Capital Budgeting

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Overview of Capital Budgeting

- **Introduction**: key concepts, importance, scope, and organization of capital budgeting

- **Capital planning component**: identifying capital needs, the CIP, prioritization, and project evaluation & costing, etc.

- **Capital financing component**: capital financing strategy, determining & forecasting financial condition, use of operating balances & capital reserves, use of debt, bond ratings, etc.

- **Project Authorization & Implementation**: Authorization, contracting, construction management, etc.
Key concepts capital budgeting

- **Capital expenditure**: expenditure of significant value ($5,000 or more) to acquire or build property that lasts for more than one year (usually for many years).

- **Capital budgeting**: process of planning, financing, authorizing, and implementing major ($100,000 or more depending on size of jurisdiction) capital projects or acquisitions.

- **Capital improvement program**: multi-year forecast of major capital project and acquisitions, capital financing therefore, acquisitions, and their impact on future operating budgets.
Importance of capital budgeting

- **Relation to development**: Major capital infrastructure & facilities are needed to spur or accommodate growth.

- **Great amounts of money are at stake** in many capital project decisions.

- **Debt or other special financing sources** are often needed. These involve long-term commitments.

- **Annual budget process is not designed** for planning and budgeting major projects.
Scope of capital budgeting

- Multi-year

- Planning, finance, decision-making, & implementation

- Operating budget impact as well as capital costs of projects
Organizing capital budgeting process

- Decide **who will coordinate** the process.
- Determine **what projects** will be considered in the process (cost & useful life floors). See page 1 of Supplementary Materials”.
- Determine **who will submit capital requests**
- **Settle on CIP preparation calendar** & tie it to annual budget preparation calendar.
Identify capital replacement & renovation needs

- Often neglected.

- Capital asset management system. Assessment of capital asset condition, e.g., Greensboro, 2003-09 CIP, p. 7.
Identify new capital project needs

- **Master or strategic plans**, e.g., Hickory, NC 2003-04, p. 8

- **Multi-year capital needs assessment**, e.g., Mecklenburg County, NC 10-year requests, Citizens Capital Budget Advisory Committee, p. 9-10

- **Citizen identification requests**
  - Irvine, CA, p. 11
  - Winston-Salem telephone survey on priorities among projects by functional area, p. 12
Prepare & approve capital improvement program (CIP)

- Multi-year forecast, e.g., six years
  - Major building, equipment & infrastructure needs
  - Capital costs related to those needs
  - Sources of capital financing
  - Impact of projects on future operating budgets

- Essentially a plan with first year becoming capital budget

- Update annually

- Most projects enter CIP in later planning year
CIP illustration

- Carrboro, NC 2006-07 to 2011-12 CIP, title page, summary, northern area fire station, lease purchase schedule for equipment, effect on debt ratios, effect on tax rate pp. 13-19.
Issues in preparing & approving CIP

- Relate calendars for CIP & annual budget preparation, e.g., Irvine, CA, p. 20
- Report on accomplishments from past CIPs, Carrboro, NC, p. 21
- Address inflation, Fayetteville, Arkansas., p. 22
- Include unfunded projects that remain under consideration, Fayetteville, Arkansas, p. 23
- Adopt CIP, Lee County, NC, p. 24
Prioritize capital needs: general approaches

- Judgment based on experience

- Program goals and priorities among them, e.g., Public safety goals may be ranked ahead of goals for other services, and this drives capital as well as operating budget priorities.

- Urgency of need criteria: legal mandates, public health and safety, service or facility deficiencies, consistency with goals, community support, etc.
Prioritization criteria
Greeley, Colorado CIP

- **Imperative (must do):** corrects danger to public health & safety, meets legal obligation, alleviates immediate service/facility deficiency, prevents irreparable damage.

- **Essential (should do):** rehabilitates/replaces obsolete facility, stimulates economic growth, reduces future operating costs, leverages State/Federal funding.

- **Important (could do):** provides new or expanded service, promotes intergovernmental cooperation, reduces energy conservation, enhances cultural or natural resources.
Prioritization system
Chatham County, NC

- System with criteria and weightings, p. 26
- Created by manager & staff & approved by commissioners
- Used by county manager & staff to establish priorities in CIP presented to Commissioner
- Used for about 10 years now
Issues in using ranking criteria or systems

- **Contributes to** but does not determine them
- **Provides rationale** for decisions
- **Function & funding** can affect criteria, e.g., In Winston-Salem, NC, legal mandates are paramount for water-sewer, and available outside funds for mass transit, housing, & community development.
Evaluate capital projects & determine scope, & costs

Design & costing

- Occurs in stages.
- Some projects (renovations) are difficult to cost.
- Testing underlies design & costing. Crucial for infrastructure. Testing may be short-changed. It can involve guess work.

- Control project scope through design process. Avoid scope creep—addition of features during design & construction stages

- Consider life-cycle costs
Capital financing strategy

- Assess and forecast financial condition
- Maintain adequate operating fund balance(s)
- Fund recurring or "low cost" capital equipment & projects from annual budget
- Create & fund capital reserves
- Determine & remain within debt capacity
- Select suitable debt option(s) for major projects: tax secured, bonds, capital lease debt, revenue bonds, etc.
- Balance debt & pay-as-go financing
- Improve or maintain bond ratings
- Identify financing for economic development: development fees, etc.
- Pursue intergovernmental grants
- Pursue opportunities for inter-local & joint public-private projects
Assessment & Forecast of Financial Condition

- Assessment & forecast supports CIP & operating budget

  Equation: annual revenues - operating spending = balance for debt service + pay-as-go capital financing

- Illustration
  - Scottsdale, Arizona, 2007-11 operating & capital forecasts pp. 28-29
Maintain adequate operating (general) fund balances

- **Importance.** Bond rating agencies expect. Capital financing source, especially in smaller cities.

- **Adopt policy**
  
  Set general fund balance floor and/or target, e.g., Greensboro, NC, p. 30
Create & fund capital reserves:

- **Authorization by statute** may be needed. In NC, it is G.S. 159-18, p. 31

- **Types**
  - Separate fund
  - Designated portion of general fund balance

- **Purposes**
  - Project-specific, e.g., fire truck
  - Function, e.g., fire
  - Across functions
Create & fund capital reserves

- **Funding:** extra fund balance, policy committing annual appropriation, policy or law committing % of general revenue or special revenue, funded depreciation

- **Illustration**
  - Plano, Texas, capital reserve funded by 75% of annual depreciation. Funds street & park projects in 2003-04, p. 32
Determine & remain within debt capacity

- **Refer to key debt ratios** (for “net” debt to be repaid with general revenues):
  - Net debt per capita.
  - Net debt as % of market or tax valuation.
  - Annual debt service on net debt as % of general fund budget 15% is cap for most local units. Debt as % of household or per capita income.
  - Debt pay-down, i.e., in next 5 years, 10 years.
  - Effect of future debt service on tax rate.

- **Examples**
  - NC ratios for cities, p. 33
  - Union County, NC forecasted ratios, p. 34
Select Suitable Debt Options for Capital projects

- **Debt secured by & re-paid from general taxes:** projects to be used directly by public, debt for projects with broad public appeal

- **Capital lease debt:** expensive equipment, renovation projects, mandated projects, etc.

- **Debt secured by & re-paid from special revenues or taxes:** public utility or enterprise projects, airports, etc.
Balance debt and pay-as-go financing

- **Preserves flexibility in future annual budgets.** In a recession, pay as go capital financing & contributions to capital reserves can be reduced. Debt service and lease payments cannot.

- **Wake County policy in 2003-2009 CIP.** Debt service should not exceed 75% of total annual appropriations allocated to capital project financing, p. 35.
Improve or maintain bond ratings: introduction

- **Bond rating** assesses ability/willingness of issuer to repay debt. Rating criteria reflect not only wealth, etc., but also good government practices.

- **Triple A rated U.S. municipalities**, general obligation or tax secured debt, Standard & Poor’s, October, 2006.

- **G. O. rating criteria**: economy, financial management, debt burden, and leadership & planning.

- **Revenue bonds**: net earning/debt service coverage, etc.
Ten ways to improve bond rating (S & P)

1. Have rainy day/budget stabilization fund
2. Regularly review revenues & the economy
3. Prioritize spending
4. Use a formal CIP
5. Establish a debt affordability model
6. Develop a pay-as-go capital financing strategy
7. Consider affordability of plans before approving them
8. Do long-term planning for all liabilities, including pensions
9. Establish and use effective management systems
10. Have a well-developed & coordinated economic development strategy

See Annual Review of AAA Rated Municipalities, May, 2005, pp. 43-46
Authorize projects & appropriate money for them

- **Authorization often occurs in stages**
  - Approval of project in concept
  - Approval of project design
  - Approval of financing
  - Approval of project budget
  - Approval of contract(s)

  Larger the project the more stages there are.

- **Capital project ordinance** e.g., G.S. 159-13.2 pp. 26-27)