OFFICE OF THE NEW YORK STATE COMPTROLLER

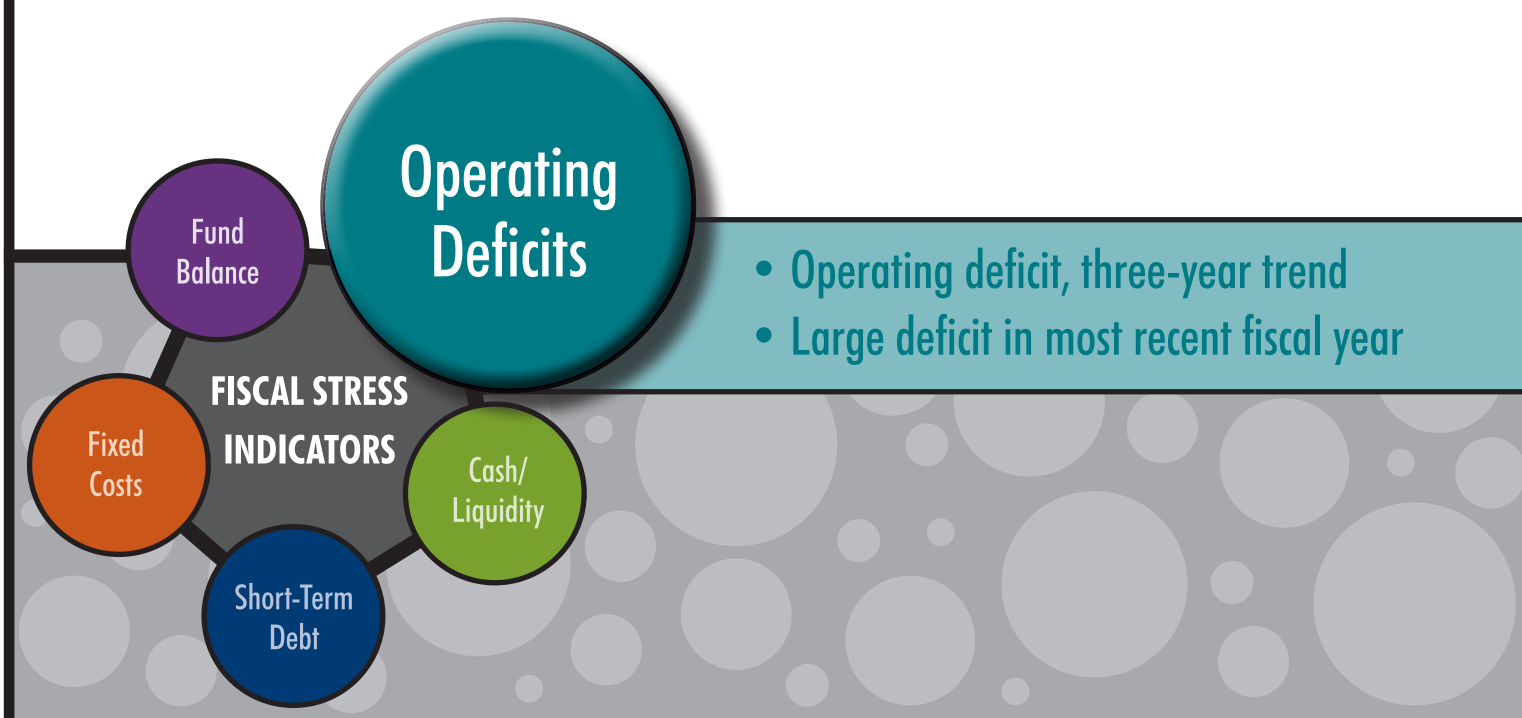
Thomas P. DiNapoli • State Comptroller

Fiscal Stress Close-Up

Operating Deficits

Local governments have operating deficits when annual expenditures exceed annual revenues.[1] Having an operating deficit in one year does not necessarily imply that a government is in financial distress. However, repeated annual operating deficits—particularly sizeable ones—are a clear sign that a government's budgets are structurally imbalanced.

The Fiscal Stress Monitoring System (FSMS), developed by the Office of the State Comptroller (OSC), includes one indicator that scores local governments based on the results of their operations (deficit or surplus) over three years. Frequent operating deficits or a large operating deficit in the most current fiscal year result in higher fiscal stress scores and indicate a higher level of stress. For cities, counties, towns and villages, the indicator uses a combination of funds (i.e., the general fund and highway, water, sewer and enterprise funds) to capture all major expenses. For school districts, the indicator uses only the general fund, which accounts for most district spending.[2] The operating deficit indicator carries a weight of 10 percent in the calculation of local governments' fiscal stress scores.

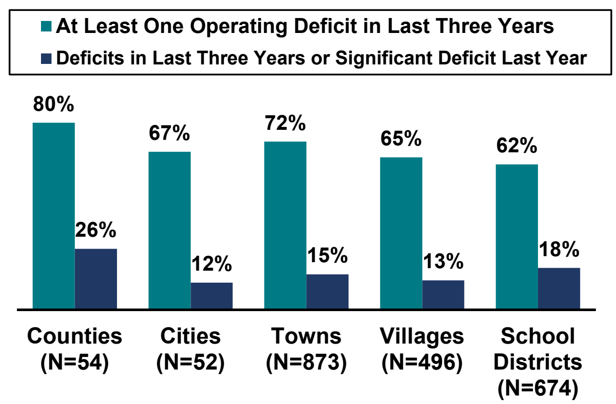


Division of Local Government and School Accountability

How common are operating deficits?

Most local governments experience operating deficits from time to time. Indeed, of the 2,149 local governments with fiscal stress scores for the fiscal year ending in 2013, 40 percent had an operating deficit in the last fiscal year and 67 percent had at least one operating deficit during the previous three fiscal years. Counties were the most likely to experience operating deficits. Four out of five counties had at least one operating deficit in the last three years; more than one-quarter had experienced either operating deficits in each of the last three years or a large deficit in the most recent year (measured as a percentage of expenditures, including interfund transfers). Roughly two-thirds of cities, towns and villages had at least one operating deficit in their combined funds in the last three years, and 14 percent either had operating deficits for three years in a row or had a significant deficit in the most recent year. School districts were only slightly less likely (62 percent) to have experienced an operating deficit (defined for school districts in FSMS as more than 1 percent of expenditures) during the previous three years. Nearly one in five school districts (120 out of 674 districts scored) either had operating deficits in each of the last three years or a significant operating deficit in the most recent fiscal year.

Percentage of Local Governments Scoring Points on the Operating Deficits Fiscal Stress Indicator,
By Class, Fiscal Year Ending in 2013



Source: Office of the State Comptroller (OSC).

Fiscal Stress Monitoring System (FSMS): What Does It Measure?

"Fiscal stress" refers to the difficulties in generating enough revenues to meet expenditures in the long term. OSC's FSMS measures a local government's ability to balance its budget, pay its bills, keep its debt in check and have some funds left over at the end of the fiscal year. It does not measure the quality or quantity of services provided, their cost-efficiency or how hard local officials have worked to achieve this balance given the local economic climate.

FSMS has five categories of indicators: fund balance, liquidity, short-term debt, operating deficits, and fixed costs. These indicators contribute to a local government's final classification of Significant Stress, Moderate Stress, Susceptible to Stress or No Designation. More information on the scoring system for each of the indicators can be found in OSC's "Fiscal Stress Monitoring System" report.

This report, which focuses on operating deficit indicators, is one of a series examining each of the five FSMS indicator categories. These reports will discuss the circumstances under which a high score in any category is cause for concern.

Counties, cities and school districts had very small median deficits (close to 0 percent) as a percentage of expenditures. Towns and villages actually had median surpluses of 1.9 percent and 3.6 percent, respectively, but with a large range of deficits and surpluses.

As we would expect, local governments in fiscal stress were more likely to experience operating deficits than local governments that were not designated in fiscal stress. In the most recent fiscal year, 72 percent of local governments in some level of fiscal stress had operating deficits compared to 38 percent of those with no designation.

Operating Deficit Indicators: Performance by Type of Local Government and Fiscal Stress Status for the Fiscal Year Ending in 2013

Class	Number of Local Governments Scored	Number of Local Governments with an Operating Deficit	Percentage of Local Governments with an Operating Deficit	Median Operating Surplus (Deficit) as a Percentage of Expenditures (EOU)
Counties	**54**	**25**	**46.3%**	**0.1%**
In Fiscal Stress	10	6	60.0%	-0.4%
No Designation	44	19	43.2%	0.2%
Cities	**52**	**23**	**44.2%**	**0.6%**
In Fiscal Stress	7	4	57.1%	-1.7%
No Designation	45	19	42.2%	1.1%
Towns	**873**	**361**	**41.4%**	**1.9%**
In Fiscal Stress	17	14	82.4%	-6.9%
No Designation	856	347	40.5%	2.0%
Villages	**496**	**157**	**31.7%**	**3.6%**
In Fiscal Stress	16	8	50.0%	-0.2%
No Designation	480	149	31.0%	3.8%
School Districts	**674**	**303**	**45.0%**	**0.3%**
In Fiscal Stress	87	66	75.9%	-2.4%
No Designation	587	237	40.4%	0.7%
Total	**2,149**	**869**	**40.4%**	
In Fiscal Stress	137	98	71.5%	
No Designation	2,012	771	38.3%	

Source: OSC. "In Fiscal Stress" includes all three levels of fiscal stress: significant, moderate and susceptible.

Why are operating deficits considered a symptom of fiscal stress?

Operating deficits are the result of an imbalance between revenues and expenditures. Inaccurate revenue or expenditure projections, whether due to unpredictable circumstances such as economic downturns or natural disasters, or to overly optimistic estimates, are frequently cited as causes. When revenues are lower than anticipated and/or expenditures are higher than budgeted, an imbalance can be expected. Failure to continually monitor - and amend - the budget at early signs of expenditure overruns or revenue shortfalls during the year can also contribute to a deficit.

Operating deficits aren't always a surprise, however, as the government may have planned to cover operating costs by using extra or surplus funds from prior years, or may have one-time or other non-current revenues it can use. To elaborate, local governments can end a year with surplus funds; the accumulated value of such surpluses is called the fund balance. While local governments may set aside some of the fund balance for a specific purpose, some is unassigned and could be available to be appropriated as part of the next year's budget. When a budget is designed with a gap that is expected to be filled with these accumulated savings (fund balance), the resulting gap is called a planned deficit. However, planned deficits can also be a problem, since the budget is essentially relying on a one-time source of funding. In the long run, as the fund balance dries up, the local government would become much more vulnerable to fiscal stress.

Audit Findings: Municipalities

A 2013 audit of a village found that the board overestimated water and sewer rent revenues, resulting in unplanned operating deficits and deficit fund balances in the water and sewer funds. The poor financial condition of the water and sewer funds created cash flow problems in both funds. The village used advances from its general fund to offset the water and sewer fund deficits. Failure to repay the interfund advances in a timely manner caused cash flow problems in the general fund.

A 2014 audit of found that a town incurred substantial storm-related expenditures in 2011 for which reimbursement was not received from FEMA until 2012. This resulted in an operating deficit in the highway fund in 2011. The town issued $260,000 in Revenue Anticipation Notes (RANs) and used interfund advances to address the shortfall. A one-year operating deficit is an unexceptional financial occurrence in the wake of a disaster, when some projects must be completed soon after the damages. However, the town exacerbated its financial problems by failing to develop detailed cost estimates and plans for financing additional storm-related work initiated in 2012. The town budget assumed federal and State aid would cover some of these additional costs, but the town's State Emergency Management Office disaster assistance representative said the town was unlikely to receive any significant reimbursement by the end of 2013.

A 2013 audit found that a city adopted budgets that have routinely relied on the appropriation of fund balance as a financing source, causing the city to incur planned operating deficits in the general fund. This has led to a significant reduction in the city's unexpended surplus funds from 2010 to 2012. During that period, the unexpended surplus funds remaining at year end declined 84 percent — from $841,747 in 2010 to $136,068 at the end of 2012 — leaving the city with little cushion to manage unforeseen events.

A 2013 audit of a county found that the board routinely relied on planned operating deficits by appropriating significant amounts of fund balance to finance operations. In addition, two of the county's enterprise funds were not self-sufficient and required subsidies from the general fund. These trends could lead to fiscal instability if they are allowed to continue.

In some situations, a deficit planned on faulty assumptions is the reason for fiscal difficulties. OSC audits have found cases where local governments appropriated more fund balance than was actually available, or were taken by surprise by deficits that were larger than budgeted. Repeated or large deficits are often an early sign that a local government may be falling into fiscal stress.

Indeed, OSC found that an increased occurrence of operating deficits was an important early warning indicator of government financial stress in the FSMS. For example, a local government had planned a deficit with the intent of applying fund balance to cover it but did not budget for an impending tax certiorari judgment, and expenditures ended up being much higher than planned. As a result, the appropriated fund balance was not enough to satisfy that year's deficit. In other cases, local governments relied on advances from other funds to plug operating deficits. This action is most useful in situations where a shortfall occurs in anticipation of revenues that are assured, since interfund advances must be paid back prior to the next fiscal year. The recurring use of interfund borrowing to fill operating gaps is another sign that a local government is experiencing a structural imbalance and showing signs of fiscal stress.[3]

Audit Findings: School Districts

A 2014 OSC audit of a school district found that declining State aid revenues and increased expenditures for debt service, personal services and employee benefits resulted in operating deficits in each of the four years from 2009-10 through 2012-2013. As a result of the operating deficits, the district relied on fund balance to fund operations. Preliminary results of operations for the 2013-14 fiscal year showed that the district has a remaining unexpended surplus fund balance of $17.8 million, which district officials stated will be used to help finance future budgets. In addition, due to the district's continued need to make tax certiorari payments, the district will likely end the year with an operating deficit of approximately $6.4 million, necessitating the use of fund balance to fund operations. With the continued depletion of its fund balance, district officials will have to identify new revenue sources or ways to reduce expenses.

A 2014 audit of another school district found that the board planned operating deficits in its budgets for the 2009-10 through 2012-13 fiscal years and appropriated fund balance to help finance the ensuing year's operations. However, it underestimated revenues and overestimated expenditures when developing budgets, which caused the district to have operating surpluses totaling approximately $1.2 million for these four years rather than deficits. As a result, the district did not use the appropriated fund balance as intended and instead accumulated unexpended surplus funds at levels that were about 10 to 12 percent of the ensuing years' budgets, up to nearly three times greater than the amount allowed by law.

A 2014 audit of a third school district found that in 2011-12 and 2012-13, the board appropriated significant amounts of fund balance to finance operations, which contributed to an accumulated fund balance deficit of approximately $275,000 at the end of the 2012-13 fiscal year. In addition, the district expended $741,000 more than the total amounts authorized for two capital projects, causing a fund balance deficit in the capital projects fund in that amount. The audit noted that the district would ultimately need to transfer money from the general fund to eliminate the deficit in the capital project fund. However, at the time of the audit, the general fund did not have sufficient funds available to do so.

Is an operating deficit ever justifiable?

Operating deficits are not always a bad thing. In some cases, a local government may even plan to spend down money it has saved from prior years, generally for a specific purpose. For example, a city may have saved some money in a capital reserve fund in order to purchase a fire truck. In the year when it needs to purchase that truck, it will spend down the savings in that account, instead of raising additional taxes. Sometimes, local leaders may decide that they have too much saved from prior years' surpluses, and choose to use some of the unreserved fund balance to reduce tax levy growth in that year.

A single instance of an operating deficit that is managed thoughtfully will not likely cause immediate and long-lasting fiscal stress, so long as a local government's fiscal picture is otherwise healthy. If the local government has an accumulated surplus sufficient to cover the difference, and if officials take steps to avoid the problem in future budgets, a local government's general financial picture may be relatively unharmed. Care must be taken when doing so, however, since using an operating deficit in this way can artificially depress levy growth and/or artificially hold the property tax rates constant over a year or two. Once the extra fund balance has been exhausted (by being appropriated annually in place of increased property taxes, water or sewer rents, or other charges), the tax levy increase necessary to maintain existing levels of spending will look much higher by comparison with the low base level from several years earlier. OSC recommends adopting a fund balance policy to guide these decisions and govern the level and use of excess fund balance in a manner that benefits taxpayers.

Because operating deficits can occur for many reasons, the FSMS operating deficit indicator does not by itself provide a complete picture of a local government's fiscal health or stress. No single indicator can serve that purpose. Instead, the FSMS examines a range of indicators in addition to operating deficits in determining fiscal condition, including measures of fund balance, use of short-term debt, cash flow, and high fixed costs.

Notes

1 "Local governments," as used in this report, refers to counties, cities, towns, villages and school districts, and does not include New York City.

2 The "combined funds" for each class of local government were selected by including the funds that are the most common for each class and also the funds that generally account for the largest percentage of each class's financial activity. The Fiscal Stress Monitoring System (FSMS) financial indicators are calculated using data filed by most local governments in annual update documents (AUDs) and by school districts in annual financial reports (ST-3s). All FSMS results presented in this report relate to the fiscal years ending between December 31, 2012 and July 31, 2013. For more detail on the FSMS indicators, visit the Comptroller's Fiscal Stress Monitoring website:
http://www.osc.state.ny.us/localgov/fiscalmonitoring/index.htm.
See also OSC, *Fiscal Stress Monitoring System*,
http://www.osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf.

3 The audit findings discussed in this report are from the following OSC audits: *Village of Speculator: Financial Condition* (2013M-381), *Town of Scio: Highway Fund Financial Condition and Records and Reports* (2013M-279), *City of Fulton: Fiscal Stress* (2013M-310), *Essex County: Financial Condition and Internal Controls Over Payroll* (2013M-177), *Haverstraw-StonyPoint Central School District: Financial Condition* (2014M-275), *Shelter Island Union Free School District: Financial Condition* (2014M-132), *Watervliet City School District: Fiscal Stress* (2014M-149), and *Village of Goshen: Financial Condition* (2014M-75). OSC audits of local governments are available online at:
http://www.osc.state.ny.us/localgov/audits/index.htm.

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