now called the Governmental Finance Officers Association (GFOA), and the International City Managers Association (ICMA).²² Three states provide representative examples

²¹Advisory Commission of Intergovernmental Relations, State Efforts to Prevent and Control Local Financial Emergencies, Bulletin No. 81-2, (Washington, D.C., U.S. Government Printing Office, September 1981), pp. 6-20.

²²Ibid, p. 13.

of the preventative approach to local government financial condition. These are Minnesota, Michigan, and Iowa.

Minnesota

The Minnesota Financial Health Program is considered a leader by the ACIR among state programs aimed at using local financial data to identify trends in fiscal health.²³ It utilizes computer generated trends to assess a municipality's internal financial posture over a five year period and then compares this data to municipalities of similar size and demographics.²⁴

The Minnesota system examines 30 measures of financial condition grouped into five categories. The indicators include:

- A. Economic Vitality;
- B. Financial Independence and Flexibility;
- C. Current Costs being Deferred to the Future;
- D. Municipal Productivity; and
- E. Management Practices.

Appendix C provides a detailed listing of the 30 measures of financial condition.

Minnesota's measures of financial condition were not intended to provide an all encompassing system to assess fiscal condition. Instead, the program is intended to be

²³Ibid.

²⁴Jean Drucker, Minnesota Financial Health Program (St. Paul: State of Minnesota, 1981), p. 2.

dynamic in nature, capable of adding or eliminating indicators to reflect the needs of individual communities. The state, therefore, encourages communities to add or delete indicators as needed.²⁵

Michigan

During the early 1980s the retrenchment of the automobile industry resulted in severe economic conditions that forced drastic budget cutting by state government in Michigan.²⁶ This placed increased financial pressures on Michigan's local governments and sparked state interest in establishing a system to head off local financial emergencies. To assist in preventing state emergencies, the State developed a series of measures that would assess local financial condition and provide an early warning of local government financial emergencies. The "Michigan Fiscal Early Warning System" was designed to serve two purposes:

1. Local officials would be able to use the system to evaluate their own fiscal situation and improve management; and
2. State government could review local fiscal data so appropriate action could be taken prior to a fiscal crisis situation. Such action included

²⁵Ibid., p. 7.

²⁶Advisory Commission on Intergovernmental Relations, State Efforts to Prevent and Control Local Financial Emergencies, p. 15.

doses of technical assistance and targeted fiscal relief.²⁷

Not unlike the Minnesota system, Michigan employed trend analysis in evaluating fiscal condition. Michigan recognized that financial emergencies do not develop overnight; rather, they develop slowly over time. The Michigan system contains 18 measures of financial condition divided into five categories:

- A. Local Economy;
- B. Financial Independence;
- C. Municipal Productivity;
- D. Deferring Current Costs to the Future; and
- E. Structure and Management.

Appendix D details the measures of financial condition developed by Michigan.

The Michigan system recognized the need for reliable relevant data on local finances. Early in its development analysts recognized that some data, including population and delinquent property tax information, were either unavailable or not current enough to provide meaningful analysis. The cornerstones of the system were data obtained from an annual survey of local finances conducted by the Michigan Department of the Treasury. This survey, the Local Unit Fiscal Report,

²⁷Thomas J. Martin, A Fiscal Early Warning System in Michigan, (Lansing: State of Minnesota, 1981), p. 2.

despite incidences of non-reporting and unreliable information, became the single most important source of data.²⁸

Iowa

The Financial Trend Monitoring System (FTMS), developed by the State of Iowa was not developed as the result of an effort by the state to monitor and react to local financial emergencies, but it was to be a practical guide for local officials to use in tracking local financial indicators and improving local financial management. Completed in August, 1985, it incorporates the latest available research on financial trend monitoring systems. The Iowa Cooperative Extension Service states that the primary purposes of the system is to assist city officials by:

- Identifying financial problems before they become serious;
- Providing information to improve the understanding of elected officials regarding city financial health;
- Improving local officials ability to communicate with the public on financial matters;
- Identifying previously hidden problems; and
- Assisting local officials in the development of financial goals and policies.²⁹

²⁸Ibid., p. 5.

²⁹Iowa Cooperative Extension Service, Financial Trend Monitoring Data Manual, (Ames: Iowa State University, 1985), p. 4.

The Iowa FTMS was designed by the International City Management System and was adapted by the staff of Iowa State University Extension Service, Office of Local Government Programs to be run on an Apple III Computer. The automated system allows university staff and local officials to calculate, graph and compare financial trend data with minimal manual effort. It is hoped that this automated approach will encourage a larger number of Iowa communities to utilize the system.

The Iowa FTMS is by far the most extensive of the existing local financial condition monitoring systems. It utilizes 51 indicators of financial condition grouped in seven general categories. The categories include:

- A. Community Needs and Resources;
- B. Revenue Patterns;
- C. Expenditure Patterns;
- D. Operating Position;
- E. Debt Structure;
- F. Unfunded Liabilities; and
- G. Condition of Capital Plant.

Appendix E details the indicators developed by Iowa.

Because the FTMS is designed primarily for use by local government officials, the responsibility for data collection and verification rests with the local governments.

period of years thus making potential problems less obvious, but correctable if noticed early.

The MFOA approach relies heavily on the analysis of selected key trends which independently would not be cause for concern, but collectively could point toward fiscal decline.

The MFOA approach examines 28 measures of financial condition which can be grouped into five categories:

- A. Economic Vitality;
- B. Financial Independence and Flexibility;
- C. Municipal Productivity;
- D. Current Costs deferred to Future; and
- E. Unsound Financial Management Practices.

Appendix F details the indicators developed by the MFOA.

International City Manager's Association

A second, more comprehensive approach to evaluating financial condition was developed in 1980 by the International City Managers Association (ICMA). This study, prepared by Maureen Godsey and Stanford Groves, resulted in a series of five handbooks designed to guide local officials in collecting and evaluating fiscal data for their cities. Broader in scope than the MFOA approach, it includes not only financial data, but environmental and legislative factors that influence policy decisions and management practices.

Handbook 2 of the ICMA approach, Financial Trend Monitoring System: A Practitioner's Workbook provides a detailed description of 36 measures of financial condition grouped into seven categories:³¹

- A. Community Needs and Resources;
- B. Revenues;
- C. Expenditures;
- D. Unfunded Liabilities;
- E. Condition of Capital Plant;
- F. Operation position; and
- G. Debt Structure.

Appendix G details the indicators developed by the ICMA.

The ICMA System of establishing financial condition emphasizes more than purely financial and financial management factors. It provides a framework for explaining the relationships that exist between financial trends and legislative policies which affect fiscal health.

The ICMA system, like the MFOA trend analysis, requires analysts and policy makers to make subjective judgments on local financial condition based on a collection of interrelated indicators. Neither system provides automatic policy solutions, nor offers a single number or index to indicate overall financial condition.

³¹Sanford M. Groves, Financial Trends Monitoring System: A Practitioner's Workbook, Handbook 2, (Washington, D.C.: International City Manager's Association, 1980).

Summary

This chapter illustrates that there are many diverse approaches to evaluating local government financial condition. The diversity of the various systems suggests that there is no "right" method. Rather, the best approach is dictated by the needs of the analyst and the community.

Municipal credit rating firms were among the first to measure local government financial condition. Their approach, however, is designed to measure a community's ability to repay debt, thus protecting individual investors.

State governments take a different approach. As regulatory agencies who are ultimately responsible either directly or indirectly for local actions, states evaluate local financial condition with regard to whether a fiscal emergency may occur. This is largely to protect the state and its residents from the financial disaster that the default of a large local government would bring.

Local government organizations take yet another approach to evaluating local government financial condition. They place more emphasis on financial management than on the financial condition of a community. Their management oriented approach seems better suited to smaller local governments.

The systems evaluated in this chapter use 202 different indicators or ratios in measuring financial condition. Far too many indicators for any single system to use. The systems developed by Iowa, Minnesota, and Michigan are promising, but each includes indicators that would not be appropriate for small towns in Montana.

The challenge is to develop a suitable system to evaluate the financial condition of Montana's small towns. Such a system must be sufficiently comprehensive to provide local officials with the information needed for meaningful long range financial planning, yet simple enough for the average citizen to understand.

The financial condition system must have the ability to evaluate fiscal trends over a fixed period of time. This is a shared characteristic among all of the various systems. Fiscal trend analysis offers the unique ability to focus on the individual characteristics of a community and allow a detailed individual analysis of a town's fiscal condition. In a state such as Montana where communities are separated by great geographic distances and share little in terms of demographics and economics, an individualized approach is a necessity.

CHAPTER 3

MEASURES OF FINANCIAL CONDITION FOR MONTANA TOWNS

The preceding chapter offered an overview of the measures and indicators of financial condition developed and implemented by various organizations and groups that are concerned with local government finance. Because the list of indices and ratios which measure fiscal performance is almost limitless, it is necessary to sort through the myriad of indicators to determine which may be applicable to Montana. Simultaneously, one must determine if there are sufficient data available to power the indicators. Even the most pertinent and all-inclusive indicator is valueless if the data are not available. Only through a process of review and elimination can it be determined if a financial condition assessment system can be developed for Montana.

To achieve any degree of success, any system of measuring financial condition must meet the following criteria:

- Simplicity;
- Economy; and
- Reliability.

Simplicity is a key element in any financial assessment system that will be utilized by smaller communities. Experts in the field of local government stress that the more complex a financial assessment technique is, the less likely it can and will be used by local officials.³² Few local officials carry degrees in Economics or Accounting, or have the time to research and learn complex financial analysis formulas. Thus, the trends and measures of financial condition must not require sophisticated fiscal or statistical knowledge for understanding their relevance to local finance. The analysis generated by the indicators must be easily understood by any local official or concerned citizen.

A financial assessment system must be economical. Since smaller local governments lack the resources to implement a sophisticated monitoring system, a financial condition analysis cannot require a substantial amount of time or money to develop and maintain. Because of limited staff resources, the data required to power the system cannot impose an additional reporting burden, nor require an elaborate data extraction device. Rather, the system must rely on existing financial reports already available at the local level.

³²Telephone interview with Girard Miller, Regional Director, Municipal Finance Officer's Association, 6 August 1982.

A financial assessment system must also be reliable. Because it can only be as accurate as the data utilized in the analysis, care must be exercised to obtain the most accurate data possible.

The problem of reliability of local government data in Montana can be summarized in a report issued by the Montana Department of Administration in 1982. The report, Local Government Financial Condition 1981, states:

One of the most important findings resulting from this study does not deal with the financial condition of any of Montana's local governments. Rather, it involves the very real problem of obtaining accurate financial data from local governments. Local governments are annually required to submit approved budgets and annual reports to the State Department of Administration. [This function has since been transferred to the Montana Department of Commerce.] They must also be audited periodically, either by the State or private accounting firms. The completeness and consistency of these budgets and annual reports are questionable at best.³³

Special care must be exercised to obtain the most accurate data available; thus, local officials should continually examine data for accuracy and question those data that vary substantially from past historic trends. Additionally, because the indicators must serve a variety of local governments, each unique in the service it provides, the measure of financial condition must be consistent in definition and interpretation from one com-

³³Larry Curran and Scott Lockwood, Local Government Financial Condition 1981, (Helena: State of Montana, 1982), p. 3.

munity to the next and from one fiscal year to the next.

There is currently a wealth of financial information available on every Montana community. Section 7-6-4111 of the Montana Codes Annotated (MCA) requires Montana towns to annually submit a complete statement of their financial condition to the Montana Department of Commerce. A detailed format for this information has been prescribed by the Department.³⁴ While these reports contain detailed financial information, there has never been a systematic method to interpret the reports and present the findings in usable format. As a result, the information has been of little or no use to most local officials.

Because of the wealth of information it provides, this report can serve as the foundation for a system to evaluate financial condition. The reports not only provide an easily accessible source of current data, but they offer historical data in a common format over several years.

Other relevant data regarding taxable valuation, population, and per capita income is easily obtained from the Montana Departments of Revenue and Commerce.

Each measure of financial condition identified in the preceding chapters carries merit in terms of its relevance to measuring financial condition. Ideally, an assessment

³⁴Montana Department of Commerce, Montana Town Annual Report, (Helena: State of Montana, 1984).

of financial condition would include a thorough examination of each aspect of a local government's financial and economic records. Unfortunately, data and time constraints preclude the use of what appears to be an exhaustive list of measures, indicies, and ratios.

If a financial condition assessment is to be employed in small towns in Montana, it must be concise and easy to understand and implement. Considering this, many of the identified measures, such as level of retail sales, or complex financial ratios must be excluded because of difficulty in obtaining necessary data or in interpreting the results.

The financial assessment systems cited in the preceding chapter employ over 200 indicators to evaluate fiscal condition. Most share sufficient common characteristics to allow them to be grouped into five general categories:

- Wealth of community and local economic situation;
- Level of tax effort;
- Revenue and expenditure patterns;
- Operating position; and
- Debt.

All of the assessment systems include indicators to evaluate the strength of the local economy and measure community wealth. A growing and diverse local economy

provides not only a stable and diverse source for revenue to support local services, it offers employment opportunities necessary to retain a stable population base. All of the systems recognize that a strong local economy and stable population are necessary elements for a healthy community.

The financial assessment systems also address the level of financial independence a community enjoys. When a local government has reached or exceeded the statutory ceilings for one or more of its primary revenue sources, its options for raising additional revenues to meet unexpected obligations are greatly diminished. The fiscal assessment systems used by Standard and Poor's, Minnesota, Michigan, the MFOA and ICMA all consider this factor.

Revenue and expenditure patterns are also key categories in fiscal assessment systems. Both Iowa and the ICMA isolate revenue patterns as an independent category for analysis to determine if the entity's incoming cash is keeping pace with inflation, other systems isolate expenditures. The systems developed by Minnesota, Michigan, and the MFOA, include expenditure measures to assess municipal productivity. The costs for providing services should grow at a pace no greater than the revenues that support operations. If expenditures are increasing at a higher rate than revenue, then in time an

entity will be unable to fund operations without incurring deficits.

The operating position of a local government is another key element in examining financial condition. If a local government is incurring frequent and growing operating deficits, it will eventually deplete its operating reserves and face fiscal difficulties. The systems developed by Iowa and the ICMA include measures to evaluate operating position. The systems developed by Moody's and Standard and Poor's employ financial account analysis to evaluate operating position. This fiscal analysis serves as the backbone to their systems.

Debt analysis and structure are important factors in the systems developed by Standard and Poor's, Moody's, Iowa, and the ICMA. Because municipal credit rating firms are primarily concerned with credit worthiness, they tend to evaluate debt with regard to a community's ability to repay additional bond issues. Iowa and the ICMA analyze debt from a different perspective. They consider the level of short-term debt incurred, and the entity's ability to provide needed services.

Ideally, a financial condition system would employ every available indicator to insure that a thorough and comprehensive examination has been made. However, this approach is neither realistic nor advisable for small

towns in Montana. The keys to a successful fiscal condition system are brevity and simplicity.

Following is a brief description of twenty-five simple measures of financial condition that could be applied in Montana. They were developed through a simple process of trial and error. The 202 indicators of financial condition previously cited were grouped into like categories. Each indicator was then reviewed against four criteria:

1. Are data for this indicator easily available?
2. Is the indicator relevant to small towns in Montana?
3. Is the indicator easy to understand?
4. Does this indicator duplicate the analysis of an indicator previously reviewed?

Through this process of elimination, a system of indicators of financial condition were developed that are easy to understand and interpret, and at the same time use readily available data. It should be noted that in addition to the above criteria professional judgement was used. The following indicators represent the judgement of one analyst and are not the only measures that could be used to evaluate financial condition. Because different communities have different information needs, indicators may be added or eliminated to reflect individual needs.

A. Community Size and Wealth

1. Population

Population is a primary determinant of the level of services that a local government must provide. Few would argue that the city of Billings with a population of nearly 100,000 must provide a higher level of police, fire, and social services than the town of Bearcreek with barely 50 residents. It is therefore important to determine whether population is increasing or decreasing. Additionally, by obtaining population estimates, per capita measures can be utilized. This will allow data to be made relative over fixed periods of time.

The exact relationships between population growth and decline, and municipal service levels are not yet clear.³⁵ On the surface it appears that a decline in population would relieve pressure for expenditures because less population will be served. However, this is rarely true. Town's have fixed costs for many services, such as water and sewer systems, that do not substantially fluxuate with changes in population. Therefore, it is rare that a town can adjust expenditure patterns in the same proportion as it is losing population. Population growth can also have an adverse demand on services if

³⁵Groves, Fiscal Trend Monitoring System, Handbook #2, p. 101.

there is a greater demand for services than existing revenues can meet.

Source of data: U.S. Census Bureau; Decennial Census, and Series p.25, population estimates.

Warning Trend: Declines or sudden increases in population.

2. Taxable Valuation

Montana's communities have historically relied on the property tax as the primary revenue source. The report, "Montana Financial Condition 1981", stated that property tax collections represented 44% of the total revenue received by towns in 1981.³⁶ Additionally, the level of taxable valuation is also considered the best universal measure of local wealth.³⁷ Real declines in taxable valuation may be a sign of failing economic health as a result of age of an entity's buildings, decline in population, or possibly as a result of the impact of State legislation which reduced valuation assessments. Regardless of the cause, real declines in taxable valuation inhibit a community's ability to raise revenue. Source of data: Montana Department of Revenue, Property Tax Division.

³⁶Curran and Lockwood, Local Government Financial Condition 1981, p. 9.

³⁷Smith, The Appraisal of Municipal Credit Risk, p. 45.

Warning Trend: Annual decline in taxable valuation per capita.

3. Tax Base Composition

An examination of a town's tax base will help pinpoint where the lion's share of the tax revenue is derived. For example, over 60% of the tax base of some eastern Montana counties³⁸ is derived from proceeds from mineral extraction taxes. A downturn in the coal or oil industry, or a change in the property classification schedule would have a tremendous effect on an affected community's ability to maintain revenues. Most analysts believe that a balance must exist if a community's tax base is to be considered healthy.³⁹ Information from the Montana Department of Revenue will allow the examination of the following categories: agricultural land, non-agricultural land, improvements on city and suburban lots, improvements on industrial sites, all other improvements, net and gross proceeds, allocation of utility property, motor vehicles, livestock, and all other personal property.

Source of data: Montana Department of Revenue, Property Tax Division.

³⁸Curran and Lockwood, Local Government Financial Condition 1981, p. 9.

³⁹Nancy T. Stark, Harvesting Hometown Jobs: A Small Town Guide to Local Economic Development (Washington, D.C.: National Association of Towns and Townships), p. 7.

Warning trend: Tax base dominated by one or two categories. This would suggest need for economic diversification.

B. Level of Tax Effort

1. Annual Tax Levy

Because the property tax represents a significant portion of a town's revenue, the number of mills annually levied is a good measure of local tax effort. Increases in the annual levy can indicate that the tax base or other revenue sources are not increasing at a rate equal to expenditure pressures.

Source of data: Montana Town Annual Report, Section V, Schedule C.

Warning trend: Number and increase in the number of mills annually levied for all purposes.

2. Relationship of Annual Tax Levies to Statutory Ceilings

Montana towns are limited by statute in the number of mills that can be levied for specific purposes. An examination of the relationship of current levies to statutory ceiling will allow a town to determine whether additional property tax can be generated if more revenue is needed. Town's which have reached or exceeded the statutory ceilings have less flexibility to increase or improve existing services.

Source of data: Montana Codes Annotated, Title 7, and Montana Town Annual Report, Section V, Schedule C.

Warning trend: Annual levy approaching or has surpassed statutory limit.

C. Revenue and Expenditure Patterns

1. Total Revenues

Total revenues represent all monies collected by an entity during a fiscal year and determine the capacity of a town to provide services. Under ideal conditions, revenues should grow at a rate equal to or greater than the combined effects of inflation and expenditure pressures. There are two approaches to examining total revenue - percent change in revenue on a yearly basis,⁴⁰ and total revenues per capita.⁴¹ Examining annual changes in total revenue will indicate whether an entity's revenues are keeping pace with long-range estimates and expenditure needs. Revenues per capita will indicate how revenues are changing relative to changes in the level of population. As population increases or decreases, it might be expected that need for services would change proportionately, and therefore, the level of per capita revenues should remain

⁴⁰Rosenberg and Stallings, Is Your City Heading for Financial Difficulty, p. 26.

⁴¹Groves, Financial Trend Monitoring System, Handbook #2, p. 12.

constant. If per capita revenues are decreasing, it can be expected that a community will be unable to maintain existing service levels unless new revenue sources are found.

Source of data: Montana Town Annual Report, Section I, Statement 02.

Warning trend: Yearly decline in total or per capita revenues.

2. Property Tax Revenue

Property tax revenues represent the total funds raised through the taxation of both real and personal property. As mentioned, the property tax comprises a significant portion of local government revenue in Montana. A suggested measure is property tax collections as a percent of total revenue. A decline in the percentage of property tax collections is not necessarily an undesirable trend, assuming other revenue sources offset the decline. However, a growing reliance on the property tax during periods of declining or stagnant taxable valuation may indicate a community will be forced to adjust its expenditure levels or face operating deficits.

Source of data: Montana Town Annual Report, Section I, Statement 02.

Warning trend: An increase or decrease in property tax revenues as a percent of total revenue.

3. Intergovernmental Revenue

Intergovernmental revenues include any funds received from another government, including county, state, and federal governments. A strong dependence on intergovernmental revenue can have an adverse impact on financial condition. If a town is relying on general revenue sharing or contributions from the State's Local Government Block Grant Program to support local services, a serious gap in revenue will occur if these external sources are lost. With the proposed elimination of general revenue sharing, and current downturn in oil revenues (which fund the Local Government Block Grant Program), town's should develop a strategy to phase out reliance on intergovernmental revenue. The suggested measure of financial condition is intergovernmental revenue as a percent of total revenue.⁴²

Source of data: Montana Town Annual Report, Section I, Statement 02.

Warning trend: Increasing intergovernmental revenue as a percent of total revenues.

4. NonTax Revenues

Nontax revenues include all funds collected by a town from fines and forfeitures, licenses and permits, charges for services, and other miscellaneous revenues,

⁴²Ibid., p. 18.

but exclude property tax and user charges for enterprise operations such as water or sewer systems. Nontax revenues can reflect a town's ability to recover all or part of the costs of providing specific services. Many nontax revenues, such as building permits, are susceptible to changes in the local economy, while others, such as swimming pool fees, fluctuate with the demand for the service. There are several ways nontax revenue can be measured - total nontax revenue as a percent of total revenues, or nontax revenue by individual source. A decline in a specific nontax revenue may reflect a decreased need for the service and/or future inability to maintain that service.⁴³

Source of data: Montana Town Annual Report, Section I, Statement 02.

Warning trend: Declining nontax revenue as a percent of total revenue.

5. One Time Revenues

A one time revenue is derived from a source which cannot be expected to continue in future years. Examples of one time revenues include; sale of assets such as land, an unrestricted federal grant, or the transfer of all or a portion of cash reserves to an operating account. The continual use of one time revenues to balance

⁴³Ibid., p. 35.

the annual budget can be an indicator that the town's revenue base is not strong enough to support existing service levels, or that the town is actually incurring operating deficits.⁴⁴ The suggested indicator is one time revenues as a percent of total revenues.

Source of data: Montana Town Annual Report, Section I, Statement 02.

Warning trend: Continued use of one time revenues to balance annual budget.

6. Total Operating Expenditures

Expenditures provide a rough measure of a town's level of service output. Assuming productivity remains constant, the more dollars a town spends, the more services it will provide. However, rapidly increasing expenditures can indicate that the cost of providing services is outstripping the community's ability to pay, especially if spending is increasing at a faster rate than the primary sources of revenue, such as the property tax. Rapidly increasing expenditures may also be an indication that municipal productivity is declining. Similar to total revenues, there are two approaches to examining total operating expenditures - percent change in expenditures

⁴⁴Ibid., p. 24.

on a yearly basis,⁴⁵ and total expenditures per capita.⁴⁶

By examining several expenditure categories, a town can pinpoint those expenditure areas where local costs are most dramatically increasing. The Montana Town Chart of Accounts includes several expenditure categories that may be tracked. These categories are listed below.

Source of data: Montana Town Annual Report, Section I, Statement 02.

Warning trend: Total or per capita expenditures increasing faster than total or per capita revenues.

7. Expenditures for General Government
(e.g., administration, financial services);
8. Expenditures for Public Safety
(e.g., fire, police services);
9. Expenditures for Highways and Streets
10. Expenditures for Public Health
(e.g., health services, animal control);
11. Expenditures for Culture and Recreation
(e.g., library, community activities, parks and playgrounds); and

⁴⁵Ibid., p. 41.

⁴⁶Rosenberg and Stallings, Is Your City Headed for Financial Difficulty, p. 17.

12. Expenditures for Social and Economic Services

(e.g., town sponsored economic development department).

Sources of data: Montana Town Annual Report, Section I, Statement 02.

Warning trends: Rapid increase in expenditures for one or two service functions.

13. Capital Outlay

The expenditure for equipment, such as vehicles, typewriters, or buildings is usually referred to as capital outlay. No uniform definition for capital outlay has ever been adopted for use by Montana towns. It instead remains a local policy option. Typically, capital outlay includes equipment with a useful life longer than one year and with a cost of above three hundred and fifty dollars.⁴⁷ The level of capital outlay expenditures as a percentage of total operating expenditures is a rough indicator of whether or not a community's stock of equipment and infrastructure is being maintained in good condition. If the ratio is declining over a one to three year time period, it could mean a town's needs have temporarily been satisfied. However, if the decline persists over three or more years, it may mean that capital outlay

⁴⁷Montana Department of Commerce, Uniform Accounting and Reporting Manual for Incorporated Towns. (Helena: State of Montana, 1984), p. 52.

requirements are being deferred, thus creating a future unfunded liability.⁴⁸ To understand the extent that capital purchases are being deferred, it is beneficial to separate major investments such as water systems which are financed through bond issues from typical capital purchases such as vehicles or typewriters.

The Montana Town Annual Reports do not separate capital purchases. Therefore, the easiest method of obtaining the data is by examining annual changes in fixed assets. It may also be helpful to discuss the data requirements with the town clerk. Because town budgets are usually small, clerks often are able to recall expenditures for major items of equipment.

Source of data: Montana Town Annual Report, Section I, Statement 01.

Warning trend: Declining capital outlay expenditures as a percent of total expenditures.

D. Operating Position

1. Operating Position

Because it is impossible to precisely estimate revenues and expenditures, in a typical year, a town will generate either an operating surplus or an operating deficit. An operating surplus develops when total revenues

⁴⁸Rosenberg and Stallings, Is Your City Headed for Financial Difficulty, p. 21.

exceed total expenditures; an operating deficit develops when the reverse occurs. An operating deficit is not necessarily cause for concern because reserves (accumulated fund balances and cash) from prior years can be used to cover the difference. It does, however, mean that the town expended more than was received during the fiscal period. The existence of an operating deficit in any one year may not be cause for concern, but frequent and increasing deficits indicate that serious fiscal problems may lie ahead.⁴⁹ The suggested measure is total operating revenues divided by total operating expenditures.

Source of data: Montana Town Annual Report, Section I, Statement 02.

Warning trend: Operating deficits increasing in magnitude or occurring with increasing frequency over a 3 to 5 year period.

2. Enterprise Fund Position

Enterprise funds are used to account for the financing of self-supporting activities that render services on a user-charge basis, and are operated in a manner similar to commercial entities. For Montana towns, the most common enterprise activities are water and sewer operations. Because these funds are expected

⁴⁹Groves, Financial Trend Monitoring System Handbook #2, p. 55.

to operate on a self-supporting basis, an operating deficit may be a distinct indicator of emerging problems.⁵⁰ The suggested measure is total enterprise revenue in relation to total enterprise expenditures.

Source of data: Montana Town Annual Financial Report, Section I, Statement 04.

Warning trend: Deficits in enterprise operations occurring with increasing frequency.

3. General Fund Balances

Fund balances are often thought of as operating reserves, because they present the accumulation of assets over liabilities. They are not however always synonymous with cash available for appropriation. Generally, they can help determine a town's ability to withstand unexpected financial emergencies, such as may result from revenue shortfalls or steep rises in inflation.⁵¹ A review of the general fund balance will help establish the annual financial position of the town. A gradual decline in fund balances may indicate that a town will not be able to meet a future need. The suggested measure is tracking the per capita general fund balances.

⁵⁰Rosenberg and Stallings, Is Your City Headed for Financial Difficulty, p. 17.

⁵¹Groves, Financial Trend Monitoring System Handbook #2, p. 62.

Source of data: Montana Town Annual Financial Report, Section I, Statement 02.

Warning trend: Declining per capita fund balances.

4. Liquidity

Liquidity is an often used measure of cash position. Liquidity refers to the level of cash on hand, as well as other assets that can quickly be converted to cash, in relation to current liabilities, and measures a town's ability to pay short-term obligations. The immediate effect of insufficient liquidity is inability to pay bills, or insolvency. While there are several possible measures of liquidity, the preferred measure for governmental entities is "current account analysis".⁵² This is the ratio of cash and short-term investments to current liabilities. For Montana towns the suggested measure is cash and short-term investments divided by the total of registered warrants, and other payables expected to become due in the near future. In this instance a ratio of less than one-to-one (i.e., a current account deficit) over a three year period would indicate a possible cash flow problem.

Source of data: Montana Town Annual Financial Report, Section I, Statement 01.

⁵²Smith, The Appraisal of Municipal Credit Risk, p. 153.

Warning trend: Declining ratio of cash and short-term assets divided by current liabilities.

E. Debt

1. Debt Service

Debt service is the amount of interest and principal that an entity must pay each year on its outstanding debt. An increase in debt service can place a fiscal strain on a community and reduce its flexibility to meet future obligations. The suggested measure is debt service expenditures among all funds divided by total operating expenditures.

Source of data: Montana Town Annual Financial Report, Section I, Statement 02.

Warning trend: Increase in debt service as percent of total expenditures.

2. Registered Warrants

When a town does not have sufficient cash available to redeem the warrants written to meet its operating obligations, the warrants are registered with a local bank until funds become available. Typically, warrants are registered during the cash poor period between July (when a new budget starts) and November (when the first half tax payments are received). However, if a town experiences a significant revenue shortfall during one

or over several fiscal periods, it may not have sufficient cash to redeem all outstanding warrants. Registered warrants are a common form of short-term debt that has plagued Montana local governments of all sizes over the past several years.⁵³ The suggested measure is outstanding registered warrants as a percent of total revenues.

Source of data: Montana Town Annual Financial Report, Section I, Statements 01 and 02.

Warning trend: Consistent increase in registered warrants as a percent of total revenues.

3. Long-Term Debt

There are several common forms of long-term debt including general obligation, special assessment and revenue bonds. Even when these types of debt are used exclusively for capital projects, a town must be cautious that its outstanding debt burden does not exceed its ability to repay as measured by the wealth of the community in the form of taxable valuation.⁵⁴ General Obligation (G.O.) bonds are one form of long-term debt for which a community has pledged its "full faith and

⁵³Curran and Lockwood, Local Government Financial Condition, 1981, p. 17.

⁵⁴Groves, Financial Trend Monitoring System, Handbook #2, p. 72.

credit" for repayment. These are payable from property taxes, nontax revenues, or whatever resources are available. The suggested measure is the level of general obligation debt as a percent of taxable valuation.

Source of data: Montana Town Annual Financial Report, Section I, Statement 01.

Warning trend: Long-term debt increasing more rapidly than taxable valuation.

Summary

This chapter presents a list of quantitative indicators of local government financial condition that is comprehensive, relevant to small towns in Montana, and tied to categories of readily available data. Throughout, the emphasis has been on collecting this data for a number of recent time periods. This permits highlighting of slight but consistent trends so that elected officials may anticipate future crises requiring current action.

CHAPTER 4

SUMMARY AND CONCLUSION

Unquestionably, local governments in Montana and across the nation are entering a period of tight revenues and reduced federal and state assistance. If local governments are to thrive and prosper, they must engage in long-range planning efforts to maximize the use of every available dollar. The starting point of this process must be an assessment of current financial condition. In order to plot a financially sound course for the future, local governments must know where they are financially and how they got there.

Because most of the current literature on local government financial condition was developed for large metropolitan areas, this paper sought to determine whether it was feasible for small towns in Montana to implement a cost effective method to assess local financial condition using easily obtainable data.

Chapter 2 indicated that there are many approaches to evaluating local government financial condition. The correct approach can only be determined if the needs of the analyst and individual community are known. Some approaches focus on an entity's ability to repay

additional bond issues, while others show more concern for fiscal solvency on financial management.

Over 200 different measures of financial condition that are currently in use were summarized in chapter 2 and listed in the appendices. The lack of data for many of their indicators preclude their use in Montana.

Using the financial indicators identified in chapter 2 as a starting point, chapter 3 developed 25 measures of financial condition that could be applied in small towns in Montana. These indicators prove that a system to evaluate local government financial condition could be implemented in Montana without costly professional assistance. If it is possible to develop a financial assessment system for small towns, which have limited staff and financial information certainly, larger cities with more sophisticated reporting mechanisms and larger, better-trained staffs can implement a fiscal assessment system.

This paper does not purport to be a cure-all for the fiscal problems of local government, nor does it suggest that the identified financial indicators provide all of the information local officials need to assess financial condition and make informed policy decisions regarding their community's financial future.

This paper should be viewed only in the spirit in

which it was written - as an educational process and a learning tool. The measures of financial condition presented here demonstrate it is feasible to establish a system to assess and monitor financial condition. It is important, however, to remember that information needs vary between communities, and change over time. To be useful, any system developed by a local government must address the information needs of the individual community. To remain useful, it must be dynamic in nature, capable not only of reflecting changes in information needs, but equally capable of assimilating new sources of data.

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APPENDICES

APPENDIX A

MEASURES OF FINANCIAL CONDITION UTILIZED BY
STANDARD AND POOR'SA. Economic Factors

1. Stability of employment;
2. Population trends;
3. Per capita market values of property;
4. Per capita volume of wholesale/retail sales; and
5. Economic performance of issuer in relation to the remainder of the state or region.

B. Administrative Factors

1. Existing form of government and authority to impose new taxes and alternative forms of revenue;
2. Professionalism of management;
3. Future capital improvement plans;
4. Collection of property taxes and delinquent rate; and
5. Balance of existing revenue sources.

C. Financial Account Analysis

1. Operating surplus or deficit;
2. Percentage increases in annual budget (operating costs);
3. Quick ratio (amount of assets that can be quickly converted to cash in relation to the short-term liabilities);
4. Dependency on federal or state aid to meet operating or debt service costs;
5. Frequency of audits; and

6. Financial management practices (e.g., using short-term debt to finance capital improvements, or using long-term debt to finance day to day operations).

D. Debt Factor Analysis

1. Per capita debt;
2. Per capita debt in relation to per capita income; and
3. Debt in relation to the market valuation of taxable property.

APPENDIX B

MEASURES OF FINANCIAL CONDITION UTILIZED BY
MOODY'SA. Population, Wealth and Income

1. Population size and growth;
2. Composition of population including sex, age, and working status (used primarily to predict future growth and migration patterns);
3. Size of labor force and diversity of employment base;
4. Age and value of housing stock;
5. Occupancy rates of rental property;
6. Per capita income; and
7. Taxable valuation per capita.

B. Governmental Organization and Powers

1. Structure of the local government (whether a city, town or county);
2. Administrative form (mayor, council commission, council manager, etc.);
3. Responsibilities delegated to the locality by the state; and
4. Taxing and revenue generating powers delegated by the state.

C. Financial Administration

1. Level of current property, taxes;
2. Limitation on property taxes;
3. Source and mix of other revenues;
4. Level of unfunded liabilities (e.g., pensions or other benefits, etc.);

5. Cash position; and
6. Current account analysis.

D. Debt Obligations

1. Level of existing debt service;
2. Past patterns of debt service; and
3. Level and type of short-term debt.

APPENDIX C

MEASURES OF FINANCIAL CONDITION UTILIZED BY
THE STATE OF MINNESOTAA. Economic Vitality

1. Taxable value of real estate;
2. Value and number of building permits;
3. Growth or decline in retail sales and businesses;
4. Number of retail businesses;
5. Rapid increase in expenditures;
6. Rapid decrease in revenues;
7. Rapid increase or decrease in population;
8. Changes in per capita income; and
9. Changes in age of population.

B. Financial Independence and Flexibility

1. Changes in general fund balance;
2. Growing amount of revenue coming from inter-governmental sources;
3. Changes in debt burden;
4. Steady patterns of budget overruns;
5. Rapid increases in fringe benefits and employer contributions; and
6. Current levy tax rate approaching legal levy limit.

C. Current Costs Being Deferred To The Future

1. Short-term liabilities outstanding at the end of the year as percentage of total "own source" revenues (includes vouchers, loans, notes, and accounts payable due other governmental units);

2. Long-term debt being applied to operating programs;
3. Low or declining funding for future replacement or repair of general fixed assets;
4. Changes in amount of funds available for capital projects; and
5. Deferral of pension liability.

D. Municipal Productivity

1. Changes in number of municipal employees;
2. Municipal enterprise fund expenditures increasing; and
3. Municipal enterprises incurring operating losses.

E. Management Practices

1. Earnings on investments declining;
2. Interest cost of loans increasing as a percent of total "own source" revenue;
3. Incidences of revenue shortfalls increasing;
4. Amount of uncollected taxes increasing;
5. Low bond ratings;
6. Consistent failure to obtain unqualified opinion on financial statements from independent auditor; and
7. Use of a cash basis of accounting.

APPENDIX D

MEASURES OF FINANCIAL CONDITION UTILIZED BY
THE STATE OF MICHIGANA. Local Economy

1. Number and value of building permits;
2. Change in retail sales;
3. Number and value of business licenses;
4. Changes in per capita income;
5. Changes in local population;
6. Percentage of families below poverty level; and
7. Ratio of pre-1950 housing stock.

B. Financial Independence

1. Taxable valuation per capita; and
2. Ratio of local taxes to aggregate income.

C. Municipal Productivity

1. Local government employment per capita; and
2. Local government expenditures per capita.

D. Deferring Current Costs to the Future

1. Capital outlays as a percent of total property tax revenue; and
2. Changes in direct and overlapping debt burden.

E. Structure and Management

1. Expenditures for police and fire services as a percent of total expenditures;
2. Existence of an increasing negative fund balances;

3. Intergovernmental transfers as a percent of total revenues;
4. Delinquent property taxes as a percent of total property tax collections; and
5. Local taxes per capita.

APPENDIX E

MEASURES OF FINANCIAL CONDITION UTILIZED BY
THE STATE OF IOWAA. Community Needs and Resources

1. Market value of property;
2. Vacancy rate of property;
3. Median age of local population;
4. Number of poverty households;
5. Number of public assistance recipients;
6. Personal income of population;
7. Number of residential households;
8. Unemployment rate;
9. Retail sales;
10. Number of business units;
11. Annual gross business receipts; and
12. Pull factor for retail business (ability of local businesses to draw customers from outlying areas).

B. Revenue Patterns

1. Total revenues;
2. Net operating revenues;
3. Changes in municipal price indices;
4. Changes in population;
5. Restricted revenues;
6. Changes in restricted operating revenues (revenue that may be utilized only for a specific purpose);

7. Intergovernmental revenues;
8. One-time revenues;
9. Net property tax revenues;
10. Uncollected property tax;
11. Budgeted net operating revenues; and
12. Revenues from user fees.

C. Expenditure Patterns

1. Expenditures for user services;
2. Net operating expenditures;
3. Level of fixed costs;
4. Changes in the number of municipal employees;
5. Changes in fringe benefits; and
6. Changes in salaries and wages.

D. Operating Position

1. Changes in governmental fund balances;
2. Enterprise operating results (surplus on deficit);
3. Changes in unrestricted general fund balances;
4. Changes in cash position;
5. Amount of short-term investments; and
6. Interest income.

E. Debt Structure

1. Level of current liabilities;
2. Changes in assessed property values;
3. Level of long-term general obligation debt;
4. Amount of total debt service; and

5. Overlapping debt.

F. Unfunded Liabilities

1. Unfunded pension plan vested benefits;
2. Pension plan assets;
3. Pension benefits paid;
4. Accumulated vacation/holiday leave;
5. Accumulated sick leave days.

G. Condition of Capital Plant

1. Expenditures for maintenance of fixed assets;
2. Changes in amount of fixed assets;
3. Level of capital outlay;
4. Depreciation expense; and
5. Cost of depreciable expense.

APPENDIX F

MEASURES OF FINANCIAL CONDITION DEVELOPED BY
THE MUNICIPAL FINANCE OFFICERS ASSOCIATIONA. Economic Vitality

1. Appraised value of real estate per capita;
2. Number and value of building permits;
3. Number and value of business licenses;
4. Change in level in retail sales;
5. Expenditures for police and social services as a percent of total expenditures;
6. Change in total population;
7. Change in income per capita.

B. Financial Independence and Flexibility

1. Percentage of expenditures for basic services funded from intergovernmental grants;
2. Proportion of own source revenue committed to meet matching requirements;
3. Debt burden;
4. Pattern of budget overruns in specific programs or departments;
5. Amount of employee fringe benefits;
6. Proximity of key revenue sources to legal ceilings; and
7. Proportion of municipal expenditures required to fund mandated costs.

C. Municipal Productivity

1. Number of municipal employees per capita;
2. Municipal expenditures per capita;

3. Municipal enterprises incurring operating losses; and
4. Rates changed for municipal enterprises.

D. Current Costs Deferred to the Future

1. Short-term debt outstanding and other obligations at year end as a percent of total own source revenues;
2. Long-term debt applied to operating program;
3. Capital outlays as a percent of total city expenditures; and
4. Deferral of pension liabilities.

E. Unsound Financial Management Practices

1. Relationship between real estate assessments and true market value;
2. Earnings on short-term investments;
3. Interest cost of short-term loans increasing as a percent of total own source revenue;
4. Incidence of revenue shortfalls;
5. Amount of uncollected taxes and fees at year end; and
6. Frequency of audit qualifications.

APPENDIX G

MEASURES OF FINANCIAL CONDITION DEVELOPED BY
THE INTERNATIONAL CITY MANAGERS ASSOCIATIONA. Community Needs and Resources

1. Changes in population;
2. Changes in median age;
3. Level of personal income;
4. Number of poverty households or public assistance recipients;
5. Changes in property valuations;
6. Changes in value of residential development in relation to total development;
7. Vacancy rates of rental property;
8. Employment base; and
9. Business activity.

B. Revenues

1. Revenue per capita;
2. Restricted revenues;
3. Intergovernmental revenues;
4. Elastic tax revenues;
5. Over-time revenues;
6. Property tax revenues;
7. Uncollected property taxes;
8. User charge coverage; and
9. Revenue shortfalls.

C. Expenditures

1. Expenditures per capita;

2. Municipal employees per capita;
3. Fixed costs; and
4. Fringe benefits.

D. Unfunded Liabilities

1. Unfunded pension liabilities;
2. Pension assets; and
3. Accumulated employee leave liability.

E. Conditions of Capital Plant

1. Maintenance effort;
2. Level of capital outlay; and
3. Depreciation.

F. Operating Position

1. Operating deficits;
2. Enterprise losses;
3. General fund balances; and
4. Liquidity.

G. Debt Structure

1. Current liabilities;
2. Long-term debt;
3. Debt service; and
4. Overlapping debt.