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FISCAL BENCHMARKING *for Indiana's Local Governments*

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The Opportunities and Challenges of Benchmarking Indiana's Local Governments

Under the 2014 fiscal transparency legislation (SB106) passed by the General Assembly, the Indiana Department of Local Government Finance (DLGF) is responsible for monitoring the fiscal health of school districts and municipal governments using a variety of financial and economic indicators. While the law affords DLGF significant latitude in choosing these indicators and how to produce them, the agency will surely encounter many challenges related to the inherent limitations of Indiana local government financial data as they are currently reported.

This issue brief explores these challenges in detail and offers the insight gained from producing similar indicators of fiscal condition for the *Fiscal Benchmarking for Indiana's Local Governments* project. Specifically, these challenges include the following:

(1) Using cash accounting for financial reporting instead of accrual accounting
(2) An inconsistent and incomplete system of fund codes and transaction coding
(3) A lack of complete budget reporting
(4) A varied treatment of enterprise operations
(5) The unique structure and treatment of Indianapolis
(6) Debt reporting issues

Based on these challenges, we offer a number of policy and administrative recommendations to improve future efforts and Indiana local government financial transparency generally.

In recent years, the state of Indiana has worked to enhance the fiscal transparency of its local governments. In 2012, the Indiana University Public Policy Institute (Institute) and the Indiana University School of Public and Environmental Affairs (SPEA) started the *Fiscal Benchmarking for Indiana's Local Governments* project *(Fiscal Benchmarking)* with the intention of remedying the lack of timely data and analysis on the financial situation of Indiana's local governments.

Thanks in large part to these initial efforts, along with the work of the Indiana General Assembly and staff of the Department of Local Government Finance (DLGF), it is now possible to assess and compare the fiscal health of Indiana's local governments on an annual basis. Under the new local government fiscal transparency law signed by Governor Pence in March 2014, DLGF is responsible for monitoring the fiscal health of school districts and municipal governments beginning in 2015 (IC § 5-14-3.7, § 5-14-3.8). The law instructs DLGF to develop several indicators of fiscal health and to make them easily accessible through an internet dashboard.[1] The law specifically recommends the following fiscal indicators:

[1] Several of the fiscal indicators found in SB106 were introduced by *Fiscal Benchmarking* faculty and staff to the Indiana General Assembly at a February 13, 2013, Appropriations Committee hearing and expounded upon in the publication *Indiana's Approach to Fiscal Benchmarking* (Indiana University Public Policy Institute, 2014).

1. The cash balance of a political subdivision
2. The debt to revenue ratio of a political subdivision
3. The condition of a political subdivision's property tax base and income tax base, if any, as measured by both the assessed value of the political subdivision and the amount of per capita revenue generated from the political subdivision's tax bases
4. The per capita amount of a political subdivision's general fund operating revenue
5. Any trends in the amount of a political subdivision's tax revenue
6. Whether a political subdivision maintains a structural deficit or a structural surplus
7. The number and size of the tax increment financing districts designated by a redevelopment commission established by the political subdivision, if any
8. The extent that the political subdivision is affected by tax increment financing districts
9. The extent that the political subdivision's property tax base is affected by exempt properties
10. The political subdivision's bond rating
11. The amount of retiree benefits paid by the political subdivision
12. The amount of pension contributions paid on behalf of the political subdivision's employees
13. Any other factor that the department considers relevant to evaluating the fiscal health of a political subdivision

Since 2012, the *Fiscal Benchmarking* project team, including a set of current and former fiscal officers as advisors, has worked to produce similar indicators of financial condition that allow for comparison of the financial situation of Indiana's local governments. The project team authored several reports to engage Indiana's state and local fiscal officials on the importance of fiscal benchmarking, as well as the different types and purposes (oversight, regulation, transparency) of fiscal benchmarking in other states (e.g., Georgia, Michigan, New York, North Carolina). The General Assembly decided to use the transparency approach recommended by the *Fiscal Benchmarking* project. The project is a joint effort between the Institute and SPEA at Indiana University in Bloomington. The first Annual Comprehensive Report was released in 2014, and details the financial situation in 2011 and 2012 of Indiana's 92 counties, 1,006 townships, and 568 cities and towns across 36 financial indicators.

Despite the growing availability of economic and financial data, there are still numerous challenges to producing high quality indicators of fiscal health for Indiana's local governments that fulfill the spirit of the new fiscal transparency law. The bulk of the financial data currently available for Indiana's local governments are reported for a particular purpose and in a way that directly serves only that purpose. For example, the *Fiscal Benchmarking* project team was forced to make numerous decisions about how to use these data to provide a comprehensive picture of the fiscal situation of local governments. This issue brief explores these challenges and offers a number of policy and administrative recommendations to improve future efforts and enhance Indiana local government financial transparency generally.

The Challenges of Benchmarking Indiana's Local Governments

DLGF will need to draw financial and economic data from a variety of sources to fulfill the new fiscal transparency law. The *Indiana Gateway for Governmental Units* (Gateway), maintained by the Indiana Business Research Center, is used to collect and store a variety of local government financial data used by both DLGF and the Indiana State Board of Accounts (SBOA). DLGF is responsible for collecting local government budgets and certifying local government tax levies and rates (IC § 6-1.1-17-16), and SBOA is responsible for auditing government units. Additionally, DLGF likely will draw on population data from the U.S. Census Bureau or other economic data provided by the federal government.

Much of the financial and economic data described above are collected for purposes other than monitoring fiscal health. For this reason, the *Fiscal Benchmarking* project team was forced to make a number of assumptions regarding certain governmental funds or types of transactions that would otherwise be unnecessary. Furthermore, a number of financial indicators used in other state's fiscal condition monitoring programs were determined to be infeasible for Indiana due to a lack of the available data. For example, Indiana's local governments are required to publicly disclose their capital assets but not their financial assets in significant detail. For this reason, indicators pertaining to total assets used by benchmarking programs in other states are not feasible for Indiana's local governments. Among the financial indicators that are feasible, the quality of the underlying financial data used to create them remains a significant concern. Several specific issues are described below.

1. *Cash accounting instead of accrual accounting.* Indiana's local governments are required to submit an Annual Financial Report (AFR) containing information on the revenue, expenditures, and debt activities of the previous fiscal year each March through Gateway (IC § 5-11-1-4). Currently, local governments are required to report all financial data in their AFRs using the cash basis of accounting. Under cash-based accounting, local governments are only required to report a transaction when cash changes hands. In contrast, accrual-based accounting requires each local government to match revenue with expenses at the time the transaction occurs, rather than when cash changes hands.

Generally, accrual accounting is recognized as superior to cash accounting, as accrual accounting provides a more accurate picture of a local government's current financial position. Under accrual, the local government must possess and report the requisite resources to meet each expense. This in turn provides a more complete picture of the fiscal situation of a local government over the course of the fiscal year. Under cash accounting, the government can simply report revenue or expenditures as they occur, making it difficult to determine if the local government's financial situation is truly in balance. As a result, local governments with unfunded liabilities could potentially hide these obligations for several years before it becomes apparent they are unable to meet them. In addition, meeting GAAP standards requires local governments to produce government-wide financial statements under the accrual format. Failure to produce GAAP-based statements reduces the comparability of Indiana's fiscal indicators to states that comply with GAAP, and likely will result in higher local government borrowing costs in the future.

2. *An inconsistent and incomplete system of fund codes and transaction coding.* Ideally, the assessment of a local government's fiscal health should be based on monies over which the local governments actually have decision-making authority. To accomplish this goal, the *Fiscal Benchmarking* project team sought to eliminate transactions that represent double counting, pass-through funds, and funds held in trust. Double counting occurs, for example, when local governments issue tax anticipation warrants and later receive the anticipated tax revenue, as well as when local governments make transfers and loans internally among their funds. Similarly, several sources of revenue are collected by local governments for distribution to other entities. For example, county governments are responsible for distributing property taxes, local option income taxes, and a number of other revenues to other local governments within their jurisdiction. Also, virtually all local governments engage in state and local income tax withholding and employee contributions for health plans. Additionally, some local governments, such as counties and townships, can hold monies in trust for institutionalized individuals, such as prisoners, county home residents, or disabled individuals. Each of these transactions is recorded in the local government's AFR, and could be potentially counted toward the government's total revenue or spending.

   AFR data are coded using a system of fund, disbursement, and receipt codes created by the SBOA. The coding system has some common coding across local governments (disbursement and receipt codes as well as certain fund codes) and some unique codes for each type of local government. While creating the first set of benchmarks for 2011 and 2012, the project team was able to exclude some desired elements using only disbursement and receipt codes. This strategy did not allow the exclusion of monies that counties distribute to other local governments or trust funds. It is necessary to use fund codes to accomplish these additional exclusions. In addition, the fund coding system for counties was changing between 2011 and 2013. Counties reported AFR data in 2011 using the "old" (and incomplete) system of fund codes. In 2012, counties had the option to report using the old system or a new, more complete system of codes. In 2013, all counties were required to use the new system. The new system of codes is more effective in facilitating the exclusion of the transactions described above. As a result, it is difficult to compare data across years and across counties for these three years. This issue should resolve itself as additional years of data are reported under a common, more complete system of fund codes.

Table 1 illustrates the challenges of accurately measuring the financial situation of Indiana's local governments using unaudited AFRs. Even after excluding pass-through and other potentially double counted monies out of the control of these county governments, the total expenditures for both Allen and Hamilton counties reported by *Fiscal Benchmarking* still exceed the government-wide totals reported in their audited comprehensive annual financial reports (CAFR). On the other hand, the *Fiscal Benchmarking* total expenditure estimates are still a significant improvement from methodology to produce the Expenditure Per Capita reports. The bulk of the remaining difference in measurement between *Fiscal Benchmarking* and each county's CAFR is largely attributable to the difficulty of identifying particular types of transactions based on the current accounting coding system. Unfortunately, only a small number of Indiana local governments regularly produce CAFRs, so benchmarking is currently only feasible using inferior sources of financial data.

Table 1. Comparison of Total Expenditure Measurements for Allen and Hamilton Counties, Fiscal Years 2011-13

	FY 2011	FY 2012	FY 2013
Allen County, Indiana			
DLGF Expenditure Per Capita Report*	$285,211,928	$289,724,607	$297,303,774
Fiscal Benchmarking	$274,912,977	$185,699,128	$216,453,449
Comprehensive Annual Financial Report	$159,080,133	$166,149,111	$142,543,932
Hamilton County, Indiana			
DLGF Expenditure Per Capita Report*	$648,512,758	$702,989,993	$1,226,766,055
Fiscal Benchmarking	$151,158,571	$140,032,356	$198,617,043
Comprehensive Annual Financial Report	$136,766,515	$112,115,518	$123,742,463

* DLGF Expenditure Per Capita Reports are available at: http://www.in.gov/dlgf/8379.htm#Local

Notes:
1. Total county expenditures reported by the Indiana DLGF and *Fiscal Benchmarking for Indiana's Local Governments* is calculated from county annual financial reports submitted to the Indiana State Board of Accounts and are reported in the cash basis of accounting.
2. The *Fiscal Benchmarking for Indiana's Local Governments* estimates exclude disbursements related to monies that are (1) legally required to be distributed to other local governments, (2) withheld from employee earnings for payroll taxes and insurance, (3) double counted through tax anticipation warrants and transfers and loans within the local government, and (4) held in trust.
3. The Comprehensive Annual Financial Reports for Hamilton and Allen counties use the accrual basis of accounting.

Creating high quality fiscal benchmarks requires the ability to disaggregate reported financial data. The current fund coding system for cities and towns and other types of local governments is incomplete. Without codes for all common types of transactions, units are forced to code them as individual "home rule" funds in Gateway and, in many cases, report related receipts and disbursements as "other-other" or essentially unclassified. This issue also is exacerbated when units are not careful to assign transactions using the proper receipt and disbursement codes and overuse home rule funds. It is difficult and expensive, if not impossible, to correctly assign these unclassified transactions. This issue likely affects the accuracy of some benchmarks for some units and creates challenges in analyzing the sources of revenue local governments are using and how they spend their resources. For example, 27.3 percent of all revenue received by Indiana county governments and 15.7 percent of all revenue received by Indiana city and town governments were reported as "other" in 2012. Some local governments reported the majority of their receipts and disbursements as "other- other." This result implies that a significant share of the financial decisions made by local governments cannot readily be accessed or understood by their residents or by other public officials.

3. *Lack of complete budget reporting.* Ideally, any local government fiscal health monitoring system would include a number of indicators related to local government budgets. However, there is currently no requirement for reporting complete local government budgets using the Gateway or another reporting platform. Rather, the information that is reported is related only to the portions of the budget that are regulated, in other words, the portions that are related to property tax rates and levies. Without a requirement that local governments report complete budgets, including both the regulated and unregulated elements, DLGF will not able to create complete and accurate budget benchmarks.

4. *Varied treatment of enterprise operations.* The operation of business-type enterprise units by many local governments presents a special set of challenges to assessing the fiscal situation of local governments. Enterprises are identified by the SBOA as activities that are treated as a business and are not funded principally with taxes. Local government enterprise operations can include public utilities such as water, wastewater, electricity, gas, or other facilities and services such as airports, golf courses, and trash collection. Most enterprises are operated by city and town governments, although there are a handful of counties and townships that operate enterprises.

Local governments are in most instances not allowed by statute to transfer monies between enterprise operation funds and their general fund except under special circumstances. For this reason, it might be tempting to ignore enterprise operations entirely when assessing the fiscal situation of a local government. However, doing so would provide an incomplete picture of the local government's financial situation. Local governments and their public officials are responsible for the prudent financial management of these enterprises. If an enterprise operation faces a fiscal imbalance or default, it would represent a threat to the fiscal stability of the sponsoring local government.

The variety of enterprises, both in number and scope, create significant challenges when comparing the fiscal situation of local governments to one another. Some local governments operate as many as five to six enterprises, while others operate none. Generally, local governments with enterprise operations appear to be larger in terms of their revenue, spending, and debt than their peers with no enterprises. The decision to include or exclude the financial data associated with these enterprises can make two otherwise similar general governments appear fiscally different, reducing the ability to make meaningful comparisons across local governments through benchmarking.

The ambiguity in structuring and reporting enterprises creates additional challenges in comparing local governments. In some cases, financial transactions related to enterprise operations are reported in the AFR of the sponsoring local government. In other cases, enterprises are structured as separate special districts that submit separate AFRs. Many cities and towns have utilities. Second class cities and a few other municipalities are allowed to form separate sanitary districts to provide these same types of services. Sanitary districts are allowed to collect property taxes in addition to user fees and charges. These activities are reported within the base unit's AFR but are treated separately for other reporting purposes.

Whether a particular activity is treated as an enterprise or a general governmental activity depends on the operational and funding decisions made by each local government. Increasingly, trash collection is identified by local governments as an enterprise operation because they fund it principally with user fees and charges. Others treat trash collection as a general government function because they continue to fund it principally with property taxes and other general revenues.

In the process of fulfilling the new fiscal transparency law, DLGF will be forced to confront whether to include or exclude monies related to business-type activities from their fiscal indicators. Either decision comes with benefits and drawbacks. A better statewide financial reporting system following GAAP would clearly delineate governmental activities from business-type activities. This would allow DLGF more flexibility in assessing the fiscal condition of general governments' governmental activities and business-type activities separately from their component units.

5. *Unique structure and treatment of Indianapolis.* Simply because of its size and unique stature, documenting and analyzing the fiscal situation of Indianapolis requires special consideration. More specifically, the financial data for Indianapolis, in some cases, is reported in the aggregate and in others is reported as a series of special units. This is an artifact, in part, of Unigov and subsequent consolidation efforts. While Indianapolis Consolidated City reports their revenue and spending under a single AFR in the Gateway, Indianapolis is treated as six separate entities in the Marion County property tax abstract and local government debt reports. These districts do not have universally coterminous boundaries:
    - Indianapolis Consolidated City
    - Indianapolis Consolidated County
    - Indianapolis Special Police Service
    - Indianapolis Special Fire Service
    - Indianapolis Sanitation (Liquid)
    - Indianapolis Sanitation (Solid)
6. *Debt reporting issues.* The requirement that local governments disclose their outstanding debt on Gateway is relatively new. Consequences for non-reporting began in 2013. DLGF cannot approve a budget or levy for units that fail to certify their previous year's debt. Local governments are required to report the following debt instruments:
    - Bond issuances

- Loans (excluding temporary loans payable from current revenues)
- Lease rentals of buildings and other permanent structures
- Equipment under a lease-to-own arrangement (excluding short-term leases of copiers and vehicles)

Ideally, indicators of total outstanding and tax-supported debt would show the outstanding principal on all debt instruments at the end of the year. Because of inconsistencies in reporting principal for lease rentals, *Fiscal Benchmarking* created measures of outstanding debt obligations that aggregated outstanding principal and interest for bonds and loans, and outstanding lease payments for lease rentals. This strategy also was used by DLGF in reporting debt information across units.

Also, only debt with terms of one year or greater are presently required to be reported on Gateway. This practice makes it difficult to gauge the true amount of outstanding debt held by local governments across Indiana, as well as to calculate the true burden of debt on each resident of a local government. Additionally, units are not currently able or required to report the date on which debt instruments are retired. For 2012, the project team used a special extract collected when each unit certified their 2012 debt data in early 2013. Without a retirement date, benchmarks created using the special extract may over- or under-count debt obligations as of the last day of a particular year.

Policy Recommendations

Many of the issues outlined above could be addressed through broad reform of the financial reporting requirements of Indiana local governments, or through smaller, incremental changes to the current requirements. Addressing these problems would considerably enhance the quality of local government financial data available to DLGF, allowing for a more accurate and comparable understanding of the fiscal health of Indiana's local governments.

1. *Adopt generally accepted accounting principles (GAAP).* The best option for resolving these issues as well as significantly enhancing the transparency of Indiana's local governments is for the state government to require the adoption of the Generally Accepted Accounting Principles (GAAP) recommended by the Government Standards Accounting Board (GASB). Under GAAP rules, local governments are required to produce government-wide financial records using the accrual, rather than cash, method of accounting. This would make it more difficult for local governments to hide or ignore long-term liabilities that are often the cause of future fiscal distress. Local governments would also be required to identify and disclose the purpose of each financial transaction, which should largely eliminate transactions reported in the opaque manner as "other-other." The government-wide financial statements mandated under GAAP rules also require that financial information for governmental activities, which are normally supported by taxes and intergovernmental revenues, be reported separately from that of their business-type activities, which are primarily supported by user charges. This change would provide additional clarity about enterprise operations within the annual financial reports filed by Indiana local governments.

   By law, all North Carolina local governments are required to prepare annual financial statements using GAAP rules (Coe, 2007). Thanks to this requirement, the North Carolina Local Government Commission was able to develop a tool that uses eight fiscal benchmarks to separately evaluate the fiscal health of local governments on the basis of their government-wide and enterprise fund financial data.[2] Several local government public officials reported making financial management changes after reports generated from the Fiscal Analysis Tool showed their local government was underperforming in some regard relative to peer governments across the state (Rivenbark & Roenigk, 2011). Instituting a similar requirement for Indiana local governments would significantly enhance the quality of annual financial reports which would facilitate better benchmarking.

   The downside to this approach is that this reform would be costly for local governments to implement, particularly for smaller local governments that lack the resources to invest in training financial officers and to purchase professional services. For this reason, it may be preferable to gradually phase in the requirement of Indiana local governments to follow GAAP. For example, the state could require that larger local governments adopt GAAP-compliant financial reports, as many of these governments already produce comprehensive annual financial reports that follow these principles. Smaller local governments could be allowed a grace period of several years to prepare for the transition to GAAP-compliant financial reporting. This approach was used in Pennsylvania, which gradually phased in GAAP-compliant financial reporting requirements over the course of several years (Patrick, 2010).

If the policymakers prefer to avoid the challenges associated with full-scale reform of local government financial reporting, there are smaller, incremental changes that could help to enhance the quality of the financial data used for fiscal benchmarking.

[2] The North Carolina Local Government Commission's Fiscal Analysis Tool can be accessed here: https://www.nctreasurer.com/slg/lfm/financial-analysis/Pages/Financial-Statistics-Tool.aspx

2. *Adopt a complete system of fund, receipt, and disbursement coding.* The new uniform fund coding system adopted by the SBOA for county governments is helpful for identifying each county government's pass through funds and other double-counted funds. Double counting could be further reduced by including a special revenue and/or disbursement code to identify pass-through transactions when reporting financial data.

   To reduce the number of reported unclassified transactions ("other-other" problem), the coding systems for each type of local government should be completed by adding new fund, receipt, and disbursement codes for all common activities. Once implemented, local governments would be required to code all transactions properly.

3. *Require reporting of full local government budgets.* A compendium of full local government budgets would be a useful addition to benchmarking and to transparency of local government finances generally.

4. *Improved quality of debt reporting.* The state should work to collect better information on the debt instruments backing lease rental arrangements, thereby allowing the calculation of a more traditional outstanding debt measures. Indiana's local governments could be required to disclose all outstanding debt, including debt with maturity periods of less than one year, as well as retirement dates for debt instruments. This disclosure requirement would allow for more accurate measurement of the outstanding debt held by local governments in Indiana. In addition, the ability to monitor short-term debt would be helpful in identifying local governments experiencing fiscal distress.

Concluding Remarks

The *Fiscal Benchmarking for Indiana's Local Governments* project team struggled with each of the issues described above in the process of producing the first annual comprehensive report. The Indiana Department of Local Government Finance is sure to encounter these challenges in the process of implementing the new local government transparency law passed by the General Assembly last year. Addressing each of the issues raised in this report will significantly improve the quality of the local government financial data needed to assess and compare the fiscal health of Indiana's local governments.

The most effective way to resolve many of these issues is to mandate the adoption of GAAP-compliant financial reporting for all local governments in Indiana. If such a reform is not possible, the state can make a number of smaller changes that would help to improve the quality and transparency of the local government financial data presently available. Successful implementation of these reforms will provide greater local government financial transparency.

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