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Setting Reserve Levels

The following is based on a "white paper" I prepared when I was the Director of Finance & Information Technology for the City of San Luis Obispo.

What's the Right Amount?

In comparing reserve levels between government agencies, it is important to recognize that "one size does not fit all." In short, other than having a reserve at all, there is no "right" level: it depends on the circumstances in each agency.

Strong Reserves Reflect Ability to Manage Risk, Not Fiscal Strength

Reserves – whether large or small – do not *per se* reflect on an agency's financial capacity or underlying fiscal strength. There are much better indicators than fund balance for this, most notably the ability over time for ongoing revenues to adequately meet day-to-day service needs, capital improvement goals and debt service requirements.

Then what does retaining a prudent level of fund balance reflect?

It measures an agency's ability to manage risk. How much can things adversely turn-out differently than "usual?" And how much fiscal capacity (measured in time) does the organization think is prudent in developing and implementing plans to respond to unexpected circumstances?

First Step: Assess Risk in Determining Reserve Policy

Based on this, the first step in assessing an appropriate reserve level is to assess fiscal risks, which fall into seven categories:

1. ***Economic.*** How dependent are the agency's key revenues on local economic performance? And how dependent is it on the fortunes of a few key taxpayers – or are revenue sources broadly distributed? In short, are all of the agency's revenue "eggs in one basket?" And if so, how large and strong is the basket?

   For example, property taxes are usually viewed as stable, dependable revenue sources (although the "Great Recession" has resulted in many rethinking this "conventional wisdom," at least in California). As such, if this is a large part of an agency's revenue base (as it is in many states), then its fiscal risks are lower, and accordingly, its reserve levels can be lower. However, sales tax is the most important revenue source for many California cities and it can be highly volatile. So, where sales tax is a key revenue source, this argues for higher reserves.

And within any one revenue source, agencies also need to assess their vulnerability (the "eggs" thing). For example, if one or two key property owners account for a large part of property tax revenues, then any adverse circumstances for them will adversely affect the agency.

How likely is this to happen? And what's the consequence if it does? The same is true for sales taxes: already a volatile revenue source, it's even worse if one or two outlets (like a single car dealership or major retailer) account for a large part of an agency's sales tax revenues.

2. ***Cash Flow.*** What cash resources does an agency need in balancing when it receives key revenues, and when it incurs expenses? For example, in California, local agencies must operate for six months before receiving their first installment of property tax revenues (which in California includes "triple flip" reimbursements and special assessments). Additionally, are there significant grant programs where the General Fund has to support expenditures before cash can be received? Again, this requires each agency to review their own unique circumstances in evaluating "lumpy" receipts and disbursements, and other cash flow commitments for other funds. In short, every agency has a different cash flow story to tell.

3. ***Expenditure Flexibility.*** How much of an agency's costs are relatively "fixed" or ongoing, like debt service and regular staffing; versus more flexible costs, like capital projects or other "one-time" costs? The more "flexible" an agency's costs, the more flexibility it will have in not disrupting day-to-day services in responding to adverse circumstances while it figures out a longer-term strategy.

4. ***Reliance by Other Funds***. How dependent are other funds on the General Fund? This could include other units of government, like a housing authority or redevelopment agency (now, "successor agencies"); enterprise funds, like water, harbor or transit; or special revenue funds, like lighting and landscape maintenance districts.

5. ***General Contingencies.*** What is the likelihood of a major, unanticipated cost?

6. ***Disasters***. What is the likelihood (and frequency) of natural or human disasters like floods, fires or earthquakes in increasing response and recovery costs, or reducing revenues?

7. ***Stability of State-Local Government Relationships.*** How likely is it that the federal or state government will structurally change revenue sources, such as no longer providing a key subvention that it routinely provided to an agency in the past? Or no longer allowing an agency to set a key fee or a tax that it has relied upon for many years? Or assessing agencies for services that the state or federal agency has traditionally provided at no cost? Placed in context, over the past thirty years, even with constitutional protections due to the passage of Proposition 1A in November 2004 and Proposition 22 in 2010, State budget takeaways have consistently been the largest single fiscal threat to local government in California.

GFOA Structured Assessment Tool

The Government Finance Officers Association of the United States and Canada (GFOA) has developed an excellent analytical resource in translating these conceptual risks into specific reserve targets. It does this by creating a structured assessment of the risk factors facing each agency. It is available on-line on the GFOA's web site at:

http://www.gfoa.org/index.php?option=com_content&task=view&id=2320

Using Reserves

When adverse circumstances do arise, appropriate reserves provide agencies with the ability to:

- Absorb "one-time" problems without disrupting day-to-day operations and services.
- Or if the problems are more systemic and ongoing, then they provides the fiscal capacity to take the time needed to fully identify how big the problem is, and then develop and implement a thoughtful longer-term strategy tailored to the problem, without resorting to extreme crisis actions.

Along with setting minimum reserve policies, agencies should also consider adopting policies for when use of reserves is appropriate, especially below the policy minimum. There are a number of circumstances where doing so makes sense. For example, reserves are often referred to as "rainy days funds," so it makes sense to use them when it rains – at least, when it rains unexpectedly.

For rain that can be reasonably expected every year, however, it doesn't make sense to use reserves. This surfaces the second point about the use of reserves: you can only spend then once. And accordingly, they should only be used for one-time purposes. While capital improvements are an obvious example, this could include servings as a bridge in tough times as part of a multi-year strategy to close a systemic gap in bringing operating costs in line with lower ongoing revenues (the "new normal"). However, smart agencies will strongly resist using reserves to fund operating costs – let alone operating cost increases, such as labor agreements.

Restoring Reserves

Agencies should also consider setting policies for how reserves should be restored to policy after they've been used. In recognition that as things improve, there will be a legitimate public policy interest in restoring/improving service levels and capital projects, an example might be:

- Restore reserves to policy level within 5 years.
- And as revenues improve, split the improved financial condition evenly ("50/50") between services and reserve restoration.

Summary

Reserves act as an insurance policy, a risk management tool. Accordingly, in setting appropriate reserve policies, an agency should ask itself:

- How much risk is it exposed to?
- And how much risk is it willing to take in the event that adverse circumstances emerge?

Knowing how other agencies answer these questions can be helpful; but ultimately, each agency needs to be guided by its own circumstances.